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EU INTEGRATION:**

**An Economic
Assessment of the
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Introduction

The objective of this article is an analysis of the impact of the EU Single Market programme (SEM). The SEM raises a number of theoretical and empirical issues regarding policy development and implementation. This paper attempts to provide a medium-term assessment of the SEM in the areas of internal trade concentration; inflation performance; GDP growth; and employment growth.

To a certain extent, the medium-term outcomes of the SEM programme are quantifiable insofar as the real economic performance of the EU is concerned. The four macroeconomic indicators denoted above are utilised as measurements of the size of EU gains or losses.

The Cecchini and Emerson studies identified four key areas of potential growth due to sector liberalisation. These were goods, services, labour and capital (the 'Four Freedoms'). While the aim of this study is not to assess or quantify the microeconomic impact of the elimination of technical, fiscal and physical barriers to EU internal trade, more detailed analyses necessarily rely upon measurement of absolute gains deriving from barrier removal.

A number of other endogenous and exogenous factors are also important in terms of interpreting the statistical data relating to the EU's economic performance. These include: accession of new Member States; the impact of globalisation (interest rates, trade, investment and capital flows); and national policy divergence.

It is difficult to separate these factors from the implementation of EU-level policies. Moreover, given the relative lack of influence EU policies can have upon global trends in

monetary policy and capital shifts, it appears reasonable to assume that the policy settings introduced by the SEM are *micro-level* within the broader framework of the global economy (that is, their impact is mostly confined to the regional, EU economy). It is important, therefore, to comprehend that the SEM was a *response* to the global economic environment of the mid-1980s. In turn, the 1992 project initiated a wide range of reactions from the EU's major trade and investment partners, the US and Japan.

This paper seeks to identify and examine the medium-term impact of the SEM programme upon the economic performance of the EU. Clearly, there are a very wide range of factors denoted by the term 'economic performance'. This paper focuses upon EU inflation, employment, GDP growth and internal trade performance. The aim here will not be to present statistics demonstrating the peaks and troughs of EU economic performance; more accurately, the objective is to assess the impact of the SEM in the medium term (i.e. twelve years since the promulgation of the SEA (Single European Act); approximately six years since the non-binding 'deadline' for the completion of the '1992' project). Thus, this paper's focus of inquiry surveys the 'pre-SEM' period from around 1985 up to the most recent figures available for 1999.¹

This paper commences with an overview of the background to the SEM and the main criticisms of the internal market strategy. It then proceeds to discuss the theoretical underpinnings of the customs union thesis and its influence upon the SEM programme. The next section provides an empirical analysis of the SEM's performance in five key areas — internal trade; economic growth; manufacturing performance; investment; inflation; and employment. Finally, I summarise the main findings and discuss areas where further research is required.

Overview of the Internal Market Programme

The 1987 EC Commission report on the *Cost of Non-Europe* (hereafter the 'Cecchini Report') was a watershed in EC public policy making. The tremendous range and scope of the report was designed to encourage legislation which would consolidate the liberal market parameters embodied in the Single European Act (SEA). The Cecchini Report optimistically forecast over five per cent economic growth, low inflation, rapid employment growth and mean GDP gains of over ECU 200 billion (Box 1).

Box 1

Summary of targeted areas for removal of inefficiencies and price distortions

- ❑ Removal of market barriers inducing flow-on effects, resulting in rises in price:efficiency ratios in both large and small-and-medium-sized enterprises (SMEs)
- ❑ Enhancement of economies of scale via the harmonisation of technical standards throughout the EC12
- ❑ An enhanced business environment resulting in an increase in mergers, greater service and financial-sector competition and goods and service delivery
- ❑ Expansion of inter-firm, inter-industry, intra-firm, and intra-industry trade
- ❑ Reduction and/or elimination of public/private sector monopolies and cartels. Harmonisation of indirect taxation system on goods and services (VAT rates)
- ❑ Cost savings through deregulation of industries (e.g., air transport, telecommunications, public procurement).

A number of studies supporting the Cecchini Report were published by the Commission. These included Emerson (1988; 1990) and Padoa-Schioppa (1987). However, there has been a tendency by the Commission to issue these studies as 'advocacy documents'. This means that a study is designed to produce a particular policy response from other EU institutions (particularly the European Parliament [EP] and the Council of Ministers). In this

respect, 'Project 1992' was an enormous public relations success, although the achievements of the SEM programme claimed by the Commission do not necessarily correspond with economic reality.

The Cecchini and Emerson forecasts attracted considerable criticism, particularly as it was evident that the Commission had produced far less optimistic estimates which were not published.² Econometric analyses are found in Neuberger (1989), El-Agraa (1990), Mercenier (1994) and Burniaux and Waelbroek (1994). Other studies have focussed upon the Cecchini and Emerson's estimates regarding the industrial impact of the SEM (for e.g., Winters, 1993).

Table 1 presents data comparing Cecchini report predictions with actual outcomes. The internal trade effects of the 1992, evaluated in Greenaway (1987), Pelkmans and Winters (1988) and Buigies *et al* (1995), suggest that only certain industries benefit from specific types of liberalisation, an assertion also supported by El-Agraa who contends that increased M&A (mergers and acquisitions) activity results in oligopolistic behaviour by firms, rather than price deflation via competition (El-Agraa, 1990: 487).

Table 1

Comparative analysis of Cecchini Report with data relating to, before, and after the completion of the SEM

	Before SEM implementation	Cecchini Report predictions (without accompanying measures)	Actual (1994)	Actual (1995)
CPI (%)	4.4 (1989)	-6.1	3.99	3.2
Unemployment† (%)	8.5 (1989)	-	11.2	11.3
GDP growth (%)	3.4	4.5	1.3	2.1
Public budget balance (% GDP)	-3.5	2.2	-6.1	-5.5
External balance (% GDP)	0.00 (1989)	0.4 ^a	-	-0.1
Total employment (millions)	143 (1988)	1.8-5.0 ^b	155	n.a.

† A 1.8 million employment gain would result in an approximate decrease of 2% in the total EU unemployment rate at 1989 levels.

^a Two years following completion of internal market. The medium-range figure (6 years) is 0.7-1.3% of GDP (Emerson, 1988: 264, Annex B, Table B5).

^b Predicted employment growth range (millions), depending upon implementation of accompanying measures. A gain of between 1.3-2.3 million jobs (the lower and mid points of the Cecchini estimates) would reduce unemployment levels by less than 2% in 1995 terms.

Source: Author's calculations based upon data in *Eurostat Review* (various years); *Eurostat Yearbook* (various years); Emerson (1988); Cecchini (1988).

Approximately 35% (ECU61 billion) of the estimated ECU174 billion gain³ in EU GDP derives from projected efficiency gains arising from economies of scale, according to Cecchini (1988: 83-5). Caballero and Lyons (1991: 45) argue that as only certain industries will make positive efficiency gains from the liberalisation

of, for example, public procurement liberalisation, this estimate should be excluded from the total. El-Agraa (1990: 487) expresses reservations concerning scale economies as these are likely to encourage concentration rather than competition amongst firms. El-Agraa speculates that the situation is possibly zero-sum, although Molle implies that the result of scale economies for firms in a CU (Customs Union) is potentially negative-sum (Molle, 1990: 106-109). For El-Agraa (1990: 487), scale economies in the SEM assume the form of oligopolistic structures where Member States act to the detriment of others for their own benefit (i.e. maximising their profits and minimising the negative effects of competition, which may ultimately lead to a 'lose-lose' situation). By contrast, Pinder (1989: 103) argues that Cecchini "understates rather than overstates" the benefits deriving from production efficiencies and capacity utilisation. Van Paridon (1996: 44-50) notes that while intra-EC investment increased after 1985, this was probably attributable to *anticipated* gains firms expected to make under single market conditions. Molle, like Geroski in Venables and Winters' study on the industry effects of 1992, concludes that while some favourable outcomes derive from scale economies, compensation is required to offset likely losses made by firms in less competitive regions within a CU.

