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EUROPEAN DEVELOPMENTS AND THE U.S. ECONOMY

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BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

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CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2226, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton and Snowe.

Also present: Hunter Monroe, professional staff member.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The committee will come to order.

This morning the committee will examine how recent developments in Europe will affect the U.S. economy. The German unification and reform in Eastern Europe and the European Community's 1992 program are all important events in their own right, but their effects on the U.S. trade deficit and interest rates may also be significant. These changes in Europe will alter trade flows and place demands on the same pool of capital, global capital from which the United States must draw to finance its trade deficit.

In addition, it is not too soon to look ahead to the potential impact on the United States of a common European currency and of the increasing influence of the European Community.

To help us explore these questions, the committee is very pleased to hear the testimony today of Mr. Robert Hormats, vice chairman, Goldman Sachs International; Mr. Stephen Cooney, director, international investment and finance, National Association of Manufacturers; and Mr. Michael Aho, director of economic studies for the Council on Foreign Relations.

We will turn now to the panel for their testimony, and we trust you will keep your statements, oral statements, to about 10 minutes in time. Your prepared statements, of course, will be entered in the record in full. We appreciate very much your presence this morning. We look forward to your testimony.

Mr. Hormats, you may begin, and we will just move across the table from my left to right.

STATEMENT OF ROBERT D. HORMATS, VICE CHAIRMAN, GOLDMAN SACHS INTERNATIONAL

Mr. HORMATS. Thank you, Mr. Chairman. I will try to be very brief and leave more time for exploring some of these issues in questions and answers. Let me just make a few general points.

First, the point about the politics of developments in Eastern Europe, particular East Germany: It's important to realize that the Germans have been under a timetable which has been forced by political and, to a degree, demographic events and developments. After the wall came down, it became inevitable that some type of economic union had to develop, and develop very quickly, for two reasons:

One, electoral politics or domestic politics on both sides of the border; that is, the West German Government wanted to provide support for their political allies in East Germany. The coalition government wanted to support its supporters on the other side of the border.

And second, there was a great deal of concern that if there was not some ray of hope provided to the people in East Germany, unification would take place on West German soil; that is to say, masses of people would move over to West Germany and there would be a nonviable East German economy. The political system would fall apart. And the polity and society would deteriorate, because so many would want to move to the West to get the economic benefits.

So, some of the things have been done for political reasons, and some economic compromises had to be made. For instance, the one-to-one exchange rate is not strictly speaking, justifiable economically because productivity rates in East Germany are about a third of those in West Germany; and therefore, one-to-one would not have been, economically speaking, the correct exchange rate. But it had to be done for political reasons.

Second, basically, while some thought the European Community might deteriorate because the West Germans would turn their backs on European unity as they moved toward the East, in fact the West Germans have gone out of their way to demonstrate that they are good Europeans and that they are proceeding to support European unity at the same time they are also pursuing German unity. And I think that is an important consideration.

One other major point that I would like to stress at the outset: Much talk in the market has focused on the enormous demand for capital in East Germany but more broadly in Eastern Europe. It's very important to make a distinction between the need for capital and the ability of these countries to absorb capital efficiently. They are very different. Surely they need a lot of capital. Just to revitalize the housing industry in Eastern Germany there is a capital requirement of billions and billions of deutsche marks.

The fact is, however, that it is very hard to utilize all these funds right away. There is an absorptive problem that is going to plague these countries. In addition, there are legal problems; there are political problems because they have not quite figured out what direction they want their economies to go in, how quickly, how far toward a market system. So they are simply not going to be able to absorb as much money as many people think at this point, and certainly not the billions and billions of dollars that many people say they need.

And the other fact is that business is not rushing to invest in Eastern Europe. In Poland, Hungary, and Czechoslovakia, places that I have been very recently, there are relatively few investments. There has been one or two notably large investments, but money is simply not coming in in large amounts. Investment is not a major factor in the outlook in these countries in the near term. It's different in East Germany because a lot of West German firms, for a variety of historic and other reasons, are investing there.

So the difference between absorption, need, and availability of capital must be kept in mind, because there are important distinctions.

Let me just make a few general points about the impact of all this on the United States. First of all, there will be some impact from German unity. There is likely to be a demand in East Germany for more capital goods. A lot of those will be supplied by West Germany. In turn, there will be greater demand in West Germany for a variety of things, and the United States stands ready, I think, to sell more capital goods to Western Europe.

