

ESSAYS IN INTERNATIONAL FINANCE

No. 182, May 1991

EUROPE AFTER 1992: THREE ESSAYS

TOMMASO PADOA-SCHIOPPA, EDITOR
MICHAEL EMERSON, KUMIHARU SHIGEHARA,
AND RICHARD PORTES



INTERNATIONAL FINANCE SECTION

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ESSAYS IN INTERNATIONAL FINANCE

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The three papers contained in this Essay were presented in August 1990 at the Fifth Annual Congress of the European Economic Association at a panel organized by Tommaso Padoa-Schioppa, Deputy Director General of the Bank of Italy and former Director General for Economic and Financial Affairs at the Commission of the European Communities. His Introduction precedes the three papers. Michael Emerson, author of the first paper, is Ambassador of the Commission of the European Communities in Moscow and former Director for the Evaluation of Community Policies at the Commission in Brussels. Kumiharu Shigehara, author of the second, is Director of the Institute for Monetary and Economic Studies at the Bank of Japan, and former Director of the Policy Studies Branch at the Organisation for Economic Co-operation and Development. Richard Portes, whose paper completes the set, is Director of the Centre for Economic Policy Research, Professor of Economics at Birkbeck College in the University of London, and Directeur d'Etudes, Ecole des Hautes Etudes en Sciences Sociales (at DELTA), Paris. We are grateful to Tommaso Padoa-Schioppa for giving us the opportunity to publish these papers and for his assistance in preparing them for publication.

PETER B. KENEN, *Director*
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INTRODUCTION

Tommaso Padoa-Schioppa

1985-86 marked a turning point for the European Community (EC) after years in which the EC had projected an image of such interminable and inconclusive wrangling that both insiders and outsiders could only be skeptical about its development. The amendment of the Treaty of Rome known as the Single European Act, and the accompanying *White Paper* (1985) on completing the internal market, while restating the objective of creating an area without frontiers, free of restrictions on the movement of goods, persons, services, and capital, introduced two crucial changes in the method by which the process of integration was to be managed. It proposed, first, a shift from unanimous to majority approval of the necessary legislation and, second, a shift from the Herculean task of harmonizing the whole body of national laws and regulations on economic matters to the two, much more easily implemented, principles of “mutual recognition” and “minimal harmonization.” A timetable was also set giving 1992 as the deadline.

Since then, “Europe 1992” has become a catchphrase for Europeans as well as for non-Europeans. This critical date has led private economic agents as well as government bodies inside and outside the Community to change their behavior in order to be ready for the post-1992 world.

Europe 1992 means much more than the creation of a simple free-trade area. The fundamental difference is that the Single Market is supported by an almost complete constitutional framework comprising legislative, executive, and judicial organs such as the European Parliament and the Council of Ministers, the Commission of the European Communities and the Court of Justice. The law of the Community, like national laws and unlike international treaties, is directly applicable to individuals and legal persons and can be invoked in national courts.

The removal of all regulatory and other barriers to the free provision of financial services and the complete liberalization of capital movements are the two aspects of the 1992 program that have posed the greatest problem for the monetary organization of the Community—in

Works cited in the Introduction and following three Essays are contained in a single list of References at the end of this volume.

which the European Monetary System (EMS) ties national central banks to a regime of fixed but adjustable exchange rates while allowing them to retain formal independence in domestic monetary-policy decisions. The only solution to what I have elsewhere (1985) called the “inconsistent quartet” (full trade integration, complete mobility of capital, fixity of exchange rates, and independent national monetary policies) is to supplement the internal market with a monetary union.

The EC Commission’s May 1986 communication to the Council of Ministers on the *Programme for the Liberalization of Capital Movements in the Community* (1986) provided the spark. In June 1988, the European Council (the heads of state and governments of the EC countries) met in Hanover and charged a committee consisting for the most part of the governors of the EC central banks with the task of studying and proposing concrete stages leading toward economic and monetary union. The report of that committee, chaired by Jacques Delors, was published in April 1989 (Committee, 1989) and made it clear that a monetary union, in which exchange rates are irrevocably locked, necessarily implies a single monetary policy and a European Central Bank, and not merely the coordination of national monetary policies.

The Intergovernmental Conference, which started in December 1990, is working on the necessary amendments to the Treaty of Rome in order to lay the constitutional foundations of the Economic and Monetary Union (EMU).

This whole process has been widely analyzed with particular emphasis on its intra-Community impact. However, the world economy will also be affected in several ways, which are less often considered. The three essays that follow take the completion of the Single Market for granted and adopt a forward-looking approach focusing on the implications for the trade and financial relations of the EC with the rest of the world.

In the first essay, devoted to the internal macroeconomic implications of 1992, Michael Emerson notes that the clarity and certainty marking the process of monetary union are not found in the process of economic union. He identifies four controversial issues concerning the Delors Committee’s proposal to establish binding rules on national budgets, the functions of the Community budget, tax harmonization, and social policies. Furthermore, he points to the potentially large economic consequences of two problems that loom over the policy agenda of the Community: the changing age structure of the European population and the risk of global warming.

The macroeconomic implications the Single Market is likely to have for the rest of the world, in particular the United States and Japan, are considered by Kumiharu Shigehara in the second essay. He believes that trade diversion will be an unavoidable result of Europe 1992 but that the patterns of the EC's external trade and financial flows will also be influenced by faster economic growth within the Community and by the level of protection it adopts. In analyzing the external financial aspects of the integration process, Shigehara emphasizes the importance of increasing competition, not only among European banks but also between European and non-European banks, for the realization of greater economic efficiency. He concludes by advocating closer cooperation between Europe, the United States, and Japan, coupled with improved surveillance.

In the third essay, Richard Portes suggests that the most crucial challenge to the renewed dynamism of the European Community in the 1990s will come from outside its borders as a result of the changes taking place in Central and Eastern Europe. Portes argues that the Community will play a central role as a pole of attraction for Eastern Europe and that there will be a direct complementarity between economic reform in that region and European economic integration. In particular, he suggests that the remarkable transformation under way should serve as a stimulus to accelerate both the development of the Community's institutions and economic integration itself.

The three essays are linked by a common concern with the role of government in economic activity. That issue, of course, encompasses a much wider range of developments than just the European Single Market. But what is special about the Community, both internally and externally, is that, in its institutional dynamics, defining the role of government appears not only as a horizontal problem, of sorting out the *agenda* and the *nonagenda* of government, but also as a vertical problem, of attributing governmental functions to the appropriate *level* of government, be it the national, regional, Community, or supra-Community level. It is for this reason that the evolution of Community arrangements, which is accelerating under the impulse of Europe 1992, is so intellectually challenging for both economists and policymakers.

Tommaso Padoa-Schioppa
Rome, May 1991

EUROPE AFTER 1992:
ASPECTS OF ECONOMIC AND MONETARY POLICY

Michael Emerson

When was 1992 and What is It?

“Nineteen ninety-two is today” said Carlo de Benedetti in early 1988, when attempting to take over the Société Générale de Belgique. Although the condottiere failed in his attempt to acquire one-third of Belgian industry, it was only because the French group Suez outbid him at great cost—in order itself to be positioned for 1992.

At that time, the Commission of the European Communities (1988a) had just published the results of its research on the prospective effects of the European Single Market. Having completed that research, several of my colleagues went out to ask some captains of European industry whether they thought the conclusions plausible. One industrialist, head of a very large company producing capital equipment for government agencies, replied: “Your analysis is correct, but it won’t happen. The monopsonist relationships between national champions and their home governments are too strong.” Within six months, however, this man had completely restructured his own enterprise through a wave of divestitures, take-overs, and joint ventures at the European level. He explained to shareholders that this was to prepare for 1992. It seems he had made a new strategic assessment. Europe 1992 was credible.

In early 1988, no more than one-tenth of the 1992 legislative program had been put on the statute book. Yet, Europe 1992 began to affect the behavior of economic agents as soon as the business world perceived it as a credible strategic plan to change the performance of the EC economy. This interplay between expectations and actions may not surprise economists whose models have come to be dominated by the play of expectational variables and assumptions about credibility, but it does raise the question “what is 1992?” if it is yet so distant from formal acts a lawyer would recognize. In fact, the legislative content of Europe 1992 is often not well known to business leaders, except for details of local sectoral relevance. Rather, it symbolizes something very loose, best captured perhaps by the Americanism, “Europe is finally getting its act together.”

A definition was made even more difficult when the Community's summit (the European Council) decided in mid-1990 that, by the same target date, December 31, 1992, the Community should ratify two new treaties to establish the foundations of Economic and Monetary Union (EMU) and to reform the functioning of Community institutions. Is EMU now part of Europe 1992? Conventionally or bureaucratically, one would have to say no, but, strategically, one must say yes. Moreover, the play of expectations and credibility will be at least as important for the effects of the proposed single currency as for the Single Market. Credible expectations that Europe's monetary policy will be unified within a few years under some kind of Euro-Bundesbank or EuroFed will surely have profound effects on governments as well as business. To help identify these effects in advance and clarify the issues for the negotiations of the forthcoming treaties, the Commission (1990c) published in October 1990 a detailed study on the potential costs and benefits of EMU.

"Europe after 1992" thus means a Community that has discovered the political chemistry for doing some obviously sensible things, such as having a single money and a single market, and exploiting its latent combined advantages of scale and diversity. As long as the politicians continue to confirm the credibility of this resolve, mobile entrepreneurs will move in to pursue first-mover advantage and so create the dynamics of a new Europe.