According to Mercenier's model (1994: 137-8), the Cecchini Report grossly overstates the anticipated welfare benefits deriving from the completion of the internal market. Mercenier estimates that general welfare effects scarcely exceed a one per cent improvement, except in Germany and Britain. Negative welfare effects arising from more integrated industry structures, Mercenier argues, are more likely. Because integration merely *reallocates existing resources*, growth prospects and welfare gains remain low, static or negative unless commensurate changes in public and

private policy are made. Should this occur, reasonably significant gains *may* be possible. However, as Mercenier notes, estimates across nine industry sectors suggest gains from integration far removed from the 2.5-6% estimated by Cecchini (Mercenier, 1994: 144-5). This compares unfavourably with Smith and Venables' analysis that gains in competition will lead to EC-wide positive welfare gains (Smith and Venables, 1988: 1501-25).

According to Geroski (1991: 23-4), "the 1992 programme has been the subject of an extraordinary amount of PR hype", and Cecchini counts the potential benefits but not the costs of 1992. Winters (1992: 12) posits that the Cecchini estimates place undue emphasis upon scale economies as engines of welfare improvement. Colchester and Buchan (1990: 25-33) argue that the SEA was "a triumph of self-delusion", and that the Cecchini Report is "of frankly dubious worth." El-Agraa (1990: 487) is also sceptical, noting that "the estimates in the Cecchini Report should not be taken at face value...it is likely that each Member State will strive to get maximum benefit for itself with detrimental consequences for all." Mercenier's (1994: 145) estimates are several percentage points lower than Cecchini's; he concludes that these figures are based on "static gains" and assume full employment in the base year used for comparison (i.e. an 'ideal type'). Burniaux and Waelbroeck's conclusions are less optimistic; they conclude that

gains from the implementation of the [SEM] are quite small...[in the post-1992 model] gross profit margins are severely squeezed by market forces and market shares are very vulnerable to the pressure of competitors...the gains at the EC level tend to be thin...part of the medium-term gains will be lost, through the movement of capital and labour to the more developed members of the Community...This will promote efficiency, but

makes for an economic system where job security is far more limited than in the past, and the shape and very existence of individual producing units much less stable than in the past (1994: 102-103).

According to Swann (1992: 138-45), the Cecchini Report suggests potential benefits, although they are exaggerated. He notes that "market segmentation, lack of economies of scale and the and the advantages possessed by local institutions mean that inefficiencies can be sustained." With reference to the elimination of non-tariff barriers (NTBs), Cutler *et al* (1989: 59-60) demonstrate that other Commission surveys were far more pessimistic than Cecchini's least optimistic estimates, with potential savings of ECU 40 billion, as opposed to a low of 65 billion and a high of 80 billion. In his evaluation of the 1992 programme, Neuberger's (1989: 1-15) analysis concludes that the Cecchini figures are entirely unrepresentative of the likely results of barrier elimination, and that the Report itself is "little short of a disgrace to the economics profession." The point is that the elimination of NTBs on their own is meaningless; the accompanying measures (scale efficiencies, rationalisation, supply-side gains etc.) are essential to the realisation of employment growth, reduced inflation and fiscal surpluses.

Internal trade was not addressed specifically in the Cecchini and Emerson studies. Most of the Commission studies' estimates were related to scale economies deriving from market enlargement and M&A. Thus, the Commission anticipated increases in both *inter* and *intra*-industry trade, together with FDI (Foreign Direct Investment) growth due to greater economic convergence. The convergence hypothesis posited by Markusen and Venables (1995) suggests that FDI and multinational corporations' (MNCs) trade might replace regular international trade flows.

The Impact of Customs Union

Perspectives on European integration strategies altered markedly during the 1980s. This was due to four factors. First, neoliberal theories challenged the state's ability to intervene in increasingly liberalised markets. Second, the notion that the state utilised large firms as state agents, or as *ad hoc* extensions of state power, was subject to some debate. Third, the relative failure of some nationalised industries suggested that states had lost the ability to control their economies in the face of international interdependence. And fourth, the propensity of EC political parties to move from intervention to liberalisation appeared to signal a profound ideological shift away from the politics of regulation.

This was the main thrust of liberal theses during the 1970s. For example, Raymond Vernon (1974) argues that EC markets had begun to be closed off from one another and that the EC customs union had failed to deliver a tangible industrial policy. The problem was the EC's growing interdependence with markets in third countries, and that West European market growth had reached its quantitative limits. Continued growth could only be procured via exports, or by increasing the size of the EC market (for example, through enlargement). However, Vernon suggested that EC governments were more likely to protect their industries from *intra*-EC competition, rather than attempt to make them internationally competitive. Neoliberal theorists such as Wolf present an alternative thesis, namely, that the EU resembles seventeenth-century France in its neo-mercantilist 'Colbertist' outlook. According to Wolf (1995: 333), "the EU combines liberalism within and mercantilism without".

The EC customs union was established rapidly following the promulgation of the Treaty of Rome. By 1968 it was complete.

However, customs union represented the minimalist interpretation of free trade, a static model through which only negative-integrative mechanisms were possible. It was naturally far preferable to the neo-mercantilism which had predominated throughout the inter-war period and even, to some extent, during the 'new imperialism' of 1870-1914. It was envisaged that the establishment of a customs union would prevent trade and investment diversion by encouraging domestic capital to remain on-shore. Further, competition would be enhanced, providing welfare benefits, together with an increase in the diversity of sources of employment. Efficiency gains would be made via the rationalisation of industries both nationally and across borders, permitting increases in overall efficiency. Capital surpluses would accumulate within a single market and be directed towards new investments with production spread across several states, rather than financing small, low-return domestic ventures.

The customs union thesis (El-Agraa and Jones, 1981) was also unsatisfactory in the longer term as it did not necessarily prompt the harmonisation or convergence of the EC economies. Without these, efficiency gains through scale production would not be made by firms operating within the internal market. In the absence of a series of harmonised product standards, firms could engage only in longer production runs (resulting in rapid obsolescence of the original design); would predominantly service the domestic market where they were based; and would be limited in technological advancements and specification according to the size and overall profit margins in a given market.

An increasing divergence in factor mobility was one of the key concerns of the EC Commission in the early 1980s. Customs union had provided for the partial liberalisation of the European market, but the impact it had was limited. Clearly, some productive factors

were inherently mobile, while others were not. Capital could be quickly shifted according to changing markets, factor costs and investment incentives. Labour, by contrast, was relatively immobile, and the establishment of a CU had demonstrated that labour mobility had had only a marginal influence upon employment. The late 1970s and early 1980s also represented a period of prolonged and intense negotiation between the EC and the three Mediterranean applicants for membership (Greece, Portugal and Spain). Weak currencies, high unemployment and low factors costs would be likely to encourage capital flight away from industrialised northern Europe, to the southern periphery. A rapid phase of structural adjustment was therefore required in order to prevent investment diversion away from the EC's northern core.

The effect of the EU customs union has also been significant in terms of its market liberalisation. During the EC's CU phase (1968-87), membership of the EU meant that quantitative restrictions (QRs) and tariff barriers to exports in the traded goods sector were eliminated. The SEM extended this principle to encompass the 'Four Freedoms' (goods, services, capital and labour). Increased factor mobility has resulted not only in greater competition, but also more flexibility in terms of component sourcing, FDIs, manufacturing bases and retailing.

