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EUROPEAN INTEGRATION  
AND TRADE WITH THE  
DEVELOPING WORLD

GERHARD POHL  
PIRITTA SORSA

THE WORLD BANK

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The World Bank  
Washington, D.C.

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## Foreword

European integration has taken a major step forward this year. "Project 92," as it is sometimes known, is the completion of the merger into a single market of the national markets of all members of the European Community (EC), before 1 January 1993. After this year, none of the twelve EC members can discriminate between goods, services, or factors of production originating anywhere in the EC. This objective was already laid down by the Treaty of Rome of the original six EC member countries, but its final implementation began in earnest only in 1986.

Since then, events have been moving fast. The timely completion of the common market of the Twelve EC members, an objective viewed with widespread skepticism when proclaimed in 1985, is now taken for granted. Attention is now focused on new objectives, new steps, and new difficulties. The Treaty of Maastricht has opened the way toward deepening the Community into European Union. New treaties with the seven members of the European Free Trade Association (EFTA) are extending most aspects of the common market to all Western Europe. Talks will soon begin on the formal applications for EC membership of four EFTA members (of the

four that have not yet applied, only Norway has a population of more than one million). Most of Western Europe is now widely expected to belong to the European Union well before the end of the century. Meanwhile, association agreements have begun to extend eastward the European free trade area and other aspects of cooperation.

The EC is the world's biggest trader, and these multiple currents do not concern Europe alone. In their paper, Gerhard Pohl and Piritta Sorsa mostly focus on the implications of European integration for developing countries. They do so in the proper historical context—the strong current of community dynamics—and with full recognition of the Community's commitment to raising efficiency through enhanced competition.

The path on which these two intertwined threads lead Europe falls short of theoretical perfection in many respects. Europe could have integrated faster and more completely. It could have boosted its competitiveness more swiftly. It could have boosted its demand for imports faster. But if the theoretical ideal is remote, practical compromises tend to move in the right direction. In each area it examines, the paper convincingly shows that for the developing countries, as for Europe, European integration leads to faster growth, greater trade, and higher welfare.

Jean Baneth  
Director, Geneva Office  
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## *Abbreviations*

ACP	Africa, the Caribbean, and Pacific
ASEAN	Association of Southeast Asian Nations
CAP	Common Agricultural Policy
CIF	Cost, insurance, and freight
COMECON	Council of Mutual Economic Assistance (CMEA)
EAGGF	European Agricultural Guidance and Guarantee Fund
EC	European Community
ECU	European Currency Unit
EEA	European Economic Area
EEC	European Economic Community
EFTA	European Free Trade Association (or area)
ECSC	European Coal and Steel Community
FRG	Federal Republic of Germany
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GDR	German Democratic Republic
GNP	Gross national product
GSP	General System of Preferences
LAC	Latin America and the Caribbean
LLDC	Non-ACP least developed
MFA	Multi-Fiber Arrangement
MFN	Most-favored nation
NIEs	Newly industrialized economies
NNIEs	Near newly industrialized economies
NNP	Net national product
OECD	Organisation for Economic Cooperation and Development
PSE	Producer-subsidy equivalent
QRs	Quantitative restrictions
SITC	Standard International Trade Classification
UNCTAD	United Nations Conference on Trade and Development
VER	Voluntary export restraint

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## Summary

European economic integration is proving to be good for most developing countries. Overall, the creation of the European Community has imparted a liberalizing trend on the trade policies of most of its members, by lowering tariffs and reducing nontariff barriers. The single market project, initiated in 1985, will complete the process of market integration for most goods and services. Market unification will improve external access and accelerate growth in EC incomes — increasing import demand. Higher growth should also help to contain protectionist pressures within the European Community.

EC policies toward developing countries are not perfect — far from it. But the effects of European integration must be compared to what would have happened in its absence. Generally, moves to strengthen integration — in the early 1960s and since 1985 — have been accompanied by reductions in external-trade barriers, while periods of slow integration have also witnessed a resurgence of protectionism and introduction of new trade barriers. However, macroeconomic conditions — such as periods of low growth or wide fluctuations in exchange rates — have been more important determinants of trade patterns and protectionist pressures. Agriculture is perhaps the only sector where EC membership may have contributed to an upward drift in protection.

### **European integration: deepening and widening**

Since 1985, economic and political integration in Europe has gained new momentum, and several

initiatives have been launched in close succession. The first is the single market project whose objective is to merge twelve national markets into a single, borderless economic space by 1992. The second is further economic and political integration, including monetary union and the introduction of common policies in entirely new areas, such as social and environmental matters, or foreign and security policy. The third initiative is the participation of other European countries in the 1992 project. All seven members of the European Free Trade Area (EFTA) intend to participate in the 1992 project through European Economic Area treaties, and several EFTA members have already opted to apply for EC membership. Last, the political revolution in Eastern Europe and the USSR has suddenly opened opportunities for an entirely new era of economic and political cooperation in Europe — with still-unmeasurable long-term consequences.

European integration thus has two dimensions: the deepening of economic and political integration among the members of the European Community — soon to become the European Union — and the enlargement of the Community to include new members, first in Western Europe and later in Central and Eastern Europe.

### **In the past, the European Community remained a fragmented market**

Even after the completion of the customs union in 1968, the European Community remained a hybrid — part common market with common external tariffs, and part national markets, separated

by cultural differences, but also by administrative hurdles and different national nontariff barriers toward third countries. Automobile imports from Japan, for example, were unrestricted in seven national markets, but severely limited in three, and somewhat restricted in another two. Even EC-wide policies, such as Multi-Fiber Arrangement restrictions on textile and clothing imports from developing countries, had very different effects in the twelve national markets, depending on the level of import penetration and the competitiveness of the local industry.

#### **Trade relations with developing countries are multilayered**

Trade relations with developing countries are complex, because special relationships between some EC members and their former colonies or territories had to be accommodated in an EC-wide framework. Developing countries fall into three categories: First, eighty-one developing countries (in Africa, the Caribbean, the Pacific, and the Mediterranean) have cooperation or association agreements with the European Community, providing for duty-free access for industrial goods and preferential access for some agricultural products. Second, the large majority of other developing countries have (somewhat less) preferential access — tariff rebates, duty-free quotas — under the General System of Preferences. Third, a small number of very dynamic newly industrialized economies in East Asia have faced the brunt of EC safeguard actions and “voluntary” restraints — mainly in textiles, but also in other “sensitive” industrial goods. These countries are also being graduated from the General System of Preferences.

#### **Developing countries face low trade barriers, except in agriculture**

Other than agriculture, the European Community is a relatively open market for developing countries. Tariffs on imports from developing countries average only 2 percent. More than seventy developing countries have quota- and duty-free access to EC markets. Outside agriculture, EC-wide nontariff barriers are few. The most important category is restrictions under the Multi-Fiber Arrangement against imports of textiles and clothing from some twenty developing countries. These vary considerably in terms of product coverage and allowed growth rates, with the most stringent

restrictions applying to a few Asian suppliers. Their main effect has been to shift EC imports to other low income countries. Mediterranean suppliers have done particularly well. Most other nontariff barriers are national measures of some EC members. National barriers and EC-wide safeguard actions — such as antidumping measures — are also aimed mostly at a few Asian exporters. Prohibitively high variable levies are applied to imports of most temperate agricultural staples from all sources, with some exceptions for some preferential partners. Fruits and vegetables face more moderate barriers and tropical products generally face low tariffs.

#### **Preferential agreements favoring poor countries have had little effect**

Preferential arrangements for the African, Caribbean, Pacific, and Mediterranean countries have had little effect — except to provide some infant exporter protection. Instead, the most restricted developing countries have succeeded in maintaining high export growth to the European Community, while, as a group, the most preferred developing countries have performed poorly. Preferences have a visible impact only for products with high levels of protection, such as textiles or agricultural products. In textiles and clothing, tariff exemptions for preferred suppliers, combined with relatively tight quantitative restrictions on the most dynamic Asian exporters, have enabled a few preferred exporters to achieve exceptionally high export growth. By contrast, the accession of Greece, Portugal, and Spain to the European Community has led to very little diversion of EC trade from developing countries.

The most successful exporters from the South have been countries that have faced most of the restrictions. This suggests that other factors, such as domestic conditions and policies, have been more important for success. Successful Asian and Mediterranean countries have implemented substantial domestic policy reforms. Overvalued exchange rates, wrong incentives, and poor infrastructure are more significant export barriers than border protection in the European Community.

#### **The single market is unlikely to become a Fortress Europe**

Loss of EC-firm competitiveness in certain high-technology sectors, where the size of the domestic market is important, finally spurred the Commu-

nity to convert the twelve separate national markets into a single market — without internal borders — by the end of 1992. Outside Europe, the single market project has generated concern about future EC policies toward third countries. It was feared that the 1992 project would lead to a generalization of the trade practices of the less-open member states to the entire European Community, and thus to a “Fortress Europe.” This is unlikely, since the single market project itself is a large deregulation exercise. First, the elimination of intra-EC border controls will make it impossible to enforce the many national nontariff barriers that account for much of the less-than-liberal trade practices of EC members. Second, the single market project will lower technical barriers to trade — through mutual recognition of technical standards, and deregulation or mutual recognition of regulatory practices in service industries. Third, transaction costs will be lower for exporters from third countries as they will have to deal with the paperwork and procedures of only one EC member country — of their choice.

#### **East-West integration should also benefit the South**

East-West integration, on balance, also should benefit the developing countries, but its effects will be limited in the next few years. The growth effects from East-West integration could become more significant in the late 1990s. Much will depend on political stability in Eastern Europe. Trade expansion with Eastern Europe will probably be concentrated in relatively sophisticated manufactured goods and — to a lesser extent — in temperate agricultural products. Trade diversion toward Eastern Europe would thus mainly affect the most advanced and dynamic developing countries, such as the newly industrialized countries of Asia. For less-advanced developing countries, trade diversion will probably be outweighed by trade creation resulting from the opening of Eastern European economies to trade and the growth in income that will eventually result from such reforms.

The most important consequences of East-West integration may lie elsewhere. The economic and political reforms in eastern Europe are a far-reaching social experiment in the transition from highly

controlled command economies to market economies, and this is relevant for many developing countries that have unsuccessfully pursued socialist or highly interventionist economic policies. Furthermore, the East-West detente could lead to a significant reduction in wasteful military spending in the East, West, and South — and thus free considerable resources for economic development. In the long term, the peace dividend may be the most important economic effect of the opening of Eastern Europe.

This generally positive assessment of the effects of European integration on the South only holds if Eastern Europe and the USSR remain politically stable. The analysis above has implicitly assumed that political cataclysms and strife will remain locally limited events and will not throw economic reforms off course in the largest countries of Eastern Europe or the republics of the former USSR. Political instability could produce large numbers of refugees, straining the ability of Western Europe and the rest of the world to cope with the consequences of the political transformations in the East.

#### **Successful conclusion of the Uruguay Round is needed**

Steady economic growth, maintenance of external openness in the European Community, and continued progress on trade liberalization within a multilateral framework are other essential complements to European integration. Although a failure of the Uruguay Round would not obliterate past progress on trade liberalization, it would be a severe blow for world trade and prosperity. When tariff barriers are low, there is always the danger of expanded nontariff barriers and the abuse of safeguard measures. The draft Uruguay Round agreements show substantial progress protecting against such moves, although they fall short of the much stricter discipline imposed on EC members as part of the single market project. Agreement in the Uruguay Round would help to contain protectionist pressures and abuse of international rules of conduct. Adoption of the Uruguay Round proposals would also extend the benefits of some elements of the single market project to developing countries, particularly in services.

# 1

## *European integration: A slow revolution*

After a promising start in the 1950s toward a single European market, followed by two decades of painfully slow integration, the European Economic Community — since 1985 — has been back on track. The Community also has agreed, as of 1991, to deepen the integration to encompass monetary and political union. Most visibly, a common European currency is to be introduced sometime in 1997-99. And — after ratification of the Maastricht Treaty on monetary and political union — the Community is to become the “European Union,” to reflect broader powers transferred from national governments. The Community’s new momentum toward true economic union has created new interest in membership among other Western European countries, while political changes in Eastern Europe since 1989 also open the possibility that the Community will expand to include many more members.

The influence of European integration on world trade has been mostly positive. The eight postwar rounds of multilateral trade negotiations might not have come as far in cutting tariffs without the perspective of tariff elimination among European nations.<sup>1</sup> The initiative for multilateral trade negotiations has usually come from the United States, motivated by its interest in maintaining access to European markets. The resulting tariff reductions have benefited all members of the General Agreement on Tariffs and Trade, and have ensured that trade creation outweighed trade diversion toward EC members. In other ways, trade has not been helped by the European economies; their sluggish performance in the 1970s and early 1980s may have contributed to a surge of new forms of protection-

ism. Another, more important factor, however, may have been the unexpected wide swings in exchange rates since the demise of the Bretton Woods system of fixed exchange rates in 1973.

The European Community — soon to be the European Union — cannot be understood simply as a customs union. Its goal, enshrined in the Treaty of Rome of 1957, is far more ambitious: “to lay the foundation of an ever closer union among the peoples of Europe.” Although this report is mostly confined to the Community’s trade relations with the rest of the world — particularly the developing countries — a discussion of EC policies should take into account the broader political goals. This chapter briefly reviews the origins and institutions of the European Community, its decisionmaking processes, and the main elements of its evolving economic and trade policies. The future direction of the European Community can be better appreciated by taking a historical perspective.

### **EC institutions: A brief history**

Several attempts were made in the early postwar years to overcome the political divisions of Europe, including an attempt to create a full-fledged federation of European states (box 1.1).<sup>2</sup> In the end, more modest approaches, concentrating on economic integration and leading to the creation of the European Community, proved more successful.

The birth of the European Community dates from a speech by Robert Schuman on May 9, 1950. The symbolism of the date — the morrow of the

### Box 1.1 Early attempts at European integration

Federalist ideas thrived in Europe at the end of the Second World War. The Council of Europe was the first ambitious attempt at a European Union. Its role was circumscribed from the beginning by Great Britain's refusal to give it supranational powers. Its apparent failure was loudly signaled by the spectacular resignation of its first president, Paul-Henri Spaak, who later led the preparations for the Treaties of Rome. Yet an important result remains: the European Convention of Human Rights, to which all Western European countries allow direct recourse by citizens.

Early Western European economic cooperation also progressed, under the aegis of the United States, in the Organization for European Economic Cooperation (OEEC) and its cousin, the European Payments Union. The OEEC governing council discussed in 1947 the creation of a full-scale

European customs union, but Great Britain preferred a free-trade area. The organization's only remaining role is as a think tank and coordinator for all industrial countries, known as the Organisation for Economic Co-operation and Development (OECD).

Attempts were also made at more limited multilateral cooperation. A customs union was formed by the Benelux countries (Belgium, the Netherlands, and Luxembourg), cooperation among the Nordic countries was reinforced, and a Franco-Italian customs union was discussed. But, ultimately, "Europe" has become synonymous with the European Community. These strands many now be coming together. European integration is being deepened to include economic, monetary, and political matters and *widened through increased membership* or closer association.

fifth anniversary of allied victory in Europe — underlined the deep intentions: "The French Government proposes to place the totality of Franco-German coal and steel production under a common authority, in an organization open to the participation of other European countries." The common authority would form "the first concrete bases of a European federation indispensable to the preservation of peace." Despite opposition from unions and politicians on the left and right, a treaty based on a proposal drafted by Jean Monnet was signed the following April — by Belgium, France, the Federal Republic of Germany, Italy, Luxembourg, and the Netherlands. The European Coal and Steel Community (ECSC) established free trade in those goods — but in a highly regulated framework — and imposed supranational rules and nondiscrimination on their production, trade, and transport. Great Britain declined to participate. It had just nationalized its steel industries and was opposed to the supranational character of the ECSC.

#### *The European Economic Community*

After the failure of the proposed European Defense Community in 1954,<sup>3</sup> efforts were again directed toward more limited economic integration, by adding to the coal and steel community a common market for all other goods — the European Economic Community (EEC) — and a separate set of institutions to develop civil uses of nuclear energy (the European Atomic Energy Community, or Euratom).<sup>4</sup> The two Treaties of Rome adopted the same institutional structure as the ECSC, with an executive, called the Commission; a Council of Ministers; an assembly, now

called the European Parliament; and a Court of Justice. The assemblies and courts of the ECSC, EEC, and Euratom were merged in 1958, as were the three commissions and councils of ministers in 1967. The three treaties, plus later amendments, including the Single European Act of 1987, form the constitution of what is now called the European Community, and will be further amended by the Maastricht Treaty, signed in early 1992.<sup>5</sup>

The EEC Treaty, often referred to as the Treaty of Rome,<sup>6</sup> promoted economic integration by indicating long-term objectives, by spelling out initial integration measures in detail, and by providing the Community with an institutional mechanism for implementing its objectives. The common market objectives included the progressive abolition, by the end of the twelve-year transition, of all obstacles to the free movement of labor, goods, services, and capital (the so-called "four freedoms"); common policies in agriculture, transport, and competition; and the approximation of other laws of member states to the extent required for the proper functioning of a common market. The specific measures included the abolition of all restrictions on merchandise trade among members, including the establishment of a customs union during the transition. The general capacity to act was embodied in the institutional structure, with the Commission as the executive; the Council of Ministers functioning more as a supranational legislature than an executive, acting on legislative proposals formulated by the Commission; the Court of Justice as the guardian and interpreter of the treaties; and the Assembly (later renamed the European Parliament) as a consultive body, with some power to supervise the Commission's work (box 1.2).

### Box 1.2 EC institutions and decisionmaking

The EC treaties provide for four main bodies: the Commission, the Council of Ministers, the European Court of Justice, and the Assembly — now called the European Parliament. In addition, the regular (intergovernmental) meetings of the Heads of State of member countries, called the European Council, have been formalized with the Single European Act, but are not, strictly speaking, an EC institution. European Council meetings are less formal and their main purpose is to discuss broad issues of common interest to EC member governments at the highest level. The Maastricht Treaty will add a Court of Accounts as a fifth main body. (In addition to the five decisionmaking bodies, the EC has established specialized institutions for some tasks, including the Economic and Social Committee, the European Investment Bank, and the Statistical Office — soon to be followed by the establishment of Environmental and Drug Agencies, Patent and Trademark Offices, and a European Central Bank.)

*The Commission.* The EEC Treaty confers on the Commission a wide range of powers and responsibilities. Only the Commission can initiate common policies. In virtually all policy areas covered by the treaty, the Commission has an exclusive right to propose Council decisions and thus influence the direction and shape of Community policies, if the Council goes along. The Council can amend a proposal only on a unanimous vote. This is to prevent the emasculation of general propositions that benefit individual member states. Second, the Commission is, to some extent, an executive body — for example, implementing agricultural or competition policies. As a general rule, however, Community policies are implemented by national administrations.

*The Council of Ministers.* Any act of general legal importance must be issued by the Council, normally based on a Commission proposal. Initially, Council decisions had to be unanimous. The Treaty of Rome provided for qualified majority voting on commercial policy issues from 1965 on, but this was not put into regular practice until the 1980s. It now takes two large and one small member country, or five

small member countries, to block a decision on commercial policy and other internal market issues. Member states are usually represented in the Council by their respective sectoral ministers, with the Council of Foreign Ministers usually handling external matters and other sensitive issues. A special Internal Market Council has been setup to coordinate all matters relating to the single market project. Council meetings, with up to 150 staff present, are more akin to a meeting of a legislature than a cabinet — and the Council may eventually become the upper house of a bicameral European legislature. The EC presidency rotates among member countries every six months.

*The Court of Justice.* The Court of Justice in Luxembourg is the only Community institution that operates totally apart from national governments. Its judges are appointed by common agreement of member governments, but the judges' deliberations and votes are secret and have never been challenged on a national basis. The Court decides the legality of Council and Commission regulations, directives, and decisions in light of the EC treaties. It also reviews cases of possible infringement of the treaties brought by the Commission against member states or private parties. National courts function as Community courts in matters of Community law. Lower national courts may — and supreme national courts must — refer any matter that raises a question of Community law to the Court for a preliminary ruling.

*The European Parliament.* Despite its promising title, the powers of the European Parliament are still limited. In the past, its powers were limited to supervising the Commission and approving its budget. Involvement in the legislative process was limited to a consultative role. With the Single European Act, the legislative powers of parliament were slightly enhanced. Parliament — by absolute majority — can now propose amendments to Council decisions which are then referred to the Commission for redrafting. Amendments that have not been included in the Commission's redraft can be passed by the Council only by unanimous vote.

### *Implementation of the customs union*

Despite the rise to power in 1958 in France of General de Gaulle, an early opponent of integration, considerable progress was made in the early years to implement the customs union. This involved not only the reduction and eventual elimination of duties in intra-EC trade, but also the elimination of many administrative and technical barriers, such as cumbersome customs formalities and incompatible indirect tax regimes. Progress had been so good during the first stage of integration (1958-61) that the Commission proposed to accelerate the completion of the common market by three years — by 1967. Shortly thereafter, how-

ever, substantial disagreements emerged. Nevertheless, the customs union was still completed eighteen months ahead of the original schedule, in 1968. Several hundred Community directives (laws) were adopted, harmonizing laws, regulations, and administrative procedures of member countries to facilitate the functioning of the customs union. Intra-Community trade expanded rapidly in the 1960s — by 17 percent a year — as firms took advantage of opportunities in a much larger market. Although trade diversion and creation cannot be estimated accurately, most empirical studies indicate that trade creation has outweighed trade diversion (box 1.3). In any case,

### Box 1.3 Regionalism versus multilateralism: Effects of early EC integration

Regional integration can help or hinder multilateral economic integration. Despite a now-voluminous literature on the subject, wide differences of opinions remain — not only on the economic effects of particular regional integration schemes but, even more important, on the political effects of regional and multilateral approaches. Will regional integration stymie efforts at nondiscriminatory multilateral integration? Or does it accelerate multilateral negotiations by providing a trailblazing experiment that will later be applied on a larger scale? Much depends on the circumstances.

#### Liberalization

Multilateral trade liberalization and most-favored-nation (MFN) treatment is a pillar of the GATT. The underlying logic is simple: extending tariff or other trade concessions to all members of the GATT has a liberalizing snowball effect on trade negotiations. The GATT originally permitted only one exception to the MFN rule: the creation of a customs union or free-trade area, involving free trade for “substantially all” trade among the members of such a grouping. Preferential treatment for, or among, developing countries was later allowed, however, and pre-existing trade preferences — for example, among Commonwealth countries — were grandfathered from GATT rules.

#### Effects of EC integration

A discriminatory regional integration scheme, such as a customs union, has two effects. First, the lowering of trade

barriers among members leads to trade diversion from outside suppliers to firms in member countries as these gain a cost advantage. But, second, increased trade and competition among firms in member countries will increase productivity and incomes, leading to increased imports from outside the union — the trade creation effect. Whether trade creation outweighs trade diversion depends on the circumstances. If external tariffs are high, trade diversion is likely to dominate. If tariffs are low, or are being lowered at the same time as internal tariffs, trade creation can exceed trade diversion. Most empirical studies for the EC have indicated that trade creation has outweighed trade diversion. However, estimates vary widely, depending on assumptions made and analytic techniques used (for an overview, see Mayes 1978). A particularly difficult, and perhaps insoluble, question is the scenario without a customs union. Would external trade have grown at the same rate as before? Or at the same ratio (elasticity) to GNP growth? Did GNP growth accelerate relative to the “without” scenario, and by how much? And so on.

The generally positive assessment of regional integration in Europe does not mean that all preference schemes are beneficial. Quite the contrary. Several regional integration schemes elsewhere have been accompanied by a substantial increase in external protection. In these cases, trade diversion has often outweighed trade creation, with negative consequences not only for outside suppliers, but also for domestic efficiency and growth.

because the common external trade barriers were lowered simultaneously, imports from the outside — particularly in manufactures — rose rapidly.

Conflict arose, however, between France — which opposed the majority voting that was scheduled to take effect for commercial policy in early 1966 — and other members unwilling to renegotiate the treaties. It led to a French boycott of Council meetings and was finally resolved in 1966 through an “agreement to disagree” — a unilateral French declaration that “vital interests” of a country could not be subjected to majority voting.<sup>7</sup> France, of course, was not the only one to boycott Council meetings, and the political will to overcome narrow national points of view was mostly missing until the early 1980s. Only with the single market project of 1985 did majority voting — and true supranationality — become a regular feature of Council decisionmaking.

#### Enlargement

The European Free Trade Association (EFTA) was formed in 1960, regrouping the Western European countries that had not joined the EC. Its

members established free trade in industrial goods among themselves, but excluded agriculture and eschewed common external tariffs and supranational decisionmaking. Shortly after the EFTA’s creation, the British government changed its mind and applied for EC membership in 1961. However, de Gaulle’s veto postponed EC enlargement until after his departure in 1969.<sup>8</sup> In 1973, the United Kingdom, Ireland, and Denmark joined the European Community.<sup>9</sup> This effectively changed the character of the Community from a limited grouping of some European states to a central force, and opened it to a much broader view of overseas relations and responsibilities. At the same time, the European Community concluded individual free-trade agreements with the remaining members of EFTA, creating a large free-trade zone in Western Europe. Greece joined the European Community in 1981, and Portugal and Spain in 1986. These successive enlargements broadened the Community, but did not help to deepen it. With the avoidance of majority voting in the Council, decisionmaking among the twelve was even slower than among the original six.



### Slowdown of the momentum for integration

The accessions of 1973 were the last major forward movement for a decade, as Europe plunged into the first oil crisis, subsequent slower growth, and mounting unemployment. Even the creation of the European monetary system in 1979 constituted more progress on paper than in reality until well into the next decade. Further internal liberalization slowed, as the elimination of tariffs and quotas exposed domestic industries to foreign competition, heightened by the strong appreciation of European currencies in relation to the dollar. Commodity price shocks forced further, deep restructuring in some sectors.

The inertia of national administrations was fostered by unanimous decisionmaking in the Council. Only one of six proposals for the harmonization of excise duties was adopted by the Council

in the 1970s, no attempt to secure gradual liberalization of capital movements succeeded, and the removal of technical barriers to internal trade slowed to a trickle.<sup>10</sup> Beginning in 1974, several Commission proposals were held up in the Council for political reasons, including thinly veiled protectionism. For example, three of the forty-four standards required for EC-wide approval of a vehicle type have been stalled for fifteen years, because some members felt that common vehicle-type approval would improve the competitive position of external suppliers. Many other examples could be cited, such as incompatible national television systems, telephone exchanges, and railway rolling stock (box 1.4). The Community even lost ground gained earlier as the application of some directives was suspended by some member states that invoked

#### Box 1.4 Trade in high-technology goods

The lack of an integrated domestic European market was a handicap, particularly in high technology sectors, where European firms were increasingly left behind their U.S. and Japanese competitors. In the United States and Japan, high technology goods represent a larger share of total exports than in the European Community, and the share of high-technology goods in Japan's exports has risen particularly rapidly. (High-technology goods are pharmaceuticals, telecommunications equipment, aerospace equipment, consumer electronics and computers, and office equipment. Research and development (R&D) expenditures are a large share of total production costs in these sectors.) If intra-EC trade is excluded, per capita exports of high technology goods are only one-third of Japanese levels. However, if intra-EC trade is included, the differences are less, and per capita exports of high-technology of EC members exceed those of the United States (see table). A closer look at trade in high technology also shows considerable two-way trade between the European Community and the United States, while Japan's imports of high-technology goods are limited. EC exports of high-technology goods to the United States were about \$9 billion in 1986 — about one-half of its imports from the United States — while high-technology exports to Japan were only \$1 billion, or about 10 percent of EC imports of such goods from Japan, indicating the difficulties in penetrating the Japanese market. (A billion is 1,000 million, and all dollar amounts are current U.S. dollars.)

#### Trade in high-technology goods, 1986

	Billions of dollars		Per capita exports (\$)	Percentage of high-technology goods in total trade	
	Exports	Imports		Exports	Imports
EC (including intra-EC trade)	83.7	88.1	260	10.5	11.3
EC (excluding intra-EC trade)	41.1	46.8	130	12.0	13.8
Japan	48.6	9.3	400	23.3	7.7
United States	44.1	53.3	180	21.6	14.0

Source: EC Commission 1989.

A major source of the lagging performance of European firms in high technology sectors was the fragmented nature of the European market. While R&D expenditures compared favorably with U.S. and — to some extent — Japanese firms, much of the commercial research and development effort resulted in duplication that deprived European firms of the competitive lead provided to U.S. and Japanese firms through their large domestic markets. This is particularly true for the highly regulated public procurement markets for high technology (telecommunications, transport, information technology, defense, and so on). The few successful exceptions (for example, the Airbus) confirm the rule. For example, the president of the European Parliament had to have two telephones installed in his car: one that links up only with Belgium and a second which complies with the specifications of the neighboring countries (Albert and Ball 1983).

safeguard clauses. With tariffs and outright quantitative restrictions against internal trade gone, the effects of more subtle administrative barriers became more evident. The loss of legislative momentum was accompanied by an increasing number of infringements against existing Community law, extensive recourse to residual *national* restrictions against third-country imports, *national* "voluntary" restraint agreements, and abuse of administrative procedures.

#### *The resurgence of momentum*

In the early 1980s, the Commission and the European Parliament became increasingly aware of the damage resulting from the Council's inertia. In Parliament, an activist group pushed for more progress,<sup>11</sup> and the Commission made several attempts to relaunch the completion of the internal market, going directly to the Heads of State,<sup>12</sup> instead of the Council. In 1982, the Heads of State instructed the Council to take action on some thirty proposals related to the internal market in priority areas defined by the Commission — and fixed deadlines for action. Recognizing that poor performance of the Council was due not only to protectionism, but also to inertia and disjointed decisionmaking, the Council was reorganized. Until then, decisions were mostly made in specialist councils — meetings of the ministers of agriculture, transport, finance, trade, and so on. Since 1983, a new Internal Market Council coordinates and supervises all decisions relating to the internal market, and makes all major decisions itself. This permits a broader perspective and trade-offs across sectoral issues. Moreover, the regular meetings of the Heads of State — now the European Council — played a decisive role in moving European integration forward.

In 1984, the Commission presented a consolidated program to abolish most of the visible checks at intra-Community borders. A more ambitious program to complete the internal market by the end of 1992 was announced by the new president of the Commission, Jacques Delors, in his inaugural speech to the European Parliament in early 1985. The Heads of State took up Delors' challenge and invited the Commission to draw up a program to complete the market by 1992. The Commission responded swiftly and boldly with a White Paper, "Completing the Internal Market," prepared under the direction of Lord Cockfield, identifying all actions needed to complete the internal market and listing some 300 required laws. The critical step in implementing the White Paper

proposals was the Single European Act, drafted in conjunction with the White Paper, and signed in 1986. The act extended qualified majority voting to most internal market issues. Unanimity is now required only for such issues as taxation, employee rights, the environment, and movement of labor.<sup>13</sup> The act also *enhanced the role* of the European Parliament in the legislative process.

#### *Monetary and political union: The Maastricht Treaty*

Emboldened by its success in launching the 1992 program to complete the internal market, the Commission turned its attention to further institutional reforms, complementing the 1992 program. In 1988, the Heads of State commissioned a report on the ways to achieve economic and monetary union. The report, drafted by a committee of central bankers under the chairmanship of Delors, proposed a three-stage plan. Negotiations were also initiated on a political union treaty, to enhance foreign and security cooperation among EC member countries and to strengthen the democratic accountability of EC institutions. Agreement on a monetary and political union treaty, formally called the "Treaty on European Union," was reached in December 1991 at Maastricht and was to be ratified in 1992.

The Maastricht Treaty is the most ambitious revision of the European Community since its founding. Most visibly, it provides for the introduction of a common European currency sometime in 1997-99. The creation of a monetary and economic union, of course, entails a considerable transfer of authority to existing and new EC institutions. Governments will have to meet strict fiscal and monetary conditions to participate in the monetary union and common currency. The principal elements of the political union are a stronger role for the European Parliament, enhanced foreign and security cooperation, introduction of a partial European citizenship, extension of Community jurisdiction into social fields,<sup>14</sup> and further widening of majority voting. Foreign and security policy remain largely intergovernmental issues but, by unanimous vote, the Council can designate issues and areas of foreign policy whose implementation is transferred to the European Community — and then is subject to majority voting in the Council. A further review of progress toward political union is to be completed by 1996, with a view to further streamline institutions and decisionmaking before the Community is enlarged further.

Progress has also been made in strengthening the Community's links with EFTA. Treaties for a European Economic Area (EEA), signed by the EC and EFTA members in May 1992, provide for the participation of EFTA members in the single market process by extending about two-thirds of existing Community legislation (*acquis communautaire*) to them. In effect, the EEA treaties expand the existing free trade in industrial goods to include all "four freedoms" of unrestricted movement of goods, services, labor, and capital by 1993, with a few exceptions (common external tariff, agricultural policy, and harmonization of taxation), and some longer transitional periods for some EFTA members (for example, labor mobility into Switzerland). The effect of the EEA agreements will be particularly important with respect to public procurement, labor, and capital mobility; entry into regulated service industries; and competition policy. Several EFTA members have indicated their intention to join the EC, and some might do so as early as 1995 or 1996. Association agreements have been concluded with three Eastern European countries in 1992 providing for duty-free access of Eastern European manufactured goods to the Community and the eventual establishment of a free trade area (see chapter 4).