Our overall estimate is that in 1990 domestic demand will grow in Germany by about 4 percent. But it is important there to bear in mind that we do not sell a huge amount of goods to West Germany compared to what the other European trading partners of West Germany sell to it. We sell about $10 billion of capital goods to West Germany every year. Let's suppose it's doubled to $20 billion. That is still only about a 1 percentage point increase in American exports. So the amounts we are talking about are not enormous; important to certain industries but not enormous.

Second, just a few general points about monetary union and about its impact on interest rates. Just to give you a couple of numbers to bear in mind, the East German GNP is about 8 percent of that of West Germany. It is relatively small. It has the GNP of about the size of the German State of Hesse, which is not by any means the biggest of the West German States.

What will happen as a result of economic and monetary union is that the money supply of a united Germany will go up by about 13 percent. So that the united German GNP will go up to 8 percent because East Germany will be added on to it, and the overall money supply will go up by about 13 percent, leaving what one might call, just in rough terms, a 5-percent overhang. It's not exactly the right term, but it illustrates the point.

Now the question is what the East Germans are going to spend this money on. I was in East Germany, and I asked a number of people, including the new Prime Minister of East Germany, de Mazière. He said something very interesting. He has three daughters. He said, "My three daughters want to travel," he said, "not only have the East Germans been deprived of hard currency for a long time, they haven't been able to go anywhere." So there will be a monetary overhang; they will have a substantial amount of money. Some of it will be spent, some of it will be saved, and some of it will be used on travel. And therefore, the West Germans are banking on the inflationary impact being relatively modest.

Now, inflation is likely to go up somewhat in West Germany as a result of increased demand resulting from monetary union and as a result of all these capital flows that are going to take place. But it should not be enormous.

The other point to bear in mind about inflation is that the West German economy is quite an open economy. While its economy is very close to full capacity utilization, it will be able, if there is additional demand, to import more goods from other parts of Western Europe and indeed the United States as well. And that should be very helpful to us and them. So that the problem is not a big one.

The impact on the United States from all the developments in Western Europe—that is to say, the increased unity of Western Europe, the elimination of borders for most items within Western Europe, and the changes in West Germany—should be an increase in exports of about 2 percentage points over the course of the next couple of years.

The interest rate impact on the United States is quite exaggerated. It is true that when the Berlin wall fell, interest rates went up. But real interest rates have been rising in this country over the course of the last decade with little blips here and there. But generally real interest rates are higher. And that is not just because of what is going on in Eastern Europe, it's because of a general decline in global savings rates. That is, virtually everywhere in the industrialized world, savings rates are down.

At the same time, inflation has been picking up very gradually. And there is a proliferation of demand for capital around the world. There is a demand for capital in Eastern Europe, East Germany being the major demander of capital and the country that is going to get most. There are more investment opportunities in East Asia. There is a lot more Japanese investment going into Western Europe than before.

An interesting point is that fully 25 percent of Japanese direct investment has gone, over the last couple of years, into Western Europe, and that is a big increase. So it means that a lot of countries are romancing the yen. A lot of people are trying to get the yen at the same time Japanese savings rates and Western savings rates in general are declining. And that has tended to pick rates up somewhat. And the fall of the Berlin wall, as I mentioned, raised in the market the general view that a lot of money was going to go into Eastern Europe.

I think that interest rates will come down a bit because of the inflated expectation of large capital flows to Eastern Europe will become a little less inflated, and the markets are becoming a little bit more realistic.

Let me also make the point that the United States does depend, at the margin, on foreigners to finance its government budget deficit. But the amounts of foreign money that come in are sometimes confused with the amounts of money we need to finance our budget deficit. A good portion of money that comes into this country in the past went to Treasury bonds or notes or bills; now we are seeing some of it, to be sure. About 20 or 25 percent of the initial bond issues in this country are bought up by the Japanese. But a lot of money that comes into this country goes into direct investment and to other things. And it is true that if Japanese savings go elsewhere in the world—to Western Europe or East Asia or other parts—it makes the global capital market more competitive and we have to compete more actively. And that does mean that if interest rates start declining here, the Japanese may say, "Well, for this particular Treasury auction we will buy a little less here and we will buy more German bonds or put more of our money into Taiwan or some other place."

The fact, however, is that the United States is by far the broadest and deepest and safest capital market in the world, even now. And it is very hard, if you are a big Japanese portfolio manager—and the people who invest this money are not the guy on the street but huge insurance companies and banks who have to run enormous portfolios—to place funds elsewhere in as liquid a market. They have an opportunity at the margin to shave off a percentage of the money that comes here. But they have to manage big portfolios, and its really hard for them to manage those in a liquid fashion without putting a substantial portion here.