According to Viner (1950) and Byé (1950), CUs have two direct effects: first, they result in *trade creation*, where high-cost domestic production is replaced by inexpensive imports from a trading partner. Import costs are further reduced by either removing or lowering tariff barriers between trading partners. The second direct effect of a CU is *trade diversion*, whereby more expensive imports from CU partners are substituted for cheaper imports from third countries. Thus, trade creation and trade

diversion increase welfare levels, but do not maximise welfare. The Cooper-Massell (1965a; 1965b) model's findings suggest that unilateral external tariff reductions are preferable to the formation of a CU, precisely the converse of the Viner and Byé model.

According to the Cooper-Massell critique, a CU is a minimalist response to the theory of free trade. Welfare could be increased without the degree of economic restructuring necessary to compete with third countries which possessed a comparative advantage in certain industries. As Johnson (1965; 1974) notes, states prefer to maintain labour-intensive industrial production to capital-intensive service sector or high-technology industries. Tariffs therefore have the strategic political advantage of maintaining on-shore rather than off-shore investment and production facilities. However, as Johnson further argues, all CUs eventually reach quantifiable limits (i.e. quantitative limits to demand) and total production output must either be domestically consumed or exported in order to maintain aggregate demand and full employment. Furthermore, should domestic production and consumer prices rise excessively (for example, through tariff increases), consumer welfare falls, inflation is fuelled and demand slows.

The alternative is the reduction of tariffs and the introduction of cheaper imports to substitute for costly domestic products. However, the price of this is a loss of production and employment in domestic industries. As a result, CUs are justified on public goods grounds as tariffs are substituted for direct government subsidies. In addition, CUs protect countries which may never be able to gain a competitive advantage in certain industry sectors.

Evaluating the Impact of the Internal Market

Internal trade performance

The key economic determinant of the maximisation of an internal market's quantitative potential is the extent to which aggregate demand is concentrated within that market. This is the crux of the CU thesis. This section evaluates the EU's internal trade performance since the introduction of the SEM programme in 1987.

Between 1986 and 1996, the level of intra-EU imports as a proportion of total national imports barely altered, rising from 63.2% (1986) to 63.6% (1996), peaking at 64.5% in 1992 (Eurostat, 1998: 450). This trend was reflected at the national level with few exceptions. Throughout this period, only the Netherlands, Ireland, Austria, Portugal, Sweden and Finland experienced significant change. Three of the European Free Trade Association's (EFTA) members (Austria, Finland and Sweden) acceded to the EU in 1995; it is therefore to be expected that they would experience growth in market share, just as Greek, Spanish and Portuguese trade with the EU grew significantly following their entry into the EC. This leaves only the Netherlands, Ireland and Portugal. Again, Portugal's rapid growth in imports from the EU is more to do with its accession to the EU in 1986 than the SEM; as the Byé thesis suggests, rapid growth in imports occur when economies are integrated into a customs union (CU).

Ireland experienced a significant drop in imports from the EU during the 1986–96 period (from 76.1% to 67.2%) (Table 2). A number of factors may explain this, including some degree of import substitution and non-EU import replacement. Greece's imports from the EU have experienced some turbulence, although

the overall rise in the proportion of imports has not altered markedly (Eurostat, 1998: 450).

What is striking about the EU's internal trade performance between 1986 and 1996 is the virtual stagnation of levels of trade concentration within the EU core. While the performance of the second, third and fourth enlargement states is explicable in terms of their late accession (although this trend is by no means uniform), the import/export:GDP ratios of France, the Netherlands, Belgium/Luxembourg and Italy have experienced little, if any, movement in terms of intra-EU trade. Of the original EC6, only Germany shows appreciable gains, although the export figures are distorted by including eastern Germany as an EU 'export market' in some of the years between 1986 and 1996.

Table 2. Imports from & exports to EU countries as % of total national imports (fob)

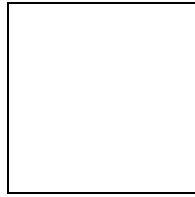
	Imports		Exports	
	1986	1996	1986	1996
EUR15	63.2	63.6	62.6	62.9
B/L	73.5	72.5	76.5	76.6
D	61.6	60.0	60.1	67.4
DK	70.4	70.8	61.3	57.1
EL	61.6	60.0	60.1	52.0
E	54.4	63.0	66.2	66.8
F	67.6	67.9	60.6	62.1
IRL	76.1	67.6	75.7	71.1
I	59.5	60.9	57.9	55.2
NL	64.5	61.2	79.8	80.6
A	69.3	74.7	62.9	64.1
P	62.1	75.6	75.8	80.0
FIN	57.6	65.3	53.4	54.5
S	65.5	68.4	57.3	57.0
UK	56.3	55.0	52.8	57.8
EEA	63.4	63.7	62.9	63.2

Source: Eurostat (1998), *Eurostat Yearbook 1997* (Luxembourg: Office for Official Publications), p.450.

The Commission's evaluation also argues that the volume of EU trade was 2.5-4.5% higher in 1994 (CEC, 1996). While the total volume of trade has increased, the EU average over the 1986-96 period has not altered to any substantial extent. In 1986, intra-EU exports as a percentage of total EU exports was 62.6%, peaking at 67.4% in 1991 (attributable primarily to German demand in 1990-91 and Germany's resulting balance of trade deficit), before falling to 62.8% in 1993 and rising fractionally in 1996 to 62.9% (Eurostat, 1998: 450). Imports over the same period demonstrate similar trends, with the peak years being 1990 and 1991. The point of significance here is that despite a brief growth in the **proportion** of intra-EU trade, the 1996 figure (63.6% is little higher than the 1986 figure of 63.2%). Consequently, these figures tend to cast doubt upon the validity of the Commission's and other analysts' assertions that trade has exhibited appreciable growth. Trade has certainly grown **externally**; figures 1 and 2 demonstrate that the EU's external trade balance has improved significantly over its pre-SEM performance. However, there is little to link the EU's improved external trade position with efficiencies deriving from the SEM. The key third-country destination for EU exports, the US, developed a growing deficit with the EU during the 1990s, having achieved a rough balance in the traded goods sector in 1985-90.⁴ Thus, the evidence suggests that growth has been driven by non-EU exports as the US has increased its level of imports.

Figure 1

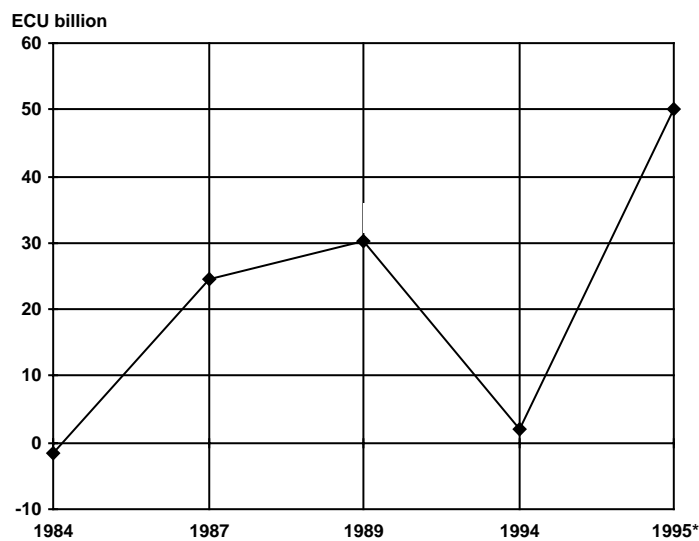
External trade balance of EC12, 1989 and 1995 (% of GDP)



Source: Calculated from data in CEC (various years), *Eurostat* (Luxembourg: Office for Official Publications).

