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THE INTERNAL AND EXTERNAL OPENING-UP OF THE SINGLE COMMUNITY MARKET: EFFICIENCY GAINS, ADJUSTMENTS COSTS AND NEW COMMUNITY INSTRUMENTS

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THE INTERNAL AND EXTERNAL OPENING-UP OF THE SINGLE COMMUNITY MARKET:

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Alexis Jacquemin and André Sapir*

INTRODUCTION

The gradual completion of the single Community market is a process of internal liberalization which takes place within the framework of a worldwide dynamics of structural adjustment. Such dynamics is inescapable and leads to a redistribution of cards among industrial countries as well as between industrial and developing countries.

It is essential that the European Community develops a capacity for strategic analysis in order to guide its actions in this dynamic environment. While the concomitance of the important decisions to be taken in the context of 1992 and the Uruguay Round negotiations makes this question particularly topical, this paper is not concerned with this short-term perspective, particularly as the negotiations in question are already well advanced. It adopts instead a longer-term view and puts forward a number of ideas and lines of action for the Community's external economic policy.

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According to the Cecchini reports, which describe and quantify the potential economic consequences of the completed internal market, the greatest gains will come not from the direct effects of lowering non-tariff barriers but from increased competition within the single market. This then raises the question of the consequences which would arise from a further opening-up of the Common Market to the rest of the world. Should equally favourable allocative effects be anticipated? What would be the consequences in terms of redistribution?

Would the Community integration process be helped or hindered by such an opening-up to the rest of the world? What instruments could be used to ensure acceptable adjustment conditions, both in terms of Community solidarity and common strategies? This type of question is made especially crucial by the fact that completion of the internal market is occurring at the same time as the Uruguay Round negotiations.

Section 1 of this paper examines the degree of competitive discipline the opening-up to the rest of the world may impose on industrial activities within the Common Market. Section 2 considers the various efficiency gains which are likely to stem from such an opening-up process, and the anticipated redistributive effects, with a distinction being made between the traditional and the new growth sectors; on the basis of the available empirical studies, it also demonstrates the limitations of unilateral commercial policies and the benefits of cooperation, particularly in a context of imperfect competition. Finally, Section 3 discusses the Community instruments and support policies that might be used to facilitate the external opening-up process for both the traditional and the new growth sectors and sets out proposals.

SECTION 1

THE DISCIPLINARY ROLE OF INTRA- AND EXTRA-COMMUNITY COMPETITIVE PRESSURES

1.1 The Cecchini studies of the gains that are likely to stem from completion of the Community internal market highlight two types of mechanism.

The first, a short-term phenomenon, consists of the direct reduction in the real costs of imports and exports within the Common Market as a result of the removal of the various non-tariff barriers. The second, a longer-term process, takes the form of a reinforcement of actual and potential competitive pressures. The consequences of this second mechanism, which is based on greater ease of market penetration for Community trade, are estimated to be greater than the direct effects. However, the question of whether or not such increase in competitive processus materialize largely depends on firms themselves.

One way of testing the competitive consequences of liberalizing markets is to analyse the impact of trade flows on industrial margins. Many studies have shown, for European countries, that the existence of a large sector exposed to international competition is a guarantee against undesirable price developments (Courbis, 1975) and that the opening-up of frontiers is the best way of controlling the exercise of a monopoly power.

A firm's monopoly power on its domestic market, which is reflected in a relatively wide gap between price and marginal cost, will be all the weaker:

- the greater the elasticity of domestic demand,
- the lower its market share, and
- the greater the share of imports in domestic demand.

Numerous econometric tests have provided empirical confirmation of the disciplinary effect that imports have on profit margins. They have also shown that this influence is exerted not only by the import flows observed but also by the pressure of potential competition: given the same import flows, the lower the trade barriers the narrower the margin.

In the context of the Community, an important distinction can be made between the competitive impact of opening up the european internal market and that of opening up the internal market to the rest of the world.

Given that overall efficiency gains are expected from increased competition within the Community, the combination of internal liberalization and external liberalization may be a superior policy to external liberalization alone if external liberalization also exerts an appreciable competitive impact.

Two recent studies shed light on this question.

The first study (Neven and Röller, 1989) examines, on the basis of a sample of some twenty-five industrial sectors (two-digit classification), the extent to which trade is affected by the Community's non-tariff barriers. The conclusion is that, on average, Community trade is affected by those barriers but that trade with the rest of the world is as much, if not more, affected. This conclusion applies especially in sectors, like textiles and cars, in which trade is subject to Article 115 of the Treaty of Rome. In such cases, barriers to intra-EC trade have been erected in order to limit extra-EC imports. The removal of non-tariff barriers in the Community should therefore lead to increased integration within the world economy provided that it is not accompanied by increased protectionism against the outside world.

The second study (Jacquemin and Sapir, 1989) shows that the degree of competitive discipline imposed by imports varies not only according to the characteristics of the industry in question but also according to the origin of the imports. On the basis of a sample of about one hundred industrial sectors (three-digit classification), the analysis made for the four major member countries concludes that, on average, extra-Community imports have a greater competitive impact than intra-Community imports.

Various factors may explain this difference:

- intra-Community trade is concerned more with differentiated goods (intra-industrial trade), with the result that many imported goods exert only slight competitive pressure since they correspond to relatively segmented markets and are imperfect substitutes for domestic products;

- intra-Community import operations are frequently more dependent on the decisions of national producers, particularly where those producers are integrated downstream towards the distribution sector and sell manufactured goods abroad through their own distribution networks; or again where there are mutual representation agreements with their foreign competitors aimed at ensuring control of the sale of products imported into their respective countries;

- intra-Community trade frequently takes place between subsidiaries and divisions of a group which is established in different Community countries and which operates an internal division of labour. Increased intra-group trade of this type is part and parcel of a strategy of internationalizing production which does not reflect any pressure on monopoly power, but instead implies a reinforcement of the oligopolistic nature of the European market.

