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External Dimension of Europe 1992: Its Effects on the Relationship between Europe, the United States and Japan

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This article examines the impacts of the European Single Market on the economic and financial relationships between Europe, the United States and Japan. It argues that the external effects of the European Single Market will crucially depend on the magnitude of the EC's domestic growth bonus associated with the Single Market and the future course of its trade and financial policy vis-á-vis the rest of the world, and examines a range of related policy issues.

I. Introduction and Summary

From December 31, 1992, the twelve countries of the EC will comprise an area without internal barriers, in which the free movement of goods, services, labour and capital is ensured. While numerous studies have been carried out about the internal aspects of Europe 1992, systematic efforts have not been made to assess the implications of Europe 1992 for the EC's external policy and the relationships between Europe, the United States and Japan. Indeed, virtually no light is shed on the external aspects of Europe 1992 in the so-called Cecchini Report (1988) on the benefits of the European Single Market, nor in the EC Commission's complimentary publication (1988) on the economics of 1992.

It was in late 1988, three years after the introduction of the Single European Act, that the EC Commission provided some general information on its external policy in relation with Europe 1992. While it helped to ease some of the anxiety initially held by many trading partners of the EC regarding the possibility of "fortress" Europe, concern is still lingering on the EC's external policy on specific issues, such as the precise meaning of its declared principle of "reciprocity," "local content" requirements and anti-dumping measures.

Without embarking on detailed discussion on such specific issues of contention, this

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note briefly examines some broad policy areas in which the relationship between Europe, the United States and Japan may be affected significantly by the EC initiative of Europe 1992. Section II analyses the external trade aspects of the European Single Market and assesses the policy implications for extra-EC trade and foreign direct investment flows. Section III covers the external financial aspects of Europe 1992 as the liberalization of financial services is estimated in the Cecchini Report to play a major role in boosting economic gains from the European Single Market. Section IV discusses the need to work out a better framework for the triadic relationship of Europe, the United States and Japan, and identifies a range of policy issues on which cooperative effort by multilateral organizations involving the Triad is required.

Major conclusions are summarized below.

(1) Trade diversion is an unavoidable consequence of Europe 1992, even if the average level of EC protection for extra-EC trade is not raised. Whether or not, and the extent to which the United States, Japan, and for that matter the other trading partners of the EC, will benefit from Europe 1992, depend crucially on the magnitude of extra-EC trade expansion through its domestic growth bonus in the EC. They are also contingent on the actual course of EC protectionist policy with regard to its trade with the rest of the world.

(2) There may be strong domestic political obstacles to internal industrial reorganization which may also make it difficult for the Commission to stick to its declared intention of not raising the average level of protection for the EC, especially if macroeconomic conditions start to deteriorate. Transparency about protection through non-tariff barriers should be increased so that multilateral surveillance of protectionist moves can be carried out more effectively.

(3) While increased efficiency in the manufacturing sector can come importantly from scale economies, there is some evidence that the economic gain through financial market integration arises overwhelmingly from increased competition among financial institutions, and not much can be expected from economies of scale and scope. This finding lends weight to the view that the free provision of financial services by U.S. and Japanese financial institutions will add to economic gains for the EC.

(4) Closer cooperation and coordination among the responsible authorities are required to prevent increased international competitive pressure from eroding the soundness of financial systems, and to narrow disparities between national tax systems which distort the allocation of investment and savings across countries.

(5) In the longer run, all trading partners will benefit from multilateral and unilateral trade liberalization and the free movement of capital on the basis of the "erga omnes" principle applied on a world-wide basis. The EC, the United States and Japan should cooperate to work out a better multilateral framework for global market integration.

II. External Trade Aspects of Europe 1992

Trade diversion is an unavoidable result of Europe 1992. This will occur as low-cost producers outside the EC, who at present maintain the capacity to export competitively to at least some of the markets in the EC, will be displaced from the European Single Market by higher-cost local producers which will benefit from the elimination of barriers with respect to intra-EC trade after 1992. Trade diversion will take place even if the average level of external protection for the EC remains unchanged as stated by the Commission.

