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International Economics Department
The World Bank
April 1992
WPS 885

The Impact of EC-92 on Developing Countries' Trade

A Dissenting View

A. J. Hughes Hallett

The trade creation and the trade diversion effects of EC-92 on developing countries may cancel each other out. But important adverse effects may come from diversion of investment from developing countries to the EC.

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This paper — a product of the International Trade Division, International Economics Department — is part of a larger effort in the department to analyze structural changes in world trade and to identify their impact on developing countries' exports. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Audrey Kitson-Walters, room S7-053, extension 33712 (April 1992, 41 pages).

Most benefits of the EC-92 program, and the greatest impact on developing countries, will probably not come from marginal changes in trade flows dependent on relatively small changes in prices and incomes. Nor will they come from cuts in average costs, from changes in market structure, from the removal of internal barriers on trade and on the free movement of factors, or from a 5 percent increase in EC output.

Those changes may be important to European policymakers, but they are of only remote interest to developing countries. The main threats to developing countries are the diversion of investment funds to EC countries and continued external barriers — especially administrative, nontariff barriers.

The EC expects higher growth and lower prices as a result of EC-92, as firms will be able to exploit comparative advantages and economies of scale more effectively — and as competition between firms will increase (although the last two effects may nullify each other). The net effect on developing countries of the removal of internal trade barriers depends on developing countries' income and price elasticities with the EC. Current estimates suggest that the effect will be small.

Competition among European firms is likely to increase if the removal of bureaucratic and trade barriers reduces collaborative agreements between firms. Those gains may not materialize if firms merge or cooperate to increase their market share and compete better against U.S. or Japanese firms. If new external barriers emerge, or if EC-wide barriers replace national barriers, EC firms may collaborate more with the large U.S. or Japanese firms, just as they have done in Europe to circumvent trade restrictions. None of these developments will improve developing countries' trade in manufactures or services.

Investment in EC countries may increase to meet the extra demand, growth, or trade diversion resulting from EC-92. That investment could lead to increased investments in developing countries, but — given limited financial resources, tight monetary policies, and heavy indebtedness in developing countries — is more likely to divert investment funds from developing countries, thus limiting their future production growth. And U.S. and Japanese firms, fearing greater EC barriers and local-content rules, may decide to establish bases in the EC.

Technical standards in EC-92 may be tougher than national standards in member countries, which could hurt developing country exporters. An increase in voluntary export restraints, a tightening of local-content rules or reciprocity agreements, and subsidies for public sector enterprises or agriculture could also make life more difficult for them.

Is "Fortress Europe" likely? The EC Commission says no, but the Community's record so far is not good. The CAP is the most blatant example of protectionism. Another example is the local-content requirement. Others are the "pyramid" of preferential trading agreements and the increasing use of nontariff barriers against low-tech, labor-intensive developing country exports and against high-tech U.S. and Japanese exports.

These barriers are likely to remain, as there has been no official commitment to their removal. The question is, will the (average) barriers be raised to protect the least efficient producers in the EC? And to the level of the highest preferential trading agreements? If national barriers are converted to EC-wide protection, there is a good chance that external barriers will increase. If so, they may do so by only a small amount, since a single market will force Article 115 (which limits the movement of restricted goods between member countries) to be abandoned. An external tariff that allows efficient producers to profit from the protection of those less efficient would conflict too obviously with the stated objective of greater internal competition.

The Impact of EC-92 on Developing Countries' Trade: A Dissenting View

by

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Summary

The bulk of the benefits from the EC-92 Program, and the greatest impact on the developing countries, will probably not come from marginal changes in trade flows dependent on relatively small changes in prices and incomes; nor from reductions in average costs, a few changes in market structure, the removal of internal barriers, or a 5% increase in EC output. Those things may be important to European policy makers, but they are rather remote from the developing countries. The substantive threats to developing countries arise from investment diversion and continued external barriers, especially non-tariff barriers of various physical and administrative kinds.

a) Internal Change: The EC expects higher growth and lower prices within the European economies as a result of EC-92, because firms will be able to exploit comparative advantages and economies of scale more effectively and because competition between firms will increase [although the last two imply a conflict which may nullify one of them]. How much the removal of internal barriers helps the developing countries depends on the relative sizes of the trade creation and the trade diversion effects. The net effect depends on the income and price elasticities of developing countries' trade with the EC. Current estimates suggest that it will not be large.

b) Industrial Structure in the EC and Commercial Policy: Competition between European firms is likely to increase because the removal of internal bureaucratic and trade barriers will reduce collaborative agreements between firms. But those gains may not materialize because firms may merge or cooperate in order to increase their market share and strengthen their competitive position vs. US or Japanese firms. If new external barriers emerge, or if national restrictions are replaced by EC-wide barriers, EC firms may collaborate more closely with the large US or Japanese firms, just as they have done within Europe to circumvent trading restrictions. None of these consequences will benefit developing country trade in manufactures or services.

c) Investment: EC-92 may lead to increased investment in EC countries to meet the extra demand, growth or trade diversion. That investment may come at the expense of investment which would otherwise be undertaken in developing countries. In that case, their <u>future</u> production potential will be diminished. Obviously there is an issue of investment creation versus investment diversion, but with given financial resources, tight monetary policies, and developing countries indebtedness, it is likely that investment diversion will dominate. It is also possible that US and Japanese firms, fearing higher EC external barriers and local content rules, will establish bases within the EC.

d) Non-tariff Barriers/Subsides: The technical standards required by EC-92 may in some cases be higher than those of some member countries. New EC-wide standards would therefore hurt developing country exporters. Similarly, an increase of voluntary exports restraints, a tightening of local content rules or reciprocity agreements, and subsidies for public sector enterprises or for agricultural prices on the scale seen so far will certainly make life more difficult for developing country exporters.

e) Maintaining/Raising External Barriers: Is "Fortress Europe" likely? The EC Commission says no, but the past record of the Community on this score has not been good. The CAP is the most blatant example of protectionism, but other examples are the "pyramid" of preferential trading agreements and the increasing use of non-tariff barriers against low-tech, labor-intensive developing country exporters or high-tech US and Japanese exports. Yet another example is the local content requirement. All these suggest that external barriers will remain, since there has been no official commitment to their removal. The remaining question is then,

will the (average) barriers be raised to protect the least efficient producers in the EC and to the level of the highest of the preferential trading agreements? There seems to be a good chance that in converting national barriers to EC-wide protection, external barriers will rise. If so, it may only be by a small amount since a single market will force Article 115 (which limits the movement of restricted goods between member countries) to be abandoned, and an external tariff which allows efficient producers to profit from the protection of the less efficient would conflict too obviously with the stated objective of greater internal competition.

1. Introduction

Trade Ministers of the GATT countries spent much of late 1990 reviewing their multilateral trading arrangements and attempting to negotiate new reductions in the tariff and non-tariff trade barriers between them. It was through these negotiations that the leading OECD countries hoped to fulfil their pledge (first made in 1983) "to halt and .... reverse protectionism". In the event, the negotiations effectively broke down amid accusations of unfair subsidies in European and US agriculture, increasing protectionist barriers against textiles, chemicals, steel, cars, and consumer electronics in "Fortress Europe", and the effects of unilateral restrictions imposed by the US against dumping or limited access for US exporters.

Far from bringing the promise of reform, trading arrangements such as the EC's 1992 program have lowered expectations of what would eventually be achieved through the GATT talks. They have revived the fear that the liberal multilateral trading system, built up since the war, was degenerating (*de facto*, if not *de jure*) into more protectionist-minded regional trading blocs. The flavor of what is to come for those outside, as well as those inside, the European bloc is conveyed very well by the following three quotes:

(1) "In the world race against the clock, which the countries of Europe have to win to survive, what was needed was a common objective to enable us to look beyond the everyday difficulties and pool our strengths and energies. That is why, when I took over as president of the Commission of the European Communities, I proposed to the European Parliament and the Heads of State or Government of the Community that we should create by 1992 an economic area where all barriers have been removed and the principles of solidarity are applied". Jaques Delors, president of the EC Commission.

(2) "We are not building a Single Market in order to turn it over to hungry foreigners" Willy de Clerq, while Commissioner for Foreign Relations in the EC (quoted in Hamilton, 1991).