If we accept that competition has the effect of maximizing the efficiency of a single integrated market, it is clear that the opening-up of the Community area to the rest of the world would increase the potential gains that the Cecchini studies attribute to the liberalization of intra-Community trade alone. These additional gains should therefore be examined more closely in the light of the conditions under which this opening-up process would take place; the question also arises of the possible perverse effects on the European integration process.

1.2 As we have just seen, the removal of non-tariff barriers within the Community could in itself produce an external opening-up effect. If, with the framework of international trade negotiations, the elimination of internal barriers is accompanied by a reduction in external ones, the increase in competitive pressure from outside the Community after 1992 will be all the greater.

In the case of internal barriers, the abolition of customs obstacles entails the <u>de facto</u> repeal of Article 115 and the necessity for Member States to adopt a common policy towards quantitative restrictions. The precise nature of that policy will be crucial for extra-Community imports.

In the industrial field, the products covered by Article 115 are concentrated in a limited number of sectors, some of which are, however, extremely sensitive. It is already apparent that a distinction will be made between two categories of products for the purposes of determining Community policy after 1992. In the case of certain products where the political implications are relatively slight (such as tyres, gloves, drawn glass, tubes and pipes, measuring instruments and toys), there would seem to be a move towards simply abolishing protective measures. In the case of products judged to be sensitive, by contrast, there are plans for new industrial and commercial measures to replace national measures. The sectors involved are either traditional industries (such as footwear and textiles) or growth areas (such as certain activities in the electronics field), the car industry being in an intermediate position. The nature of those measures will determine whether or not the competitive discipline imposed by extra-Community imports is stepped up.

As to technical barriers to trade, their elimination within the EEC will provide third countries with easier access to the Community market. Products from those countries will benefit from the principle of mutual recognition in the same way as Community products, provided that they comply with the legislation in the Community country of entry. Moreover, where compulsory Community harmonization exists for reasons of public interest, third-country products will have to comply with a single Community Directive rather than with twelve different sets of technical rules and regulations.

Community technical rules and regulations will nevertheless continue to present a major obstacle to imports from outside the Community. For example, tests and certification procedures carried out in third countries will still not be accepted in the Community, except where there are bilateral EEC/third country agreements. The GATT code on technical barriers does not adequately cover testing and certification procedures.

In the public procurement field, the opening-up of bids to tender at Community level will clearly have a limited external impact. With a number of key sectors (transport, energy, water, telecommunications and services) being excluded from the scope of the current GATT code on government procurement, foreign suppliers will not have automatic access to the Community market. However, contingent on present constraints imposed by Member States, the subsidiaries of foreign multinational companies benefit, under Article 58 of the Treaty of Rome, from identical conditions of access to the Community market even if their countries of origin do not accord the same treatment to Community companies.

It is clear from the above that the removal of intra-Community non-tariff barriers will entail a major increase in competitive pressure from outside the Community. Furthermore, the abolition of both tariff and non-tariff external barriers could reinforce that pressure noticeably.

With regard to tariffs, it is clear that, although the common external tariff now generally has little restrictive effect on many trading partners, it still constitutes a major barrier for certain products. This is particularly the case with labour-intensive products from the developing countries (textiles and clothing, footwear, certain electronic products, etc.).

However, the principal constraint on international trade nowadays consists of course of non-tariff barriers such as quantitative restrictions, price controls, technical barriers and public procurement.

In a recent study, Sapir (1989) has analysed the external impact of 1992 on the forty sectors identified by Buigues and Ilzkovitz (1988) as being the most sensitive to the completion of the internal market. According to that study, the external impact of 1992 will be felt most in those sectors where the Community's competitive position has weakened most since the mid 1970s. Those sectors can be divided into two clearly distinct categories.

The first category consists of industries which are characterized by a low or average level of R&D and by slight or average economies of scale: shipbuilding, footwear, textiles and clothing. Despite considerable external barriers, European producers have suffered appreciable market losses in these sectors, generally owing to the comparative advantage enjoyed by the developing countries.

The second category consists of high-tech sectors characterized by relatively substantial economies of scale, important learning processes and high sunk costs: telecommunications, electronics and office machinery. In these sectors the weak performance of Community producers contrasts with the gains by United States and Japanese exporters.

In both these sector categories, important choices will have to be made in the run-up to 1992. In the case of the low- or average-technology sectors, steps must be taken to ensure that Community commercial policy is not used in place of a more effective structural adjustment policy. In the high-tech oligopolistic sectors, the public authorities will have to resist purely defensive reactions and calls for protection and will have to ensure that strategies designed to promote Community competitiveness are put in place.

SECTION 2

EFFECTS OF AN EXTERNAL OPENING-UP OF THE SINGLE MARKET ON ECONOMIC EFFICIENCY

2.1 A number of studies have attempted to shed light on the allocative and distributive effects of the removal of tariff and non-tariff barriers to extra-Community imports.

Before presenting the main results of those studies, it is important to place them in the context of the current analyses of international trade which distinguish between the two types of sector identified in the previous section: traditional sectors and the new growth or "strategic" sectors.

