Europe 1992: Implications for U.S. Firms

By Thomas Bennett and Craig S. Hakkio

In 1946 Winston Churchill stood before the people of an economically ravaged Europe and said, "We must build a United States of Europe." Churchill's dream was to tear down barriers to trade and commerce within Europe so that European nations could enjoy economic freedom and prosperity. Today the 12 members of the European Community (EC) are closer than ever to making Churchill's dream a reality. But some observers fear that the EC's current initiative, Europe 1992, might become "Fortress Europe," a community of nations bent on tearing down internal walls only to build them externally against foreign competitors.

The implications of Europe 1992 for U.S. firms doing business with Europe are not clear—and the stakes are high. Two types of U.S. firms do business with Europe: U.S. exporters and subsidiaries of U.S. firms.[1] In 1987 U.S. sales in the EC were 56 percent more than U.S. sales in Canada and Japan combined. If members of the EC encourage a world trade system unencumbered by barriers to trade, a single economic market in Europe could prove beneficial to U.S. firms. However, if EC members strive to close their markets to outsiders, Europe 1992 could prove costly to U.S. firms.

This article examines the implications of Europe 1992 for U.S. firms doing business with Europe, focusing on nonfinancial firms and banks. The article concludes that U.S. firms will benefit from Europe 1992 unless the EC members raise external trade barriers or adopt discriminatory financial regulations. The first

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[1] In this article the term "Europe" designates the 12 EC member countries: Belgium, Britain, Denmark, France, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and West Germany.

The European Community

Economic integration has been a European goal for 30 years, with Europe 1992 the most recent and most ambitious initiative. The information contained here briefly reviews the history of European integration leading up to Europe 1992. Key dates in the history of the EC are listed in the table.

In 1951 the European Coal and Steel Community established the framework for European integration. The original six members of the Community—Belgium, the Federal Republic of Germany, France, Italy, Luxembourg, and the Netherlands—subsequently signed the Treaty of Rome in 1957, which formally established the European Community (EC). The principal aims of the treaty were to preserve and strengthen peace; to create a region with the free movement of goods, people, services, and capital; and ultimately to form a political union.

Following the signing of the Treaty of Rome, barriers to trade began to fall. Tariffs between EC member countries were eliminated by 1968, 18 months ahead of the schedule in the Treaty of Rome. And, while not the sole reason, eliminating tariff barriers probably contributed to Europe's strong economic performance over the next 15 years. From 1958 to 1972 the EC's economy expanded nearly 5 percent per year, while intra-European trade grew about 13 percent per year (measured in constant dollars).[1]

The period from 1973 to the early 1980s, in contrast, was a difficult one for European integration. The oil price shocks in 1973-74 and 1979 led to numerous problems, most importantly, a slowdown in economic growth. Real gross domestic product growth averaged 2.4 percent from 1972 to 1979 and 1.4 percent from 1979 to 1985. Partly in response to slower economic growth, integration slowed, or even reversed, as member states levied new border taxes, reintroduced trade quotas, increased subsidies, and established implicit barriers against both outside countries and other EC countries.

The movement toward integration resumed in the 1980s. Europeans became convinced that raising trade barriers did not improve economic growth and that low growth resulted from inefficient and inflexible economies. Moreover, the stubbornly high unemployment rates of the 1980s—relative to the 1960s and relative to the United States—provided additional incentive to integrate. Finally, increased international competition from the United States and Japan convinced Europeans of the need for economic integration.

In the mid-1980s, the EC launched a systematic program to eliminate trade barriers and create a single European marketplace. The 1985 White Paper, officially known as "Completing the Internal Market," established the program to create a single European marketplace for goods and financial services. The White Paper included approximately 300 directives designed to eliminate barriers to the free movement of goods, people, services, and capital among the 12 EC member states. The Single European Act—ratified in 1986—adopted the White Paper, amended the Treaty of Rome, and set 1992 as the completion date of the Internal Market.

[1] The Commission of the European Communities, *The European Community* (Brussels: 1987), p. 7.