Nonetheless, we are going to have to compete more actively in a much more competitive global capital market if more money does go into Eastern Europe, more money does go into East Germany, and the Japanese do diversity. That will tend to have an upward bias on interest rates in the United States. And that upward bias does not mean 2 or 3 percentage points, but it does tend to make it a little bit more difficult for us to lower rates here without the possibility of a weakening of the dollar.

Some of the numbers I have talked about are discussed in my prepared statement.

Just one point on the German demand for capital, to illustrate the last point I made. In 1989 the West German Federal deficit was 15 billion deutsche marks. In 1991 it will be about 35 billion deutsche marks. The individual Länders—the German States—deficits will rise from 5 to 15 billion DM because the Länders have to contribute part of the money to rebuild East Germany. And then there is what is known as the German Unity Fund, which, of course, didn't exist in 1989, and that will take 35 billion deutsche marks. So the general view is that West German public sector bond issues, along with East German public sector bond issues, are likely to grow from about DM26 billion in 1989 to about DM100 billion in 1991.

The German current account surplus in 1989 and 1990 was just about 100 billion deutsche marks. So the amount of money that the Germans are going to have to borrow, that the united Germany is going to have to borrow, equals roughly the same amount as the West German current account surplus in 1989 and in 1990.

So the Germans are able, by and large, to take a large share of this capital burden—with a little bit of inflation, a little bit higher interest rates.

The one wild card—and this is my concluding point—that we don't really understand and we can't measure is the cost of the final agreement between NATO and the Soviet Union on the future security or architecture of Europe and most particularly the question of what it will take to encourage the Soviets to give up what are known as their "Four Power rights" and to remove their troops over a period of time from East Germany.

We don't know the answer to that, but the amounts talked about are quite large. There is going to be, among other things, continued West German subsidy of East German exports to the Soviet Union for a period of time. How long we don't know, but the amounts could be 5 billion deutsche marks a year.

There is going to be money spent, presumably, to help the Soviets to resettle troops that are now in East Germany, and they are going to have to be sent back to the Soviet Union. There will obviously be some Western support, particularly German support, for civilian housing for those demobilized troops. And there are going to be other elements of this package.

We don't know how much that is going to cost. The probability is the West Germans will take a large share of that burden. You hear numbers discussed, but since I don't know what they are, I don't want to repeat the rumors. But they are in the billions of dollars. So this is another sort of wild card that we don't fully understand, and it will certainly have an impact on our economy and, more particularly, on their economy.

Thank you.

Representative HAMILTON. Thank you, Mr. Hormats.

[The prepared statement of Mr. Hormats follows:]

PREPARED STATEMENT OF ROBERT D. HORMATS

THE IMPACT OF THE UNITED STATES OF RECENT DEVELOPMENTS IN EUROPE

Mr. Chairman:

You asked in your letter of invitation that I address how German unifieation, reform in Eastern Europe, and the European Community's investment boom will affect the United States economy.

I have been highly impressed with the approach the two Germanies have taken towards unification. The Berlin Wall fell only six months ago. In the short space of time since then, a remarkable amount of work has taken place to unite, in an orderly fashion, two very different economies and political systems. It must be made clear at the outset that some of the decisions taken responded more to political than to economic requirements. For example, East German productivity rates are less than half those of West Germany; therefore a one-to-one exchange rate between the Ostmark and the Deutschemark was not, strictly speaking, <u>economically</u> justified. But without it there would have been an even greater flow of East Germans to the West than actually took place. That would have put politically and economically unacceptable stress on the West German society and economy, and risked the collapse of the East German economy and policy. So the decision was politically necessary. And the economic cost is manageable.

I also believe that the European Community has show remarkable vision in the way it has accommodated developments between the two Germanies. Close cooperation between German Chancellor Helmut Kohl, French President Francois Mitterand, and EC Commission President Jacques Delors has paid off. The speed of European integration has not been slowed, as some feared. In fact it appears to have been speeded up. The Germans want to demonstrate that they are not so preoccupied with absorbing East

Germany that they are turning their backs on the rest of Europe. And the other Europeans seek to bind Germany even more tightly in a strong Western European economic and political network.