In traditional competitive sectors, where the number of firms is large and barriers to entry are low, international specialization is based on comparative advantages : trade patterns are determined by relative factor endowments. On the other hand, in oligopolistic new growth sectors, tradepatterns are explained by recent theories based on imperfect competition : economies of scale, scope and learning are important, and there is a small number of firms (usually from Europe, Japan and the United States). If products are differentiated, an increase in competition augments the number of varieties without much structural adjustment. In the case of homogenous products, however, an increase in competition tends to increase production in certain locations and decrease it elsewhere.

It should be emphasized, however, that the distinction between these two categories of sectors is far from being sharp. Thus, at a given time, some sectors may belong to both categories (e.g., in the telecommunications sectors, where certain sophisticated products require important R&D efforts, while others are based on relatively standard technology). Equally, it may be that, over time, some sectors move from one category to the other (e.g., in the case of textiles, where certain fibres have become high-tech products).

In the first type of sector, specialization is based on comparative advantage and leads to inter-industrial trade. Factor endowments, and in particular relative levels of labour and capital intensity, are bound to determine the distribution of activities at world level. In fact, it is found that, for much of world trade, net trade flows, on average, have a relative factor content which corresponds to relative factor endowments.

Thus, countries relatively rich in (human and physical) capital tend to be net exporters of relatively capital-intensive products, whereas those relatively rich in labour are generally net exporters of labour-intensive goods.

Even in the traditional sectors, however, changes are occurring. On the production side, the scope for automation is leading, in some countries and for such activities as textiles and footwear manufacture, to increased capital intensity; on the demand side, requirements are becoming increasingly varied and are in some cases promoting product differentiation and market segmentation which can create forms of monopolistic competition and give rise to intra-industry trade, i.e. trade in similar products.

Furthermore, specialization based on comparative advantage is not fixed but is subject to change. The work carried out by Balassa (1979 and 1986) shows that a country's accumulation of human and physical capital brings about a change in the structure of its trade in manufactured products. This phenomenon is intensified by direct investment by multinational companies, which promotes the development of intra-industry trade. Recent developments in the newly industrialized countries provide a clear illustration of this.

In the case of the new growth sectors, trade is dependent on a series of phenomena linked to the exogenous characteristics of demand and cost functions, or to the strategic behaviour of the parties involved, or to a combination of the two.

The dominant presence of a small number of large multinationals in these sectors stems from substantial economies of scale and scope and from the specific nature of their intangible assets but also from their policy of controlling markets through concentration and cooperation. Similarly, product differentiation is based on geographical location, transport costs and the physical characteristics of products but also on the creation of a reputation for products. Barriers to entry stem from the existence of substantial sunk costs but also from the deliberate action of those already established in the domestic or international market. Finally, in situations of uncertainty, where markets for risks are incomplete, the opportunity arises for monopolistic power based on control of information.

It should be noted that the nature of the trade in the new growth sectors subject to major economies of scale differs according to whether the products are homogeneous or differentiated. In the case of homogeneous products, the trade is of the inter-industry type. Where products are differentiated, however, the trade is of the intra-industry type.

Realization of these phenomena has called into question the traditional explanations for international trade, the expected welfare implications and the anticipated effects of commercial policy measures based on the ultimate case of perfect competition.

It must be emphasized, however, that recent theoretical and empirical work incorporating this new approach has led to the conclusion that the effects of international trade are predominantly positive.

At allocative level, three types of efficiency gains have been identified in addition to the traditional effects : greater production efficiency through the widening of the market to international level and the opportunities for rationalizing industries; a reduction in monopolistic power in domestic markets; and an extension of the range and diversity of the products and services available (A. Jacquemin, 1982).

In order to ensure that these effects promote collective welfare, however, an increasingly crucial role must now be played by international organizations in order to prevent an upsurge in protectionism and trade wars.

In the case of traditional sectors, such as certain labour-intensive industries (textiles, footwear, etc.), the achievement of a better world-wide division of labour entails major structural adjustment costs. On the one hand, developed countries are bound, ultimately, to disengage themselves from certain activities because their current specialization depends less and less on the necessary condition of a comparative advantage stemming from their factor endowment; on the other, the developing countries fulfil the necessary condition of the comparative advantage but some of them have to supplement that with adequate conditions in terms of infrastructures and managerial capacity in order to be really competitive. Unilateral action alone is not likely to bring about the dismantling of the barriers which currently impede structural adjustments, and concerted international action is essential in order to facilitate such adjustments at the same time in both developed and developing countries.

The situation is even clearer in the case of the new growth industries, where offensive measures are on the increase. Competition in these industries is not based on a series of simultaneous interactions between passive agents which regard comparative advantage, market structures and the behaviour of others as fixed. It is instead a sequential process in which the implementation of new forms of organization, the penetration of new markets and the introduction of new products and standards correspond to private and public strategies capable of influencing the rules of the game and of "moving the goalposts" in favour of certain actors.

It is clear that the distributive effects of more open trade in the new growth sectors vary sharply according to whether products are differentiated or homogeneous. In the former case, the opening-up entails an increase in intra-industry trade. This leads to relatively straightforward adjustments within existing activity areas, with each country specializing in the production of certain varieties of differentiated products.

The situation is quite different in the case of homogeneous products. Here the opening-up process leads to inter-industry trade entailing an expansion of production in certain countries and reduction in others, which may necessitate major adjustment costs. Furthermore, there is the danger of conflicts arising between countries over the maintenance or even expansion of production in these sectors. Such conflicts will be all the more bitter if the degree of competition is imperfect and there are therefore substantial opportunities for rents. In the absence of international agreements, there is therefore the danger that strategic commercial policies will be used to safeguard national advantage at the expense of other countries.

An important implication of the above arguments is that it would be dangerous, even at the level of economic theory, to count on the "invisible hand" to ensure optimum results.

In the case of competitive markets, economic theory teaches that unilateral free trade is apt to produce a Pareto-optimal situation. However, this is true only of a "small" country, that is a country whose international transactions have no impact on international prices. Where, by contrast, a country is sufficiently large to be able to influence world prices, it will generally benefit from eschewing free trade and imposing an optimum import or export tax. However, the ensuing improvement in welfare for the large country is usually gained at the expense of its trading partners. The use of an optimum commercial tax is therefore a zero-sum game. Of course, the final outcome of this game will depend on the strategies of the different players. The country which imposes an optimum tax will obtain an improvement in welfare if its trading partners remain passive. If, however, they take retaliatory measures, all the countries involved could suffer a loss in welfare compared with the free trade situation. In that event, the optimum solution is cooperation aimed at ensuring free trade.

The European Community, with its market of 320 million consumers, is clearly a "large country". As such, the trade barriers it maintains could be desirable from the viewpoint of its collective welfare. It could even be argued that a reinforcement of some of those barriers would provide an optimum solution. Such a policy would, however, be undesirable. A substantial proportion of Community imports of certain traditional products (particularly clothing) comes from developing countries which do not possess the economic strength to resist the import barriers imposed by the large industrialized countries. Those barriers therefore entail a transfer of income from the poor to the rich countries that runs counter to a better distribution of world income.

The role of institutions and policies is even more essential where the international trade context is one of markets under imperfect competition. In that case, the Pareto-optimal solution frequently requires the exchange of information,[1] negotiation or coordination, which, to be effective, may require public intervention.

This may then lead us back to traditional recommendations favourable to free trade. But this return to sources is no longer based on the result obtained by the "invisible hand", according to which the pursuit of individual interest alone produces the greatest benefit to society as a whole. It is based, instead, on the need to avoid, through deliberate policies, a process of unilateral strategies and counter-strategies leading to ruinous trade wars.

1 Recent studies have shown that purely private bargaining does not generally lead to an effective solution where the partners do not have a full knowledge of each other (for a survey, see J. Sutton, 1986).

Hence the crucial role which the Community institutions and such international bodies as GATT are required to play in devising codes of conduct and consultation, monitoring and cooperation mechanisms which are credible, workable, verifiable and stable. They also play an important part in limiting the perverse effects of asymmetries which exist between countries and which are based on such diverse factors as development level, size, type of government or quality of information.

The need to reinforce the rules of conduct governing international trade is particularly important for the developing countries, since their relative weakness makes them vulnerable to action by the large industrialized countries.

2.2 A number of empirical studies have attempted to shed light on the consequences, for collective welfare, of the removal of the various types of tariff and non-tariff barriers affecting the external opening-up of the Community. These studies provide a good indication of the main implications; while, owing to their partial nature and sensitivity to hypotheses chosen, they can scarcely provide general quantitative estimates, certain lessons can be learnt from them. The following three sectors will be used as illustrations : a traditional sector (namely textiles and clothing), a major mature industry (cars) and a growth industry (aircraft).

Among the traditional sectors, the textile and clothing industry has long been an area of dispute between industrialized and developing countries. This industry, which is highly labour-intensive (particularly in the clothing sector), plays a key role in the industrialization process which the developing countries are undergoing. It accounts for a quarter of their revenue from exports of manufactured products. At the same time, this industry continues to have appreciable importance in the industrialized countries, particularly as an employer of low-skilled labour in certain regions. For that reason, the textile and clothing industry is heavily protected in the Community and in the other industrialized countries. Community producers are protected from foreign competition by the common external tariff (which, on average, is 7% for textiles and 13% for clothing). In addition, imports from many developing countries are strictly limited by the quantitative restrictions laid down by the Multifibre Arrangement (MFA).

Many studies have examined the impact of tariff and non-tariff barriers in the textile and clothing sector. The paper by Trela and Whalley (1988) is particularly useful in that it presents a general equilibrium model for assessing the impact of the dismantling of such barriers. The main finding of this work is that the abolition of customs duties and the Multifibre Arrangement would bring about an improvement in the welfare of both the developing and the industrialized countries. The increase in welfare would amount to US$8 billion (at 1986 prices) for the developing countries and to US$3.5 billion for the Community.

The improvement in welfare in the Community is, of course, an overall consequence which conceals two opposing effects: on the one hand, a loss for producers and, on the other, a gain for consumers. An OECD study (1985) shows that the adjustment may be severe because the job losses would be concentrated in regions already hard hit by unemployment. However, part of the large gains for consumers could be channelled towards promoting the reallocation of the workers affected to more productive jobs.

The car industry is a sector for which many quantitative studies have been carried out based on one or other imperfect competition model. This industry is protected against extra-Community competition, both by the common external tariff (approximately 10%) and the use of Article 115 of the Treaty of Rome, which has preserved the effectiveness of certain national quotas in a number of countries. An article by Laussel and others (1988) is particularly revealing of the main factors involved in the search for an optimum commercial policy in this field.

Using a Cournot-type model, they examine the rivalry between European and Japanese companies on the Community's national markets on the basis of the assumption that European and Japanese cars are differentiated between each other but are perfect substitutes within each group. On the basis of a Community welfare function correctly defined as the sum of consumers' surplus, the profits earned by European firms on each market and the income of the Community authorities, they compare the effectiveness of various European policies. Their main conclusions are as follows :

1. Quotas are generally found to be ineffective, except in promoting collusion between Japanese producers. This is confirmed by many previous studies, according to which such quotas, even where they benefit European producers, are prejudicial to overall Community welfare (Venables and Smith, 1986).