Completing the Economic and Monetary Constitution

The Community will still be completing its economic and monetary constitution after 1992. The intergovernmental conferences that will negotiate the two new treaties began in December 1990, with the content of the economic and monetary treaty already quite extensively prepared. The Delors Committee's proposals have remained the guiding concept, and more precise proposals have emerged from the Commission, the Monetary Committee, and the Committee of Governors of Central Banks. The Commission's proposals (1990a) for the work of the conferences were adopted in August 1990 and published in September, and draft statutes of the future European Central Bank were prepared by the Committee of Governors of Central Banks and were transmitted to the governments in November 1990. The following paragraphs draw extensively from the Commission's proposals, and, although the Commission's positions may not be followed on all points, its proposals do offer a unified view of the future economic and mone-

tary constitution of the Community, a view that may well be close to the actual outcome. The evolution of positions, from the Delors Committee's report to the Commission's proposals, also serves to spotlight a number of key issues.

A large degree of consensus is already apparent on the future monetary constitution of the Community. The debate is now basically concluded concerning the design of the future Central Bank. It will resemble both the Bundesbank and U.S. Federal Reserve System. It will be independent politically, having a federal structure with a board including representatives from each member state and the Community; it will be committed to monetary stability as its chief objective (close on this point to the Bundesbank); and it will be accountable to democratic and political institutions in the literal sense of giving them accounts of its activities (closer on this point to the Federal Reserve). Important for the rest of the world, it will share its powers regarding external exchange-rate policy with the governmental authorities, with the exact formula still to be defined but lying somewhere between the discretionary power to intervene given to the Bundesbank and the larger power given to the U.S. government in the federal system.

Should there be fixed exchange rates or a single currency? The Delors Report discussed both but gave more weight to the former. The Commission now advocates a single currency as the primary goal, with the fixed-rate formula to serve for no more than a transitional period. This view is strongly justified by the arguments presented in the Commission's *One Market, One Money* (1990c), which identified no fewer than five respects in which a single currency is economically superior to a system of fixed exchange rates. Only a single currency will (1) eliminate transaction costs, (2) give maximum credibility to the union, (3) assure complete transparency of prices, (4) exploit all economies of scale made available by a large financial market, and (5) offer the full advantages of a major international currency.

The future monetary constitution will thus have classical features of the German-Swiss-U.S. central banking models. The independent Central Bank and the ECU as the single currency can already be described in terms of their definitive characteristics. There is little innovation in the design of the plan or uncertainty in the outlook, and it is widely recognized as the best of choices in economic cost-benefit terms.

This degree of clarity and certainty is not found in discussion about the economic branch of the union, except for agreement on the importance of having a single, open market for goods, services, labor, and

capital. Other post-1992 characteristics of the economic union are more tentatively identified in the Commission's proposals, and the economic system will probably continue to be evolutionary in nature, rather than defined rather quickly as has been the case with the monetary union.

This evolution is likely to take place on several fronts. First, there will be a post-1992 Single Market agenda. This may not be so epoch-making as the 300-item agenda of Lord Cockfield's *White Paper* (Commission, 1985), but it will be substantial. The *White Paper* announced a qualitative change but not the definitive regime, and several economic sectors, energy and civil aviation, for example, were only lightly touched in the proposed agenda. The many intersections between the Single Market and environmental policy will need strong specification at the Community level, given the strong development of both in recent years. Similarly, the intersections between competition policy (regarding both concentration and state subsidies) and R & D policy will also need stronger resolution at the Community level. Both of these will have large and growing agendas, with the potential for contradictions between them. Some elements of common economic infrastructure will be promoted to amplify the potential of the Single Market: the inauguration of, for example, cross-frontier tunnels, bridges, highway connections and, above all, high-speed train networks on a scale that begins to be worthy of the interstate networks of the United States. Indeed, the post-1992 Single Market will increasingly resemble this part of the U.S. federal system.

The more controversial items are concerned with powers over national budget deficits, functions of the Community budget, tax harmonization, and social policy. There will be innovation in all these areas, for there is no appropriate federal constitution to copy, and there will be uncertainty and tâtonnement in the search for the most desirable system.

The Delors Report was criticized more for its proposal of "binding guidelines" for national budget deficits than on any other point. But the opposition, which advocated total reliance on national autonomy and market pressures, has not prevailed either, certainly not in governmental circles (pure economists, allowing themselves the luxury of ignoring political economy, are more often close to the extreme liberal position). The Community and member states are now searching for a power-sharing formula that will constrain "excessive deficits" rather than control each country's actual budget balance every year, as was implied by the "binding guidelines." They are trying to find a way to

overcome the problem of “government failure” that has persistently beset fiscal policies in a number of member states, most notably Italy, Belgium, Greece, and Portugal. Although all economists find it difficult to identify the optimal budget deficit, few would even try to justify the past policies of these countries. Most (but not all) member states appear willing to contemplate some legal power at the Community level to “outlaw excessive deficits,” subject to a voting procedure of the Council of Ministers. This appears to represent an alliance between representatives from two groups of countries, those who know they have problems of government failure and who would welcome constraints on their unreliable government coalitions and parliaments, and those who are not concerned about their own countries but would be quite happy to see others constrained.

It is certain that the Community will not expand its budget in line with established federal models. Some moderate expansion of the budget is advocated by the Commission—extended eligibility criteria for the structural funds, for example, and a new special support scheme to extend a mix of grants and loans to countries experiencing major economic problems. These discretionary instruments are as far as the Commission recommends going to help absorb country-specific shocks in the absence of national exchange-rate flexibility. Yet, some economists are issuing ominous warnings that monetary union will not be viable without something much closer to fiscal union alongside it. How can such an enormous divergence of judgment persist? The political leaders of the Community seem to be saying that there is no clear functional need in the Community for a massive redistribution system: in the classic federations, such systems reflect both political maturity and, functionally, the need to prevent the divergent fiscal capacities of the constituent states from inducing large amounts of socially inefficient migration. Interestingly, the integration of the two Germanys illustrates the latter point: had it not been for the prospect of massively inappropriate migration, the functional need for fiscal equalization between the Germanys would have been much weaker. These political and functional justifications, however, are not currently found at the Community level.

Social policy together with taxation are the main frontier areas in the continuing pursuit of the optimal degree of microeconomic policy harmonization. Defining the mix of centralism and decentralization seems to proceed rather smoothly for goods, services, and capital markets, with debate and negotiations largely channeled along pragmatic and nonconfrontational lines. The outlook is less clear, however, for the

social and fiscal domains. Here, the essential issue is whether free regime competition among member states risks leading to a serious underprovision of socially desirable public goods, including public regulations, or an erosion of efficient and equitable taxes. The problem, of course, is that member states have different views about optimal policy in these domains, irrespective of the issue of Community competence: some welcome the prospect of a market-driven slimming down and others fear such an outcome. Not surprisingly, it is in the social and fiscal domains that the legal basis for Community legislation is weakest, with the unanimity requirement as yet giving little or no ground to voting by qualified majority in the Council of Ministers.

The Community is likely to proceed by trial and error. There will be persistent pressures in favor of some social and fiscal legislation, but blanket changes of regime, implying wholesale transfers of political competence, seem out of the question. A far more subtle and selective process seems likely. The dominant criterion for Community action will be the well-tried tenet of fiscal federalism, the intensity of the spillover effects across frontiers.

These effects are most intense, almost by definition, when the factor of production or tax base is geographically mobile. Capital is certainly the most mobile factor, and the problem of taxing financial capital will surely be persistently on the post-1992 agenda. Yet, capital is so mobile worldwide that Community action alone risks being ineffective, and various tax havens will also undermine the feasibility of international agreements. Corporate capital is, on the whole, less mobile than financial capital, and the Commission has recently withdrawn an old proposal for harmonization of corporate taxes, signaling recognition of a need for more open and frank reflection. However, the current integration of European corporate structures is sure to render inefficient and obsolete the existing maze of national corporate taxes and intergovernmental agreements on double taxation. After 1992, the Community may become interested in having a common corporate tax, which would be a natural potential source for enhancing the revenues of the Community.

More technical, indeed too technical for elaboration in this essay, is the problem of the value-added tax. The proposed agreement for eliminating fiscal frontiers with respect to this tax (keeping for the time being to zero-rated trade flows coupled to the destination principle) is only intended to be transitional. It will have to be reworked after 1992, if only in response to the threat of cross-border tax fraud.

The question asked in Brussels about social policy is whether the

Social Charter recently adopted by eleven member states and dealing with basic features of labor-market law and with social security systems remains only declaratory in character or whether it should be translated, at least in part, into binding legislation at the Community level. The Community would, under such legislation, establish minimum standards in those domains, so as to put a floor under the process of regime competition. How serious will these pressures of regime competition be to the existing state of social policy in post-1992 Europe? With a steady evolution of the economy, they are unlikely to be very great, bearing in mind the high communality of European social-policy systems, the relative immobility of labor across language frontiers, and the strong interest groups defending the status quo. The social security system will not be in a steady state, however, if only because the population is aging. We return to this issue later.