IMPACT ON U.S. TRADE

For the US, the economic restructuring of European will generate some, but only limited, trade benefits over the next year or two. These developments might boost the growth of total U.S. exports by perhaps 1-2 percentage points; the primary beneficiaries will be capital goods exporters selling to Germany and, to a lesser extent, to other parts of the continent.

Capital goods exports are likely to increase to Germany because manufacturers there will seek to accommodate increased demand in an economy whose capacity to produce is already strained. Hence they will need to invest in new productive capacity. And US companies will gain some competitiveness in the FRG to the extent that the prospect of unification has caused the D-mark to rise against the dollar.

The latter effect will not be large, however. The D-mark dollar rate appears to have stabilized, and indeed some of the strength of the German currency has ebbed of late. As for capital goods exports, they are a prominent part of US exports to Germany but are a comparatively small portion of total US exports. In 1989, US shipments of capital goods to Germany were probably around $10 billion. Therefore, even if German demand for US capital goods were to double over the next two years, total US export growth would increase by only about 1 percentage point.

With respect to developments in Eastern Europe, the trade benefits for the US will also be modest in the near term. Collectively the five countries other than East Germany -- i.e. Bulgaria, Czechoslovakia, Hungary, Poland and Romania -- have a combined GNP of only $500 billion; these countries bought less than $750 million worth of goods from US exporters in 1989. Their road to a market economy will be long and rocky. The transition will take place in a highly charged political environment. Cultural differences, questions surrounding private property ownership, an uncertain legal environment, and a shortage of hard currency to finance imports and permit repatriation of profits earned from investment in these countries will pose obstacles not easily overcome in the next few years. To the extent US exporters benefit from the transition, it will be mainly by supplying capital equipment to West German, Austrian, Swiss and other firms which are in the best position to satisfy increased consumer and other types of demand in Eastern Europe. However, in some special areas, telecommunications equipment, environmental cleanup equipment, American cultural items such as Levi's jeans, and certain consumer items such as Pepsi and Coke, American companies should do quite well.

Finally, measures to reduce and/or eliminate cross border barriers within the EC as part of the 1992 initiative will have mixed implications for US trade. In general they will expand export opportunities for US companies by affording wider and less costly access to European markets for companies operating and selling anywhere within the EC. But at the same time Community, Japanese and EFTA companies investing heavily to strengthen their productive capacity and build market share will offer stiffer competition; and some markets, like the very lucrative European government procurement market, will be denied US exporters in part as long as the US maintains its own "Buy American" preferences.

US capital goods exporters stand to benefit from Europe 1992 to the extent that European manufacturers setting up new operations purchase equipment from US manufacturers. Some of this increased demand is probably already built into recent trends, which suggest that capital goods exports to Europe rose by nearly 50% between 1987 and 1989. With capacity utilization rates declining outside Germany, it is likely, however, that the growth in US capital exports to Europe will recede from this unusually strong pace. Nonetheless gross fixed capital formation in the EC is expected to expand by a still healthy 4.6% in real terms this year -- far higher than in the early 1980s. Its slowdown reflects the impact of policies aimed at preventing economic overheating in some EC members; particularly the UK, Belgium, Greece and Spain. This slowdown in capital formation is most pronounced in the equipment area, in which investment grew by 9% in 1989, and will fall to 6.2% in 1990. We estimated that in 1990 overall domestic demand will grow in Germany by 4%, in France by 2.8%, in Italy by 2.6% and to the UK by -0.6%. By way of comparison, in 1989 27.6% of US exports went to Western Europe; 21.6% to Canada and 11.7% to Japan.

GERMAN ECONOMIC UNIFICATION

There are many estimates of the impact of German monetary and fiscal union on interest rates, inflation and growth. Let me make a few general comments to put the subject in perspective. Regarding the question of the capital requirements of East Germany, one should make a clear distinction between need and absorbtive capacity. The amount of money East Germany will receive will be limited by the capacity of the East German economy to effectively utilize funds. It has been estimated that East Germany will need about one-half trillion dollars to bring its capital stock up to par with West Germany and to clean up the environmental mess that the Communist government left. But even with the organizational, managerial and financial skills of its own people and the great technical and managerial, not to mention financial, help it will receive in these areas from West Germany, it is unlikely to be able to absorb more than about $55 billion of annual investment in infrastructure and productive capital stock. A large part of this will probably be generated in East Germany -- $30 billion according to one estimate -- leaving a requirement for capital transfer from West Germany and other Western countries of about $25 billion annually. This is equivalent to just about 8% of the savings of West German households and enterprises, according to Dresdner Bank.