Key dates in the history of the European Community

April 1951	The European Coal and Steel Community—the forerunner of the European Community—is formed by France, Germany, Italy, Belgium, the Netherlands, and Luxembourg.
March 1957	Treaty of Rome is signed by the same six countries, establishing the EC.
July 1968	All customs duties are removed for intra-EC trade; a common external tariff is established.
January 1972	Denmark, Ireland, and the United Kingdom join the EC.
March 1972	The "snake" exchange rate system is established, setting narrow margins for exchange rate movements among EC currencies, while maintaining fixed, but wider, margins against the dollar.
March 1979	The European Monetary System (EMS) is established.
May 1979	Greece joins the EC.
January 1985	Spain and Portugal join the EC.
June 1985	The EC Commission submits the White Paper, "Completing the Internal Market."
February 1986	The Single European Act is signed.

section of the article describes the goals of Europe 1992 and discusses the extent to which the initiative might become a reality. The second section shows that, in the absence of external walls against international trade, Europe 1992 would help U.S. firms operate more efficiently in Europe. The third section examines why some U.S. firms are apprehensive about Europe 1992.

The dimensions of Europe 1992

The road to a fully integrated Europe has not been smooth. An important milestone was achieved in 1957 when the six members of the European Coal and Steel Community—Belgium, West Germany, France, Italy, Luxembourg, and the Netherlands—signed the Treaty of Rome. The Treaty of Rome established the EC and set forth goals of economic integration. By 1968, EC members had eliminated all tariffs within the EC. Due in part to the removal of tariffs, economic growth in the EC was strong from 1958 to 1972. Slow growth returned to the EC following the oil price shocks of the 1970s, however, prompting member countries once again to protect themselves against foreign competitors, including other EC countries. Border taxes, trade quotas, and subsidies were reintroduced. It was not until the mid-1980s, amid stubbornly high unemployment and rising international competition, that Europeans gave economic integration another big push: the Europe 1992 initiative (see box).[2]

What is Europe 1992?

In 1985 the EC issued a White Paper titled "Completing the Internal Market." The White Paper set forth about 300 directives designed to create a single European market for goods and financial services. Full implementation of the White Paper's directives was set for 1992. Currently, about 40 percent of the directives have been approved and are being implemented. When Europe 1992 is completed, goods, services, and capital will no longer be restricted from moving freely across European borders. But before this can happen, remaining trade barriers and financial restrictions need to be torn down.

Goods market integration. The EC hopes to create a single European market for goods; however, three major types of barriers stand in the way of integrating the 12 separate markets of the EC. All three types of barriers—technical, fiscal, and physical—need to be eliminated before goods can move freely within the EC.

One set of technical barriers comprises health, safety, and environmental standards. Such standards can impede the flow of goods from one country to another. In some cases, these standards reflect varying national preferences for safety and consumer protection. However, many believe that some of the standards were established simply to keep foreign goods out of domestic markets.

Under the Europe 1992 program, health, safety, and environmental standards will be standardized among EC members.[3] The guiding principle in setting standards will be if a product is good enough to be offered in one EC country—and meets minimal EC requirements—it is good enough to be offered in all EC countries. This principle is called mutual recognition.

Another set of technical barriers relates to the selection process for public contracts. Public contracts represent about 15 percent of the EC's gross domestic product. However, most successful bids for government projects come from firms in the home country; only 2 percent of public supply and public construction contracts are awarded to firms from other member nations.[4] In an attempt to open up bidding on public contracts, the EC has adopted common standards in the procurement process. The EC also plans to extend competitive bidding to telecommunications, water distribution, energy, and transportation industries.

The second type of barriers to be removed

[2] For further information on Europe 1992, see Kristina Jacobson, "A United European Community by 1992," *Financial Letter,* Federal Reserve Bank of Kansas City, September 1988.

[3] Prior to the adoption of the White Paper, European integration was slow because it was thought that national standards had to conform to European standards. In addition, decisions previously required unanimous approval. Consequently, integration was difficult to achieve. *The Economist* ("Europe's Internal Market," July 9, 1988, p. 7) put it as follows: "It was a hopeless prospect wherever countries were asked to take unanimous decisions over national quirks that were dear to them."

[4] "The Economics of 1992," *The European Economy* (Brussels: Commission of the European Communities, March 1988), p. 55.

TABLE 1
VAT rates in the European Community (April 1987, percent)

	Low rate*	Basic rate	High rate*
Belgium	1 and 6	19	25 and 33
Denmark	—	22	—
France	2.1 to 7	18.6	33⅓
Germany	7	14	—
Greece	6	18	36
Ireland	2.4 and 10	25	—
Italy	2 and 9	18	38
Luxembourg	3 and 6	12	—
Netherlands	6	20	—
Portugal	8	16	30
Spain	6	12	33
United Kingdom	—	15	—
Europe 1992 proposal	4 to 9	14 to 20	abolished

*Imposed on necessities such as food and children's items.
**Imposed on luxury items.