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

While the Commission's estimate of EC income growth bonus is derived from an analysis of the Cecchini Report on the once-and-for-all effect on resource allocation arising from Europe 1992 (Table 2), Baldwin (1989) estimates its possible dynamic effects through technological innovation and higher business investment. Applying the "new" growth theory developed by Romer (1983) and others, he suggests that Europe 1992 may add 0.2 to 0.9 percentage point to the long-term growth rate of EC output and income. This may accordingly accelerate the growth of extra-EC imports.

The possible geographical distribution of the external trade impacts on EC's trade

Table 1

Consequences of EC 1992 for EC Income in the Medium Term

Consequence of:	Change in EC GDP (%)
Eliminating frontier controls	0.4
Opening up public procurement	0.5
Liberalising financial services	1.5
Increasing economies of scale and productivity—supply effects	2.1
Total average (range)	4.5 (3.2–5.7)

Source: Commission of the European Communities (1988). "Economics of 1992," European Economy, No. 35.

partners coming from Europe 1992 has been analyzed by Stoeckel, et al. (1990). Simulations with their world trade model suggest that under the scenario where the EC's macroeconomic policy is assumed to be conducted in such a way that an increase in its international competitiveness derived from Europe 1992 is allowed to be reflected in the improvement of its trade balance, North American exports decline by US$ 36.2 billions (1988 prices) and Japanese exports fall by US$ 21.6 billions (Table 3). The negative

Table 2

Potential Gains in EC Economic Welfare from EC 1992

Gain	Billion ECU	% of GDP
From removing barriers to trade	8–9	0.2–0.3
From removing barriers affecting overall production	57–71	2.0–2.4
Gains from removing barriers	65–80	2.2–2.7
From exploiting economies of scale	61	2.1
From intensified competition	46	1.6
Gains from market integration	61–107	2.1–3.7
Total gain		
– For EC-12 at 1988 prices	174–258	4.3–6.4
– mid-point of above	216	5.3

Source: Cecchini (1988).

Table 3

Simulated Effects of EC 1992, by Region

(Changes in 1988, US$ billion)

Region	EC external surplus			No EC external surplus		
	GDP	Exports	Imports	GDP	Exports	Imports
EC	230.8	88.3	-80.3	230.8	20.0	11.8
North America	-20.8	-36.2	-25.3	5.4	2.1	2.7
Asia-Pacific	-12.3	-33.5	-31.7	-0.3	-0.2	0.5
Japan	-17.7	-21.6	-7.6	-2.0	-0.7	-0.4
Australia	1.2	-0.7	-1.5	0.6	0.3	0.2
China	0.2	-1.4	-2.1	0.2	0.0	0.4
India	0.4	-0.7	-1.3	0.2	0.1	0.1
Tigers	-0.8	-7.5	-6.7	0.0	0.0	0.0
ASEAN*	3.9	-1.1	-11.6	0.6	0.0	0.1
Other Asia	0.5	-0.4	-0.9	0.1	0.0	0.1
World	197.6	18.7	-137.2	235.9	21.9	14.9

Notes: ASEAN is all ASEAN members except Singapore. Figures are changes from base data in 1988 values.*
Source: Stoeckel, et al. (1990).

impacts on the exports of the EC's other trading partners are virtually nil except for those of South Korea, Taiwan, Hong Kong and Singapore which in the aggregate decline by US$ 7.5 billions. On the other hand, under the scenario where EC's domestic demand is boosted by expansionary macro-economic policy so that its trade balance remains unchanged, North American exports rise by US$ 2.1 billions while Japanese exports decline by US$ 0.7 billions. The impacts on exports by all the other regions are negligible.

There is a good deal of uncertainty about the numerical results of these studies. The final outcome will depend importantly on the actual course of external policy actions by the EC, which remains far from clear. There are at least three basic issues that need to be addressed.