2. Rival commercial policies pursued by European countries generally lead to a deterioration in collective welfare.

3. A small increase in the current common external tariff is in general favourable to collective welfare, although the gains are remarkably low owing to the relatively low level of rents (or surpluses) accruing to the Community authorities.

4. The best policy is to replace quotas with Community subsidies, particularly if this is combined with an increase in the common external tariff. This stems partly from the acquisition of monopoly rents of foreign producers and partly from a fall in European companies' costs, which may lead to prices closer to true marginal costs. Even in the event of a major shift in sales in favour of Japanese producers, the additional gain by European consumers would be much greater than the profit reduction suffered by Community firms.

Even though this type of exercise fails to answer important questions, it goes to the heart of the problem. It shows that strategic policies are in fact capable of generating gains in national welfare.

The study made by Winters (1988), which examines in more general terms the policies that may replace Article 115, broadly confirms the above findings. The simple abolition of national quotas would substantially increase Community welfare. Their replacement by a Community quota (which would be the sum of existing national quotas for a given product), although less favourable, especially for those countries which had hitherto been without quotas, would at least be an improvement on national quotas. A system of uncoordinated and possibly rival national subsidies is also an inferior policy to Community action.[2]

With regard to the growth sectors, aviation is clearly one of the fields in which strategic action is frequently taken to modify interactions between producers and hence equilibria. One basic objective is to cause a shift in profits from foreign to national firms (Brander and Spencer, 1985). Other objectives include the wish to modify international competitive conditions by means of

2 National subsidies are all the more damaging as there is perfect mobility of capital.

entry support policies. In this connection, Dixit and Kyle (1985) classified the possible equilibria where a government decides to cover all or part of the substantial sunk costs which must be borne by a company wishing to enter an international high-tech market which is more or less monopolized. Under certain conditions, they show that such action may simultaneously increase national and global welfare.

They cite, by way of illustration, the case of Airbus. By challenging the dominant position enjoyed by Boeing, which controlled up to 80% of the market in passenger aircraft and which benefited from enormous defence contracts, the Airbus economic interest grouping has seen its world market share increase from 11% in 1985 to more than 30% today. The result is an intensification of international competition which, despite distortions created by strategic action, is likely to produce a net gain in world welfare.

The Baldwin and Flam study (1989) goes further since it simulates quantitatively the effects of these strategic policies on the basis of a partial equilibrium model calibrated for the case of short-haul aircraft with 30 to 40 seats. This market, which is relatively well defined, comprises three producers : a Brazilian (Embraer), a Canadian (de Havilland) and a Swedish producer (Saab-Scania).[3] This industry is characterized by a homogenous and durable product, major static and dynamic economies of scale, a high level of R&D expenditure and initial investment and marginal costs which diminish substantially as a result of the learning process. Policies likely to affect capacity and production choices therefore have appreciable effects on costs and profits and on the distribution of the latter and welfare between countries. Each firm is assumed to choose the (constant) capacity which maximizes its profits, given world demand, the capacity of

3 For a study of medium-haul aircraft, see Baldwin and Krugman, 1987.

competitors and its technology. In addition, two of the three governments in question seem to have used strategic commercial policies, namely restrictions on access to their domestic markets (Canada) and export subsidies (Brazil).

On the basis of their simulations of the effects of an absence of strategic commercial policies, the authors reach two conclusions:

1. These policies have actually transferred profits from foreign firms to the domestic firm;

2. World welfare has not been reduced for all that. The action taken has increased welfare by cutting average marginal costs and/or by increasing competition.[4]

Similar results have been obtained for other growth sectors (for example, 16KRAM chips; see Baldwin and Krugman, 1987).

Once again, however, the conclusion should not be one of general encouragement given to strategic commercial policies. It is rather a question of recognizing that, given the possibility of achieving gains in national (and, occasionally, even international) welfare through such policies, it is inevitable that the public authorities, which are already inclined to adopt them as a result of the activities of pressure groups, will increasingly have recourse to strategic policies if the current drift in the international environment towards the formation of economic blocs and the adoption of non-cooperative attitudes continues.

We will return to this subject in the final section.

4 Even if the lowest marginal cost were obtained through a monopoly over production, this allocation would be inefficient in net terms because of the reduction in competition.

SECTION 3. INSTRUMENTS AND POLICIES FOR ENCOURAGING THE OPENING-UP OF THE COMMUNITY

The aim of this section is to highlight a number of policies likely to facilitate the opening-up of the European Community to the outside world. A simultaneous process of internal and external liberalization of the single market is a source of increased potential benefits. However, the realization of those benefits calls for agreement on the long-term prospects which such liberalization entails.

3.1 In the case of the traditional sectors, a gradual change in specializations and production methods has to be accepted if there is to be an international division of labour which is more compatible with the dynamics of the European Community's comparative advantages.

In the case of the new growth sectors, the aim must be to ensure that the Community has the greatest possible access worldwide to strategic activities.

In the first case, major structural adjustment policies designed not to prevent but to encourage change have to be put in place at sectoral level. Such policies are made all the more urgent by the fact that, in the majority of the countries in the north of the Community, the traditional sectors have already carried out major industrial changes by either changing the technology or by relocating highly labour-intensive activities, whereas in the countries in the south of the Community, where these industries are a key source of jobs, adjustments have been very limited and competition from third countries is fierce.

In the second case, a policy of consultation must be established to bring about better world cooperation in the high-tech field and to avoid the dangers of bilateralism and anti-competitive behaviour. Here again, there is need for urgent action, since the Community's relative position in the new growth sectors has deteriorated in recent years by contrast to the highly effective export policy pursued by Japan and the newly industrialized countries of south-east Asia. The aim must be to avoid withdrawal and to develop, instead, an outward-oriented strategy, linked to the liberalization of the internal market.