In view of the large German current account surplus, which hovers in the $50-60 billion range, part of which could be diverted to East Germany, even if the West Germans supply all of this, it should not strain that nation's financial markets or significantly push up interest rates.

There will also be other expenses. Calculations of Dresdner Bank economists indicate that the Bonn government will need additional financings of $15 billion to guarantee East German social security during a transition period; this calculation anticipates a high initial unemployment rate of about 20%. (The West German government, however, puts this figure at only $3 billion.) Offsetting these costs, German officials note, will be a reduction in the amounts currently spent on grants and tax breaks for West Berlin and for businesses close to the West German side of the inner-German border. These now come to $20-30 billion annually, but they will not be cut all at once.

In 1989 the West Germany federal deficit was DM 15. In 1991 it will be roughly DM 35 billion. Länder deficits will rise from DM 5 to DM 15 billion. The German Unity Fund, which, of course, did not exist in 1989, will absorb DM 35 billion in 1991. All together East and West German public sector bond issues are likely to grow from DM 26 billion in 1989 to roughly DM 100 billion in 1991 -- roughly the size of the West German current account surplus. The German and international capital markets should be able to accommodate this. (We estimate that long term bond yields will rise from about 7.6% in 1989 to 9.5% in 1990 and remain in that range in 1991.)

Monetary union raises another set of issues. After 1-1 conversion on July 2, there will be a boost in West Germany's money supply (M3) of 13% -- which includes private individual holdings of cash and bank deposits plus companies holdings of bank deposits (assuming all company sector deposits are counted in M3, which might not be the case). It is difficult to calculate how much of this 13% boost in money supply will end up in savings and how much will be spent by East Germans, who have not previously had access to convertible currencies. Some of the funds will be used for travel, because East Germans have not been able to leave their country for forty years either.

It should be noted also that the size of the economy that will be covered by the new expanded money supply will be about 8% larger than before; this represents the size of the East Germany's GNP relative to that of West Germany. The potential monetary overhang, therefore, will be about 5% of Germany M3. This is still large -- equivalent to around DM 65 billion, or 3% of West Germany GNP. If the East Germans decide to spend this amount immediately on foreign (i.e. non-East German) goods, most of which would come from West Germany, inflation would rise in the Federal Republic, although the openness of the West German economy to foreign imports, and the possibility that some of the money will be used for travel elsewhere, should mitigate the inflationary impact.

It is hard to determine the level of inflationary pressures will emerge. But together with the strength of demand growth which is already underway, the odds are that monetary union will push up German inflation to about 3% in 1990, and, as noted above, interest rates will rise to perhaps 9.5%.

Big borrowing and spending will probably also lead to a drop in the German current account surplus, which could decline from DM 100 billion in 1990 to DM 50 billion next year. That should help Germany's European neighbors, who have been troubled by their big trade deficits with the Federal Republic. In contrast to the US, which sells Germany only 5.7% of its overall exports, 18.5% of French exports go to Germany, for Italy the figure is 17%, for Switzerland 23%, and for Holland 26%. That boost should benefit these economies and American exports to them.

What is the impact of all this on US interest rates? For a time it was the accepted wisdom in the market that higher rates in Germany would make it difficult for interest rates to decline here. The argument was based on the notion that in light of higher interest rates in Germany, if internal rates fell here the dollar would collapse, leading to new inflationary pressures. With less upward pressure on the mark and less downward pressure on the dollar, the concern has abated. The Fed is focused far more on the internal US level of inflation, the underlying strength of the economy and the outcome of the Budget Summit than on the precise value of the dollar. It will run monetary policy accordingly. The US bond market might suffer mildly if German interest rates remain high because that attracts American, Japanese and other capital into Deutschemark securities, which would tend to keep US yields high. But much of that expectation has already been incorporated into US bond yields, so signifiant further weakness in US bonds for that reason appears unlikely.

One last point, Germany will have to pay not only for unification with East Germany but also to ensure expeditious Soviet troop withdrawal from East Germany as well as Soviet acceptance of the new European security architecture; the latter will involve the Soviets relinquishing their Four Power rights and accepting the inclusion of a united Germany in NATO, albeit with certain transitional measures. The price paid by Bonn will likely be Western German subsidy of continued East German exports to the USSR for a period of time (DM 4-5 billion annually), subsidies for civilian housing in the USSR for demobilization of repatriated Soviets troops, help with emergency imports of consumer goods, and loans for the revitalization of the Soviet economy. These amounts combined will total several billions of dollars.