First, there is the question about how industrial reorganization will proceed within the EC. An essential source of increased efficiency and competitiveness of the industrial sector in the EC is the achievement of greater scale economies. This means that the number of business firms must be reduced. The need for such restructuring can be illustrated by a plain fact that there are 16 manufacturers of electric locomotives and 12 industrial boiler-makers in the EC, whereas the United States has only 2 manufacturers in each of the two industries. One extreme assumption adopted by the Commission in estimating the economic gains from Europe 1992 was that 207 footwear firms will disappear out of the 739 firms now existing in the EC. In the simulations by Smith and Venables (1988), the United Kingdom is predicted to lose 46 of its 65 footwear firms. Losers in other industrial sectors in the process of reorganization should also be numerous and the associated pains could be great.

There is the risk that longer-run macro-economic considerations may be subordinated to the short-run socio-political requirements of reducing conflicts of interest in individual member countries and different local regions where losers are likely to be many. In any democratic society, political reality is such that reactions of electorate to imminent large changes in income distribution in the process of industrial reorganization can influence policy making. It may press the argument that the increased competitive pressure on losing companies in its district must be offset by protectionist measures against non-EC producers, especially if macroeconomic conditions in the EC start to deteriorate. Under such circumstances, dauntless courage and tenaciousness would be needed for the Commission to stick to its declared intention that the average level of external protection for the EC will not be raised.

Second, uncertainty arises partly from the fact that the effective degree of protection for each trading partner is not at all clear in the present situation. Through successive multilateral trade negotiations, the importance of tariffs as trader barriers in industrial countries was reduced remarkably in the post-war period, although the process of tariff reductions has slowed in most industrial countries since 1980. The average ratios of customs duties to the value of imports for the United States were 3.08 percent in 1980 and 3.53 percent in 1985, whereas the comparable numbers for Japan were 2.46 percent in

1980 and 2.42 in 1985.[1] The average ratios for EC countries other than the new members were somewhat lower both in 1980 and 1985 than those for the United States and Japan because of lower tariffs applied to intra-EC trade, but the declines between the two years were generally modest.

It is well known that data on average tariffs do not indicate the effective degree of trade protection. Indications are that in recent years there has been growing resort to non-tariff measures such as voluntary export restraints, antidumping actions and industrial subsidies. The UNCTAD (1988) noted that non-fuel imports of industrial countries subject to non-tariff measures rose from 19 percent of their total non-fuel imports in 1981 to about 23 percent in 1987. A study by the staff of IMF (1988) reported that the number of export restraint arrangements to protect EC markets stood at 138 in May 1988, while the comparable numbers were 62 for the United States and 13 for Japan (Table 4). It also noted that the increase in such protectionist arrangements was most remarkable for the EC during the period examined — September 1987 to May 1988 — when EC countries were already preparing themselves for Europe 1992.

Again, these numbers fail to convey the extent to which certain sectors are effectively protected, but they are enough to raise concern among non-EC trading partners about the credibility of the EC Commission's policy of not raising the average level of protection for the EC in effective terms. Difficult as it may be, cooperative efforts must be strengthened to quantify the effective degree of protection by major trading partners. Such efforts should include thorough and objective assessment of the view often expressed in the United States and Europe that intangible impediments such as administrative complications and restricted business practices in Japan make its domestic market practically inaccessible to foreign companies — the view often used as a justification for erecting and maintaining barriers against Japanese products.

Third, there is the risk that EC's trade policy may distort the international flow of direct investment and work as an impediment to a desirable world-wide allocation of resources, which should be determined by market forces. Subsidiaries of U.S., Japanese and other non-EC firms already operating within the EC should benefit along with EC firms from Europe 1992. An influential view in the United States (Peck, 1989) appears to be that, because many U.S. firms are already well established in most of the EC countries and have EC-wide marketing and production strategies, they may be better positioned to reap benefits from Europe 1992 than European firms. A recent survey in the United States (Lipsey, 1990) observes that most U.S. firms do not feel a strong need to accelerate their direct investment for new entry into the EC markets in preparation for Europe 1992. The preparations for 1992 may take the form of intra-European mergers and acquisitions rather than of acquisitions by U.S. firms.