(3) "The literature on customs unions is general, whether written by free-traders or protectionists, is almost universally favorable to themselves, and only here and there is a sceptical note to be encountered, usually by an economist with free-trade tendencies. It is a strange phenomenon which unites free-traders and protectionists in the field of commercial policy" (Viner, 1950).

By virtue of its EC-92 and monetary union programs, the European bloc has by far the most developed and comprehensive integration plans. It is significant therefore that two of these quotes come from the European policy makers most closely concerned with the development of those two programs. And the third quote clearly reflects the experience that those within a customs union usually perceive the advantages very differently from those outside, whatever their interests in the matter.

The possibility of North American and East Asian trading blocs1 may also lead to similar attitudes there, but that (at least in the judgement of Schott, 1991) seems unlikely for several reasons. First, the possible East Asian bloc is too dispersed and too diverse in terms of income levels and market structures. Secondly, its external trade still outweighs its within-region trade by 2 to 1, so the incentives to integrate are weak. Thirdly, East Asian trade is too dependent on access to US markets, which gives them a vested interest in supporting the GATT system as the best safeguard of their trading interests across bloc boundaries. Although the North American bloc is more cohesive economically, its external trade is 1½ times the within-block trade; and each member needs to do something to cure a persistent current account deficit. Thus, unless significant scope can be found for substituting imports domestically, the North American bloc will have to expand its exports to the rest of the world. That gives it an incentive to support the GATT trading rights and discipline. In practice the successful conclusion of the Uruguay Round remains a priority and the North American trade zone has been designed to reinforce the existing GATT arrangements.

The data in Table 1 underline the relative cohesiveness of the EC as a trading bloc. It therefore makes sense to look at the EC initiatives as the source of change and the main threat to production and trade in the developing countries. Nevertheless, by their participation in the Uruguay Round, it is demonstrated that all the main players now recognize that protectionism is on the rise and needs to be reversed. The new protectionism is different however. Not only have non-tariff barriers, such as technical and environmental standards, been increasingly used, but also protectionism now reflects the emergence of trading blocs, as agents, in place of individual countries. Unilateral restrictions have developed into multilateral ones. These trading arrangements, and the potential they offer for increased protectionism, probably have more profound implications for the developing countries and those outside the major blocs than the breakdown of the GATT negotiations. Indeed, a new institutional framework is already emerging. The United States has formed a free trade zone with Canada (and a pact with Mexico is under negotiation). Having become disillusioned with progress under the Uruguay Round, and with the implementation of earlier agreements, the US has tended to pursue a more aggressive unilateral trade policy in certain markets, under its Omnibus Trade and Competitiveness Act.

The European Community has become increasingly immersed in its EC-92 program, the logic of which suggests greater barriers will be needed between "Fortress Europe" and the rest of the world in order to ensure success on the scale foreseen. Elsewhere, countries have grouped themselves together for policy purposes and in defence of their special regional or sectoral interests. Obvious examples of this are the ASEAN, ACP, or Latin American countries (the LAIA, CACM, MERCOSUR, or Andean groups, depending on the issue). Meanwhile, sectoral interests have led to the emergence of the Cairns group in the current GATT negotiations.

Any tendency towards regional (or sectoral) trading blocs must raise serious questions about the economic efficiency and welfare implications of the system that results, and whether free trade is hindered or enhanced. In the EC-92 context, the main questions for the rest of the world are:-

a) What does EC-92, and the emergence of other trading blocs, mean for world trading patterns and for the developing countries in particular?

b) What are the implications for trade in manufactures, and how do they compare with the likely effects of liberalising agricultural trade?

c) Should the developing countries regard these changes as consistent with the GATT framework and hence positive in the sense of inducing extra growth and investment? Or should they regard them as a means of denying market access in order to protect the least efficient industries in the OECD economies? Should they attempt to form trading blocs to similarly provide protection for their own industries?

In all this it is important to focus on whether Europe's commercial policies are likely to prove protectionist, and hence damaging, in effect rather than in word.

2. EC-92: General Implications

The completion of the internal market in Europe entails removing all the barriers to trade between member countries of the EC. That nearly 300 separate directives are needed to achieve this gives an idea of the scope of the legislative changes required to secure the free movement of goods, services and factors of production. Many of the changes are directed at improving market access for EC participants; some are directed at making markets function more flexibly (to improve competitiveness, setting standards, or establishing pollution controls); and some are concerned with promoting greater competition or to exploit comparative advantage/economies of scale in EC production. These directives were considered necessary because the EC had remained a fragmented market, and was becoming more rather than less fragmented with different national controls and restraints (especially in the capital, labor and services markets) and differing health and safety standards. To meet US and Japanese competition, it was argued, European firms would need to exploit economies of scale and establish a stronger competitive position.

2.1 The Development of Prices and Incomes after EC-92

There is broad agreement among analysts that EC-92 will bring benefits to EC countries when all the directives are implemented. There is very much less agreement on how large those benefits are likely to be and how they will be distributed over member countries or regions. And there even less agreement - largely because there has been so little analysis of this question - on how strong the effects on other economies (North American, East Asian, developing countries and East European) would be. In fact there is little agreement on whether the net impacts on the outside economies will be positive or negative, let alone what the distribution of the changes will be across the OECD, NICs, developing countries, or East Europe.

In general terms, the EC countries can expect higher income levels and lower prices as internal barriers to trade come down under the EC-92 program. Increased competition, greater efficiency through exploiting economies of scale and the wider scope for investing according to comparative advantage, removal of internal customs duties and other transactions costs,2 the removal of price discrimination, competitive tendering for government contracts, free circulation of goods from the cheapest supplier, a lower cost of capital through more efficient (for which read integrated) financial markets; these are all things which will reduce prices within the EC. Falling prices will of course expand the EC markets and therefore lead to expanding income levels (as well as incomes higher in real terms because prices are lower than otherwise). One can expect this to have a continuing effect through increased investment, both in response to rising incomes and the lower costs of capital (an accelerator argument, in the absence of risk premia) and in order to exploit greater efficiency through economies of sale and comparative advantage (again without risk premia). Foreign producers may also be tempted to invest in the EC to establish a base within the union.

There may be some effects which will work in the opposite direction, offsetting the price falls and income gains. If health and safety standards are raised to the level of the most stringent within the EC, or if pollution controls are tightened everywhere, then industry's costs must rise everywhere. Similarly if external barriers (tariffs, quotas, or voluntary restraints) increase while the internal barriers are being dismantled, then cheaper external suppliers will be shut out and prices will rise. It may also be that firms will form cartels or make collusive agreements to overcome competitive pressures and that this will be condoned by the EC Commission in order to gain support for its program (and there have already been cases of this in activities such as airlines, car producers, electronics, banks, and food products). Non-EC imports could be excluded by using aggressive reciprocity arguments or applying discriminatory standards. Nevertheless, these countereffects are generally thought to be small in scope. The remaining questions are then: (i) by how much will prices fall and incomes rise; (ii) what proportion of those changes will spill over onto the external economies; and (iii) will those spillovers be favorable or unfavorable for the non-EC economies? The empirical evidence on the first question is slight and conflicting, except that the gains in EC variables are likely to be fairly small. Optimistic estimates from the Cecchini report suggest 1% extra GNP for each of 5 years and a ½% improvement in the EC's terms of trade.

2.2 Trade Creation and Trade Diversion in Other Countries

The spillovers onto outside economies could be quite large, if they are smaller economies dependent on EC trade - such as the Lomé Convention or East European countries. The two determining factors here are the proportion of EC trade conducted with third countries (at present a bit over 40%, ranging from 52% for the UK and Denmark to 25% for the Netherlands) and the share of exports in the third country's GDP. The relevant parameters will therefore be the price and income elasticities of third country exports since they determine the amount of trade diversion (exports lost as EC prices fall with increasing competitiveness), and the amount of trade creation (exports gained as EC incomes rise with market expansion and efficiency). The balance between these two effects will largely determine whether the trade spillovers are positive or negative overall. Over and above that there may be a terms of trade effect as the prices of imports from the EC fall and EC import penetration rises. In that case, import price elasticities in non-EC countries may also play a role. Indeed there may be offsetting price and income effects in the third country as the domestic price index falls with import prices and export industries expand towards greater economies of scale, so incomes may start to rise there too. But these would no doubt be second order effects. Finally, the spillover effects may be complicated if EC-92 reduces market access, tightens local content requirements, or raises other trade barriers for non-EC producers.