A final word is warranted on the institutional requirements of the economic union. The Commission proposes no categorical innovation of the sort contemplated for the monetary union. The expectation, or challenge, is that the Council of Ministers (comprised of the ministers of economy and finance), together with the Commission, will be able to develop into an important agent of policy formation. The prevailing view is that the economic union must balance the monetary union to some degree, even though it will involve much less centralization of economic policy. If the economic union is insufficiently developed politically, the economic performance of the union will risk revealing an undesirable bias with respect to the balance between final policy objectives. Employment levels, equity, and real economic efficiency may be underrepresented; monetary stability may be overrepresented.

In fact, the economic-policy agenda of the Council will be a large one after 1992 and will include Single Market affairs, the coordination of national budget policies (as well as the administration of constraints on excessive deficits), collaboration with the European Central Bank in the making of external monetary policy and the macroeconomic policy mix, the Community budget, and issues of fiscal and social policy. The view being advanced implicitly in the Commission's proposals is that institutional design is not a major problem. Legislative and financial authority exists or can be created, and the forthcoming treaties will provide the occasion for evolutionary moves to extend the scope for majority voting in some of the domains discussed. The dynamic tensions created by the Single Monetary Authority and the Single Market will suffice to upgrade the effective policymaking capability of the existing Council. When the hour comes, after 1992, the Council should be able

to rise to the occasion. At the very least, this thesis is likely to be tested in practice, before the contemplation of more radical changes in the economic constitution.

Back to Basics: Population and Climate

The economic and monetary constitution may be quite basic. Yet, Europe will not by this means escape the impact of two forthcoming economic problems, population and climate, that will loom large on the policy agenda after, or even before, 1992. At best, the new economic and monetary constitution will provide a more robust and dynamic base from which to confront these challenges.

The economics of the Community's aging population remains a curiously dormant issue. Nothing is more surely predictable than the change in the age structure of the domestic population over the next few decades. The word "domestic" is to be stressed, for international migration is the major unknown in the demographic outlook. We shall return to this later.

The size of the cohort of new young entrants into the labor market is falling throughout Europe, and the share of the elderly in the total population is rising. The share of the elderly is expected to rise from 14.5 percent in 1980 to 17.1 percent in 2010 and to 23.7 percent in 2040. In 1900, it was only 4 percent in the United States (Hurd, 1990). By the time today's teenagers reach pensionable age, the burden of pensions on the economy will be almost double recent levels. If pension policies do not change, public pension expenditure will rise on average in the Community from a level of 14 percent in 1980 to 26 percent by 2040 (Emerson, 1988).

Statisticians and economists signal the alarm. In July 1990, for example, the Institut National de Statistiques et d'Etudes Economiques (1990) published a detailed analysis with the same general message. The dependency ratio (retired to active subscribers to social security) will have risen in France from 42 percent in 1985 to 89 per-cent by 2040. In the absence of any reform of the financing system (pay as you go), the level of subscriptions as a share of the average salary will have to rise from 18 percent in 1990 to 32 percent by 2040. Details differ by country, especially in financing systems, but the broad shape of the required economic adjustment is common to all of Europe.

The policy response could in principle consist of any mix of five components: (1) a reduction of the pensioner's relative income, (2) a rise in the average pension age, (3) an increase in the labor-force

participation rate, (4) an increase in social security taxes, and (5) an increase in immigration. None is attractive politically. Social security taxes are already very high in the Community, and any substantial increase might recreate the vicious circle of falling employment and rising nonwage labor costs. A two-year rise in the retirement age early in the next century, however, would reduce the required rise in social security taxes—in Germany, for example, from 8 to 3 percentage points (Auerbach et al., 1989). Labor-force participation rates are relatively low in the Community, so an increase here might be attractive. As I have argued elsewhere, however (Emerson, 1988), this would require important reforms in the regulation of employment contracts affecting marginal members of the labor force (part-time workers and the elderly) and in social security systems. Research shows that social security variables are important in explaining labor-force participation in the United States, and Europe is unlikely to be different (Hurd, 1990). The immigration option will also press itself, especially if the Community's economy continues to be buoyant compared with poor-to-catastrophic economic performance in Central and Eastern Europe and in North Africa. Legal immigration from these areas is tightly restricted, but illegal immigration from both regions is significant, if not yet of Mexican proportions. Turkey, as a Community applicant with a large and fast-growing population, effectively volunteers officially to supply labor to the Community. Also, the potential supply of economic, if not political, refugees from Central and Eastern Europe is surely considerable, though immigration from these regions is hardly an attractive option for the viability of the reform process in the sending countries, as the example of East Germany already illustrates.

Each of these options raises major issues with respect to the social dimension of the Community's Single Market. Any of them would be extremely difficult to negotiate even within a single country, but all could have important spillover effects across the Community with respect to the coordination of macroeconomic policies. Macroeconomic tensions might be easier to absorb in a completed EMU, but they will not help to achieve a smooth transition toward union. At the very least, member states will surely want to consult and concert their responses to the aging problem, to seek solidarity in numbers in promoting difficult policy changes, and to avoid possible beggar-thy-neighbor effects.

The economics of global warming threatens to double existing and prospective strains on resource allocation and income distribution. Our old people and our old planet will need more attention at the same

time. According to currently available information, the magnitude of global warming is quite uncertain: an increase of 1 to 4 degrees Centigrade in average global temperature over the next century, a rise of 1 to 3 feet in sea level. At the low end, the cumulative cost of these changes could be less than 1 percent of national income (Nordhaus, 1990). The intergovernmental panel on climate change, however, focuses on estimates at the higher end of these ranges (an increase of more than 3 degrees Centigrade, a rise of more than 3 feet by the year 2100). Moreover, the cost curve for curbing carbon dioxide emissions rises steeply after the first 25-percent cut. The macroeconomic impact would also be much more adverse if there were a panicky recourse to quick-acting, but economically inefficient, regulatory instruments. Nordhaus offers one such scenario in which an inefficient policy could reduce GNP growth by 5 percent per annum for a twenty-year period (Nordhaus, 1990).

The problem of judging the best policy response is aggravated by the possibility, of unknown probability, that catastrophic changes could occur in ecological systems and climates. For example, José Lutzenberger, the Brazilian ecologist who is now minister of the environment, warned the White House Conference on Global Warming in May 1990 that a collapse of the heat-exchange function of Amazonia could damage the supply of Gulf Stream warmth to temperate Europe. Northwestern Europe would then find itself on a climatological, as well as latitudinal, par with the Canadian tundra. Who knows?

As with demography, there is an important Central and Eastern European dimension. Estimates by the Norwegian authorities suggest that the cost effectiveness of measures to reduce carbon dioxide emissions in Poland or Czechoslovakia are, at the margin, ten times greater than in the most advanced Western European countries. Put another way, Central and Eastern Europe have the potential for damaging the economy of Western Europe very seriously indeed after 1992 in either or both of two ways: by cross-frontier pollution or by large-scale migration of refugees. Even a unified Community of 336 million people will not be able to function as a closed economy. The beginnings in 1989 and 1990 of economic assistance to Central and Eastern Europe have been small indeed compared to the size of the spillover effects these countries could transmit across the old iron curtain.

On present information, the most advisable policy for dealing with global warming would seem to be similar in broad principle to that needed to address the demographic problem. Start now or soon and spread the adjustment over a long period, well into the next century.

To avoid a crash program equivalent to an oil shock, give the economy and technology time to prepare, but give clear and valuable incentives to do so. Unnecessary damage to the economy may thus be averted, even if the price adjustment required over time is equivalent cumulatively to a large oil shock.

The Community's agenda for the rest of the millennium thus seems cast in remarkably clear terms. The politicians have set their agendas: sentiments expressed at the October 1990 summit meeting favored completion of the Economic and Monetary Union between 1994 and 1997. The business community seems increasingly to view not only the Single Market but also a single currency as being in the pipeline, and they begin to adapt accordingly. And Mother Nature has put two additional items on the agenda: adaptation of social policy to deteriorating ratios of active to inactive age groups and adaptation of energy and environmental policies to the task of stabilizing and later cutting greenhouse emissions. This completes the orthodox economic agenda.

The cozy and (relatively) ordered world of the EC should be capable of handling this orthodox economic agenda. It should even be possible to deal smoothly with applications for membership from most of the countries of the European Free Trade Association (EFTA) without upsetting the Community's main agenda. But the Community's Eastern neighbors have some 400 million people who now confront dramatically difficult conditions and changes. The last year's experience with this transition, from the old East Germany through to the Soviet Union, offers no encouragement for those who think Western Europe will be able to proceed as before—that Central and Eastern Europe will have only a slight impact on the evolution of affairs in Western Europe. The editor has kept me out of Central and Eastern Europe. We have dealt that wild card to Richard Portes. This limitation makes me very aware of having offered only a partial sketch of the problems ahead, but I am rather relieved that it was imposed.

THE EXTERNAL DIMENSION OF EUROPE 1992: ITS EFFECTS
ON RELATIONS BETWEEN EUROPE, THE UNITED STATES,
AND JAPAN

Kumiharu Shigehara

Introduction

After December 31, 1992, the twelve countries of the European Community will comprise an area without internal barriers, in which the free movement of goods, services, labor, and capital is ensured. Although numerous studies have examined the internal aspects of Europe 1992, systematic efforts have not been made to assess its implications for the Community's external policy and for relations between Europe, the United States, and Japan. Indeed, neither the Cecchini Report (1988) nor the Commission's "Economics of 1992" (1988a) shed significant light on the external aspects of Europe 1992.

