What global challenges will Europe face in the twenty-first century?

The processes of European integration have coincided with the emergence of a more globally interdependent world economy. Both globalisation and regionalism have brought about fundamental changes to the way in which economic activities are organized and to the relationships that sustain them. *The European Economy: The Global Context* argues for a more outward looking approach to Europe in the light of these developments.

In addition to core European issues, the book highlights the influence of other countries in the region. It also describes how European decisions shape other countries. Topics discussed include:

- Europe's experience of regionalism
- the single market
- plans for economic union
- European Union enlargement
- Europe's Triad rivals
- EU external trade and trade relations
- technology and innovation
- environmental issues
- the shift of economic strength to Pacific economies and Europe's need to compete.

This fresh approach will provide students of economics, European studies and international studies with a deeper understanding of Europe's global role. General business readers will gain an insight into the opportunities and changes evolving in Europe.

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The European Economy

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THE THEORETICAL BASIS OF REGIONAL INTEGRATION: EARLY CONSIDERATIONS

Static customs union theory

Much of the original work developed on customs union theory can be attributed to Viner (1950). He wrote at a time when there was much contemporaneous interest in European integration, but was to demonstrate that RIAs could only aspire to a secure 'second best' position. According to Viner, non-discriminatory trade concessions negotiated at a multilateral level would always provide superior welfare-inducing effects compared to selective preferential trade agreements. This was not the first time that this argument had been postulated. Robson (1987) notes that both Adam Smith and David Ricardo were critical of the counter-free trade 1703 Methuen Treaty signed between Britain and Portugal which enabled British wool and Portuguese wine into each other's respective markets on preferential terms. The basis for Viner's own theory rested on the twin concepts of trade creation and trade diversion.

Trade creation and trade diversion

Trade creation entailed the displacement of one member's domestically produced goods by cheaper imports from more efficient partners. Trade diversion, on the other hand, involved cheaper external imports being replaced by more expensive partner equivalents as a consequence of the CET's imposition on the former. Viner argued that while trade creation may generate higher welfare levels, trade diversion effects diminishes them (see Figure 2.1).

Two countries decide to enter into a preferential trading arrangement. Figure 2.1 illustrates the market situation of the home country. S_h and D_h represent its respective supply and demand schedules for the product in study. S_w is the world's own product supply schedule while S_p denotes the supply schedule from the partner country. Both schedules are assumed to be perfectively price elastic and, in our initial position, face an import tariff (t) that induces the effective supply schedules of S_w' and S_P'.

Price P_w is derived from the more competitive external producers and undercuts below price P_P of the partner country's producers in the home country's market when no tariff is imposed. If we now apply preferential trading terms, external producers will be put at a disadvantage with respect to the partner country. The latter now enjoys tariff-free conditions for its exports of the product in the home country depicted by the reduction in their supply price from P_{P+t} to P_P ($S_P' - S_P$). External producers, on the other hand, are still confronted with price P_{w+t} for their exports.

The application of these preferential trading terms has both trade creating and trade diverting effects. Before their adoption, the home country demanded $0Q_1$ supply from its domestic producers and Q_1Q_2 was imported from competitive external producers at price P_{w+t}. Combined area VZ is the tariff revenue acquired by the home country. The removal of tariffs on the partner country's exports lowers the price faced by the home country's consumers to P_P. Consequently, consumption increases from $0Q_2$ to $0Q_3$ as do total imports from Q_1Q_2 to Q_4Q_3, which now all originate from the partner country. It can also be noted that the diversion of trade away from external world producers amounts to Q_1Q_2.