Representative HAMILTON. Mr. Cooney, please proceed.

STATEMENT OF STEPHEN COONEY, DIRECTOR, INTERNATIONAL INVESTMENT AND FINANCE, NATIONAL ASSOCIATION OF MAN-UFACTURERS [NAM]

Mr. COONEY. Thank you very much, Mr. Chairman. As you may know, NAM has been heavily involved in following the 1992 issue and the other European developments affecting Eastern Europe and the Soviet Union. I would like to request that, in addition to making our prepared statement available for the record, I would like to supply some copies of our updated report on 1992, and make those available for your committee as well.

Representative HAMILTON. Without objection, it is so ordered.

Mr. COONEY. Thank you.

I would say that what I wanted to do here, of course, is briefly summarize the prepared statement that I have prepared. I think following on from the previous witness, Mr. Hormats, whom we have known a long time and respect quite a bit, there is one thing I want to say in introducing my comments and perhaps amending or giving a different impression from what he said. I want to empha size the strength of the European market, particularly the West European market, for the American economy and for the American industrial community.

I think that there is a risk, when you listen to the previous wit ness' statement, that one would tend to understate or underesti mate the U.S. export opportunities there. In preparing this pre pared statement, looking at the 1990 numbers, I myself was even surprised to see how strongly the trends of the last couple of years have held up and have strengthened in terms of U.S. export in creases to the European Community.

Now, just to give you some idea of the order of magnitude here over the last 2 years, we have reduced our total trade deficit by about a third, by about $44 billion. Now, about half of that im provement has come in our net trade with the European Communi ty. And while in my prepared statement I do not divide the Euro pean Community up by individual countries, West Germany is usu ally our second largest export market, usually a close second to the U.K. One of the reasons I don't divide these numbers up by member states is I think our exports to Germany are understated Even during the worst of our U.S. trade deficit period, we had sub stantial surpluses with the Netherlands and Belgium. I think tha a lot of the goods that are exported to the Netherlands and Bel gium ultimately end up in Germany, perhaps after some furthe processing.

So I think that really Germany is not only the engine of econom ic growth in the European Community, but also in fact the bigges U.S. export target in Europe. And I think that the developments i East Germany will increase that tendency, as I note near the en of my prepared statement.

This growth trend is continuing. If you look at our trade develop ments over the past several months in 1990, you will find, for ex ample, that our overall trade balance on an annual basis is surpris ingly continuing to move downward fairly strongly, much mor strongly than many of us anticipated, to the $85 billion or $90 billion level. And again, about half of that improvement is due to the improvement in our annual rate balance with the EC. We are now running on an annual basis about a $10 billion surplus with the EC compared to about a $1 billion to $2 billion surplus last year. That is roughly $9 billion, roughly half of our total improvement.

So I think that this is a tremendously strong-growing market.

The other point I make in looking at some more detailed figures—and this was also something of a surprise to me—is the rate at which we are increasing all our exports. We have known about the strong exports in computers, in aircraft. About half of our computer exports worldwide go to the EC. We have an $8.5 billion surplus with the EC in computers. We have a $6 billion surplus in aircraft, despite the heavily subsidized airbus program in Europe.

What surprised me was that even in the areas of more traditional industrial machinery, where we have deficits with the EC, we have strongly increased exports. These products have participated in the U.S. export boom. Areas like construction and special machinery, general industrial machinery and parts have all increased their exports. Agricultural machinery and tractors have all increased their exports to the EC over the past 4 or 5 years by 50, 100 percent, or more.

So this has been a strong export market for the United States across the board, even in areas where we had and still have trade deficits with the EC on a product-by-product basis.

The next point I want to make there is that this is related to the 1992 program. The 1992 program is a program that encourages industrial investment and industrial restructuring, and what people are looking for in Europe is competitively priced, high-quality capital goods, and that is America's strongest suit on a comparative basis as a world trading nation. About a third of our exports each year are manufactured capital goods, and that is also the strong point in terms of our exports to the EC.

Now I have painted a fairly sunny picture here. There are certainly some clouds on the horizon in terms of specific EC policies. I have heard you talk on them, so I know you know about them. But I would certainly like to mention them here again because we think they are some of the most important areas of discussions currently between the United States and the EC. The three that I have highlighted in this particular prepared statement are the area of testing, standards, and certification, where it is very important for U.S. manufacturers that we are able to have testing and certification, certainly the testing component, done in the United States and test results accepted in Europe—an expansion, in other words, of existing bilateral agreements. And we are fully supportive of the discussions between the Commerce Department and other U.S. agencies and the EC on that subject.

