

# European Integration and the World Economy

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This symposium covers a vast topic—the implications of the development of trade and monetary zones—and many timely subjects.

As the only European on the overview panel, I shall try to present my general remarks from a European point of view. My intervention shall be based on the three following ideas:

- (1) The Common Market has stimulated its member states' economic growth and trade;
- (2) from a trade zone, the European Community (EC) has evolved into a zone of exchange rate stability and will soon become a single market. It is moving toward monetary union;
- (3) increased integration does not mean that the EC will close itself off from the rest of the world.

**The Common Market has stimulated crossborder trade as well as growth both in Europe and abroad.**

Since 1958, the primary and fundamental goal of the European Community has been to create a common market between member countries in which people, services, capital, and merchandise could circulate freely. It was in the area of merchandise that significant

progress was the most quickly obtained, thanks to the creation of a customs union; quantitative restrictions on intracommunity trade were lifted in 1961, and by 1968, all customs duties between members had been gradually abolished.

***The liberalization of merchandise trade prompted a sharp rise in intracommunity trade.***

The EC has progressively acquired a dominant position in the international community. With the considerable liberalization of trade, the EC has become the world's leading trading power, accounting for 36 percent of international trade today. Even if we exclude intracommunity flows (which now represent 22.3 percent of world trade compared with only 11.8 percent in 1957), the EC, as a whole, is still the world leader, accounting for around 18 percent of all world trade, intracommunity trade excluded.

Most of the European Community's trade is, indeed, carried out between member states. Since the creation of the EC, intracommunity trade has grown more quickly than world trade. Between 1958 and 1987, trade between EC members increased in volume terms by a factor of eight while world trade grew only by a factor of five. The proportion of intracommunity trade in the twelve members' foreign trade represented 43 percent in 1961 and 61 percent in 1990.

The liberalization of trade, which had as its main consequences intensified competition and a better use of economies of scale, undoubtedly played a major role in developing the EC's economic potential. As a result, the combined GDP of the twelve member states, which in 1960 represented only 57.7 percent of the American GDP, now accounts for 91.6 percent of the U.S. figure.

Economic integration has spread from the twelve nations of the European Community to the entire Western European area. Since the signature of free trade agreements between the EC and the European Free Trade Area (EFTA) in the 1970s in particular, trade between the two areas has increased noticeably. Today, EFTA is both the EC's leading importer and leading supplier, ahead of the

United States. Today, 70 percent of Western European nations' foreign trade is made within the EC-EFTA zone.

*The EC's trade relations with the rest of the world have strengthened markedly.*

First of all, the Common Market has not isolated the EC from the rest of the world; as it developed, the EC progressively reduced the common external tariff, which represented the only form of EC protection on industrial products, even if a few national quantitative restrictions remain.

While EC trade with non-EC countries (which increased in volume terms by a factor of 3.5 between 1958 and 1987) grew more slowly than intracommunity and world trade (respectively multiplied by 8 and by 5), it rose substantially nonetheless. Since the beginning of the 1970s, the lower level of growth can mainly be explained by the leveling-off, and even the slide, in the volume of exports to non-EC countries, and especially to areas in recession, such as Africa and Latin America. On the other hand, the volume of EC imports from non-EC countries has soared. The deficit in the EC's trade balance (CIF/FOB) with the rest of the world that appeared in 1987 has increased since, rocketing from 0.7 billion ECU (0.02 percent of EC GDP) to 42.9 billion ECU (1 percent of EC GDP) in 1990. European economic integration did not, therefore, penalize imports from non-EC countries but rather, actively furthered the development of trade and world economic growth.

It should also be noted that trade between Europe and other developed nations grew at about the same pace as trade between other areas. Trade between Europe and Asia increased in value by 10.5 percent each year from 1980 to 1989; during the same period, trade between North America and Asia rose by 11 percent per year. Similarly, North America's trade with Western Europe grew more quickly (+ 6.5 percent) than world trade in general (+ 5 percent).

**From a trade zone, the EC has evolved into a zone of exchange rate stability and will soon become a single market. It is already moving toward monetary union.**

The European experience shows that economic integration, the will to strive for exchange rate stability, and the implementation of converging economic and monetary policies are three complementary processes.

*The European Monetary System: a zone of stability and convergence*

Whereas monetary cooperation, in the form of the "snake," was a relative failure in the 1970s, substantial progress was made in the 1980s. In a world where floating exchange rates prevailed, the EMS helped provide significant stability to the participating countries throughout the 1980s, and contributed to a higher degree of convergence in economic policies and performances. The most striking success in this area was the general reduction in inflation rates and in their dispersion. Indeed, the member countries consider that disinflation is a requirement for healthy and lasting growth.

