FRBSF Weekly Letter

August 12, 1988

1992: A United and Prosperous Europe?

The European Community (EC) was established in 1957 with high expectations that a common market would bring lasting economic prosperity to Europe. However, the EC has had difficulties living up to its promise. In recent years the EC countries have experienced lagging income growth, high unemployment, and a diminished ability to compete with the U.S. and Japan in high technology sectors. The stagnation of Europe compared to the U.S. and Japan, termed "Eurosclerosis," prompted European policy makers to accelerate the unification of the European market as a way of competing more effectively with the other industrial economic powers. In recent months, policy makers have approved measures that would, by 1992, liberalize capital flows, develop a compatible payments system, and permit the issuance of a single European banking license. These measures have attracted considerable attention and prompted a flurry of mergers and acquisitions within the EC in anticipation of 1992. This *Letter* reviews the plan for a united European market, its implications, and the prospects for its achievement. As a solution to the problem of economic stagnation and diminished European competitiveness, this plan may not be sufficient in the absence of other measures.

Eurosclerosis

The economic performance of Europe began deteriorating compared to that of Japan and the United States in the late 1970s. Since 1979, growth in the U.S. and Japan has outpaced that in the EC by an average of 0.5 and 2.1 percentage points a year, respectively. Unemployment in Europe has remained above 10.5 percent in the last five years, despite government programs designed to create jobs and retrain unemployed workers. Efforts to increase competitiveness in high technology sectors have met with little success, as the EC lost 1.4 percentage points of its market share in industrial exports to all OECD (Organization for Economic Cooperation and Development) countries from 1979 to 1985. In the same period, the U.S. increased its share by 0.7 percentage points and Japan by 5.4 percentage points. The EC's loss of market share is particularly troubling because the loss occurred in sectors where world demand has been growing most rapidly, such as electronics and information technology. The accompanying charts illustrate the EC's less favorable economic performance compared to that of the U.S.and Japan in the last decade.

Chart 1
Lagging E.C. Growth

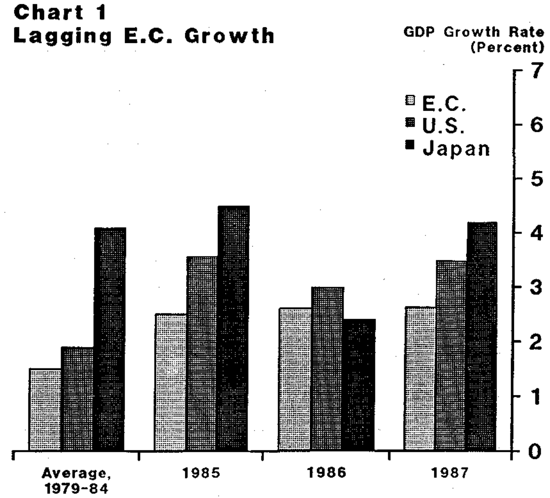
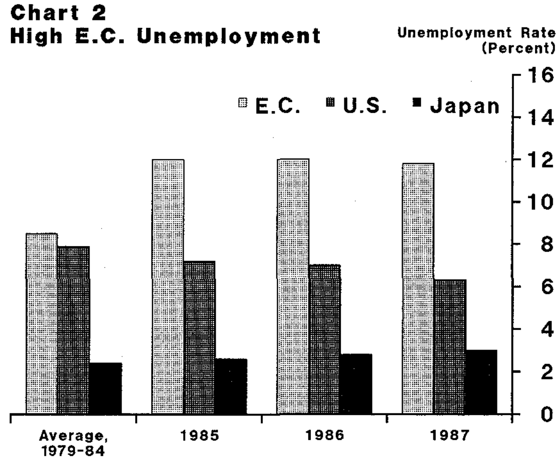


Chart 2
High E.C. Unemployment



Contractionary macroeconomic policies partly explain Europe's unfavorable economic performance and high unemployment in recent years. In particular, the major EC countries generally followed tight fiscal and monetary policies in the 1980s. Nonetheless, it is hard to attribute the prolonged stagnation of the EC economies to tight macroeconomic policies since similar policies were pursued in Japan.

Two other factors have played a major role in the poorer performance of the EC economies. The first is economic policies in EC countries that inhibit competition by reducing innovation and the incentive for firms to respond to market forces. Restrictive labor market practices that affect firms' abilities to hire and fire workers, as well as high bankruptcy costs, discourage risk-taking and the entry of new firms into the market, particularly the small entrepreneurial companies that frequently provide innovation in high technology and many new jobs. Government subsidies that typically benefit large and established firms and/or inefficient nationalized industries exacerbate this bias against competition and small companies. Also, significant barriers to external trade, including import quotas on cars, textiles, footwear, and electronics discourage competitiveness.

The second factor that has hurt the EC is setbacks to economic integration. The energy crisis and disruptions in the international monetary system in the 1970s prompted EC members to look after their national interests and to erect or reintroduce a variety of non-tariff trade barriers, including production quotas, subsidies to domestic firms, and cumbersome administrative procedures. By limiting the size of the markets within which European firms could operate, these measures may have contributed to Europe's lagging performance in recent years.