On the other hand, the presence of Japanese firms in the EC is far more limited than

[1]The applied weighted average tariff rate for Japan in January 1989 was 1.9 percent.

Table 4

Export Restraint Arrangements, 1987–88[1]

	September 1987	May 1988	Reported Increase Between September 1987 and May 1988
Total export restraint arrangements[1]	135	261	126[2]
By sectoral composition			
Steel	38	52	14
Agricultural and food products	20	55	35
Automobiles and transport equipment	14	17	3
Textiles and clothing[3]	28	72	44
Electronic products	11	19	8
Footwear	8	14	6
Machine tools	7	7	–
Others	9	25	16
By protected markets			
European Community	69[4]	138[5]	69
United States	48	62	14
Japan	6	13	7
Other industrial countries	12	47	35
Eastern Europe	–	1	1

[1] *Includes voluntary export restraints, orderly marketing arrangements, export forecasts, basic price systems, industry-to-industry arrangements, and discriminatory import systems. Excludes restrictions under the Multifiber Arrangement.*

[2] *Of the reported increase, almost half were in existence prior to 1988 but were reported by GATT only in 1988.*

[3] *Excludes restrictions under the Multifiber Arrangement.*

[4] *Includes 20 arrangements involving individual EC member states.*

[5] *Includes 51 arrangements involving individual EC member states.*

Source: Kelly, et al. (1988).

that of U.S. firms. However, Japanese direct investment into the EC has accelerated in the past few years. A survey conducted recently by Japan's Ministry of International Trade and Industry (1990) indicates that the surge reflects both Japanese businessmen's expectation of high growth in the EC market through the 1992 market integration and their concern about protectionist pressures in the EC. Adverse reactions to a surge of Japanese direct investment have been manifested in certain member states of the EC. In some of them, "local content" requirements have been imposed, although there are some Europeans (Andersson, 1989) who worry that these kind of measures threaten the quality of Japanese goods manufactured within the EC. The United States government expressed the view that any EC restrictions against imports of Japanese cars, even transitional ones, should not inhibit sales of U.S.-built Japanese nameplate cars in the EC. At the same time, it stated that EC car policies should not act as artificial inducements for U.S. auto parts producers to establish plants in Europe.

III. External Financial Aspects of Europe 1992

The EC initiative for monetary and financial integration consist of three distinct but interrelated components: free capital movements; freedom to provide financial services; and the creation of European Monetary Union. While the first two components are both integral parts of the plan to complete the European Single Market by the end of 1992, the time-frame and the form to be taken for monetary union beyond Stage 1 remain undecided. This section assesses the external policy implications of the first two components and ends with some very brief comments on the third component.

A. Free capital movements

Liberalization of international capital flows within the EC is the first major component of Europe 1992, which has been fully implemented before the agreed deadline of July 1, 1990 by all the EC countries (except the newest members) in their joint task. Controls on international capital flows produce a wedge between risk-adjusted real returns on domestic investment and saving in different countries with different propensities to invest and save. Elimination of exchange controls should lead to higher real rates of return to savers in surplus countries and lower borrowing costs to business enterprises in deficit countries through narrowing international spreads between borrowing and lending rates in real terms. Thus, Europe 1992 will contribute to a better allocation of saving and investment across the EC member countries.

Economic gains from the free movement of capital will be greater when it is achieved on a global basis than when it is limited to transactions within the EC. The possibility of lowering the real cost of capital to firms in deficit countries would be greater if they are allowed to have free access to borrowing opportunities in surplus countries outside the EC as well as those within this area. It is therefore quite appropriate that the Directive adopted by the EC Council embodies the principle of an "erga omnes" liberalization of capital movements.