Figure 2

EC^a trade balance, 1984-95 (ECU billion)



^a Figures after 1986 include enlargement to encompass Portugal and Spain.

* Figures for 1995 comprise first half year total.

Source: Calculated from data in CEC, *Eurostat* (Luxembourg: Office for Official Publications, various issues); and CEC, *EU News*, Vol.14, No.2 (February-March 1996).

Although there was a relatively significant boost in intra-EC trade average throughout the 1985-90 period, there was a marked slowdown during the 1990s and, consequently, the overall change in the percentage of trade done within the EU is much lower when one considers the 1985-97 period as a whole. At least one contributing factor was the depth and length of the recession of the early 1990s. But clearly this does not account for the entire decade.

While the accession of Austria, Finland and Sweden in 1995 to some extent explains the increase in the EFTA 3's percentage of total trade with the EU, there are some puzzling anomalies. First, the level of EU-sourced imports to the former EFTA 3 rose more rapidly than EFTA exports to the EU. Second, an analysis of the trade position of states outside the EEA (European Economic Area), such as Switzerland, demonstrates that a **lack** of integration with the EU has made virtually no difference to Switzerland's import/export ratio. EEA/EFTA states, such as Norway and Iceland, have had different experiences. Norway has largely followed EU trade trends, whether upward or downward. Its 1995 position was little different to that of 1986. Conversely, Iceland has experienced a very significant alteration in its terms of trade with the EU. Its imports have declined year-over-year by almost 10% on its 1986 position. However, it has made a better than average improvement in its export performance, although this position declined rapidly after 1992. Iceland's largest export gains were during 1986-90, which reflects the EU's upward trend in trade during this period (Eurostat, 1998: 450).

It is important to note that the EU altered its method of calculating trade data from 1993, following the abolition of a number cross-border customs formalities. Previously, data was gathered by customs, whereas from 1993 data has been gathered via surveys of EU firms. The Commission argues that this method understates significantly the volume of intra-EU trade and that the official statistics are therefore unrepresentative of the extent to which the SEM has increased the overall level of trade (CEC, 1997: 189; Eurostat, 1998: 463). One might justifiably criticise such an indeterminate system of data collection; moreover, critics of EU integration are right to be suspicious of such claims when there is

little evidence in recent years that consumption, private expenditure and general government receipts from consumption have increased. In a large number of Member States, the reverse is the case: government revenue has fallen or remained flat, which suggests that consumption has fallen (i.e. the share of revenue deriving from Value-Added Tax [VAT]). While this may also indicate lower rates of indirect taxation, VAT rates in most EU countries have in fact risen over recent years, and this is particularly true of services. As a result, EU states have relied increasingly upon **direct** means of income taxation, together with social security contributions, in order to increase net government receipts (CEC, 1997: 65). This has also occurred during a period when EU new job creation has remained negative or static. With a shrinking full-time workforce, tax rates on employed labour have risen on average from 35% (1980) to 41% (1994) (CEC, 1997: 67).

The fact that net government receipts have not kept pace with public expenditure has not only meant that EU governments relied increasingly upon higher debt:GDP ratios, but also that public sector investment has declined significantly. Gross capital formation (GCF), an important indicator of government expenditure and investment in capital goods (the public sector remaining the major consumer of durable goods), has fallen across the EU15, in some cases significantly, while some states have demonstrated a marginal rise in GCF (Eurostat, 1998: 237). On average, GCF fell in every surveyed period from 1973 to 1996. In only one period (1989-93) was there no change in GCF (CEC, 1997: 65). One may extrapolate from these figures that the liberalisation of public procurement, a cornerstone of the Cecchini and Emerson reports, has not achieved a particularly high level of liberalisation and that it has not been a major contributor to EU growth in merchandise or services trade.

GDP growth

This section discusses factors contributing to GDP growth in the SEM. The most important of these include: manufacturing GDP and levels of manufactured exports; and domestic, intra-EU and foreign direct investment.

The SEM was introduced in an attempt to stimulate levels of EC growth via the introduction of a series of micro and macroeconomic reforms, generally known as the 'Four Freedoms' (goods, services, labour and capital). These included the elimination of physical, technical and fiscal barriers to intra-EC trade. Broader macroeconomic stimulus of the EC economy was encouraged in terms of efficiency gains and price competition achieved through corporate M&A. Other measures included gains from economies of scale arising from both the elimination of production barriers (for example, access to a larger market), as well as lower overall costs of bringing goods or services to market, due to fewer barriers to introducing a given product into an export market (Cecchini, 1988: 84).

The question here is the extent to which these efficiencies have been realised in terms of real GDP growth since the introduction of the SEM. During the high growth period of the post-war boom, EC annual growth averaged 3.9% per annum between 1960 and 1972, while growth slowed to 1.5% in the wake of the oil crisis and stagflation from 1973 until 1985. Growth rose to 3% in 1985-87 and peaked at an average of 4% for the 1988-90 period.

It must be conceded that the 1992 project stimulated business confidence in the EC during the late 1980s. However, the

global economy as a whole during the 1980s experienced some enormous fiscal stimuli, much of it deriving from the US. This coincided with a boom in US defence spending, resulting in massive public procurement contracts, particularly between 1981–86. US borrowing had an important impact on both the Japanese and EC bond markets, leading to their explosive growth during the 1980s. As a result, US, Japanese and European institutional investors sought to inject capital into income-earning fixed assets. In the EC, where asset prices were inflated (though not to the extent experienced in the US and Japan), excessive liquidity in the global economy was the major factor behind the recovery of the EC economies from the mid-1980s as FDIs flowed into EC-based enterprises. The resurgence of the US economy also saw a rapid growth in demand for EC exports, particularly in the luxury goods sectors. The favourable terms of trade experienced by the West German economy throughout this period led to extremely large surpluses which, in turn, West German enterprises redirected, largely into intra-EC investments. Effectively, this restored the German economy to its role as the engine of growth in the West European economy.

While EC average economic growth outstripped that of the US throughout this period (1986–90), it lagged behind that of Japan by 1.3% (CEC, 1998c: 2). However, over the ensuing period (1991–95), the position was reversed, with the US recovering relatively quickly from the global recession of the early 1990s, while Japan continued to experience low or negative growth throughout the decade. The EU improved its growth performance to achieve an annual rate of 2.5% in 1995, although this proved short-lived, with growth falling substantially to 1.8% in 1996 (Table 3). As has often been the case, Commission growth forecasts published in 1996–97 for the next triennium were overly optimistic (CEC, 1998c: 2);

revised forecasts published in 1999 predicted much lower growth for 1999–2000 than originally anticipated. These have proven far more accurate, although DG-II⁵ has suggested that “the slowdown is temporary” (CEC, 1999c: 1). EU growth remains largely premised upon strong US domestic demand and a constant or increasing US deficit in goods and services (Eurostat, 1999). A tightening of US monetary policy, designed to dampen demand and control inflation, would have a major impact upon the size of the EU’s surplus with the US (figs. 1 and 2).

The Commission’s *Single Market Review* (1996) estimated a cumulative net gain of 174-207 billion ECU for the period 1988-94 as a direct result of the SEM. This, according to the Commission’s figures, resulted in an increase of 1.1-1.5% of GDP for 1994 (CEC, 1996: subseries VI). According to Eurostat figures, EU GDP grew from ECU 3.83 trillion in 1989) to ECU 4.12 trillion in 1993, an increase of ECU 290 billion. However, taking into account the incorporation of the former GDR into the EU in 1990, one may add approximately ECU 65 billion to the sum of EU GDP for 1990.⁶

Table 3
Main economic indicators, EU15

	1996	1997	1998
GDP growth^a	1.8	2.7	2.9
Employment^a	0.3	0.5	1.1
Unemployment rate^b	10.9	10.6	10.0
Inflation^c	2.7	2.1	1.5
Public deficit (% GDP)	-4.1	-2.3	-1.5
Government debt (% GDP)	72.8	71.7	69.7
Current account balance (% GDP)	0.9	1.5	1.2
GDP growth EUR-11^a	1.6	2.5	3.0

^a Real annual percentage change.