2.3 Investment Diversion

That is not the end of the spillover story however since investment expenditures are likely to rise in the EC for a variety of reasons noted earlier in this section. Once again this leads to spillovers which depend on the extent of investment creation vs. investment diversion. If the net trade effects (creation vs. diversion) are positive, then some new investment will be induced in third countries too. But if the net trade effects are negative, or if local investment funds originate in the EC, or if they originate in other OECD countries who wish to invest in the post-1992 EC, then investment will be diverted from third countries. In fact, any increase in output must lead to increased investment in the EC, in response to the higher rate of return there. That in turn must divert some investment from the rest of the world which sees a higher cost of capital from the increase in investment demand without any rise in its rate of return on capital.

Investment diversion is likely to have a greater impact on developing countries as their output-linkages to changes in EC output are smaller, and therefore the relative change in output will appear greater. More important, foreign risk capital will be diverted to the EC from the developing countries, impeding technology transfer. On the other hand it is possible that some labor-intensive investment, and investment in cheaper but environmentally unhealthy technologies, will divert to the developing countries as economies of scale and tighter regulation take hold in the EC. Nevertheless, developing countries will tend to be affected adversely because much of the increase in EC output will come from reduced costs, and much of the attraction of developing countries has been lower production costs rather than the size of their markets. So this point is especially relevant for manufacturing economies. Moreover, investment diversion has dynamic implications because, with low labor costs being weakened as an investment incentive, the developing countries' productivity and technical capacity will fall further behind - lowering their competitiveness and their ability to attract new investment. Falling investment means falling expenditures and a lower supply capacity later on.

Diversion could result from EC firms choosing to stay home, other industrial countries switching from developing countries, or developing countries themselves investing in the EC. The potential effects are particularly important for Latin America and South-East and East Asia both because they have been the principal recipients of foreign investment and because they have industries of a size and sophistication that compete with EC firms for investment funds.

2.4 The Influence of Commercial Policy on EC-92 Outcomes

Since the impact of EC-92 on the non-EC economies depends on a trade-off between expansionary (trade creation) and contractionary (trade and investment diversion, external barriers) elements, we need to understand the composition of those elements in more detail before we can say how the trade-off will work out in practice. Two distinctions matter here: first, between the consequences of removing barriers operating on prices/costs vs. those operating on quantities, and second, between the case where the reduction of trade barriers is restricted to intra-EC trade vs. the case where liberalisation affects all trade (imports) equally.

Examples of barriers operating on prices are import duties; price discrimination, market segmentation, local cartels, or discrimination in government contracts; transactions costs; extra testing formalities; and barriers to economies of scale or comparative advantage in production. Capital market imperfections, currency transactions costs, risk premia or inadequate financial market access, would have the same effect on investment. Examples of quantity barriers are obviously import quotas, voluntary trade restrictions, purchasing agreements, local content requirements or other restrictions preventing economies of scale being realised, and environmental controls etc; and, for investment, capital controls or ownership "cartels" blocking a free market in corporate control. In fact most of the EC-92 measures, whether operating on prices or quantities, are designed to improve market access and the competitiveness of EC firms - through greater labor and capital mobility, the free circulation of goods internally, better market structure and price responses (competition policy), and larger R and D expenditures, etc. These measures will have different effects on EC and non-EC firms, so they must potentially cause trade diversion rather than trade creation for on-EC firms. Meanwhile, reduction in external barriers (quotas, voluntary restraints, common external tariffs, standards) would result only in trade creation. But it is not clear if these external barriers will actually be reduced; standards may be harmonised at the highest level, quotas and tariffs may be maintained to allow the internal changes a smoother passage, and price supports (above world prices) on such fundamentals as agricultural products, coal and steel which already operate on an EC-wide basis are unlikely to change much. So it's not clear how much trade will be created. Indeed one can even interpret the opening statement by Delors as meaning that the purpose of EC-92 is to increase the competitiveness of EC companies vs. non-EC companies, not to increase competition and performance within Europe.

2.5 The Scope for Trade Creation and Trade Diversion After EC-92

a) *The effects in perfectly competitive markets:*

Which markets are likely to be most affected by these developments? The traditional trade creation - trade diversion analysis assumes perfect competition and segmented markets (i.e., no spillovers between markets). Together those assumptions imply prices at marginal costs and no spillover gains into other markets following the removal of barriers internally. The increased competitiveness would then equal the sum of the barriers removed - said to be equivalent to about 1%-2% of the value of internal trade for the EC (Winters, 1991). Certain markets offer greater scope than that because they are not competitive or because prices are fixed by intervention, investment subsidies or stabilisation schemes - for example agriculture, coal, steel, textiles and possibly cars and certain "high tech" manufacturing. Although there is ample scope for re-orientating and increasing trade in these markets, it is reasonable to assume that their intervention schemes will not be dismantled. Certainly that has been the impression left by the Uruguay round negotiations. So, except for imperfectly competitive markets and investment diversion, EC-92 is likely to produce few improvements within the EC and correspondingly few gains or losses for the non-EC economies.

b) *The effects of investment diversion:*

Our earlier discussion suggested that changes in investment patterns are likely to be a more important consequence of EC-92. There is already evidence that investment flows have been influenced both by accelerator effects based on growth expectations and by a lower cost of capital resulting from greater financial stability. Stronger influences are probably the desire to invest where there is (as yet) unexploited comparative advantage or economies of scale, or to establish plants which can satisfy local content restrictions.

How large is the impact of investment diversion likely to be? Imagine two firms before EC-92, each with its own national tariff. After EC-92 the more efficient of the two will capture the market and the other will vanish. The more efficient firm will either match world prices or need an EC-wide tariff; had it been capable of matching world prices before, it would have done so and have expanded to its optimal size by exporting what could not be sold domestically (Corden, 1972). Hence there are limits to the EC-92 gains: investment designed to capture economies of scale or comparative advantage can only reduce costs to the extent of the pre-1992 barriers. Had there been greater potential, it would have been exploited before EC-92. Hence for non-EC economies, there is little likelihood that the EC's import competing firms will suddenly become exporting firms. That limits trade diversion to eliminating the EC's existing imports, and probably rather less than that. If the reduction in intra-EC trade, due to barriers within the EC, amounts to about 1% to 2% of the gross value of that trade (the estimate in Winters, 1991), it means that the extent to which new investment can divert trade in those markets is still only 1%-2%. That may not seem a great deal to the Europeans, but for a developing country or East European economy dependent on a few export markets it may represent a substantial loss in exactly those sectors which are crucial for development and growth. And we have to add to it the possibility of aggregate supply changes: greater efficiency brings EC firms closer to the optimal production size (Muller and Owen, 1985). Average industry costs will then fall, expanding the size of the market - but putting yet further pressure on the external producers.

c) The effects in imperfectly competitive markets:

The possibilities for re-orientating trade in imperfectly competitive markets are much larger. Here the less efficient firms in one EC market may find their domestic market share shrinks as lower cost producers elsewhere in the EC move in. Such firms will get smaller or even vanish. However, through price discrimination they may have nevertheless been able to sell in other EC countries or in third countries. It is entirely possible that they might then benefit from the opening of other EC markets by expanding towards greater economies of scale in a way that was previously blocked by the fragmented nature of the market and certain pre-1992 trade barriers. In that case, EC-92 would enable them to reduce costs, survive in the EC, and to capture more of the third countries' markets through their increased competitiveness compared to the rest of the World (Smith and Venables, 1988). Hence imperfect competition carries the danger that EC firms may not only displace third country producers from EC markets, but also start exporting into the corresponding third country markets. The potential effects of EC-92 are now much larger: not only trade diversion, equivalent to reducing internal trade barriers which can in this case be larger than the 1%-2% we considered before, but also trade reversals (Norman, 1989). Hence, in imperfectly competitive markets, the developing countries may have something significant to worry about.

A number of additional points need to be made. One is that the existence of fixed costs means that, as prices fall with lower barriers and increased competition, the number of firms (or at least production facilities) will start to fall and the returns to the marginal firm start to rise along with larger market shares for EC firms. But there is no reason to expect the number of non-EC suppliers to increase. Consequently a smaller number of EC suppliers will tend to reinforce the imperfect competition characteristics of the market in question, reviving profit margins while reducing costs through greater scale economies. Indeed models of oligopoly relate mark-ups positively to market share. Thus if EC producers gain a larger share of their home (and hence world) markets, EC export prices may rise which, given import prices are falling, leaves the non-EC economies with worsening terms of trade. Thus EC-92 may not in fact have any strong pro-competitive effects.