Source: "The Economics of 1992," *European Economy* (Brussels: Commission of the European Communities, March 1988), p. 61.

is fiscal barriers, such as differences in tax rates. The value-added tax (VAT), a form of sales tax, provides an example.[5] Broad differences in VAT rates throughout the EC require that individual countries control the movement of goods to prevent consumers and firms from buying goods where VAT rates are low and bringing them into countries where VAT rates are high.

VAT rates vary in several ways from one EC country to another. Member countries have both different levels of rates and different goods that are covered. Table 1 shows the range of VAT rates for EC countries. The basic VAT rate ranges from 12 percent in Spain and Luxembourg to 25 percent in Ireland. In addition, many countries impose a lower VAT rate on necessities. The United Kingdom, for example, imposes no value-added tax on food or children's clothes. Some countries also impose a higher VAT rate on luxuries. Italy, for exam-

[5] A value-added tax is an indirect broad-based consumption tax. It is essentially equivalent to a retail sales tax except in the method of administration. For a detailed discussion of the VAT, including a comparison with a retail sales tax, see Glenn H. Miller, Jr., "The Value-Added Tax: Cash Cow or Pig in a Poke?" *Economic Review*, Federal Reserve Bank of Kansas City (September/October 1986), pp. 3-15.

ple, imposes a tax of 38 percent on automobiles.

Under the Europe 1992 program, the EC proposes to standardize VAT rates by establishing two ranges of tax rates. The low VAT rate will range from 4 percent to 9 percent, and the basic VAT rate will range from 14 percent to 20 percent (see the bottom line in Table 1). In addition, the high VAT rate currently used by some EC countries will be abolished.[6]

The third type of barriers confronting European nations is physical barriers, namely, border controls. Border controls are perhaps the most visible obstacles to the free movement of goods across borders in the EC. Member countries use border controls to collect VAT taxes, to ensure conformity with varying health and safety regulations, and to regulate products subject to import quotas.

Some progress has been made toward eliminating border controls. For example, in January of last year the EC adopted a policy of permitting truck drivers to pass through customs by showing a single document. In the past, drivers had to show border officials copies of invoices, forms for import statistics, and reports for tax authorities—sometimes up to 100 separate documents—before entering the country. Consequently, a 750-mile trip from London to Milan, for example, routinely took about 58 hours (excluding crossing the channel), while today a similar trip might take only about 36 hours.[7]

Financial market integration. Just as the EC hopes to create a single European market for goods, it also hopes to create a single market for financial services. Market forces, such as the globalization of capital markets and financial innovations, are moving the world toward a single capital market. To complement these market forces, the EC under Europe 1992 will work to streamline financial operations within member countries. Capital controls will be eliminated, and banks that are licensed in one country will automatically be allowed to establish branches in any other EC country.

Many kinds of capital market controls will be eliminated in an integrated Europe. Firms in one EC member country will be permitted to issue bonds denominated in the currency of another EC country without obtaining approval from that country's central bank. EC citizens will be allowed to hold bank accounts and tap into credit markets throughout the EC. All restrictions on short-term capital flows will be removed, and capital flows between EC countries and non-EC countries will be liberalized.[8] Three countries—the United Kingdom, Germany, and the Netherlands—have already liberalized capital movements, and an EC directive

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6 Recent discussion in the EC has led to possible new approaches to harmonizing tax rates. One idea is to keep the lower band at 4 to 9 percent, but to give the high band a floor of 17 percent and no ceiling. Other discussion focuses on changing the lower band to accommodate the United Kingdom's and Ireland's desires for having no taxes on some items.

7 Kate Bertrand, "Scrambling for 1992," *Business Marketing*, February 1989, p. 54.

8 As long as some EC country does not restrict capital movements from non-EC countries, restricting capital movements between an EC country and a non-EC country would be pointless. The reason is simple: If, for example, U.S. funds can flow freely into the United Kingdom, and if U.K. funds can flow freely into Italy, then there is no reason to prohibit U.S. funds from flowing freely into Italy.

TABLE 2
Permissible banking activities under Europe 1992

(1) Deposit-taking and other forms of borrowing;
(2) lending (including consumer credit, mortgage lending, factoring and invoice discounting, and trade finance);
(3) financial leasing;
(4) money transmission services;
(5) issuing and administering means of payment (credit cards, travelers' checks, and bankers' drafts);
(6) guarantees and commitments;
(7) trading for the institution's own account or for the account of its customers in (a) money market instruments (such as checks, bills, and CDs), (b) foreign exchange, (c) financial futures and options, (d) exchange and interest rate instruments, and (e) securities;
(8) participation in share issues and the provision of services related to such issues;
(9) money brokering;
(10) portfolio management and advice;
(11) safekeeping of securities;
(12) credit reference services; and
(13) safe custody services.