It was not until late 1988, three years after the introduction of the Single European Act, that the Commission began to indicate in general terms how Europe 1992 would affect the Community's external policy. These indications helped to ease some of the anxiety initially felt by many of the EC's trading partners about the possibility of "fortress" Europe. Yet, concern still lingers regarding the Community's external policy on specific issues, such as the precise meaning it gives to "reciprocity" and the way it will apply local-content requirements and anti-dumping measures. Without embarking on a detailed discussion of these specific issues, I shall briefly examine some broad policy areas in which relations between Europe, the United States, and Japan may be affected significantly by Europe 1992.

External Trade Aspects

Trade diversion will be an unavoidable result of Europe 1992. It will occur as low-cost producers outside the Community, who at present have the capacity to export competitively to some or all EC markets, will be displaced by higher-cost local producers able to benefit from the elimination of barriers to intra-EC trade. Trade diversion will take place even if the average level of external protection for the EC remains unchanged, which is the expectation of the Commission.

A key question for producers outside the EC is the extent to which this trade-diverting effect will be offset by an expansion of extra-EC trade resulting from faster income growth within the EC caused by Europe 1992. The Commission (1988a) estimates that GDP in the EC will increase by 4.5 percent over the medium term (Table 1). A back-of-the-envelope calculation based on this estimate of additional income growth and an estimated 1.5 income elasticity of EC demand for extra-EC imports suggests that higher economic growth may increase EC imports from the rest of the world by 6.7 percent. The Commission's study also estimates, however, that trade diversion will amount, on average, to 9.1 percent of EC imports from non-EC countries. These two figures suggest that EC imports from the rest of the world will decline by 2.4 percent as a combined result of the trade-diversion and market-growth effects associated with Europe 1992.

The Commission's estimate of additional EC income growth is derived from the analysis in the Cecchini Report of the once-and-for-all effect of Europe 1992 on resource allocation (Table 2). Baldwin (1989) estimates its possible dynamic effects on technological innovation and business investment. Applying the "new" growth theory developed by Romer (1983) and others, he suggests that Europe 1992 may add between two- to nine-tenths of a percentage point to the long-term growth rate of EC output and income. This may accordingly accelerate the growth of imports.

The possible geographical distribution of the impact on the Community's trading partners has been analyzed by Stoeckel, Pearce, and

TABLE 1
CONSEQUENCES OF EUROPE 1992
FOR EUROPEAN COMMUNITY INCOME IN THE MEDIUM TERM

Measure	Percent Change in GDP
Eliminating frontier controls	0.4
Opening up public procurement	0.5
Liberalizing financial services	1.5
Increasing economies of scale and other supply effects	2.1
Total average	5.4
Average range	(3.2-5.7)

SOURCE: Commission of the European Communities, *The Economics of 1992*, 1988a.

TABLE 2
 POTENTIAL ECONOMIC GAINS
 FOR THE EUROPEAN COMMUNITY FROM EUROPE 1992

Measure	Billions of ECUs	Percent of GDP
Removing barriers to trade	8-9	0.2-0.3
Removing barriers to production	57-71	2.0-2.4
Total from removing barriers	65-80	2.2-2.7
Exploiting economies of scale	61	2.1
Intensified competition	46	1.6
Total from market integration	62-107	2.1-3.7
Total for EC countries at 1988 prices	174-258	4.3-6.4
Midpoint of above	216	5.3

SOURCE: Cecchini, Catinat, and Jacquemin, *The European Challenge 1992*, 1988.

Banks (1990). Simulations with their world trade model examine a scenario in which the Community's macroeconomic policy is conducted in a way that causes the increase in EC international competitiveness resulting from Europe 1992 to be reflected in an improvement of the Community's trade balance. Under this scenario, North American exports decline by U.S. \$36.2 billion at 1988 prices, and Japanese exports fall by U.S. \$21.6 billion (Table 3). The negative effects on the exports of other trading partners are virtually nil, except for those of South Korea, Taiwan, Hong Kong, and Singapore, which decline in the aggregate by U.S. \$7.5 billion. Under a different scenario, in which domestic demand is boosted by an expansionary macroeconomic policy so that the EC trade balance remains unchanged, North American exports rise by U.S. \$2.1 billion while Japanese exports decline by U.S. \$0.7 billion. The effects on the exports of the other regions are negligible. There is a good deal of uncertainty about the numerical results of these studies, and the final outcome will depend on the actual course of the Community's external policy, which remains far from clear. At least three basic issues need to be addressed:

First is the question of how industrial reorganization will proceed within the EC. Greater-scale economies will be an essential source of increased efficiency and competitiveness for the industrial sector, but this means that the number of firms must be reduced. The need for such restructuring is illustrated by the plain fact that there are 16 manufacturers of electric locomotives and 12 industrial boiler makers

TABLE 3
SIMULATED EFFECTS OF EUROPE 1992, BY REGION
(changes in billions of U.S. dollars at 1988 prices)

Region	EC External Surplus			No EC External Surplus		
	GDP	Exports	Imports	GDP	Exports	Imports
EC	230.8	88.3	-80.3	230.8	20.0	11.8
North America	-20.8	-36.2	-25.3	5.4	2.1	2.7
Asia-Pacific [Japan]	-12.3	-33.5	-31.7	-0.3	-0.2	0.5
	[-17.7]	[-21.6]	[-7.6]	[-2.0]	[-0.7]	[-0.4]
World	197.6	18.7	-137.2	235.9	21.9	14.9

SOURCE: Stoeckel, Pearce, and Banks, "Western Trade Blocs," 1990.

in the EC, as compared to only 2 in each industry in the United States. One extreme assumption adopted by the Commission in estimating the economic gains from Europe 1992 is that 207 of the 739 European footwear firms will disappear. Indeed, simulations by Smith and Venables (1988) predict that the United Kingdom will lose 46 of its 65 footwear firms. The numbers of losers in other industrial sectors during the process of reorganization should also be considerable, and the associated pain may be great.

There is the risk that long-run efficiency considerations will be subordinated to short-run sociopolitical pressures to reduce conflicts of interest within individual member countries and regions where losers are likely to be many. In any democratic society, policymaking can be influenced by the reactions of the electorate to impending changes in income distribution caused by industrial reorganization. There will thus be political pressure to offset the competitive threat to losers by protectionist measures against non-EC producers, especially if macro-economic conditions start to deteriorate in the EC. Under such circumstances, dauntless courage and tenacity will be needed for the Commission to stick to its declared intention not to raise the average level of external protection.

Second, the *effective* degree of protection for each trading partner is not at all certain at the present time. Successive multilateral trade negotiations in the postwar period have reduced remarkably the importance of tariffs as trade barriers in industrial countries, although the process of tariff reduction has slowed since 1980. The average ratio of customs duties collected to the value of imports was 3.08 percent in 1980 for the United States and 3.53 percent in 1985; the comparable

numbers for Japan were 2.46 percent in 1980 and 2.42 in 1985. The average ratios for EC countries (other than the new members) were somewhat lower in both years than those for the United States and Japan because no tariffs were applied to intra-EC trade, but the declines between the two years were generally modest.

It is well known, however, that data on average tariffs do not measure the effective degree of trade protection. Indications are that there has been growing resort to nontariff measures in recent years, such as voluntary export restraints, antidumping actions, and industrial subsidies. The United Nations Conference on Trade and Development (1988) noted that the nonfuel imports of industrial countries subject to nontariff measures rose from 19 percent of their total nonfuel imports in 1981 to about 23 percent in 1987. A study by the staff of the International Monetary Fund (Kelly et al., 1988) reported that the number of export-restraint arrangements protecting EC markets stood at 138 in May 1988, compared to 62 for the United States and 13 for Japan. It also noted that the increase in these protectionist arrangements was most remarkable for the EC during the period examined (September 1987 to May 1988), the period during which the EC countries were preparing themselves for Europe 1992.

The data also fail to convey the extent to which certain sectors are effectively protected, but they are significant enough to raise concern among the Community's trading partners about the credibility of the Commission's commitment not to raise the average level of protection in effective terms. Difficult as cooperative efforts may be, they must be made in order to quantify the effective degree of protection by major trading countries. These efforts should include a thorough and objective assessment of the view often expressed in the United States and Europe that administrative impediments and restrictive business practices in Japan make its domestic market practically inaccessible to foreign companies—the view often used as justification for erecting and maintaining barriers against Japanese products.

Third, there is a risk that EC trade policy may distort the international flow of direct investment and work as an impediment to a desirable world-wide allocation of resources, which should be determined by market forces. Subsidiaries of U.S., Japanese, and other non-EC firms already operating within the Community should benefit from Europe 1992 along with EC firms. An influential view (Peck, 1989) in the United States appears to be that many U.S. firms may be better positioned to reap benefits from Europe 1992 than European firms, because they are already well established in most of the EC countries

and have EC-wide marketing and production strategies. A recent survey (Lipsev, 1990) observes that most U.S. firms do not feel a strong need to engage in additional direct investment for new entry into EC markets in preparation for Europe 1992. The preparations for 1992 may take the form of intra-European mergers and acquisitions, rather than acquisitions by U.S. firms.