^b Percentage of the civilian labour force.

^c Private consumption deflator.

Source: CEC (1999c), *European Economy*, Supplement A, No.4 (April), p.1.

Given that much of the EU's growth has been traditionally centred around consistent German economic growth, the problem posed by German unification has proven an intractable one. It has taken a great deal longer for Germany to make the structural adjustments necessary to accommodate the costs of east German enlargement. The large current account surpluses accumulated by West Germany during the 1980s have been redirected to both eastern Germany and the Central and East European Countries (CEECs). As a result, gross public debt doubled between 1980 and 1998, placing Germany fractionally beyond EMU's (Economic and Monetary Union) gross debt criterion (60% of GDP) when the government reported its financial position in March 1998. The severe downturn in German economic performance commenced in 1990-91 when Germany recorded its first post-war balance of trade deficit with France and a rare trade deficit with the EC as a whole.

The net effect of declining terms of trade was to push unemployment further upward, with even Germany's largest industrial combine, Daimler-Benz, cutting 9,000 jobs from its DASA aerospace subsidiary in 1995. Although some recovery had been made during 1991-95, German trade surpluses with the rest of the EU have not recovered to 50% of their 1987-89 levels (Eurostat, 1998: 458). This was a substantial factor in the slow recovery during the 1990s and meant that the EU has grown much more slowly than other developed economies such as the US, Australia and Canada.

Manufacturing GDP

The EU Commission claims an overall increase of 7-8% in intra-EU trade in manufactures as a result of the SEM (CEC, 1996). At the national level, there appears to have been little evidence to support this contention. Between 1986 and 1996, Belgium/Luxembourg, Denmark, Ireland, the Netherlands, Austria, Portugal and Sweden experienced only nominal increases in their level of manufactured exports to the EU, while Spain and France had more substantial growth. The UK has exhibited the strongest level of growth in this area⁷ (almost 3%), while the German share of manufactured exports to the EU has plummeted 8.7% over the same period (Eurostat, 1998: 463). This reflects a ten-year downward trend in Germany's level of manufactured exports to the EU, and does not necessarily indicate that German unification has been the key factor in this shift. There is also some evidence to suggest that German direct investment in the EU has displaced German manufacturing production and, as a result, exports.

The weakness of EU manufacturing output is reflected on two levels: first, the falling gross operating surplus (GOS)⁸ in the EU-11

from 1990; and second, the increased share of service sectors resulting in reduced output and employment in manufacturing.

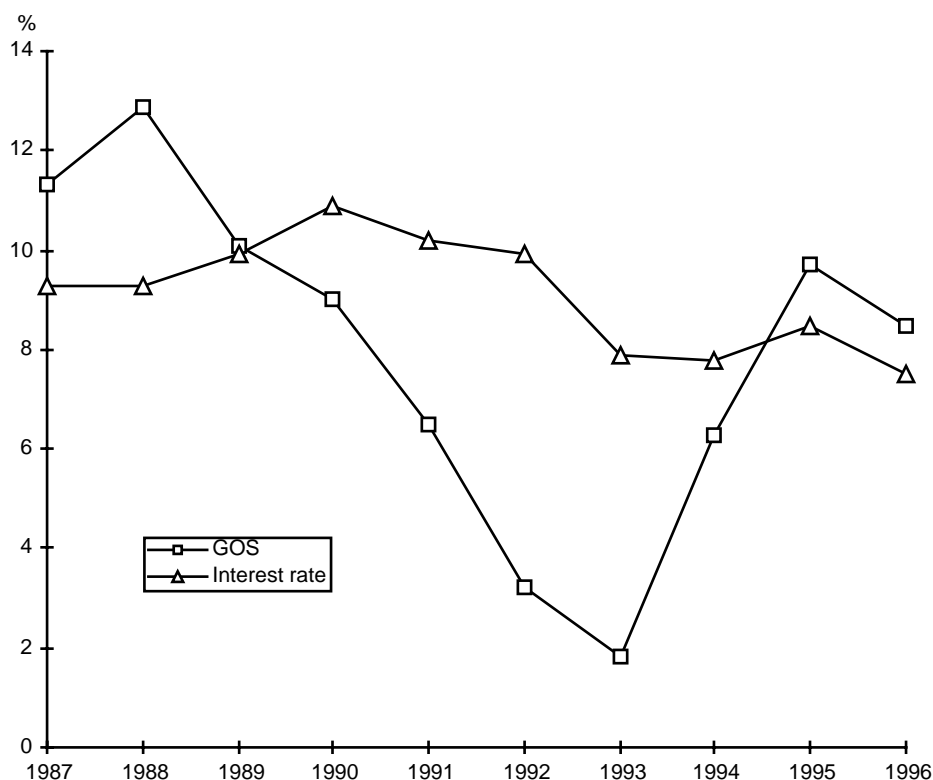
Firms' GOS over the 1987-96 period peaked during 1989 and reached its nadir in 1993. Although interest rates also declined during the 1990s, the interest rate:GOS differential remained negative until 1994-95. As figure 3 shows, the GOS:interest rate ratio was positive in 1995, but began trending downwards from 1995-96 (CEC, 1998d).

In the Commission's assessment of the industrial impact of the SEM on the less-developed regions, the report found that the SEM had a positive impact upon only six out of eleven sectors in Italy (CEC, 1996). FDI and factor flows were influenced to a negative or insignificant effect; the main impact was in intra-industry trade. In Greece, the Commission study found that the SEM had no effect upon capital accumulation and that there was "no evidence of any impact on growth with the exception of the paper sector" (CEC, 1996). Portugal has experienced growth in the level of intra-EU FDI, while some positive effects are notable in primary products and food processing. Spain has not experienced convergence in factor flows as a result of the SEM. There appear to have been moderate gains in FDI, although the size of the gains does not show that the SEM programme has had a decisive impact. In Ireland, FDIs have been largely from foreign sources which has resulted in higher levels of inter-industry trade and specialisation, particularly in high-technology sectors (CEC, 1996). However, there is no evidence that the SEM has prompted significant alterations in the level of intra-EU FDIs, which suggests that the capital mobility provisions of the SEM programme have not affected Ireland to any major extent.

Removal of barriers to trade, together with scale economies deriving from access to a larger market usually produces higher rates of industrial output. However, EU industrial output has not recovered to 1987-89 levels and recovery has been sporadic. For four consecutive months during 1998/99 industrial output was negative for three of the four months and static for one, before recovering slightly during 1999. In summary, manufacturing GDP has not demonstrated any pattern of sustained growth under the SEM.

Investment

Some recent studies have focussed upon the relationship between the internationalisation of the modern MNC and the development of regional integration. The key question here is 'what causes what?' — does regional integration *prompt* firms to diversify their operations and increase levels of intra-industry and intra-firm trade? Or is this a business *response* to altered international economic conditions? How do states and firms position themselves in customs unions and regional trade blocs? Dunning (1988) has found that the SEM reduced the incentive to invest in defensive intra-EC production, but has also increased the level of investment in certain member countries owing to reduced transaction costs as a result of the establishment of the SEM (Dunning, 1988: 293).

Figure 3**Financial profitability and nominal long-term interest rates, EU-11, manufacturing industry (all sizes).**

Source: CEC (1998d).

There is little disagreement that both intra-EU and third-country FDI has been chiefly responsible for boosting levels of EU intra- and inter-industry trade, and output of equipment goods.