B. Freedom to provide financial services

Freedom in the provision of financial services within the EC constitutes another essential component of the plan towards financial market integration by the end of 1992. In theory, economic gains from removing restrictions on providing financial services can come basically from two sources: increased competition among financial institutions and economies of scale and scope in financial services. If economies of scale and scope are the major source of economic gain, the policy implication is that steps should be taken to increase the size of EC financial institutions for example through mergers, and to widen the range of their business activities. If, on the other hand, increased efficiency from competition is the dominant source of economic gain, measures should be taken to promote more competition through the elimination of impediments to new entry by competitors both domestic and foreign. It is therefore crucial for EC policy makers to identify the relative importance of increased competition and economies of scale and scope as the source of economic gains from financial market integration.

In the Cecchini Report, however, no clear indication is given about the relative importance of these two sources of efficiency gains from financial market integration within the European Community. Recently Dietrich (1990) has attempted to shed some light on this issue. Based on data for some representative banks in each of the EC countries and the three non-EC countries, Austria, Finland and Sweden, he has found that there is no evidence of economies of scale in their banking operations. The finding by Dietrich is consistent with existing evidence in the United States and Japan. For example, Benston, Hanweck and Humphrey (1982) find in U.S. banking data for 1978 that economies of scale are very limited beyond a minimum efficient scale of about $25 million in total assets. A broadly similar conclusion is reached by Kasuya (1989) for Japan. While these studies based on U.S. and Japanese banking data do not negate the possibility of economies of scope, it would be reasonable to assume that the additional economic gain from this source in the EC countries would be very small, given the fact that universal banking is already in place in major EC countries such as Germany.

While these findings must be treated with all due caution, they suggest that economic gain from financial market integration in the EC should come largely from increased competition. The presence of foreign banks, in particular, those of the United States and Japan, and the possibility of their new entry into EC financial markets should contribute to increased competition for financial services and hence economic gains in EC countries, although, because of the presence of asymmetric information and monitoring costs between lenders and borrowers, the role of foreign banks may be limited in promoting regional economic development within the EC.[2] At the same time, European banks should be encouraged to contest more vigorously for banking and other financial services in the United States, Japan, and the rest of the world. Given their power to conduct universal banking, they should also be encouraged to operate more actively as intermediaries to facilitate the flow of non-bank capital, in particular direct investment capital, into any places both within and outside the EC where risk-adjusted market rates of return on investment are comparatively high. This global perspective of European banks would also enhance the benefits to be accrued to European savers.

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[2]Montgomery (1988) argues that local banks in the EC have a natural advantage in evaluating and monitoring local non-bank borrowers, and that this creates a two-tiered financial system within the EC, which consists, on the one hand, of wholesale banks that deal with each other and with large business firms and, on the other, local banks which borrow and lend locally.

One aspect of the EC's external policy that gave rise to concern in both the United States and Japan was the treatment of foreign banks as providers of financial services within the EC market after 1992. This is partly because U.S. and Japanese financial firms had a good deal of interest already vested in Europe before the single-market initiative started (Table 5). The source of main concern was the "reciprocity clause" in the initial proposal for a Second Banking Coordination Directive. The vagueness of the original draft added to the confusion of the debate. Some feared that they might mean mirror-

Table 5

Number of Branches, Subsidiaries, and Representative Offices of Foreign Banks in Major Financial Centers

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

**Excludes UK banks.*

Source: "Foreign Banks in London" The Banker, Nov. 1980, Nov. 1985, and Nov. 1989; "Foreign Banks in New York" The Banker, May 1985 and June 1989; "Annual Report of the Bureau of International Finance" Ministry of Finance of the Japanese Government.

image, or identical, reciprocity which would allow a bank from a non-EC country to conduct only those activities in EC markets that EC banks are permitted to conduct in the foreign country.The final version of the EC Second Banking Directive stipulates that whenever it appears that a country is not granting Community banks effective market access comparable to that enjoyed by the third country's banks within the EC market, the Commission may initiate procedures to remedy the situation or, in some circumstances, may limit or suspend the request for authorization of a banking license in the Community.