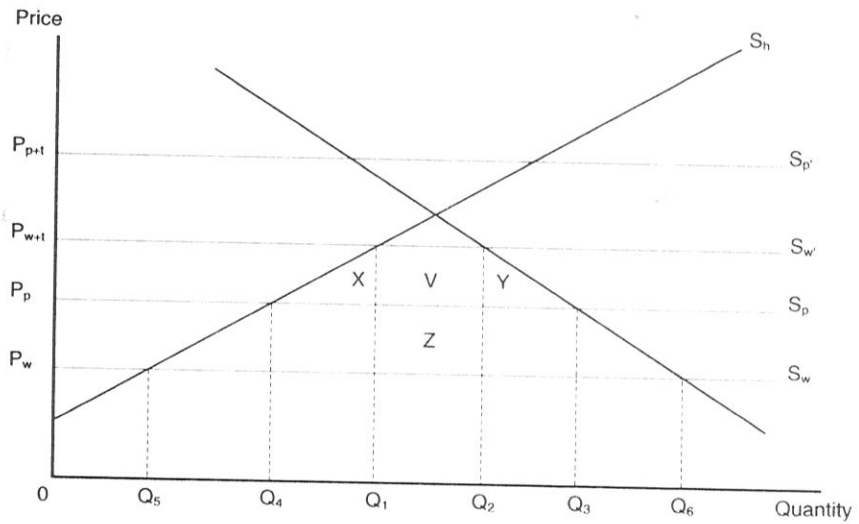

Figure 2.1 Trade creation and trade diversion

In addition, the partner country is now responsible for the trade creation represented by Q_4Q_1 derived from the partner country supplying the product at more competitive terms than domestic producers. This in turn enables domestic producers to concentrate more on activities where they possess a comparative advantage over their partner country. Area X denotes the gain in consumer surplus from this development (production effect) and, along with area Y (consumption effect), combines to form the welfare improvements associated with trade creation.

Area V is simply the loss of import tariff revenue arising from preferential trading terms, but simultaneously depicts a welfare gain to consumers in the shape of reduced prices. The same case is applicable to area U, though the transfer originates from a producer surplus loss. Meanwhile, area Z accounts for the loss of tariff revenue that is not passed on to consumers, and hence constitutes a trade diversion cost arising from

supplanting imports from essentially low-cost producers with those from a higher cost equivalent (i.e. the partner country).

An evaluation of the preferential trading arrangement's net welfare effect rests on the calculation X+Y−Z. A positive outcome would obviously indicate that the trade creation gains outweigh the trade diversion costs, while a negative outcome would suggest the opposite. The result would depend on such factors as the size of the initial tariff imposed, the relative efficiency of both home and partner producers to their external rivals and the elasticities of demand and supply for the product.

It would also depend on the degree to which the participating countries shared competitive or complementary industrial profiles. If the countries possessed a similar range of industries (e.g. Germany and the UK), then their competitive nature would propagate greater scope for trade creation. This is due to a wider range of lower cost producers being granted the chance to exploit improved trading opportunities. The scope is narrowed by the more significant degrees of complementarity that exist between countries (e.g. Germany and Portugal) and increases the risk of trade diversion.

Johnson (1965) noted that both trade creation and trade diversion yield gains to RIA members – with trade diversion directly benefiting the members to whom preference is deferred – while disadvantaging its more competitive third party rivals. Moreover, Viner and others have argued that whatever consequences evolved from the agreement, a universal reduction of tariffs produces superior welfare gains as external producers would then be able to expand trade creation to Q_5Q_1 and increased consumption Q_3 to Q_6. Hence, the relevance of the preferential trade arrangement offering only a 'second best' option.

The economics of a free trade area

In addition to those points made in the previous section on FTAs, let us assume that the partner country shown in Figure 2.2 possesses a relatively elastic supply schedule and that T_P and T_h are the respective tariff-induced price levels for the partner country and home country.

Under pre-FTA circumstances, the home country's domestic producers supply 0A to the market with AC derived from the imports of competitive external producers. Again, combined area VZ is the tariff revenue collected by the home country's government. The partner country's tariff ensures that its own domestic producers supply the total market's needs at price T_P and quantity 0B. If an FTA now operates between the two countries the following events unfold.

The FTA's total supply at price T_P would amount to 0A′ plus 0B between the two countries. This would lead to unsatisfied demand within the FTA (0A′+0C′). As this shortfall is less than the partner country's capacity to produce at T_P – that being 0B – it would have the incentive to supply the home country's market with A′C′ (=A″B), domestically pro-