Regional variations in FDI flows within the EU are highly apparent. While both annual flows and the net stock of FDI increased substantially in 1986-96, the distribution of FDI was uneven. For example, France experienced a rise in its annual FDI:GDP ratio, rising from 0.38% (1986) to 1.33% (1996) (\$US2,749 million to 20,401 million). By contrast, Germany's position declined substantially, leading to a net reduction in FDI of 0.14% of GDP (OECD, 1997). While the net stock of inward FDI (by volume) increased throughout the OECD in 1985-95, there are few

statistics available which supply EU states' net FDI positions in terms of percentage of GDP. EU Commission statistics suggest that there was a four-fold increase in inward FDI between 1984 and 1992 (0.15% to 0.62% of GDP) (CEC, 1996). These figures also indicate a rise in the overall proportion of total inward FDI flows originating from the EU, with the average rising from 55% (1986-90) to 62% (1991-93) (CEC, 1996).

These figures are not particularly significant, however, as the global economy has experienced a net increase in levels of investment since the mid-1980s (OECD, 1997). Given that over the corresponding periods there was also a very substantial rise in the level of Japanese FDI in the EU (predominantly transplants designed to avoid the perceived threat of 'Fortress Europe'), the EU FDI figures are potentially misleading, as investment by both US and Japanese subsidiaries, for example, is regarded as originating from the EU (Nicolaidis, 1990). Investment by the European subsidiaries of GM and Ford are examples of the difficulty of determining the origin of FDI. Moreover, the tendency to 'recycle' investments magnifies the problem of determining origin. Although there have been positive gains in terms of the greater propensity of EU industries and financial institutions to invest within the internal market, it is not clear whether this trend of higher local investment concentration will persist; arguably, the key strategic investments made by larger firms (such as in the auto industry, where BMW, Ford and GM have made major acquisitions and investments; Asea-Brown-Boveri in the electrical goods industry; and the Glaxo and Smith Beecham merger in the pharmaceuticals sector), are aimed largely at horizontal integration.⁹

Significantly, **net EU investment inflows and outflows have declined** appreciably since 1990. In 1995, the EU was the

destination for 35.5% of the world's total FDI inflows, a fall of 12.3% on 1990.¹⁰ Despite an increase in the volume and proportion of intra-EU investment (from 57% to 65% of inflows),¹¹ the EU has **declined** in its global share of inward FDI. This trend is even more pronounced in terms of outward FDI which fell from 55.4% of global investment (1990) to 41.6% (1995). By contrast, US outward FDI, while not matching EU volumes, more than trebled over the corresponding period (an increase of \$US68.3 billion), while EU volumes, despite the 1995 enlargement, decreased by around \$US1 billion (CEC, 1997: 41). Following a fall in EU inward FDIs in 1991, there was a rise in 1992, although not to the levels of 1990. Subsequently, there were successive falls in FDI levels from 1993 (CEC, 1997: 42). This suggests that while the SEM's capital liberalisation may have facilitated intra-EU investment, the EU has not been as attractive a destination for US investment as East Asia, although global fund flows declined markedly in the wake of the East Asian debt/currency crises of 1997-98. Although there appears to have been a shift in funds back to the EU since 1998, it is too early to discern whether this is a structural or cyclical condition. During 1999, with stronger signs of growth in the Chinese and South Korean economies, there were indications that US funds were returning to East Asian markets.

Therefore, there is some evidence that the level of both EU and global FDIs **peaked** in 1990, well before the 1993 'completion' of the SEM programme. Moreover, the upward trend in both intra-EC and global FDIs was evident several years prior to the introduction of the SEA and SEM. For example, inward FDIs in the EU more than doubled between 1984 and 1986 (CEC, 1997: 42). One may extrapolate further from these figures that the SEM has had little impact upon FDI outcomes, except in terms of EU capital market liberalisation which may have influenced the rise in intra-EU

FDIs. EU firms are also generally better placed to take advantage of internal liberalisation due to a variety of factors, not the least of which is a firm home market base within the EU.

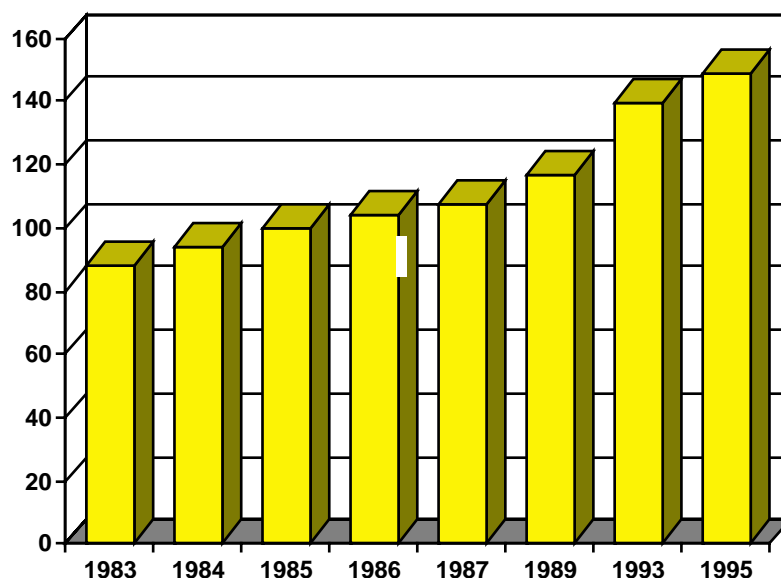
Inflation

It is notable that in terms of annual percentage changes in inflation rates over the past decade that there has been an improvement in the EU's inflation performance. To some extent this has been due to the development of Economic and Monetary Union (EMU) which has compelled the EU-11 participants in EMU to remain within two percentage points of the EU-11 inflation average. Other factors include the onset of the global recession of the early 1990s which resulted in deflated demand and reduced pressure on the CPI. The Bundesbank's tight monetary stance throughout the 1990s also forced other EU states to ensure that monetary growth remains relatively restricted.

However, a closer examination of the CPI figures which measure real price changes across the EU presents a different perspective. While inflation in the EU-15 grew by an average of 4.3% per annum throughout the 1986-90 period, inflation fell to only 4.1% during 1991-95, despite the rapid fall in consumption throughout the EU (figure 4). Whereas the Cecchini Report predicted a 6.1% fall in the CPI based on 1985 figures (without accompanying SEM measures) (Cecchini, 1988: 98, Table 10.1), the CPI figures in fact show an aggregate increase of 48.5% between 1985 and 1995 (1985 = 100) (Eurostat, 1995; Eurostat, various years), an average of 4.85% per annum.¹² In the EU-11 (euro zone), average inflation was **higher** during the 1991-95 period (3.9%) than in 1986-90 (3.7%) (CEC, 1998b: 2). With depressed demand during the recession and tighter monetary policy, one

would anticipate a general reduction in inflation. The higher rate can to some extent be accounted for by the widespread impact of the 1992/93 currency crashes which saw sterling, franc and lira depreciations. On balance, it appears reasonable to state that global financial conditions were much more influential upon EU inflation rates than the SEM. While some Commission studies have asserted that inflation performance would have been worse without accompanying SEM measures, there is little or no empirical evidence which might justify such a claim. Why might the EU's inflation performance have been better? If one accepts the Commission's claim that the SEM stimulated market performance and thus consumption expenditure, one assumes that the SEM in fact pushed inflation *higher*. Conversely, had there been no implementation of the SEM, reduced levels of demand would have kept inflationary pressures lower.¹³

Figure 4
CPI levels in the EC* 1983-95 (1985 = 100)



* Figures from 1986 include enlargement to encompass Portugal and Spain.