Before discussing these two types of approach, it should be emphasized that, at both national and international levels, they are not simply concerned with commercial relations but are part of political relations in the broad sense, whether that involves the stability of a country's regime, its external security or its foreign policy.

It should further be pointed out that, in the two types of sectors, unilateral commercial policy alone - whether protective, aimed at cushioning the external shocks of competition or used in an activist fashion to gain positions of strength in the international economy - has limited scope. As Baldwin (1985), has showed commercial policy exerts its effects in three stages. It modifies the relative prices and quantities of imported and exported goods, thereby transforming domestic prices and trade; that modification is in turn supposed to induce the desired reaction from firms or consumers; this should lead, finally, to a favourable change for the initiator of the policy in terms of production, employment and income levels. At each stage, however, various obstacles may prevent the anticipated indirect effects from materializing.

As many empirical studies have shown (see in particular Section 2), measures such as the use of quotas or "voluntary" export restrictions (as in the car, footwear or textile industries) may produce perverse effects and trade diversions which bring about a reduction in the Community's overall welfare. In fact, a commercial policy which is restricted to making specific and residual corrections to external shocks runs the risk of jeopardizing the more fundamental objectives of European integration and long-term restructuring.

3.2 The competitive pressure exerted by the developing countries in the manufactured product sectors, and particularly in the traditional highly labour-intensive activity sectors, has increased sharply in recent years. The developing countries have carried out major structural changes, with the result that the share of manufactured products in their exports to the industrialized countries has increased from 7% in 1965 to 40% in 1985. The change is particularly spectacular in the case of the newly industrialized economies (NIEs) in Asia (the four "tigers": Hong Kong, Korea, Singapore and Taiwan) where this share, which was already relatively high in 1965 (40%), today stands at 80%, i.e. a level slightly higher than that of the EEC (see European Economy, No 39, Graph 12).

This competitive pressure is not about to be relaxed; quite the contrary. The industrialization model provided by the NIEs has been taken up by other countries. Thus, we are now seeing the arrival of "baby tigers" (Indonesia, Malaysia and Thailand), which are following in the wake of their elders. The whole of Asia - not only the east but also the south - is involved in a process of rapid development based, initially, on exports of traditional labour-intensive products.

Moreover, this phenomenon is not restricted to Asia alone. It is found in Latin America and also close to the EEC: not only in many Mediterranean countries but also in eastern Europe. In short, more and more countries are joining the ranks of exporters of traditional manufactured products.

This development is consistent with the theory of comparative advantage. A relatively abundant pool of labour and, as a result, relatively low wages give the developing countries a marked advantage in the labour-intensive industries. Among those industries, textiles and clothing play a dominant role. This sector alone accounts for 25% of the developing countries' exports of manufactured products. That proportion is as high as 60% in Turkey and 70% in Pakistan. The competitive advantage enjoyed by the developing countries in the clothing sector is such that, despite protective measures (high customs duties and quantitative restrictions), those countries now account for 25% of the EEC's consumption of clothing.

Within the Community, the southern countries, owing to their relatively low wage levels (for example, there is a ratio of one to five between Portugal and Germany in the clothing sector), enjoy a comparative advantage over their northern neighbours in the traditional sectors. However, those countries are themselves faced with fierce competition from certain developing countries in which wage levels are much lower still (for example, there is a ratio of one to five between India and Portugal in the clothing sector).

Under these conditions, the countries in the south of the Community are faced with two possibilities: that of maintaining their positions in the traditional sectors or of transforming their industrial structures. The first option holds little attraction. It would entail fierce competition from developing countries on their terms, i.e. those of low wages. Alternatively, that option could be exercised by maintaining or even reinforcing protective measures, such as those provided for under the Multifibre Arrangement. However, such a policy would be disastrous not only for the developing countries but also, ultimately, for the southern Community countries themselves, whose inadequate openness would lead to inefficient industrial specialization. This therefore leaves the second option - one which, moreover, has already been adopted by the Asian NIEs, which are demonstrating great capacity to adjust. These areas, formerly targeted for relocation, are in turn relocating to the advantage of the "baby tigers" and other developing countries. For example, in 1988 Taiwan took over from Japan as the primary investor in Indonesia. This adjustment has led to a major transformation in the structure of the NIEs' exports. Between 1965 and 1985, the share of textiles and clothing in exports of manufactured products fell from 68% to 44% in Korea, from 49% to 35% in Hong Kong and from 17% to 7% in Singapore. Over the same period, that share showed a less favourable trend in southern Europe, moving from 21% to 46% in Greece and from 39% to 37% in Portugal (but from 15% to 6% in Spain). Restructuring may of course take place within traditional sectors through the selection of specific growth areas. Italy has countless examples of clothing manufacturers which have switched, with great success, from mass production to up-market batch production.

Steps should therefore be taken to implement structural adjustment policies designed not to prevent but to encourage change towards less specialization in traditional activities. Community policies based on the structural Funds have shown the limits to what they can do in pursuit of this objective. These stem from a lack of <u>ex ante</u> measures anticipating changes in comparative advantage and leading to restructuring in the direction of activities offering greater prospects for growth. With a view to adopting more than simply a defensive approach and to improving Community policies in the face of the growing challenges from the developing and eastern European countries in the traditional sectors, the following approaches could be discussed :

(a) analysis of the international trend of the traditional sectors and stocktaking of Community adjustment policies (possible use of sectoral observatories). The first task here is to examine what the real situation is regarding international changes. More and more countries are industrializing and the newly industrialized economies are changing rapidly. This trend is creating new competitors but is also offering new outlets. The Community should better analyze these changes. It should also take a critical look at its structural policies.