#### Economic structure and trade patterns

With a population of about 330 million, the European Community is now the largest trading partner in the world. Average per capita income, at market exchange rates, has increased to 91 percent of the U.S. average in 1990, up from only 37 percent in 1960 (table 1.1). Most of this increase is due to an appreciation of European currencies in relation to the dollar, reflecting an improvement

**Table 1.1 Per capita income in Europe, 1960-90 (percentage of U.S. GDP)**

	1960	1990
<i>At market exchange rates</i>		
EC-12 (average)	37	91
member with highest income	59	116
member with lowest income	10	30
EC-6 member with lowest income	28	85
Japan	17	107
<i>At purchasing power parities</i>		
EC-12	53	66
Japan	29	79

Source: EC Commission 1990a.

in European competitiveness in tradable goods, particularly during the 1960s. In terms of purchasing power, however, the European performance appears less vigorous — as higher prices, notably for food and housing, reduce European income levels, relative to the United States. Another important feature is the narrowing of differences in productivity and living standards among the original six members. But the enlargement of the Community to twelve members has increased the income dispersion far beyond the range that existed among the original six when the EEC was founded — with important consequences for trade patterns and Community policy.

Economic growth in the European Community was stronger than in the United States in the 1960s, slightly higher in the 1970s, and somewhat lower than in the United States in the 1980s, reflecting mostly the poor performance at the beginning of the 1980s. Recently, growth has again been slightly stronger than in the United States. Compared with Japan, the European economic performance looks less impressive: Japan has caught up with the United States from a much lower level. The main reason appears to be the higher share of income devoted to saving and investment in Japan (table 1.2). Investment productivity — the ratio of incremental output to capital — remains somewhat higher in Japan, probably due to the larger share of business investment in the total, but differences have narrowed.

Intra-Community trade increased from about 8 percent of Community GDP in 1960 to 18 percent in 1990, and today accounts for about 50 to 60 percent of total trade for the larger economies, and 60 to 70 percent for the smaller ones. Extra-Community trade has continued to expand in line with national income, and remains at about 10 percent of Community GDP, almost exactly the same ratio as in the other large industrial economies, the United States and Japan (table 1.3). Despite different endowments and trade regimes, the three major trade blocs are thus engaged in foreign trade to a similar extent.<sup>15</sup> The commodity structure of trade is, however, different, with the resource-rich United States importing mainly manufactures (74 percent), Japan importing mainly primary commodities (63 percent), and the European Community in an intermediate position (58 percent manufactures). As income elasticities are low for primary commodities, the share of manufactures in total imports will probably continue to rise. Intra-Community trade is predominantly

**Table 1.2 Growth and investment, 1960-90**

	1961-70	1971-80	1981-90	1986-90
<i>GDP growth (percent per year)</i>				
EC-12	4.8	3.0	2.3	3.1
Japan	10.5	4.6	4.3	4.7
United States	3.8	2.7	2.9	2.9
<i>Investment/GDP ratio (percent)</i>				
EC-12	23	23	20	20
Japan	32	33	30	31
United States	18	19	17	17

Source: EC Commission, 1990a.

mutual exchange of similar manufactured goods (intra-industry trade), reflecting similar levels of economic development, economies of scale, and differentiated consumer tastes.

Even though the common external policy of the European Community has been fully in effect for more than twenty years, different members participate to different degrees in international trade.<sup>16</sup> Until the completion of the single market project, trade policies of EC members remain partly national and partly common EC policies, with differences relating mostly to the use of residual national quantitative restrictions or similar restraints (see below). For example, Germany has a much higher import/GDP ratio than the other large EC economies.<sup>17</sup> This can be explained, in part, by the fact that Germany does not use national quantitative restrictions for industrial goods under the EEC Treaty and has not applied for intra-EC transshipment restrictions since 1983. More recently, the Benelux countries (Belgium, the Netherlands, and Luxembourg), Denmark, and the United Kingdom have also ceased to apply transshipment restrictions (see below). More important, all EC members are becoming increasingly open. The single market process will probably accelerate the opening of the less-open EC economies in the

1990s (see chapter 3).

Import growth in the 1980s was strongest in the United States, followed closely by Japan, with EC imports growing somewhat less. The most important determinant of import growth appears to be domestic economic growth as the ratio of (real) import growth to GDP growth — the income elasticity of imports — and is similar for the three major trade blocs (table 1.4).<sup>18</sup> Imports into the United States grew more vigorously than in the European Community or Japan in the early 1980s, reflecting mostly the strong appreciation of the dollar and higher domestic growth, while the reverse has been the case in the second half of the 1980s. Income elasticities for manufactured imports from developing countries have been nearly identical in the European Community and the United States (see chapter 2).

Despite ample evidence of increased protectionist pressures in the late 1970s and early 1980s, income elasticities for imports of manufactured goods from developing countries have increased in the 1980s, compared with the 1970s. Because manufactured goods now account for well over half of total exports of developing countries, the high (and rising) income elasticities in industrial countries and still-low market penetration by de-

**Table 1.3 Import/GDP ratios**  
(imports of goods and services as a percentage of GDP)

	1960	1970	1980	1990
EC-12, including intra-EC trade	19	21	28	28
France	14	16	21	23
Germany	19	21	26	33
Italy	13	16	22	21
United Kingdom	21	23	25	27
EC-12, excluding intra-EC trade	10	9	13	10
Japan	10	10	15	12
United States	4	6	11	11

Source: EC Commission 1990a.

**Table 1.4 Import growth and income elasticities, 1980-90**  
(percent per year)

	<i>Total imports of goods and services</i>		<i>Imports of manufactured goods from developing countries (1980-88)</i>	
	<i>Real growth (% p.a.)</i>	<i>Income elasticity</i>	<i>Real growth (% p.a.)</i>	<i>Income elasticity</i>
EC-12	4.4	2.1	10.2	4.9
Japan	7.0	1.5	15.3	3.8
United States	7.2	2.5	15.0	5.2

Source: OECD 1991b; UNCTAD 1990.

veloping countries (4 to 5 percent for manufactures) point to continued good export opportunities. By contrast, trade in primary commodities is likely to expand only slowly, as demand is inelastic. Trade in manufactures among the major industrial economies will also grow only at moderate rates, as market penetration is already high. Direct investment will probably continue to substitute for increased trade of some goods, with Japanese cars or German pharmaceuticals being produced on all three continents. Although protectionist pressures may in some cases be a motivation for cross-border investment, there are often considerable other advantages in producing inside a foreign market.<sup>19</sup> An exception to the generally moderate growth in trade is likely to be East-West trade in Europe where normal trade patterns have been interrupted for the past fifty years. East-West trade may thus expand significantly, at least from the perspective of the Eastern European countries (see chapter 4).

#### Trade policymaking in the European Community

The EEC Treaty provides for different instruments to implement common policies: regulations, directives, decisions, recommendations, and opinions. Regulations are directly applicable and legally binding in their entirety in all member states. Directives have to be implemented in national law, but national administrations have to comply with them even before their encoding into national law. The Commission supervises the implementation of common policies by members, issues formal notices of infringements, and brings cases before the Court of Justice, if infringements persist. The Commission has no direct means to enforce Court decisions, but relies on national enforcement. Community law is an integral part of national legal codes, and the same means of enforcement are available as for national laws.

Enforcement is thus reasonably efficient — but not perfect — and varies across member countries. The Maastricht Treaty will strengthen the role of the Commission in Community law enforcement.<sup>20</sup>

The EEC Treaty enumerates the elements considered necessary for establishing a common commercial policy, including a common tariff, common trade agreements with third countries, and uniform application. The treaty provides no detailed rules for the conduct of trade policy — this has been left to subsequent Council decisions. The main general import regulations include the Common Customs Tariff, the Common Rules for Imports, several arrangements for imports from centrally planned economies, the Common Procedure for the Administration of Quantitative Restrictions, and the New Commercial Policy Instrument.

The Common Rules for Imports (Regulation 288/82) apply to all products, except agricultural products, textiles (yarn and fabrics), and coal and steel,<sup>21</sup> and regulate imports from all sources, except state-trading countries. The common rules start from a general premise of unrestricted market access, but enumerate exceptions in an annex and allow maintenance of preexisting national quantitative restrictions and surveillance measures by member states (see below). The New Commercial Policy Instrument — enacted in response to retaliatory provisions in U.S. legislation (Section 301 of the U.S. Trade Act) — allows the imposition of any commercial policy measure that is compatible with the EC's international obligations. This instrument has been used twice. Apart from these general regulations, Community regulations provide, for example, for remedial action in specific situations — dumping, subsidization — or lay the basis for trade-related policies, such as procurement and standardization. These regulations are often related to EC obligations under GATT agreements.

The EC maintains a number of reciprocal or unilateral trade preferences regarding third countries. Preferences are granted in the context of regional free trade agreements (EFTA countries, Israel); a wide range of association and cooperation agreements, including the Lomé Convention; association or cooperation agreements with Mediterranean countries; and the Community's generalized system of preferences (GSP) for other developing countries. The free-trade and association agreements provide for unrestricted and duty-free access for industrial goods (see chapter 2), but often treat textiles and coal and steel separately. Agricultural goods are either completely excluded or subject to constraints involving product coverage, quantitative ceilings, minimum price undertakings, seasonal calendars, and so on.

### Trade policy instruments

Instruments for trade policy range from tariffs and quantitative restrictions to voluntary restraints and more-subtle barriers, such as product standards.

#### Tariffs

Although tariffs used to be the main instrument of protection, their importance has drastically declined in all industrial countries as the result of postwar trade negotiations under the GATT. Indeed, the tariffs of the major trade partners are now so low that they have, in most cases, lost their protective effect. Total tariff revenue of the European Community is now only about 2 percent of extra-EC imports — and less than 1 percent if intra-EC trade is included. Most-favored-nation (MFN) tariffs on industrial goods are about 6 percent (table 1.5), with the lower total tariff collection resulting from a combination of duty-free MFN imports of many raw materials,

the EC-EFTA free-trade agreements in industrial goods, and tariff preferences for developing countries (see chapter 2). Tariffs collected on imports from the "least-preferred" group of developing countries — the GSP beneficiaries — also average about 2 percent.

The EC generally applies advalorem tariffs. Specific duties are imposed on some agricultural commodities (one-third of all tariff lines) and coal, and a combination of specific and advalorem schedules is applied for some fruits and vegetables and a few manufactured items (glass, watches).<sup>22</sup> Seasonal tariffs are in place for some fruits and vegetables and cut flowers, and very high "variable levies" are imposed on most temperate agricultural products (see below). As part of the ECSC treaty, some members continue to impose tariffs on coal. In 1988, the weighted MFN tariff on dutiable imports was 5.1 percent. Average tariffs for broad categories of goods are nearly identical to those in Japan or the U.S., and range from 0.2 percent for raw materials to 5.6 percent for manufactured goods. Tariffs on agricultural products average 5.5 percent, excluding the variable levies. About one-third of all imports enter under zero MFN duties, another third under free-trade agreements and preferential schemes, and the remainder at positive MFN rates. Two-thirds of all imports face MFN duties of less than 5 percent, and 90 percent of less than 10 percent (table 1.6). For the most sensitive industrial products, such as clothing or footwear, tariffs average only 13 percent — but protection is increased by the imposition of quantitative restraints, at least for the most competitive East Asian suppliers (see chapter 2). Agriculture is the main exception to the generally very low level of tariff and other trade restraints (see below). More than 90 percent of the tariff lines of the Common External Tariff are bound in the GATT.

**Table 1.5 Average MFN tariffs on manufactured goods, 1902-85 (percent)**

	1902	1913	1925	1962	1970	1989
European Community	—	—	—	11	8	6
France	34	20	21	11	8	6
Germany	25	13	20	11	8	6
Netherlands	3	4	6	11	8	6
United States	73	44	37	12	9	5
Japan	10	20	13	16	12	3
Argentina	28	28	29	141	78	—

Note: 1962, 1970, and 1989 figures for Germany are for the Federal Republic of Germany.

Source: Anderson and Garnaut 1987; Little, Scitovsky, and Scott 1970; Balassa and Associates 1982; GATT (internal).

**Table 1.6 Imports by level of MFN tariffs, 1984-85**  
(percentage of total imports from all sources)

Tariff rate (percent)	Zero	<5	5-10	10-20	>20
EC (10)	38	26	25	8	-
Japan	27	57	8	4	2
United States	19	59	14	4	5

Source: Takase 1988.

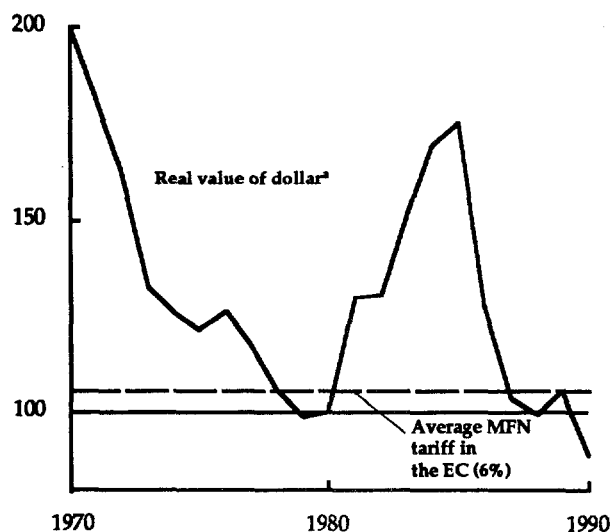
One consequence of the low tariffs in industrial countries is that domestic growth and exchange-rate fluctuations have become far more important determinants of external competitiveness and trade flows, and have, at times, been an important source of protectionist pressures and trade frictions. For example, in 1970-75, the real value of the dollar declined by about 42 percent compared with the deutsche mark (figure 1.1). In terms of the competitiveness of a fully U.S.-made good, this is equivalent to a reduction of EC tariffs by about 70 percentage points — far more than was achieved (or necessary) in forty years of multilateral trade negotiations (figure 1.2). Similarly, the real value of the dollar strengthened by about 70 percent, compared with European currencies in 1980-85, and declined again to 1980 levels by 1990. Not surprisingly, these large swings of real exchange rates have been a major source of friction, not only between the European Community and the United States, but with other trade partners. The sharp appreciation of European currencies in the 1970s explains the sudden loss of competitiveness of many industries (clothing, footwear, steel, toys, consumer electronics, and so on) and pressures to introduce nontariff barriers. The sharp depreciation of European currencies in the early 1980s provided temporarily relief and led to a slowdown of import market penetration in the European Community, but caused trade frictions with the United States — leading, for example, to the “voluntary” restraint arrangements for steel exports to the United States. The situation was again reversed in the second half of the 1980s. This time, however, resort to additional protective measures was limited, because of implementation of the single market project (chapter 3) and a protection stand-still agreement during the Uruguay Round negotiations.

### Nontariff barriers

Nontariff barriers include quantitative restrictions, which are widely used but in decline. Member states continue to apply four types of quantitative restrictions against imports from third countries. First, residual restrictions of member countries, predating the establishment of the European Economic Community, are applied to all third countries or to individual trading partners — but only by a member country. Prominent examples are motor vehicles and bananas. Second are a few EC-wide quantitative restrictions — agricultural products, textiles, and clothing under the Multi-Fiber Arrangement (MFA), and footwear from the Republic of Korea and Taiwan (China). Third, specific restrictions may be imposed by member countries on imports from state-trading countries, including China. Fourth, Portugal and Spain still impose a range of national quotas under the transitional provisions of their EC accession agreements. These will be phased out for industrial goods by the end of 1992, and for agricultural products by 1995.

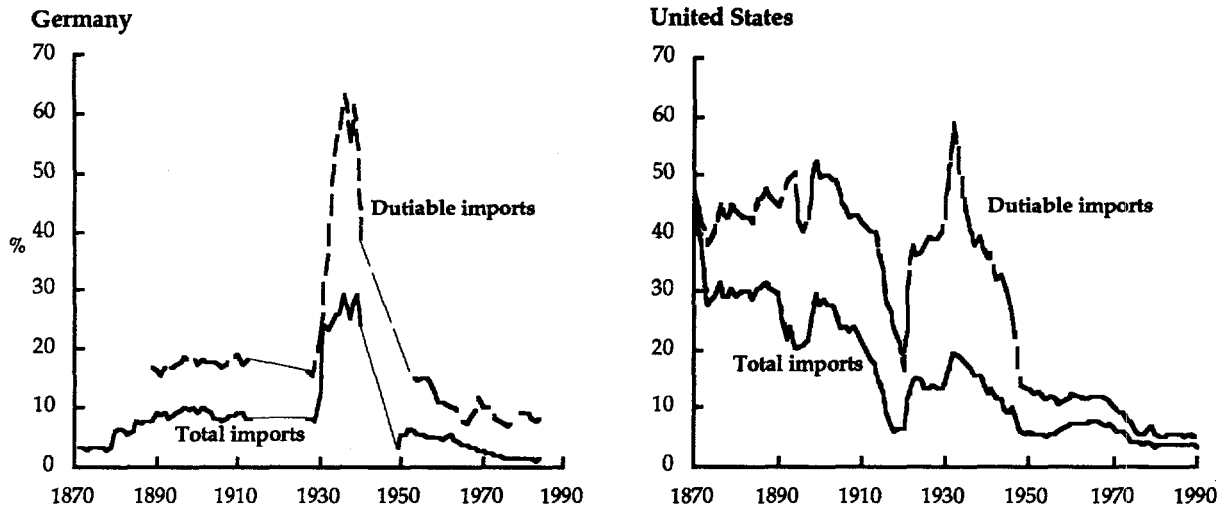
Apart from the transitional provisions of accession agreements, and the variable levies for agricultural products, 7 percent of all eight-digit tariff lines are affected by quota restrictions in one or several member countries. About one half of these

**Figure 1.1 Real dollar/deutsche mark exchange rate, 1970-90**  
(1980 = 100)



a. 1980 = 100, deflated by relative wages.  
Source: IMF, IFS.

**Figure 1.2 Tariff rates, Germany and the United States, 1870-1985**



are EC-wide restrictions on imports of textiles and clothing under the Multi-Fiber Arrangement (see chapter 2). Apart from the MFA restraints, about 3 percent of all tariff lines are affected by quantitative restrictions in one or several member countries. Germany and the United Kingdom maintain no national quantitative restrictions, and the Benelux countries, Denmark, and Ireland very few. France and Italy maintain most of these restrictions — about 1.5 percent of nontextile tariff lines each — but only a few restrictions are enforced. One important reason is that intra-EC transshipment of third country imports cannot be restricted, unless specifically authorized by the Commission through an Article 115 derogation. Because only a small part of national quota restrictions are backed by Article 115 restrictions, national quotas are far less effective trade restraints in the European Community than in most other countries (see chapter 2 for examples).

Member states must obtain the Commission's authorization to intervene at internal borders to prevent transshipment under Article 115. Authorizations are limited to one year, but can be renewed. France, Ireland, and Italy have used Article 115 most often, and textiles have been the most important category. Most Article 115 restrictions affect imports from only one country. China, Hong Kong, Japan, and Korea are targeted most. For example the seven authorized nontextile restrictions<sup>23</sup> by France in 1991 affected car radios from China and Korea, TV sets from Korea, and bananas from the "dollar zone."<sup>24</sup> Article 115 restrictions thus reinforce only a few quantitative restrictions — about 4 percent — and only from a

few sources (Langhammer 1990). Since transshipments cannot be prevented after 1992, most of these residual restrictions are likely to become ineffective. In addition, criteria for granting transshipment restrictions have been tightened in recent years, and recourse to Article 115 is to be terminated with the completion of the internal market in early 1993. The Commission has granted only 45 transshipment restrictions in 1991, down from 157 in 1987 (table 1.7). For a few goods, however, other ways may be found to restrain intra-Community transshipment, at least until contested in court (see chapters 2 and 3).

In addition to quantitative restrictions, several other types of nontariff restraints are in effect, including voluntary export restraints (VERs), export forecasts, or import surveillance involving the European Community or, more often, individual members. These arrangements vary widely in their legal character, their coverage, and the degree of restrictiveness. The bulk of these measures were concentrated on a limited number of product areas — agricultural products, textiles, motor vehicles, steel, and footwear. The use of

**Table 1.7 Use of EC Article 115 import restrictions**  
(number of measures in force)

	1980	1985	1989	1990	1991
Total	222	176	119	79	45
Textiles	164	119	78	48	31
Agriculture	5	12	5	4	3

Source: EC Commission.



voluntary restraint agreements has declined somewhat in recent years, notably in steel, where imports under restraint dropped from 68 percent of steel imports in 1980 to 19 percent in 1989 (box 1.5). A large share of these voluntary restraint arrangements involve Japan. In most cases, a back-to-back licensing system is used, issuing import licenses automatically in parallel to the granting of an export permit by the exporting country. Licenses are usually issued to individual firms based on past performance, with some room for newcomers. Japan has also complained about the delayed issuing and the short duration of automatic licensing in France. In 1990, EC-wide measures were introduced for the first time outside textiles, as a self-restraint arrangement for footwear from Korea and Taiwan (China) (chapter 2).<sup>25</sup> Article 115 restrictions cannot be granted for VERs.

Antidumping and antisubsidy actions have become the most important category of safeguard actions in recent years although the number of antidumping measures in effect has declined from close to 200 in the mid-1980s to 120 in 1989. Antidumping measures are applied to exports of individual firms, rather than all exports from a country. Antidumping measures have also been applied to screwdriver assembly plants, set up in the EC to circumvent antidumping actions.<sup>26</sup> Although antidumping safeguards can be applied to

intra-EC trade, this has not happened. Noncompetitive behavior of EC firms is dealt with through the more far-reaching provisions of EC competition policy. A total of 393 antidumping investigations were pursued by the Commission in 1981-90. In about 70 percent of the cases, antidumping actions were taken (duties, or price undertakings, that is, negotiated price increases in place of duties). About 0.6 percent of extra-EC imports are affected by antidumping duties, and Japan accounts for two-thirds of all trade affected by antidumping duties (table 1.8).

Antidumping actions are in principle a legitimate element of trade policy because competition policy cannot be enforced abroad — and they are sanctioned under the GATT antidumping code. Most antidumping measures were applied to products where economies of scale are important,<sup>27</sup> inviting discriminatory pricing — steel, chemicals, mechanical engineering — particularly in periods of worldwide overcapacity. Although EC antidumping practice has followed GATT principles — dumping did occur and cause some injury to domestic industry — there is doubt about whether antidumping measures had the desired effects. Dumping often results from protection and monopolistic markets in the exporting countries, but does not necessarily reflect predatory intent (see, for example, Bark 1991). In other cases,

### Box 1.5 Steel industry restructuring

In the 1970s, the European steel industry, like those of other industrial market economies, experienced severe adjustment problems. The main factors were lower-than-expected demand, due to the oil price shocks and substitution by new materials, and large increases in world steel capacity that had been built in anticipation of uninterrupted rapid growth. The problems were accentuated by the strong appreciation of European currencies in relation to the U.S. dollar — which suddenly rendered European producers uncompetitive. Although steel consumption increased by 55 percent in the 1960s, it stagnated in the 1970s, and capacity utilization fell from 87 percent in 1974 to 56 percent in 1982.

The European Community has dealt with the problems by restructuring the domestic industry — employment was halved between 1974 and 1988 — and by negotiating voluntary export restraints (VERs) with the main exporters. The ECSC Treaty allows for considerably stronger government intervention for coal and steel than the Treaty of Rome permits in other sectors. In the steel crisis of the early 1980s, EC-wide production quotas and price controls were established as part of the so-called Davignon Plan. A steel-aid code was introduced that linked sectoral assistance to the closure or adjustment of production capacities. About 15

percent of EC steel capacity was dismantled under the code. In total, the Commission approved about \$30 billion of aid from 1980 to 1985, when the code expired. In 1988, production quotas were replaced by surveillance. Since the expiration of the steel-aid code in 1985, state aid can be given only for research and development, environmental protection, and plant closures.

The VERs arrangements have been renewed annually, with reductions in country and product protection since 1985. The share of imports under restraint agreements fell from 68 percent in 1980 to 19 percent in 1989. In 1990, VERs remained in effect only for Brazil and five formerly centrally planned economies in Eastern Europe. Antidumping measures are in effect for Mexico, Turkey, and Yugoslavia. On the export side, the European Community agreed to prolong its export restraint arrangement with the United States until March 1992, when it lapsed. The arrangement also included agreements to phase out subsidies. Recently, steel consumption has recovered, and capacity utilization again exceeds 70 percent of nominal capacity (effective capacity is about 85 percent of nominal capacity). For most steel makers, more normal competitive conditions have thus been restored.

**Table 1.8 EC antidumping actions**

	Antidumping investigations 1981-90	Trade affected by antidumping duties	
		(billions of ECU's)	(% of total imports)
Industrial countries	92	1.80	0.6
Japan	31	1.60	3.5
United States + Canada	23	0.03	0.1
EFTA	15	0.17	0.2
Developing countries	144	0.51	0.8
Asia NIEs	38	0.25	0.5
Latin America NIEs	28	0.09	0.9
Turkey and Yugoslavia	49	0.17	1.3
Other	29	0.06	0.1
State trading countries	157	0.08	0.2
Eastern Europe	127	-	-
China	29	-	-
Total	393	2.39	0.6

Source: EC Commission 1991a.

antidumping findings simply reflect irrational economic policies in the exporting countries, particularly in the large number of antidumping cases involving state trading countries. In some cases, successful antidumping cases led to the strengthening of industry cartels in the EC, which had to be remedied by competition policy (Messerlin 1990). Last, European firms have not always responded adequately to the relief granted by antidumping measures, and price undertakings (instead of antidumping duties) may have strengthened the competitive position of leading foreign suppliers.<sup>28</sup> The solution would be to use more comprehensive competition policy — and enforcement — instead of the all-too-simplistic antidumping provisions. This, however, would require a transfer of sovereignty to a supranational competition authority that has so far only been possible within the EC — although it will soon extend to all of Western Europe.

With the declining importance of tariffs and quantitative restrictions, more subtle trade barriers, including *domestic standards* and *certification* procedures have moved to the forefront. In the European Community, the reality has been that the twelve markets are not fully integrated, due to a host of different standards and other administrative and technical requirements. These have hindered intra-EC trade and have made it more difficult for exporters from third countries to penetrate markets — as products had to meet different requirements. With the move to a single integrated market, and the new approach of mutual

recognition — rather than complete harmonization — of national standards, technical barriers in intra-EC trade will diminish significantly. Products that are legally marketed in one country are entitled to free circulation throughout the European Community.

#### *Competition and subsidy policies*

Introduction of a common competition policy was an important objective of the Treaty of Rome. Articles 85, 86, and 92 restrict collusive behavior, abuse of dominant position, and competition-distorting state aid. Member countries had to introduce implementing legislation for the enforcement of the competition policy during the first phase of the European Economic Community (1958-61). Most members modeled their legislation on the German law of 1957, and a competition directorate was established in the Commission (see Boner and Krueger 1991). Affected parties can take competition cases either to their national agencies and courts or to the Commission and European Court of Justice. The Court has issued a number of landmark decisions — for example, ruling against German technical standards and against French price controls on petroleum products as competition distorting. The enforcement of competition and subsidy provisions benefits EC and external competitors alike in industry, but not in agriculture (see below).

With respect to government subsidies, the Commission has tightened enforcement as part of the single market project (chapter 3). A first survey of

state aids was completed in 1988 and repeated in 1990, providing an overview of subsidies provided by national governments — and the European Community. Overall, government subsidies have declined in the European Community in the 1980s. Budgetary subsidies in 1986-88 equaled about 2.8 percent of Community GDP, down from 3.6 percent in 1981-86 (table 1.9). If the transfers from consumers to farmers are included, however, total EC subsidies in 1986-88 were about 4.6 percent of GDP, with more than half in agriculture (see below). Manufacturing, railways, and coal (box 1.6) account for the remainder.

Subsidies for manufacturing have declined from about 1.3 percent of Community GDP in 1981-86 to 0.9 percent in 1986-88, with the largest reductions in Italy, France, and the United Kingdom. Subsidies have also been restructured from assistance to declining industries toward functional support — for example, research and development, promotion of small and medium enterprises, or regional investment incentives. National practices vary widely. In Germany, for example, more than half of the subsidies to industry were in the form of regional assistance for Berlin. Italy's assistance was also predominantly under regional programs, while the largest category in France was for losses from export credit guarantees. Specific subsectoral schemes remain important in Spain and France. Multilateral agreements on state subsidies are still weak, but discussions are under way on a subsidy code for steel and aircraft manufacturing.<sup>29</sup>

### The Common Agricultural Policy

The Common Agricultural Policy (CAP) is the most important departure from the largely mar-

**Table 1.9 EC and national budgetary subsidies (percentage of GDP)**

	EC-12	France	Germany	Italy	U.K.
Total 1981-86 <sup>a</sup>	3.6	3.4	2.9	4.8	2.3
Total 1986-88 <sup>a</sup>	2.8	2.9	3.0	3.9	1.6
Agriculture	0.8	1.1	0.6	1.1	0.7
Manufacturing	0.9	0.7	0.9	1.4	0.6
Other <sup>b</sup>	1.1	1.1	1.5	1.4	0.3
Consumer transfers to agriculture, 1986-88	1.8	-	-	-	-

a. Annual average.

b. Coal and railways.

Source: EC Commission 1990b; OECD 1990.

### Box 1.6 Coal

Coal mining is highly supported in several member countries. Coal mining subsidies amount to 1 percent of GDP in Belgium, 0.6 percent in Germany, and 0.3 percent in France. Subsidies per employee are highest in Belgium and France, and support is highest in Germany. Energy security and social problems were the main reasons for the support schemes. Coal mining is concentrated in a few areas that have already suffered from the restructuring of the steel industry and have high unemployment rates. In 1986, the Commission established new criteria for the approval of state aid to coal mining. Under this decision, which is in effect until the end of 1993, aid may be compatible with the common market only if it contributes either to improving the coal industry's competitiveness or new economically viable capacities, or to solving social and regional problems arising from the contraction of the coal sector.

In Germany, the coal mining industry concluded in 1985 a ten-year supply contract with the electric power industry at prices above the then-prevailing high world market prices, with the difference covered by a levy on electricity prices. (Germany also imposes a national tariff on coal under the ECSC Treaty — of 6DM/t, or about 6 percent of cif prices.) As coal import prices have since declined by about 50 percent, the subsidy has increased enormously. The Commission has recently tried to limit the subsidy. The German government has disputed the validity of that decision and the European Court of Justice has ruled in favor of Germany. However, it is unlikely that the (mostly private) electric power industry will agree to renew the present arrangement when it expires in 1995. Eliminating the coal subsidy could pay for 10 percent of the costs of German unification.

ket-oriented economic and trade policies of the European Community. For many observers, agricultural protectionism and the CAP are synonymous. The CAP is characterized by high price support for most temperate agricultural products, a nearly airtight separation of domestic agricultural markets from world markets, high levels of budgetary spending, and the preservation of an outdated farm-size structure. Excessive agricultural protectionism is not limited to the European Community: several other European countries and Japan have similar or even higher levels of protection, and agricultural subsidies in the United States account for the same share of national income.

The sources of high agricultural protection are historical. Inappropriately designed policy measures and unanimous decisionmaking at the EC-level have added to the costs of the agricultural policy and have heightened distortions in domes-

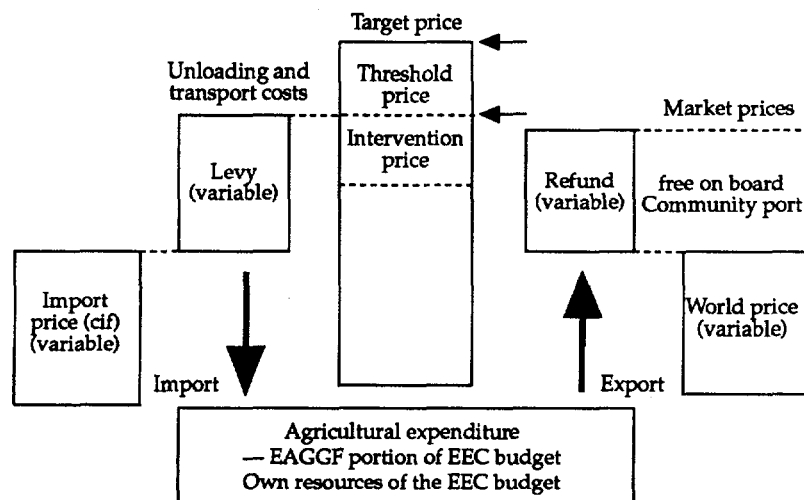
tic and world markets. In principle, the policy instruments of the CAP could have been designed to ease structural adjustment and could have been adapted to reflect changing market conditions. But this did not happen until recently. Instead, narrow national and sectoral interests dominated decisionmaking and led to inertia. The mounting costs of the CAP, greater acceptance of supranationality (majority voting), and pressure by other trade partners have led in recent years to a rethinking of the common agricultural policy (annex 1).