The presence of Japanese firms in the EC is far more limited than that of U.S. firms, but Japanese direct investment in the EC has accelerated in the past few years. A survey of Japanese firms conducted recently by Japan's Ministry of International Trade and Industry (1990) indicates that the surge reflects the firms' expectations of high growth in the EC market because of Europe 1992 market integration as well as their concern about potential protectionist pressures in the Community. Adverse reactions to the surge of Japanese direct investment are already manifest in certain member states of the EC. Some have imposed local-content requirements, although some Europeans (Anderson, 1989) worry that these measures threaten the quality of Japanese goods manufactured in the EC. The U.S. government has expressed the view that restrictions on EC imports of Japanese cars, even transitional ones, should not inhibit EC imports of Japanese nameplate cars produced in the United States. At the same time, it stated that EC policies should not artificially induce U.S. auto-parts producers to establish plants in Europe.

External Financial Aspects

The EC initiative for monetary and financial integration has three distinct but interrelated components: free capital movements, freedom to provide financial services, and the creation of a European Monetary Union. Although the first two components are both integral parts of the plan to complete the European Single Market by the end of 1992, the schedule and form for monetary union remain matters of debate. This section assesses the external implications of the first two components.

The liberalization of international capital flows within the EC was the first major component of Europe 1992, and it was fully implemented before the agreed-upon deadline of July 1, 1990 by all the EC countries (except the newest members). Controls on international capital flows drive a wedge between risk-adjusted real rates of return on investment and saving when countries have different propensities to invest and save. Elimination of these controls should narrow international spreads between borrowing and lending rates in real terms and

so should raise real rates of return to savers in surplus countries and reduce borrowing costs to business enterprises in deficit countries. Thus, Europe 1992 will contribute to a better allocation of saving and investment across EC member countries.

The economic gains from the free movement of capital will be greater when it is achieved on a global basis than when it is limited to transactions within the EC. The possibility of lowering the real cost of capital to firms in deficit countries will be greater when they have access to borrowing opportunities in surplus countries outside the EC as well as in those within it. It was therefore quite appropriate for the Council of Ministers to adopt an *ergo omnes* approach in the directive liberalizing capital movements.

The freedom to provide financial services within the EC is another essential component of the plan for financial integration by the end of 1992. The economic gains from removing restrictions on the provision of financial services can come basically from two sources: from increased competition among financial institutions and from economies of scale and scope. If the economies of scale and scope are to be the major source of economic gain, steps should be taken to increase the size of EC financial institutions, through mergers, for example, and to widen the range of their business activities. If increased competition is to be the dominant source of gain, steps should be taken to promote more competition through the elimination of impediments to entry by both domestic and foreign competitors. It is therefore crucial for EC policymakers to identify the respective roles that increased competition and economies of scale and scope can play in providing economic gains from financial market integration.

In the Cecchini Report, no clear indication is given about the relative contributions of these two sources of economic gains from financial market integration, but Dietrich (1990) has recently attempted to shed some light on this issue. Using data for some representative banks in each of the EC countries and the three non-EC countries, Austria, Finland, and Sweden, he has found that there is no evidence of economies of scale in their banking operations. The finding is consistent with existing evidence for the United States and Japan. Benston, Hanweck, and Humphrey (1982), using U.S. banking data for 1978, find that economies of scale are very limited beyond a minimum efficient size corresponding to about \$25 million in total assets. Kasuya (1989) reaches a broadly similar conclusion for Japan. Although these studies do not negate the possibility of economies of scope, it would be prudent to assume that the additional economic gains from this source will be

very small in the EC countries, given the fact that universal banking is already in place in major countries such as Germany.

Although these findings must be treated with caution, they suggest that the economic gains from financial integration in the EC must come largely from increased competition. The presence of foreign banks, those of the United States and Japan, in particular, and the possibility of their broader entry into EC financial markets should thus contribute to the gains from financial integration by increasing competition for financial services. Because of the presence of asymmetric information and monitoring costs, however, the role of foreign banks may be limited in promoting regional economic development within the EC.¹ At the same time, European banks should be encouraged to compete more vigorously in the United States, Japan, and the rest of the world. Given their power to conduct universal banking, they should also be encouraged to operate more actively as intermediaries in order to facilitate the flow of nonbank capital, in particular, direct-investment capital, to places within and outside the EC where risk-adjusted rates of return on investment are comparatively high. By adopting a global perspective, European banks would also enlarge the benefits accruing to European savers.

One aspect of the Community's external policy that initially gave rise to concern in both the United States and Japan was the proposed treatment of foreign banks as providers of financial services within the EC market after 1992. This was partly because U.S. and Japanese financial firms had involved themselves extensively in Europe before the Single Market initiative started (Table 4). The main source of concern was the "reciprocity clause" in the initial proposal for the Second Banking Directive, and the vagueness of the original draft added to the confusion of the debate. Some feared that it might mean mirror-image, or identical, reciprocity, which would allow a bank from a non-EC country to conduct only those activities in EC markets that EC banks were permitted to conduct in the non-EC country. The final version of the directive is a bit less vague but may still pose problems. It stipulates that, whenever it appears that a non-EC country is not granting EC banks effective market access comparable to that enjoyed

¹ Montgomery (1990) argues that local banks in the EC have a natural advantage in evaluating and monitoring local nonbank borrowers and that this creates a two-tiered financial system within the EC that consists of, on the one hand, wholesale banks that deal with each other and with large business firms and, on the other, local banks that borrow and lend locally.

TABLE 4
 NUMBERS OF BRANCHES, SUBSIDIARIES, AND REPRESENTATIVE
 OFFICES OF FOREIGN BANKS IN MAJOR FINANCIAL CENTERS

	1980	1985	1989
Japanese banks			
Branches in			
New York	22	25	37
London	22	23	23
Subsidiaries in			
New York	0	0	1
London	1	2	8
Representative offices in			
New York	4	6	12
London	2	15	18
U.S. Banks			
Branches in			
London	41	42	32
Tokyo	22	21	21
Subsidiaries in			
London	14	10	13
Tokyo	0	1	6
Representative offices in			
London	21	13	7
Tokyo	14	15	10
EC banks			
Branches in			
New York	43	64	69
London ^a	39	65	70
Tokyo	21	24	28
Subsidiaries in			
New York	5	6	10
London ^a	8	14	5
Tokyo	0	0	1
Representative offices in			
New York	49	38	33
London ^a	35	35	29
Tokyo	38	40	41

SOURCE: "Foreign Banks in London," November 1980, 1985, 1989; "Foreign Banks in New York," May 1985, June 1989; Ministry of Finance of the Japanese Government, "Annual Report," October 1980, 1985, 1990.

^a Excludes U.K. banks.

by the non-EC country's banks in the EC market, the Commission may initiate procedures to remedy the situation or, in some circumstances, may limit or suspend the request for authorization of a banking license in the Community.

This version of reciprocity may cause problems, because the EC countries, the United States, and Japan have different financial regimes and restrictions. In the EC countries, after 1992, the Second Banking Directive will allow banks to conduct any operations, including securities activities, listed in the directive and permitted in their home countries, regardless of the regulations maintained by the host country. Therefore, the directive is likely to lead to a unified EC financial market based on the system of universal banking that already exists in Germany and some other EC countries, rather than the system based on specialized financial institutions. Financial systems are more segmented in the United States and Japan. In the former, commercial banking is separated from investment banking by the Glass-Steagall Act. In the latter, the financial market is even more segmented than in the United States, because there are several types of banking institutions, each with its own separate capacities.

A brief review of the treatment of foreign banks in the United States and Japan is relevant in this context. In the United States, the operations of foreign banks are subject to federal regulations under the International Banking Act of 1978, which applied the principle of national treatment. Some foreign banks argue, however, that elements of discrimination exist at the level of state regulation in the United States. During the 1980s, some states introduced "regional compacts" that permit banks from other states to acquire local banking institutions. In some of those states, however, foreign banks are not allowed to enjoy the benefits of the interstate compacts. Be that as it may, foreign banks seem to enjoy national treatment, *de jure* and *de facto*, at both federal and state levels.

Japan also applies the principle of national treatment to foreign banks. In certain areas, they enjoy better than national treatment. They are permitted to establish full-service securities affiliates, and they can own and acquire trust bank subsidiaries. The Japanese government also applies a flexible approach to the opening of new local branches by foreign banks. Domestic banks, by contrast, are not allowed to establish trust bank subsidiaries in Japan, and the opening of new branches is under government control. Actual market access by foreign banks has also improved in recent years.

It is, of course, not clear at this stage how the Community's princi-

ple of reciprocal national treatment will be implemented in specific circumstances after 1992. In the meantime, there appears to be increased concern in the United States about the competitive position of U.S. banks in the global market and growing awareness that their position is affected more seriously by statutory restrictions imposed in their own country than by restrictions imposed in foreign countries. Many economists in the United States support the view that the international competitiveness of U.S. banks would be improved by eliminating the remaining restrictions on interstate banking. In Japan, various approaches to restructuring the domestic financial system are being studied, including those involving the establishment by banks of separate subsidiaries for securities business. It remains to be seen how the balance between arguments for and against those approaches will be influenced by the Community's Second Banking Directive, which will allow EC banks to conduct a wide range of activities, including securities business, under the "single banking license."

In any event, the importance of economic gains to be achieved from free competition between domestic and foreign financial institutions must be taken fully into account in applying the principle of reciprocal national treatment to foreign banks in the markets of the EC, the United States, and Japan. At the same time, closer cooperation and coordination on the part of supervisory authorities are required to prevent increased international competitive pressures from eroding the soundness of domestic financial systems.

Toward a Better Framework for Global Integration

Despite the statements by EC leaders that the Community will not reinforce barriers to extra-EC trade, concern still remains among the Community's trading partners that Europe 1992 will lead to "fortress" Europe. Stoeckel et al. (1990) used their world trade model to estimate the effects of "fortress" Europe. Their findings suggest that all countries and regions, including the EC itself, would lose from higher protection by the EC. By contrast, a more liberal policy by the EC with respect to extra-EC trade is estimated to give a substantial boost to the world economy, with the greatest beneficiary being the EC itself. The model also shows that retaliation by North America would result in losses for all major trading partners, and that unilateral liberalization by North America and countries in the Asian-Pacific region would increase their own economic welfare (Table 5).

Although the precise numerical results of their simulations should be

TABLE 5
 CHANGES IN GDP FROM EUROPEAN COMMUNITY AND NORTH AMERICAN
 PROTECTION OR LIBERALIZATION
(in billions of U.S. dollars at 1988 prices)

	North America Protects (Retaliates)		North America Liberalizes	
EC protects ("fortress" Europe)	EC	-132	EC	42
	North America	-64	North America	53
	Asia-Pacific	-18	Asia-Pacific	38
	World	-214	World	133
EC liberalizes	EC	37	EC	211
	North America	7	North America	124
	Asia-Pacific	7	Asia-Pacific	63
	World	50	World	397

SOURCE: Stoeckel, Pearce, and Banks, "Western Trade Blocs," 1990.

taken with a grain of salt, the broad policy message, that trade liberalization pays off even if it is done unilaterally, must be taken seriously. Indeed, the overwhelming body of evidence indicates that protection imposes a net social cost by distorting resource allocation and weakening competition. A large part of this evidence is based on the traditional theory of comparative advantage, which assumes that markets are perfectly competitive. But the case for free trade is not necessarily weakened by the "new" trade theory, which emphasizes the importance of scale economies and imperfect competition. A recent report by the Organisation for Economic Co-operation and Development (OECD, 1989) concludes that the existence of scale economies and imperfect competition actually increases the potential gains from free trade, and these gains will be large in sectors where entry and exit are relatively free.

There is a pressing need to work out a better framework for global market integration. Its success will depend essentially on a cooperative effort by all members of the triad: the EC, the United States, and Japan. The program must have six elements:

(1) It is crucial to arrive at a successful resolution of contentious issues in the Uruguay Round of trade negotiations and to reverse the trend toward protectionism. The institutional framework of the multi-lateral trading system should be strengthened by setting up an effective trade-policy review mechanism within the General Agreement on

Tariffs and Trade (GATT), which must be supported strongly by the EC, the United States, Japan, and other major trading countries.

(2) Action to strengthen the international trading system should be supported by measures to liberalize restrictions on international flows of direct investment. Efforts have been made within the OECD to promote this sort of liberalization through the OECD Code of Liberalization of Capital Movements and the National Treatment Instrument. These call upon member countries to treat inward direct investment and the local activities of foreign-controlled firms on a basis equal or equivalent to the treatment of domestic firms. In accordance with the request made by OECD ministers at their meeting in May 1990, the OECD should strengthen the National Treatment Instrument. Moreover, in line with the view expressed by the leaders of the G-7 nations at the Houston Summit in July 1990, the IMF and the multilateral development banks should encourage the liberalization of restrictions on investment in their programs for Central and Eastern Europe and for developing countries.

(3) Because structural reforms to improve economic performance in individual countries can have significant externalities, those reforms should be subjected to multilateral surveillance. Over the past few years, the OECD has made major contributions to the identification of priorities for structural reforms in individual member countries. At the Houston Summit, the G-7 leaders encouraged the OECD to strengthen its surveillance and review procedures and to find ways of making its work more effective. The implementation of Europe 1992 and bilateral negotiations such as the U.S.-Japan talks on structural impediments should be conducted in a manner consistent with OECD activity.

(4) Competition policy should be strengthened both within and outside the EC as a way to promote domestic structural reforms. In 1989, the Economic Policy Committee of the OECD noted that the effectiveness of competition policy continues to be threatened by domestic subsidies and by border protection. It stressed the importance of treating domestic and foreign firms evenhandedly and maintaining an open and international trading system, undistorted by subsidies. The OECD should make further efforts to increase the transparency of subsidy programs in member countries.

(5) As regards financial markets, recent amendments to the OECD codes, which extend the liberalization undertakings of the member countries to the full range of capital movements and financial services, should be implemented by giving new impetus to the liberalization process. The EC program for Europe 1992 should continue to be

reviewed in the light of the codes. Closer cooperation and coordination by national supervisors are needed to ensure the safety and soundness of financial markets within a framework conducive to innovation and competition. The Bank for International Settlements (BIS) should play a key role in this process.

(6) The free flow of capital and the globalization of factor and product markets may cause differences in national tax policies to distort the allocation of investment and savings across countries. Closer cooperation among the fiscal authorities of the industrial countries may be required to narrow disparities between national tax systems.

THE EUROPEAN COMMUNITY AND EASTERN EUROPE
AFTER 1992
Richard Portes

Introduction

The exhilaration and optimism created by the fall of the Berlin Wall and the revolutions of 1989 in Eastern Europe have given way to economic deterioration and political strife. There is growing apprehension, indeed pessimism, in both Eastern and Western Europe.

In one case, we can be sure any pessimism is wrong, at least for the long run: that is East Germany, whose future has been guaranteed by reunification. There are grounds for serious concern about the short run elsewhere in Eastern Europe, but one may still be optimistic about the longer run: we in the European Community cannot afford, politically or economically, to permit failure in the democratic transformation of Eastern Europe. That is my basic premise.

I take as given the achievement of Europe 1992, the implementation of the basic corpus of measures that will bring about a single market in goods and factors of production as well as substantial further progress toward economic and monetary union. This is an assumption, not a forecast. Indeed I shall attempt no predictions, nor any assessment of the consequences of 1992 (for these, see *Economic Policy*, 1989 and 1990). I simply suppose that the economic transformation of Eastern Europe will take place in an environment dominated by the economic integration of Western Europe.

My discussion excludes German Economic and Monetary Union (GEMU), because its course and the overall destiny of East Germany are already determined. GEMU will nevertheless be relevant to the other Eastern countries and their relations with the European Community. The abrupt reorientation of East German trade relations is already affecting their economies, and East German economic transformation will offer many lessons for them, doubtless both positive and negative. Finally, the EC member countries' assessment of future relations with Eastern Europe will be influenced by East Germany's role as a new poor region within the EC and a new source of pressure on the Common Agricultural Policy (CAP).

For quite different reasons, I also exclude explicit consideration of

Yugoslavia and the Soviet Union. The former's background of partial decentralization, self-management, regional conflict, and inflation is systemically *sui generis*. The USSR's size, military strength, large Asian area, and natural-resource base qualitatively distinguish its economic and political relations with Western Europe from those of the smaller Eastern European countries. The longer history of central planning and its legacy of distortions will make radical economic reform in the USSR much more difficult than elsewhere in Eastern Europe, and the forces for political fragmentation are much stronger.

Framework

The development of relations between the European Community and Eastern Europe will depend mainly on what happens *within* the EC and the Eastern European countries. Each will influence the other, but less by direct flows of goods, services, and factors, or even cultural interpenetration, than by observation, example, and impact on a long-run vision of Europe.

This is perhaps pessimistic. The Community could give them massive aid, as I suggest below. And, if we in the Community were as economically rational, flexible, and willing to take difficult adjustment measures as we shall require of Eastern Europe, we would take their transformation into market economies as the final overwhelming reason to dismantle the CAP. In the medium run, that is probably the most important single thing we could do for them, as well as for the Community. We are unlikely to do this voluntarily.

We can nevertheless promote the transformation process in several ways. The EC acts as a strong pole of attraction for Eastern Europe. It offers the economic and political model to which they aspire. A German-style constitution might be best suited to generate the strong coalition governments they will need, just as the emerging federal structure of the Community and the principle of subsidiarity might be an appropriate framework for the USSR (or, indeed, for Czechoslovakia or Yugoslavia).

For Eastern Europeans, prospects for the development of links with the Community—the quest for early association and the passionate desire for ultimate accession—are a strong incentive to move now in ways that will be consistent with those goals. Indeed, just as the “the IMF says we must” has given many governments a politically useful excuse for taking tough economic measures, so “this will bring us closer to the EC” can be a political shield—and without seriously endangering the popular attraction of that objective.

This argument suggests the converse, that the Community should take the remarkable transformation of Eastern Europe as a stimulus to develop EC institutions and economic integration *faster* (see Hassner, 1990, for an extended discussion along these lines). This will not mean excluding Eastern Europe. “Deepening vs. widening” is here even more clearly than elsewhere a false opposition, built up and exploited by those who simply oppose deepening and may not actually be that keen on widening.

The Eastern countries have already manifested their desire for association with and eventual membership in a closely knit European Community, not in a loose free-trading area (such as EFTA), and even less within an outer ring of some set of concentric circles. If the target is moving, that will just be an incentive for them to move faster too. The long-run reward will remain credible, however, only if we give priority to our relations with them, while encouraging them in the ultimate goal and helping to guide the transformation process toward it. We must be realistic and frank. The countries of Eastern Europe cannot expect membership by 1995, probably not even by 2000. They have a tremendous program before them, and they will have to learn that moving to democracy does not mean they can discard the patience and fortitude they have exhibited for several decades.