Another factor is that EC-92 can only lead to less market segmentation in the EC, so the pro-competitive spillovers from one market onto another will be larger than before. That will multiply the instances of falling prices/costs in the EC and hence of trade diversion. However all this has assumed an elastic supply of the factors of production in the EC. If firms run into constraints, possibly local ones as labor fails to be as mobile as hoped, costs will start to rise faster. That would offset some of the pressure for trade diversion.

d) The effects of EC trade policy:

All the changes listed so far are market effects, but the impact of EC-92 on non-EC economies will obviously be affected by EC trade policy. And EC-92 necessarily entails changes in trade policy, although what those changes will be is an open question. For example, will national import quotas be replaced by EC-wide quotas? If the level of the lowest is chosen, trade with non-EC partners will be encouraged; if the level of the highest is chosen it will be suppressed. But even if an unchanged average level of quotas is chosen, the volume of trade with non-EC countries will change because, in the absence of article 115, that trade will automatically be redirected with the previously more restricted markets taking more non-EC imports.3 If those more restricted markets are in the larger economies then the trade will expand, but if they are in the smaller economies it will contract. The same set of questions arise with the application of health and safety standards, and with the application of voluntary export restraints. Also the use of anti-dumping policies, discriminating standards or voluntary restraints, or the aggressive use of reciprocity and tighter rules of origin cannot be ruled out. These are all policy responses which will worsen the position of the developing countries' economies and, as such, are anti-GATT. They are unlike the changes in the previous paragraphs which are endogenous changes due to improved competitiveness, and hence not "unfair" in any sense.

2.6 The GATT as a Cooperative Game and the EC's Trade Policy

Evidently much depends on what we should expect from the EC in terms of trade policy. Are we more likely to get Fortress Europe or a more open EC after 1992?

It is extremely difficult to "second guess" the EC Commission's responses on trade policy. No clear pronouncements have been made and, barring warnings about retaliation and the need for recipriocity, none are likely that are anti-free trade. Nevertheless it is important to distinguish policy in word from policy in practice. There is a great fragility in announced policies because of what Gardner (1969) has called excessive "legalism": a preference for "exalting agreement in form over agreement in substance". The current GATT negotiations provide no pointers for the longer term: having been stalled for a year, a softening of attitudes "could" yield agreement if the participants so choose. Similarly, the EC Commission is not a political party with a manifesto and established ideology which might guide us.

So the only indicators of what might happen are the interests of the EC's constituency and its track record. That, as Wolf (1987) points out, makes greater protectionism look more rather than less likely. Wolf argues that the GATT's fragility, and its lack of self-enforcing controls by individual participants, has led the EC policy (among others) to weaken the whole arrangement. That has happened because of the EC's increasing preference for using trade policy as an instrument of its foreign policy, as well as a device for disguising its economic weakness or delaying uncomfortable adjustments. Wolf argues that the post-War trading system has been a cooperative regime in which there is no advantage in unilateral liberalisation - but there are advantages (for all) in multilateral liberalisation so long as all "play the game". The threat of discrimination against those who broke ranks, in particular denial of access to the large US market, sustained this process of liberalisation for many years. But, like any cooperative regime, there is in fact often little sanction against individuals who revert to their best noncooperative policies - and quite possibly none at all against those who form a coalition against the rest. First, participants may judge retaliation to be uncertain, unreliable, and costly for the injured party. Second, countries may be reluctant to incur the costs of retaliation against dissidents whose unilateral actions do not much affect them.

Similarly, those who would be affected will be reluctant to afford trade benefits to those who, in their own interests, fail (or have failed) to play the game. That in itself will start to produce coalition groupings, and once there are 2 or more larger "players" in operation the pressure for freer trade will fade, since the competitive offering of access to the coalitions' markets will secure much of the cooperative gains for most participants, while reciprocal discriminatory trade policies will ensure that free trade in a wider sense is always denied to some group(s). Indeed it is quite possible, and maybe likely, that some coalitions will form which can secure greater benefits for its members than would have been possible under full cooperation. But the cost of that will be worse outcomes for those outside. Those outsiders may then form a coalition in self-defence.

Viewed from this perspective, the EC is just such a coalition which in principle rivals the US and Canada. On that basis one should expect it to follow protectionist policies with respect to nonmembers. Whether it does that remains to be seen, but several strands in its EC-92/Monetary Union programs already show a tendency to move in that direction. The EC has been reluctant to extend most favored nation status to competitors in certain fields (e.g., to East European or East Asian economies); it has kept its preference areas (Lomé convention countries, the GSP system); it has used commercial policy to further its external policy (most notably in the former Soviet Union and Yugoslavia); and it uses commercial policy to further its aims of political change (e.g., to secure agreement on the steps to monetary and political union). Once again one would have to conclude that the EC is likely to become more rather than less protectionist. But to go further and say exactly what form that protectionism might take is extremely difficult because each measure has differential impacts on the EC members and hence damages some as it helps others. As a result EC trade restrictions are not systematic, but reflect a patchwork of improvised deals and it would be very hard to secure agreement on more than piecemeal changes. This may in part explain why the GATT negotiations have stalled in the face of an apparently intransigent EC position, while some commentators are able to define some softening in the background. It may also explain why the EC is able to maintain a reasonably GATT-consistent fa^^ to the world while operating restrictions which have a more protectionist impact in practice. The standard instruments are - agriculture excepted - tariffs (the GATT's preferred instrument), quotas, voluntary export restraints, and nontariff barriers covering health, technical standards, or environmental protection. The EC now uses tariffs very infrequently, having largely removed them since World War II. It has also been reluctant to impose nontariff barriers except in quite specific industries where it can differentiate the product in a technical sense (Greenaway 1991, Wolf 1987). That is because general restrictions of this type will damage most member states while helping onl` ᵔpecific states or industries. It is far easier to use quotas and dumping or ᵣort restraints which can be targeted rather precisely and which are otherwise invisible. Perhaps more important, their taxation, redistribution (or subsidy) and rent transfer effects are largely invisible both inside and outside the EC.4

Reducing the general barriers, while maintaining and possibly increasing the particular (implicit?) non-tariff barriers, therefore allows the EC to retain the semblance of GATT - consistent policies in its rhetoric and negotiations while achieving rather different effects in practice. Not that such a strategy is in anyway unfair, but it does make it extremely difficult to tell whether the EC's policies are actually GATT - consistent or not. After all some endogenously improved (and hence fair) competitiveness may result from a GATT - illegal barrier: quotas on Japanese cars may retain enough economies of scale for European producers to make them more competitive against other non-EC producers. But none of this gives any reason for supposing that the EC will be lessening the protectionist tendency of its trade policies.

3. EC-92 and the Developing Countries

3.1 What the Developing Countries Might Fear

Which of the preceding arguments matter for the developing countries? Until recently their concern about EC-92 was muted, and it is easy to see why. The overall effects on Europe seem likely to be quite limited and the impacts on developing economies correspondingly small. And as developing countries are usually seen as suppliers of inputs to the industrial countries, rather than of competing products, any gains in the EC should also spillover onto them.

However, we have identified a number of areas where the developing countries could encounter significant difficulties. First, nearly all the analysis on the subject (and the EC commission's own evaluation in particular (Cecchini, 1988)) has been concerned with the trade in goods, whereas one of the main effects is likely to be investment diversion. Economic development in the developing countries is particularly sensitive to foreign capital and investment. Secondly, what is small to the EC may, depending on the shares of trade in GDP and the impact of a foreign exchange constraint, be very important to the developing countries. Here the EC's rhetoric is important. In 16 volumes of studies of the EC-92 program, the Commission made no more than one or two parenthetical references to the rest of the world. And then there are the quotes from Delors and de Clerq about restricting outsiders' access to any benefits. The developing countries are also painfully aware that for every ECU spent on aid, roughly 2 ECUs are spent on restrictions to keep their exports out.5

Thirdly, LDCs are not exclusively commodity producers; trade has switched substantially to manufactures, especially in Latin America and the Asian NICs or near-NICs. Manufactures are competitive with EC products and therefore subject to trade diversion which might well outweigh any trade creation.