This emphasis on internal and external monetary stability progressively attracted the attention of certain other EC countries whose currencies were either fluctuating within wider margins or were not participating in the Exchange Rate Mechanism at all. In the last two years, the Spanish peseta and the British pound have joined the Exchange Rate Mechanism (in June 1989 and October 1990, respectively), and the Italian lira has entered the narrow fluctuation band (January 1990). In addition, three European countries that are not members of the EC (Norway, Sweden, Finland) have decided in the last few months to peg their currencies to the ECU as well.

*The completion of the single market*

Until the middle of the 1980s, European economic integration moved ahead in a rather uneven way. As we have already seen, merchandise trade was liberalized. Nontariff barriers continued to be used, however, and tended to become even tougher after the **first**

oil shock. The free movement of people and services lagged behind, and above all, progress on financial integration (the right to establish and provide financial services in any member country, the freedom of capital movements) remained very limited.

All of these imperfections led political leaders in the EC countries to give a new impetus to the EC's development in 1986, with a far more encompassing and ambitious project than ever before: the completion of the single market. It was in 1986 that the EC set as its goal the creation, by the end of 1992, of "a unified economic area in which people, goods, services and capital would be able to move freely." In essence, this meant completing economic integration by removing all administrative, tax, or technical barriers to free exchange, as well as competition between member states.

I would like to remind you that if the EC has managed over time to become a major power, it is because of the constant increase in competition between its members and because of each country's individual dynamism. By gradually eliminating trade **barriers**, it is the European Community's role to reveal each member **state's** true competitiveness (or its lack of competitiveness) and encourage efficiency and streamlined production methods. The approach adopted for completing the single market is in keeping with this thinking. Indeed, with the principle of mutual recognition, any product, service, or establishment of one member country will be able to circulate freely in the other member countries as long as it fulfills its home country's regulations. This is a very flexible principle that gives companies more initiative. It also encourages competition and even more liberalization when it comes to the conditions for exercising production activities in the different member countries.

The most important change, however, may lie in the prospect of creating—for the first time—an integrated financial area by 1993 including the right to establish and provide financial services in any other EC country, and complete freedom of capital movements. Most EC countries, in fact, have allowed the free movement of capital since July 1, 1990.

The completion of the single market will stimulate member states'

growth. According to the Cecchini report, with an unchanged macroeconomic policy, the single market's cumulative impact in terms of GDP should be an increase of 4.5 percent after five or six years (2.1 percent of which will stem from supply-side effects involved by the strengthening of both competition and market effects, and 1.4 percent of which will result from the liberalization of financial services).

### *The single market has led to the idea of monetary union*

The crucial decision to aim for a single market led the twelve countries' leaders to take a new and decisive step between 1988 and 1990 toward Economic and Monetary Union. In the long run, EMU entails setting irrevocably locked parities and moving toward a single currency. In an environment where capital movements are free, this implies formulating and implementing a single and indivisible monetary policy to be carried out by a single and independent body. This body will have a federative structure and its primary objective shall be to maintain price stability. Monetary union will also bring about tighter economic and budget policy coordination.

EMU is truly the natural and logical outcome of the single market. While the single market means that free competition will lead to unified price formation, it is also clear that a single currency is likely to amplify the single market's effects from the moment it is introduced by eliminating costs linked to exchange rate variability and uncertainty, as well as noticeable transaction costs (administrative costs, bank fees) which, according to the European Commission, now account for 0.5 percent of the EC's GDP.

Three stages have been set for the path to Economic and Monetary Union. The first stage, which began in July 1990 (at the same time as the last restrictions on the movement of capital were lifted), is mainly devoted to strengthening economic and monetary policy coordination within the existing institutional framework. In the second, transitional stage, which should get under way at the beginning of 1994, and which I believe should be as short as possible, the common monetary authority should be set up but would not yet exercise all of its prerogatives. The EC would move onto the final

stage—the single monetary policy—once sufficient convergence has been reached and transitional measures have been taken for countries which still have significant progress to achieve.

### **Increased integration does not mean closed doors.**

The European Community has always affirmed that it does not want to remain an "exclusive club." The expansion of the European Community toward Northern Europe in the 1970s and toward Southern Europe in the 1980s attests to this. But even stronger proof can be found in the multitude of trade and cooperation agreements that have been signed between the EC and non-EC countries or groups of countries—agreements that have successively become more and more wide-ranging. The constant reinforcement of agreements with EFTA over the last twenty years is about to lead to this creation of a "European Economic Area."