Source: Annex to the Second Banking Coordination Directive.

adopted in June 1988 requires the other member countries to remove all remaining capital controls by 1990.[9]

Moreover, banks will be allowed to operate throughout the EC under a single banking license. The same principle that is applied to technical standards for goods—mutual recognition—will govern EC banking. In other words, a bank established in one EC country will be allowed to branch into any other member country without obtaining permission from authorities in that country.

The EC has proposed a list of activities permissible to European banking. The list adopts the universal banking principle; that is, EC banks will be allowed to provide securities-related and advisory services in addition to commercial banking services (Table 2). As long as the country in which a bank is domiciled (the home country) permits its banks to engage in one of the essential activities, then those banks may engage in that activity in another country (the host country), even if the activity is prohibited to domestic banks in the host country.

Bank supervision under Europe 1992 will generally be the responsibility of the home country. Bank regulators in the home country can impose restrictions to ensure the safety and soundness of banks domiciled in their country. In three areas, however, banks will be subject

[9] Four countries that are heavily reliant on capital controls have an extended deadline: Spain and Ireland, 1992; Greece and Portugal, mid-1990s.

to host-country supervision. First, branches will be subject to host-country rules imposed for monetary policy purposes. For example, reserve requirements on various assets will be set by the host country. Second, the host country will supervise the securities activities of banks. And third, the host country will retain primary responsibility for supervision of liquidity.

Eventually, a common set of banking regulations will likely emerge within the EC. Because banks domiciled in different countries will initially face different regulations, banks located in countries with stringent regulations will be at a competitive disadvantage. Over time, one would expect political pressures to remove regulatory disparities. To keep these political pressures from leading to regulatory anarchy, however, the EC plans to adopt some essential requirements for safety and soundness. For example, minimum standards will be set for capital adequacy, and minimum levels for deposit insurance will be established.[10] Moreover, procedures will be established for handling bank failures.

Thus, like goods market integration, financial market integration is moving ahead. Europe 1992, if fully integrated, would reduce burdensome financial regulations.

How likely is full implementation of Europe 1992?

A common desire for the benefits of integration has given Europe 1992 an irreversible momentum. EC officials estimate that if Europe 1992 becomes a full reality, by 1997 the EC's real gross domestic product will be increased 7 percent, 5 million new jobs will be created, and consumer prices will be lowered 4.5 percent.[11] Such benefit estimates have bolstered the EC's commitment to Europe 1992. Yet many roadblocks remain. Two major obstacles are a reduction of national sovereignty and a temporary increase in unemployment.

Any movement toward uniform EC standards reduces national sovereignty. Standardizing VAT rates, for example, requires countries to change their tax systems. In many cases, the philosophy behind a tax system is deeply rooted in a nation's psyche. For example, taxes on necessities, such as children's clothes, are much lower in some countries than in others. Europe 1992 will take this power to tax according to national beliefs out of the hands of the governments in individual countries.

Viewed another way, full integration represents a shift in the center of power from national governments to the governing bodies of the EC in Brussels—a shift that politicians and civil ser-

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[10] Capital adequacy standards will be based on the work of the Basel Committee on Banking Regulations and Supervisory Practices. The Basel Committee is made up of representatives from the G-10 countries (Belgium, Canada, France, West Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States), plus Switzerland and Luxembourg. For additional information on the Committee's proposal, see "Fed Staff Summary and Recommendations on Risk-Based Capital Plan," *BNA's Banking Report*, vol. 51 (Washington, D.C.: The Bureau of National Affairs, Inc., 1988).

[11] Glennon J. Harrison, "The European Community's 1992 Plan: An Overview of the Proposed Single Market," a report prepared for Congress by the Congressional Research Service, September 21, 1988, p. 9.

vants may regard as a personal threat. Each sovereign country's reluctance to transfer power to Brussels may slow the momentum of Europe 1992.

The second roadblock to Europe 1992 is a potential short-run increase in unemployment. Unemployment will rise temporarily as less efficient or highly protected firms are forced to adjust to heightened competition. The EC estimates that job losses during the first years of the program will amount to more than 250,000 per year.[12] As a result, despite projections of large unemployment decreases in the long run, some governments may be reluctant to permit short-run increases, causing a strain on the movement toward free markets.