Fourthly, the LDCs have already seen how increasing protection can damage their prospects not only in agriculture and food products (e.g., coffee) where liberalisation is no nearer, but also in textiles, steel and light manufacturing. The EC's stubbornness in the Uruguay Round, and the fact that East Europe was able to secure concessions on market access and debt which were denied when the developing countries asked for them, also suggest that the developing countries should not expect any concessions to help offset any trade diversion that may occur.

Finally, there is the possibility that changing market structures in the EC could significantly affect trade volumes and direction even when the overall price and income effects are relatively small. That, coupled with tighter standards, and the aggressive use of reciprocity, anti-dumping, or local content rules, more than offset any reductions in tariffs and non-tariff barriers.

3.2 A Sectoral Analysis

It is clear from these remarks that the consequences of EC-92 will be country, or perhaps country group, specific. We need to distinguish manufacturing economies from commodity producers; as well as distinguishing countries by different types of manufactures, by their dependence on foreign capital, trade in services, or receipts from migrant labor etc.

a) Trade in Manufactured Goods:

While the removal of national barriers will produce both trade creation and trade diversion effects, that will only be the case if no new EC barriers are introduced to replace them. However, it is likely that new restraints (Silbertson, 1989) will appear, partly to satisfy the pressure groups which pressed for the original restraints, but mainly on the argument that there is no reason why foreign producers should benefit as much as EC producers. Transitional arrangements may also be needed to allow EC producers to adjust to the new circumstances. The barriers which, if retained, would be important to developing countries producers are those on textiles (the MFA), clothing, footwear, light manufactures, consumer electronics, cars, and certain commodities (bananas, sugar, coffee etc). They have already been agreed for cars. Pressure from French and Italian car firms, where national voluntary export restraints are now in force, led to an EC-wide restraint on Japanese cars and that could easily be extended to Korean or Malaysian cars. The significance of this should not be underestimated; cars represent a symbolically important and high profile sector. Restraints here imply an important precedent for "special arrangements" and other sectors will surely be tempted to follow suit. The Commission may find it convenient to allow them to do so because that gives the Commission direct control over trade policy.

Of course, the Commission could argue that the arrangements are 'transitional'. This is, however, precisely the argument which was made with the introduction of the Short Term Arrangement on Cotton Textiles in 1961 and its subsequent extension into the MFA. Thirty years later these restraints still exist. The source quotas here are maintained by Article 115 but that could be replaced by an EC-wide restraint. And there is pressure for some kind of transitional arrangement, especially from the Southern European producers who have gained significantly from trade diversion. As yet no specific arrangements have been made, since the MFA is an item in the Uruguay Round. If, as seems likely, an agreement is reached to prolong the MFA, this could be used by the industry to argue for the maintenance of Article 115 restrictions for the 'transitional' period. Whereas with cars the principal external losers would be just one or two countries, in the case of textiles and clothing it would be a wide range of NICs and developing countries.

b) Trade in Services:

Services is a large sector (about 50% of GDP in the developing countries and more than that in the EC) so EC-92 should show major effects here. But most services output is not tradeable, so few of these changes would spillover to the developing countries. The three tradeable components which will become (significantly more) tradeable within the EC after EC-92 are financial services, government procurement, and transport (in addition to professional services and telecommunications). Messerlin (1990) provides a useful summary of the EC's policies with respect to services.

Financial services have been a very fragmented market in Europe and their integration would be a major source of the gains from EC-92. However developing countries are not big suppliers of financial services, and the opportunities for outsiders to profit from expansion in this sector may be very limited because the EC Commission has given clear indications that it will enforce aggressive "mirror image" reciprocity rules for market access. Since the provision of financial services tends to be structured very differently in other countries, this is likely to shut out third parties (principally the US and Japan). But that is not of great interest to the developing countries.

Government procurement contracts is another area which is potentially lucrative to outsiders. The Cecchini Report estimates the gains from greater competition in this area to be worth ½% of European GDP (EEC, 1988a), and there is no doubt that the internal barriers will come down. But it is not at all clear that any outsiders will benefit. There will be excluded sectors (water, transport, energy) where developing countries could have contributed. Local content rules may also be applied, with non-EC suppliers having to demonstrate that 50% (or more) of a contract's value is locally supplied in order to qualify for government business. That may remove the incentive for developing country producers, and may also divert investment from them to local EC plants. Finally EC governments may, as in financial services, demand reciprocity for their firms before opening up access to their contracts. Nevertheless, there may still be some benefits for the LDCs here. Cheaper and better aid may be available when it is tied, if the tie is changed to the EC as a whole rather than to a particular member country. And greater competition among public services might reduce the cost of developing countries government contracts.

Removing restrictions on transport also offers the prospect of considerable gains for the EC, but the interests of outsiders will again raise issues of reciprocity and equal access. This issue really involves airlines. It is not clear that the EC, which will take over the negotiation of routes on a bilateral basis, will want to relax the price support given to the national carriers or open up the already fairly extensive transport rights within the EC area without concessions elsewhere. Tourism offers the developing countries much better prospects, however. For many countries it is important for foreign exchange earnings and it has a rather high income elasticity. Growth in the EC should produce strong growth in tourist receipts.

c) Standards:

Many of the fears about EC-92 concern the setting of standards because non-EC firms have no control over that process. Standards could be manipulated against the interests of non-EC firms. Greenaway (1991) cites the case of high definition television, where no standards have been agreed yet. Once they have been agreed, the EC might set somewhat different standards to suit its own producers and to place other producers at a disadvantage. Testing could also be complicated which raises transactions costs for outsiders. That is particularly important for agricultural food and health products. In principle this area of difficulty could apply to all producers, developing countries and NICs alike.

d) Factors of Production:

Much has been made of the advantages of having mobile factors of production so that economies of scale and comparative advantage can be fully exploited within Europe. The removal of barriers to the mobility of labor and capital (e.g., harmonising qualifications or social security arrangements, removing capital controls, etc) is an essential part of EC-92. This issue has two implications for developing countries. The first is the probability of, and scope for, diverting investment away from them. That was discussed in detail in previous sections.

The second concerns migrant labor. The EC has traditionally absorbed large numbers of largely unskilled workers from the North and West African countries, East Africa, Turkey, and the Indian subcontinent, as a result of an excess demand for labor, and more recently as refugees. There have been few internal barriers for the past decade, so new internal migration on any scale seems unlikely. On the other hand with the regional inequalities in unemployment in the EC becoming stronger with the advent of a single market (and then single currency), the pressure for internal migration will inevitably grow. As that happens, EC citizens will presumably get priority over non-EC migrants. And non-EC migration may become more restrictive, even if internal migration is avoided. The EC's migration rules will have to be harmonised. That harmonisation may well be downwards to meet the demands of the most restrictive. It can be argued that this is already happening with the introduction of tighter regulations for controlling asylum and immigration because certain previously liberal countries (e.g., Italy) want to tighten their rules, while many other countries (especially Germany) fear a huge excess supply of low wage labor from East Europe. Indeed, even if the rules are tightened significantly, East European labor is likely to substitute for developing countries labor. Thus the developing countries stand to suffer losses of remittances from their migrant workers which, in many cases, are a vital source of foreign exchange and, in a smaller way, capital.

e) Aid:

There are three issues here: the general system of preferences, the Lomé Convention, and aid disbursements. The system of trading preferences is already severely constrained by quotas and the general reduction of tariffs. The EC-92 program is not intended to change that. The Lomé Convention is intended to continue as it is. It has a large impact perhaps because it deals with a low income group of countries, heavily dependent on food exports covered by the Common Agricultural Policy. As such it, and the preference system, may eventually be revised downwards as the pressure for agricultural liberalisation mounts. But that is not part of EC-92.

Direct aid disbursements for the poorer developing countries may be affected by EC-92 in two ways. First, as noted above, aid may be tied to the EC as a whole rather to a specific country. Donors tie aid in order to internalise some of the benefits, so they are unlikely to give up the practice although a smaller proportion of total aid might be tied in the future. But the main gain here would be the ability to choose the cheapest supplier within the EC, raising the real value of that aid. On the other hand, the completion of the internal market will accentuate the structural adjustment needs of the poorer, declining and peripheral regions of the EC. Regional inequalities within the EC are already much larger than within any of its constituent countries, and they are widening. The single market is likely to accelerate that process. There is also increasing pressure to reduce fiscal deficits in the EC countries. It therefore seems inevitable that a greater proportion of public expenditure will be devoted to fiscal transfers and structural adjustment programs within Europe. On top of that, monetary union, if it comes, requires greater fiscal activity if stability is to be maintained in the real sector and regional divergencies contained. It is hard to see how all this can occur without further downward pressure on the aid budgets for the developing countries.

4. Empirical Estimates of the Impact of EC-92 on Developing Country and World Trade Manufactures

There are very few empirical studies of the trade effects of EC-92, despite the fact that the central points of trade creation vs. trade diversion, the terms of trade effects, or the impact of imperfect competition and investment diversion, are essentially empirical questions. The little evidence we have is derived from incomplete "thumbnail sketches" of the likely impacts on certain industries or certain variables. No analytically rigorous general equilibrium studies of these empirical questions have been published - although that will no doubt change over the next few years. This section tries to draw such conclusions as are possible from the rather scattered evidence currently available.

The EC's own analysis of the effects of EC-92 (EEC, 1988b) emphasises the increase in total output, resulting from traditional trade creation and consequent efficiency and income effects within the EC itself. Later, when the effects on the rest of the world became an issue, this was translated into increased imports. But of course there are also going to be lower prices within the EC, leading to the trade creation vs. trade diversion trade-off. If the relative costs between EC and other suppliers change, then applying a conventional income elasticity, without allowing for an unfavorable relative price effect on outside suppliers, is not correct. Further, a higher estimate for the income effect (or finding a dynamic effect on the growth rate, not just the level effect) causing greater external trade creation, can occur only if the initial trade effects are also positive.

4.1 Trade Creation Outside the EC

If the EC-92 program has any impact, it will be to raise the level of EC income. This was calculated by the EC at about 5% over 5 years.6 That implies a small but plausible figure of roughly 1% on GDP each year. Much the same estimates have been put forward for the gains to be expected from explicit policy coordination in Europe. [In that literature such gains were, by common consent, regarded as worthwhile but small]. Any conventional import elasticity can be applied to this. If developing countries are assumed to be balance-of-payments or demand constrained, a reasonable assumption at the moment, an upper limit for their gains can be obtained. The results tend to be small because the EC as a block is a small part of their markets, and tends to import relatively low income-elasticity goods. Income effects are higher for the more advanced exporters of manufacturers. Given the low shares and import elasticities in the EC and the rather high ones of some developing countries the relationship is likely to be less than half a point in income growth for every extra point on EC growth, and <u>substantially</u> below that for the poorest.

A standard estimate of the income elasticity of EC imports would be about 2, implying that the demand for non-EC products would rise by 10% over 5 years, or 2% each, as a result of EC-92. That income elasticity estimate would not be accepted by all. Langhammer (1990) suggests a figure of 5.5 for developing country manufactures. Goldsborough and Zaidi (1986) prefer 4.3 for the "more important" developing country manufactures, while Bond (1987) and Matthews and McAleese (1990) report income elasticities of between 2.8 and 0.3 for the EC's various commodity (including food, energy and mineral) imports. Hence elasticities of around 2 seem to be a consensus estimate for all products, and that is the preferred value of both Winters (1991) and Davenport (1990). However, this range of estimates does suggest that the trade creation effect is likely to vary considerably over different product groups and over different supplying countries, with NICs, low income developing countries or commodity producers as the obvious categories. The later parts of this section will attempt more detailed estimates for the developing countries and for the trade in manufactures. In those individual product groups, however, the additional effects of EC commercial policies (e.g., quotas on textiles; voluntary restraints on consumer electronics and cars; domestic agricultural price supports; banana preferences or coffee excise taxes etc), will become increasingly important. Here we have no information on the average impact of the external barriers to be expected after EC-92.

4.2 Trade Diversion Outside the EC

Here the estimates of the price effects of EC-92 are even more variable across product groups, and hence country groups (and authors!). Diversion will be greatest for low value, undifferentiated, price elastic goods such as textiles, clothing, footwear, leather, consumer products and simple electronics, metals and chemicals. It will be lowest for non-competing primary goods and specialised high-value goods. In other words, the typical NIC, near NIC, and middle income (diversified) developing country stands to lose its export trade in manufactures to EC firms. But the commodity producers and the non-European OECD economies are likely to be relatively unaffected by trade diversion.

The EC's estimates of trade diversion suggest that EC imports would fall about 2½% as a result of removing internal barriers to trade, and a further 7½% as a result of the removal of cost increasing restrictions (i.e., restrictions preventing scale economies and full comparative advantage in EC production processes).7 On top of this the Cecchini report estimates the non-EC countries terms of trade will deteriorate by about ½% (EEC, 1988a,b). Thus on the EC's own estimates, the trade creation and trade diversion effects on outsiders will roughly cancel out - leaving the non-EC countries marginally worse off overall because of the terms of trade effects on their own imports. However, with such a variety of estimated price and income elasticities to choose from, different authors may come up with alternative estimates, as they certainly will if they look at different product groups or producing countries. For example Davenport (1990) arrives at extremely similar conclusions for developing country manufactured exports, whereas, as a result of his larger income elasticity estimates, Langhammer (1990) argues that trade creation would outweigh trade diversion by a factor of 4.

4.3 Investment Diversion Outside the EC

To complete these estimates of the effects of EC-92 on outsiders we need to have some idea of the size and likely consequences of investment diversion. Unfortunately there have been no studies to guide us on those questions, but the effect must be to worsen the developing countries' position somewhat further - even if it does not have the same impact on the developed non-EC countries. It may quite possibly worsen the developing countries' position by enough to turn a marginal loss as a result of EC-92 into a significant one.

4.4 Trade Creation and Diversion in Imperfectly Competitive Markets

The remaining extension is to consider the gains and losses in imperfectly competitive markets. Our earlier discussion suggested that imperfect competition pre-1992 would exaggerate the gains (and losses) because the trade reorientation element would be larger, perhaps even to the extent of converting trade diversion into a trade reversal. Smith and Venables (1988) explore this possibility in a ten industry model and find that EC-92 would, for those industries, raise both within EC trade and EC exports to the rest of the world, while also reducing EC imports and raising the EC's GDP. How large the changes would be varies from industry to industry, depending on the production structure and degree of imperfect competition. Nevertheless, Winters (1991) quotes a typical example (office equipment) with 45% extra internal trade, but 26% less imports into the EC and 6% greater exports from the EC. That's not going to do the developing countries' (or other non-EC economies) any good at all. Even stronger results may be obtained in the more concentrated industries with larger economies of scale, and with greater degrees of market integration. But the point to note is that imperfect competition is clearly important; it does exaggerate the effects of EC-92 on outsiders, causing sharper falls in EC imports and beginning a trade reversal in which the EC starts to increase its share of other countries' markets. The Cecchini Report attempts to extend these results to all the industry groups in the EC by calculating ratios of the gains for the original 10 industries, to those from the general analysis of two paragraphs earlier (EEC, 1988b). Then classifying all industries by scale and concentration allows those ratios to be multiplied up or down by the relative scale/concentration indices. Detailed results for international trade are not given but they must increase the estimates of gains/losses since the ratios necessarily all exceed unity. However this seems to be a very doubtful basis for calculation and must be treated as no more than a pointer to the likely outcomes.

Many of the calculations designed to gauge the empirical impacts of EC-92 on different industries and countries are, of necessity, incomplete and rather approximate. As a result the empirical estimates and their interpretation offered by different authors tend to vary rather widely depending on the definitions, assumptions, and data used. It is not possible within the scope of this paper to examine and adjudicate in detail between these different estimates. Instead Table 2 summarises the position we have now reached, combining the theoretical propositions of section 2 with the empirical evidence of sections 4 and 5. Even if some of the individual empirical estimates lack credibility, the signs of the spillover effects of EC-92 look fairly safe on both theoretical and empirical grounds.

4.5 Dissenting Estimates: Will Anything Significant Happen at all?

At this point it is probably worth pausing to consider whether EC-92 really will produce the increases in competitive pressure, scale economies, and the higher growth and lower prices that have been predicted. That nothing at all may happen is perhaps an extreme view. But there are arguments which suggest that removing internal barriers may have much smaller effects than those discussed in the official publications. Kay (1991) points out that removing internal barriers, harmonizing standards and mutual recognition, or creating simpler financial conditions for exporting, will make exporting and multilateral control (i.e., mergers and acquisitions) more attractive options. Barriers, on the other hand, tend to foster collaboration or the setting up of plants abroad to get round these constraints. And the empirical evidence over the period 1983-88 does show that mergers and acquisitions in the EC have increased as market access has increased (in the form of closer integration). In fact during that period, collaborative/complementarity agreements have only been maintained across EC boundaries (i.e. with the US or Japan). Exactly similar evidence can be found in the development of the US as an established single market.

Increased merger and acquisition activity, with the remaining firms trying to go it alone in the expanded EC market, is bound to have some anti-competitive consequences; and it will certainly ensure the continued fragmentation of European industry, instead of promoting greater scale economies and comparative advantage via a fresh burst of EC-wide investment. Thus, according to Kay, the EC Commission's own evidence does not support its own arguments8, nor do these arguments seem to be logically correct. Hence the gains in incomes and prices may well turn out to be much smaller than advertised.

Another dissenting voice is Hamilton (1991). Hamilton argues that the price effects of removing national import quotas and the internal barriers of Article 115 will have little, if any, effect on prices within the EC. He also argues that any increase in EC income levels will have little impact on many developing country exporters because the thousands of voluntary export restraints are defined in volume terms. Hence, as the EC economy expands those restraints will bind tighter and transfer larger rents abroad. Thus unless the voluntary restraints are repealed, and that seems hardly likely at this stage, EC-92 will have only a small effect on the developing countries - and a considerably smaller effect than the simple estimates based on fixed exogenous restraints (including price and income elasticities estimated on the assumption of fixed restraints) would suggest. This is very much at variance with the "official" estimates (Cecchini 1988, Sapir 1990, Winters 1988). Once again it is important to note these arguments, and to be prepared to revise one's estimates of the impacts of EC-92 down rather than up.

5. The Impact of EC-92 on Manufacturing vs. Commodity Trade in the Developing Countries

5.1 Aggregation Issues

Langhammer (1990) points out that price and income elasticities vary over different classes of goods; and that, in practice, the elasticities themselves (as well as the product-by-product differences between them) tend to rise with increasing disaggregation. Similarly price and income elasticities for individual countries, or for the developing countries or the NICs as a group will differ from any estimates for the non-EC countries taken as a whole due to differences in economic structure, trade patterns and economic policies.

Naturally enough that means that, although all the arguments above stand, the general estimates of the trade creating vs. trade diverting effects of EC-92 given above may be of limited interest to policy makers concerned with particular cases. A country-by-country analysis which takes into account the trade pattern of each is not possible here. Similarly, a detailed product-by-product breakdown is not possible. Such detailed information might only be of limited value because restrictions on what can actually be computed in this context inevitably means many of the interactions between neighbouring product markets, or the price-income linkages between different countries, will be ignored.

Thus one can either have a series of very partial equilibrium studies at a level of some disaggregation, or a general equilibrium analysis at a high level of aggregation. At this stage general equilibrium analysis of EC-92 is in its infancy, and has only been undertaken for some EFTA countries and for Japan and some Asian NICs (Haarland 1991, and Stoeckel et al 1990). On the other hand, it is possible to give some broad estimates of the likely effects of EC-92 on product groups such as manufactures, primary commodities, services, or on certain country groups such as Asian NICs, OPEC, ASEAN or ACP, Subsaharan Africa, Latin America etc, based on the usual partial equilibrium/estimated elasticity approach. Papers which give disaggregated results of that kind are Davenport (1990), Davenport and Page (1990), Page (1991), Langhammer (1990), Matthews and McAleese (1990), Nicolaides (1990) and Stevens (1990). The partial nature of such an approach may not be too restrictive if the product groups are chosen to fit with the usual separability patterns of demand systems; but for the country groups it may be worse because they tend to have overlapping trading patterns, or to be linked to the EC or the same EC trading partners via trade or capital markets. This section now summarises those results in so far as they refer to developing countries (or developing country groups) and to the trade in manufactures.

5.2 Trade Patterns after EC-92

The EC is predominantly an importer of primary rather than manufactured goods from developing countries. The trade creation and trade diversion effects suggested by our earlier arguments, and confirmed in the empirical results quoted below, will reinforce this pattern with an additional bias against the lower end of manufactures which traditionally comes from the middle income developing countries and near-NICs. The manufacturing sector may well have higher than average income elasticities, as Langhammer claims, but the relatively simple developing country manufacturing exports (textiles, clothing, food products, consumer products, chemicals, steel etc) also have higher price elasticities. Moreover, there is likely to be increased competition from aggressive NIC-type industries in Southern Europe. So a significant expansion of the trade in developing country manufactures is not likely, and trade diversion will tend to offset any trade creation. Conversely, the income elasticities for primary commodity exports may be smaller than those for manufactures. But the price elasticities are in most cases smaller still. Consequently, trade creation is more likely to dominate any diversion here. Hence, existing trade patterns will be reinforced; and the effect will be to obstruct those developing countries which are making a serious attempt to diversify away from a dependence on one or two commodity markets, especially if their strategy is to diversify into manufacturing industries. It will also make things more difficult for those Latin American and Asian countries which are trying to diversify away from too great a dependence on the US (or Japanese) markets. And the EC's preference system will also deter any diversification of the poorest African countries away from their heavy dependence on particular EC markets.

5.3 The Impact of EC-92 on Developing Countries Manufacturing Output by Country Groups

If EC-92 reinforces existing trading patterns, how are the developing economies likely to fare? Table 3, which is taken from Page (1991), gives some typical estimates by country grouping. The main feature is that, just as in the aggregate results quoted above, the total effects of EC-92 on any developing country grouping is extremely small. Positive trade creation effects are offset by negative trade diversion figures, so that not one of the group's total exports is changed by more than 1%. Of course the impact on exports to the EC itself is rather larger; 6% down for the NICs, 4% up for OPEC, and rather less for the others. But those figures are also remarkable for being so small against a background where year-on-year changes in exports of 10-20% are commonplace.

Very small price elasticities for primary commodities and fuels ensure that the trade diversion effects are <u>all</u> felt in the manufacturing sector. Our conjecture that EC-92 will serve to reinforce existing trade patterns is therefore confirmed; trade creation expands the EC's imports of primary commodities, but trade diversion outweighs trade creation in manufactures <u>in every case</u>. Thus:

a) Trade in manufactured goods will be dampened by EC-92 in all developing country groups, making their attempts to diversify more difficult and reinforcing their dependence on prices in a few international primary commodity markets.

b) Despite EC-92 having a positive but very small effect on developing countries as a whole, the gains are very unevenly distributed. Commodity dependent economies, such as the ACP and OPEC countries, gain on average. But those with significant manufacturing activities, principally the Asian NICs and ASEAN economies, lose out by almost as much as the others gain. Africa and Latin America are largely unaffected.

c) The net effects of EC-92 on output and trade in the developing countries is likely to be quite small (0.3% of total exports). The more serious effects lie in the increased obstructions to diversification and in the problems caused by investment diversion. Damage here would have serious long term consequences, but no quantification of that has been undertaken.

The income elasticities underlying Table 3 are between 0.5 and 0.7 for non-fuel primary commodities, 1.2 for fuels, and around 2 for manufactures (but 2.4 for machinery and transport) (Page, 1991). Price elasticities are effectively zero for primary commodities as a group (intercommodity substitution between these developing country groups being negligible). They are around 5 for chemicals, machinery and transport (being highly substitutable by EC products) and 2 for other (simpler) manufactures which are less easily substituted. Such estimates fit into the range of figures preferred by most authors looking at the pattern of overall EC trade; see Winters (1991), Davenport (1990), Cecchini (1988), Matthews and McAleese (1990) and so on. However there have been other estimates. Langhammer (1990) prefers an income elasticity of 5.5 for developing country manufactured exports to the EC and +1.7 for the EC's relative price. With a higher income and lower price elasticity, Langhammer concludes that trade creation will outweigh trade diversion by a factor of 4. On that basis, the results in Table 3 would be reversed and the developing countries would be gainers from EC-92 on all counts - including diversification and investment. However it is difficult to give credit to these estimates as there is no explanation why the income elasticity should be so much higher than in other studies. In a wide ranging survey, Goldstein and Khan (1985) find income elasticities of 1-2.5 for different categories of manufactured imports. Moreover, the price elasticity has the wrong sign (implying that <u>falling</u> EC prices would divert trade <u>towards</u> the developing countries) and is statistically insignificant. A positive price elasticity might be appropriate if the existing national quotas are abolished instead of being translated into EC-wide quotas. Since that is a theoretical possibility, if extremely unlikely, one should perhaps note this dissenting estimate in passing. However Langhammer also acknowledges that the impacts of EC-92 on developing country manufactures is not likely to be dramatic and notes that EC imports of developing country manufactures have actually been falling in comparison to US imports of the same throughout the period of greater integration and liberalisation of the European markets (1968-85). Both of those observations support Table 3's estimates rather than the alternatives.

Davenport's (1990) analysis of EC-92 and developing country manufactures is another study which concludes that the effects on the developing countries will be relatively minor because there is a rough balance between trade creation and trade diversion and because the changes within Europe will not be large enough to have a big impact (despite elasticities greater than unity). Most countries in his sample of 18 Asian or Latin American developing countries show small gains in certain industries (e.g., textiles), but those gains are substantially smaller than the average annual growth of 5%-7% experienced over the past decade. But much greater <u>negative</u> effects are to be expected from investment diversion and from either a tightening of the existing national import quotas/voluntary restraints; or even from an extension of those restrictions to an EC-wide basis, since the current practice of transferring unused quotas from one national import market to another would have to cease. Calculations for textiles suggest that developing country exports to the EC would expand by only a fifth of the potential expansion implied by EC-92's trade creation. One may expect further quota restrictions on consumer electronics (to safeguard Europe's "high tech" potential), footwear, household goods and cars since investigations of the EC's vulnerability in these markets are already underway or complete. Davenport argues that these are likely to involve EC-wide voluntary restraints which lie outside the scope of EC-92. And on investment diversion no figures are, as usual, forthcoming.

5.4 The Impact of EC-92 on Commodity Producers

Finally, Matthews and McAleese (1990), in their study of the effects of EC-92 on primary commodity producers, provide further evidence to support the estimates in Table 3. They put the growth effect across four commodity groups at an extra 6% of exports to the EC, or an extra 1.2% of total exports. To this the change in the terms of trade would add another 0.1% on total exports. But of the estimated total increase of 1.3% in total exports, just one quarter would go to non-oil producers and three-quarters to the oil countries. And of that one quarter share, most (two thirds) goes to food and beverages. So the minerals producers see very little benefit. Thus the effects here continue to be small and poorly distributed across different product groups and different commodity producers. And as noted earlier, the price effects are very small compared to the income effects, but the net outcome is at least positive in each case.

Matthews and McAleese also point out that the fiscal regime, more than the agricultural supports within the CAP, will have a big impact on commodity producers. One problem here is the harmonisation of the VAT between EC members. That will raise EC taxes on food imports since food is zero-rated in some member countries. Secondly, there are sharp excise taxes on coffee in Germany, Italy and Denmark, plus a system of preferences and quotas for other products. Technical and health standards on food products are also important. Finally, the CAP has a whole range of price supports which distort trade in foodstuffs. As always it is not clear what will happen to these items, but it seems rather unlikely that the existing taxes and restrictions will be lowered. So the estimates above, and in Table 3 in particular, are likely to be a reasonable picture of the effects of EC-92 on different groups of commodity producers.

Footnotes

1. Consisting of the US, Canada and Mexico; and of Australia, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Taiwan Province of China and Thailand (i.e., the Asia-Pacific Economic Cooperation initiative, plus Hong Kong and Taiwan Province of China) respectively.

2. This in itself is said to be worth ½% of the EC's GNP (Greenaway, 1991)

3. Recall that at present Article 115 forbids that an item whose import is subject to restrictions, quotas or tariffs in one country, shall be imported in another and then transferred in through the unrestricted internal EC market.

4. Wolf (1987) points to those taxation effects; Hamilton (1991) focusses on the gains to non-EC suppliers from the rent transfers implied by the EC quota system.

5. This is a figure often used by the media when reviewing EC aid policy. If anything, it appears to be an underestimate. Greenaway (1991) sets direct aid expenditures by EC countries at between 0.05% of GNP for Ireland and 0.4% of GNP for the Netherlands. The EC average is around ¼% of GNP. Meanwhile EC trade with the developing countries as a whole amounts to 3.4% of EC GNP (European Economy, No.42, 1989). Hence to spend 2 ECUs on keeping developing countries' imports out for every ECU spent in aid would involve trade barriers amounting to ½% EC GNP, or the equivalent of a 14.3% tariff on developing country import prices. But the the agricultural policies of the EC countries (as part of the OECD) are estimated to have increased agricultural prices in those countries by 70% (Anderson and Tyers, 1990). Since the remaining EC trade barriers cost up to 2% of that trade (Winters, 1991), non-agricultural developing country exports cannot suffer less than the equivalent of a tariff of 2% - actually much more because trade in textiles, clothing, footwear, consumer electronics etc are subject to much sharper restrictions than that. The share of agriculture in developing country production is approximately 18% overall (World Development Report, 1989). Based on those figures the average tariff equivalent on exports from the developing countries would then be 14.2%, equalling ½% of EC GNP or 2 ECUs for each ECU of aid.

6. This estimate must be regarded as very tentative. Baldwin (1989) argues it is too small by a factor of 2. But Peck (1989) and Backhoven (1990) think it is too large by a factor of 2. The EC's preferred estimate is therefore a mid point and it is said to incorporate most of the dynamic gains.

7. Cawley and Davenport, 1988.

8. The reason for this is that the EC Commission apparently manipulated its survey questions and made selective use of the results to get the evidence it quotes. A wider view of the evidence suggests the opposite conclusions (Kay, 1991).

Table 1

The Emerging Trading Blocs: Export Markets ($bn)

		1980	%	1986	%	1989	%
EC	Intra Regional	369	48	451	49	678	52
	North America	47	6	85	9	101	8
	East Asia	26	3	36	4	66	5
	ROW	322	42	343	38	456	35
North America*	Intra Regional	100	24	129	29	205	28
	EC	68	16	59	13	100	14
	East Asia	52	12	59	13	116	15
	ROW	205	48	195	44	304	42
East Asia*	Intra Regional	96	24	116	19	224	23
	EC	42	11	59	9	100	11
	North America	68	17	153	24	207	22
	ROW	187	48	298	48	418	44

Source: Schott (1991)

* = USA, Canada, Mexico

** = Australia, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, The Phillipines, Singapore, Taiwan, Thailand

ROW = Rest of the World

Table 2

A Summary of the Effects to be Expected from the 1992 Program on Non-EC Economies

	Non-EC relative to EC	Developing relative to non-EC developed	Manufactures exporters relative to primary
Individual '1992' Changes			
Removing Internal Legal Barriers	-	0	-
Removing Country Preferences	0	0	0
Transport restrictions	-	-	-
Ending Border Controls	-	-	-
Private Services	?	?	?
Public Procurement	?	+	-
Standards	-	-	0
Total Effects on Goods			
Increased Trade from Higher Income	-	-	+
Trade Diversion: competitive markets	-	+	-
Trade Diversion: imperfectly competitive markets	-	?	-
Net Effects: competitive markets	-	?	?
Net Effects: imperfectly competitive markets	-	?	?
Effects on Investment			
From Structural Changes	?	+	+
From Increased Income	-	-	-
Effect on Labor	-	-	?

Adapted and extended from Page (1991)

Table 3

Estimates of '1992' Effects on Developing Country
Exports of Goods in Constant 1987/8 Values
(million Ecus)

	Additional exports to EC		Diversion effects	% of exports	% of total
	Primary	Manufactures	(in all manufactures)	to EC	exports
All developing countries	2804	4434	-5655	+1.5	+0.3
ACP	534	315	-477	+2.3	+1.0
Maghreb countries	244	370	-534	+0.9	+0.5
South Asia & China	86	920	-1125	-1.0	-0.1
Four Asian NICs	12	2574	-4077	-6.1	-0.9
ASEAN countries	102	344	-464	-0.3	-0.0
Western Hemisphere	502	495	-751	+1.3	+0.3
OPEC	1156	515	-847	+3.8	+1.1

Source: Page, 1991

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