1 Introduction

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1 Enlargement and integration

The enlargement of the European Community (EC) is the expansion which brought in Greece in 1981 and Spain and Portugal in 1986. For want of a better term, we shall refer to the three recently added members of the Community as 'the newly integrating countries' (NICs) of the EC. The integration of the NICs is made more complex by the fact that the EC and its European environment are changing so fast. Thus the problem of transition includes the effects on the NICs and on the rest of the EC of the mutual desire to achieve an integrated European economy.

On the internal front, the single market initiative embodied in the Single European Act of 1985 will abolish by January 1993 a wide range of barriers to trade within the Community, including customs procedures, local quality regulations, and many similar constraints. Deepening and broadening the existing European Monetary System (EMS) will amplify the single-market effects and may induce an even greater growth momentum than was observed in the past eight years. By raising the standards of convergence of performance and policies among heterogeneous countries, however, the objective of a single currency will also raise the risks of divergence of living standards across the European economies.

On the external front, the attractiveness of the Community as a whole has been dramatically illustrated by the requests for assistance following the rebirth of democracy in central and Eastern Europe. Further enlargements or deeper forms of association with neighbouring countries are therefore likely. These will affect the degree of divergence among the current members, but in which direction it is hard to predict. Pessimists will claim that the re-emerging Central European division of labour will threaten cohesion among the Twelve. Optimists will argue that a broader market will bring the NICs closer to the EC core.

Uncertainty attaches to the question of what changes will be brought about by the single market. The road to the single currency, let alone the objective, remain controversial for some EC member states. Excessive state intervention and regulation, protected and inefficient industry, obsolete and stagnant financial systems, low wages and low productivity; these are not invariable features of the NICs. Yet they are found even in Spain, the least 'southern' of the NICs. The optimists and the pessimists alike will look to the NICs for an indication of what a single market and currency might bring. In those countries both the greatest benefits of the reforms and the most awkward transition problems may be encountered.

For this reason, an examination of these countries can illuminate the general issue of what full membership of the single-market Community en route for economic and monetary union will entail. This will in turn shed light on possible future enlargements – Austria and Turkey – as well as on the upgrading of relations with the European Free Trade Association (EFTA) – the creation of the European Economic Space – and last but not least the prospect of a Common European Home.

2 Unity with diversity

Unification raises many issues and it would be a mistake to attempt a comprehensive list. The issue of convergence versus divergence often arises, however, and may help to focus the enlargement and integration discussion. Of course both tendencies will assert themselves and policy will often be addressed to influencing the consequences of unification in this regard. Unification will necessarily imply a considerable convergence of goods prices and of the environment of regulations and institutions within which producers and factors will operate. We shall call this regime convergence, and unity in the title has that connotation. It does not follow that regime convergence will cause the regions of the Community, or particular member countries, or like groups, such as industrial workers, to experience convergence in the sense of the constituent economies of the Community tending to become more alike. On the contrary, divergence may be the outcome.

The theme of this book is that both convergence and divergence are likely to result. Indeed, diversity is what we observe in the experience of the three NICs. While we would take their diversity to be fundamental in their European heritage – and indeed in what is sometimes called European culture – an enduring disparity of living standards among the twelve member countries would threaten mutual political responsiveness. In time the disparity of living standards across the Common European Home will be questioned along similar lines. Hence diversity and unity interact on the internal and external fronts.

Regime convergence will not always lead to uniformity of local situations. For example, Community-wide codes and regulations for banking and finance may not eliminate the local market effect on conditions experienced by borrowers, just as national codes have not eliminated local financial markets. Also, greater regime unification may result in actual conditions moving further apart. Countries and regions may increase the extent of their specialization when the market is enlarged. This suggests that convergence and divergence coexist and that whether convergence or divergence dominates depends on the particular situation: initial conditions, national and worldwide developments and policy responses at the regional, national and international level.

Standard trade theory teaches that international exchange will often tend to make countries more alike with regard to standards of living and more unlike with regard to production activities. The arguments pointing to that type of outcome are powerful and should not be lightly dismissed. But taking scale economies and imperfect competition into account, as has been increasingly done over the last ten years, substantially qualifies these long-accepted presumptions.

The finding that freeing trade will tend to make for a divergence in the pattern of production specialization turns out to be more robust than the conclusion that living standards will tend to converge, or even to improve everywhere. It is possible for an enlarged market to exhibit a strong centripetal tendency and for the peripheral regions or countries to suffer an absolute decline.

Three factors which counter that tendency need to be taken into account:

(1) As long as the periphery remains a source of cheap labour, it will compete for mobile, and especially labour-intensive, activity;
(2) Labour migration out of the disadvantaged regions should raise the standard of living, at least of the migrants, and ideally of those who remain behind; and,
(3) Policy directed towards raising income in the periphery may offset what would otherwise be net losses. The policies might take the form of direct transfers, might involve the partial subsidy of investment, or might consist of assistance to adjust through, for example, retraining.