When the Treaty of Rome was signed, agriculture still was the main source of income for a large part of the population of all member countries, ranging from 10 percent of the labor force in Belgium to nearly 40 percent in Italy. The United Kingdom, then a nonmember, was the only European country with a small agricultural labor force (5 percent). The agricultural sector had been declining everywhere for some time, and all members, except Holland, had found it politically expedient to stabilize agricultural incomes and ease the transition to nonagricultural occupations. Because of the variety of agricultural support policies in member countries before the formation of the European Community, a common policy was needed — if trade in agricultural and food products was to be liberalized. The CAP objectives are set out in Article 39 of the Treaty of Rome as increasing agricultural productivity, improving standards of living for farmers, stabilizing markets, obtaining food security, and ensuring rea-

sonable food prices. Within these broad goals, the common agricultural policy operates under three principles: a unified market, Community preferences, and common financial responsibility. The principle of a unified domestic market has at times been breached through a system of "monetary compensation amounts," introduced to cope with the effects of exchange rate fluctuations.<sup>30</sup>

Although CAP market interventions differ by type of product, the principal tool is price policy: domestic agricultural prices are set by politicians to ensure farmers a "fair standard of living." To enforce these policy-determined prices, variable levies on imports and subsidies — restitutions — on exports are used to insulate domestic markets from international price fluctuations, to protect farmers from foreign competition, and to dispose of surplus quantities on international markets (figure 1.3). (For nonagricultural products, such dumping is prohibited under GATT rules.) For most staples, the price guarantee is accompanied by a marketing guarantee, with EC or national intervention agencies buying up any quantity that cannot be marketed at domestic (intervention) prices. Variable levies are set to increase import prices above prevailing domestic prices and are highly effective trade barriers.<sup>31</sup> The variable levy system does not apply to some types of animal feeds, fruits, and vegetables, or to some other temperate products. Protection has been expanded to include additional products (olive oil, oilseeds, wine) and has been strengthened for products that had only limited protection, such as fruits,

Figure 1.3 The EC variable levy and export refund system



vegetables, beef, and veal. Recently, changes have been introduced to curtail overproduction, particularly for dairy products (box 1.7).

The design of the CAP did not provide for the enormous gains in agricultural productivity that became possible as a result of increased applications of chemical fertilizers and pesticides, and improved seeds and husbanding techniques. Yields are now at least double the level of thirty years ago. This, plus even larger increases in labor productivity due to farm mechanization, turned the Community from a net importer of grain and other basic staples in the 1960s, to approximate balance in the 1970s. In the late 1970s and 1980s, ever increasing production surpluses had to be disposed of, contributing to the secular decline of prices for grain and other temperate agricultural products on world markets, and leading eventually to strong trade frictions with the land-rich agricultural exporters in the "new world." The

large volume of export subsidies required to dispose of surplus production on international markets has been a major source of trade frictions with the United States and other land-rich countries worldwide (chapter 2).<sup>32</sup>

Domestically, the main result of the high-price policy has been to slow the exit from agricultural employment. In the 1960s, about 4 percent of the agricultural labor force left the land yearly, but in the 1980s the rate had slowed to about 2.5 percent a year. In absolute terms, the difference is even larger: in the 1960s, six million people left agricultural employment; in the 1980s only two million (in the EC-9). Although the share of the labor force employed in agriculture has declined significantly (from 17 percent to 6 percent in 1960-90 for the EC-9), a slightly higher rate of intersectoral labor transfer could have brought agricultural employment closer to U.S. levels (3 percent of the labor force), and likely would have resulted in larger

### Box 1.7 Types of Common Agricultural Policy market intervention

There are about five types of market intervention. A new system is being proposed.

1. *High external protection and unlimited price support*: most grains, and milk until 1984. The classical variable levy system: farmers are guaranteed a minimum price for their product — the intervention price — with an unlimited marketing guarantee. Imports are only permitted if domestic market prices reach a much higher ceiling price — the target price. Variable levies are determined annually — or more frequently — and are set to increase the lowest offered import prices to the level of target prices (figure 1.3). Since domestic market prices tend to be below target prices, the variable levy system is a highly effective import barrier — more like an import ban than a tariff. A system of "stabilizers" introduced in 1998, reduces intervention prices when output exceeds a target (by the same percentage as excess production).

2. *High external protection and limited but guaranteed support*: sugar, milk since 1984. Operates like the classical variable levy system, but domestic support is limited by quotas given to individual producers. This limits overproduction and distortions in export markets — if quotas are adjusted to reflect domestic consumption. The quota system is only feasible for products where production limits can be easily checked, for example, at processing plants. The quota system also tends to freeze past production structures. Quotas could, in principle, be made tradable, mitigating some of the undesirable effects.

3. *External protection and limited optional domestic support*: meat, fruit, and vegetables. External protection operates

through variable levies (meat, except mutton) or tariffs (fruits and vegetables). Intervention agencies may purchase excess production and support domestic prices, but are not obliged to do so.

4. *Moderate external protection without domestic support*: processed products, eggs, and poultry. External protection through the variable levy system is set to compensate for the cost disadvantage resulting from high domestic grain prices. The objective is to set effective protection to zero, but temporary deviations have occurred due to technological change or exchange-rate fluctuations.

5. *No external protection, but production subsidies*: rapeseed, soybeans, tobacco, flax, hops, hemp, olive oil, and mutton. For these products, the European Community is precluded from imposing high trade barriers because tariffs are bound in the GATT. Support is provided through "deficiency payments" to increase producer revenues. This system is sometimes difficult to monitor and subject to abuse — for example, subsidized olive oil production has in some regions exceeded total production.

6. *Low external protection, with "decoupled" income support*. This is the proposed new common agricultural policy under the "McSharry Plan" to be introduced for most products in the 1993-94 crop year. Domestic prices are to be aligned gradually with world market prices. Income support is to be decoupled from current production, with production control measures through land set-aside requirements (see annex 1).

Source: Koester and Tangemann 1990.

**Table 1.10 Agricultural products' self-sufficiency (percent)**

	EC-9		EC-10	EC-12	
	1970	1980	1985	1985	1988
Cereals	86	103	118	110	113
Wheat	(91)	(118)	(132)	(124)	(123)
Vegetable oils and fats	23	31	-	56	70
Beef and veal	93	105	109	107	104
Vegetables	91	97	-	107	106
Fresh fruit	76	79	94	87	84
Sugar	91	136	128	123	124

Source: EC Commission, 1991b.

farms and higher productivity — reducing the costs of the CAP.

#### *Intervention costs*

The costs of intervention — storage and disposal at lower world market prices — is covered by the European Agricultural Guidance and Guarantee Fund (EAGGF). At the CAP's inception, variable levies were believed to be sufficient to finance the EAGGF. But the rapid rise of agricultural output has led to a reduction in imports and receipts from levies — and falling world market prices have raised the costs of the CAP, which is now financed by the general budget. The costs are about 0.6 percent of Community GDP, and agricultural spending by member states adds another 0.3 percent. Total budgetary spending on agriculture in the European Community is similar to that in the United States. Total transfers to farmers, however, including transfers from consumers because of high border protection, are higher than in the United States (table 1.11) and similar to Japan's (OECD 1991a). Compared with the small share of agriculture in employment (7 percent) and in GDP (3 percent), the total transfers to agriculture are very high — equivalent to 75 percent of the sectoral value added.

Protection of the agriculture sector is far from uniform and varies strongly with fluctuations in world market prices (figure 1.4). Protection is high for grains, oilseeds, sugar, beef, and most dairy products, but low or moderate for pork, poultry, eggs, and fruits and vegetables. The pattern of support is complex with a wide dispersion of effective protection for fairly close substitutes. Tariff equivalents of border protection and subsidies range, in the case of meat, from 6 percent for pork to 270 percent for mutton (table 1.12). The high protection afforded to feed grain has created a lucrative import market for animal feed substi-

tutes such as manioc or oil cake. The situation is further complicated by a large number of tariff rebates for some developing country suppliers (chapter 2).

A broad characterization of the effects of the agricultural sector can be given by comparing intra- with extra-EC imports (table 1.12). Overall, the share of extra-EC imports of agricultural products is lower than for manufactured goods,<sup>33</sup> but the difference is not as large as might have been expected, given the high level of protection and subsidies. In fruits and vegetables, sugar, tropical products, and animal foodstuffs, the share of extra-EC imports is similar to that of manufactured goods.<sup>34</sup> Despite various interventions (for example, minimum prices for some fruits and vegetables), the effect on trade flows does not seem large for agricultural products other than the staples: cereals, meats, and dairy products.

#### *Efforts to reform agricultural policy*

Recently, the Commission has tabled a fundamental reform proposal that would replace price supports with income supplements (annex 1). Income supplements would be paid largely in relation to (past) factor inputs — for example, flat per-hectare subsidies for cereals and oil crops, and headage payments with quantitative limits for meat and dairy products. The intent is to limit the decline of asset prices that would result from a shift to net income supports and lead to a large number of bankruptcies. Although this reform would use more of the budget at first, it would distort markets less than the present system, and would eventually cost less, as the mostly older farmers retire. Consumers would benefit immediately from reduced food prices.

Agricultural reform does not mean that Europe would become uncompetitive in agriculture and a major importer of food. Reform would primarily lead to larger farms, higher productivity, lower land prices, and more extensive cultivation practices, dramatically improving competitiveness

**Table 1.11 Agricultural subsidies, 1989 (percent of GDP)**

	Budgetary spending	Total transfers to producers
EC <sup>a</sup>	0.9	2.0
US	0.9	1.3
Japan	0.5	2.0

a. Including national expenditures.  
Source: OECD 1990.

**Table 1.12 EC agricultural protection and trade patterns, 1989  
(percent)**

<i>SITC code</i>	<i>Tariff-equivalent of protection and subsidies<sup>a</sup></i>	<i>Share of extra-EC imports in total imports (%)</i>	<i>Instruments of protection</i>
01 Meat	6-270	20	Variable levies
02 Dairy products	0-200	8	Variable levies
03 Fish	0-30	59	Tariffs
04 Cereals	20-130	17	Variable levies
05 Vegetables and fruit	0-30	40	Tariffs
06 Sugar	180	44	Variable levies
07 Coffee, tea, spices	0-18	67	Tariffs
08 Animal foodstuffs	0-50	59	Tariffs, variable levies
0 Food, total		35	

a. Producer subsidy equivalent as percent of border prices.  
Source: OECD 1991a; EC trade statistics.

compared with other temperate-zone producers. Current crop price supports are largely capitalized in agricultural land prices. Land owners, large and small, have benefited most, and stand to lose most from reforms. The decline of European

export surpluses, resulting from a shift away from price supports, is likely to raise world market prices for food in the medium term, but the continuing increase in agricultural productivity may lead again to a downward trend in the long term.

# 2

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## *The European Community's trade with the South*

EC integration has influenced imports from the South through three main forces: border measures, the EC system of trade preferences, and macroeconomic conditions in the European Community. Overall, this influence has been positive.<sup>35</sup> However, it has been outweighed by the influence of world market prices on exporters of primary commodities, mainly petroleum; and, above all, by domestic conditions and policies in the developing countries. The European Community's moderate barriers to imports of industrial goods have not prevented increased penetration of EC markets by developing country suppliers. Trade preferences have not produced export champions — or prevented the least-preferred suppliers from registering the greatest gains — but may have helped some new exporters enter EC markets. In temperate agricultural products, EC policies have protected domestic producers and disturbed world markets with subsidized exports.

Developing countries may derive three main lessons from trade with the European Community. First, given the moderate nature of trade restrictions, export success — except in agriculture — depends more on domestic conditions and policies than on changes in protection or on preferences in the European Community. Second, given moderate levels of protection, macroeconomic factors in the industrial countries — such as growth rates, exchange rates, and world commodity prices — influence their imports more than do changes in trade barriers. Third, EC integration and trade preferences have not detracted from multilateral trade liberalization.

### Trade patterns

The substantial increase in EC imports from the South in the past decade suggests that the European Community has been a relatively open market for the developing countries. In manufactures, the volume of EC imports from the South grew at twice the rate of intra-EC trade during 1980-90 — despite the image of "Fortress Europe" (table 2.1).<sup>36</sup> As a result, market penetration by the South has increased even in sensitive categories, such as garments and footwear. Meanwhile, EC imports of manufactures from other industrial countries (including free-trade partners from EFTA, the European Free Trade Association) grew somewhat less fast than intra-EC trade. In the primary sectors, imports from developing countries grew slower than did intra-EC trade, but faster than extra-EC trade with developed countries. This slower growth of primary imports is because of a combination of low income-elasticities, EC domestic oil discoveries, declining world prices, and — particularly in agriculture — protection. Compared with Japan and the U.S., the European Community lagged behind in import growth (table A2.1).

Although in recent years the United States has replaced the European Community as the most important market for developing countries, the European Community remains their second trading partner, buying about one-quarter of their exports. Import penetration from developing countries at the end of the 1980s was nearly identical in the European Community, Japan, and the U.S. —



**Table 2.1 Change in EC import volume, 1980-90**  
(percentage change in ten years)

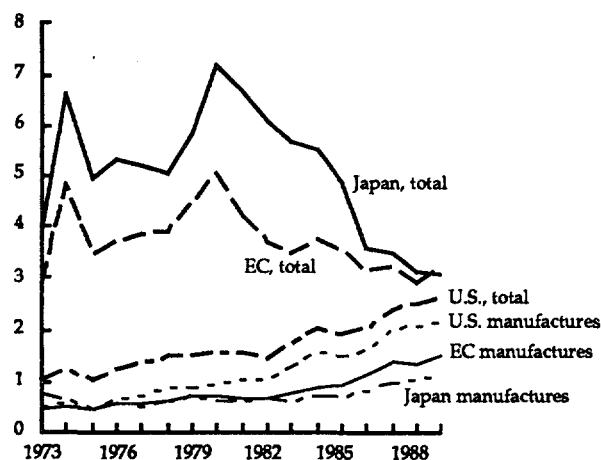
	Total	Food products	Fuels	Other raw materials	Manufactures
Intra-EC	+59	+60	+10	+50	+62
Extra-EC	+33	+22	-17	-7	+73
Industrial countries	+48	-11	+102	-16	+57
Developing countries	+11	+44	-34	+8	+139

Source: Eurostat 1991.

at about 3 percent of GDP (figure 2.1). Apart from differences in endowments the flows and ratios reflect structural and cyclical factors such as changes in exchange rates, commodity prices, and incomes. For example, manufactured imports from developing countries grew fastest in Japan in the 1980s, most likely because its economic growth was fastest.

The structure and overall value of developing-country exports to all three markets (the European Community, Japan, and the United States) has been sensitive to large swings in the prices of international commodities, particularly oil (table 2.2). Fuels accounted for a little more than one-third of EC imports from developing countries in 1970, rose to nearly two-thirds in 1980 (after two oil price rises), and dropped to about one-quarter by the end of the decade. Non-oil primary commodities accounted for nearly half of EC imports in 1970, but only about one-quarter in 1989. Although food export volume from developing countries to the European Community has grown vig-

**Figure 2.1 Import penetration by developing countries in major markets**  
(imports/GNP)



Source: UN COMTRADE, World Bank data.

orously in the 1980s — by 44 percent — the export receipts have improved much less (only by 24 percent in current U.S. dollars) because of falling commodity prices.<sup>37</sup> Manufactures have been the most dynamic component in EC imports from developing countries — more than doubling in volume during the 1980s. Manufactured goods accounted for only 15 percent of EC imports from developing countries as recently as 1980, but have increased to about 50 percent. Textiles and machinery each accounted for nearly one-third of the total.

Asian countries — especially the newly industrializing economies (NIEs)—Hong Kong, Korea, Singapore, and Taiwan (China)—and the four larger members of the Association of Southeast Asia Nations (Malaysia, Indonesia, the Philippines, and Thailand) (table 2.3) — were the most successful developing country exporters to the EC. The two groups account for more than half of all EC manufacturing imports from developing countries. The worst performance was by the ACP countries, which export mainly primary goods. The other preferential group — Mediterranean — performed relatively well in manufactured exports. But total export receipts were strongly influenced by oil prices. By and large, the most successful exporters also had the fastest overall economic growth.

#### The influence of macroeconomic conditions

Changes in EC macroeconomic conditions have influenced imports from the South more than have border measures. The large difference in growth rates of EC imports from the South between the two halves of the 1980s is a good illustration. In the second half of the decade, EC annual imports of manufactures from developing countries were ten times greater — 28 percent a year — compared with the first half, when they were 2.5 percent a year in nominal dollars (table 2.4). This

**Table 2.2 Commodity composition of imports from developing countries  
(percentage of total imports for each trade bloc)**

	EC-12			Japan	United States
	1973	1980	1989	1989	1989
<b>Manufactures</b>	16	15	48	37	65
Textiles and clothing	10	7	15	12	14
Machinery	2	3	14		
<b>Primary commodities</b>	84	85	52	63	35
Fuels	39	63	25	35	25
Food	12	5	7	2	5
Other	33	20	20	26	5
<b>Total</b>	100	100	100	100	100
(billions of dollars)	32	156	148	90	169

Source: UN COMTRADE database.

growth occurred despite the accession of three lower-income members, Greece, Portugal, and Spain. Over the decade the dollar first substantially appreciated compared with the ECU, the European currency unit, then later depreciated by similar amounts. In the second half of the decade the EC growth rate doubled as well. As there has been no radical change in EC trade policies the difference in import growth must be attributed to exchange-rate swings and other macroeconomic factors like growth — and not protectionism.

Sensitivity of trade flows to macroeconomic variables is also illustrated by the large differences in growth of EC and U.S. imports from developing countries in the two halves of the 1980s. In the first half of the decade, the appreciating dollar and

faster recovery from the 1980 recession made the United States an attractive market for exporters of manufactures. The reverse was true for the European Community. In the second half of the decade, faster growth and appreciating currencies in Europe (and Japan) provided rapidly growing markets for developing countries. Such large differences in performance underline the importance of macroeconomic conditions as determinants of trade flows in markets where the overall level of protection is moderate.

#### EC trade policy toward developing countries

Nevertheless, EC trade policies and instruments do play important roles influencing imports from

**Table 2.3 EC imports by origin**

	1973	1980	1989	Annual growth 1980-89 (percent)
	(percentage of extra-EC imports)			(current U.S. dollars)
<i>All exports</i>				
From developing countries	36	45	33	-0.6
ACP	7	7	3	-5.5
Mediterranean	5	6	6	3.7
NIEs	3	3	8	12.1
ASEAN four	2	2	2	6.7
From industrial countries	54	46	59	5.5
<i>Manufactures</i>				
From developing countries	14	18	25	13.2
ACP	1	1	1	6.6
Mediterranean	3	4	5	12.1
NIEs	6	8	12	13.5
ASEAN four	0	1	2	19.4
From industrial countries	78	76	70	7.7

NIE = Newly industrializing economy; ASEAN four = Indonesia, Malaysia, the Philippines, and Thailand.  
Source: UN COMTRADE database.

**Table 2.4 Macroeconomic conditions and trade flows  
(percentage of annual change)**

	1980-85	1985-90
Developing country exports		
Nonoil (current U.S. dollars) to:		
EC-12	-1.4	20.0
United States	12.9	14.6
Japan	2.7	25.2
Manufactures (current U.S. dollars) to:		
EC-12	2.5	28.5
United States	18.2	16.4
Japan	7.4	35.8
Memorandum:		
ECU/U.S. dollar rate	-7.4	7.8
Commodity prices (current U.S. dollars)	-5.8	4.5
GDP (constant U.S. dollars) <sup>a</sup>		
EC-12	1.5	3.1
United States	2.9	2.9
Japan	3.9	4.7

a. World Bank Commodity Price Index for 33 Commodities (source: table 1.2).  
Source: UN COMTRADE database, IMF: International Financial Statistics.

the South. Apart from temperate agricultural products, developing country exports face moderate overall protection in EC markets. Tariffs are low and nontariff barriers — mostly national — have been used selectively against the most competitive exporters, the NIEs. Yet imports from these grew fastest (table 2.3), suggesting that the barriers at most slowed down the NIEs' export growth, and redistributed some of their potential business to new exporters. Domestic conditions and policies in exporting countries have been more important than trade barriers in export success.

The main nontariff trade measures against developing country exports are national quantitative restrictions, VERs, surveillance measures, and antidumping investigations — all of which mostly affect manufactures. Sensitive sectors — textiles and agriculture — representing about one-third of EC imports from developing countries, are covered by EC-wide arrangements. In temperate agriculture, the CAP has shielded EC markets from foreign competition through variable levies for some products and has considerably protected the markets in many other goods.

The EC system of border protection is not without cost. Exports from the South would have grown more without the selective border measures. No doubt substantial sums have been transferred from EC consumers to EC producers and to exporters in the South. Structural change in the Economic Community has been delayed. Compe-

tion has been distorted by selective policies. Still — except in agriculture — the EC has been able to continue lowering its external trade barriers during its decades of integration and to fend off the worst demands for protection.

*National quantitative restrictions* are used selectively by a few EC members against the most competitive Asian exporters. Most measures are importer- and exporter-specific and cover a small share of Community imports from developing countries. The most frequent targets have been the Asian NIEs and China. Most measures have been applied by France and Italy. In addition, Portugal and Spain, and to some extent Greece — have retained a number of trade restraints as part of their transitional arrangements for joining the European Community. Most national measures should disappear after the completion of the single market program in 1993, because of the likely enforcement difficulties in a frontier-less European Community.

These measures are only a minor part of total tariff lines,<sup>38</sup> and their restrictiveness varies greatly. Enforcement of national restrictions in a customs union is difficult, unless intra-union trade can be restricted. The use of Article 115 restrictions on intra-EC transit of restricted third country exports thus is a good indicator of the restrictiveness of the national measures. The most frequent past users of this provision were France and Italy, mostly in textiles (to support MFA and other national quotas), but also in footwear, consumer electronics,

and some agricultural goods (bananas to support ACP preferences).

*Voluntary export restraints and surveillance measures* are also used — mostly against the Asian NIEs and China. Because many of these arrangements are informal, it is difficult to list or describe all of them. A recent GATT study identified some 30 VERs and surveillance measures in the European Community (table A2.2) against industrial goods from developing countries. Korea has been the main target. EC-wide VERs against developing countries exist in footwear (Korea and Taiwan (China)), textiles (six Mediterranean countries), and steel (Brazil). National VERs exist for umbrel-

las (Singapore, Taiwan (China), and Thailand), footwear (China and Taiwan [China]), and metal flatware (Korea). Surveillance measures are mostly EC-wide and concern textiles from small suppliers and some electronics products from Korea.

The nature of the measures makes it hard to discern any trend or their restrictiveness — but the most important restraints clearly are EC-wide. In steel, for example, the number of VERs against developing countries has declined. In footwear, the previously national quotas in France and Italy were replaced in 1990 by an EC-wide restraint until the end of 1992 (see box 2.1). The restrictiveness of the arrangements varies greatly. In prin-

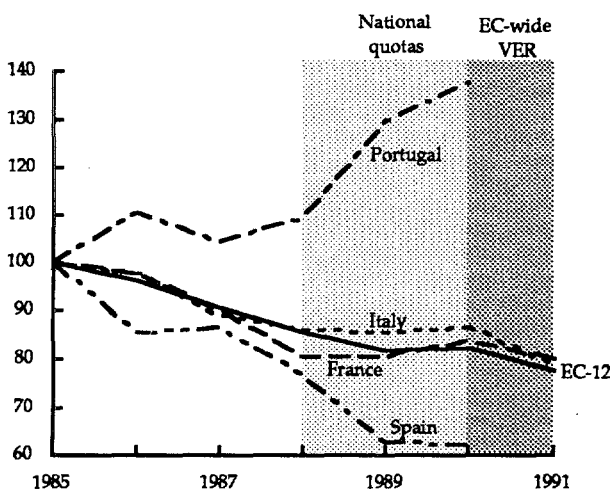
### Box 2.1 Protection and its effect on footwear imports

*Protection.* EC tariffs on footwear are moderate (average MFN 11.7 percent). Developing country exporters have been subject to various nontariff measures in the past decade. VERs and quotas are in place in Ireland, but cover a minimal share of total EC trade. The United Kingdom had VERs with Korea and Taiwan (China) since 1979, but has not officially renewed them in recent years. Portugal and Spain have global quotas for third countries until 1993. France maintains a quota with China on slippers. In 1988, France and Italy introduced quotas with Korea and Taiwan (China). Despite the decline in the volume of external imports since 1988, quotas for Korea and Taiwan (China) were replaced by an EC-wide VER in 1990. The EC quota allows a 6 percent yearly increase in import levels for the two sources from their 1987 levels.

*The market.* The industry is heterogeneous — with such items as slippers, sports shoes, high-fashion leather shoes, and limited product substitution. Developing countries in Asia export mainly plastics and rubber sports shoes in the lower price range, whereas EC producers are more specialized at the higher end of the market—leather shoes. From 1986 to 1988, imports from the two new members of the EC (Portugal and Spain) and developing countries increased substantially. The share of extra-EC imports in apparent consumption increased from 28 to 38 percent in 1986-88. Production in the EC-10 declined by about 10 percent, mostly in France and Italy (table A2.3). Some market disruption likely resulted from increased intra-EC competition from Portugal, although the disruption was blamed mainly on Korea and Taiwan-China.

*The effect.* Initially, the national quotas in France and Italy, reinforced by intra-EC transshipment restrictions, succeeded in stopping the growth of imports from developing countries. France and Italy's share in EC imports was stabilized. Among the exporters from outside the European Community, Korea has maintained its market share by upgrading to higher-value goods. Taiwan (China) is getting out of the market — which has helped growth in other Asian developing countries, especially China, Indonesia, and Thailand. The decline in production in France and Italy was halted temporarily in 1990. Portugal and Spain also have benefited, as their production and exports to the European Community have continued to increase. This has put an additional pressure on French and Italian producers. Despite the EC-wide VER for Korea and Taiwan (China), preliminary data for 1991 indicate a new surge of imports from extra-EC sources. Production in the European Community has also resumed its decline (-5 percent in 1991). The new surge in imports may increase pressure to extend the VER to new suppliers. Portugal and Spain also have to eliminate their quotas on imports from third countries by 1993. The experience thus far indicates that new EC-wide restrictions on the most competitive suppliers have not prevented increased market penetration by developing countries. Their main effect has been a more rapid shift to new suppliers.

EC production of footwear



ciple, VERs cannot be enforced by Article 115 restrictions (Winters 1991), but the exporting country may partially control transshipment. Surveillance measures are authorized by the Commission and only require import licenses (issued at national borders), but do not entail quantitative limits. VERs target exports of a few countries, affect only a small share of trade, and usually have only moderated export growth. In footwear, the two main targets — Korea and Taiwan (China) — accounted for only 12 percent of EC footwear imports in 1988. The effect of the national restrictions after 1988 was to slow growth from the restricted sources, but boost imports from other developing countries and from southern members of the European Community, such as Portugal. Initial data for 1991 suggest a further surge in footwear imports from developing countries despite EC-wide restraints since 1990.

Experience with the quotas and VERs reveals many of the difficulties in enforcing specific restrictions in a customs union. In textiles, the VERs on the Mediterranean countries have not prevented substantial increases in their exports to the EC (see below). Restrictions tend to raise prices to EC consumers, transferring parts of the rent to the exporting countries; shift some trade to other suppliers; and entice restricted exporters to offer higher-value goods. For example, Korean footwear exports have shifted to much-higher-value products.

Developing countries — mainly the Asian NIEs and China — increasingly have been the object of EC *antidumping* investigations (table 2.5). But the share of trade covered has been small. Cases initiated against developing countries nearly doubled between the two halves of the 1980s, although total cases initiated in the EC declined. This change coincides with a substantial increase in developing-country exports to the European Community. From 1986 to 1990, thirty-six cases were initiated against Asian NIEs — and eighteen against China (table A2.4). The products were mostly heavy-industry goods (steel, synthetic fibers, and chemi-

cals), and some consumer durables (video recorders). Brazil, with seven cases, Mexico (four), Turkey (fifteen), and Yugoslavia (fifteen) were also affected. Most recent data on antidumping investigations initiated against developing countries show no clear trend. From 1986 to 1990, new cases fluctuated from thirteen to thirty-five annually, and declined from thirty-five to ten from 1990 to 1991. Only 0.6 percent of all imports — and 1.2 percent of manufacturing imports — from developing countries were affected in 1989; 0.9 percent of the exports of the Asian NIEs to the European Community, and 0.6 percent of Turkey's. Yugoslavia (2 percent) had the highest incidence.

The domestic conditions in the South and EC antidumping practice make it relatively easy to initiate antidumping cases against developing countries. In accordance with the GATT, a determination of dumping requires proof of price discrimination between home and export markets, and injury to EC industry. As many developing countries have highly protected home markets, price discrimination between domestic and export markets can easily arise. Injury to an EC industry can be more difficult to prove, especially in the case of smaller suppliers. But recent EC cases have grouped suppliers of the same product, facilitating a finding of injury by firms from smaller countries. Many of the investigations involving developing countries have ended in price undertakings, which are less onerous for the affected exporters than the imposition of definite duties; price undertakings transfer the rent or margin to the exporter.<sup>39</sup>

#### *Trade policy in textiles and clothing*

Textiles and clothing industries illustrate the marked differences in comparative advantage and production structures within the European Community. The share of textiles and clothing in manufacturing varies from 4 percent in the Netherlands to about 30 percent in Portugal. This reflects the restructuring of the industry in the northern member states, where imports have made substantial

**Table 2.5 EC antidumping investigations in the 1980s against developing countries (number of cases)**

	Total 1980-85	Total 1986-90	1986	1987	1988	1989	1990	1991
All developing countries	61	112	13	22	25	18	35	10
All countries	244	149	24	39	40	27	43	20

Source: EC Commission 1991a.

inroads. It also reflects the still-substantial wage differentials in the Community — manufacturing wages in Portugal in 1990 were one-fifth of those in Germany.

Textile and clothing imports from developing countries face tariffs, which — while well above the EC average — are modest (the average MFN tariff is about 13 percent). Moreover few developing countries pay the full duties in textiles, and clothing suppliers from Africa, the Caribbean, and Pacific (ACP) and Mediterranean countries pay no duties. And other developing countries — under the general system of preferences — benefit from tariff rebates on part of their textile exports (table 2.6).<sup>40</sup> As a result, quota restrictions are the main instrument of protection. Twenty-one developing countries have been subject to bilateral arrangements under successive Multi-Fiber Arrangements (MFA) covering two-thirds of their textiles and clothing exports to the European Community in 1988. Taiwan (China) has a separate MFA-like agreement. In addition, six preferential suppliers (Cyprus, Egypt, Malta, Morocco, Tunisia, and Turkey) are subject to VERs covering four-fifths of their exports to the EC. Imports from all restricted suppliers (MFA and Mediterranean) accounted in 1989 for about 93 percent of textile and clothing imports from all developing countries.

The restrictiveness of the quantitative restraints varies substantially among exporters. MFA restrictions are not applied to Bangladesh or Uruguay, for example. Trade with some other MFA signatories — Colombia, Guatemala, Haiti, and Mexico — is governed by an “exchange of letters” stating that import licensing procedures could be initiated, if exports surge. But the number of products covered and quota growth are more restric-

tive on the more competitive suppliers (table 2.7). Korea faces the most constraints — in forty-one categories out of 123 MFA categories. China and Hong Kong have the lowest quota growth rates — less than one percent a year. The broad definition of categories allows the exporter to move to higher-value items — for example, from one-dollar to ten-dollar shirts. The impressive growth of imports from the Mediterranean suggests that the VERs are not applied restrictively to them.

Estimates of the restrictiveness of the quotas are subject to many caveats. Most existing studies rely on data from Hong Kong, one of the most restricted suppliers. Hamilton’s (1991) estimates of rents for the 1980s range around 15 percent, show high fluctuations over the years, and decline toward the end of the decade. The rents are bid down by the increasing variety of new competitors, and perhaps by a decline in Hong Kong’s comparative advantage as its wage and other costs rise. The rents are also highly sensitive to seasonal fluctuations, and to changes in fashion. A hot fashion item might fetch high rents early in the selling season. The Hong Kong market for quotas is also far from perfect<sup>41</sup> — actual quota transactions are small relative to total exports. The differences in quota coverage and allowed growth rates limit extrapolation of the estimates of the effect of restraints on Hong Kong to other suppliers.

Although the restraints have probably slowed market penetration by developing countries in the European Community, the extent is difficult to assess. Market penetration by developing countries in the Community has increased substantially in the past decade. With the restraints, the share of developing countries in EC imports of textiles and clothing increased from 22 percent in 1980 to 27 percent in 1989. Import penetration varies substantially among EC members, being highest in Germany and the smaller northern members. As markets become more saturated in the North, most future growth is likely to come from the less-open southern members of the European Community.

Switzerland provides an indication of the limits to market growth in high-income countries and the reliability of the data. Switzerland does not apply quantitative restrictions on textile imports from developing countries and imposes low tariffs (8 percent). Nevertheless, market penetration in textiles and clothing from developing countries is low compared with Germany, but is comparable to that in the Netherlands. About 71 percent

**Table 2.6 GSP benefits in textiles and clothing for selected suppliers in the European Community, 1987**

<i>Country supplier</i>	<i>Percentage of EC imports that are duty free</i>
Bangladesh <sup>a</sup>	19
China	10
Hong Kong	1
India	35
Korea	12
Malaysia	22
Nepal <sup>a</sup>	88
Thailand	25

a. Least developed.  
Source: UNCTAD 1991a.

**Table 2.7 Growth of EC imports of textiles and clothing**

<i>Suppliers</i>	<i>Quantitative limits (number of categories) 1991</i>	<i>Annual quota growth<sup>b</sup> 1986-90</i>	<i>Annual growth 1980-89 (percent) (current U.S. dollars)</i>	<i>Percentage of extra-EC imports 1989</i>
Developing countries			8.5	71
MFA-restricted	0-41 <sup>a</sup>	2.8	9.9	48
Hong Kong	28	1.2	4.8	9
China	23	0.8	19.5	6
India	13	3.0	8.6	5
Korea	41	2.6	6.3	5
Taiwan (China)	36	2.6	7.3	3
Thailand	14	3.8	18.7	3
Bangladesh	0	-	13.6	1
Mediterranean	0-31 <sup>a</sup>	-	12.7	20
Turkey	31	-	27.2	9
Yugoslavia	11	-	15.2	6
Morocco	4	-	19.3	3
Tunisia	2	-	10.4	3
ACP	0	-	6.5	3
Mauritius	0	-	18.0	1
Eastern Europe (MFA)	11-37 <sup>a</sup>	2-3	4.5	7
Industrial countries	0	-	4.7	22
Intra-EC	0	-	6.3	
Portugal	-	-	14.1	

a. Range of categories per country.  
b. Erzan and Holmes 1990; GATT 1991a.  
Source: UN COMTRADE database.

of Switzerland's garment imports come from neighboring EC countries. This may well reflect a taste for EC-made high-quality clothing. It may also reflect changes in origin — re-exports of imports by EC members — possibly after further processing and finishing. In either case, the fact that restriction-free Switzerland imports proportionately less from developing countries than does the European Community, indicates that the EC's restrictions are not very onerous. Within the EC, too, clothing imports into small countries are often indirect — with a change in origin. Also, exports in a number of small EC countries (Denmark, the Netherlands, and Portugal) are twice their domestic production — which hints at the importance of intra-EC transshipment. Import and market penetration figures have to be used with caution.