Source: Calculated from data in Eurostat (1996); *Eurostat Review* (various years); *Eurostat Yearbook* (various years).

Average inflation has gradually fallen across the EU-15 from 1990 when the CPI was 6%, falling to under 2% in 1998. In the EU-11, the CPI was slightly lower. However, the 1987 figure of under 4% was only beaten in 1996, although the CPI continued to fall thereafter. Clearly the post-1985 figures are a marked improvement on the 1980-85 period. There was not a significant downward movement in inflation until the 1991 recession. Although CPI increases fell during the 1990s, the Commission has forecast increases over the 1999-2001 period. In 2000, there has been a rapid price in energy prices, with light crude oil approaching 1981-2 prices. Given the EU's heavy dependence upon imported energy, it is highly likely that upward revisions in inflation forecasts will be required. Moreover, there is evidence that inflation has not been overcome; in January 2000, inflation in the EU-11 reached the European Central Bank's (ECB) 2% ceiling, the highest rate since January 1997.

Arguably there have been two major factors influencing inflation rates in the EU, neither of which are directly attributable to the SEM. The first was the early 1990s recession; the second was interest and inflation rate convergence under EMU. The recession acted as a general deflator of demand and forced reductions in prices due to surplus capacity. In combination with tight monetary policy exercised by the Bundesbank, the EMU convergence criteria forced EU states to adopt more disciplined monetary targets. Notably, states outside the euro zone (for example, Britain and Denmark) experienced slightly higher inflation levels on average. However, Britain and Denmark also recovered from the recession far more quickly and grew at higher rates than France, Germany and Italy during the 1990s.

It is extremely difficult to assert that the SEM in general or liberalisation in particular have created conditions for lower rates of inflation. It is more accurate to suggest that macroeconomic policies and conditions — such as the 1990s global recession, relatively low and stable long-term interest rates, together with fairly strict fiscal and monetary policy within the EU-11 — bear greater responsibility for capping rates of inflation growth throughout the 1990s. The absence of currency crises in the EU since 1993 has also produced much slower monetary growth. By contrast, the 1997 Asian financial crises, which resulted in massive currency devaluations, fuelled widespread inflation throughout the region.

Employment

The area where the SEM has had arguably the least impact has been employment. Commission studies also acknowledge that labour markets have performed “very poorly” and that Europe’s record on employment growth has been “dismal” (Lucio et al, 1999: 126). The objective of this section is not to argue for or against labour market deregulation, but to examine the EU’s employment record since the commencement of the SEM programme.

One of the key aspects of the Cecchini Report was to address labour market rigidities. The introduction of completely free movement of labour was integral to the ‘Four Freedoms’; it was designed to complement capital liberalisation. As capital is highly mobile and labour is not, the policy objective was to shift labour to investment areas. This was — and remains — in marked contrast with regional employment policies pursued by the Commission and national governments. The tendency has been to encourage public and private investment in the EU’s less developed regions which, in turn, *discourages* labour mobility.

Other EU initiatives have also proven obstacles to labour market flexibility. The Social Charter, appended to the Maastricht Treaty, stipulates a number of minimum conditions for workers, including a maximum 48-hour week. Britain under the Conservatives vigorously opposed the Charter, having introduced the *Deregulation Act* in 1994 which made the UK the least regulated labour market in the EU. Although the Blair government subsequently adopted the Charter, it is not binding legislation and its impact in Britain to this point has been limited.

The Cecchini and Emerson reports note that the SEM would be likely to impose some painful structural adjustments upon the labour market, although both reports are lacking in specificity about how long it might take for benefits to accrue. Recent Commission studies make a similar point and suggest that it may take “a considerable time span before the full benefits become manifest” (Lucio et al, 1999: 153). The Commission also argues that commitment to real wage moderation needs to occur, with one report asserting that without such commitment, a sustainable solution to EU unemployment will not be found (CEC, 1997).

The EU’s record of new employment creation has been poor since the 1970s. For example, Thurow (1994) calculates that the EU has not created *a single net job* since 1973. In this respect, the EU compares poorly with other OECD economies such as the US and Australia. During the 1980s and 1990s, the US economy created several million new jobs, while even the relatively small Australian economy produced approximately 1.8 million net jobs over the same period (OECD, 1999).

The majority of the employment gains in the EU have derived predominantly from enlargements. In 1988, EC employment stood

at 143 million with 8.5% of the civilian labour force unemployed. In 1994, in the wake of the completion of the SEM programme, total employment had risen to 155 million, while unemployment had grown to 11.2% (Eurostat, 1996). However, virtually none of the employment gains were due to the SEM. Almost all of the employment growth was due to German unification, an enlargement which, while boosting short-term demand for EU output, also made a significant contribution to German and EU unemployment.

As Table 4 shows, unemployment was higher for 1991-95 than the 1986-90 period. This trend persisted throughout 1996-98. The euro zone has had notably higher unemployment over the same period, which shows that Member States outside EMU (Britain, Denmark, Greece, Sweden) reduced the overall unemployment average, although Greece has had a high unemployment record. Figures for the 1982-85 period also show lower unemployment (averaging around 9.0%) than the 1991-98 period.

Table 4
Unemployment, EU15, 1986-98 (%)

	1986-90	1991-95	1995	1996	1997	1998
EU15*	8.9	10	10.8	10.9	10.5	10
EU11†	9.3	10.3	11.4	11.6	11.6	11

* Including new German Länder from 1991 onwards.

† Euro zone.

Source: Lucio *et al* (1999).

Two key factors account for the rise in unemployment after 1990. The first was structural readjustment made by firms under the SEM. Attempting to improve efficiency and productivity, EU firms aimed at leaner work forces and this shift was complemented

by the trend towards mergers after 1987. M&As frequently removed product duplication and the SEM's elimination of technical barriers also reduced the proliferation of standards which meant that firms often produced several national variations of the same product. The establishment of harmonised technical standards to some extent removed the necessity for an exceptionally large variety of intermediate and finished goods, a process which largely affected small and medium-sized enterprises, the largest source of employment in the EU economy. An example of this is the automotive components industry, the largest employer in the EU manufacturing industry. The net result was that employment was markedly affected in industries where there was a strong degree of vertical integration.

The second factor was the fiscal and monetary tightening prompted by EMU which was introduced in stages from 1990. Traditionally, post-war western economies pursued employment and economic growth at the cost of inflation (the inflation:unemployment trade off). There was a distinct shift in national and EU macroeconomic policy, which sought to implement deflationary measures during the early 1980s, particularly in France, Germany and the UK. The objective was to reduce inflation via strict monetary growth targets. In reality, only Germany succeeded in achieving its targets during the 1980s.

At the time of the 1991 recession, this meant that governments were restricted in terms of deficit spending designed to prompt employment growth. This problem was further exacerbated in France, Italy and the UK by the collapse of their exchange-rate position in the 1992-93 EMS crises. This, together with the convergence criteria, placed dual constraints upon public spending. As Lombard's (1998) study shows, EMU's targeting of

inflation and public deficits resulted in unemployment remaining high. The ECB's conservative fiscal and monetary position prevents euro zone members from high levels of public borrowing via the 'excessive deficit' procedure which imposes fines upon states which stray beyond the boundaries imposed by the ECB. As a consequence, states cannot engage in a large-scale Keynesian fiscal stimulus in order to increase economic activity and employment levels.

As the above discussion on inflation suggests, both the SEM and EMU have pursued traditional 'fight inflation first' policies on the basis that excessive monetary growth wipes out the value of savings, and investment incentives are reduced as interest rates increase to combat rising prices.