Recent developments in Eastern Europe naturally open perspectives for closer ties, but this can be done only gradually, given these countries' numerous structural difficulties. Outside Europe, the EC has for several years affirmed its desire to promote a better integration of the Third World in world trade, in particular through the various Lomé conventions.

### ***The European Community's increased economic integration and the added growth it will create will continue to benefit non-EC countries.***

The European Community has already made a large contribution to its major partners' trade and growth. The single market will give them an additional boost. With the system of mutual recognition, non-EC countries which want to export to or establish in Europe will no longer have to abide by twelve different sets of regulations, but just one. With more than 340 million consumers, the European single market will be the largest integrated market in the Western world. A recent United Nations study said that the single market would bring about an increase of 15 percent in imports from non-EC countries over five to six years.

*The perspective of the single market has led to a rise in direct investment toward the European Community, but this is, in fact, a worldwide phenomenon that is not specific to Europe.*

Since the second half of the 1980s, the members of the European Community have become more and more attractive to foreign investors. Foreign direct investment in the EC doubled between 1984 and 1988 to reach 14.2 billion ECU (\$16.2 billion). During the same period, the flow of investment between EC countries themselves grew even more noticeably—by a factor of 4.5—to reach 19.1 billion ECU in 1988 (\$22.5 billion).

However, this development was not made at the expense of other countries as it was due to a worldwide, rather than European phenomenon mainly attributable to the growing internationalization of companies. More and more European companies have become international in size, strengthening their ties with foreign markets and adopting a global attitude in their forecasts, strategies, and operations. In particular, mergers, acquisitions, and strategic alliances have become important methods of investment as companies try to boost their sales as quickly as possible at the lowest cost. This is the reason why the United States remains the leading beneficiary of foreign direct investment, according to the Organization for Economic Cooperation and Development (OECD); the flow of foreign direct investment grew more rapidly in the United States than in any other OECD country, and the EC has remained a net exporter of direct investment capital. The EC's direct investments outside the EC have increased noticeably (\$36.2 billion in 1988), and exceed, by far, those received by the EC from non-EC nations, as well as intracommunity investments. According to estimates from the EC's statistical office, each time an EC company invests 2 ECU in another member state, it also invests 3 ECU outside the EC.

*Europe: a major financial power?*

Already a major economic and trading power, Europe has every chance of becoming a major financial power given its considerable assets: a sound financial system, a universal bank system that has allowed Europe to spread its risks and deal in most financial sectors,



the generalized freedom of capital movements, smooth coordination among supervisory authorities, and a harmonization of prudential rules. The progress made in harmonizing regulations in the banking and financial sectors will also be an additional advantage for the EC's foreign partners.

I would like to note that both the creation of an integrated financial area and monetary union in the EC are being carried out in a regulatory framework characterized by a great deal of economic liberalism. As of January 1, **1994**, banks will be able to open branches and provide services outside their home countries according to the second banking directive of December **1989**. This directive sets the principle of mutual recognition of national regulations by which the authorization granted to an institution in its home country is recognized throughout the entire European Community. With this system, which is just like that for goods trade and direct investments, banks from outside the EC that want to establish in the EC will no longer have to comply with several different national legislations. I would also like to mention that the European solvency ratio was developed in keeping with the international rules set up by the Banking Supervision Committee of the **BIS** in Basle, both in its contents and in its timetable which calls for gradual implementation by the end of **1992**. Europe will thus be a major financial power open to the rest of the world.

The European example demonstrates that while the creation of a free trade zone tends to increase the share of internal trade in the total trade of the area, it does not necessarily lead to a closing of the area to the rest of the world. In any case, the European Community has always spoken out against an excessive compartmentalization of international trade and has rather campaigned for the development of trade between large trading blocks. The increasing concentration of trade around three large zones—Western Europe, North America, and Asia—as well as the temporary failure of the GATT negotiations have raised fears that these **blocs-in-formation** will close themselves off from external partners. It is, however, in everyone's interest that trade (of goods, services, and in particular, financial services) continues to be organized on a multilateral basis.

Regional organization should, therefore, be thought of more as a means of strengthening free trade and competition **between** countries with close geographical, economic, political, and cultural ties than as an independent system to replace the web of multilateral relations. This is true for trade and finance, and should also be true for currency. Far from being obstacles to multilateral relations, regional organizations should one day play an important role in spreading the rules of the economic liberalism they **practice** to the rest of the world. In this process, it will be the most dynamic organizations—those that have been able to create the largest growth potential and that have been the most successful in generating monetary stability and financial market confidence—that will be in the best position to provide the inspiration for the future "world model" that mankind will always dream of creating: