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The European Economic Community (EEC) was formed in 1957 with the signing of the Treaty of Rome. This brought together six countries (Belgium, France, West Germany, Italy, Luxemburg and the Netherlands) which were involved in the conflict of the Second World War. The impetus for the establishment of the EEC was political but the economic gains from the operation of the scheme, popularly known as the Common Market, were so significant that eventually the original membership of six was doubled to include Denmark, Greece, Ireland, Portugal, Spain and the United Kingdom.

The so-called Europe 1992 Project aims to bring about further economic co- operation in the EEC, now known as the European Community (EC), by removing all the current major obstacles to intra-European trade. These include red tape and border regulations, restrictive government procurement practices, differences in technical regulations and standards, and differences in tax regulations, accounting standards and social security laws.

The impetus for the 1992 plan is the belief that these barriers were largely responsible for the EC having lower output, investment, productivity and employment growth rates and higher inflation rates than the USA and Japan. The EC also did not do as well in the export market. In the period 1979-85, its share in the world export market fell in spite of a 35 per cent decrease in its effective exchange rate. The poor export performance was especially noticeable in the industries of the future, such as information technology, electrical and office equipment and telecommunications.

The Europe 1992 Project has generated a great deal of interest and anxiety, not least among the major trading nations of Asia. This article examines the economic and trade implications of the 1992 program for these countries.

The plan

If realised, the Europe 1992 plan will represent a very high level of economic cooperation. The lowest level of cooperation is the formation of a free-trade area, where member countries remove trade barriers among themselves but maintain their own separate national barriers against trade with the outside world. The 1992 plan goes beyond this as well as the next stage of forming a customs union, where member countries maintain no obstacles on trade with each other and have the same set of obstacles against trade with non-member countries. From 1957 to now the EC has operated such a system, together with other arrangements. The 1992 plan aims for a common market where a customs union operates and where there is complete freedom of movement for capital and labour. The highest stage of economic cooperation will be full economic union where member countries become, in effect, part of a bigger country, under the same set of economic policies.

The fears that the trading nations of Asia have of the Europe 1992 plan are in the following areas:

- By abolishing all trade barriers among the member countries, the plan will encourage them to buy from each other and divert trade from non- member countries, even though the latter might be more efficient. This is the so-called trade diversion effect.
- Combining a population of 325 million people with very high income levels, the plan will give the group extraordinary bargaining strength and drawing power. These will be used as leverage to open foreign markets or to keep out all those whose markets are highly protected, on terms which are favourable to the EC. This is the so-called "Fortress Europe" effect.
- The EC may give special trade preferences to eastern Europe and divert its private and official capital flows to it at the expense of Asian countries. Some diversion may also take place with funds from richer EC countries going to poorer EC countries such as Spain and Portugal rather than to Asian countries.

Trade diversion

This fear is based on the fact that the EC is an important market for Asian exports and that the EC has increased its overall level of protection against developing countries in the 1980s. Table 1 shows that the EC's share of Asian exports in 1989 was over 30 per cent and had increased over the 1980-89 period. The EC was also the second most important destination after the US. For South Asian countries it remained the most important export market.

Table 1: Regional distribution of the exports of developing Asian countries 1980, 1987 and 1989 (per cent)

	EC		USA		Japan	
			total exports			
	1980	1989	1980	1989	1980	1989
ASEAN	18.4	39.2	26.5	28.8	49.0	33.3
NIEs	30.3	24.9	44.7	44.3	15.5	19.9
South Asia	51.2	46.9	21.5	27.2	17.7	18.2
China	30.8	27.6	13.0	33.0	48.5	30.7
Asia	**26.2**	**30.8**	**31.6**	**37.0**	**34.6**	**25.4**
			manufactured exports			
	1980	1987	1980	1987	1980	1987
ASEAN	33.3	29.0	48.2	54.1	8.8	8.9
NIEs	32.1	23.3	47.4	55.8	10.5	10.7
South Asia	55.3	46.0	26.9	34.9	6.2	9.4
China	40.1	29.2	40.1	29.2	24.7	17.9
Asia	**35.0**	**26.3**	**43.8**	**52.0**	**10.8**	**11.0**

The increase in the EC's share of Asian exports hides some very disturbing trends. Protection in EC has become more discriminatory against certain products from certain countries and also very sophisticated and non-transparent. The newly industrialising economies (NIEs), especially those in Asia, have been affected particularly and the second-generation exporting nations from Asia have also been increasingly targeted. Non-tariff barriers have replaced tariffs, and among the non-tariff barriers quantitative restrictions have been replaced by voluntary export restraints, surveillance and anti-dumping procedures which are partly outside the jurisdiction of the General Agreement on Tariffs and Trade (GATT). These changes in the nature of protection have made it easier for the EC to camouflage its level of protection and more difficult for its competitors to break into or maintain their share of the EC market.

In contrast to these trade restrictions, the EC's trade preferences to developing countries are of limited value. They are generous for the export of manufactured goods from countries which cannot supply them, such as the African, Caribbean and Pacific (ACP) countries of the Lomé Convention, and much less so for the export of agricultural and manufactured goods from those which can.

The fear that the trade diversion effect will be substantial is not allayed by the stand taken by the EC in the Uruguay Round. It has not been keen to reduce agricultural protection or to give up the principle of special treatment and selectivity in its trade with non-EC countries.

It should be pointed out that the negative trade diversion effect from the establishment of a trade bloc may be offset by the positive trade creation effect. This refers to the possibility of new trade between the member countries of the EC once barriers to trade are removed, when some of them will be encouraged to replace domestically produced goods by goods produced more efficiently by other member countries.

It has been estimated that this reallocation of production activities, together with the free movement of capital and labour, will bring about structural change and increase the EC's GDP by 1 per cent per year well into the 1990s.[1] Other important economic gains are an average annual decrease of 6.1 per cent in the level of consumer prices, an improvement in the budget by an average of 2.2 per cent of GDP, an improvement in the external balance by an average of 1 per cent of GDP, and 1.8 million jobs being created which would reduce the unemployment rate by 1.5 per cent.

If the income elasticity of import demand remains the same over the 1990s, the resulting increase in the EC's imports will be far greater than the resulting decrease from the trade diversion. It has been estimated that an annual increase in the GDP of 1 per cent will increase imports by 5.5 per cent per year, with the trade diversion being no more than one fifth of the increase in import demand.[2] The major beneficiaries of the increase in EC's import demand will be countries which can supply manufactured goods and services at competitive prices, and this includes the major trading nations of Asia. Those countries which export primary products will benefit less as technology in Europe continues to save on raw materials and to conserve the environment.

A recent study on the ex ante effect of the EC 1992 plan on South Korean exports to the EC suggests that too much has been made of the adverse effects.[3] The plan will produce an immediate static effect in reducing the prices of EC goods: trading costs will be reduced from less delay at the frontier as will production costs from greater competition and economies of large-scale production. However, this will reduce Korean exports to the EC by only 2.4 per cent on the average. There is also a long-term dynamic effect which will reduce it by 5.6 per cent. These losses will be insignificant compared to the increase in exports generated by the increase in the EC's GDP.

Fortress Europe

The second area of concern that the trading nations of Asia have of the 1992 Europe plan is that it may operate as "Fortress Europe". It may erect substantially more barriers against competition from the rest of the world in an attempt to reduce the overall competitive shock from having a single European market, or it may make use of its enormous combined strength to extract unfair gains from the rest of the world.

Possible forms of the move towards "Fortress Europe" might include the following:

- EC members might impose on non-members the harshest form of protection currently used by one of them while abolishing such restrictions among themselves. This might happen with textiles and automobiles which are among a small number of products on which national quotas are still imposed.
- The EC might deny national treatment for non-EC firms seeking to enter the EC market through the establishment of subsidiaries, so that foreign- owned subsidiaries are treated less favourably than domestically-owned ones.
- The EC could interpret the principle of reciprocity strictly so that foreign- owned subsidiaries would be granted the benefits of the integrated market only if EC subsidiaries in the foreign country were to enjoy similar benefits.

The move towards "Fortress Europe" may materialise because of the more protectionist and discriminatory trade policies pursued by the EC over the last twenty years and the increasing use of non-tariff barriers, as noted already. There is also talk in official documents and statements from the EC of the integrated internal market giving the EC the negotiating leverage to obtain global reciprocity, as well as sectoral reciprocity in certain areas not covered by GATT, especially services.

The decision by a large number of Japanese manufacturers (for example, Fujitsu, Matsushita, Mitsubishi, Toshiba and Toyota) and banks (for example, Fuji Bank and the Industrial Bank of Japan) to establish themselves in Europe has undoubtedly been prompted by the fear that firms not established in Europe will not have fair access to the lucrative European market. This fear is not unfounded as the EC has made greater use of anti-dumping duties against Japanese producers of printers, cassettes, video tapes, photocopiers and electrical motors. As a result of this fear, direct Japanese investment in Europe has been growing at around 90 per cent a year.