The main cost of higher interest rates is a general rise in unemployment as the price of capital discourages new investment. EMU's convergence criteria also prescribed much lower fiscal deficits, and in states such as Italy where traditionally there has been a high level of deficit spending, falls in government expenditure pushed unemployment upwards. Under Chirac and Prime Minister Juppé, France also underwent an austerity regime as Juppé held to the 'franc fort' policy and cut welfare in an attempt at reining in public expenditure. In 1997-98, a point of high unemployment, French consumption fell, and output was also reduced significantly as the government's moves prompted a wave of strikes.

In summary, the SEM has had a negative impact upon EU employment levels and this has been exacerbated by EMU. A medium-term assessment of the SEM (1987-99) suggests that the internal market has yet to demonstrate any tangible employment

benefits arising from the liberalisation of labour markets. The SEM has also introduced structural unemployment problems into the EU economy as manufacturing employment declines as firms become more integrated and streamlined. In addition, unless EMU suffers serious problems, the ECB is unlikely to relax its strict fiscal and monetary targets which, in turn, suggests that the EU will continue to experience high unemployment rates.¹⁴

Conclusions

The extent to which the EU completes its internal market has important implications for Australia, as the EU is Australia's largest source of FDI, and its second largest destination for outward FDI. It is also Australia's biggest source of imports, and in two-way trade the EU ranks as Australia's most important economic partner (Davison, 1991; Field, 1998).

There is some evidence that the CU thesis advanced by Viner and Byé, the Cooper-Massell critique, and Johnson's work, all have resonance in the piecemeal attempts by the EU to integrate the West European economy. In reality, the SEM represents an attempt to complete the CU of 1968, which was a largely unfinished process. As a result, it is inappropriate to describe the SEM in terms of a 'full economic union', an objective which the Commission sought to achieve via the dual implementation of the SEM and EMU from 1987. While this paper does not discuss EMU (see Davison, 1998b), there is no clear evidence that the introduction of the single currency (which, in any case, has not been adopted across the EU) has contributed to economic growth or welfare. What is more apparent is that in order to realise economic gains across the EU, further harmonisation must occur at the microeconomic level. Even

liberalisation in itself, in combination with convergent monetary policy settings, is no guarantee of sustained growth. Since the mid-1980s, it is clear that **investment**, rather than trade, has been the main stimulus of growth in the EU, and the quantifiable market size limits imposed by a CU suggest that the EU cannot depend upon consistent growth in **intra**-EU investment to provide future employment growth.

Moreover, there is little research on the question of whether extra-EU FDIs **displace** or **supplement** intra-EU FDI, as the majority of high value-added goods and services where investment is most capital-intensive are duplicated across highly-competitive sectors throughout the OECD, whence most FDIs derive. These sectors include automobiles, information technology (where the EU is well behind the US and Japan), consumer electronics, machine tools, transport equipment and telecommunications equipment and services.

In relation to employment, it is odd to note that in a climate of increased intra-EU investment, factor mobility and scale economies, and where inflation and long-term interest rates have remained comparatively low, employment levels deteriorated markedly under the SEM during the 1990s. Labour market performance was not improved by the rigid fiscal and monetary targets established by the EMU convergence criteria, which imposed a decade of deflationary policy. In recent years, export-oriented firms have been most responsible for providing employment growth, particularly as the EU's traded goods surplus with the US improved measurably. The evidence suggests that Johnson's (1965; 1974) thesis is essentially correct, in that the EU market has achieved its quantitative limits and can only increase demand by either exporting more output to third countries, or enlarging its

membership. Of the two, the latter course is the one being pursued by the EU and, in a sense, it is a substitution for the former course of action, which is much more difficult to achieve in a highly-competitive global environment.

Political scientists and economists should be questioning why the SEM has failed to deliver tangible benefits in the areas of trade and employment, and whether the model of EU integration adopted in the 1980s and 1990s is inadequate in terms of prospects for future economic development and employment growth. In essence, future research should analyse why the internal market has performed so poorly despite much national and EU institutional support for the project. In summary, the internal market has produced much market **convergence** but little market **growth**. It is worthwhile reiterating Mercenier's (1994) point that integrated industry structures only produce negative welfare effects, while integration merely *reallocates existing resources*. Thus, the scale economies envisaged by Cecchini and Emerson are only relevant to 'sunset' manufacturing industries, whereas much of the growth in the global economy since 1995 has been in 'sunrise' industries such as information technology where manufacturing is not the high value-adding sector of the industry.

The statistical data demonstrate clearly that, at least in the medium term, the SEM has had little impact upon structural unemployment, and there is some preliminary evidence to suggest that the SEM and EMU have contributed to a declining labour market. More seriously, it suggests that the 'advocacy documents', such as the Cecchini and Emerson reports, were more than optimistic — they were seriously misleading. As investment from the core EU economies shifts increasingly towards Central and Eastern Europe, employment prospects in the EU periphery

(Ireland, Greece, Portugal, Spain, eastern Germany, southern Italy) are likely to decline, which itself will place greater strains upon welfare and may force the ECB and national governments to reassess fiscal and monetary policy in the euro zone. In summary, the relative failure of the SEM raises profound public policy challenges for the EU as it moves to extend the internal market to encompass Central and Eastern Europe.

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ENDNOTES

¹ 1985 is employed for some comparative data as this was the base most frequently utilised by the Cecchini and Emerson reports.

² This provides further evidence of the fact that the Commission tends to produce 'advocacy documents' which envisage a preferred position or ideal outcome which is usually designed to elicit elite and public support.

³ This is the lowest of the three estimates.

⁴ For example, the trade balances in 1986, 1991 and 1995 were ECU +20 billion, -14 billion and +1 billion respectively.

⁵ Directorate-General II of the EU Commission (Economic and Financial Affairs).

⁶ Author's calculations based upon the following formula: GDR Net Material Product (NMP) (equivalent to GDP) in 1988 was 269 billion ostmarks. The 2:1 currency swap of 1990 halves this amount to approximately DM 135 billion. The DM:ECU ratio in October 1990 (the point of unification) was 2.06:1. This results in a rough additional GDP estimate of ECU 65 billion. See *European Economy* (1991); DFAT (1990) and CEC (1996), Subseries VI - "Aggregate Results of the Single Market Programme".

⁷ This, in turn, has led to a sterling appreciation recently which has consequently affected the export performance of the UK manufacturing sector.

⁸ GOS refers to profit share.

⁹ Notably, the pharmaceuticals industry is not highly concentrated and the impact of M&A in the sector is not as significant as the auto industry for example. Had the abortive Glaxo and Smith Beecham merger succeeded, the firm would have had a combined share of only 10% of the global pharmaceuticals market.

¹⁰ This includes both intra and extra-EU FDI. See CEC (1997).

¹¹ These are 1986-91 and 1992-96 figures respectively. The 1986-91 figure refers to the EC12. The 1992-1996 figures refer, from 1995, to the EU15.

¹² Author's calculations based upon Eurostat statistics.

¹³ Typically, growth economies attract increased levels of foreign investment. Where capital and exchange controls are few, states are rarely able to regulate the degree of short or longer-term liquidity in the economy. As a result, unless central banks take firm measures to limit the growth of M3 (broad money), inflationary pressures invariably grow, placing increased demands upon monetary policy decisions.

¹⁴ The ECB has proven particularly bullish on interest rates in the second half of 2000, following continued weakening of the euro against the US dollar and the yen.

About the Author

Rémy Davison has lectured in international business, international relations, international political economy, international law, European politics, East Asian economics, political theory and European history at Monash, Melbourne, Griffith, La Trobe and Deakin Universities. He is a former Editor of *CESAA Review* and is Deputy Editor of the *Australasian Journal of European Integration*. Currently, he is lecturer in international relations at La Trobe University.

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