The picture has been painted with a very broad brush. To obtain a clearer view one has to look at the particular, which is what the following chapters do. The chapters divide according to how they select their specific approach. The issues of structural interventions, trade and financial liberalization, complemented by a supra-national view of the

European car market, are addressed by the first collection of papers. Building on the issue papers, three country studies describe the present state of the newly integrating national economies and point up implications for their further integration into the European economy.

3 Adjustment and compensation

What can economic theory teach us concerning such radical economic reforms as the single market initiative or the 1988 decision to use the new Community structural funds to enhance economic and social cohesion? Christopher Bliss offers the twin concepts of identification and addressing to illuminate the problem of helping groups adversely affected by reforms. The former concerns the selection of the groups to be assisted, the latter the choice of the mechanism for delivering assistance. The two need to be considered together because a process of self-selection frequently operates.

With regard to identification, losses that are due to reform and losses, or relative disadvantage, that are due to unrelated causes stand side by side, for there is no good reason to differentiate strongly between them in the way that the Pareto compensation principle does. The ideal mechanism is the lump-sum transfer, a once-for-all pay-off of the minimum cost of a loss. Only unanticipated compensation schemes are lump-sum and non-distorting.

Although self-selection is a good principle to aim for, it may be that no scheme that achieves what is wanted will also meet this requirement. An appealing idea is that parties should be compensated for the cost of adjusting. It is argued, however, that subsidy for adjustment is only an ideal mechanism where paternalistic considerations or externalities bulk large. Questions of dynamics and future responses raise substantial problems. Once-for-all payments for the costs of reform and a refusal to pay more later may not be a credible strategy.

The Community is concerned with the reduction of inequality as well as with compensation for the cost of change. It proposes a loosely specified application of its structural funds to achieve these ends. The concept is correct. In some versions, however, this programme could prove to be extremely expensive. Otherwise the coverage may have to be disappointingly narrow. Focusing on accelerated adjustment will not necessarily narrow the scope and control the cost. If rapid adjustment generates external economies, then it should in principle be subsidized. Yet the gains may be private or the externalities negative. Some formula will be needed, but this one seems questionable. Confounding aid for adjustment with assistance for the unfortunate may lead to ineffective unfocusec intervention. The Community's problem is similar to those addressed by various national regional policy programmes. These have often disappointed, and the Community should seek to learn from these experiences.

Bliss also emphasizes the need to maintain adherence to the principle of openness and expanded trade with the outside world. Internal reform and external trade relations interact in complex, even obscure, ways. There is a danger that the commitment to openness will amount to little more than the avoidance of extreme injuries from trade, and that trade policy will become a mechanism for alleviating internal stresses within the Community, including the problems which the structural funds were meant to obviate but to which they may in practice prove unequal.

In his comment, Michael Emerson argues for a more precise description of the objectives of the structural funds. Specifically, equalizing resource endowment and securing regime change are as much central concerns in the application of Community policy as are the regional issues emphasized by Bliss. Equalizing resource endowment involves ensuring that all regions have the infrastructure to permit them to 'accept the full force of EC competition'. Regime change is a similar concept with a still broader reach. The structural funds are a sweetener which may help to persuade the weaker EC members to risk the perilous switch away from 'protectionist state corporatism'.

4 Trade liberalization and catching up: another U curve?

The effects of reducing trade barriers between national units which vary in market size and wage level are examined by Paul Krugman and Anthony Venables. In the context of the popular constant-returns-to-scale perfect-competition trade models, the size of the domestic market is unimportant, and, provided that factor availability does not differ excessively, trade allows the periphery to find employment for its labour at the same level of wages as is paid at the centre.

Krugman and Venables show that these conclusions are profoundly altered when increasing returns to scale and an imperfectly competitive sector are introduced. There are clear implications here for the European Community. The addition of new members and the 1992 single market reforms both constitute reductions in barriers to trade, and the importance of increasing returns, and of imperfect competition and oligopoly, are generally conceded.

The country is not the natural unit to consider. Rather the centre will be a densely populated region with a high wage level, corresponding in Europe to the North–West industrial region centred on Belgium. The periphery may be thought of as Ireland and Southern Europe, including the three NICs. The advantage of the periphery is its low wage level. The disadvantage is the small size of its market.

The choice of industrial location may show a U-shaped response to a lowering of barriers to trade. If barriers are huge, production has to be located close to individual markets. The periphery attracts some manufacturing production, but its low labour costs do not suffice to attract industrial production destined for the centre. With moderate barriers to trade, economies of scale dominate and production is concentrated at one point, which will then be the centre with its large market. Finally, when there are very low barriers to trade, production is pulled to the low-cost production point, and the periphery becomes the manufacturing producer.