There is also some evidence to show that Japanese or other non-European firms, once established in Europe, might have been discriminated against. Standards and regulations might have been set to favour European firms, strict local content rules could have been enforced and public procurement contracts have not been granted to non-European firms in spite of much more competitive bids from them. An example is the decision by the Spanish Government to accept French and German tenders for its high-speed railway system in spite of these being 30 per cent higher than a tender by Mitsubishi.

The extent to which these measures become a permanent feature of the EC after 1992 will depend on the outcome of debate among EC countries themselves on the relative merits of competition and regulation. Some countries believe that the prime objective of the 1992 scheme is to give European firms a competitive edge over non-EC ones, whereas others believe that it is to encourage greater competition and freer trade. All the major decisions are still pending.

What is clear so far is that with its bargaining strength the EC will insist and be accorded rules of reciprocity which would deny Asian firms/countries access to the European market unless equal access is granted to European firms/countries. The implementation of such reciprocity rules will affect small and open trading nations such as Australia very significantly. Suppose the EC insists that Northeast Asia buys more of its subsidised agricultural products before allowing it greater access to the EC market for manufactured goods. Australia accounts for 2 per cent and 3.7 per cent of Northeast Asian exports and imports respectively. These figures show Australia to be an unimportant trading partner as far as Northeast Asia is concerned. Under pressure and threat from the EC and because of the size of the EC market (US$3,794 billion), there is little doubt that Northeast Asia will reduce its import of cheaper Australian agricultural products rather than reduce its domestic production of such products in order to accede to the EC's request.

If the 1992 Europe plan results in a North American trading bloc, the situation for Australia would be worse. The North American trading bloc could exert the same type of pressure on Northeast Asia. As it accounts for 39 per cent and 21 per cent of Northeast Asian exports and imports respectively, and has a market of 270 million people and a GDP of US$4,509 billion, there is also little doubt that Australian interests would again be sacrificed.

Diversion of funds from Asia

The third area of concern is that the EC 1992 plan will divert private and public EC capital away from Asian countries. This would happen for two reasons. The first is that the newer and poorer EC members, Spain and Portugal, will compete with developing Asian countries for private investment from richer EC countries because they have more or less the same factor endowments. As members of the EC, Spain and Portugal will have a huge advantage, one that will be further strengthened by the operation of the Regional Fund of the EC Commission which subsidises capital expenditure in the less developed areas of the EC. In the absence of the 1992 Europe plan, private investment fund could have found its way to Asia.

The second reason is the special trade and aid programs which have been worked out for eastern European countries to help them develop their market economic systems. The EC has agreed to give these countries preferential market access and the newly established European Bank for Reconstruction and Development and other Western donors appear keen to support the reform process with massive injections of public funds. If the granting of special trade preferences and special aid programs to eastern Europe were to result in the successful economic transformation of their economies, this would increase the EC's private investment in them and reduce such investment in the developing nations of Asia. It might also increase investment in the EC to facilitate exports to eastern Europe, thereby reducing further direct foreign investment in Asia.

While such a development might come about even without the 1992 Europe plan, it would be more likely with it in place. The EC would like to see the East European countries adopt political and economic systems which are similar to its own. As the 1992 Europe plan is supposed to demonstrate the superiority of factor and trade mobility under a market-determined economic system, the EC would be particularly keen to help the eastern European countries integrate into the international division of labour.

The concern that western European private and public funds will be diverted from Asia may be exaggerated. First, direct foreign investment has already begun to move away from developing countries as a group (table 2). The share of the Asian NIEs and near-NIEs in the total direct foreign investment went down from 6.6 per cent in 1980-84 to 5.5 per cent in 1988, though their share in the direct foreign investment going to developing countries went up and by 1988 had accounted for half of this. Second, over the 1980s the EC had become a more attractive place for investment for both EC and non-EC countries, with Spain and Portugal being preferred. This pro-EC investment trend will be strengthened by the 1992 plan as the EC provides subsidies for investment in its peripheral areas and as non-EC investors move in to benefit from its larger market and for fear of the EC adopting a predatory policy. However, the point is that the EC 1992 plan will only continue a trend which began some years back. Third, with economic growth in Spain and Portugal, labour costs will rise and make them less attractive investment destinations. Their participation in the European Monetary System will also mean that they cannot adjust their exchange rates to deal with rising labour costs. Moreover, the social harmonisation program of the EC will reduce the inter-country differences in labour costs. As a result, Spain and Portugal will lose their comparative advantage in labour- intensive activities and attention will switch back to the developing Asian countries.