This vision may imply some form of “variable geometry” within the Community itself. I personally would prefer that the “slower” or “lagging” countries accelerate; but the essential is not to restrain the overall pace just to let them—or, indeed, EFTA countries or Eastern Europe—catch up, because that would lose the momentum generated in the past five years. That momentum, after all, has pulled the lagging EC countries along too, though perhaps not quickly enough.

We are already offering financial and technical assistance to the democratic countries of Eastern Europe. This direct flow is of some significance but is still rather limited. Compare, for example, the costs of GEMU or the heavy debt burdens of several Eastern countries. Whatever the level of our aid, appropriate economic as well as political *conditionality* is indispensable to promote the transformation process (see Portes, 1990a).

When, as we must hope, democracy and the commitment to a market economy are firmly established in Bulgaria and Romania, there may also be a case for changing the mode of aid delivery, especially if the amount were to increase sharply. The relatively loose framework of the PHARE program (Poland and Hungary: Aid for the Restructuring of Economies) coordinated by the Commission and currently including

six Eastern European countries might better become the kind of cooperative organization for which postwar Western institutions provide several models.

Prospects for Eastern Europe

The Eastern countries must, of course, help themselves. We have made it clear that we shall not give significant assistance until we are satisfied that they have established functioning democracies and have decisively chosen a market framework for their economies. Czechoslovakia, Hungary, and Poland have already qualified.

Romania may still not satisfy these criteria. The USSR certainly does not, although geopolitical reasons have led some major Western countries (and hence the international institutions) to be ambivalent in their attitudes toward it. There is in Romania, however, a technocratic group trying to launch serious economic reforms, and there are encouraging signs of improvement in the political sphere, so there may soon be progress in economic relations between Romania and the EC. The USSR is chaotic and unpredictable, as are our policies toward it.

Bulgaria is an ambiguous and difficult case. There is widespread acceptance of the IMF. But the recent democratic elections produced the “wrong” result, not only because the former (renamed) Communist party won a parliamentary majority, but because its own internal divisions (and perhaps perceived illegitimacy) made it unable to govern effectively. Major economic-policy mistakes early in 1990, the disintegration of the Council for Mutual Economic Assistance (CMEA), and the oil shock have brought economic catastrophe to Bulgaria. The new coalition government, however, launched radical market-oriented reforms in February 1991—with IMF support. The Community should back this reform program economically and politically.

To go beyond assistance and develop economic and political relations with the EC will require that Eastern Europe do much more than establish a democratic and market-based system.

First, the market economy must be constructed from the outset with some attention to the need for *compatibility* with the Community and its developing Economic and Monetary Union. The hundreds of EC directives already promulgated or in process for Europe 1992 should be required reading for those creating new legal and institutional frameworks for the Eastern economies. Taxation, company law, social security, capital-market regulation, and competition policy are just a few of the areas in which technical assistance from the Community

should help those countries implement the principles we ourselves are applying. And it is not farfetched, though it is perhaps premature, to suggest that they consider unilaterally adopting an “ECU standard” and tying their monetary policies to those of the Community (see Bofinger, 1990).

Second, Eastern Europe cannot expect that we shall want to take in a very large new poor region. If only for this reason, talk of EC membership in the mid-1990s is clearly unrealistic. The Eastern countries must not merely establish markets but must use them productively, by committing themselves to the effort that will be necessary to achieve per capita income levels at least as high as those in the less-developed regions of the EC. Here again, they will have to catch up with a moving target.

Third, Eastern Europe should be expected to make substantial progress toward economic integration with the Community with regard to trade and investment. In 1989, only about 15 percent of Eastern Europe’s exports came to the EC; this percentage doubtless rose sharply in 1990 because of a collapse of intra-CMEA trade, but the volume is not up much. Its share in the Community’s total imports, even excluding intra-EC trade, is only 6 percent. Eastern Europe cannot succeed in raising these figures, however, unless we liberalize *access* for their goods. There has been some minor progress in this direction, but the CAP is still a key obstacle, and when they adopt realistic (undervalued) exchange rates and begin to penetrate our markets more seriously, we must be prepared to resist new calls for protection against Eastern European “cheap labor” and “dumping.” If we are at all sincere in our political welcome, we must strenuously endeavor to maintain and extend our economic welcome.

It is difficult to assess the prospects for Eastern Europe as a whole. There is too much diversity across countries, and they themselves are resisting any generalizations and attempts to group them together, except those arising from their own initiatives. This is partly a reaction to decades of involuntary association and partly a manifestation of competition for attention and aid from the West. But individual country studies are far beyond the scope of this paper (for Hungary and Poland, see Commission, 1990b; for Czechoslovakia, see Commission, 1991, and Begg, 1991).

There are obvious and plausible analogies with experience elsewhere—will Hungary become a newly industrializing country and Poland behave too much like Argentina? Within the Community, the recent histories of Spain, Portugal, and Greece are relevant. Perhaps

most important are the lessons to be learned in how to manage the emergence from authoritarian regimes and to launch economic modernization. Moreover, Eastern Europe faces many of the issues that Europe 1992 and progress toward EMU have raised for the southern frontier of the EC: where will industry locate and how can its location be influenced? If full adjustment is not feasible, are partial reforms second best or worse? Will aid from outside go to improving infrastructure and creating positive incentives, or will it simply generate rent-seeking behavior? How can external institutions—the Commission, or the IMF, the OECD, and the International and European Banks for Reconstruction and Development—best support domestic change? (see Emerson and Portes, 1990).

Notwithstanding political obstacles, Bulgaria and Romania appear to share with the other Eastern European countries a popular will to move toward some version of market capitalism. Little support remains for the illusion of a “third way” after inarticulate efforts in this vein failed to attract support in the German Democratic Republic and Czechoslovakia (Atkinson, 1990; Portes, 1990b). But the models chosen by individual countries will differ in the long run, perhaps as much as Austria differs from the United States or Germany differs from the United Kingdom. The differences will show in economic organization (the structure of markets and their regulation), in property rights and their implications, and in the incentive structures arising from these two building blocks of market capitalism.

The current transition period exhibits specific problems the resolution of which will affect the ways these countries interact with the EC. What is the minimum package of reforms necessary to establish a credible, irreversible change of economic regime? What is an appropriate sequencing of a reform program, and how can it best be strengthened to withstand external shocks and errors in assessing behavioral responses?

Although these questions arise from the academic literature, they are not merely academic issues, for at least two reasons. First, it is administratively and institutionally impossible to implement all the required reforms at once; the hypothesis that a “big bang” is the most effective policy is not testable, barring war or revolution. Second, the outcome is not independent of the path toward it, and we shall be better able to ease the path if it is properly begun and coherently laid out (Portes, 1991b).

Macroeconomic stabilization must come first, then some country-specific sequence of freeing prices, breaking up monopolies, creating

financial markets, privatizing, and introducing much more rational, uniform tax-subsidy systems for both households and firms. Some of this is almost entirely internal. It is the international side that is most relevant for relations between the EC and Eastern Europe, and here we immediately encounter the key issues of exchange-rate policy. Should rates be fixed or floating? If they are pegged, to what currency (basket) and at what rate? And where does convertibility come into the sequence (see Portes, 1991a and b).

All the Eastern European countries suffered heavily from the 1990 oil shock and from the 1991 switch to market pricing and convertible-currency settlement in their trade with the USSR. In addition, Bulgaria, Hungary, and Poland are already overindebted—indeed, of the three, only Hungary is currently servicing its debt, and with extreme difficulty. The CMEA is effectively disintegrating, and volumes have fallen drastically in trade within Eastern Europe and with the USSR. In the short run, with low-quality production and weak marketing, Eastern Europe can compete with the West only by choosing exchange rates that are deeply undervalued by comparison with purchasing power parity. The consequent reduction in real wages will provoke political resistance, pressures for emigration (mainly to the EC), and protectionist responses from trade partners.

One proposal to mitigate these adverse shocks is to create an Eastern (Central) European Payments Union (EEMU), analogous to the postwar European Payments Union (EPU) in Western Europe. There may be some potential advantages to such an arrangement, but there is little support for it now in Eastern Europe itself and a strong argument against it insofar as convertibility might play a key role in economic reform.¹ If current-account convertibility vis-à-vis Western currencies can be installed quickly and sustained, a payments union will be otiose (see also the discussion by Kenen, 1990).

But a free-trade area or customs union—with some external protection—among the (former) CMEA countries would be another matter, if those countries were so inclined. It could be useful in maintaining those trade patterns that are worth saving (thereby easing the transition), in giving each country a larger “home” market than its own, and in promoting common approaches to common problems.

The European Community might sponsor such an initiative, as the

¹ Centre for Economic Policy Research, 1990a; a limited variant of the EEMU proposal, perhaps using the ECU as a settlement currency, may gain support as the effects of the CMEA breakdown become more pronounced.

United States did for the EPU after World War II. After decades of eschewing relations with the CMEA as a bloc, we (and they) might now find that a regional trading arrangement for Eastern Europe would be advantageous in facilitating parallel treatment and in constraining the efforts of individual countries to compete for our attention and favors. The Commission's PHARE program currently functions bilaterally, but, as it takes in more countries, it could provide an impetus for multilateral cooperation among them and with us.

In any assessment of the future of Community relations with the Eastern European countries, the internal political prospects of those countries are just as important as economic developments, although harder for an economist to evaluate. One can be confident, however, that the chances for a successful transition to democracy depend on a successful transition to the market economy and, conversely, that the economic transformation will fail if the political structure cannot support it.