(b) Consideration of the possibility of implementing specific long-term adjustment programmes in sectors (such as textiles and footwear) in which job losses, resulting from the opening-up of markets, are likely to be concentrated in regions already hard hit by unemployment: this work will have to be based on the conclusions drawn from the stocktaking of Community policies recommended above. It will be necessary in particular to ensure that adjustment measures are not taken after the event in response to crisis situations. They will instead have to form part of a cohesive package of policies designed to improve the functioning of the labour market. One radical long-term approach would be to consider that the resources of the structural Funds are not so much means of facilitating Intra-Community adjustment - which is now, perhaps, less difficult than anticipated - as an instrument of adjustment to inevitable external competition. These Funds would then be devoted primarily to sectorally targeted measures rather than to horizontal programmes. They would support investment projects aimed at developing new specializations or higher quality production rather than maintaining existing products which have become unsustainable due to foreign competition.

3.3 The problem of the high-tech growth industries - whether aerospace, super-computers or semiconductors - has been made all the more acute by the fact that these areas, which partly come under GATT, have become the object of geostrategic struggles between trading blocs.

What is the current situation in the Community in these sectors?

It is first of all clear that the recent trend of exports and imports of high-tech products is still disturbing. When measured in terms of average annual growth rates over the period 1982-88, it is found that in such industries as data-processing equipment, telecommunications and consumer electronics the Community is concentrating on its own market through the intensification of intra-EEC trade. But, despite the progress towards completion of the internal market, it is losing market shares on its own territory: "... extra-EC imports have tended to progress more rapidly than their intra-EC counterparts, pointing to an increased dependency on third country suppliers for those products characterized by high technological content" (European Economy No 42, p. 223). The principal suppliers are the United States and Japan. The market share losses suffered by Community exporters are even more marked in third countries : the rate of growth of Community exports of the products previously mentioned and of specialist equipment was virtually zero or fell in 1988.

While it is not easy to identify the precise causes of this trend, it is clear that, despite the increasing number of Community programmes, "technological Europe" continues to suffer from a variety of handicaps (see the Commission's internal paper of 28 February 1989 on the scientific and technicalogical bases of Europe's economic and social development).

On the supply side, these handicaps include:

- the growing gap between European investment in R&D and that in the United States and particularly Japan;

- the inadequate level of human resources allocated to research and technological development;

- the delays in the transition from scientific and technological capacity to the product development and marketing phase and in the introduction and efficient use of the new diffusing technologies in the production field (robotics, materials technology, biotechnologies, etc.).

On the demand side, the handicaps include:

- the role of the various national barriers and policies (standards, tariff systems, public procurement, etc.), which limit potential demand for high-tech products and undermine the learning and training effect exerted by accumulated experience of past consumption;

- the lesser receptiveness of European companies to new products compared with attitudes in the United States and Japan;

- too great a distance between technology producers and users, which reduces the possibility of adapting technologies to technical, economic and social needs;

- an inadequate level of training in new technologies linked to the failure of educational systems to adapt, which applies to both initial and in-work training.

Numerous Community measures have been taken to reinforce the Community's competitive position in the growth industries. The mechanisms are set out in Article 130 of the Single European Act: the multiannual framework programme and specific programmes, coordination of national R&D policies by the Member States in liaison with the Commission, cooperation with third countries and international organizations, and the setting up of joint undertakings for the execution of programmes. Nevertheless, despite the expected strengthening of the Community's position in these sectors, that position is likely to remain relatively weak in a situation of confrontation between major trading blocs.

The strategic nature of the high-tech industries has reinforced the trends towards technological protectionism, unilateral or bilateral actions and the undermining of multilaterialism.

This is particularly the case in the United States, which no longer regards multilateralism as a priority option and which, subjected to aggressive competition from Japan, is endeavouring to force that country to open up unilaterally to American industry. More specifically, influential economists are encouraging the United States to commit itself to a commercial policy based on recognition of the need for different treatment of different trading blocs. Thus, in the case of Japan and in accordance with the spirit of section 301 of the current trade law, targets expressed in terms of the rate of growth of United States exports to Japan would be set[5] and arrangements for automatic sanctions adopted.[6] This approach is presented not as a mercantilist step (the aim of which would be to restore the trade balance to a situation of equilibrium) but as a contribution to the liberalization of international trade through the forced opening-up of a dominant and closed economy.

In the same way, the Europe of 1992 programme is perceived by those economists to constitute a serious threat to the US position, which has led to the suggestion of a North Atlantic free-trade area that would be better able to exert pressure on Japan, which is now attempting to create a Pacific bloc and to develop cooperation with the USSR, to open up its closed economy. If the Community did not wish to commit itself to such a free-trade area and to league together against the Asian bloc to enforce openness, the United States would be encouraged to go it alone, which would mean that Europe would be greatly affected by significant effects of trade diversion. In addition, the controls and limitations on access to US science and technology would be maintained or stepped up (differentiated use of the COCOM arrangements, use of national defence funds to prevent US subsidiaries of European companies from participating in programmes financed by the DOD, restricted access to scientific conferences, etc.).

Japan's attitude remains ambiguous. Numerous measures to protect the domestic market involving finance and the cost of capital, conditions governing the entry of direct investment, participation

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5 According to R. Dornbusch of the MIT ("Is there a case for aggressive bilateralism and how best to practise it?", 1989), this rate of growth, adjusted for inflation, should be 15% a year during the next decade.