EC trade policies are likely to have contributed to a shift among developing country exporters. The tariff preference and the quota rent provide a comfortable margin — up to 30 percent — for ACP

and the Mediterranean countries, and some GSP beneficiaries. First, the most restricted suppliers — with low quota growth and a high number of restricted categories — like Hong Kong, Korea, and Taiwan (China), still rank high among the top suppliers. The growth of their exports to the European Community, however, has been only half the average of MFA countries. The value growth in their textile and clothing exports is likely to reflect upgrading either to unrestricted categories or higher-value products. *Second*, EC imports from some new suppliers have grown rapidly. Imports from China and Thailand grew at roughly 19 percent — twice the average rate for MFA-restricted countries. The most rapid growth was from the Mediterranean sources. Despite "voluntary" restraints, imports from Turkey grew fastest — by 27 percent per year — making it the second-largest exporter to the European Community. This suggests that the restrictions on the Mediterranean countries were applied loosely. Two small suppliers, Bangladesh, a GSP beneficiary, and

Mauritius, an ACP beneficiary, also became notable garment suppliers in the 1980s. Both have benefited from zero duties and freedom from quantitative restraints. The southern enlargement of the EC has not had a major effect on EC imports from developing countries. Portugal has increased its exports to other EC members less than have many restrained developing countries, and Spain is a marginal producer of textiles.

The shift in textile exports among developing countries also reflects changes in comparative advantage. As wage levels rise in the Asian NIEs, they lose competitiveness in low-skill labor-intensive goods. In 1990, manufacturing wages in Korea, Singapore, and Taiwan (China) equaled those in Czechoslovakia or Portugal. Wages in many of the new exporters (China, Indonesia, Malaysia, and Thailand) are much lower (table 2.8). This also explains the NIEs' "natural" upgrading of exports toward more sophisticated, skill-intensive goods like machinery. Furthermore, sharp differences in this sector's import growth between the two halves of the 1980s suggest that exchange-rate realignments — and changes in GDP growth — have been important determinants. Between 1980 and 1985, EC imports of textiles and clothing from developing countries declined by 7 percent in nominal dollar terms, but increased by 125 percent in the second half of the decade.

Inside the European Community, quantitative restrictions on imports of textiles and clothing may have delayed structural change, but not prevented it. Output of textiles has remained stable, while that of clothing has declined (figure 2.2). Many producers have shifted to outward processing in neighboring lower-cost countries in the Mediterranean and Eastern Europe.<sup>42</sup> In 1989, imports under special agreements that cover such outside processing accounted for 12 percent of EC imports of textile and clothing. Among developing-country exporters, the restrictions may have

accelerated structural change, moving production to new suppliers, but only to those with conditions and policies that enabled them to seize the opportunity.

#### Agriculture

The main tools of protection in agriculture are variable levies, other related quantity restraints (see chapter 1 and annex), and tariffs. Developing countries benefit from a number of special arrangements. In addition, the system of preferences facilitates their market access for some products. The resulting system of protection is complex. Its effect on developing country exports is analyzed in more detail below.

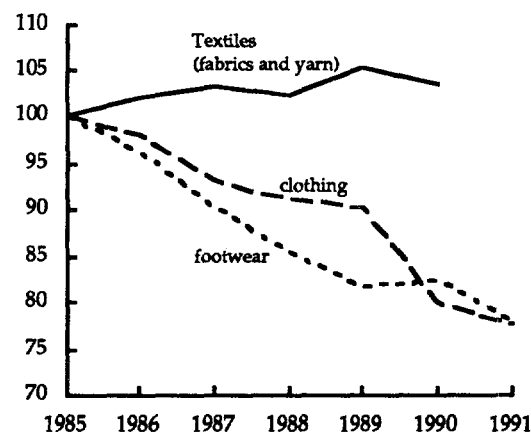
*Variable levies* are the most important and generally most restrictive instrument of the common agricultural policy.<sup>43</sup> Tariff equivalents can be 100 to 200 percent. Import penetration in products subject to variable levies is small, ranging from one to 18 percent of apparent consumption (table A2.5). Some developing countries have been granted preferences through reduced or zero levies for limited quantities. These vary by country and product and are specified in preferential trade agreements. For example, the tariff equivalent of variable levies is about 180 percent for beef and veal (1989). Five ACP countries get a reduction of the variable levy to 18 percent for fixed yearly quantities of exports.<sup>44</sup> Argentina, Brazil, and Uruguay have yearly quotas on high-quality beef at fixed tariffs of 20 percent. Sugar from thirteen ACP countries enters under special quotas (see the section on preferences, below).

**Table 2.8 Wage costs in manufacturing, 1990**

Country	\$ per hour
France, United States	15
Spain, United Kingdom	12
Czechoslovakia, Portugal	4
Korea, Singapore, Taiwan (China)	4
Hong Kong	3
China, Indonesia, Malaysia, Thailand	< 1

Source: *The Economist* 1992.

**Figure 2.2 Industrial production in sensitive sectors (EC-12), 1985-91 (1985=100)**



Source: Eurostat.



The European Community produces surpluses of some of the products protected by variable levies, and these are exported with the help of subsidies. These exports benefit developing country importers — through lower prices and, arguably, food aid — and harm other exporters by reducing their market shares and lowering world prices. Subsidies vary according to destination. In 1989, the export subsidy for wheat was about 30 percent and for beef about 43 percent of internal prices. As the Community is a major exporter of many subsidized products, losses to other exporters can be substantial. In 1989, EC exports of cereals were 13 percent of world exports; of beef, 28 percent of world exports.<sup>45</sup> Domestic agricultural production in developing countries may also have suffered in some cases from subsidized imports that distort prices.

Wine, some fish, and fruits and vegetables are protected through *seasonal or specific duties*, and some are also subject to (seasonal) minimum prices.<sup>46</sup> In addition, selected developing countries are subject to national quantitative restrictions on some items during the EC growing season (Davenport 1991).<sup>47</sup> The restrictions are not enforced with Article 115, are used selectively, and can be circumvented by transshipment. Developing countries with preferential agreements — ACP, Mediterranean — are entitled to some duty reductions but often within specified quantitative or seasonal limits. Some duty reductions are granted for only two weeks during the year. The GSP scheme provides duty reductions for a number of goods subject to country and product-specific limits. These measures have created a complex country and product-specific set of conditions of market access (for example, see box 2.2).

EC imports of fruits and vegetables — from a number of developing countries with varying degrees of preferences — grew moderately in the 1980s (table A2.6). Most growth was outside the EC growing season, when EC import restrictions seem to be effective. Intra-EC trade in fruits and vegetables grew faster in 1984-89 than extra-EC trade.

For products with *voluntary export restraints*, market access has been substantially restricted. VERs were introduced for some products because duties were bound in the GATT (tapioca, oil seed, and mutton). Argentina and Uruguay have been subject to VERs on mutton. A high quota rent compensates the exporters for the restrictions on market access. The implicit rent from the quotas

can be as high as 100 percent of world prices because imports are priced close to domestic prices in the European Community. Oilseeds have no quantitative import limits, but EC producers receive large subsidies (deficiency payments). Extra-EC imports of oilseeds rank second in total imports of agricultural goods. The implicit protection given has been estimated by the OECD as 185 percent of the EC price in 1990. Suppliers of substitute products for cereals, such as tapioca (Indonesia and Thailand) or sweet potatoes (China), have also been under VERs with yearly quotas.<sup>48</sup> These imports rank tenth in total agricultural imports and have grown little in the past decade. If EC grain prices are lowered in the context of the proposed reform of agricultural policies, these exports may be substantially reduced as EC consumers (animal farmers) shift to feed grains — particularly, if meat production also falls.

In products not subject to market organization — mostly tropical and other noncompeting agricultural goods — EC imports from developing countries are relatively restriction free. Such products total about 37 percent of current EC agricultural imports. Imports of these goods are affected more by low income-elasticities of demand (or excise taxes in some countries)<sup>49</sup> than by border protection.<sup>50</sup> Protection is generally limited to tariffs, bound in the GATT. Some of these products also benefit from GSP, ACP, or Mediterranean duty reductions. Very few products are restricted by national quantitative restrictions. Some tropical products — for example, bananas — are subject to preferential access quotas in some national markets, reflecting historical trade flows.<sup>51</sup>

The slow growth of extra-EC agricultural imports in 1980-90 compared with intra-EC trade — 22 percent in volume compared with 60 percent — suggests that the common agricultural policy provides substantial protection (see table 2.1). Most of the protection affects other producers of temperate agricultural staples, mainly the land-rich industrial economies. The volume and value of such exports to the European Community declined over the same period. Still, the widely differing growth rates for imported agricultural products suggest that import protection is only one factor influencing developing country export earnings for products not covered by variable levies (see table A2.7). A liberalization of EC trade policies in agriculture would have different effects for different types of developing countries. Food exporters in Latin America (Argentina and Uruguay, for

## Box 2.2 The EC market for fresh tomatoes

*Protection.* During the summer, tariffs are 18 percent and all imports must comply with EC reference (minimum) prices. Only Turkey has a preferential zero tariff. In the winter (November 1 to May 14) an 11 percent duty is in effect, and the Mediterranean and ACP suppliers benefit from reduced duties (4.4 percent for Maghreb and ACP, 0 percent for Turkey). There are no other restrictions, the reference prices apply during the first and last month of the winter season (see table). In some markets (Belgium and France) access is also restrained by national quantitative restrictions in summer. Recently some of the Mediterranean producers have obtained exemptions from the reference price system during the spring (when they are most competitive), in the form of quotas corresponding approximately to their off-season supplies, and enhanced tariff rebates.

*The market.* Most tomatoes consumed in the Community are grown locally. External imports account for only 6 percent of consumption, and 18 percent of production is sold to other EC countries (intratrade) mostly from the Benelux countries. Costs of (heated) greenhouse production are more than double of open-air production. During the

summer, producers benefit from (optional) intervention buying if producer prices fall below a certain threshold. The difference between reference and EC producer prices during summer (minimum import price/producer price) ranges from a low 70 percent in mid-summer to a high 200 percent in the early summer months.

*The effect.* In summer, the European Community does not import tomatoes. The Netherlands and Spain sell a small amount within the European Community. In spring (from April to mid-July), the reference prices are very high (100 to 200 percent of prices of greenhouse tomatoes). In April, for example, reference prices can increase the payable duty severalfold. The reference price helps to shield the European Community from outside suppliers when the suppliers are at their peak growing season. In winter, extra-EC imports are about 45 percent of total EC trade. Two preferential suppliers, the Canary Islands and Morocco, are the main sources of outside supply — providing 28 and 17 percent of the outside supply, respectively. Without the reference price system Morocco and other third country exporters could sell more during spring and summer.

(ECU/100 kg, 1991)	April	May	June	July	August	September	October	November	December
Reference price	196	136	100	42	42	45	47	47	47
Producer price (close to market price)	-	-	28	23	21	22	24	28	-

Source: EC Commission.

example) and Asia (Indonesia and Thailand) are likely to gain, but food importers are likely to lose because of the higher world market prices for cereals that likely would result from a reduction of subsidized surplus production in the European Community.

### The types of preferences

Preferential agreements between the European Community and developing countries can be divided into three types: the Lomé and Mediterranean Agreements, and the General System of Preferences (GSP) (see table A2.8).

The successive *Lomé Agreements* were negotiated to maintain and develop the traditional economic and commercial relations between EC member countries and now sixty-nine developing countries in Africa, Asia, the Caribbean, and Pacific. The agreements cover financial aid, technical cooperation, and specific nonreciprocal trade preferences. ACP exporters are granted unrestricted

and duty-free access to the EC market in industrial goods, including coal, steel, and textiles and clothing. ACP countries also benefit from reductions in duties on a number of agricultural products, sometimes combined with quantitative limits on preferential access (tariff quotas). In some highly protected commodities, some ACP countries have guaranteed quotas at EC internal prices. The fourth Lomé convention, signed in 1989, covers ten years.

The twelve *Mediterranean Agreements* of association or cooperation are an expression of the historical interests and present political sensitivities of some EC members — and also economic interests: in 1990 the Mediterranean absorbed twice as much in EC exports as Japan and nearly half as much as did the United States. Some also believe the agreements help prevent massive out-migration from less-developed neighbors. Under them, the EC grants duty- and restriction-free access for industrial goods. With each southern enlargement of the Community (adding Greece, Portugal, and Spain), the Mediterranean Agreements

have been updated to maintain preferential access and traditional trade flows. (In recent years textiles have been subject to voluntary export restraints, and some other products to antidumping investigations, especially those from Turkey and Yugoslavia. But these have not constrained export growth seriously.) Tariff reductions have also been granted for certain agricultural products. In agriculture the system of preferences is complex, with country and product-specific preferences limited to off-season periods, subject to seasonal tariffs and EC reference prices during summer. Following the southern enlargement of the European Community, these duties are being phased out for traditional quantities of exports to the European Community. In addition to these EC-wide restraints some member countries apply quantitative restrictions. The southern Mediterranean countries — Algeria, Egypt, Jordan, Lebanon, Morocco, Syria, and Tunisia — have no reciprocal obligations. For the more developed Mediterranean countries, the agreements provide for unrestricted duty-free access for industrial goods in the European Community, followed by gradual (asymmetric) dismantling of trade barriers by the partner, leading to a free-trade area (Israel, since 1989) or customs unions (Cyprus, Malta, and Turkey, by 1995-98).

The *General System of Preferences (GSP)* was introduced in 1971 in response to demands by developing countries for preferential access to help diversify their exports. The GSP involves some 40,000 bilateral and EC-wide tariff rebates. Renewed annually, it extends preferential trade treatment to some 146 developing countries and territories (not including Eastern Europe and Taiwan (China)). As the ACP and Mediterranean countries have more favorable access under their special agreements, the effective beneficiaries of the GSP system now are sixty-six developing countries in Asia and Latin America.<sup>52</sup> Benefits under the GSP scheme are temporary and nonbinding. As a general rule exports of covered manufactured products enter the EC duty-free. Nonsensitive industrial products are duty- and ceiling-free, as long as such imports do not lead to market disruption. Duties may be reintroduced against a beneficiary, if deliveries reach 6 percent of extra-EC imports. This provision has been invoked less frequently in recent years — and not at all in 1990.

Sensitive products — for example, some chemicals, tires, footwear, tableware, steel, and electron-

ics — are subject to country-specific limits on tariff rebates, differentiated according to import market shares in the European Community (6 percent or 2 percent of extra-EC imports). If limits are exceeded, duties are reimposed. In textiles, the duty-free limits are smaller and can only be applied to countries that have signed the MFA. The GSP scheme also applies to agricultural products, but benefits are more limited.

Since the mid-1980s the GSP system has been subject to substantial differentiation among the beneficiaries. Although benefits for the most competitive suppliers are being limited, the eight non-ACP least-developed countries and four Andean countries receive more generous benefits — tariff rebates without quantitative limits.<sup>53</sup> The GSP system was extended to Albania, five former Yugoslav republics, and the Baltic countries — Estonia, Latvia, and Lithuania. And six Central American countries are granted duty-free access in some agricultural goods.<sup>54</sup> These changes have made the system more complex and have caused discontent among traditional developing country beneficiaries.

#### The effects of the preferences on trade

The overall success of EC preferential trade policies in launching self-sustaining exporters has been modest. As a group, the most-preferred — ACP — countries were the worst-performing developing country exporters. Annual growth rates of manufactured exports of the ACP countries were about one-third of the second-least-preferred group, the four ASEAN countries (table 2.3). In a world where trade barriers are low, preferential access does not mean much — as illustrated by the widely diverging performances within groups: North and South Korea (NIE), Madagascar and Mauritius (ACP), and Algeria and Morocco (Mediterranean).

First, the value of preferences to one country depends on the level of protection against other countries. In many cases, the actual preferential margin amounts to a few percentage points' reduction from already-low MFN tariffs, which average 5 percent. A large share of EC imports — 38 percent — face no tariffs. Although tariffs applied to all imports were about 2.5 percent, they were 1.9 percent for the Mediterranean countries and about 2.1 percent for GSP beneficiaries. It has sometimes been alleged that trade preferences reduce the interest of developing countries in multilateral

trade liberalization. However, in sensitive sectors, like textiles and agriculture, benefits can be more important. In textiles and clothing MFN tariffs average around 13 percent and quota rents can be up to 15 percent. Due to preferences, tariffs applied to clothing were reduced from the statutory 13 percent to 9 percent for GSP beneficiaries, and to zero for other preferential groups. Such small margins are unlikely to distract countries from attempting serious policy reform or multilateral trade liberalization. This is also evident from the active participation in the Uruguay Round by many developing countries that have undertaken policy reforms in recent years (for example, Argentina, Korea, Morocco, Turkey, and ASEAN members).

The large number of beneficiaries further erodes the value of preferences. Sixty-nine ACP and twelve Mediterranean beneficiaries — and the EFTA countries — now face zero industrial tariffs in the European Community. The GSP covers sixty-six developing countries. In fruits and vegetables, Morocco and Turkey compete with Israel with similar preferences. In textiles and clothing, Bangladesh and Mauritius compete with Morocco, Tunisia, and Turkey, with nearly similar preferences. The value of preferences is further reduced by quantitative restrictions on preferential imports. This is true especially in agriculture. The GSP scheme is a good example of administrative complexities limiting the value of preferences. The scheme is “general” only in terms of country coverage. Benefits are subject to a complex system of yearly quantitative limits, safeguard provisions, and rules of origin — and correlate inversely with the beneficiary’s competitiveness and level of development, and the sensitivity of the product in the EC markets (table 2.9).

Administrative complexities add uncertainty to some benefits. GSP benefits are granted unilaterally and are subject to yearly revisions.<sup>55</sup> Exporters often do not know whether they will get benefits, because some quotas are exhausted on the first days of the year. In some product groups, getting the benefits is more like a windfall. Such uncertain and — in any case — low preferential margins are unlikely to influence investment decisions on their own. But beneficiaries will apply for them as long as the value of doing so outweighs the cost.

Second, given the limited expected value of benefits, domestic supply conditions, which are in large part policy-determined, are the most important determinant in developing exports. A margin of a few percentage points does little to compensate for the overvalued exchange rates, wrong incentives, anti-export bias from high import barriers, inefficiencies from poor infrastructure, public service monopolies, underdeveloped transport networks, and so on that hinder export development in many developing countries. Despite limited preferences and targeted import restrictions, the four Asian NIEs’ share in EC imports of manufactures rose most, from 6 to 12 percent between 1973 and 1989 (table 2.3). ACP countries, which get the highest preferences, have lost market shares both in manufactures — now barely 1 percent — and in primary commodities. Their exports are still dominated by oil (51 percent), diamonds, coffee, cocoa, and copper, with manufactures accounting for only 15 percent in 1989.

Despite ceiling limitations, GSP benefits are used mostly by the most advanced developing countries, particularly in manufactures. The most important beneficiaries have been Asian and Latin American countries. Brazil, China, Hong Kong,

**Table 2.9 Imports benefiting from the GSP, 1987 (percent)**

	<i>Covered by GSP</i>	<i>Received the benefits</i>
Agriculture	41	23
Non-ACP least-developed countries <sup>a</sup>	88	66
Main suppliers	41	23
Industry	49	17
Least-developed countries	67	42
Main suppliers <sup>b</sup>	88	24

a. Non-ACP least-developed countries: Afghanistan, Bangladesh, Bhutan, Laos, Maldives, Myanmar, Nepal, and Yemen.

b. By order of importance in 1987: Korea, Hong Kong, China, Brazil, India, Singapore, Romania, Thailand, Malaysia, Saudi Arabia, Indonesia, Philippines, Kuwait, and Pakistan.

Source: UNCTAD 1991a.

India, Indonesia, Kuwait, Malaysia, Romania, Singapore, and Thailand accounted for 70 percent of the benefits in 1988. In agriculture, despite important preferences, exports from the ACP countries are small and benefits underused. Examples are numerous. ACP countries with preferential quotas that reduce tariffs on beef and veal by 90 percent (for example, Botswana, Madagascar, and Zimbabwe) are not using them fully.<sup>56</sup> Rice or sorghum exports are also well below preferential tariff-quotas.<sup>57</sup> Thailand is the main supplier of manioc (tapioca), although it is a major crop in many ACP countries. For several green vegetables and some fruits in which many developing countries have a natural comparative advantage, ACP countries are exempt — without seasonal restrictions — from tariffs that range up to 20 percent in the European Community. Yet Thailand is the main fruit supplier, and Brazil, Chile, and China have all more than doubled their exports from 1984 to 1989 (in nominal dollar terms) despite lower preferences and the longer distance. Export growth rate from the largest ACP supplier in fruits and vegetables — Côte d'Ivoire — was merely 13 percent. Other ACP countries have done even less well (table A2.6.) — although some — Cameroon and Ghana — benefit from climatic conditions similar to those of Côte d'Ivoire. Chile's per capita exports of both fish and fruits and vegetables (\$25) are higher than Morocco's, and much higher than Turkey's — despite much lower preferences and the long distance. The Chilean exports were also much higher than Argentina's (table A2.9).

*Third*, although EC preferences that allow access to highly protected markets may be small from the EC's point of view, they can be very valuable to the exporters in the few countries concerned — for example, for selected sugar and banana exporters. The preference margin coupled with quota-guaranteed market access works like an export subsidy and transfers fiscal revenue (or consumer surplus) to the exporting developing country in higher prices. In 1989 the quota rents were about 40 percent for sugar and 52 percent for bananas compared with cif prices of other exporters. EC consumers transferred more than \$340 million to the few ACP beneficiaries. In St. Lucia and St. Vincent and the Grenadines, the banana rent exceeded \$200 per capita. Even Mauritius still receives \$70 per capita from the European Community as sugar rent (box 2.3). These are high multiples of the direct financial aid received by all

but a handful of developing countries. Although in Mauritius this bounty has cushioned the effects of adjustment and diversification efforts, and facilitated their success, adjustment and diversification have not been undertaken elsewhere — and adjustment to the loss of preferences, as EC trade is liberalized, will be difficult.

*Fourth*, preferential access for some countries combined with restrictions on the most competitive suppliers have nevertheless contributed to export successes of countries which did have favorable domestic conditions. The importance of domestic policies is well illustrated by the countries with similar preferences and natural conditions but strikingly differing export performances. For one, Morocco has developed into a significant exporter of garments and fruits and vegetables, but Algeria and Egypt have not. In textiles and clothing, Turkey (27 percent annual growth rate of its exports to the European Community) and Morocco (19 percent) implemented domestic structural reforms that have allowed them to benefit from Mediterranean preferences. Both countries also have benefited from extra quotas under outward-processing agreements.

Preferences may have helped Bangladesh and Mauritius to become noteworthy exporters of textiles and clothing. Bangladesh has increased textiles and clothing exports from \$63 million in 1980 to about \$330 million in 1990. The tariff advantage in many products and exemption from quotas are likely to have helped market access. In Mauritius, income from preferential sugar quotas was invested in infrastructure and the garment sector. Foreign investment was attracted by a stable macroeconomic environment and low labor costs, but also, in well-documented cases, by preferential market access to the European Community. The country is now an exporter of up-market clothing to the European Community — and has diversified from its initial market, the United Kingdom, to France and Germany. Recently, Zimbabwe and other African countries have started to increase small amounts of textile exports to the European Community (see McQueen and Stevens 1989). The destination of exports also hints at the value of preferences. Nearly 80 percent of textile and clothing exports from the Mediterranean countries and Mauritius are directed toward the EC, sharply higher shares than for Thailand (47 percent) and Bangladesh (37 percent). But in restriction-free Switzerland less than 2 percent of all imports of textiles and clothing are from Mediterranean

### Box 2.3 EC sugar and banana bonanzas

In bananas, intra-EC trade restrictions protect market access to France, Italy, Spain, and the United Kingdom for bananas from former colonies or overseas territories, and prevent exports and production by more competitive suppliers. The corresponding consumer transfer to ACP countries was \$137 million in 1989 or 50 to 88 percent of world prices. In some beneficiary countries, the rent amounts to more than \$200 per capita. The transfer is even more substantial for EC territories (about \$250 million): the Canary Islands alone receive a higher transfer than do all ACP countries together.

The banana rent received by the 1.5 million Canarians is equal to one-third of regional aid received by the 40 million Spaniards from the European Community.

Imports of sugar under the common agricultural policy are mostly allocated to 13 ACP countries with quotas at high internal prices. In 1989, quota rents were up to 44 percent of world prices and transferred over \$206 million to the selected beneficiaries. In Mauritius, the largest beneficiary, this amounted to over \$70 per capita.

	Share of EC imports (%)	Quota protection <sup>a</sup> (percent)	Quota rent (US\$)	
			millions	per capita
<i>Bananas</i>				
Protected main suppliers				
ACP	18	52	137	n.a.
St. Lucia	4	75	42	283
Jamaica	1	27	5	2
Côte d'Ivoire	3	55	23	2
EC territories	23	n.a.	n.a.	n.a.
Canary Islands	11	88	143	102
Martinique	7	52	50	149
Other	59	0	0	0
<i>Sugar<sup>b</sup></i>				
Protected main suppliers				
ACP	78	38	206	n.a.
Mauritius	25	44	78	71
Fiji	10	41	29	38
Jamaica	7	41	22	7

a. Protected / nonprotected unit import price.

b. Raw cane sugar CCCN 170111.

Source: Eurostat, OBCD 1990.

Banana quotas have become an important transfer in the European Community. Direct regional aid would be more equitable and efficient. In most of the beneficiary developing countries the quota rents have only helped to maintain monocultures and created lobbies in defense of the existing

bonanzas against multilateral liberalization. Only in Mauritius have the sugar millions contributed to diversification. But there, the current per capita income of nearly \$2,000 hardly justifies such special aid.

sources, no doubt partly because those countries are outsold by the most efficient suppliers — the NIEs.

Exports that have survived only because of preferences — like the preferred banana and sugar exports — would probably not survive in a fully

competitive environment. In other cases, garment producers in Bangladesh, Mauritius, or Morocco would most likely be able to survive without the preferences; but preferences may have given an essential boost to nascent exports — and even now help profitability and growth rates.

# 3

## *The single European market*

The single European market—"1992"—project, adopted in 1985, is the first major effort to relaunch economic and political integration in Europe since the enlargement of the Community from six to nine members in the early 1970s. The project is implementing liberalization and deregulation measures simultaneously in twelve countries—and soon, partly, in seven EFTA countries. Assuming that the Community remains open to external trade, and depending partly on the trade policies of developing countries, European integration should benefit most of those countries somewhat. A modest, but positive increase in trade is likely. These improvements in trade should be reinforced by the Uruguay Round of trade talks, if it is concluded successfully.

The project includes measures taken for granted in most national markets (for example, public procurement and uniform health standards), deregulation measures that have been introduced elsewhere in the past ten or fifteen years (for example, airline and trucking deregulation), and measures that have not yet been introduced in some other large national markets (for example, interstate banking, electronic payment standards, and rules on government subsidies to industry). The technique to facilitate the removal of all kinds of regulatory barriers is also pathbreaking, and later could be adopted multilaterally: instead of trying to agree on common regulations in minute detail, the single market project relies mainly on mutual recognition of national standards, with EC-wide regulations and standards limited to features needed to ensure fair competition.

To the surprise of skeptics, the single market project is well on its way to completion by the deadline, the end of 1992. It is not so important that all 300 measures proposed originally by the Commission be enacted. Far more important is the earlier shift to majority voting that has enabled the EC Council to adopt far-reaching changes in many fields, including most of the original 300 measures and pathbreaking agreements in areas such as agricultural policy, monetary union, and social and environmental policy.<sup>59</sup>

Even if all measures are enacted on time, the European Community will not suddenly become, on January 1, 1993, a homogeneous market. But very substantial progress will have been made toward this goal, which will then have to be put into practice through investment decisions, marketing strategies, administrative enforcement, and court decisions to clarify and strengthen the market's functioning. Language barriers will, of course, remain and intra-Community labor mobility will — for language and cultural reasons — remain more limited than within member countries, even if all legal obstacles are removed.

### **The single market project**

To ensure the achievement of the original goal of a truly common market, the Commission, under the leadership of Jacques Delors, replicated some of the techniques that helped ensure completion of the customs union in the 1960s. First, the Commission got the Heads of State — in the White Paper proposals — to commit themselves to a

simple goal, the completion of the internal market. Second, it got them to agree to a deadline, the end of 1992. Third, it obtained approval of a detailed program with a timetable for the introduction of some 300 legal acts, phased over seven years. Fourth, the Commission refused to assign priorities to individual measures, to avoid political discussions on the scope of the program. Fifth, it stayed clear of all controversial issues that might derail the single market program, such as reform of the common agricultural policy, divisive budgetary issues, monetary union, or a further transfer of sovereignty to the Community. Last, the White Paper was also silent on the effects of the single market on other trade partners. In this way, the single market program was presented as a purely commercial issue to which all member governments could agree relatively easily.

The White Paper grouped the required measures under three headings: physical, technical, and fiscal barriers. The most obvious barriers are physical, notably the remaining customs controls at internal borders. But technical barriers are economically far more important. The issues in this category ranged from diverging technical standards that impede trade in some goods, to public procurement, restraints on capital movements, and restrictive regulation of transport and other service sectors. Fiscal barriers are mainly the excise and value-added tax regimes — the main rationale for retaining controls at intra-EC borders.

The threefold classification of the single market program into elimination of physical, technical, and fiscal barriers is easily understandable to the layman, but does not satisfy the economist. In particular, many different things are thrown into the category “technical barriers.” An economic classification would use the markets — or “four freedoms” — and four types of market integration measures, ranked according to the extent of required government intervention (table 3.1). Market access is a first — necessary but not sufficient — category. Competitive-condition measures are to be adopted to prevent distortions in competition that could arise from national government interventions or restrictive business practices. Market-functioning measures are needed in some sectors to avoid market failures that would occur if trade were left to private initiative alone. For the regulated sectors, integration necessitates deregulation or a common regulatory policy.

Broadly, the Commission has given strong priority to market-access measures, eradicating bor-

der controls across all four markets. Flanking measures have been selected pragmatically, based on perceived gaps in the common market. Most of the 300 legislative measures are technical and food health standards, but the number of proposed directives is not related to the likely importance of different measures. The seven directives on public procurement, for example, would have far more effect than the eighty-one directives on animal and plant health standards.

The single market project will not eliminate all trade barriers among member countries. Rather, the intent is to achieve the same degree of market integration among the twelve members that characterizes transactions in each national market. The distinction between national markets and the “common” EC market is to disappear. The achievement of a single market requires a combination of dismantling of barriers to trade with the approximation of national policy measures and occasional adoption of common rules that may be administered centrally or by national administrations. Complete implementation of the White Paper would eliminate some barriers that have never been fully removed among the Canadian provinces, the Swiss cantons, or the United States (see Pelkmans and Vanheukelen 1988). In some respects, however, post-1992 Europe will remain less integrated, particularly with respect to a single currency, fiscal policy, and a federal political system — as typified by the different languages, tastes, and customs.<sup>60</sup>

The internal gains of the 1992 project are expected to be quite substantial (box 3.1). Most of the gains are expected to result from the removal of technical barriers in industry, the opening of national public procurement markets to EC-wide competition (particularly for high-technology goods, such as communications equipment), and further opening of national markets in highly regulated service industries (finance and insurance, trucking, air transport, and so on).

#### *Merchandise trade*

Border controls continue to exist because of the technical and fiscal divisions between member states, and residual national trade restrictions affecting third country exporters. The Commission focused on the complete removal of border controls because they are so visible and because their elimination in the transit of goods would make other economic barriers by member states more difficult. Eliminating physical barriers reinforces the implementation of a common commercial



**Table 3.1 Economic classification of the single market proposals**

<i>Measures</i>	<i>Goods</i>	<i>Services</i>	<i>Labor</i>	<i>Capital</i>
Market access	Abolition of intra-EC frontier controls	Dismantling trucking quotas	Abolition of intra-EC frontier controls	Abolition of exchange controls
	Approximation of: - technical regulations - VAT rates and excises - food health standards	Access to interregional air travel markets	Relaxation of residency requirements	Admission of securities listed in other member states
	Implications for trade policy (unspecified)	Mutual recognition and home-country control in financial services	Right of establishment for professionals	Industrial cooperation
Competitive conditions	Liberalization of public procurement	Increased competition in air transport	European "vocational training card"	Harmonization of takeover and holding regulations
	Merger control	Approximation of fiscal and regulatory aspects in service markets		Fiscal approximation of parent-subsidiary relations
	Review of state aid to industry			
Market functioning	Research programs in telecommunications and information technology	Approximation of banking and insurance regulations	Approximation of training programs	European company statute
	Proposals on standards, trade marks, company law, and so on	EC system of permits for road haulage	Mutual recognition of diplomas (especially for professionals)	Harmonization of intellectual property rights
		EC standard for electronic payments		Common bankruptcy provisions
Sectoral policy	Agriculture: elimination of monetary compensation amounts (MCAs)	Common air transport policy on access, capacity, and prices	Maastricht Treaty	Maastricht Treaty
	Steel: subsidy reduction	Common rules on mass risk insurance		

*Source:* Based on Pelkmans and Winters 1988.

policy by making most national interventions unenforceable. Other border controls — road safety, public security, drug control, and immigration — are to be moved inland or replaced with other measures, such as police cooperation, to remove all temptations to reestablish border controls. The White Paper did not take a position on whether national restrictions should be phased out entirely or replaced by EC-wide restrictions. But because each member country's residual restrictions differ and a small minority of liberally minded member governments (in two large countries and one small country) can block new protection measures, the cards have been stacked in favor of liberalization. The obvious implication of the elimination of border controls is that the technical and fiscal divisions also need to be eliminated or, at least, sharply reduced.

For technical barriers, a new strategy has been adopted. The Commission's approach had been to

fully harmonize national technical standards by issuing new, detailed EC standards instead of national standards. Under the EEC Treaty, harmonization of technical standards required unanimous decisions in the Council. This process was slow and painful, and had ground to a halt by the late 1970s. The 1979 Cassis de Dijon decision of the European Court of Justice prompted a new approach: mutual recognition.<sup>61</sup> The principle is that, once a product has been lawfully manufactured or distributed in one member country, other member countries must accept it. Common EC standards are to be limited to a few fundamental issues — health, safety, the environment, and essential inter-operability (such as for telecommunications equipment). EC standards will also include less detail, leaving the details to national or European industry associations and standard bodies. The Single European Act extended qualified majority voting to technical harmonization issues, making

### Box 3.1 Internal market barriers and their costs

After the elimination of customs duties and most quantitative restrictions in intra-EC trade in the 1960s, market barriers were at first thought to be low, limited to the inevitable delays at borders and the paper work needed to meet different national requirements and standards. But gradually it was realized that the transaction costs resulting from a fragmented market are far larger — as available economies of scale were not exploited, and competition remained stifled, with a few firms controlling national markets in many sectors. The costs of market fragmentation have risen as economies of scale have become more predominant, not only in manufacturing, but increasingly in services as well. One indicator of poor market integration is the dispersion of prices across the European Community. For example, automobile manufacturers are adjusting their prices to the strength of the local competition. Price differentials have not eroded, as different national requirements (car standards, certification) and uncompetitive practices by manufacturers (warranty restrictions, exclusive dealerships) have made parallel importing difficult and costly.

To shed some light on the likely economic effects of the 1992 program, the Commission initiated a study in 1987 (the Cecchini Report). The total economic gains from full implementation of the 1992 program have been estimated at around 5 to 6 percent of Community GDP (table). The benefits of removing physical trade barriers at the borders are only a small part of this 0.2 percent of GDP. Far more important are the effects of removing subtle technical barriers in manufacturing, construction, road and air transport, financial and business services, and so on. Sixty percent of the total benefits are estimated to accrue in industry and 40 percent in services. About half the gains in industry are expected in four subsectors: chemicals, mechanical engineering, electrical goods, and motor vehicles,

where economies of scale are particularly important and competitive behavior far from ideal. This estimate does not include the dynamic effects resulting, for example, from more rapid innovation and higher investment stimulated by the 1992 program (Baldwin 1989). These figures are far larger than estimates of EC welfare gains from trade liberalization under the main GATT trade liberalization rounds, estimated at around 0.1 percent of GDP for the reductions in tariff and nontariff barriers agreed to in the Tokyo Round (Baldwin 1984). The Cecchini study, prepared under the general direction of Paolo Cecchini, was first published in *European Economy*, No. 35, 1988, and published, in book form, as Emerson 1988. A shorter version was published in Cecchini 1988.

**Quantifiable welfare gains of the 1992 program**  
(billions of ECUs, 1985 prices, percentage of EC GDP)

	Billions of ECUs	Percentage of Community GDP
Costs of barriers affecting trade only	8	0.2
Costs of barriers affecting all production	57	2.0
Industry	24	0.8
Services	33	1.1
Economies of scale from restructuring	60	2.0
Industry	49	1.7
Services	10	0.3
Competition effects	46	1.6
Industry	46	1.6
<b>Total</b>	<b>171</b>	<b>5.8</b>

Source: Emerson and others 1988, tables 10.1.1 and A.8.

it far easier to adopt EC standards, where they are still needed. The most difficult item was perhaps the adoption of the last three standards required for EC-wide automobile type approval, which was held up by differences of view about access of Japanese automobile producers to the EC market (see below). A system of notification of national technical regulations has been introduced giving the Commission an opportunity to comment on, and postpone adoption of, proposed national standards to prevent the emergence of new trade barriers through national technical standards.

Public procurement is another major source of market fragmentation and lagging competitiveness of European firms — particularly in high-technology sectors, such as telecommunications and information technologies. National public procurement was previously exempted from EC

rules in four sectors: energy, telecommunications, transportation, and water supply. These sectors account for a large share of public investment. Even in the sectors subject to EC-wide procurement, few awards — 2 percent — have been made to nonnational suppliers. The single market project will open these four sectors to EC-wide procurement, and include additional measures to facilitate cross-border participation in public procurement. The Commission will monitor and enforce EC-wide public procurement at all government levels.

Fiscal checks feature prominently among the functions carried out at the Community's internal frontiers. Removal of border controls thus requires reducing the excessive differences in tax regimes that give rise to the controls. Experience in other large federal states has shown, however,

that total harmonization of the tax system is not needed to hold economic distortions to an acceptable level. The approach proposed by the Commission entailed approximation of indirect — excise and value added — taxes with similar, but not identical, scope and rates, and establishment of a clearinghouse to divide VAT receipts. Under the new value added tax regime, VAT rebating will apply only to extra-EC exports, with all intra-EC trade handled in the same way as in domestic trade.<sup>62</sup> Because VAT regimes are not identical, this will also involve settlement of tax receipts among national tax administrations on the basis of the destination principle to avoid a shifting of tax revenues among member countries.<sup>63</sup>

#### *Trade in services*

Deregulation of services is another important element in the program to reduce technical barriers. National regulations impede EC-wide competition in service sectors, including the airline industry, communications, financial services, trucking, and sea and inland water transport. The result is limited competition, low productivity, and high prices. The 1992 project opens these sectors to EC-wide competition by the elimination of entry restrictions, deregulation of pricing, and — for safety and prudential standards — mutual recognition of regulatory and supervisory procedures, based on home-country control, with EC-wide harmonization limited to essential elements.

Despite the provision for unrestricted intra-EC trade in services in the EEC Treaty, progress in liberalizing trade in services has been much slower than the progress on free movement of goods. Regulatory restrictions have been particularly long-lasting in transport, banking, and insurance. Most of these restrictions have been justified by safety and prudential concerns. Opening these markets requires the adoption of EC-wide minimum standards, for example, for capital adequacy for financial institutions, accounting and disclosure requirements, bankruptcy regulations, and safety features for trucks. It also requires harmonization of indirect tax regimes — for example, road-user charges for trucking — or free access could lead to distorted competition and pressure to introduce new restrictions to assure fairness.

#### *Personal and labor mobility*

Although the principle of intra-EC mobility of labor has been established, it is not yet fully achieved in practice. EC travelers still must show

identification papers at border crossings. Labor mobility is unrestricted for employees, but self-employed people and members of regulated professions still face hurdles in practicing in other member states. The Commission proposed to eliminate all controls of people at internal borders. This would have required full harmonization of visa, asylum, and residency requirements for nationals of third countries, and the approximation of firearms and drugs legislation. This proposal — the approval of which required a unanimous vote — did not prove politically feasible. Only the Benelux countries, France, Germany, Italy, Portugal, and Spain have agreed to eliminate all border controls from 1993 on. Denmark, Greece, Ireland, and the United Kingdom will maintain passport controls for non-EC citizens. More progress has been achieved in removing regulatory hurdles for the regulated professions — as exemplified by mutual recognition of vocational training certificates and professional education and training, including the health professions.

#### *Capital flows*

Complete liberalization of capital flows was achieved for eight member countries by the end of 1990. The remaining four — Greece, Ireland, Portugal, and Spain — are to eliminate remaining controls by the end of 1992. The liberalization of capital flows is to be further enhanced by harmonizing company legislation, including merger and bankruptcy provisions, and common provisions for intellectual property rights.

#### **Implementation of the single market program**

The most important step in the implementation of the single market program was the *Single European Act's* taking effect in 1987 — extending qualified majority voting in the Council to include all single market issues, except fiscal issues, worker rights, and personal mobility. A second important milestone in the implementation of the 1992 program was the doubling of regional aid funds for the poorer members — to 28 percent of the EC budget in 1992 — agreed upon in 1988, which made it easier to obtain their approval of internal and external liberalization measures.<sup>64</sup> Implementation of the single market program is broadly on track, but not exactly on the Commission's ambitious timetable (box 3.2). Many important measures will not take effect until 1993.

The private sector has strongly supported the

single market program and has reacted with new vigor to the opportunities created. From 1984 to 1988, direct foreign investment flows within the EC more than quadrupled to ECU 19 billion (\$24 billion), and their share in total foreign direct investment (intra and extra-EC) doubled to 38 percent (table 3.2). Similarly, cross-border merger activity sharply rose in 1986-87 — and is now about three times the level of the early 1980s. This process is not limited to European firms, as one-third of all cross-border acquisitions are initiated by non-European multinationals, positioning themselves for a unified market.

These moves do not mean that all of the effects of the 1992 program will be felt before the deadline. Compared with Japan and the United States, market concentration in Europe remains low in many sectors, including automobiles, steel, paper, air transport, and insurance. Moreover, in many cases, companies will be permitted to take advantage of the larger market only after 1992. The German anti-trust agency (Kartellamt), for example, will continue to apply national concentration tests in its approval of horizontal mergers until 1992, and will only apply a European criterion from 1993 on. Thus, mergers of the leading

**Table 3.2 Foreign direct investment by EC firms**

	Billions of ECUs		Percentage of total	
	1984	1988	1984	1988
Intra-EC	4	19	20	38
Extra-EC	17	31	80	62
Developing countries	3	4	14	7
Total	22	50	100	100
(% of EC GDP)	(0.7)	(1.2)		

Source: Eurostat.

German household appliance makers had to be postponed because their position is dominant nationally, but not throughout the Community. Corporate restructuring, prompted by the single market project, is likely to last until the end of the decade.

### The effects of the single market on third countries

The 1992 single market project should affect other countries in at least three ways. First, the 1992 project will change the commercial policy of the

### Box 3.2 Progress in implementation of the single market project

Adoption of the originally proposed 300 legislative acts — later consolidated to 279, and then expanded to 286 — exceeded 80 percent by the end of 1991. The transposition of directives into national laws is also proceeding satisfactorily, although there are difficulties in a few member countries. Predictably, difficulties have emerged in areas subject to unanimous decisionmaking, such as fiscal issues and worker rights, and the siting of new EC agencies — such as the Environmental Agency, the Drug Agency, and the Trademark Office — which has been stalled by France's insistence on guarantees protecting the Strasbourg location of the European Parliament.

*Border controls* on goods are to be eliminated on January 1, 1993, with the abolition of intra-EC transit documentation (the "single administrative document"). The administrative basis for border controls will thus be missing, even if the European Community's other steps are not taken on time. Progress in *technical standards* has been the most satisfactory, although agreement on automobile standards was reached only in 1992. The public works and public supplies directives have taken effect, and the *public procurement* directive for the hitherto excluded sectors—energy, transport, telecommunications, and water supply—has been adopted and will take effect in 1993, with temporary derogations for Greece, Portugal and Spain. Standard models for tender notices were published in 1991. And the Commission has started to check public tender notices systemati-

cally. Infringement procedures have been started to make regional preferences conform with EC law.

In the *service sectors*, good progress has been made in financial services. The most essential banking and insurance directives were adopted in 1989 and 1990, and remaining directives on mass risks in insurance and on consolidated supervision and large exposures in banking were adopted in 1991. The directives for the liberalization of trucking and air transport have also been adopted, but directives on passenger transport by road and sea may not be passed in time. The proposed measures in telecommunications and electronic payments systems have also been adopted, paving the way for EC-wide inter-operability in these new technologies — for example, leased lines, mobile telephones, and debit cards.

Complete liberalization of *capital movements* has been achieved in 1990, with partial derogations for Greece, Ireland, Portugal, and Spain until 1992. Measures accompanying the liberalization of capital movements have been introduced, but a directive on provision of investment services has run into some difficulties. Good progress has also been made in the harmonization of *company law* and corporate income taxation, notably the elimination of double taxation of related companies. The proposals on harmonization of takeover rules and a European company statute are still awaiting adoption. Harmonization of *intellectual property rights* and trade marks is progressing satisfactorily.

EC toward third countries — implicitly, for example, as European standards are introduced instead of twelve sets of national standards, or explicitly, for example, by eliminating national import quotas (or rendering them ineffective). Second, the single market should have indirect economic effects — trade creation, resulting from faster EC growth, stimulated by the single market, but also trade diversion from external suppliers to EC firms because of the elimination of intra-EC barriers. Third, the single market program should affect the commercial policies of third countries, through their direct emulation of EC policies and perhaps more important — through the introduction of single market issues into multilateral trade agreements. One effect is the European Economic Area Agreements, signed in 1992, which will expand the single market project to include the seven EFTA members.

#### *Commercial policy*

Although the White Paper did explicitly address future development of the European Community's commercial policy toward third countries, the abolition of intra-EC borders implies that a fully unified Community policy has to replace residual national trade restrictions and trade-related domestic policies, such as technical standards and certification procedures. The White Paper stated only that "it is not an unreasonable aim to achieve the abolition of national and regional quotas by 1992," but left the possibility open that "any import restrictions would have to be applied on a Community-wide basis." This ambivalence and the loud rhetoric about rather minor transatlantic trade frictions have led to fears that, instead of being abolished, remaining national trade restrictions might be extended to the entire Community.

As the European Community refines its policy on national import restrictions — eliminating them or extending them to the entire Community — two competing interest groups are directly affected: protected EC producers and some preferred developing-country suppliers. Fears have been expressed in the Community that the benefits from the single market program could accrue unduly to powerful firms from third countries, particularly Japan and the United States. There is the possibility that large, powerful third countries could press the Community to form bilateral agreements, especially in trade not covered by multilateral trade rules — services and public procure-

ment in some sectors. In response to such concerns, an EC commissioner (de Clercq) has stated that "we see no reason why the benefits of our internal liberalization should be extended unilaterally to third countries." But if developing countries are to benefit from the internal market — and, in most cases, even maintain their current market shares — the Community's planned external openness will have to be maintained.

Those who conjured up the image of a Fortress Europe have overlooked some essential features of the 1992 program. First, the vastness of the single market program makes it difficult to maintain national restrictions. And extending residual national restrictions to the Community would be against the spirit of the program. Second, protectionist lobbies in member countries do not yet care much whether the competition comes from the European Community, or elsewhere. Internal liberalization makes it harder to maintain restrictions against other supplies. Third, with the adoption of qualified majority voting, a large majority of member countries is required to introduce protectionist measures. One small and two large liberally minded member countries are enough to stop protectionist measures (box 3.3). The new political arithmetic also applies, of course, the other way around: a liberalization move can be thwarted by a protectionist minority. But because most nontariff barriers are residual national measures, the process is tilted in favor of liberalization — except for entirely new issues, such as services or the liberalization of agriculture, where a sufficiently strong minority can block agreement in the Council. Mobilizing an effective minority to block liberalization is difficult, however, because commercial interests vary considerably among even similar countries.<sup>65</sup> The poorer southern members do not have enough voting strength to form a blocking minority and might be swayed by a promise of financial assistance to alleviate adjustment costs.

The much stricter criteria applied by the Commission since 1988 in approving EC-wide measures to replace residual national restrictions thus far indicate that residual national restrictions will become ineffective by 1993 — although administrative restrictions, such as registration requirements for cars, may be possible for a few products. It appears that EC-wide restrictions will be substituted for national measures only in a few cases, including — so far — automobiles, textiles, and footwear — and they may be less restrictive. Simi-

### Box 3.3 The calculus of qualified majority voting

Most EC decisionmaking since 1986 has been by qualified majority voting. A Commission proposal can be passed with fifty-four of seventy-six votes (71 percent). Qualified majority voting makes it easier (than unanimous voting) to make a decision, but requires a wide consensus. One small and two large countries can block a proposal. Each country has at least two votes, with the remainder roughly proportional to population. France, Germany, Italy, and the United Kingdom have ten votes each; Spain, eight; Belgium, Greece, the Netherlands, and Portugal, five each; Denmark and Ireland, three; and Luxembourg two.

Given the removal of internal borders and the widely diverging interests of member states — which could make unanimous agreement elusive — the system of qualified majority voting favors liberalization. Except in agriculture

and textiles and clothing, there are few EC-wide nontariff barriers. Nontariff barriers are mostly national and apply to external imports only or — in the case of technical barriers — to both intra and extra-EC trade. The diverging economic development and interests of member countries make it difficult to form a large enough coalition to introduce new trade barriers or to expand national restrictions throughout the European Community. Qualified majority voting also works, of course, the other way around: a small minority can block the liberalization of EC-wide measures—for example, the common agricultural policy. And the liberal cast of the system does not mean that liberal members will always block the introduction of new restrictions. Occasionally, they may agree to “package deals” in exchange for other measures.

larly, the number of import restrictions affecting steel (VERs, antidumping measures) has markedly declined in recent years (chapter 1), an agreement to open the restricted national car markets over a seven-year period has been negotiated with Japan, a ten-year phase-out of the Multi-Fiber Arrangement is under consideration — although it has been tabled — in the Uruguay Round, and an agreement on reducing trade-distorting agricultural subsidies now also seems in sight.

A few EC-wide VERs may be introduced to substitute for former national restraint arrangements (box 3.5). With the phasing out of residual quantitative restrictions — assuming a phase-out

of the MFA is agreed to in the Uruguay Round, and adhered to — the remaining potentially protectionist measures likely will be the excessive use of safeguards (antidumping and antisubsidy measures) and the application of domestic policies (especially technical standards and certification procedures) to foreign firms. But the crystal ball is not yet entirely clear on the likely effects of technical standards. The mutual recognition principle for national technical standards should make it much easier for smaller exporters to meet EC standards, because they have to meet only one standard.<sup>66</sup> But, the adoption of EC-wide health and safety standards is leading to stricter require-

### Box 3.4 The automobile test case

The agreement between the European Community and Japan to phase out national restrictions on car imports from Japan — mainly in France and Italy, but also in Portugal, Spain, and the United Kingdom — provides an important test case. The arrangement, negotiated in 1991, is a voluntary export restraint by Japan for the five restricted national markets — France, Italy, Portugal, Spain, and the United Kingdom — for a seven-year transition from 1993 to 1999. Direct imports from Japan are to be restricted at 1990 levels (1.2 million), but production from Japanese plants in Europe — or elsewhere — will be unrestricted, and is expected to increase to 1.2 million cars by 1999, doubling current market penetration to 16 percent. Actual market penetration could be more or less. EC-wide monitoring of the Japanese VER will not be restrictive and will be confined to collecting statistics in the unrestricted national markets. Import licensing will be limited to the five restricted markets. (Ironically, the mutual restrictions between Italy and Japan were concluded in the 1950s at the behest of Japan, fearing rapid market penetration by the Italian producers of small passen-

ger cars, who were much more competitive then.)

Although this is not an immediate move to free trade, it is a substantial liberalization for the five restricted markets. At current import volumes and considering the low wages in several EC member countries, production in the EC is probably the best strategy for Japanese producers. Transport and logistics are a large part of total costs, and economies of scale relate mostly to research and development (see Womack and others 1990). Adoption of the transition agreement has cleared the way for EC-wide vehicle type approval. The exemption of automobile distribution from full EC competition rules will expire in 1995, and will probably be prolonged only in modified form. (The exemption permits exclusive dealer licenses, restrictions on sales to other dealers, warranty restrictions, and so on. These impede parallel intra-EC trade and raise entry barriers. In Japan, entry barriers are even higher, as the large nationwide dealers tend to be fully owned subsidiaries of the producers [Womack and others 1990].)

ments for some products in some member countries, for example, in plant and animal health. As in the past, protectionist abuse of certification and other administrative procedures cannot be ruled out. But unrestrained transshipment should make it much easier for third-country exporters to circumvent abuse of administrative procedures. In the safeguards area, the best protection for third country exporters would be a strengthened GATT code that ensures that antidumping and antisubsidy actions meet agreed-upon principles.<sup>67</sup>

#### *Indirect effects on trade with the South*

A deepening of EC integration is likely to benefit most developing countries. The direct effects of the single market program on labor-intensive Southern exports will be modest — because most of the adjustments of the single market program are concentrated in regulated high-tech industries and services where developing countries do not (yet) have a comparative advantage. The main effects of the single market program on trade with the South will result indirectly from the European Community's gains from integration.

*Influences on the effects.* The effects of European integration on developing countries will depend on the openness of trade in the EC — and, more important — on the developing countries' economic and trade policies. The Community is likely to remain a relatively open market. Tariffs are low and bound; most nontariff measures affect only a few goods and should prove difficult to enforce in a frontierless Europe. The main beneficiaries from higher growth in the European Community will be the most competitive suppliers — which underlines the importance of domestic policy reform

in developing countries, if they are to succeed in EC markets.

The successful conclusion of the Uruguay Round of trade negotiations could enhance the positive effect of European integration on developing countries (box 3.6). Because current tariffs and nontariff barriers are moderate, however, the further reductions envisioned in the Uruguay Round likely will only yield modest gains. International trade rules reinforced by the Uruguay Round would restrain the introduction of new trade barriers, improve the investment climate, and limit selective application of commercial policy measures to individual countries. Agreement on services would allow outsiders to enjoy some benefits of the single market program — services and public procurement. In textiles, market access would improve overall, but the most competitive suppliers would gain most. In agriculture, net exporters would gain market share (mostly in third markets); but net importers could suffer from higher prices and lower export subsidies. There will be gainers and losers from these changes. Competitive exporters of income-elastic manufactures will gain most from growth. At the same time, however, global liberalization would reduce the value for countries of preferential access to the European Community — under the ACP, Mediterranean, and other schemes.

Trade growth and openness in the 1990s will also depend on macroeconomic developments and adjustment pressures from the changes within the European Community. Growth makes adjustment easier, but recession tends to strengthen protectionist lobbies. The fact that some remaining decisions related to the 1992 program may be

#### **Box 3.5 The proposed EC-wide banana quota**

A proposed EC-wide quota on imports of bananas from efficient Central American suppliers, "dollar bananas" is likely to result in reduced market share for the less-competitive preferential suppliers, the overseas territories, and perhaps a major expansion for more competitive preferential suppliers (African countries). The case of bananas has gained some symbolic importance as one of the first candidates for post-1992 Community quotas. Recently, the Commission proposed an EC-wide quota for Central American suppliers, combined with a 20 percent EC-wide tariff (preferential suppliers face no tariffs and quotas). (The tariff would be higher only in Germany — where it was bound pre-European Community in the GATT.) The restrictiveness of the quota would depend on its size, its allocation among exporters, and allowed growth rates, which are still being negotiated. Nor is it clear how preferential suppliers would share

markets in the frontierless Community. As costs of preferential suppliers vary considerably (box 2.3), the effect of the new regime (elimination of market segmentation plus a quantitative restraint on the most competitive suppliers) would probably be a substantial reduction in imports from the most protected suppliers (overseas territories with high wage costs), an expansion of imports from other unrestrained suppliers (such as African countries), with export growth of the most competitive Central American suppliers depending on permitted quota growth rates. Whether prices to EC consumers rise would depend on the restrictiveness of the quota and the supply response of new suppliers. If the supply response is limited (or quotas restrictive), Central American suppliers may be able to reap substantial quota rents at the expense of EC consumers.

### Box 3.6 Relation of the single market program to the Uruguay Round

The Uruguay Round and the single market program overlap in many areas or complement each other. First, lower tariffs and nontariff barriers reinforce trade creation effects from the single market program. Second, the discipline of strengthened international trade rules makes it more difficult to take selective "gray-area" actions to protect domestic markets. Third, an agreement in services could extend some single market benefits to third countries on an MFN basis.

With respect to *market access*, reductions in tariffs and nontariff barriers would further reduce protection, but would also reduce the importance of tariff preferences. Because EC tariffs are already low, the most important effects would be due to reductions in other barriers. In textiles and clothing, the EC's future trade policy would be determined largely by the Uruguay Round. The current proposals are to increase present quota growth rates gradually over ten years, but leave a substantial amount to be liberalized afterward. Assuming 6 percent quota growth for restricted items and 10 percent for nonrestricted items, the current plan would permit an 8.6 percent average annual volume growth for most MFA-restrained countries (except the more restricted Asian NIEs), augmented by shifts to higher-value items. Results in the agricultural negotiations could offer some new market opportunities for developing countries in the European Community, but the main effect is likely to be felt in third markets as reductions in export subsidies would enable developing exporters of temperate agricultural products to capture larger market shares. Latin America and Asia likely would gain most. Much depends on how the tariff proposals develop and how tariffs are reduced.

The most important effects of this round would be from *reinforced discipline* in international trade. A successful Uruguay Round would make it more difficult to raise new trade barriers against outsiders. It would enhance growth by reinforcing credibility in the rules and their application — and thereby reinforce investor confidence. Stronger rules would also discipline the use of the so-called gray-area measures like voluntary restraints. A failure of the round, on the other hand, could erode adherence to existing rules, heighten trade frictions and protectionism, and lead to a pattern of bilateral deals, with serious effects on investment and growth. Different countries are affected differently. The phasing-out of gray-area measures, such as voluntary export restraints or "orderly marketing arrangements," would perhaps be the most important outcome for the more advanced developing countries. In antidumping, the proposed

rules would expand the scope of antidumping action to include avoidance, but would also strengthen the rules on determination of dumping and injury. In subsidies, the present proposal strengthens discipline, compared to current weak GATT rules. In government procurement, the Uruguay Round is unlikely to change key sectors — transport, energy, water supply, and telecommunications. Thus the European Community could continue to exercise reciprocity with outsiders in the excluded sectors. This is more important for other industrial country exporters than developing countries.

In the new areas — services, intellectual property rights, and trade-related investment measures — EC laws may have to be modified to take the negotiations into account. In services, a strong agreement would limit the potential for bilateral reciprocity in outsider access to EC markets. This limitation would help developing countries gain access to some benefits of the single market program. As the European Community has comparative advantage in many service sectors, a liberalization would enhance EC exports of services, reinforcing the structural change and growth effects of the single market program. In trade-related investment measures, the present proposal reiterates existing GATT rules and gives trade partners two years to comply. This may affect some EC local-content requirements. The direct effects in these areas on the developing countries are less important than for other industrial countries. But, in the longer term, developing countries would benefit indirectly from the ensuing structural change in the EC.

Compared with the growth effects of the single market program estimates of welfare effects of previous multilateral trade liberalization rounds are modest. Total welfare gains from the Tokyo Round, for example, were estimated at only 0.2 percent of world GDP. This is low compared with the estimated 5 percent from the single market program for the Community's GDP in five years. The Uruguay Round agenda has been more ambitious in attempting to extend the GATT system to new sectors. If successful, the Uruguay Round could affect growth more. Current estimates range widely. Lowest quotes set total gain in world GDP at 0.5 percent — the highest at 3 to 5 percent in the next ten years. Most of the direct welfare gains would come from liberalization of services and the growth boost to the world economy from the maintenance of the trade rules. Sectoral and country-specific estimates vary greatly.

made in a recessionary environment may influence the degree of liberalization — for example, the replacement of national with EC-wide quotas — although effects of the single market program and the Uruguay Round on economic growth could improve the economic environment by the mid-1990s. Present forecasts project further declines in commodity prices, which would reduce gains for exporters of primary goods. Exchange

rates are likely to remain volatile and have an important effect on trade flows and protectionist pressures.

*Three likely effects.* The single market and maintenance of external openness likely would have three main effects on the South.

- Reductions in costs for EC producers may cause a shift from external to intra-EC suppliers — reducing external trade (trade diversion). Efficiency



gains are likely to raise economic activity and increase demand for imports (trade creation). The *net trade creation effect* on developing countries is likely to be modest but positive. The main effect of the 1992 program on developing country exports will be from the dynamic gains through growth and related structural change. Structural change within the Community will improve growth by enhancing efficiency. Higher growth will benefit all exporters, but in relation to their competitiveness and the elasticity of demand for their exports. The shift of resources to high-technology goods and services should will shift comparative advantage of EC firms further into skill- and technology-intensive goods. This should promote international specialization in trade with the South where relative factor endowments are more important, benefiting especially labor-intensive exports.

- Higher demand for goods will increase prices of EC imports, whereas EC export prices are likely to decline because of cost-saving efficiency gains. The *terms-of-trade* effect is likely to be small but positive for developing countries. Developing country exporters of commodities may experience slight price increases from increased demand. Opening of public procurement may also reduce costs of aid-financed exports to developing countries if it can be extended to tied aid (see Tovias 1990). EC-wide bidding of tied-aid contracts has been estimated to reduce the cost of tied imports by up to 20 percent in developing countries.

- Elimination of bilateral national quotas — with or without EC-wide quotas — will redistribute trade in favor of the most competitive suppliers. The size of the *export redistribution effect* depends most on developments in the external commercial policy of the European Community. Maintenance of external openness would favor the more competitive suppliers at the cost of the beneficiaries of the present preferences. This is because most present national barriers against the most successful developing country suppliers would become unenforceable without Article 115 restrictions. The same applies for national preferences (bananas, rum).

*The differing effects among developing countries.* The effects of the single market will differ substantially among products and countries, depending on such factors as the countries' types of exports and the size of the export operations. Overall, the largest gainers among the developing countries are likely to be the exporters of manufactures,

with gains being proportional to the sophistication of the products exported. At the other end, some small agriculture- and preference-dependent developing countries — for example, the Caribbean Islands — could actually lose out.

Most of the effects of the single market likely will come from income growth. Exporters of manufactured goods likely will benefit most because demand for them increases as incomes grow, while exporters of goods with low income-elasticity (most primary goods) will not benefit much. Income elasticities for most primary goods are low — ranging from 0.3 to 1.0.<sup>68</sup> Environmental concerns and resource-saving technological progress also should dampen trade in primary goods. Oil probably will be an exception because of its higher income elasticity and its importance in present trade flows — 25 percent of EC imports are from the developing countries. In addition, continued strong protection for temperate agricultural products, competition from the southern EC members in fruits and vegetables, and competition from Eastern Europe in temperate products may hurt import growth for those products from developing countries.<sup>69</sup>

Exports to the European Community from the South are concentrated in labor-intensive products, where the single market would have little effect on EC firms. The scope for further economies of scale or intra-industry specialization within the Community in textiles, footwear, or other labor-intensive goods is limited. In these sectors, the European Community has been losing comparative advantage for some time and substantial restructuring already has occurred under pressure from imports. New trade diversion toward EC firms likely will be very limited, and substantial trade creation from income growth, continued loss of comparative advantage, and reduction of trade barriers is likely to continue.

An important effect of the single market — particularly for new and smaller exporters from developing countries — should be a reduction in transaction costs. These costs include border formalities, intra-EC transshipment, and the information and compliance required for national standards, certification, and all kinds of paperwork.

### Quantitative estimates

The assumptions of trade elasticities with respect to GDP growth — known as income elasticities of import demand — are crucial to the assessment of

**Table 3.3 Incremental growth of developing country exports to the EC resulting from the single market program and the Uruguay Round (percent per year)**

	Share of manufacturing exports (percent)	Scenarios			
		Optimist	Standard	Most likely	Pessimist
All developing countries	48	2.7	1.2	1.7	0.6
ACP	14	1.7	0.9	1.1	0.5
Mediterranean	50	2.9	1.2	1.7	0.6
NIEs	95	4.1	1.5	2.4	0.7
Four ASEAN	54	2.7	1.1	1.6	0.5
Latin America	22	1.8	0.9	1.1	0.5

*Source:* Authors' calculations are for a five-year period drawing on Emerson and others 1988. Trade elasticities: 3.5 for manufactures, 0.6 for food, 0.3 for agricultural raw materials, 0.7 for ores and metals, and 1.0 for fuels. Baseline 1989 trade in nominal U.S. dollars.

trade creation. Existing estimates of trade creation from the completion of the internal market are extremely sensitive to the choice of income elasticity of demand for imports.<sup>70</sup> That choice has become a key in distinguishing Euro-enthusiasts from Euro-pessimists. The long-term elasticity of income of manufactured imports from all sources has been around 2, which means that long-term trade growth was double GDP growth. Past performance of developing countries suggests a higher elasticity, of 4 to 5 (see table 1.4), but those numbers may have reflected lower initial levels of exports and higher supply elasticities. At the product and country level, econometric estimates give a whole range of numbers.<sup>71</sup> Empirical estimates for developing countries in the past decade suggest much higher rates.<sup>72</sup> A safe bet for the 1990s in manufactures from developing countries is likely to be around 3 to 4. Any increase in selective protection by the Community would probably lower these rates.

Gains in the South from the changes will be unevenly distributed. Simple estimates vary according to different assumptions about growth and net trade creation resulting from the single market—and the Uruguay Round—on different groups of developing countries (table 3.3). The main variables are trade diversion and growth. The optimistic high-growth scenario assumes 1.5 percent additional GDP growth in the European Community per year. This can result from a realization of most of the gains from the single market and a successful Uruguay Round. The pessimistic scenario assumes the opposite; incremental GDP

growth is assumed to be 0.5 percent per year, and trade creation 5 percent over five years.<sup>73</sup> The standard scenario assumes a 10 percent trade diversion in manufactures over five years and 1 percent incremental growth, which are the most frequent assumptions in existing studies. The likely scenario differs from this by assuming a lower trade diversion estimate—5 percent—for developing countries.

Despite their simplicity, the simulations show a number of trends and sensitivities. The results are very sensitive to assumptions of growth, underlying its importance as a determinant of gains from the changes. In the pessimistic case, gains among different developing countries are about the same, whereas in the optimistic or likely scenarios exporters of manufactures gain substantially more than do others. Their overall gain from income growth may be modest—except in oil. In manufactures, competition with Asian exporters may increase if national quotas in protected markets are abolished. In textiles, much depends on how the MFA quotas are phased out. The gains for mainly-primary exporters in Asia and Latin America are likely to depend on their performance in manufactures and more on the CAP reform and Uruguay Round than on the single market program. The export redistribution effect can be expected to favor the more dynamic exporters at the cost of current preferential exporters. The likely largest losers or least gainers are the low-income countries where supply elasticities hinder the reaping of export gains.

# 4

## *East-West European integration*

Recent political and economic reforms in Eastern Europe and the USSR open the possibility of a new era of political and economic cooperation in Europe.<sup>74</sup> After an initial and painful adjustment to the new economic realities, the Eastern European economies may recover production and incomes as strongly as did postwar Western Europe in the 1950s and 1960s. Rapidly expanding trade and investment links with the West could be an important engine in the transformation of Eastern Europe from distorted production and trade patterns and stalled economic development.

The most important determinant of progress in the successful transformation of Eastern Europe will be the speed and scope of political and economic reforms. Second in importance will be non-discriminatory access to markets in the West. Third, political and institutional integration — such as the recently concluded association agreements between the European Community and Czechoslovakia, Hungary, and Poland — could further improve trading opportunities and, more important, enhance the credibility of political and economic reforms, and induce faster, larger inflows of private capital and technology.

The events in Eastern Europe also have implications for the rest of the world. The opening of Eastern Europe and the USSR mean the emergence of both new competitors and new trading partners for everybody. Eastern European countries will compete mostly with the more advanced and dynamic industrializing economies of East Asia, Latin America, and Southern Europe. In all

likelihood, trade creation, resulting from the integration of the Eastern bloc into the world economy, will outweigh trade diversion, particularly for countries whose resource endowment is different from that of Eastern Europe. But, given the small volume of East-West trade — about 3 percent of total imports of EC members — its rapid expansion likely would have only small effects internationally, at least for the next five years. In the late 1990s, the effects of economic reforms in Eastern Europe and the former USSR could become more significant — but only if the pace of reforms is sustained.

### **Economic development in Eastern and Western Europe, 1938-90**

Because the current structure of production and trade in Eastern Europe has been heavily distorted by past misallocation of resources, current production and trade patterns cannot be relied on to project future production and trade patterns. Projections are made even more difficult by the current disequilibrium. Eastern European output and trade are low because past investment decisions and management practices led to irrational production patterns and an ill-adapted capital stock. Unclear responsibilities and conflicting signals for managers led to poor performance, a lack of initiative, slow technological progress, and low productivity. Enterprises tended to be self-contained, producing large shares of needed components in-house, at suboptimal scale, and often

with inefficient artisanal methods. Outdated production techniques, combined with sectoral monopolies, eliminated competition and stifled innovation and efficiency. Large units were created where there were no significant economies of scale — for example, in agriculture. But at the same time opportunities to reap economies of scale — for example, through specialization and buying-in of standardized components — were often missed. The consequences of forty years of autarky and inappropriate economic incentives are made clear by comparing per capita incomes in Western and Eastern Europe today with the interwar period.

In 1938, per capita income in Czechoslovakia was roughly on a par with Austria and Finland, in Hungary and Poland with Italy and Spain, and in Bulgaria and Romania with Greece, Portugal, and Turkey (table 4.1). Today, that order has changed dramatically. According to the World Bank Atlas, Czechoslovakia and Hungary are now below Korea and Portugal, Bulgaria below Malaysia, and Poland and Romania at about the same level as Turkey. Most Northern European countries have essentially caught up with the United States, while all Eastern European countries have fallen far behind their comparators of fifty years ago.<sup>75</sup> Italy's per capita income has increased by a factor of twelve in the past fifty years, but Eastern Europe's has only doubled or tripled. In terms of Western statistical concepts, the performance of Eastern Europe has been very poor, with per capita income growing at only 1 to 2 percent a year<sup>76</sup> — compared with 3 to 5 percent a year for Western Europe. Sustained through two generations, this differential has led to enormous differences in incomes and living standards.

One consequence of the ill-advised production and investment patterns of Eastern European economies in the past is that their income and wage levels at market exchange rates are now very low compared with their productive potential. Market exchange rates indicate dollar incomes — and wages — of 5 to 20 percent of Northwestern European levels.<sup>77</sup> Living standards, however, are higher than indicated by these figures.<sup>78</sup> Educational achievements are also higher than indicated by current wage and income levels. Generally, Eastern European countries have missed the electronics and information technology revolution of the 1970s and 1980s that has pervaded the West — from clerical chores to factory automation and basic research and development. But most

**Table 4.1. Per capita income in Europe, 1938-90**  
(per capita GNP in 1990 U.S. dollars)

Country	1938	1990	Implicit growth rate (percent per year)
United Kingdom	3,800	16,100	2.8
Germany	3,400	22,700	3.7
France	2,400	19,500	4.1
Austria	1,800	19,200	4.7
Czechoslovakia	1,800	3,100	1.1
Finland	1,800	26,100	5.3
Italy	1,300	16,800	5.0
Hungary	1,100	2,800	1.8
Poland	1,000	1,700	1.0
Spain	900	10,900	4.9
Portugal	800	4,900	3.5
Greece	800	6,000	4.0
Bulgaria	700	2,200	2.2
Romania	700	1,600	1.6
Turkey	600	1,600	1.9
United States	5,900	21,700	2.5

Note: The figures for 1938 have been adjusted to 1990 prices with the U.S. GDP deflator. A common depreciation factor has been used to derive GNP from net national product (see Kaser and Radice 1985, tables 6.32 and 8.1).

Source: Economic Commission for Europe 1949; Kaser and Radice 1985; World Bank: World Atlas 1991.

Eastern European countries have large numbers of well-trained technical personnel, particularly at the intermediate levels — skilled machinists and technicians. The autarkic development of the past forty years was thus not entirely wasteful. The challenge now is to improve productivity in industry and services, rather than the far more difficult and longer transition from agricultural to urban employment, which remains the principal challenge for most developing countries.

In at least one respect, Eastern Europe is better off today than were some of the successful newly industrialized economies at their "take-offs." The most important factor is *proximity* (box 4.1). When the East Asian economies began their outward-oriented industrialization drives in the 1950s or 1960s, they were thousands of miles away from export markets. Some Eastern European countries, by contrast, are just a few miles from the industrial heartland of Europe. It should be easier for German automobile manufacturers to include plants in Czechoslovakia or Poland in their just-in-time component-supplier networks than plants in relatively "distant" Portugal or Spain, let alone Brazil or Korea. Proximity is of even greater importance for the many efficient smaller companies

### Box 4.1 Determinants of spatial trade patterns

In the absence of high tariffs or other high trade barriers, spatial trade patterns are strongly influenced by transaction costs, not only transport costs but, equally important, information costs. For example, two-thirds of Austria's trade is with members of the European Community, and half of that with Germany alone, but only five percent of its trade is with North America. The broad validity of that observation has been demonstrated by various "gravity" models of international trade, where economic size ("mass") and distance are shown to be the most important determinants of trading patterns. (See, for example, Linneman [1966], Balassa and Bauwens [1988], or Havrylyshyn and Pritchett [1991] for applications to European trade flows. The parameter estimates quoted are from Balassa and Bauwens.) Parameter estimates typically indicate that a halving of distance increases trade two-and-a-half times. A number of authors have also estimated the effects of membership in various preferential schemes and other factors lowering informa-

tion costs, such as sharing a common culture and language. These estimates show that membership in the European Community increases trade by about 60 percent, about the same effect as sharing a common language. (The effects of English as a common language are usually higher, probably reflecting former political and commercial ties — and larger cross-border investment.) Together, these factors help to explain why Austrian exports to Germany are more than thirty times larger (per-dollar GNP of the recipient) than its exports to the United States, but Italian exports to Germany "only" seven times larger (the two countries do not share a border and language). Among all these factors, geography is the most powerful force. EC membership would be equivalent to moving Finland to southern Sweden, but would move New Zealand barely beyond the north shore of Australia. This underlines the benefits of deeper economic integration among neighboring countries.

that remain the most important and most dynamic sector in much of Western Europe. Moreover, Eastern European wages are now only one-third those of Spain.

#### Past East-West trade relations

In comparison to "normal" trading patterns, determined by endowments, income levels, and proximity, the potential for expanding trade between Western and Eastern Europe is enormous, particularly from the perspective of the Eastern European economies (table 4.2). Per capita exports of Austria are today five times those of Czechoslo-

vakia, but were roughly the same between the world wars. Bulgaria and Poland have only one-third of Portugal's per capita trade, and one-tenth of Austria's or Germany's. The close integration of the Council for Mutual Economic Assistance (Comecon) — the economic bloc including the USSR and Eastern Europe (excluding Albania and Yugoslavia) — was largely a fiction. The GDR's merchandise exports to Comecon members were equivalent to about 11 percent of GNP, compared with about 36 percent for intra-EC exports of a Western European country of the same size — the Netherlands.<sup>79</sup> Eastern European export/GNP ratios are more comparable to isolated, far-away

Table 4.2 Per capita merchandise exports and direction of trade, 1970 and 1990

	Per capita exports (1990 U.S. dollars)		Share of Comecon in total exports (%)		Share of EC/EFTA in total exports (%)	
	1970	1990	1970	1990	1970	1990
GDR	1,000	1,100	68	35	24	57
Bulgaria	900	600	76	54	16	24
Czechoslovakia	1,000	700	64	37	24	51
Hungary	900	900	62	31	30	57
Poland	400	500	60	39	31	51
Romania	400	200	50	24	36	57
<i>Comparators:</i>						
Fed. Rep. of Germany	2,200	6,600			67	71
Finland	1,900	5,400			69	67
Italy	1,000	2,900			60	68
Portugal	400	1,600			56	84
Spain	300	1,400			73	71
Turkey	70	200			60	58

Note: Based on revalued (and uniform) transfer ruble-dollar cross rates (table 4). The 1970 data have then been converted into 1990 prices using the World Bank's unit value index for exports of manufactured goods.  
Source: Economic Bulletin for Europe 1991, table 4; IMF 1990.

market economies with low trade/GNP rates, such as Australia (9 percent) or New Zealand (13 percent) — or developing countries with very high tariff and other trade barriers — than the small, well-integrated economies, sharing land borders, that they should be.

The stagnating or declining values of Comecon trade between 1970 and 1990 do not indicate contracting export volumes, but a continued decline in the prices of Eastern European manufactured goods due to growing obsolescence (table 4.3). GDR camera and Czechoslovak machine tool manufacturers could not keep pace with quality and productivity increases in the West (or Far East), and had to resort to ever-larger price concessions in international markets — analogous to a substantial devaluation. This adjustment reveals that, despite growing exports to the West at realistic transferable/dollar (TR/\$) exchange rates,<sup>80</sup> the share of trade in the Eastern bloc was shrinking — and less than had been commonly thought — as the adjusted value of increasingly uncompetitive products dropped. So adjusted, only 30 to 50 percent of total trade was with Comecon partners by 1990. At the same time, real per capita exports of most Western European countries tripled or quadrupled.

Per capita exports of the former German Democratic Republic were somewhat higher than those of the other Eastern European economies, reflecting the somewhat higher level of economic development and the special trade relationship with the FRG that treated imports from the GDR as domestic trade — without tariffs or other trade barriers — and extended short-term credit to finance that trade. The GDR was in effect a “thirteenth” member of the European Community. Despite that advantage, per capita exports to the Community were only 20 percent higher<sup>81</sup> than for Hungary or Czechoslovakia, indicating that the difference

between most and least preferential treatment by the European Community had relatively little effect, equivalent to only one year’s growth since the reforms and the opening to foreign trade (see below). The poor export performance of Eastern European economies was thus mostly due to domestic factors. In the past two years, East-West trade has grown rapidly, averaging 15 to 20 percent a year in current dollars (table 4.3). Most of the incremental trade was with Western Europe, which already accounts for nearly 60 percent of the total trade of Eastern Europe.

This recent, more realistic, assessment of Comecon trade has several implications. First, it underlines the relative autarky of the mostly small Eastern European economies and indicates an important source of inefficiency in these countries. Second, it puts the recent collapse of Comecon trade in a somewhat different light. Because total Comecon trade wasn’t quite as large as had been commonly thought, its collapse also did not have the catastrophic consequences that had been feared. Indeed, the early reformers — Czechoslovakia, Hungary, and Poland — have been able to compensate for the loss of markets, first in the GDR and then in the USSR, with large increases in their exports to Western Europe and, in particular, Germany. Nevertheless, the loss of Soviet oil supplies was considerable for Eastern European countries, as they had previously bartered manufactured goods for oil and other raw materials at favorable prices.<sup>82</sup> The loss of the Soviet market has affected Bulgaria more seriously, while Romania’s export trade has suffered from domestic instability.

Although EC members were permitted to restrict imports of “sensitive” goods from state-trading countries, the treatment of Eastern European exports was not very different from most-favored-nation status. Even countries not granted most-favored-nation treatment faced the comparatively low autonomous tariff of the European Community — averaging about 10 percent.<sup>83</sup> The European Community’s high variable levies on agricultural products applied to Eastern Europe. The most significant EC-wide nontariff barrier against Eastern Europe was in textiles, where Eastern European countries faced EC-wide restrictions in many textile and clothing categories, with only a limited quota growth of 2 to 3 percent annually. Import restrictions for textiles and clothing were similar to those for the most restrained East Asian suppliers. Even in textiles, however,

**Table 4.3 Direction of exports from Eastern Europe**  
(billions of U.S. dollars)

	EC-10		United States		Japan	
	1988	1990	1988	1990	1988	1990
<i>Origin:</i>						
Eastern Europe	12.6	20.2	1.6	1.3	0.9	0.6
USSR	16.7	28.4	0.5	1.0	2.0	2.5
Total	29.3	48.6	2.1	2.3	2.9	3.1
<i>Percentage of</i>						
East-West trade	(64)	(73)	(5)	(3)	(6)	(5)

Source: UN Comtrade.

the poor performance cannot be entirely attributed to import restrictions in the West, as the unrestricted GDR exports to the FRG did not perform much better.

Discrimination against centrally planned economies *through national measures* was possible under two EC regulations. Regulation 3420/83 established procedures for a list of imports from centrally planned economies that could be subjected to national quantitative import restrictions, while regulation 1765/82 listed fully liberalized imports. Except in textiles and agriculture, quantitative restrictions under the state trading regulations were not used much. Safeguard actions — such as antidumping measures or voluntary export restraints — were frequently applied against Eastern European countries. Although only 7 percent of extra-EC trade originated in Eastern Europe, one-quarter of all antidumping cases involved Eastern European exports.

The position of Eastern Europe as the least-favored trading partner of the European Community did not mean EC markets were closed. For those goods for which Eastern European countries *should* have had comparative advantage — labor-intensive engineering and consumer goods — there were few restrictions. Moreover, resort to the quantitative restrictions under EC Regulation 3420/83 was limited. The Federal Republic of Germany applied national quantitative restrictions only on 0.5 to 2 percent of its imports from Eastern Europe, and trade controls were used exclusively only in Italy (on imports from Poland) and France (on energy imports from Bulgaria, Romania, and the USSR).<sup>84</sup> Italy's use of national restrictions against Eastern Europe was similar to its use of restrictions against Korea and Taiwan (China).<sup>85</sup> The concentration of safeguard measures on Eastern Europe resulted more from the arbitrary and uneconomic trade practices followed by the centrally planned economies than a conscious effort to discriminate against them. In Western economic concepts, exports of chemicals derived from subsidized Soviet oil are indeed dumping, even if direct evidence could not be found in Eastern Europe to establish that directly.<sup>86</sup> Prices simply did not matter in centrally planned economies, and economic irrationality was customary. The most important restrictions on trade with Eastern Europe were perhaps not import restrictions, but export restrictions for military and dual-use technology that forced Eastern European firms to spend large resources duplicating research and

development — reinventing the wheel.

Since 1988, trade relations between Eastern and Western Europe have rapidly improved. The first important step was the conclusion of trade and cooperation agreements, granting most-favored-nation treatment and eliminating national quantitative restrictions the European Community had applied to state-trading countries. The first of these agreements went into effect in early 1990 for Hungary and Poland, followed by Bulgaria and Czechoslovakia in November 1990, and Romania in May 1991. The provisions for MFN treatment have been expanded in 1991 to include coal and steel products through protocols with the European Coal and Steel Community. Quantitative restrictions on textiles have been eased considerably through large quota increases, most recently as part of the prolongation of MFA IV to 1992, and again in the context of the association agreements (see below). For other Eastern European countries — for example, the Baltics — eventual association agreements will similarly be preceded by trade and cooperation agreements providing for MFN treatment.

#### Future trade patterns

Reorienting Eastern Europe's trade to the West is not simply a question of shipping the same commodities somewhere else: many products are uncompetitive. The problem is most serious for firms that have specialized in manufactured goods for Comecon markets. They cannot find new markets without significant improvements in design and quality. The problem is less severe for manufacturers that had some success in Western markets and for exporters of primary commodities — in particular, the USSR.

In the short term, the best export prospects are in countries that have already well-developed trade and joint-venture relationships with the West, such as Hungary. The transition is more difficult in countries that have relied very little on Western designs and cooperation — for example, Czechoslovakia. For the medium term, the most important factors will be domestic policies — including policies toward foreign investment — and proximity to Western Europe. From this perspective, the chances of Czechoslovakia, Hungary, and Poland look better than the prospects for countries further away. Assuming similar policies, economic development will probably gradually trickle further east. But since political stability

and good economic policies are not automatic, the economic landscape of Eastern Europe is likely to be checkered with good and not-so-good performers.

For the most advanced Eastern European countries, the best export prospects are in engineering and consumer goods — in line with Eastern Europe's good endowment with relatively well-skilled labor (box 4.2). These prospects also are fostered by the proximity to Western Europe, which makes Eastern Europe an attractive potential location for bulky manufactured goods (such as household appliances and furniture), for products that require intensive contacts (such as specialized machinery and trade in engineering services), and for participation in highly integrated manufacturing (such as the just-in-time method). In the medium term, engineering goods will probably become the most important sector, particularly in the more advanced Eastern European countries. In the short term, there could be an expansion of trade in simple labor-intensive goods, such as processed foods, clothing, or footwear,

but mostly in the less-developed regions of Eastern Europe. As the example of Spain shows, rapid expansion of trade in engineering goods is more likely in a country that has already developed its basic engineering capabilities.<sup>87</sup> It may be easier to train mechanics to assemble machinery for Western markets than to turn them into tailors.

Strong *geographic influences* on trade patterns — particularly for trade in manufactured goods — are closely related to the high transaction costs imposed by distance. "Gravity" models to simulate future trade patterns for Eastern Europe show a strong geographic concentration of trade toward Western Europe — once domestic impediments to exports are removed in Eastern Europe. Model calculations show that 75 percent of Eastern European exports would normally be directed toward Western Europe, and only about 15 percent to Eastern Europe and the Soviet Union (table 4.4).<sup>88</sup> Less than 10 percent of total exports would normally go outside Europe, including about 3 percent to the United States. These simulations do not assume EC membership — or a free-trade

#### Box 4.2 Product structure of trade

The past product composition of the Eastern European countries was peculiar. Trade with the West was heavily biased toward homogeneous manufactured goods — for example, steel and basic chemicals. By contrast, the product composition of intra-Comecon trade was similar to that of industrialized market economies. More than 90 percent of Eastern European exports to the USSR were manufactured goods — mostly machinery and consumer goods (table). This peculiar trade pattern existed because the past trading system did not provide any incentives for enterprises to compete in Western markets. There were very few direct contacts between firms and their customers — transactions were usually conducted by specialized trading companies. Often, domestic sales were more profitable than export

sales — if profitability mattered at all. Moreover, the political and economic system made it very difficult to market differentiated goods (such as machinery) — as this would have required extensive traveling, after-sales services, and frequent changes in design to meet customer demands. Such marketing went against the principles of the political and economic system. The structure of exports was not determined by comparative advantage, but by central planning and the overriding wish to minimize "unnecessary" contacts with the West. Because there was a need to import sophisticated products not available locally, something had to be exported to pay for imports. Typically, the choice fell on standardized intermediate goods, such as bulk chemicals, for which specifications were easy to meet.

Product composition of exports, 1988  
(percent of total exports)

	Eastern Europe to:		Comparators:		
	West	USSR	Spain	Portugal	Austria
Primary commodities	37	9	28	21	13
Agricultural products	17	8	19	10	8
Fuels	14	1	5	3	1
Other	6	—	4	8	4
Manufactured goods	52	91	72	78	87
Chemicals	10	7	9	6	7
Metals	11	2	10	3	16
Machinery	11	59	34	17	34
Consumer goods	19	24	19	52	30
of which: textiles	8	6	5	29	10
Unclassified	11	—	—	1	—

Source: UNCTAD 1990, tables 4.1 and A1-A13.



**Table 4.4 Gravity model predictions of Eastern European exports after the transition  
(percentage of total exports)**

Source	Eastern Europe (excluding CIS)	Czechoslovakia	Hungary	Poland	Romania	Bulgaria
<i>Destination</i>						
Eastern Europe (including CIS)	15	5	8	12	11	29
Western Europe	74	90	85	77	74	42
Mediterranean <sup>a</sup>	5	1	2	3	12	12
North America	4	2	3	6	9	9
Asia	2	1	1	2	6	6
Latin America	1	—	—	1	1	1

a. Including Greece, Portugal, and Spain.  
Source: Havrylyshyn and Pritchett 1991.

agreement. In terms of geographic trade patterns, the effect of membership would probably be small. But in terms of trade volumes the effect could be more significant, as association or eventual membership would lead Eastern European countries to adopt an outward-oriented economic policy with low tariffs and few nontariff barriers — except, perhaps, in agriculture — and would also lower perceived political risks.

Thus, a rapid expansion of East-West trade in Europe is likely after successful market reforms — and the maintenance of some modicum of political stability — in Eastern Europe. Initially, export performance results from decentralization of trade decisions: factory managers, who can now make these decisions, have better knowledge and stronger motivation than trade functionaries. In a short time factories can find new outlets in the West for existing, or slightly modified, products. In the medium term, new products and designs play a larger role — by working to Western specifications or through licensing and joint venture deals with Western partners. Privatization of state firms by foreign investors can eventually play an important role. Although the benefits of rapidly expanding East-West trade would be very substantial for Eastern Europe and the former USSR, the effects on Western Europe should remain small for the foreseeable future, as total imports from the East are only a small share of EC trade.

#### Association agreements with the European Community

The Community has negotiated — and signed in 1991 — association agreements called “Europe Agreements” with Czechoslovakia, Hungary, and Poland. Similar agreements are to be negotiated with several other Eastern European countries in

the next few years. Negotiations with Bulgaria and Romania could take place in 1992. Although the Europe Agreements fall short of the membership objective of the Eastern European countries, they go well beyond the scope of the EC-EFTA free-trade agreements, and are very different from other association agreements, such as those with the ACP and Mediterranean countries. The new agreements’ scope lies between the free-trade agreements with EFTA members and the recently negotiated European Economic Area. The Europe Agreements provide for duty-free and nontariff-barrier-free access for all industrial products (including textiles and steel) and enhanced access for agricultural products. The agreements go beyond simple free-trade agreements by including provisions on competition policy and subsidies, foreign investment, intellectual property rights, and a commitment to harmonize Eastern European economic legislation with that of the European Community. Many provisions are similar to the commitments of EC members in the first stage of the EEC (1958-61). Last, the political importance of the agreements is underlined by an Association Council at the ministerial level, and cooperation at all political levels, including legislatures.

The preamble of the agreements states the objective of the Eastern European countries to join the European Community later and notes that the association agreements will facilitate this process. The agreements cover two stages of five years each, except for commercial policy (see below). In the last year of the first stage (1996), the agreements are to be reviewed to decide on the transition to the second stage, and to modify the agreements, if necessary. As in the case of the Mediterranean association agreements, the EC has by and large accommodated the different trade strategies of the three Eastern European countries. But the

time allowed to establish reciprocal free trade, and free entry and national treatment of companies has been set at a maximum of ten years. Because the ratification of the Europe Agreements will take some time (fourteen parliaments have to ratify each treaty), interim treaties were signed to ensure that tariff dismantling could start on March 1, 1992.

### Commercial policy

In trade, the association agreements have been modeled on the 1973 free-trade agreements between the European Community and the European Free Trade Association, but — in contrast to the 1973 agreements — the association agreements liberalize agricultural trade. The EC proposal accepted the asymmetry of having the European Community reduce its tariffs and trade barriers early on, while the Eastern European countries will be given more time to reduce their tariffs and other trade barriers. For industrial products, the European Community proposed an immediate elimination of its tariffs on “nonsensitive” products, a progressive reduction of tariffs on textiles and steel, and a gradual increase in tariff-free quotas for other “sensitive” goods for which developing countries are granted tariff-free quotas under the Generalized System of Preferences — for example, automobiles and parts, footwear, television sets (see chapter 2). The Eastern European countries were to reduce their tariffs affecting the European Community to the level accorded to the more advanced developing countries (NIEs) during the first phase — and to progressively eliminate tariffs during the second phase (table 4.5).

For the large majority of “nonsensitive” items, accounting for about two-thirds of present EC imports from Eastern Europe, the European Community eliminated all duties and other restrictions on March 1, 1992. For iron and steel, textiles, and other “sensitive” industrial products, the European Community will eliminate tariffs over five years (six years for textiles), with duty-free quotas in the interim on items other than steel and textiles. Except for a small difference with respect to concessions granted to Hungary for “other sensitive industrial goods,” the conditions for market access in the Community are identical for all three associated countries. Each of the Eastern European countries will apply a different transition schedule for imports from the European Com-

munity. Poland will eliminate tariffs on about 30 percent of its imports from the European Community in 1992, and the remainder over seven years with duty reductions in the last four years. Hungary will liberalize 12 to 13 percent of its imports over three years, another 20 percent in 1995-97, and the rest (two-thirds) by January 1, 2001, with most of the duty reduction during 1996-2001. Czechoslovakia will dismantle over seven years — like Poland, but somewhat less frontloaded.

Quantitative restrictions on imports of *textiles* and clothing from Eastern Europe have already been eased considerably over the past three years, most recently as part of the prolongation of the Fourth Multi-Fiber Arrangement to 1992, and again during the negotiations of the association agreements. The number of restrained categories has been reduced and, more importantly, very large increases in quotas have been granted already for 1992, averaging about 200 percent compared to the original MFA IV quotas for 1991. Additional outward-processing quotas add a similar amount. Quota and duty-free trade in textiles and clothing is to become effective after a transition period of six years, that is, on January 1, 1998.<sup>89</sup> A textiles quota dismantling protocol will be negotiated in 1992. Given the huge increases in quotas granted already for 1992 (500 percent, including outward processing, compared to the original MFA-IV quotas for 1991), the Eastern European countries will probably have substantial difficulties filling these quotas.

Specific restrictions on import of *coal and steel* products are being liberalized in the context of ECSC trade protocols that have been negotiated as a follow-up to the trade and cooperation agreements. Full MFN treatment for coal and steel products has been granted in 1991. Import duties on steel products will be reduced over a five-year transition period, in four annual steps of 20 percent, followed by two steps of 10 percent. Import duties on coal will be eliminated on March 1, 1992, except for Germany and Spain, which can maintain their national tariffs on coal for up to four years. As the Eastern European steel industry is suffering from excess capacity, the agreements provide some support for steel industry restructuring.

For *other “sensitive” industrial goods* — such as automobiles and parts, footwear, light bulbs, semiconductors, and TV sets — duties will be reduced in five annual steps of 15 percent and eliminated at the end of 1996. For these products, the Eastern

**Table 4.5. EC tariff and quota dismantling granted to Czechoslovakia, Hungary, and Poland in Europe Agreements**

	<i>Share in EC imports from Eastern Europe</i>	<i>Date of full duty elimination and mode of reduction</i>	<i>Quantitative restrictions</i>
Nonsensitive industrial goods	1990: 66% medium term: 48% long term: 63%	March 1992 one step (a few items by 1993)	None
Iron and steel	1990: 5% medium term: 4% long term: 4%	January 1997 four steps of 20%, then two steps of 10%	None
Textiles	1990: 7% medium term: 4% long term: 7%	January 1998 2/7th in 1993, then five steps of 1/7th	Quota increase of about 200% in 1992 over original MFA quota for 1991. Additional outward-processing quotas equivalent to 100% of increased quotas for 1992; full phase-out by January 1998
Other sensitive industrial goods	1990: 14% medium term: 27% long term: 13%	January 1997 five steps of 15%, then 25%, duty-free GSP quotas for about 50% of imports, growing at 20%	None
Agricultural products	1990: 8% medium term: 17% long term: 13%	Not specified Reductions of tariffs on some non-CAP products, typically up to 50%	Preferential access for CAP products, except cereals, at 50-75% reduced variable levies and tariffs with 8% quota growth; levy reductions phased over three years

*Note:* It has been assumed that the structure of Eastern European exports to the European Community will resemble Spain's exports as of 1990 in the medium term, and total intra-EC trade in 1990 in the long term.  
*Source:* Europe Agreements, authors' calculation.

European countries also benefit from duty-free quotas under the Generalized System of Preferences for developing countries. Duty-free quotas amount to about 50 percent of the imports in these categories, and are to be increased by 20 percent a year.<sup>90</sup> Although current imports of these items are relatively small (14 percent), they could become more important. For Spain, they are 27 percent of exports, dominated by automobiles and parts. It will probably take some years until new production facilities are operating in Eastern Europe, and duties will have been eliminated by that time.

As opposed to the EC-EFTA free-trade agreements, which exclude the *agricultural sector* entirely, the Europe Agreements provide substantial preferential access for Eastern European countries. The concessions granted are similar to those in the Lomé Convention and the Mediterranean agreements. For highly protected agricultural products — except cereals — reductions of up to 75 percent of variable levies and tariffs will be granted, subject to tariff quotas growing at about

8 percent a year. The most frequent formula is a 60 percent reduction of variable levies and tariffs, phased in with three annual steps of 20 percent each (for example, for beef, poultry, mutton, pork, and dairy products). For products not covered by common market organizations (and subject to lower fixed tariffs) — for example, fruits and vegetables — duty reductions of about 50 percent will be phased in over five years.

The effects of the preferential access granted are difficult to assess at present since a far-reaching reform of the Common Agricultural Policy is to start with the 1993-94 crop year. In light of the current high, protective levies, the preferential access granted in the Europe Agreements would become very valuable — although limited by quotas. But because the European Community is to shift from price supports to trade-neutral measures (for example, flat per-hectare subsidies for grain) — combined with a reduction of domestic prices in the European Community to world market levels — the value of preferential access should become limited, and imports from Eastern Europe

will not merely add to EC surplus production. The agreements provide for a review of the agricultural concessions granted by the European Community, taking into account the results of the Uruguay Round and the eventual reform of the CAP.

The usual rules of origin for countries with preferential trading arrangements with the European Community will apply — product is normally considered “domestic” if the processing of foreign inputs is enough to change the four-digit tariff heading (exceptions to this rule are defined in an annex to the EC’s rules of origin). When complying with rules of origin, inputs from the European Community or the same preferential group—in this case, Eastern Europe—are counted as if obtained domestically.

EC member countries will grant free entry and national treatment for *investment* by all firms from the associated countries from 1992 on, except in air- and water transport. The associated countries will do the same, but have been granted temporary exceptions for some sectors until the end of the ten-year transition period — for example, for steel, mining, defense industries, banking and financial services, real estate, and the acquisition of state assets in privatization programs. Natural resources, agricultural land, and historic buildings are entirely excluded. For other industrial and commercial sectors undergoing restructuring, temporary restrictions to entry and national treatment can be applied by the Eastern European countries in the first six years — 1992-97. Free movement and full repatriation of profits and invested capital will be granted to EC investors. Associated countries are also to introduce no new foreign exchange restrictions after the fifth year, 1996.

The *competition* rules of the European Community are to be introduced in the associated countries — in particular on collusive behavior, abuse of dominant position, and competition-distorting state aid (Articles 85, 86, and 92 of the EEC Treaty). The associated countries are to adopt implementation legislation within three years. State aid — compatible with EC rules for disadvantaged regions — can be applied to the entire territories of the associated states in the first five years. The agreements also provide for increased information and disclosure of state aids. The adequacy of these provisions is to be determined by the Association Council.

The associated countries will introduce laws to protect *intellectual, industrial, and commercial property rights*, equivalent to those prevailing in the European Community, by the end of the fifth year. The countries are also to accede by that time to the European Patent Convention and other multilateral conventions on intellectual, industrial, and commercial property rights.

Companies from the associated states will be able to participate in *public procurement* in the European Community starting in 1992 on the same terms as EC firms at the time the association agreements take effect. This includes provision of supplies, public works, services (subject to the limits on labor mobility) — and possibly also previously excluded public procurement sectors in the European Community (see chapter 3).<sup>91</sup> The associated countries are required to grant national treatment to EC firms by 2002.