Also, there are two other areas that have now been brought into the GATT Round, the rules-of-origin issue, which affected semiconductors initially but threatens to affect other products as well; and the issue of the so-called utilities directive or excluded sectors, directive in public procurement, by which there are officially recognized discriminations in the EC against non-EC imported products.

Those are some of the big issues that we see in U.S.-EC relations that could threaten to reduce the opportunities for U.S. exports, could in effect encourage U.S. companies and others to either source in Europe or to produce the goods in Europe rather than export it from the United States on a competitive basis.

Now, looking at the question of Eastern Europe. The first thing I want to say is that we do see that as an issue that is, in effect, farther down the road, but important policy decisions have to be made now if we are going to be able to help develop that market and if the United States is going to get a good share of that market.

I have put statistics in my prepared statement, for example, indicating that, quite frankly, compared to our trade with the EC, our current trade with the rest of Eastern Europe and the Soviet Union is infinitesimal. We are talking probably only a billion dollars in manufactured exports to Eastern Europe, probably less than that to the Soviet Union today.

So even the numbers we have in total trade, which aren't very big, are dominated by one factor: U.S. grain sales to the Soviet Union. And of course, there are tremendous political and economic problems in those countries which will probably hold down the rate of development or the rate of growth of the market. But we think there are several things which need to be done to improve the U.S. ability to access that market, because we think that eventually it will take off.

Eventually it will be an important market, and those things need to be done today. They need to be done, to some extent, in this Congress. These actions include full U.S. participation in the Eastern Bank for Recovery and Development, which is part of the Seed II Act legislation, I believe, which NAM fully supports.

Second, we need new trade and investment agreements with most of these countries, including the Soviet Union. And from NAM's point of view, that would include establishing most-favored-nation trade status for the Soviet Union. We also need an enhanced and more credible Eximbank program. This is not in my prepared statement, but I think we find that in Europe most European countries, their Eximbanks support 20 to 40 percent of their total exports. In our case, it's somewhere around 3 to 5 percent. And obviously, if you're dealing with an area like Eastern Europe which has tremendous debt problems and currency convertibility problems, official export credits and export supports are very important.

Finally, the last item on our agenda with respect to Eastern Europe is the CoCom negotiations on export controls, and I can't overemphasize their importance. Every day, in almost every conversation I have with European companies and potential European purchasers of American goods—I hear of the problem of different requirements between the United States and European countries.

My closing comment will be on the question that Mr. Hormats spent some time on, and that is the question of East Germany. There, I think, some of the general conditions regarding Eastern Europe don't apply because of the integration of the two economies. East Germany will be endowed with a strong currency and with a strong economic base, right off the bat, through their integration with West Germany. But, while there will be some increased American investment, we find that both American and European investors are dubious about investing even in East Germany let alone elsewhere in Eastern Europe and the Soviet Union.

So I would expect that we would see, as Mr. Hormats said, that the major benefit to the U.S. economy and to the U.S. industrial exporting be indirect through increased economic activity in West Germany and therefore increased demand for U.S. goods for the unified German market.

Thank you very much, Mr. Chairman.

Representative HAMILTON. Thank you, Mr. Cooney.

[The prepared statement of Mr. Cooney, together with the report referred to for the hearing record, follows:]

PREPARED STATEMENT OF STEPHEN COONEY

Mr. Chairman, I am Stephen Cooney, Director of International Investment and Finance for the National Association of Manufacturers. NAM is a voluntary business association of over 13,500 manufacturing companies of all sizes, and their subsidiaries. Our members employ over 85 percent of all U.S. workers in manufacturing. They produce over 80 percent of the nation's manufactured goods and a similar share of the nation's manufactured exports.

Over the past two years, our members' economic concerns with Europe have been dominated by the issue of the European Community's Single Internal Market Program (EC-92). Last year, I testified before this committee regarding EC-92 and its possible trade and economic impact on U.S. companies. Since then, we have seen many great changes in Eastern Europe and the Soviet Union. I think it is no exaggeration to say that we are dealing with a Europe today that is totally different from just one year ago, in terms of its political and security relationships.

Yet the major engine of growth and development in Europe, in my view, remains the EC, and the dynamic process represented by EC-92.