Although the EC has made substantial progress in adopting the Europe 1992 directives, many difficult issues still need to be resolved. As of late January 1989, about 85 percent of the White Paper's directives had been submitted to the EC's decision-making body, the Council. Half of the directives submitted to the Council have been adopted. However, some of the most controversial proposals, such as standardizing tax rates, have not been acted upon.[13]

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[12] Harrison, "The European Community's 1992 Plan . . . ," p. 12.

[13] The EC's decision-making process on many issues has changed from unanimous consent to qualified majority. Qualified majority voting refers to weighing each member state's votes according to its population. Thus, France, the Federal Republic of Germany, Italy, and the United Kingdom have ten votes each. Spain has eight. Belgium, Greece, the Netherlands, and Portugal have five votes each. Denmark and Ireland have three each, and Luxembourg has two. To pass a proposal requires at least 54 out of the total 76 votes. This prevents the four largest countries from dominating community decisions and removes the possibility of one country imposing a veto. Unanimous voting is still required for the harmonization of tax rates.

Potential benefits of Europe 1992 for U.S. firms

Europe 1992 will replace 12 separate national markets with a single EC market. The EC comprises 320 million people, a third more than live in the United States. The EC's gross domestic product is $4.6 trillion, nearly equal to that in the United States. As long as the EC market remains open to outsiders, increased uniformity brought about by the Europe 1992 initiative will prove advantageous to U.S. firms. As restrictions are removed, nonfinancial U.S. firms will be able to operate more freely throughout the EC, thereby reducing their production and distribution costs. And U.S. banks will be able to branch throughout the EC while providing a greater range of financial services.

Potential benefits for nonfinancial U.S. firms

Removing physical and technical barriers will reduce the cost of U.S. firms doing business with Europe. Without physical barriers, such as border controls, U.S. firms will obviously be able to reduce transportation costs. Without technical barriers U.S. firms will benefit in several ways. First, U.S. firms will be able to realize economies of scale in production and distribution. Second, U.S. firms will be able to sell their products in a market not inhibited by overlapping or conflicting regulations and standards. And third, U.S. firms will be able to use a base in one country to develop a network for selling their products throughout the EC, resulting in lower transportation and capital costs.

Moreover, U.S. firms stand to benefit from their experience in highly competitive markets. As existing trade barriers fall, inefficient domestic firms will no longer be protected from outside competition. As competiton increases, more efficient U.S. firms will be rewarded.

To take advantage of the benefits of an integrated market, some U.S. firms may change the way they operate in Europe. Once technical standards become uniform, subsidiaries of U.S. firms may choose to expand the scale of their European operations. U.S. exporters to Europe may choose to move production from the United States to Europe, perhaps by forming European subsidiaries. And because Europe 1992 is leading firms to become "European" rather than simply national, some U.S. firms may try to gain sales by shedding their foreign image—that is, they may try to merge or form joint ventures with European firms.

Potential benefits for U.S. banks

If the Europe 1992 proposals are adopted by the EC, banks will be able to operate in all 12 member countries under a single banking license and under a universal banking concept. The single license will enable all banks in Europe, including banks from the United States, to realize a number of cost benefits. The universal banking concept will expand the powers of U.S. banks providing services in Europe.

A single banking license will directly lower bank costs by enabling banks to operate throughout the EC using common distribution networks, managers, and support staffs. Additional cost savings could be realized by centralizing funding of loans. Moreover, operating under a single banking license will enable banks to reduce risk by diversifying the geographic distribution of their loans. For example, if a bank's portfolio includes loans to farmers in one country, the risk to the bank may be very high due to the possibility of drought. However, a portfolio with loans to farmers in all EC countries may be much less risky, since crop damage is less likely across all EC countries than within a single country.

A single banking license and home-country supervision of banks will also indirectly lower bank costs in Europe. Currently, to operate in all 12 EC countries, a bank must meet the standards set by each country's regulators. However, with a single banking license and home-country supervision, a bank need meet only one set of regulations—those set by the home country. If overlapping or conflicting standards and regulatory procedures are eliminated, the cost of banking in Europe will decline. Furthermore, whereas in the past a bank might have chosen to locate and operate in only the larger European markets, it will now be able to establish itself in one market and then branch into all the other markets of the EC.