6 Primarily tariff surcharges on imports from Japan.

in research programmes, public procurement, access to distribution and the lack of a competition policy are coupled with an opportunistic attitude to multilateral negotiations, in which Japan takes an active part only in those specific fields where it is directly concerned.

In such an environment, there is a danger of "non-cooperative games" between trading blocs, which could lead to trade wars and collectively disadvantageous equilibria.

Compared with the integrated entities of the United States and Japan, the Community is currently still only a more or less stable coalition of States which, at certain times, endeavour to go it alone or to benefit from the collective advantages of the whole without contributing to them. The opening-up process in eastern Europe can, for the time being, only accentuate this instability.

Acceptance of the international economic system's drift towards relations between trading blocs is more likely to be unfavourable to Europe since its economy is the most dependent on the rest of the world and the least likely to implement a common strategy.

In order to respond adequately to the challenge presented by the high-tech growth sectors, there must be a minimum consensus within the Commission and between Member States on the adoption of a purposeful policy which could ensure a concerted and cooperative transcontinental approach.

The measures to be considered would include:

(a) taking stock of the Community's relative position in the growth sectors. This information would be supplemented by a survey among the main European companies which are active in these fields and which have dealings with US and/or Japanese firms as suppliers, business partners or customers. This survey would have to establish in particular the extent to which the many forms of private inter-continental cooperation which exist are favourable or prejudicial to the Community's technological objectives.

At international level, the Commission would suggest to its principal partners that the high-tech sectors judged by all to be strategic should be identified and that a report on the existing situation and trends in those sectors should be drawn up. This exercise could be carried out within the OECD and would be aimed at settling latent or open conflicts.

(b) Clarification of international arrangements regarding competition rules, on the basis of which convergence or even consensus could be achieved concerning principles and actual implementation. Analyses of cases should make it possible to identify points of strain and the corrective antitrust measures to be taken.

(c) Consideration of the idea of drawing up international framework programmes concerning high-tech activities; these would define the objectives and priorities of international cooperation at precompetitive level and would aim to establish common approaches to training, researcher mobility, information transmission and large-scale scientific projects. One point of departure would be the framework programmes which already exist in the Community and also in the United States and Japan (white paper on science and technology, OTA and STA approaches).[7] A coordinated approach to a number of large-scale scientific projects, such as the identification of the human genome or the construction of space platforms, is made all the more urgent by the fact that suspicions of, and attempts at, exclusion are increasing in number.

CONCLUSION

In conclusion, it seems useful to examine various possible scenarios regarding international economic relations as well as the choices that confront the Community. The purpose is not only to analyze how the EC's partners could behave but also how she, as a major actor on the international scene, should influence the probability of the different possible scenarios.

The first choice that confronts Europe is to know, on the one hand, which of the cooperative or non cooperative scenarios is more likely and, on the other, what is her interest. As we have underlined earlier, one cannot exclude the possibility of heightened tensions leading to conflictual relations among economic blocs and a drift of the international system. Our conviction is that such prospect is harmful for the world in general and Europe in particular. In order to avoid this prospect, Europe should use all its influence in favor of the cooperative scenario.

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7 With the prospect of an integrated technological Europe, the National Science Board of the United States National Science Foundation is preparing a study on the impact of 1992 on US access to European scientific initiatives. The White House Office of Science and Technology is establishing a system of framework agreements which would lay down the guidelines for scientific and technical cooperation with the Community.

Assuming this scenario prevails, the next step, regarding the identification of the actors of the cooperation, raises a delicate problem. The principal alternative is between a cooperation on the world scale and a cooperation between, on the one hand, industrial countries and, on the other, developing ones. If the second alternative is adopted, it would imply, probably, a cooperation within the triangle EC-USA-Japan.

In the commercial field, multilateral liberalization on a world scale is generally considered most attractive. It offers the advantage of enabling a better international specialization thanks to various possible trade-offs. In addition, multilateralism encourages the improvement of political relations by allowing to diffuse commercial tensions which, within a narrow bilateral framework, could degenerate into sharp conflicts. Nonetheless, multilateral trade liberalization also carries problems. One of its main problems concerns "free-riders". This issue arises mainly in the context of certain developing countries which are perceived as enjoying the rights of the multilateral system without respecting its obligations. Clearly, the reinforcement, or even the survival, of GATT as a pilar of international trade requires the integration of these countries in the multilateral system. The failure or the success of the Uruguay Round depends on the capacity of both industrial and developing countries to exchange mutually advantageous concessions. A failure would have grave consequences, not only in the commercial field. It would lead to an increasing disequilibrium in the distribution of wealth at the expense of the vast majority of the world's population and could strengthen extremist political, or even religious, behaviors.

Whatever the outcome of the Uruguay Round it is, probably, necessary to reinforce the cooperation among industrial countries which operate within a "strategic environment". Concerning the EC, the USA and Japan, it is clear, indeed, that the actions of each bloc deliberately influence (and are influenced by) the actions of its partners. It is important, however, that such cooperation among these giants does not turn into a cartel at the expense of other, smaller nations. One should, therefore, insure that this cooperation will be open to all countries, just like GATT codes can be signed by all GATT members. In other words, the cooperation among a limited number of powerful countries should not lead to the exclusion of weak nations but, rather, help reinforce international cooperation.

Such prospects indicate that, generally, whether we are concerned with traditional or new growth sectors, whether in the cooperative or non cooperative scenarios, it is important for the EC to supplement and balance its trade policiers with structural policies and to have a permanent capacity for long-term strategic analysis that goes beyond the role political dimension.

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