The associated countries will endeavor to harmonize their *legal systems* gradually with EC laws to foster further integration. This applies to customs, company, banking, accounting, and corporate tax laws; intellectual property rights; worker safety; financial services; consumer protection; indirect taxation; plant and animal health standards; and other technical and environmental standards. The European Community will provide extensive technical assistance, including translation of relevant EC legislation and documentation.

Very little has been agreed to for labor migration. This issue remains largely an area of national — instead of Community — policymaking. The main EC-wide provision is for cumulation of social security benefits earned by nationals of associated countries in different EC-member countries. There are also provisions for the exchange of students, for training, and for technical assistance.

The Europe Agreements provide for substantial *technical and financial assistance* but do not contain specific numbers. Technical and financial assistance is to be detailed in further protocols replacing existing arrangements. Technical and financial assistance will cover virtually every field — industry, agriculture, mining, energy, defense industry restructuring, transport, tourism, financial services, and so on. Collaboration will also extend to education and training, research and development, and cultural matters.

A number of institutions will be created to foster political cooperation at all levels, including an

Association Council at the ministerial level, parliamentary association committees, and committees at lower levels to foster further integration.

### **Effects of European integration on developing countries**

The effects of East-West European integration on the rest of the world — and on developing countries in particular — are difficult to quantify. Much will depend on political stability in Eastern Europe and the progress in implementing economic and institutional reforms. If progress in domestic reforms in Eastern Europe remains limited, trade will not expand much, and effects on the rest of the world will thus remain small. If large-scale political instability arises, the cost may become very large for Western Europe — and other countries. Excluding major political dislocations, trade patterns would be affected most in an optimistic scenario.

For most developing countries, the rapid expansion of East-West trade would have only very limited effects — as trade expansion will in all likelihood be concentrated in relatively sophisticated manufactured goods, and perhaps in temperate agricultural products. Trade diversion from developing countries to Eastern Europe would thus mainly affect the most advanced and dynamic developing countries, such as the newly industrializing economies of East Asia. It is the NIEs, too, that are being hurt most by the large increase in EC textile quotas granted for 1992. But if the NIEs' past performance is a guide, they will meet this challenge head-on. For the less-advanced developing countries that export primary products and simple manufactures, trade diversion could be outweighed by trade creation arising from the opening of Eastern European economies to trade and the likely growth in Eastern European incomes that will eventually result from reform. As the exports of Eastern Europe continue to increase rapidly, their capacity to import should also rise, and some spending will focus on imports that have been severely limited — such as tropical

beverages and fruits. Developing-country exporters of agricultural products thus could develop new export markets in Eastern Europe.

The situation for exporters of industrial raw materials is different. Although exports from the former USSR are presently limited by supply constraints and economic dislocations, large mineral resources make the USSR potentially an important supplier of nonagricultural primary commodities, with some effect on world trade patterns — and perhaps future prices, for example, in oil and natural gas. In the immediate future, however, these effects will be small. Successful economic reforms in the former USSR may also lead to a rapid improvement in agricultural production — lowering Soviet imports in the medium term, particularly for temperate agricultural products. This may be a welcome development for food-importing low-income countries, as the reform of agricultural policies in the European Community would tend to lower excess production and thus increase prices of temperate agricultural products. For land-rich exporters of agricultural products the opposite applies.

The direct effects of Europe's East-West integration on developing countries are thus likely to remain small in the next five years. Indirect effects from higher incomes and more open markets in Eastern Europe could provide a moderate boost in demand for exports from low-income countries. The most important consequences may lie entirely elsewhere. First, the economic and political reforms in Eastern Europe are a far-reaching social experiment in the transition from highly controlled command economies to market economies — a shift that is relevant for many developing countries that have unsuccessfully pursued socialist or highly interventionist economic policies. Second, the East-West détente could result in a significant reduction in wasteful military spending in the East, West, and South — and free considerable resources for economic development. In the longer term, the peace dividend may prove to be the most important economic effect of the opening of Eastern Europe.

## *Annexes*

## **Annex 1 Reform of the Common Agricultural Policy**

In response to the spiraling costs of the Common Agriculture Policy (CAP), and mounting criticism at home and abroad, the European Community has begun to consider far-reaching reforms of the CAP. Agricultural policy reforms are being discussed in the Uruguay Round and, quite separately, within the European Community.

### **Uruguay Round proposals**

In the Uruguay Round, the European Community has proposed a partial reduction in protection and domestic subsidies — both by 30 percent — with a further review later on. The United States and the land-rich Cairns Group of agricultural exporters have proposed to include the agricultural sector under normal GATT discipline, and to impose much larger reductions in tariffs, and steeper cuts in export subsidies and other trade distorting barriers — import prohibitions, quotas, variable levies, regulatory and licensing requirements, and so on — than in domestic support. The initial United States proposal was to eliminate trade barriers over ten years and export subsidies over five years; product-specific domestic subsidies were also to be eliminated, but general income subsidies to farmers were to be allowed under certain conditions. As a compromise — between the European Community and the United States-Cairns Group — the GATT secretary-general proposes converting all nontariff barriers into tariffs, reducing these and the other tariffs by 36 percent over six years, and reducing domestic support measures — such as price support — by 20 percent. Production- and trade-neutral income support to farmers are to be exempted from reductions.

### **The 1992 Common Agricultural Policy reform**

Independently of the Uruguay Round negotiations — but not entirely unrelated — the EC Commission proposed in 1991 a far-reaching reform of the EC Common Agricultural Policy — the McSharry plan — which was adopted by the Council of Ministers in May 1992. The proposal goes well beyond the EC offer in the Uruguay Round, and possibly also beyond what will be its final offer there. The European Community seems to distinguish between its own reforms — under-

taken for its own good — and the extent to which the Community is willing to limit its freedom through binding international commitments. Even so, there are still some discrepancies between the European Community's CAP reform plan and the compromise proposal for the Uruguay Round (see below). The Commission's reform plan is briefly summarized below. In view of the complexity of agricultural policies (and the reform proposals) the discussion is limited to cereals. Very similar proposals have been adopted for other crops, however — and support in the meat and dairy sectors has been partly a consequence of the high protection of cereals (to compensate for the cost disadvantage resulting from high input (feed) costs). A thorough reform of the crop sector should make animal husbandry much more competitive.

### *Background*

Until now, protection for cereals — and other staples — has been provided by high variable levies that increase the costs of imports to a domestic policy — threshold — price. Protection has been highly variable, as the domestic target price remained fairly constant in domestic currencies, while import prices fluctuated in response to supply and demand, exacerbated by wide swings in exchange rates between the major currencies. In 1986-88 — the base period for the Uruguay Round agreements on agriculture — variable levies on imported wheat averaged \$215 per ton, or about 150 percent of the cif import price (\$142 per ton). A considerable part of this high tariff protection was redundant, however, as domestic prices in the European Community were "only" 40 to 80 percent above cif import prices (table A1.1, last column). The most frequently cited "tariff equivalent" for agricultural protection is the ratio of producer-subsidy equivalent (PSE) to the producer price in the lowest-cost supplier — for wheat, often New Zealand or Australia. This tariff equivalent fluctuated from 88 to 134 percent for the European Community, and 54 to 142 percent for the United States (table A1.1, middle column). In the Community, the tariff equivalent reflects mostly border protection, in the United States the effect of domestic subsidies. The OECD's PSE-based comparisons overestimate border protection in the European Community by 30 to 50 percentage points, because the effect of transport costs is combined with the effect of border measures.

**Table A1.1 Different measures of tariff equivalents for wheat (percent)**

Tariff equivalents		Variable levies <sup>a</sup>	PSE-based <sup>b</sup>	Domestic price excess <sup>c</sup>
European Community	1986	168	92	60
	1987	172	134	80
	1988	118	88	40
United States	1986	-	68	-
	1987	-	142	-
	1988	-	54	-

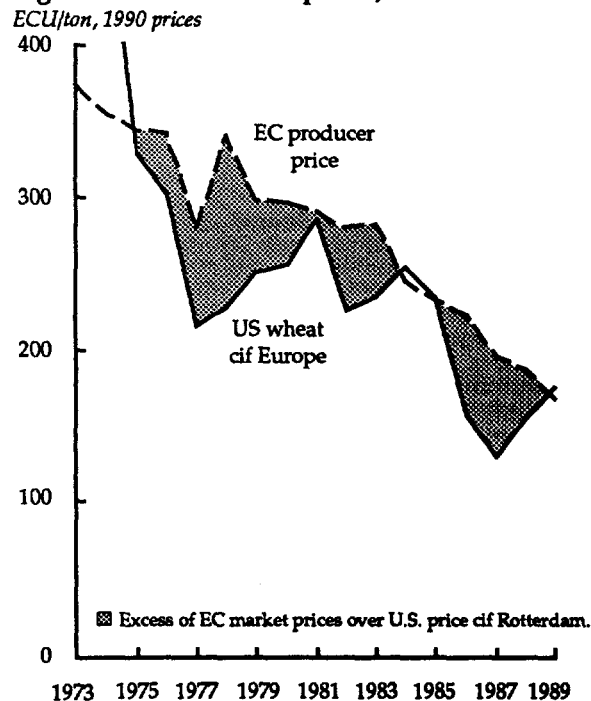
a. Variable levies as percentage of cif import prices for U.S. soft red winter wheat.  
 b. Producer-subsidy equivalent as percentage of fob export prices for lowest-cost exports.  
 c. Excess of domestic wholesale prices in the FRG over cif import prices (percent).  
 Source: OECD 1991; EC Commission.

*Specifics*

The EC Commission proposes a drastic reduction in the target price for wheat from the current 233 "green" European Currency Units (ECUs) per ton to 110 ECUs per ton — about \$140 per ton at 1991 exchange rates.<sup>1</sup> This is the Commission's estimate of "long-run" world market prices, and is fairly close to recent cif prices in Europe — \$130-\$180 in the past five years (figure A1.1). For farmers, the reduction would be less, as intervention prices are lower — 155 green ECUs per ton, net, if allowance is made for the stabilization fees that are applied to intervention purchases. Future intervention (minimum) prices

will be set at 100 green ECU/ton, a reduction of 35 percent from present intervention prices.<sup>2</sup> Farmers will be compensated for the loss of revenue by a flat per-hectare subsidy — of 45 green ECUs — differentiated regionally according to land productivity. Similar changes will be introduced for most other field crops, replacing support prices with flat per-hectare subsidies equivalent to 45 green ECUs per ton for land of average productivity. Farmers with production equivalent to more than 20 hectares of average cropland will have to set aside some land — initially set at 15 percent of the cropping area. The set-aside could be varied to keep production within guidelines. The reform is to be phased in over three years, starting with the cropping year 1993-94.

**Figure A1.1 Real wheat prices, 1979-90**



a. Deflated by ECU GDP deflator for EC-12.  
 Source: EC Commission.

**Relation of EC's Common Agricultural Policy reform and EC Uruguay Round proposals**

The CAP reform goes considerably beyond the Community's offer in the Uruguay Round. In the Uruguay Round, the European Community has proposed converting the variable levies to tariffs at 10 percent above 1986-88 intervention prices — a sharp reduction from present levels — and a 30 percent reduction of tariffs over five years (to about 80 percent on an ad-valorem basis). The internal CAP reform proposal — not bound in the GATT — would reduce domestic prices to world market levels, with the new threshold price set at 155 green ECU per ton, equivalent to a 55 percent tariff at projected world market prices (100 green ECU per ton, or \$140 per ton). Export subsidies would be reduced sharply, with intervention prices reduced from 155 percent of expected world market prices to 100 percent of expected world market prices. All this, of course, assumes that world market prices remain at present levels. But eco-



conomic modeling indicates that international market prices would rise as a result of agricultural trade liberalization (see below). At the same time, continued improvements in agricultural technology could lead to further substantial long-term price reductions requiring further deep structural adjustment in the agricultural sector. Three percent of the labor force today can feed the entire population of industrial countries, compared with 80 percent a century ago; perhaps only 1 percent of the labor force will be needed in a few years.

Although the Commission's reform proposal goes considerably beyond the EC offer in the Uruguay Round — and also beyond the likely final agreement — the reform proposal is not necessarily compatible with the objectives of other negotiating partners, or the compromise proposal of the GATT secretariat. Agricultural markets are so distorted — and domestic policies of the main suppliers so complex and mutually incompatible — that a final agreement will take time. Several points in the Community's proposal need to be agreed by other trade partners. One is the level at which nontariff barriers would be tariffied. The Commission chairman's draft guidelines are vague enough to permit widely varying interpretations of the appropriate level of tariffication — spanning the entire range of tariff equivalents indicated in table A1.1. The second issue is the extent of decoupling of the proposed transfer payments to farmers that are to replace price-supports. In one respect the Community's proposal meets the GATT decoupling standards: the hectare-based supplements are to be determined based on past output. But the Commission's proposal requires the farmers to produce to be eligible and thus appears to contradict the requirement that "no production shall be required to receive such payments." The Commission's proposal also differs slightly for different types of crops — and differs entirely for animal husbandry — and thus apparently contradicts the requirement that "payments shall not be related to the type and volume of production in any year after the base year."

Whether these differences will prove fundamental or merely justify gray-area deviations remains to be seen. One main objective of decoupled income support is to permit an orderly and gradual adjustment of the agricultural capital stock and asset prices to the new realities. There is room for disagreement, however, about what is an efficient, fair, and politically acceptable transition mechanism. Some observers have suggested simpler and more radical approaches based, for ex-

ample, on "exit bonds" (for example, Tangermann 1992). Although such approaches are theoretically elegant, practitioners and policymakers are not convinced that they would be fair and can be generalized (the Commission's proposal includes a tradable quota system for the milk sector that would function like an exit bond). In addition, the issue of rebalancing protection among close substitutes with widely varying degrees of protection has not yet been settled. The economic logic of rebalancing is obvious. Politically, however, it may be difficult to obtain agreement on substantial increases in protection for a few commodities that now have zero or very low protection (nongrain animal feed substitutes).

### The likely effects of agricultural reforms

Would drastic reduction in border protection and price support reduce *surplus production* in the European Community and elsewhere? The answer to this is, unfortunately, no. For the neoclassical economist this answer appears counterintuitive: a decline in prices should, of course, reduce production and supply. But the production function for intensive arable crop production is strongly nonlinear. Yields are unlikely to decline much — even for large decreases in prices — because yield responds favorably to additional nitrogen up to levels of 130 to 150 kilograms per hectare and then suddenly stagnates. Huge changes in product or input prices are required to obtain a measurable effect. A halving of product prices reduces the optimal level of fertilizer application only by 10 to 20 kilograms per hectare, with very limited effects on yields that would soon be compensated by the effects of improved planting and pest-management techniques. If yields are unlikely to decline, surplus production can only be curtailed through reductions in planted area — which is why land set-aside requirements figure so prominently in attempts to deal with excess production in the European Community and elsewhere.

Ideally, reductions in planted area should be in response to market forces, ensuring that the least productive areas are withdrawn first. These, however, may also be the areas where adjustment costs are largest and the effects of "de-agriculturalization" the most severe — socially, environmentally, or politically. The obvious alternative is to design special policies for disadvantaged areas — which is being done, but not enough: the main reason is that such special policies would drastically alter the national distribution of ben-

efits from the CAP. Eighty percent of support is captured by the largest 20 percent of farms, located mostly in the higher-income member countries of the European Community. Decisionmaking in the Agricultural Council is still strongly influenced by national considerations. Thus the current proposal decouples support from production decisions, but changes the distributional incidence (toward large farms) only marginally — for obvious reasons.<sup>3</sup>

Extensification — expanding the land area that is cultivated — has also been suggested for *environmental reasons*. For example, high levels of nitrogen application — from organic manure or chemical fertilizer — has caused drinking water to deteriorate in several areas, particularly in the Netherlands. Pesticides also have harmed plants and animals. The solutions to these problems cannot, however, be found in general extensification, and even less in increased reliance on “organic” fertilizer, which tends to have even more adverse effects on water quality. Nitrogen leaching varies strongly with soil types and root systems — there is more leaching in sandy soils, such as in the Netherlands, and less in areas with permanent grass cover. In most cases the right answer is direct intervention, limited to particularly affected areas, such as watersheds. Often, the appropriate solution is the mandatory conversion of arable land to permanent grass cover, with limits on animal density. Increases in crop yields release ever larger areas of land for extensive animal husbandry.

This highly simplified summary of the microeconomic consequences provides the heuristic ra-

tionale for the results of relatively sophisticated macroeconomic modeling exercises of agricultural reform and trade liberalization. The models tend to show relatively small *effects on world production and trade patterns* and welfare, even for radical changes in policy, such as a complete liberalization of trade and a full elimination of subsidies. The literature is by now voluminous. The results of one of the most recent studies are briefly summarized below, as its scenarios are closest to actual reform proposals and Uruguay Round negotiation positions (McDonald 1991). Of course, as with all such modeling exercises, the study can represent complex policy changes only in highly stylized form. Nor does it take account of other changes on the horizon, such as the agricultural reform in the former USSR that could lead to a major reduction in its food import requirements. The computable general equilibrium approach has, on the other hand, the advantage of modeling the consequences of policy change in a comprehensive, if highly simplified, way.

Table A1.2 summarizes the status-quo of agricultural policy intervention in the EC, Japan, and the United States as represented in McDonald’s model. Estimates of policy interventions closely correspond to the difference between domestic and cif import prices (McDonald 1991, table 1, last column), and are consistent with the characterization of the effects of EC agricultural policies in chapters 1 and 2.

Full liberalization and subsidy removal in agriculture is expected to lead to a decline of agricultural output in the European Community of about 9 percent (table A1.3) while U.S. output would

**Table A1.2 Current agricultural policy interventions (percent)**

	Feed grains	Food grains	Meat	Milk	Oilseeds	Sugar	Tropical products	Miscellaneous agriculture
<i>European Community</i>								
Tariffs	50	60	50	30	—	70	6	—
Export subsidies	30	35	50	20	—	70	6	—
Producer subsidies	—	—	2	2	60	-9	—	—
<i>United States</i>								
Tariffs	—	—	2	—	—	—	2	9
Quotas (tariff equivalent)	—	—	—	20	—	62	—	—
Export subsidies	—	7	3	7	—	—	—	—
Production subsidies	14	13	2	—	5	—	—	8
Land set-aside	11	11	—	—	11	5	—	6
<i>Japan</i>								
Tariffs	150	300	90	200	—	70	5	5
Production subsidies	220	12	—	6	350	10	—	—

Source: McDonald 1991, table 2.

increase modestly (1 percent). Producer prices in the European Community would decline by 14 percent, on average, ranging from 13 percent for meats to 18 percent for oilseeds. The return to all agricultural factors of production (land, labor, and capital) would decline by about 18 percent in the European Community and 7 percent in the United States — with most of the decline coming in steep reductions in land prices, estimated at 38 percent for the EC and 19 percent for the United States, because the supply of farmland is highly inelastic. Total agricultural liberalization would thus make both EC and U.S. farmers worse-off. The consequences for Japanese farmers would be even larger. These effects would be offset by a moderate gain for farmers in the land-rich regions of the world who would receive slightly more for their products (3 percent) and be able to expand output (3 percent). Factor returns are expected to increase slightly more (8 percent), mostly because of increases in land prices (15 percent). Welfare would rise most in Japan and the United States — by 0.2 percent in both countries — but by much less in the European Community (0.04 percent), mostly because of lowered prices for consumers. But benefits would also be limited for the land-rich agricultural exporters (0.02 percent), because

the moderate benefits for farmers affect only a small part of their economies.

A complete liberalization of farm policies has also been assumed in the U.S. proposal (table A1.3), but with one major difference: farmers would obtain income subsidies that do not affect production and trade. The decoupled income supports have been modeled as farmland subsidies, and correspond closely to U.S. plans and the Commission's proposal. This solution does not change production and prices significantly, compared with full liberalization, other than to transfer income to land owners. In the model, the subsidy rates have been set in each region so that the real return to farm land does not decline by more than 10 percent. The size of needed *ad valorem* subsidies would be 12 percent in the United States, 45 percent in the European Community, and 195 percent in Japan. Overall welfare changes are not much different from those under the full liberalization scenario.

The EC proposal in table A1.3 reflects the EC negotiation position in the Uruguay Round and does not include the more far-reaching changes included in the McSharry plan. Actually, the adopted CAP reform is much closer to the U.S. proposal in table A1.3 than to the EC proposal.

**Table A1.3 Simulated effects of agricultural policy reforms**  
(percent change from status quo)

	Full liberalization			U.S. proposal			EC proposal		
	EC	U.S.	World	EC	U.S.	World	EC	U.S.	World
Agricultural output	-9	1	0.3	-9	1	0.3	-2	0	-0.1
Feed grain	-7	-11	-0.8	-7	-11	-0.7	-1	-3	-0.4
Food grain	-14	-5	1.4	-14	-5	1.4	-2	-5	0.1
Meat	-12	5	0.5	-12	5	0.5	-3	2	0.1
Milk products	3	-6	-0.2	3	-6	-0.3	0	-4	-0.6
Oilseeds	-75	27	-1.6	-75	27	-1.6	-24	7	-0.6
Product prices <sup>a</sup>	-14	-4	-	-14	-4	-	-4	-2	-
Feed grain	-16	-4	-0.4	-16	-4	1.1	-6	-2	-0.8
Food grain	-17	-5	1.3	-17	-5	1.1	-6	-2	-0.3
Meat	-13	-1	-0.1	-13	-1	-0.3	-4	-1	-0.7
Milk products	-14	0	-0.6	-14	-1	-0.8	-4	-1	-0.7
Oilseeds	-18	-7	2.6	-19	-7	0.3	-7	-3	-0.1
Agricultural factor prices	-18	-7	-	-10	-4	-	-6	-3	-
Labor	-1	-5	-	1	0	-	0	0	-
Capital	-21	-5	-	-19	5	-	-6	-2	-
Land	-38	-19	-	-10	-10	-	-14	-8	-
Welfare (percentage equiv. variation)	0.04	0.17	0.07	0.04	0.16	0.07	0.05	0.06	0.03

a. The price changes indicated for the "world" are the weighted average effect for all areas (including the European Community and the United States) and not the effects on (free) world prices.

Source: McDonald, 1991.

The effects of the EC proposal on output and prices would be much less marked than under full liberalization, and welfare changes are a little higher in the European Community than in the other scenarios. This shows that the European Community has carefully chosen its negotiation position in the Uruguay Round. This position limits the effects of structural changes for EC farmers, and would provide the same—or slightly higher—benefits for the nonagricultural sector in

the European Community. It is, of course, less favorable to U.S. and Cairns Group farmers than is full liberalization or the U.S. proposal. For the European Community, the best of all worlds would be a combination of the U.S. and EC proposals, combining gradual removal of border protection with decoupled income supports borrowed from the U.S. proposal. This is, indeed, what the adopted CAP reform proposes to do.

## Annex 2 Supplementary tables

### Table A2.1 Exports of developing countries

	1973	1980	1985	1989	Annual growth 1980-89 (percent)
	Billions of current U.S. dollars				
<i>All exports to</i>					
World	113	584	501	713	2.2
EC-12	32	156	98	148	-0.6
Japan	13	83	66	90	0.9
United States	21	117	111	169	4.2
Developing countries	27	152	158	231	4.8
<i>Nonoil exports to</i>					
World	72	234	293	550	10.0
EC-12	20	58	54	112	7.6
Japan	9	21	24	59	12.2
United States	14	42	77	133	13.7
Developing countries	17	76	95	183	10.3
<i>Manufactures</i>					
World	27	113	179	385	14.6
EC-12	5	23	26	71	13.3
Japan	3	7	10	34	19.2
United States	7	26	60	110	17.4
Developing countries	8	44	61	129	12.7

Source: UN COMTRADE database.

### Table A2.2 EC VERs and surveillance measures against developing countries in industrial goods, mid-1990s

	Exporter	Importer	Product	Measure
Footwear	Korea, Taiwan (China)	EC	Footwear (excluding slippers)	Voluntary export restraint
	China	France	Slippers and sandals	Autolimitation
	Korea	Ireland	Footwear	Industry-to-industry
Textiles	Cyprus, Egypt, Malta, Morocco, Tunisia, Turkey	EC	Certain textiles and clothing	Informal restraint
	Bolivia, Chile, Costa Rica, Cuba, El Salvador, Honduras, Nicaragua (outside Multi- Fiber Arrangement), Paraguay, Venezuela	EC	Certain textiles and clothing	Exchange of letters (surveillance)
Steel	Brazil	EC	Pig iron and steel	Voluntary export restraint, price monitoring
Electronics	Korea	EC	Microwave ovens	Export moderation (industry)
	Korea	EC	Videocassette recorders	Surveillance/export Monitoring/ moderation
Other	Korea	Belgium, Netherlands, Luxembourg,	Metal, flatware	Industry-to-industry
	Singapore, Taiwan (China), Thailand	France	Umbrellas	Industry-to-industry

Source: GATT 1991.

**Table A2.3 Selected indicators in the EC footwear market**

	1986	1988	1989	1990	1991
Market penetration by external suppliers, EC-12 (percent)	28	38	37	32	
Extra imports (value) as percentage of total EC-12 imports (percent)	28	35	35	35	41
Korea	3	6	6	6	
Taiwan (China)	5	7	6	4	
Indonesia + Thailand	0	1	1	2	
Production (millions of pairs)					
EC-10	975	874	770	821	
• France	195	167	168	178	
• Italy	499	436	407	425	
Portugal	66	81	96	102	
Spain	171	163	181	252	
Import growth (percent)	(1987)				
Intra value (ECUs)	3	-4	9	11	
volume	3	-3	-1	n.a.	
Extra value	22	16	11	11	
volume	39	6	-2	-19	
By country (value, in ECUs)					
Italy	-1	-9	9	8	
Portugal	23	9	18	15	
Spain	10	4	6	20	
Korea	55	44	-1	19	
Taiwan (China)	34	12	2	-30	
China + Indonesia + Thailand	88	49	36	67	

Source: Eurostat.

**Table A2.4 EC antidumping investigations against developing countries, 1986-90**  
(number of cases)

	Total 1986-90	1986	1987	1988	1989	1990	1991
Asia	64	4	10	22	11	17	7
Korea	19	1	5	7	1	5	1
China	18	2	-	7	5	4	4
Hong Kong	6	-	1	3	2	-	-
Taiwan (China)	6	-	3	1	1	1	2
Thailand	5	-	-	3	-	2	-
Latin America	14	3	5	-	1	5	-
Brazil	7	2	1	-	-	4	-
Mexico	4	1	3	-	-	-	-
Venezuela	2	-	1	-	1	-	-
Mediterranean	34	5	7	3	6	13	3
Turkey	15	1	3	-	4	7	1
Yugoslavia	15	4	3	3	2	3	1
All developing countries	112	12	22	25	18	35	10
All countries	149	24	39	40	27	43	20

Source: EC Commission 1991a.

**Table A2.5 EC trade in agriculture, 1989  
(percent)**

	<i>Imports as share of agricultural goods</i>	<i>Exports as share of production</i>	<i>Imports as share of consumption</i>	<i>Comments</i>
<b>CAP products</b>				
Variable levies	12	n.a.	n.a.	
Cereals	6	16	4	• Levy 94 percent, export subs 30 percent; some imports at reduced levies (U.S.-Portugal)
Beef, veal	3	14	6	• Levy 180 percent of world price, refund 43 percent of domestic price
Pork	0	4	1	
Poultry	1	7	2	
Olive oil	0	12	4	
Sugar	2	23	18	• Imports from 13 ACP countries at quotas with EC prices
Milk	1	29	4	
<b>Other restrictions</b>				
Fruit	}		3	8 • Reference prices,
Citrus	}	11	7	21 seasonal duties
Vegetables	}		1	2
Wine	0	7	3	• Reference prices
Mutton	1	7	21	• Voluntary export restraints, no duty, levies 160 percent of world prices
Fish	12	n.a.	n.a.	• Reference prices
Oils and fats	14	n.a.	n.a.	
Other	18	n.a.	n.a.	
<b>Non-CAP products</b>	<b>37</b>	<b>n.a.</b>	<b>n.a.</b>	<b>• Mostly tropical products</b>
<b>Total</b>		<b>100</b>		

CAP = Common Agricultural Policy.

n.a. = Not available.

Source: Eurostat; EC Commission 1991b.

**Table A2.6 EC imports of fruits and vegetables by origin, 1989 (percent of total imports)**

	Percentage of total EC imports	Increase in period 1984-89 nominal growth
Intra-EC trade	60	86
Developing countries	31	69
Thailand	3	12
Turkey	3	86
Brazil	2	112
Israel	2	29
Morocco	2	102
China	1	186
Chile	1	217
Côte d'Ivoire	-	13

Source: OECD Databank.

**Table A2.7 EC imports of ten major food products, 1979-88**

Food products	Share in total food imports (%)		Increase in nominal growth in dollars (%)
	1979	1988	
Coffee	12	9	-17
Soybeans	8	6	-25
Oilcake	4	5	34
Bananas	2	3	75
Cocoa	4	3	-31
Crustaceans	1	3	212
Fish	0	2	233
Fish, prepared	1	2	83
Oranges	2	2	15
Manioc and other roots	2	2	2
Total food imports <sup>a</sup>	100	100	7

Note: Data are calculated at the five-digit Standard International Trade Classification (SITC) level, Revision 2. Data are for EC-10.

a. SITC 0, 1, 22, and 4.

Source: UN COMTRADE database; GATT 1991a.



**Table A2.8 EC trade preferences and their limitations for developing countries**

<i>Beneficiaries</i>	<i>Agriculture</i>	<i>Industry</i>
ACP 69 African, Caribbean or Pacific countries	<ul style="list-style-type: none"> <li>- tariff quotas at reduced or zero rates with seasonal limits</li> <li>- quotas at reduced variable levies</li> <li>- sugar quotas at EC support prices for thirteen ACP countries</li> <li>- banana quotas</li> <li>- national quotas</li> </ul>	<ul style="list-style-type: none"> <li>- duty free</li> <li>- some antidumping investigations</li> </ul>
Mediterranean countries 12 Mediterranean countries	<ul style="list-style-type: none"> <li>- tariff quotas at reduced or zero rates with seasonal limits</li> <li>- national quotas</li> </ul>	<ul style="list-style-type: none"> <li>- duty free</li> <li>- Voluntary export restraints on textiles, some antidumping measures, national quotas</li> </ul>
Generalized system of preferences <ul style="list-style-type: none"> <li>• LLDCs (8)</li> <li>• Andean group</li> </ul> 4 Latin American countries <ul style="list-style-type: none"> <li>• Other developing countries</li> </ul> 52 mainly Asian and Latin American countries Eastern Europe Baltic countries, Albania	<p>Four types of benefits:</p> <ul style="list-style-type: none"> <li>• reduced duties for fixed ECU amounts on sensitive goods</li> <li>• some nonsensitive goods duty free with seasonal limits</li> <li>• reduced variable levies for fixed amounts</li> <li>• some sensitive primary products excluded (metals and chemicals)</li> </ul> <p>- VERs, national quotas</p>	<ul style="list-style-type: none"> <li>• in general duty free, LLDCs and Andean exempt from quota limits</li> </ul> <p>Six types of limits to benefits:</p> <ul style="list-style-type: none"> <li>• <i>sensitive industrial goods</i> - fixed ECU limits (ceiling) by country</li> <li>• <i>nonsensitive industrial goods</i> - zero duties (China, Hong Kong, and Korea excluded), subject to safeguards</li> <li>• <i>Multi-Fiber Arrangement (MFA) textiles</i> - limited to signatories of MFA, LLDCs, and Andean; smaller tariff quotas for competitive suppliers; higher limits (ceilings) for others</li> <li>• <i>other textiles</i> - country-specific tariff quotas or limits (ceilings)</li> <li>• <i>jute</i> - zero duties for India, Thailand, and LLDCs</li> <li>• <i>steel</i> - zero tariff quotas according to competitiveness</li> </ul> <p>- VERs, national quotas, anti-dumping measures</p>

LLDC = non-ACP least developed countries.

**Table A2.9 Per capita exports of moderately protected agricultural goods by selected developing countries**

	<i>Fruits and vegetables (SITC 05) to</i>		<i>Fish (SITC 03) to</i>	
	<i>EC</i>	<i>OECD</i>	<i>EC</i>	<i>OECD</i>
<b>Preferential suppliers</b>				
<b>Mediterranean</b>				
Israel	116	150	-	-
Morocco	20	26	10	18
Turkey	13	17	1	1
Tunisia	7	7	11	12
Algeria	0	0	-	-
<b>African, Caribbean, or Pacific countries</b>				
Côte d'Ivoire	12	13	11	11
Cameroon	3	3	-	-
Ghana	0	0	3	2
<b>Generalized system of preferences</b>				
Chile	25	72	14	30
Thailand	14	20	7	33
Argentina	9	15	6	10
Brazil	4	10	0	1
<b>For reference</b>				
Spain	80	102	8	14
Greece	7	12	7	7
Portugal	6	9	17	23

a. Standard International Trade Classification.  
Source: OECD Trade Databank.