The problem of reciprocity arises basically from the co-existence of different financial regimes and restrictions in EC countries, the United States and Japan. In EC countries, after 1992, the Second Banking Directive will allow banks to conduct any operations, including securities activities, listed in the Directive and permitted in their home country, regardless of regulation by the host country. The EC strategy is likely to lead to a unified financial market based on the system of universal banking which already exists in some EC member countries such as Germany rather than the system based on specialized financial institutions. On the other hand, financial systems are more segmented in the United States and Japan. In the former, commercial banking is separated from investment banking by the Glass-Steagal Act. Japan's financial market is even more segmented than that of the United States, because there are several different types of banking institutions each with its own separate capacities.

A brief review of the treatment of foreign banks in the United States and Japan would be relevant in this context. In the United States, the operations of foreign banks in the U.S. market are subject to federal regulations under the International Banking Act of 1978 which adopted the principle of national treatment. The extraterritorial application of U.S. federal regulations have been limited by grandfathering the interstate deposit-taking offices and the securities affiliates of foreign banks in the United States. However, some foreign banks argue that some elements of discrimination exist at the level of state regulation in the United States. During the 1980s states have introduced "regional compacts" which permit banks from other states to acquire local banking institutions. But, in some states, foreign banks are not allowed to enjoy the benefits of these interstate compacts. Be that as it may, on the whole foreign banks seem to enjoy de jure and de facto national treatment at both federal and state levels.

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

It is of course not clear at this stage how the EC's principle of reciprocal national treatment will be implemented in specific circumstances after 1992. In the meantime, there appear to be increased concern in the United States about the competitive position of U.S. banks in the global market, and growing awareness that it is affected by the range of statutory restrictions in their home country than by restrictions imposed on their operations by foreign countries. Many economists in the United States support the view that the international competitiveness of the U.S. banks would be improved by the elimination of remaining restrictions on interstate banking. In Japan, study is under way about various approaches to restructuring the domestic financial system, including those involving the establishment of banks' separate subsidiaries for securities business. It remains to be seen how the balance between arguments for and against such approaches will be influenced by the EC's Second Banking Directive which will allow EC banks to conduct a wide range of activities including securities business under the "single banking license" concept.

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

C. Steps towards European Monetary Union

While free capital movements and freedom to provide financial services are two essential components of the plan to establish the European Single Market by the end of 1992, the process of monetary union remains uncertain. Indeed, Stage 1 of the process started on July 1, 1990, but the time schedule and the form to be taken by the second and third stages of monetary union are still a matter of controversy. Whatever form the later stages may take, price stability should be accorded the highest priority in decision-making arrangements. The working of the European Monetary System which started in 1979 has been asymmetrical in the sense that West Germany sets its price stability target independently and pursues its monetary policy autonomously to achieve the lowest inflation rate among the member countries while the other countries adjust their interest rate policies to stabilize their exchange rates against the Deutsche Mark. The extent to which this feature of asymmetry has contributed to bringing their inflation rates down to the German level and what it implies for decision-making arrangements for European Monetary Union are matters which deserve careful analysis. In any event, what is clear from the experience of the EMS is that a firm commitment to a clearly defined price stability objective is essential to the credibility of European Monetary Union. Externalities of European Monetary Union in this setting would be beneficial. Central banks in the United States and Japan would be assisted in their own efforts to achieve and sustain non-inflationary growth, if price stability is the top priority of EMU.

IV. Toward a Better Framework for Global Integration

Despite the statements by EC leaders that the Community will not reinforce barriers to extra-EC trade, concern still remains among the EC's trading partners that EC 1992 will lead to "fortress" Europe. Stoeckel, Pearce and Banks (1990) estimated the effects of "fortress" Europe through simulations with their world trade model. Their findings suggest that all countries and regions, including the EC itself, would lose from higher protection by the EC. This is in contrast to the case of a more liberal policy of the EC with respect to extra-EC trade which is estimated to give a substantial gain to the world economy, the largest gainer being the EC itself. Their model also shows that retaliation by North America would result in losses for all major trading partners, and that unilateral liberalization by North America and countries in the Asian-Pacific region would improve their own economic welfare (Figure 1).