U.S. banks, like others, will have an incentive to expand into new countries because the prices of banking services vary greatly from one country to another. Chart 1 shows that the prices of two banking services, commercial loans and credit cards, differ considerably among EC countries.[14] To the extent these differences persist, at least temporarily, countries with high prices will attract new entrants. Some U.S. banks may also attempt to gain presence in the EC market by merging with existing European banks.

As noted earlier, under the Europe 1992 pro-

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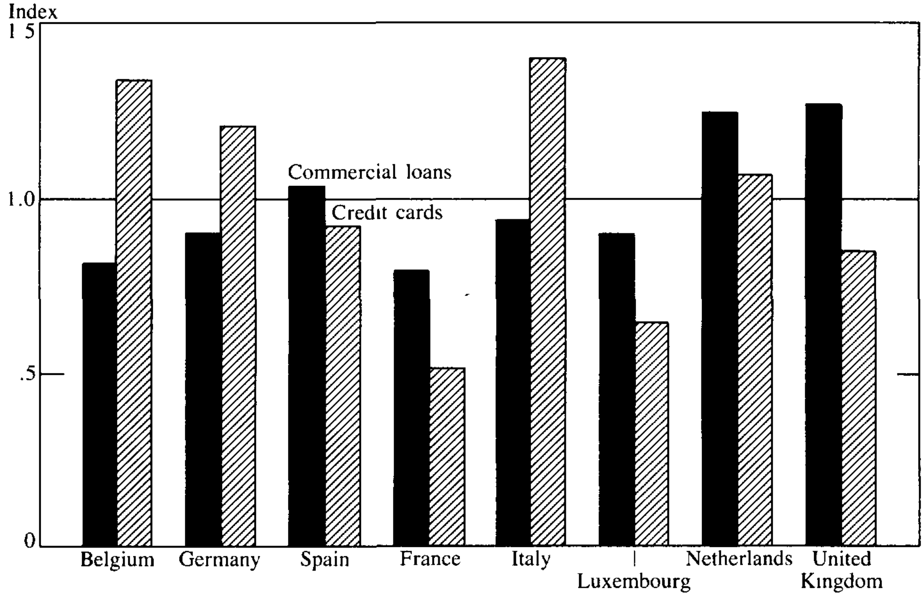
[14] For more detail on the calculations shown in Chart 1, see "The Economics of 1992," *European Economy*, (Brussels: Commission of the European Communities, March 1988), pp. 86-94.

CHART 1
Prices of banking services in selected European countries



Note: Prices for each country are expressed as a fraction of the average price in the eight countries. The price for a commercial loan is the annual cost (including commissions and charges) to a midsized firm of a 250,000 ECU commercial loan; the price for credit cards is the difference between the interest rate on a 500 ECU debit and money market rates.

Source: "The Economics of 1992," *European Economy* (Brussels: Commission of the European Communities, March 1988), p. 91.

gram universal banking will become the norm for European banking. Subsidiaries of U.S. banks operating in the EC will be able to engage in capital market activities, such as underwriting securities—unlike their parent banks operating in the United States, which are prohibited from underwriting securities by the Glass-Steagall Act. These expanded powers will give U.S. banks the opportunity to use their expertise to earn additional income in European capital markets. Furthermore, with U.S. banks underwriting securities in Europe, the U.S. Congress may be more inclined to repeal the Glass-Steagall Act and thus increase the international competitiveness of U.S. banks.

Thus, if adopted, Europe 1992 will enable both nonfinancial U.S. firms and U.S. banks to operate more efficiently in Europe. Nonfinancial U.S. firms, unhampered by costly overlapping standards and regulations, will be able to reduce both production and distribution costs. And U.S. banks will benefit from both expanded powers and the ability to operate in all 12 EC countries.

U.S. apprehensions of Europe 1992

Europe 1992 presents U.S. firms not only with opportunities but also with potential dangers. Access to a barrier-free market with a population that is one-third larger than the United States opens up lucrative possibilities. However, these possibilities will be realized only if the EC's markets remain open. If the EC becomes a Fortress Europe by raising trade barriers against foreign competition or by adopting financial regulations that discriminate against foreign banks, U.S. firms will be harmed.

Implications of a Fortress Europe

Many apprehensions of a Fortress Europe arise because the international implications of Europe 1992 for non-EC members are still not clear. The EC's 1985 White Paper focused on the internal aspects of integration rather than on its external implications. In the fall of 1988 the EC approved a 300-page document outlining member-country views on the external aspects of the Europe 1992 program. Currently, however, only a six-page summary of the document is available. The summary suggests that the EC does not intend to become a Fortress Europe; however, few specifics are given. Consequently, the possibility that the EC will close its doors to foreign competition has many U.S. firms worried.