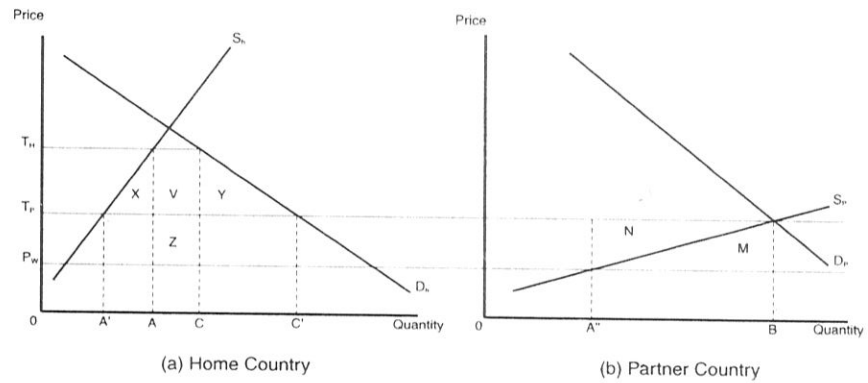

Figure 2.2 The economics of a free trade area

duce 0A″ and import the remainder (A″B) from external producers. Consequently the partner country would acquire the tariff revenue aggregated in area M (Figure 2.2b) and cause an indirect trade deflection effect. Moreover, price T_P effectively becomes the equilibrium price for our product concerned within the FTA. Areas X+Y and Z (Figure 2.2a) again represent the respective trade creation and trade diversion zones. In the example shown, we can also conclude that external producers will enjoy an improved position from the increase in export demand from AC to A″B. The net welfare balance will once more rely on the same determining factors discussed earlier.

The economics of a customs union

In our partial equilibrium analysis below, the same two countries now commit themselves to forging a customs union and their CET is formulated at the arithmetic average of preceding tariff levels.

From Figures 2.3a and 2.3b it can be ascertained that union supply at the CET price level exceeds demand. As a result, the CET will only set the ceiling price within the market. The equilibrium price P_{cu} will arise if it emerges that the excess supply in the partner country's market (GB″) equates with the supply deficiency in the home country's market (JF). Trade creation's production and consumption effects (X+Y) are again evident, but are diminished owing to the higher equilibrium price of P_{cu} over T_P. Trade diversion costs therefore rise accordingly, illustrated by an expanded area Z.

In the progression from an FTA to a customs union it is the partner country in our example, though, which will be most affected. A prevailing union market price of P_{cu} will entail a contraction of demand from B to G

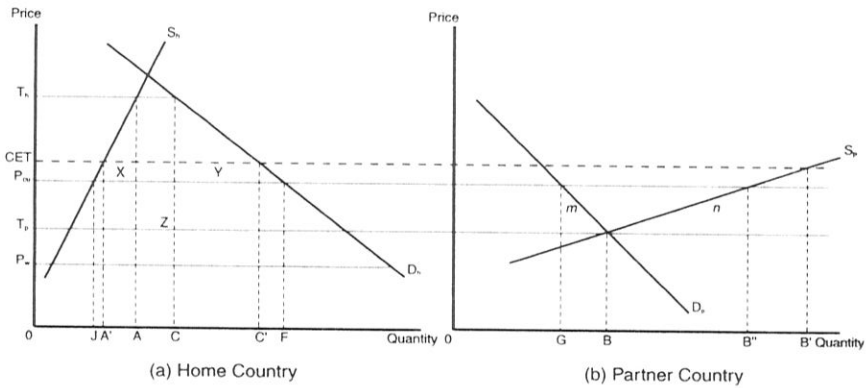

Figure 2.3 The economics of a customs union

and a consumer surplus loss of *m*. A concurrent producer surplus increase is represented by area *n*. The imposition of this relatively high CET denies the access of lower cost external producers to either market, unless they are able in the future to reduce P_w to such an extent that even when inflated by the CET their import price undercuts P_{cu}. Meanwhile, with no imports entering into the union, the partner country is also denied the tariff revenue it once enjoyed under previous arrangements. Thus, only the decision to adopt a CET based on the lowest pre-union tariff of any member would circumvent the adverse welfare effects relative to the FTA of our analysis.