Although the precise numerical results of their simulations should be taken with a grain of salt, the broad policy message from their work that trade liberalization measures pay off even if they are taken unilaterally, must be well taken. Indeed, the overwhelming body of evidence indicates that protection entails a net social cost by distorting resource allocation and weakening competition. It is true that a large part of this evidence is based on the traditional theory of comparative advantage in perfectly competitive markets. But the case for free trade is not necessarily weakened by the "new" trade theory which emphasizes the importance of scale economies and imperfect competition. A recent report by the OECD (1989) concludes that the existence of imperfect competition and

Figure 1. Payoff Matrix from EC and North American Protection or Liberalization

(Changes in GDP in 1988, US$ billion)

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

Source: Stoeckel, et al. (1990).

scale economies actually increases the potential gains from free trade, and these gains will be large in sectors where entry and exit are relatively free.

Given this, there is a pressing need for working out a better framework for global market integration as set out below. Its success will depend essentially on cooperative effort by all members in the Triad: the EC, the United States and Japan.

— It is crucial to arrive at a successful resolution of contentious issues in the Uruguay Round and reverse the trend towards protectionism. The institutional framework of the multilateral trading system should be strengthened by setting up an effective trade policy review mechanism within the GATT which involves the EC, the United States, Japan and other trading partners.

— Action to strengthen the international trading system should be supported by free international flows of direct investment. Efforts have been made within the OECD to promote liberalization of foreign direct investment flows through the OECD Code of Liberalization of Capital Movements and the National Treatment Instrument, which call upon member countries to treat inward direct investment and the local activities of foreign-controlled firms on an equal or equivalent basis with domestic firms. In accordance with the request made by OECD Ministers at their meeting in May this year, the OECD should strengthen the National Treatment Instrument. Moreover, in line with the wish expressed by the leaders of G-7 nations at the Houston Summit in July 1990, the IMF and the multilateral development banks should encourage investment liberalization in their programmes for Central and Eastern Europe and developing countries.

— Because of the externalities of structural reforms to improve economic performance in individual countries, such reforms should be subjected to multilateral surveillance. Over the past few years, the OECD has made major contributions to identifying priority policy areas for structural reforms in individual member countries. At the Houston Summit, the G-7 leaders encouraged the OECD to strengthen its surveillance and review procedures, and to find ways of making its work more effective. The EC initiative of Europe 1992 and bilateral negotiations such as the U.S.-Japan talk on structural reforms should be consistent with this activity of the OECD.

— Competition policy should be strengthened both within and outside the EC as an instrument for promoting domestic structural reforms. In its 1989 Report to the Ministers, the Economic Policy Committee of the OECD noted that the effectiveness of competition policy continue to be threatened by domestic subsidies and by border protection. It stressed the importance of treating domestic and foreign firms evenhandedly and maintaining an open and international trading system, undistorted by subsidies. Following the mandate by the Ministers, the OECD should make further effort to increase transparency of subsidy programmes in member countries.

— As regards financial markets, recent amendments in the OECD Codes, which extend liberalization undertakings of the member countries to the full range of capital movements and financial services, should provide new impetus to the liberalization process. The EC initiative of Europe 1992 should continue to be reviewed in the light of the Codes. Closer cooperation and coordination between national systems of prudential supervision are called for to ensure the safety and soundness of financial markets within a framework conducive to innovation and competition. The BIS should play a key role in this area.

— The free flow of capital and the globalization of factor and product markets may increase the possibility of differences in national tax policies leading to distortions in the allocation of investment and savings across countries. Closer cooperation among the responsible authorities may be required to narrow disparities between national tax systems.

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