Protectionist measures by the EC, if adopted, would threaten U.S. firms in two fundamental ways. First, U.S. firms doing business with Europe could be discriminated against. For example, if the EC limits imports, U.S. exporters will lose sales. Such a loss could be significant since U.S. exports to the EC in 1987 amounted to $120 billion, 28 percent of total U.S. exports. Additionally, if the EC adopts laws favoring European firms over foreign firms operating in Europe, subsidiaries of U.S. firms could lose sales. Such sales totaled about $350 billion in 1987.[15]

The second fundamental way that U.S. firms would be threatened, and perhaps the most important danger of a Fortress Europe, is that protectionist measures by the EC would inevitably force the United States and other nations to respond in kind. One round of protectionist policies is bad; ensuing rounds—a trade war—would be disastrous to all parties involved.[16]

Will trade barriers be erected?

Some observers are apprehensive that the EC may erect trade barriers against nonfinancial

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15 U.S. Secretary of Commerce C. William Verity, "U.S. Business Needs to Prepare Now for Europe's Single Internal Market," *Business America*, August 1, 1988, p. 2.

Some subsidiaries of U.S. firms operating in Europe could actually be helped if the EC adopts discriminatory regulations against foreign firms. Some EC countries have local content requirements that determine whether a firm is considered "European." For example, a U.S. firm may need to purchase 60 percent of its inputs from an EC country in order to be considered European. Therefore, although discriminatory regulations would harm subsidiaries of U.S. firms that were not sufficiently European, subsidiaries of U.S. firms that were sufficiently European could gain business.

16 Recent tensions between the United States and the EC exemplify the potential problems from protectionist policies. For instance, on New Year's Day the EC imposed health regulations barring imports of the United States' and other countries' beef from cattle implanted with growth-inducing hormones. In retaliation, the United States placed a 100 percent tariff on certain European products.

U.S. firms. One reason is that EC countries and industries will be subject to short-run unemployment increases resulting from integration; consequently, they may try to offset unemployment costs by stifling competition from abroad. And perhaps more important, EC countries may erect trade barriers simply to keep all the benefits of Europe 1992 to themselves.

Seemingly conflicting statements by European officials underscore the uncertainty regarding the EC's policies toward foreign competitors. Some Europeans argue that the EC, as the world's largest trading bloc, has a vital interest in maintaining and expanding the trading system. For example, West German Chancellor Kohl has asserted, "We are aware of our responsibility in maintaining a world trade system that is free of protectionism and impediments to trade. I assure you that it isn't our goal to tear down barriers internally, only to resurrect them outwardly again."[17] In contrast, other Europeans feel the benefits from integration should accrue primarily to members of the EC. According to Jacques Delors, president of the European Commission, "We are not building a single market in order to turn it over to hungry foreigners."[18]

Potential trade barriers can take many forms. Currently, some countries have quotas on as many as 1,000 individual items. The EC will have to decide whether to completely eliminate these quotas or to establish EC-wide quotas.[19] Alternatively, EC standards for certain products, the so-called essential requirements, could be written in such a way that they discriminate against the products of non-EC countries. Furthermore, EC legislation might establish local content laws requiring products to contain a certain percentage of local labor, materials, and capital to be considered domestic.

Thus, whether the EC will ultimately decide to erect external trade barriers is still an open question. Some EC member countries may be tempted to limit access by foreign firms to European markets. Others will likely be committed to keeping markets open to all firms.

Will discriminatory financial regulations be adopted?

Apprehensions that U.S. banks might be discriminated against arise because the EC has not made it clear how it will treat foreign banks. The EC has indicated that access to a single European financial market will be limited to banks from those countries outside the EC that provide reciprocal treatment to banks from all EC countries.[20] Unfortunately, the EC's definition of reciprocity is unclear—both in its meaning and its implications. Reciprocity may mean

17 Remarks by West German Chancellor Helmut Kohl to a gathering of diplomats in Bonn, Telerate Systems, November 18, 1988, p. 155.

18 Scott Sullivan, "Who's Afraid of 1992?" *Newsweek*, October 31, 1988, p. 34.

19 A related concern is how Europe will treat "Japanese" autos produced in the United States. For example, if Hondas are exported from the United States, will they be treated as Japanese autos or U.S. autos?

20 While reciprocity provisions could be applied to any product or firm, they have been incorporated only into directives on banking, investment services, and public procurement.

either "national" treatment or "mirror-image" treatment. National treatment would strengthen U.S. banks; but mirror-image treatment would severely limit the powers of U.S. banks operating in the EC.