By the first half of the 1980s European policy makers were aware that they were losing ground to their main industrial country competitors. As a result, these policy makers sought to improve economic performance by accelerating the establishment of a truly unified European market. Unification, they assumed, also would improve the competitiveness of European firms.

The plan

In June 1985, EC members adopted a White Paper outlining an ambitious plan to create a fully integrated internal European market by 1992. The White Paper contains 300 directives for dismantling barriers to flows of goods, services, capital, and labor, and a timetable for accomplishing each. It covers four main areas: merchandise, services, capital, and mobility of professionals.

With respect to removing barriers to merchandise trade, the 1992 plan would eliminate a number of government subsidies and production quotas, and harmonize value-added taxes within the EC. By 1992, legislation establishing uniform safety and performance standards would permit goods satisfying these standards to be marketed freely throughout the Community. Border controls, which delay intracommunity shipments, also would be eliminated.

To remove barriers to services trade, banks would be granted a single European license, and banks already authorized to operate in one EC country would be permitted to open branches freely in other EC countries. Barriers to cross-border marketing of other financial services such as insurance also would be abolished. Trade in nonfinancial services would be stimulated by allowing open competition throughout the EC for most public works and supplies contracts.

Existing controls on financial transactions between member states would be repealed by 1992 to enhance capital mobility within the EC. Residents of any EC country would be able to open bank accounts in any other member country. Cross-border corporate mergers and acquisitions also would be facilitated.

Finally, the 1992 plan provides for enhanced mobility of professionals. University degrees and vocational training certificates would be mutually recognized, thereby enabling accountants, teachers, and other professionals to engage freely in their professions throughout the EC.

The White Paper was well received by the European Council of Finance Ministers, which has agreed to reach a legislative consensus on each directive before 1992. Seventy of the 300 directives proposed in the White Paper have been approved so far, and the Council expects to adopt 50 more in 1988.

The benefits expected from these measures are substantial. A study by the Commission of the European Communities estimates that if fully implemented, the 1992 program may double Europe's annual growth to four percent. The dismantling of internal trade barriers and the integration of capital markets will lower the cost of goods and capital within the EC, and promote more efficient allocation of resources. Europe will have the largest consumer market in the world by 1992, permitting firms to exploit economies of scale. Harmonizing safety and performance standards will further enhance efficiency. Research and development most likely will be spurred by increased competitive pressure and the changes in marketing strategy necessary to appeal to a market of 320 million consumers. These benefits will enable companies to lower prices, increase employment, and expand investment, setting the stage for faster economic growth.

Uncertainties

Although the progress that already has been made towards a united Europe is significant, skeptics question whether key directives in the White Paper will be rapidly and fully enacted. It has taken the Council three years to approve less than one third of the proposed directives, and there are major obstacles to approving a number of the remaining directives. For example, there has been no progress in eliminating some of the most glaring internal EC quotas and subsidies in agriculture, steel, and textiles.

Some EC members also are concerned that capital movements to other EC countries with lower taxes and higher investment yields may cause serious problems for exchange rate stability and domestic monetary policy. This raises the additional question whether governments will be able to pursue the convergent and non-inflationary fiscal and monetary policies that are required to guarantee the benefits and the stability of a unified market.

A more serious potential problem is that even if the 1992 plan is fully implemented, the benefits expected from a united Europe may not be realized. The 1992 plan assumes that a larger market will lead to greater competitiveness by lowering the costs of production and distribution within the EC. However, the plan does not tackle a number of economic policies within the EC that discourage competitiveness. For example, there is no specific provision in the plan to prevent governments from subsidizing their domestic manufacturing and financial sectors. Such subsidies could continue to insulate domestic businesses from competition even as other trade barriers within the EC fall. Instead, the plan relies on vigorous implementation of existing rules against anti-competitive subsidies, even though these safeguards have not been fully effective in the past. There also are fears that Europe will raise trade and finance barriers with the rest of the world while it "gets organized." A rise in such external trade barriers would further insulate European producers from competition.

The plan's failure to address these anti-competitive policies directly will diminish the potential benefits associated with economic integration. Experience suggests integration and large domestic markets are neither necessary nor sufficient conditions for stimulating competitiveness and growth. For example, the newly industrializing countries of the Asia-Pacific Basin with access to small domestic markets have proved formidable competitors in world markets and have experienced rapid economic growth. In contrast, many Latin American economies with much larger domestic markets have had difficulty competing internationally and have experienced sluggish economic growth, in part because of policies which discourage competition.

These examples suggest that economic integration alone may not improve Europe's sluggish economic performance. Other economic policies that discourage competitiveness also need to be changed. Otherwise, Eurosclerosis may persist, even if substantial progress is made in achieving economic integration in Europe by 1992.

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MONETARY POLICY OBJECTIVES FOR 1988

On July 13, Federal Reserve Board Chairman Alan Greenspan presented a mid-year report to the Congress on the Federal Reserve's monetary policy objectives for the remainder of 1988. The report reviews economic and financial developments in 1988 and presents the economic outlook heading into 1989. For single or multiple copies of the report, write to the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco, CA 94120, or phone (415) 974-2246.