Many individuals and groups will suffer economically, at least at the outset. The massive inefficiencies in the economies of Eastern Europe suggest that it ought to be possible to make everyone better off in the transition, and, in the medium or long run, perhaps not very many will be much worse off. But the transition itself *must* be painful, if only to force economic agents to change deeply ingrained expectations and behavior.

The political configurations in these countries do not yet suggest that they can withstand the pain. A dominant presidency with wide executive authority might seem an attractive solution—and this may indeed happen in some cases—but examples from Latin America are not encouraging. It has been suggested that Eastern Europe needs strong, freely elected, parliamentary coalition governments—free elections for legitimacy, coalitions to accommodate and master the political conflicts arising in new democracies under economic pressure (Garton Ash, 1990). But Poland's parliamentary elections were not free, Hungary's coalition is not strong, Czechoslovakia's single dominant party has now broken up, and Bulgaria's majority party was unable to govern. These are still very early days, but even the best designed economic reform package may prove politically infeasible in the medium term. We should be under no illusions; there will be no development of EC relations with Eastern Europe if the latter follows unfortunate Latin American precedents.

The Future of European Community-Eastern European Relations

We can do our part to make a success of European Community-Eastern European relations if the task is not too great for the Community's own political strength and will. Market access for Eastern European agricultural and industrial exports is an elementary, essential, yet extremely difficult issue for the Community. The association agreements now being negotiated between Eastern European countries and the EC must be transparent—to ensure they do not include subtle restrictive provisions, for example, in the guise of “fair-pricing” requirements and other “safeguard” clauses.

Political and economic uncertainty will limit our direct investment in Eastern Europe for a considerable period. The European Bank for Reconstruction and Development (EBRD) and World Bank will offer important assistance, but the financial resources allocated so far are limited. Permitting massive labor migration from Eastern Europe into the EC might seem helpful in the short run, but it would risk the same sort of hemorrhage that has so weakened Eastern Germany. Moreover, although it would doubtless benefit our economies, it would meet with strong social and political opposition.

The economic transformation of Eastern Europe will nevertheless have significant effects on the EC economy. The macroeconomic signs are already visible; we should soon see changes in trade patterns and in industrial structure; and we cannot assume that the CAP is hopelessly immobile, even if we cannot assume the contrary (on the economic effects of Eastern Europe on Western Europe, see Centre for Economic Policy Research, 1990b).

In the macroeconomic sphere, we already see the consequences of Western Germany's effort to revive Eastern Germany. The transfer of resources to support East German consumption and begin massive investment is putting tremendous pressure on the economy of Western Germany. The consequences are fast growth in Western Germany and the disappearance of the formerly large current-account surplus. Without monetary accommodation, this is accompanied by upward pressure on interest rates.

The effects on trade will take longer to appear, but if the economic transformation of Eastern Europe does proceed, it should eventually release substantial supplies of agricultural goods and energy onto world markets. There will be some diversion of investment and of the attentions of multinationals from Southern to Eastern Europe. Yet, Eastern Europe is unlikely to compete much with Portugal and Greece in their

traditional exports; Eastern Europe is better endowed with human capital and so should go into industries like consumer electronics.

These trends will add to the forces for change in the EC, and they call for both deepening and widening—not one at the expense of the other. Even to come to a common policy on widening, the EC will have to deepen.

The urgency of a coherent response to Eastern Europe requires that we *accelerate* the unification of the Community. This is particularly important with regard to economic and monetary unification: the external shock from Eastern Europe to the EC economy seriously threatens the EMS in its present form.² This, in turn, entails a greater role for central initiative in creating—indeed imposing—economic and political structures, backed by the legitimacy derived from the intergovernmental conferences and having due regard to subsidiarity. We have learned that “competition among rules” is often preferable to harmonization, but that does not apply to monetary affairs, trade, and aid, much less to developing a common response to those who share our common European home.

Conversely, a coherent approach by Eastern Europe to the EC requires a concrete demonstration of willingness and ability to play by Community rules. The long-run goal of accession should induce Eastern European policymakers to accept an important implicit conditionality. The process of establishing the European Single Market in the Community is fundamentally one of moving from piecemeal and discretionary economic policies to a rule-based system that constrains the natural interventionist tendencies of policymakers. Their Eastern European counterparts, and the bureaucracies they still control, will encounter and must resist repeated temptations to intervene for the purpose of shifting or softening the costs of essential changes that markets bring.

There is no better way for the Eastern European authorities to “tie their hands” than to enter into commitments to the Community, formalized in association agreements—to follow EC practices and procedures wherever possible (e.g., in competition policy). This could be extremely helpful in giving market-oriented policies the credibility they need—but lack, after decades of bureaucratic dominance—in

² “If European governments are prepared to trade the costs of surrendering the exchange rate as a policy instrument for the benefits of a common currency, the time to accelerate is now” (Centre for Economic Policy Research, 1990b, p. 69), before a realignment forced by the “East European shock” takes us back to the “old EMS,” in circumstances that might destroy even that.

order to change the expectations and behavior of economic agents.

For the Community, the challenge of widening should motivate deepening. Our ultimate goal should be a continental EC, following a route that leads us to strengthen the Community and reorient it eastward. There are, however, several intermediate models. One is to encourage the Eastern European countries to seek membership in EFTA as a “halfway house.” But this external arrangement would have no integral relation to the internal transition in these countries. Moreover, there is no reason to believe that EFTA, if it survives the desires of several of its existing members to join the EC, would now want to be a mere stepping stone, as it has been in the past. And this model is not a solution, even temporarily, for the Community itself. We should want to have the Eastern European countries eventually in the EC, and the route chosen should be seen to lead from here to there, however long it may be.

A second model envisages a Europe with a “core” and “periphery” undergoing a process of integrating the latter with the former. The area included in the Bristol-Hamburg-Genoa triangle produces 60 percent of Western European GDP. We evidently have our northern and southern peripheries; we can just add an eastern sector, give it some “structural funds,” and let it get on with catching up or not—like Greece and the Mezzogiorno. In practice, regional policy is never so simple, economically or politically (in the EC context, see Bliss and Braga de Macedo, 1990). And regional policy, whether interventionist or laissez-faire, as an attitude to the revolutions of 1989 is simply historically inadequate.

A much more sophisticated model has “concentric circles.” Each version of this model, however, gives different lists of countries in each ring and different specifications of what will be common within the rings. If the central group comprises those in full EMU, will they also have tighter political links than the other (current) EC members? If there are different categories of EC members, can some dispense with the CAP—please? If the next ring includes nonmembers who subscribe to the European Single Market, must they agree to the free movement of labor as well as goods and capital? If so, Eastern Europe is likely to remain pretty far out for a pretty long time.

None of these intermediate models is satisfactory. We have yet to determine how to get from here to there, and the outcome will depend on the path. I believe we should be deeply concerned about the direction we are taking in the short run. The experience of Poland in 1981 shows how the interaction of economic and political disintegration can

lead to disaster, when prompt and massive aid might—under appropriate conditions—have created a virtuous rather than a vicious circle (Portes, 1981 and 1982).

This is a major test for the Community, as important as the drive to EMU and, indeed, complementary to it. The current PHARE effort coordinated by the Commission appears to be proceeding well, within its limits, but it is not overwhelmingly generous or visionary. We are not meeting our considerable and historic responsibility. We could offer major help under appropriate economic and political conditions, but we would have to deliver both aid and access.

The 1990 oil shock should make us appreciate the urgent needs of Eastern Europe rather than lead us to focus on our own lesser concerns. Social and economic self-interest should reinforce altruism and political objectives: if our capital does not go east, their labor will try to come west, in a wave of mass migration that will be impossible to assimilate. It is in our common interest, east and west, that the Community not be pushed to the point that internal politics will cause it to erect barriers against Eastern European migrants. Such a reversal of 1989 would be a highly significant obstacle to the long-run widening of the Community.

The argument that technical assistance is most important, whereas substantial financial aid would just be wasted (Crook and Franklin, 1990), holds for the USSR but certainly not for Hungary, Czechoslovakia, and Poland. The USSR is too big in any case for Western financial assistance to make much difference. Fundamentally, it must solve its own problems. Until it does, financial aid will go down a “black hole”; when it does, its strong resource base will make Western aid unnecessary.

Meanwhile, however fascinating and globally important are the problems of the USSR, they are distracting us and diverting our resources from Eastern Europe, where they could have an impact. The balance-of-payments prospects there are potentially disastrous. Although wide-ranging technical assistance is indeed essential, untied financial aid will be at least as important—in large amounts, and with the maximum share taking the form of grants and debt reduction for the severely indebted countries. One promising form of non-project but highly conditional aid would be to finance a social fund to provide unemployment compensation to those displaced by structural change. This could mitigate the consequences of the tough policies needed while stressing our commitment to them. It would send all the right signals.

The window of opportunity now open may close quickly. We should act purposefully and generously, before resentments accumulate,

before democracy and the EC lose their attraction for the Eastern citizens of Europe, before the healthy nationalism that sparked the exit from Soviet domination gives way to the negative and destructive nationalism that has previously incited Eastern Europe to disturb the peace of Western Europe. If we do, the current wave of pessimism could give way to a renewed enthusiasm for the prospects opened by the revolutions of 1989. The relations of the EC with Eastern Europe after 1992 will depend greatly on what we do now.

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