As a matter of policy, the United States accords national treatment to foreign banks. Under national treatment, all powers granted to U.S. banks are also granted to foreign banks operating in the United States. By allowing domestic and foreign firms to compete on an equal footing, national treatment is nondiscriminatory.

U.S. policymakers have urged the EC to provide national treatment to U.S. banks operating in the EC. An official of the U.S. Treasury Department has argued, for example, that national treatment is consistent with our treaties with European nations, with the codes and instruments of the Organization for Economic Cooperation and Development, and with U.S. federal law.[21] U.S. officials further argue that since the United States provides national treatment to foreign banks, the EC should provide national treatment to U.S. banks.

If the EC adopts national treatment as its definition of reciprocity, U.S. banking in the EC will not be unduly restricted. Since EC banks can branch throughout Europe and underwrite securities, national treatment will allow U.S. banks operating in Europe to do likewise.

On the other hand, if the EC adopts a mirror-image definition of reciprocity, U.S. banking activity in the EC will be severely restricted. Under mirror-image reciprocity, treatment of U.S. banks in the EC will mirror the treatment of EC banks in the United States. Since the United States prevents EC banks (and U.S. banks) from branching throughout the United States and from underwriting securities, mirroring that treatment in the EC will prevent U.S. banks from branching throughout Europe and underwriting securities. Thus, U.S. banks would be unable to compete effectively against European banks, which would have much wider powers.

The October 1988 document on the external aspects of Europe 1992 has allayed some of the apprehensions about the reciprocity provisions. Lord Cockfield, Internal Market Commissioner of the EC, assured foreign bankers that the reciprocity provisions will not be applied retroactively.[22] As a result, U.S. banks already established in the EC will be treated the same as European banks, regardless of the definition of reciprocity.

Lord Cockfield also asserted, however, that reciprocity provisions will be applied to "newcomers." In the event that reciprocity is defined as mirror-image, Lord Cockfield's assertion raises several questions. Suppose, for instance, a nonfinancial company already established in the EC establishes a new financial services subsidiary. Is the firm a newcomer? Alternatively, suppose a U.S. bank becomes established in the EC between 1990 and 1992. Is it a newcomer?

[21] U.S. Deputy Secretary of the Treasury M. Peter McPherson, "The European Community's Internal Market Program: An American Perspective," remarks before the Institute for International Economics, Washington, D.C., August 4, 1988, p. 6.

[22] "EC Allays Freeze-Out Fears," *American Banker*, October 24, 1988, p. 6.

Or suppose a U.S. bank, already established in the EC, reorganizes or adds another subsidiary. Is the reorganized bank a newcomer? Is the new subsidiary a newcomer?

As debate has continued within the EC over the treatment of foreign banks, U.S. policymakers have emphasized the importance of adopting the national treatment definition of reciprocity. For example, Governor Heller of the Federal Reserve System stressed that anything other than national treatment "would be detrimental not only in that it would harm the ability of U.S. banks to compete in the European market for financial services, but it could lead to further protectionist pressures that would be harmful to all."[23] And Mr. McPherson, then Deputy Secretary of the Treasury, argued that mirror-image reciprocity "could be applied in a manner that would discriminate against firms in the United States seeking entry to the EC," concluding that the U.S. government finds this reciprocity concept "particularly troubling."[24]

23 *Daily Report for Executives*, November 3, 1988, p. A-12.

24 M. Peter McPherson, "The European Community's Internal Market Program . . . ," pp. 4-6.

Summary

With Europe 1992, members of the European Community are creating a single market for goods and financial services. Tearing down trade barriers and removing financial restrictions will strengthen the EC's economic power, create millions of new jobs for its citizens, and lower consumer prices.

The implications of Europe 1992 for U.S. firms doing business with Europe are not clear, however. If the EC keeps open its doors to world trade, U.S. firms could share in the benefits of a single European market. On the other hand, if the Europeans close their doors to foreign competitors, some U.S. firms could pay a high price. This article argues that U.S. firms will benefit unless the EC raises external trade barriers or adopts discriminatory financial regulations.

Complete integration of Europe 1992, as envisioned by the White Paper, may not become full reality by 1992. Disagreement on such central issues as tax rates, banking control, and national sovereignty may take years to unravel. Yet there is little doubt that Europe 1992 is moving strongly toward implementation —and that it will have significant ramifications for U.S. firms.