**Table A2.10 Imports from developing countries by main product categories**

	<i>In dollars</i>			<i>Share (percent)</i>		
	1962-70	1970-80	1980-90	1970	1980	1990
<b>All products</b>						
EC-12	7.8	22.2	1.5	100	100	100
United States	7.9	29.5	6.8	100	100	100
Japan	17.5	27.4	2.5	100	100	100
<b>Oil</b>						
EC-12	10.3	29.0	-5.6	33.8	56.9	27.3
United States	3.1	43.3	-3.1	16.8	54.2	22.2
Japan	13.0	38.1	-2.6	31.6	67.7	39.0
<b>Nonoil</b>						
EC-12	6.9	18.1	9.3	66.2	43.1	72.7
United States	9.2	21.4	13.3	83.2	45.8	77.8
Japan	17.9	19.3	12.3	68.4	32.2	60.9
<b>Other primary</b>						
EC-12	7.3	12.5	3.2	26.9	11.3	11.1
United States	3.9	17.4	2.0	16.5	6.1	3.8
Japan	18.3	14.6	4.2	43.7	14.8	13.7
<b>Food</b>						
EC-12	3.7	14.4	4.2	26.1	11.7	12.9
United States	5.0	14.5	3.3	32.5	9.6	6.8
Japan	14.5	19.4	10.5	15.5	6.8	11.5
<b>Manufactures</b>						
EC-12	15.1	28.1	13.8	13.1	20.1	48.6
United States	22.0	26.4	16.3	34.1	30.2	67.0
Japan	24.7	30.0	19.2	9.2	10.5	35.6

*Note:* Developing country total includes Eastern Europe and the former USSR.  
*Source:* UN COMTRADE database.

**Table A2.11 Imports of manufactures from developing countries by product (percent)**

Product	1980			1990		
	EC	U.S.	Japan	EC	U.S.	Japan
Chemicals	10.8	3.8	13.3	7.6	3.2	8.9
Iron and steel	5.2	4.5	9.2	3.7	2.3	11.4
Machinery	18.9	27.9	14.7	27.8	38.4	18.5
Power	1.4	0.5	0.4	1.3	1.1	0.3
Other nonelectric	2.3	2.4	1.4	2.8	3.0	3.0
Office machines	4.6	9.9	3.6	11.6	15.3	6.3
Electric machinery	4.8	12.7	7.1	7.8	1.1	7.9
Motor vehicles	2.0	1.1	0.1	2.1	4.7	0.4
Other transport equipment	1.7	1.5	2.1	1.9	1.1	0.6
Textiles	10.3	3.7	14.7	7.1	2.7	6.6
Clothing	20.1	18.7	15.3	20.5	18.3	19.8
Miscellaneous	14.6	24.3	13.6	17.5	23.9	17.8
Other	16.4	14.9	17.0	11.8	5.4	16.0
All manufactures	100	100	100	100	100	100
Billions of dollars	45	39	10	127	155	45

Note: Developing country total includes Eastern Europe and the former USSR.  
Source: UN COMTRADE database.

**Table A2.12 Imports of manufactures from different countries by source (percent)**

	1980			1990		
	EC	U.S.	Japan	EC	U.S.	Japan
All developing countries	100	100	100	100	100	100
Asia	47.2	69.0	82.4	56.7	73.8	89.8
NIEs	26.9	46.1	41.7	28.0	39.9	40.9
ASEAN four	3.7	6.6	6.1	7.5	8.8	11.6
China	3.3	1.9	9.5	8.0	9.4	13.0
Other Asia	12.7	14.1	24.7	12.6	15.3	24.0
ACP	-	-	0.1	-	-	-
LLDCs <sup>a</sup>	0.7	0.3	0.2	0.6	0.4	0.1
Latin America	7.3	19.0	5.5	6.5	21.2	3.7
ACP	1.2	2.3	0.4	0.5	1.8	0.1
Other LAC	6.1	16.7	5.1	6.0	19.4	3.6
Sub-Saharan Africa	9.3	6.0	6.0	4.2	0.7	1.0
ACP	5.7	0.3	3.4	2.8	0.4	0.1
Other Africa	3.6	5.6	2.5	1.4	0.3	0.9
Mediterranean	13.4	3.3	2.7	19.1	3.2	2.3
Other Middle East	3.5	0.2	0.2	2.1	0.3	1.4
Eastern Europe and Central Asia	19.2	2.3	3.0	11.3	0.7	1.7
Former USSR	6.5	0.6	2.3	3.1	0.2	1.1
Other	12.7	1.7	0.6	8.2	0.5	0.6
Note:						
All ACP	6.9	2.7	4.1	3.3	2.2	0.3
All LLDC	0.7	0.2	0.2	-	0.4	1.0

ACP = Asian, Caribbean, and Pacific countries.

LLDC = Non-ACP least developed countries.

Note: Developing country total includes Eastern Europe and the former USSR.

a. See table A2.9.

Source: UN COMTRADE database.

**Table A2.13 EC imports of manufactures from different developing countries  
(percent per year, percent)**

Main sources	Growth			Share		
	1962-70	1970-80	1980-90	1962	1980	1990
Total developing	15.1	28.1	13.8	100	100	100
<i>Asia</i>	13.5	31.9	15.8	33.9	47.2	56.7
NIEs	15.2	31.3	14.5	16.1	26.9	28.0
ASEAN four	25.4	45.8	20.6	0.5	3.7	7.5
China	18.1	28.5	22.8	2.2	3.3	8.0
Other Asia	10.2	31.2	14.3	14.5	12.7	12.6
ACP	10.5	36.3	7.7	-	-	-
Non-ACP LDCs	-4.1	42.2	13.5	0.6	0.7	0.6
<i>Latin America</i>	19.4	24.4	11.3	6.0	7.3	6.5
ACP	23.3	20.8	5.4	1.0	1.2	0.5
Other LAC	18.8	25.2	12.1	5.0	6.1	6.0
<i>Sub-Saharan Africa</i>	20.9	30.6	6.7	11.0	9.3	4.2
ACP	22.3	28.4	7.8	5.0	5.7	2.8
Other Africa	19.3	32.9	5.0	6.0	3.6	1.4
<i>Mediterranean</i>	12.7	25.0	17.1	15.8	13.4	19.1
<i>Other Middle East</i>	11.3	27.0	9.4	4.5	3.5	2.1
<i>Eastern Europe and Central Asia</i>	14.7	24.3	8.1	28.7	19.2	11.3
Former USSR	9.4	36.7	8.4	11.7	6.5	3.1
Other	16.9	20.5	8.0	17.0	12.7	8.2
<i>Note:</i>						
All ACP	22.6	26.6	7.4	5.8	6.9	3.3
All LLDCs	-3.9	42.6	13.3	0.7	0.7	-
Billions of dollars				1.3	45	126

ACP = Asian, Caribbean, and Pacific countries.

LLDC = Non-ACP least developed countries.

Note: Developing country total includes Eastern Europe and the former USSR.

Source: UN COMTRADE database.

**Table A2.14 EC imports of manufactures from developing countries by major products  
(percent per year, percent)**

	Growth			Share		
	1962-70	1970-80	1980-90	1962	1980	1990
Chemicals	14.2	25.2	9.3	13.9	10.8	7.6
Iron and steel	10.4	19.0	11.4	13.7	5.2	3.7
Machinery	16.0	31.6	18.4	11.4	18.9	27.8
Power	6.4	30.0	10.8	2.6	1.4	1.3
Other nonelectric	15.8	20.4	15.4	3.6	2.3	2.8
Office machines	19.6	38.4	25.8	1.1	4.6	11.6
Electric machinery	24.6	33.7	19.3	1.4	4.8	7.8
Motor vehicles	7.2	36.4	12.8	1.3	2.0	2.1
Other transport equipment	19.8	24.2	11.3	1.4	1.7	1.9
Textiles	8.5	22.7	9.3	20.3	10.3	7.1
Clothing	18.9	31.1	12.9	8.4	20.1	20.5
Miscellaneous	16.1	31.2	16.0	9.4	14.6	17.5
Other				20.2	16.4	11.8
All manufactures	15.1	28.1	13.8	100	100	100

Note: Developing country total includes Eastern Europe and the former USSR.

Source: UN COMTRADE database.

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## Notes

### Chapter 1

1. For a detailed analysis see, for example, Kock (1968, chapters 3 and 4) or Dam (1970, chapter 5). In particular, the method of general, across-the-board tariff cuts had been suggested by EC member governments and was later espoused by the U.S. in the Kennedy Round (1963-68) in place of the traditional reciprocal line-by-line approach, which proved too cumbersome and thus unsuccessful. Similarly, early rounds of trade negotiations were mostly concerned with tariff reductions, in part as a response to the tariff elimination in the EEC, while the much broader scope of the Uruguay Round (services, technical standards, government procurement, and so on) reflects, in part, the extension of European economic integration to include these issues.

2. For an insider account of the early post-war efforts at European integration see, for example, Denis de Rougemont, "The Campaign of the European Congresses," in Ionescu (1972).

3. The plan for a European Defense Community, also originated by Jean Monnet, failed in 1954 when the French national assembly refused to ratify the EDC treaty.

4. The preparatory work for the EEC and Euratom treaties was launched at a conference of the foreign ministers of the ECSC in 1955 in Messina. Two plans had been proposed at Messina. The Benelux countries and Germany favored

broader economic integration, based on a customs union, but the French government favored the sectoral approach proposed by Jean Monnet who wanted to add nuclear power to the responsibilities of the ECSC. To persuade France to take part in the discussions on wider economic issues the others decided to support Monnet's proposal on atomic energy, eventually leading to the two treaties (see, for example, Wistrich 1991, chapter 2).

5. It has become general practice to use the term "European Community" for the three, now fully integrated, communities. This practice is also followed by the European Community, except in legal contexts, where the official title "European Communities" continues to be used. After the ratification of the Monetary and Political Union Treaties, agreed upon at the Maastricht Summit in December 1991, the European Community will become the European Union.

6. Due to the broad scope of the EEC Treaty, it would have been possible to subsume the ECSC and Euratom under the EEC Treaty. A proposal by the Commission in the early 1960s to fully integrate the three treaties was not adopted because of opposition by France, which feared that a single-treaty structure would broaden the Commission's powers. The three Commissions and councils of ministers were merged in 1967, but the three treaties remain separate instruments (there was only one Assembly and one Court from the start). The ECSC Treaty expires in 2002.

7. The incident leading to the boycott of Council meetings was the Commission's proposal to transfer the revenues from the agricultural levies to the Community's own budget and to strengthen Parliament's budgetary powers. The real issue, however, revealed by de Gaulle's speech of September 9, 1965, was the shift to majority voting, set for the beginning of 1966. The firm stand by the other five members against a revision of the treaties, and strong domestic opposition to his position led de Gaulle eventually to agree to the Luxembourg compromise of January 1966. Other political issues, such as his opposition to the U.S. proposal for a multilateral force, also played a role. For a detailed account see Camps (1967) or von der Groeben (1987).
8. De Gaulle's veto of the British membership application in 1963 — and again in 1967 — was motivated mainly by his desire to minimize U.S. influence in Europe (see Camps 1965). He actually shared earlier British apprehensions about the supranational character of the European Community.
9. Norway also signed the accession treaty in 1972, but the treaty was later rejected in a popular referendum. To ease Britain's entry into the European Community, free-trade agreements were signed in 1973-74 with the seven members of the European Free Trade Association that did not choose EC membership. These agreements were bilateral, excluded agriculture, and had four-year transition periods coinciding with the first EC enlargement. Free trade in industrial goods among these sixteen countries went into effect in July 1977.
10. For a detailed account see Albert and Ball (1983), Schmitt von Sydow (1989), or Wistrich (1991).
11. Parliament commissioned, among other things, the Albert-Ball report of 1983, which highlighted the many nontariff barriers separating national markets and closely linked the lagging performance of European firms in high technology to the fragmented European market.
12. Regular meetings of the Heads of State of EC members, now called the European Council, have been held since 1974, when French President Giscard d'Estaing persuaded his colleagues that facilitation of Community goals was a French priority. The role of the European Council, meeting three times a year, was formalized with the Single European Act.
13. The Court of Justice has recently issued a ruling that implies that most environmental issues can be regarded as internal market issues and are thus subject to majority voting. Moreover, the Maastricht Treaty will extend majority voting to environmental and social issues and some aspects of foreign, security, and defense policies.
14. The United Kingdom and Ireland have obtained an exception from the common social policy provisions of the Maastricht Treaty and thus will be excluded from voting on social policy matters in the Council. The United Kingdom has also been given the option of remaining outside the monetary union. For other members that meet the fiscal and monetary preconditions, membership is compulsory.
15. The high ratios of imports to GDP for the European Community and Japan in 1980 reflect the high price of imported petroleum at that time.
16. Since trade/GDP ratios vary for countries of different sizes, table 1.3 gives national data only for the larger four countries with populations of 50 to 60 million each.
17. The external trade of the Federal Republic is slightly understated in table 1.3 (and in most other sources), as intra-German trade before unification was excluded from official statistics and treated as domestic trade. However, the total volume of intra-German trade was small — about 1.5 percent of the external trade of the Federal Republic of Germany.
18. Income elasticities have been calculated by using volume data. Price indices for exports of manufactured goods from developing countries are not available. The Bank's unit value index (MUV) for manufactured exports from five industrial countries has been used as a proxy to deflate current dollar trade values for manufactured goods.
19. For example, Japanese automobile producers have shown in the United States and elsewhere that it is possible to transplant the high productivity and quality production and management sys-

tems to other countries and cultures (see Womack and others 1990). An additional incentive for cross-border investment are the large swings in exchange rates that cannot always be fully hedged several years into the future.

20. The Maastricht Treaty strengthens the enforcement of EC legislation by enabling the Commission to assess fines on member states if the Court has confirmed a violation of treaty obligations.

21. Trade in coal and steel is formally the responsibility of the ECSC.

22. Specific duties are imposed on these goods mainly to facilitate customs valuation and administration — for example, to avoid customs delays resulting from valuation disputes about perishable goods.

23. Article 115 transshipment restrictions are defined in terms of 4-digit tariff lines (corresponding to about 20 8-digit lines) and for textiles and clothing in terms of MFA categories (about 100 8-digit tariff lines each). There are about 27,000 8-digit tariff lines.

24. In addition, cars from Japan are restricted through domestic registration procedures.

25. The VER for Japanese automobiles is not really EC-wide (see chapter 3).

26. Antidumping measures can be applied to assembly operations in the European Community, if the value of inputs from the exporting country in question exceeds 60 percent. A GATT panel has found this rule inconsistent with relevant GATT provisions. The European Community has decided not to apply the antiscrewdriver provisions, while negotiations on anticircumvention rules continue in the Uruguay Round.

27. A number of antidumping cases involve textiles, where opportunities for discriminatory pricing might be expected to be limited. Closer inspection shows, however, that all successful antidumping cases relating to textiles involve synthetic fiber production, where economies of scale are substantial and, with substantial overcapacity, invite discriminatory pricing.

28. See for example, the case of Japanese photocopier exports in the European Community (Messerlin and Noguchi 1991).

29. Agreement has been reached on a narrow definition of permissible subsidies for steel, but disagreements continue on whether allowable subsidies can be included in the determination of dumping margins.

30. The principle of the unified market has been partly breached through the introduction of the system of Monetary Compensation Amounts (MCAs). MCAs date to the devaluation of the French franc in 1969, were intended to prevent the inflationary effects of currency devaluations on food prices, and are essentially border taxes and subsidies. The system was expected to promote monetary and exchange rate stability. Instead, it led to different national food prices. For the members of the European Monetary System (EMS) that have narrow exchange rate fluctuations, of up to 2.25 percent, the divergence of national agricultural food prices has remained small — mostly within normal transport cost margins. But for members with high inflation and large exchange rate adjustments, national food prices are significantly below the EC average. MCAs are no longer applied among members of the narrow EMS band, and the entire system is to be dismantled in 1992.

31. The effect of variable levies has been accentuated in the case of grain by determining variable levies on the basis of the lowest available cif prices (from marginal supplies). This increases import prices from potentially significant suppliers even beyond the high ceiling — target — prices (see figure 1.4).

32. Ironically, the exemption of agricultural products from normal GATT disciplines was introduced in the 1950s in response to a request by the United States (Dam 1970 and Jackson 1969). Similarly, there was a general post-war consensus — even among today's land-rich food exporters — that agricultural prices needed to be stabilized. The distortions introduced by stabilization schemes have been underestimated (Johnson 1991).

33. The large intra-EC trade in tropical products reflects the spatial concentration of importers and primary processing plants, and the absence of transshipment restrictions (except for a few Ar-



title 115 restrictions, notably on bananas — see chapter 2).

34. Unless supported through “decoupled” income supports such as the proposed flat per-hectare subsidies.

## Chapter 2

35. The definition of a developing country — or the South — is getting increasingly difficult with the rapid growth in some formerly poor countries and integration of the formerly centrally planned economies into the world economy. Because this chapter makes use of GATT, UNCTAD, and UN data, it adopts their definition. The UN definition also better corresponds to the groups of countries receiving special treatment in the European Community. This includes China and Turkey and all non-OECD countries other than Eastern European and other formally centrally planned economies. For reference, annex tables 2.10-2.14 provide trade statistics for developing countries including Eastern Europe and the former USSR. Because their per capita GDP is below \$7,000, they have been classified as developing countries in recent statistics by international organizations.

36. For a complete discussion of EC mechanisms, refer to chapter 1.

37. The World Bank food commodity price index (in current U.S. dollars) in 1990 was about 30 percent below its 1980 level.

38. According to Möbius (1991) in 1991 there would still be 819 national restrictions for industrial products — after the termination of the Eastern European ones. Many of the restrictions are not enforced. Most are maintained by France (312) and Italy (386), but only the United Kingdom and Germany have no national quantitative restrictions. In agriculture most quotas are applied seasonally or to only a few suppliers. (EC COM(90) 194.)

39. Data on price undertakings are not collected by the European Community, but according to the EC Commission undertakings have been used less often and probably affect a smaller volume of imports than do duties.

40. The GSP scheme provides duty-free access for MFA signatories in products covered by the scheme, but subject to country-specific quotas. The benefits vary according to degree of competitiveness. In 1987 only 1 percent of EC imports from Hong Kong entered duty free under the GSP against, say, 25 percent for Thailand and 88 percent for Nepal.

41. The protective effect of quantitative restrictions under the Multi-Fiber Arrangement is difficult to determine. A number of authors have used prices from quota transfers in Hong Kong and have added these to MFN tariffs to arrive at an estimate of total protection facing all developing country textile exports. This is wrong for three reasons: first, many developing countries benefit from zero tariffs on textiles under association agreements (ACP and Mediterranean) or tariff rebates under the GSP scheme. Second, Hong Kong is one of the most restricted exporters and quota prices in Hong Kong may be much higher than elsewhere. Third, the functioning of the Hong Kong quota market has not always been fully understood (see Silberston and Ledié 1989 for a detailed discussion). For Hong Kong, adding tariffs and quota prices to arrive at the total protection would be correct, if all quotas were auctioned off by the government every year. This is not the case. The (private) quota market is a (thin) market mostly for annual quota repurchases to avoid reallocation of *unused* quotas by the government. Prices for quota repurchase agreements for the same item fluctuate widely in a year. The market can be better understood as a spot market for perishable fashion ideas in the face of quota restrictions. Whenever a manufacturer has a hot selling high-rent item it pays to buy additional quotas at substantial prices. Quota prices may even exceed unit profits on a particular item, for example, if inventories become less valuable due to rapidly shifting fashion trends, or if suppliers for high-demand items want to maintain customer goodwill by supplying additional quantities below average (or even marginal) costs. This view is also corroborated by the small volume of quota repurchase transactions (about 15 percent of the total) (Silberston).

42. Most EC textile agreements contain extra quota provisions for outward processing arrangements. This means that textile products are assembled abroad using EC inputs and the inputs are duty

free when the end product reaches the border.

43. They affect milk, beef and veal, pork, poultry, cereals, olive oil, and sugar.

44. Botswana, 18,916 tons a year; Kenya, 142; Madagascar, 7,579; Swaziland, 3,363; and Zimbabwe, 9,100. (Lomé IV, Protocol 7.)

45. The EC export amounts were 26 million tons of cereals and 994,000 tons of beef.

46. Cauliflower, tomatoes, oranges, mandarins, nectarines, tangerines, eggplants, lemons, table grapes, apples, pears, peaches, and apricots.

47. The most important ones are maintained by France (beans, grapes, melons, tuna, skipjack, and orange juice) and Greece (oranges, tomatoes, beans, melons, and grapes). Belgium and Luxembourg (tomatoes and grapes) and Italy (orange juice) have a few notable restrictions. In addition, Portugal and Spain are subject to separate restrictions, as they will be subject to the CAP only around 1993.

48. After a considerable surge in imports in tapioca in the early 1980s, the EC negotiated a VER with the main suppliers (Indonesia and Thailand).

49. For example, coffee and cocoa are subject to excise taxes of up to 50 percent in Denmark, Germany, and Italy.

50. The overall decline in commodity prices in the past decade has influenced export earnings in many categories of tropical products. In 1989 coffee prices were 30 percent and cocoa prices 53 percent below their 1980 levels, and over ten years the dollar-value of coffee and cocoa imports to the European Community declined by 17 percent and 31 percent (table A2.4).

51. France has restrictions on honey and pineapple with a few developing country suppliers.

52. As Portugal and Spain gradually gain duty-free access to EC markets in agricultural products, the European Community compensated Mediterranean countries for potential loss of markets by granting duty-free access for traditional volumes imported from Mediterranean countries.

53. Bananas from a number of ACP countries or overseas territories have a guaranteed market access in France, Italy, Portugal, Spain, and the United Kingdom, enforced by Article 115 restrictions. These countries restrict imports of bananas from the more competitive Central and South American producers to the benefit of their former colonies in Africa and the Caribbean.

54. Non-ACP LDCs: Afghanistan, Bangladesh, Bhutan, Laos, Maldives, Myanmar, Nepal, and Yemen; Coca countries: Bolivia, Colombia, Ecuador, and Peru.

55. Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama.

56. ACP and Mediterranean benefits are contractual.

57. The tariff equivalent of all protection and support measures for beef and veal, including variable levies and tariffs, can be up to 100 percent of world prices.

58. The tariff equivalent of border protection for rice can be up to 130 percent.

### Chapter 3

59. Many issues subject to majority voting are in fact decided by common agreement. However, the "threat" of majority voting is now taken more seriously and members who cannot muster a blocking minority now usually go along with the majority view.

60. The 1991 Maastricht Treaty, however, will lead to a common currency sometime between 1997 and 1999, and the provisions of the monetary union treaty imply considerable convergence on fiscal policy — limits on deficit spending, public debt ceilings, and so on.

61. The Cassis de Dijon case was brought by a German retailer against a German law that required liqueur to have a 32 percent alcohol content, and thus excluded Cassis de Dijon — which has only 17 percent from the German market. The Court ruled that Germany could not exclude the French liqueur, even though it did not meet German standards, because it was legally produced and sold in France. The ruling has since been

applied to German beer and Italian pasta purity standards.

62. This involves, among other things the creation of an EC-wide system of customer identification numbers, and application of the self-enforcing features of VAT EC-wide. This requires private-sector cooperation and involves a shift of responsibility (and possible liabilities) to vendors — such as, for verifying status of tax-exempt customers in other member countries.

63. Tax collections would not be affected by the shift to the new system if rates were identical or trade flows symmetrical. Because this is not the case, a net settlement of VAT receipts will be made among tax administrations to maintain the current pattern of tax revenues.

64. However, two-thirds of the budget is devoted to the common agricultural policy, and three-quarters of this flows to richer, northern farmers.

65. For example, as long as Germany applied its traditional solidarity with France to the common agricultural policy, only one small member (Ireland) was required to block reform of the CAP. However, since failure of the Uruguay Round was too large a risk for Germany's trade interests, it finally broke ranks. Similarly, approval of the last three technical standards required for EC-wide vehicle type approval has been blocked by a coalition of France, Italy, and Spain, fearing that this would increase the advantage of foreign car manufacturers. However, as one of the most attractive locations for foreign assembly operations in the European Community, Spain switched sides, once agreement on a transitional arrangement with Japan was reached.

66. Some authors have suggested that mutual recognition of technical standards and certification within the EC does not necessarily imply application of this principle to third country suppliers. Although this has not yet been tested in the Court, it seems likely that the Court would rule in favor of third country suppliers, otherwise free intra-Community trade of products with foreign components would also be affected, totally unravelling the objective of the 1992 program.

67. Some authors — such as Messerlin 1989 — have argued that antidumping actions have become a main tool of protectionism. This seems

exaggerated in view of the very limited coverage of antidumping measures (around one percent of EC imports), and the fact that nearly all antidumping measures are for products with a high share of fixed costs in total production costs and worldwide excess capacity — inviting discriminatory pricing to obtain some return on investment (for example, steel, urea, and synthetic fibers).

68. For these categories of primary goods the following elasticities are best guesses for the 1990s: food (0.4), raw materials (0.3), fuels (1.0), and ores and metals (0.7).

69. Portugal and Spain are important producers of agricultural goods competing with the Mediterranean fruits and vegetables. Eastern Europe is more likely to affect temperate agricultural products exported from Latin America. The effect of both enlargements is likely to be short term and small. Costs in the southern members are likely to increase from the wage trends in the single market, harmonization of EC labor and social laws, and increased investment. With fixed exchange rates, appreciation in the real exchange rate would be reflected in higher costs of production.

70. The effect of the single market on developing countries has been studied by Davenport and Page (1991), Langhammer (1990), Alizadeh and Griffith-Jones (1991); UNCTAD (1991); Koekkoek, Kuyenhoven, and Molle (1990); and Emmerij (1990) — who show different results and opinions. The studies rely on partial equilibrium analysis and are highly speculative. The effect of 1992 will be spread over years and depend on developments in several unknown external factors. Most studies also assume that the main source of trade creation for developing countries is EC income growth: current exports are multiplied by varying assumptions on income elasticities and growth.

71. Summaries of various econometric studies (mostly on total import demand from all sources) are in Goldstein and Khan 1985. The common range for manufacturers is 1 to 2.5 for all sources. For developing countries they tend to be from 2 to 4. Goldsbrough and Zaidi (1986) report 4.3 for manufacturers from developing countries.

72. The most pessimistic existing estimates are by Davenport and Page (1991) and Möbius and Schumacher (1991). They use income elasticities

of 1.3 and 2.0, respectively, for manufacturers. Regression results by Langhammer (1990) and by Alizadeh and Griffith-Jones (1991) show higher elasticities (5.5 and 3.5, respectively) from past trends. The only sectoral estimates available are those of Alizadeh and Griffith-Jones: those for typical developing-country industries are low, 2.5 in textiles and clothing, 3.7 in leather, and 3.4 in metal manufacturing. Estimates for higher-technology industries are higher, 13.5 in office and data processing, and 7.7 in electrical machinery. The empirical estimates with data from the 1980s are likely to reflect the dollars-ECU exchange rate fluctuations, low initial level of exports, and supply factors, which may not continue in the 1990s.

73. The average estimate of trade diversion by the European Community — 10 percent over five years — is for all sources and sectors, and is likely to be an overestimate for developing countries. This is because, in many sectors, developing countries have been more competitive than Community- or other industrial country-competitors. During the 1980s, EC imports of manufacturers from the South grew twice as fast as those from industrial countries, despite selective border protection. For a given income growth, the higher import growth is likely to reflect more flexible supply conditions. In many labor-intensive products developing countries are likely to remain more competitive.

#### Chapter 4

74. In the following chapter, the term Eastern Europe usually excludes the successor states to the USSR, except when indicated. Data usually refer to the five former Comecon members — excluding Albania and the successor states to Yugoslavia. Sometimes, the former German Democratic Republic is included, when indicated. Names reflect the usage at the time — for example, USSR until December 1991.

75. Purchasing power is somewhat lower in Northern Europe than indicated by market exchange rates, because of higher prices for food and housing, particularly in the high-income countries (particularly in the Nordic countries and Switzerland). The highly protected agriculture in most of Europe is one reason, the profligate use of cheap energy in the United States another. Purchasing power comparisons usually cannot take account of the quality of public services.

76. This is the growth rate derived from comparing current per capita income at (estimated) market exchange rates with similar estimates for 1938 (table 4.1). These figures most closely show the progress of the formerly centrally planned economies in comparable western statistical concepts. Estimates based on Eastern European postwar output data would show much higher growth rates (comparable to those of Western Europe). The difference does not primarily arise from an intentional falsification of economic statistics — this was the case in some countries — but from the lack of structural change in the Eastern economies. Output of increasingly outdated and unwanted goods continued to rise at a moderate rate. By contrast, Western economic statistics tend to understate qualitative changes in the composition of output.

77. Market exchange rates are for those countries that have adjusted overvalued exchange rates and introduced convertibility for commercial transactions; estimates of market rates are for those that have not yet done so.

78. Although market exchange rates often deviate from purchasing power parities, the large deviations for Eastern Europe are unusual for countries at that level of income. They can be explained by the low competitiveness of Eastern European economies in manufactured goods and the high demand for imported capital goods, reflecting the sudden opening of their economies to international trade and competition.

79. For countries with a population of less than 50 million, export/GNP ratios tend to be strongly influenced by the size of the domestic market. Past export/GNP ratios for Eastern European economies have to be used with caution as trade prices and exchange rates were often arbitrary. The number given — and representative for other Eastern European economies before the transition — is based on the domestic currency costs of Comecon exports. Due to the sharp depreciation of Eastern European currencies in relation to convertible currencies, total export/GNP ratios now appear relatively high. However, these ratios reflect the unusually large gap between market exchange rates and purchasing power parities, resulting from the current disequilibrium.

80. Trade data for Eastern European countries in table 4.3 are based on a revaluation of noncon-

vertible currency trade with uniform transfer ruble/dollar cross rates, based on Hungarian estimates of domestic costs of transfer ruble and convertible currency exports (available for 1976-90). Official statistics of different Eastern European countries have, in the past, used a wide variety of transfer ruble/dollar rates, ranging from highly overvalued to somewhat undervalued. Although transfer ruble prices in Comecon trade are quite arbitrary, the Hungarian cross rates are as close as possible to a realistic assessment of the magnitude of Comecon and total trade. Unfortunately, trade statistics from most official Western sources (including the IMF's Direction of Trade Statistics), still show total trade figures for Eastern Europe aggregated at (arbitrary) official transfer ruble/dollar exchange rates.

81. This was true until the early 1980s, when the GDR embarked on a desperate export drive to reduce external debt by substituting domestic high-polluting solid fuels for Soviet oil and gas, which was then exported in slightly processed form to the West — in effect, a debt-for-pollution swap.

82. Although USSR oil prices were raised to reflect world market prices, prices for manufactured goods were reached by negotiation. Many of these goods were outdated and not competitive in international markets.

83. By contrast, the autonomous tariff of the United States, applied to the USSR and some other Eastern European countries, was very high and almost prohibitive — averaging 35 to 50 percent.

84. The Federal Republic of Germany's coal imports from Poland were restricted through a ten-year supply contract between the FRG coal mines and the electric power industry, scheduled to expire in 1995 (see box 1.6). Germany also imposes a specific national tariff on coal under the ECSC treaty (6DM/ton, or about 6 percent of cif prices).

85. See Möbius (1990) for a more detailed analysis of past specific restrictions of exports from Eastern Europe.

86. Antidumping cases relied usually on an analysis of production costs of surrogate suppliers from market economies to establish the dumping margin.

87. Spain is an interesting comparator because it also pursued a policy of autarky during most of the Franco period (1939-75). Although the economy was opened somewhat to trade and foreign investment in the 1960s, tariffs and quantitative restrictions remained high and per capita exports low. The Preferential Trade Agreement (PTA) with the European Community, concluded in 1970, lowered trade barriers somewhat, but even with the PTA, quota restrictions continued to apply to one-quarter of imports, and effective tariffs remained high (14 percent) by the standards of free-trading Europe. Full opening of trade with the European Community, as now proposed under the Europe Agreements for Eastern Europe, started for Spain only in 1986 (and will be fully effective for industrial goods in 1993). In Spain, this opening has also required a deep restructuring of the industrial sector that was excessively oriented to heavy industry, like Eastern Europe's industrial sector. By contrast, for Portugal, full free trade in industrial goods with the European Community became effective in 1977 — which helps to explain Portugal's higher export orientation, despite its otherwise more backward economy (table 4.3).

88. The parameter estimates in table 4.6 are based on a sample of fourteen semi-industrialized countries in Asia, Latin America, and Southern Europe. Simulations with parameter estimates based on trade patterns of high-income countries would show an almost identical geographic distribution (see Havrylyshyn and Pritchett 1991).

89. The dismantling period for quantitative restrictions has been set at one-half of the dismantling period for the Multi-Fiber Arrangement to be determined in the Uruguay Round, with a minimum of five years. Because the chairman's draft for the MFA dismantling agreement proposes a transition period of ten years, starting in 1993, dismantling of textile quotas under the Europe Agreements would be completed by January 1, 1998, at the same time as full duty elimination.

90. The only differentiation in EC concessions to Eastern European countries is in this category. In view of Hungary's higher tariff levels and its much-later dismantling of tariffs, duty reductions for Hungary will be effected in five steps of 10 percent and then the remainder (50 percent) — and duty-free quotas will grow at 15 percent a year (instead of 20 percent).

91. The excluded public procurement sectors would be formally included only if the treaties are ratified after November 1, 1992.

#### **Annex 1 notes**

92. The reform proposal was first made public in a broad "Reflections Paper" in February (EC Commission 1991, COM 91-100) followed by a detailed proposal, "The Development and Future of the Common Agricultural Policy," (EC Commission 1991, COM 91- 258) in July, and detailed legislative texts in November (EC Commission 1991). In view of the ongoing negotiations in the Uruguay Round, these texts will probably be further modified before they are adopted by the Council.

93. EC policy prices are expressed in "green" ECUs (units of accounts). These are not the same as the commercial ECU. For wheat, one green ECU approximately equals 1.13 commercial ECUs. Unfortunately, EC documents normally refer, somewhat confusingly for the uninitiated, to both as ECUs.

94. The proposed small — 15 percent — reduction in benefits for the largest five to ten percent of farmers (larger than fifty hectares) has already led to heated arguments about the Commission's proposal.

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