Table 2: Foreign direct investment by home and host countries/regions, 1980 and 1988 (in per cent of total stocks)

	USA 1980	USA 1988	Japan 1980	Japan 1988	West Germany 1980	West Germany 1988	UK 1981[a]	UK 1987
developed countries	73.6	75.1	45.7	61.4	82.8	89.1	57.2	84.0
EC	37.4	38.7	11.1	15.0	36.8	39.6	20.7	27.9
CMEA[b]			0.5	0.1	(0.1)	0.0		
developing countries	24.7	23.5	53.8	38.5	17.1	10.7	21.8	16.0
Asia	3.8	5.5	27.0	17.3	2.1	2.2	8.3	5.6
South Asia	0.2	0.1	0.1	0.1	0.3	0.3	1.5	0.6
ASEAN	2.2	3.0	19.6	10.0	1.2	1.0	3.9	2.8
China, PR			0.1	1.1		0.1		
NIEs	1.4	2.4	7.3	6.1	0.6	0.8	2.9	2.2

a Excluding oil companies, banks and insurance companies.
b Council for Mutual Economic Assistance.
Source: Hiemenz et al., "European trade policies", p. 17.

The concern that political and economic developments in eastern Europe will divert funds from Asia may also be exaggerated. Most of these countries are heavily indebted in hard currencies and it is highly unlikely that they will be able to borrow significant amounts from the private capital market. Their ability to absorb direct foreign investment and foreign aid is also limited. This is because physical and institutional infrastructures are poor, there is no experience and skill in managing large-scale investment projects, the market is in an embryonic stage and property rights are not protected.

Political considerations will result in a significant increase in private and public EC funds being channelled into eastern Europe but it will not be of a magnitude that will starve developing Asian countries of such funds from the EC. Some Asian countries, especially the South Asian ones, will suffer more, particularly as far as the receipt of foreign aid is concerned. Others, especially the Asian NIEs and near-NIEs, will benefit from the increased demand for capital goods arising from the economic reconstruction of eastern Europe. The dynamic economic performances of these Asian countries will continue to attract EC direct investment. If the demands of eastern European reconstruction are to be met it will be more likely to be at the expense of investment in the peripheral areas of the EC.

Conclusions

If the EC were to adopt an outward-looking strategy in its dealings with the rest of the world after 1992 and if beggar-my-neighboui" policies are not adopted by the various trade blocs, the major trading nations of Asia will benefit from the 1992 exercise. An increase in the EC's

GDP will increase its demand for imports, which will the negate the trade diversion effect and increase the level of economic activity in the rest of the world. Those Asian countries which are efficient producers of goods demanded by the EC will benefit. They will also benefit from the increase in demand for capital goods that will accompany the economic reconstruction of the East European countries. The past economic and export performances of the Asian NIEs and near-NIEs suggest that they will be the ones most likely to gain from these developments in western and eastern Europe.

These gains can be strengthened by a more sustained effort to break into the European market. Asian NIEs and near-NIEs account for only a relatively small part of the EC's imports. They have tended to concentrate on the American market, partly because of its large size and partly because the American dollar has been over-valued. The gains can also be increased by a more targeted approach to marketing in Europe. Protectionist measures will remain for sectors such as agriculture, some steel products, cars, textiles and clothing and some electronics products, where structural adjustment is overdue, and may even increase for sectors considered important for the future such as aircraft and telecommunications. These measures have also been concentrated on Japan and the Asian NIEs, which need to diversify their exports to the EC by moving away from highly protected industries into the less protected capital goods sector.

The effectiveness of the Asian response will be increased by investing directly in the EC. This has been recognised by the Japanese and their direct investment in the EC in recent years has increased very substantially. It is a step which should be considered very seriously by the Asian NIEs and near-NIEs, as the EC may react to the pain of structural adjustment within its boundaries by reducing competition from outside.

On balance, the Europe 1992 plan should be seen as a boon and not a bane for the major trading nations of Asia. Other Asian countries, especially those which have to depend on foreign aid to make ends meet, will find the going a great deal more difficult. But such countries will find things tough whether or not the 1992 plan takes place.

[Footnote]

1. P. Cecchini, The Cost of Non-Europe (Brussels: The European Commission, 1988).
2. U. Hiemenz et al., "European trade policies toward developing countries", in I. Yamazawa and A. Hirato (eds.), Trade Policies Toward Developing Countries (London, 1991).
3. Seung Jin Kim, Na Seong Lin and Kittack Hong, "The effects of European single market on Korea-EC trade patterns", paper presented at the Conference on the Future of Asia-Pacific Economies (FAPE IV), New Delhi, 11-13 March, 1991.