Whether lowering barriers to trade will help or harm peripheral industry involves a genuine ambiguity. It is important to note that the welfare issue is by no means identical with the location issue. Even when location is unaffected the small country benefits from a reduction in trade barriers because of increased competition among sellers in its home market. The model indicates that these welfare benefits are large.

In his comment, André Sapir stresses the unusual nature of the message that location matters. Drawing an analogy with Korea, which 'remains badly located', he sides with the optimists: 'neither Greece nor Portugal will remain in the periphery if they succeed like Spain in building a sufficient infrastructure'.

5 The European car market: a specific case of adjustment

The results of a computable model of the European car market are presented by Alasdair Smith in a modified version of his and Venables' well-known model. As is often the case with an exercise of this kind, as much interest attaches to the input of assumptions and the special considerations that have to be taken into account as to the conclusions.

The European car market is modelled as an imperfectly competitive environment, with access by outsiders, especially Japanese exporters, importantly restricted by voluntary export restraints (VERs). As in the Krugman and Venables model discussed above, a quantitatively important effect on welfare is the lowering of prices in regions in which the enlargement of the market strengthens competition.

When markets are merged, their individual VERs have to be consolidated into a Community-wide VER. It is shown that the outcome, say for welfare levels, is highly sensitive to the level at which the overall VER is set. A VER of given size is more costly in an integrated market than with segmented markets. The analysis is oriented towards computing short-run effects with a fixed number of firms. The authors note, however, that some of the effects modelled are so large that substantial long-run restructuring is no doubt implied.

6 Financial liberalization and integration

When the 1992 legislation on financial markets removes all formal restriction on capital movements, it will not be possible for a country which pegs its exchange rate to the EMS grid to pursue an independent monetary policy. Even a country which is outside the EMS but targets its exchange rate on the EMS, say by the stabilization of the real exchange rate with the EMS, will forfeit an independent monetary policy. Monetary policy cannot be applied both to stabilizing the exchange rate and to stabilizing the domestic economy against real shocks.

This seems to be a striking example of convergence, in this case of macroeconomic policies. If, however, macroeconomic policy must converge and disturbances to individual countries are separated and distinct in their timing and scale, convergence of policy will be associated with a divergence of individual instability, against which the authorities will be powerless to act.

William Branson argues that the above simple and familiar conclusion needs substantial qualification when local financial intermediaries enjoy an advantage in assessing and monitoring local borrowers. This is an instance of the well-known conclusion that imperfections of information importantly affect how the capital market operates.

The local intermediary enjoys a partial monopoly power, purchased with the overhead outlays necessary to gain the information and expertise with which to assess and monitor local borrowers. A two-tier interest rate system results, with a higher rate being paid by the small local borrower. The local intermediary and its depositors earn a surplus which is the difference between the high local lending rate and the common international rate of interest paid by the usually large internationally creditworthy borrower.

The existence of a two-tier market does not allow the domestic monetary authority to regulate the local rate of interest by altering its own money supply. Monetary policy as such remains constrained by the requirements of a fixed exchange rate. Other instruments which regulate local lending, however, such as credit ceilings, and especially the deposit rate paid by the intermediary, will affect the cost of credit to small borrowers in the domestic economy independently of the level of the international rate of interest.

An extra degree of freedom for the domestic monetary authority follows from its ability to regulate the local financial intermediary, and with that freedom comes the possibility of applying a domestic stabilization policy even when the exchange rate is fixed. A clear implication of this line of argument is the idea that national governments should aim to maintain control over the financial intermediaries that operate within their borders.

Another point emphasized by Branson is the radical consequences for the NICs' financial sectors implied by the structural reforms which follow the opening up of banking to international competition and the imposition of common regulatory principles. In Greece and Portugal (and also in Turkey) administered interest rates and credit rationing have favoured public enterprises and large capital-intensive private businesses. The consequence has been a kind of dualism, with costs of borrowing and marginal returns to investment differing markedly between the favoured entities and small-scale private business. Also, the balance sheets of some financial institutions are burdened with a mass of non-performing debt. Hence an abrupt liberalization could be followed by business failures, public deficits and unemployment.

Where fiscal policy is concerned, Branson argues that because stability of incomes increases factor mobility, there is a complementarity between an integrated fiscal system, such as that provided by the Federal Government in the USA, which stabilizes incomes against local fluctuations, and the factor mobility which aids adjustment in the face of fluctuations in demand.