Dynamic customs union theory

Traditional or Vinerian customs union theory (also associated with Meade 1955, Lipsey 1957, and others) concentrates on the detrimental, 'one-off' effects produced by preferential trading arrangements and has therefore been duly labelled as a 'static' form of analysis. Dynamic customs union theory, on the other hand, considers the longer term advantages that evolve, concentrating on how productive capacity is duly affected, as opposed to the allocative efficiency focus of static theory. These advantages are usually borne from the opportunities presented by enlarged markets, a liberalised competitive environment and a widened scope for mutually beneficial collaborations between business and industry. It should be noted that the larger the membership of the customs union the more distinct these opportunities become. Let us now examine the forces at work within this theory.

Economies of scale

As regional integration deepens, the opportunities to exploit economies of scale become more frequent. Corden (1972) has specifically referred to these as 'economies of time'. The conditions for internal specialisation created within a customs union will lead to cost efficiencies that in turn engender welfare gains. Each member will specialise according to their own comparative advantages being able to expand production within a larger and commonly protected market. The larger the customs union, the more likely it is that it will encompass the more competitive producers necessary to secure these gains. One would expect that larger union members would be in the better position to exploit scale economies. However, what is perhaps more relevant is a participating country's industrial structure. An illustration of this is given by Davenport (1982) who claims that many Dutch and Belgian multinational companies have flourished within the integrated European market which has included similarly structured economies.

Increased competition

The effective opening up of the union's market will intensify the competitive pressures exerted on domestic producers from their partner equivalents. These pressures should force firms to reduce prices, invest in new technologies and strive to improve efficiency in order to survive and prosper in the new competitive environment. In theory, monopoly power will either be undermined by increased competition or consolidated by broadened opportunities to exploit scale economies. Third countries can benefit from the structural changes brought about by both economies of scale and intensified competition: efficiency gains will lower the prices of their imports from the RIA, while RIA demand for their exports should rise from the increased growth rates induced from those changes.

Terms of trade effects

The terms of trade refer to the relationship between export and import prices. If a country or RIA experiences an increased price for its exports and a reduced price for its imports, its terms of trade are said to improve. Depending on the size of the customs union, the imposition of its CET could eventually force external producers to lower the price of their own exports in an attempt to circumvent the CET's effects. The larger the customs union, the more success it has in instigating this situation and, in addition, manipulating the welfare gains that are admittedly appropriated at the rest of the world's expense.

Benefits derived from closer collaboration

A variety of advantages are to be had from union members establishing closer collaborative links with each other. The extension of joint ventures and other forms of strategic alliances between businesses should result in a greater transfer of technology and skills across the membership and additional synergetic effects. By acting as one party, union members may also benefit from an improved international bargaining position, enabling particularly smaller member countries to 'punch over their weight' on the world stage.

In conclusion, the accumulation of those dynamic effects discussed will provide the incentive for more progressive forms of regional integration. Moreover, Pryce (1973) and Jansen and DeVree (1985) have contended that FTAs and customs unions ultimately constitute an unsustainable set of arrangements between member countries, and argue that further integrational steps need to be taken to repel the external forces opposed to the RIA's existence.

Europe, trade creation and trade diversion – the evidence

Most studies that have been conducted on the trade effects of European integration use a static theoretical and *ex ante* mode of analysis. Even though static theory would seem to underplay the welfare gains generated by RIAs, most studies indicate that regional integration in Europe has provided trade creation benefits which significantly outweigh the trade diversion costs (see Mayes 1978). This has been particularly revealed as more progressive forms of integration have evolved.

Dynamic and *ex post* studies have been few and far between, mainly due to the difficulties arising from isolating various relevant variables in order to evaluate the longer term effects of integration. Major disturbances such as oil shocks complicate this task to a significant degree. Furthermore, Markheim (1994) has observed that most *ex ante* studies encounter methodological problems arising from a miscalculation of *ex post* adjusted supply elasticities that consequently underestimate new trade volume flows. This has also led to an understatement of the effect of tariff rate changes on valuing the resources that have been subsequently redirected to exporting activity. *Ex post* studies have generally adopted the 'anti-monde' hypothesis which considers what would have occurred to a country's pattern of trade had it not joined an RIA, with trade creation and trade diversion effects then estimated from this position. The central problem of using the anti-monde model is that rather simplistic assumptions have to be built into it for it to be at all manageable.

In a more recent study, Sapir (1992) analysed the consumption patterns of the EC9 from 1980 to 1991 using the 'three-source' method to determine more contemporary trends in European trade creation and trade diversion.