Paul Krugman's note on macroeconomic adjustment and entry to the EC models a policy dilemma well-advertised by the example of Spain, but equally applicable to Portugal, Greece, or any country outside the narrow band of the EMS. A country which chooses to enter the exchange rate mechanism, or even to align its exchange rate informally with the EMS, has to take an important decision as to what level of its exchange rate to select. Moreover, argues Krugman, there is an essential asymmetry in the costs to the policy-maker of aiming too high or too low. Rolling back the real consequences of an undervalued exchange rate by creating a bit of extra inflation is less costly than repairing the consequences of an overvalued exchange rate by contractionary policies.

This asymmetry encourages the policymaker to aim low. Capital markets, however, always aim for the centre, as a systematic bias reduces profitability. The resulting conflict between the exchange rate which the policy-maker would like to start out with and the exchange rate which capital markets regard as right is the macroeconomic policy dilemma.

A characteristic outcome will result when the government tries to use monetary policy to hold down the exchange rate below the level which the capital market would otherwise think appropriate. This in turn leads to an expansion of the economy and to inflation. The inflation which the government wanted to keep in hand, in case its estimate of the right level for the exchange rate should turn out to be too low, is forced on it at the outset. In a version of the IS–LM model discussed by Branson, the author shows that a combination of looser monetary policy and tighter fiscal policy would provide a solution to the macroeconomic policy dilemma. Whether such a policy combination would be feasible depends on the particular case. For Spain a rough calculation suggests that a very severe fiscal tightening would be required.

Vitor Gaspar's joint comment on Branson and Krugman is concerned to refine those authors' arguments rather than to refute them. For Krugman's model he proposes that expectations about future exchange rates should be endogenous. Employing the strong assumptions of fixed long-run output and purchasing power parity, Gaspar derives an expression for the steady-state equilibrium exchange rate. It follows, for instance, that financial integration, by lowering the risk premium and transactions costs, will tend to lower the real exchange rate. Also, encouraging domestic saving emerges as an alternative to Krugman's fiscal tightness.

In response to Branson's paper Gaspar considers the question of the sustainability of public sector budget deficits. Not surprisingly his conclusions are quite similar to the conditions relating to the feasibility of debt service that have been applied to the case of debt-burdened countries.

7 Spain: the least 'Southern' country

In a synthetic paper José Viñals examines how 'Southern' the Spanish economy was when it joined the EC in 1986, and again today. He sees the adjustment process as involving the opening up of trade, the opening up of the capital account, and the liberalization of banking and financial services. In this context he asks which specific characteristics of goods, factor and financial markets make for difficult adjustment problems, and how far automatic market mechanisms can be relied upon to mitigate these problems. Finally he raises the issue of which Community-wide policies are both desirable in themselves and would facilitate the successful integration of Spain.

Among the four relatively poor members (Greece, Ireland, Spain and Portugal), Spain has by far the highest per capita income. Spain's inflation rate, public finances and external debt are closer to those of an average EC member than to the other three. Spanish unemployment is much higher, however, and this seems to go beyond differences in the measurement and meaning of unemployment in the various countries.

In the period before Spain joined the EC, trade deficits persisted and were only partly offset by surpluses on the services account, especially from tourism and remittances. The rising cost of energy imports contributed to the problem. There was a rapid expansion in international trade, and the current and trade account deficits shrank. Even so, Spain was relatively less open than other late entrants to the Community, because of its high nominal and effective protection.

Spain's exports included a large component of manufactures (78% on the eve of entry), but their composition was strongly biased towards moderate- and weak-demand products. Trade is seen to consist to a great extent of intra-industry exchange with the versions of products sold abroad being inferior to those imported. A careful comparison of the labour and capital inputs to exports and to domestic demand shows that Spain exports relatively labour-intensive goods to other OECD countries, while exporting relatively capital-intensive goods to non-OECD countries.

An examination of the size of Spanish manufacturing plants reveals that they are mostly small (only 0.2% employ more than 500 workers) and particularly they are smaller than comparable plants in Germany, France or Britain. This may help to explain the failure to develop new technology and new products, which in turn may account for the bias towards the production of weak-demand goods. The financial structure of Spanish industry exhibits the heavy reliance on bank debt to be found in several other EC countries.

Spain is often thought to be a country of cheap labour. The relevant comparison, however, is of unit labour costs evaluated at current exchange rates in a common currency. Spanish labour had a considerable advantage in 1970 which it lost by 1979 and largely regained by 1985 (when it is estimated as a 43% advantage). Will Spain retain this comparative advantage in cheap labour following the 'EC cum 1992' shock?

Spain has made extensive use of capital controls, both on short and long-term transactions, since 1939. Only recently has the process of dismantling these controls begun, and much remains to be done. Eventually, however, in a single-market Community, they must all go. The effect of controls on short-term capital movements is revealed by covered interest arbitrage differentials. Although these have been small, the reason is that the authorities intervened regularly in the forward market. None the less, the abolition of short-term capital controls is unlikely to produce a large shock to the economy.