EC-92 is part of a restructuring process that has already dramatically raised U.S. exports, and may continue to do so. Also, the most important international economic questions among the non-member countries - both the Western EFTA countries and the COMECON states - concern their relationship with the powerful EC bloc. Economically, what is happening in Eastern Europe and the Soviet Union is not a sideshow. But in terms of our efforts to keep U.S. exports growing and reduce the trade deficit, maintaining and improving the access and performance of U.S. exports in the EC market is still the critical immediate issue.

Summarizing the situation in terms of the focus of this hearing:

-- U.S. exports are continuing to perform well in the EC market. The growth is led by technology-intensive capital goods, but almost all industrial exports are selling well. The United States last year converted its overall trade deficit with the EC into a surplus, and exports in early 1990 are running at nearly a $100-billion annual level.

-- EC currency unification and monetary union (EMU), if it proceeds on schedule, should create few problems for the United States - unless the German currency is fixed too low by comparison to other EC currencies for a prolonged period.

-- The EC is likely to remain the key U.S. export market in terms of growth opportunities for the next few years - development of Eastern Europe and the Soviet Union is a longer term proposition. The latter process can be speeded up by adoption of specific U.S. policies, which NAM fully supports. East Germany may be an exception, in that reunification may lead to immediate trade benefits for the United States.

EC Remains the Big U.S. Export Market

The rate of U.S. export growth to the EC in 1989 was 14 percent, or well over $10 billion. While less than the spectacular 25-percent growth rate of 1988, this still represented a continuation of the strong U.S. growth in exports to the EC, which has been a main feature of U.S. trade performance since the mid-1980s (see Table 1). Our overall trade deficit with the EC, which was over $20 billion annually earlier in the 1980s, became a $1.5 billion surplus. Between 1985 and today, growing U.S. exports to the EC have probably created nearly a million new U.S. jobs.

U.S. exports to the EC will almost certainly top $90 billion in 1990. In fact, during the first four months of 1990, U.S. exports were up over 15 percent compared to the 1989 total, and were running close to the $100 billion annual level. U.S. imports from the EC were also up slightly in early 1990 after falling in 1989, but the annual rate U.S. surplus has still increased to over $10 billion. (Based on previous experience, I expect the U.S. balance to remain positive and larger than 1989, though not necessarily this big.)

Since serious structural problems persist in the domestic U.S. economy, it is becoming more apparent every year that neither individual U.S. companies nor the U.S. economy as a whole can ignore the growth potential offered by the rejuvenated EC economy. To a great extent, continuing a positive rate of growth in our country in the next few years is linked to maintaining high levels of export growth, especially in the European market.

Capital Goods Should Lead Continuing U.S. Export Growth

The growth in EC demand for U.S. exports should continue. This statement is based on official EC economic analyses that indicate strong and continued growth in investment in industrial equipment -- another 6 percent in 1990, according to recent estimates and forecasts, after growth in the 9-11 percent range in 1988-89. This strong investment growth has been directly stimulated by the EC-92 program, and industrial restructuring in anticipation of its impact. It plays directly to the greatest U.S. trade strength -- manufactured capital goods and technology-intensive products.

Table 2 reflects this profile. It is part of a current NAM project aimed at analyzing comparative U.S. manufacturing strengths in various global markets.

The table shows that the United States is relatively strong with respect to more technology-intensive products, such as computers (over $11 billion in exports and $8.5 billion surplus with the EC) and aircraft (about $9.5 billion in exports and a $6 billion U.S. surplus). The EC took about 44 percent of all U.S. computer exports and 39 percent of all exports of aircraft and parts. The U.S. has similar strong positions and positive balances in most other technology-intensive product areas - electrical machinery and parts (including semiconductors), power-generating machinery, non-consumer telecommunications equipment, and professional, scientific and controlling instruments. In Europe and elsewhere, these products have been associated with high levels of industrial restructuring and reinvestment.

In most other manufactured goods, the United States has deficits with the EC, and it still had an overall manufactures deficit of about $4 billion in 1989. But the trade pattern among these industries varies considerably.

The EC forms a major and growing market for traditional industrial equipment, such as machine tools, industrial machinery and parts, and agricultural, construction and other special-purpose machinery. In these categories, U.S. exports to the EC have increased 50 to 100 percent or more since 1985, even though the United States remains a net importer with the EC. Thus, it is not only those industries popularly considered as "high tech" or "leading edge" whose exports are growing fast, and who need access to the strong EC market.

Other industries in which the United States is a net importer from the EC include products where trade in Europe is heavily affected by subsidies, quotas and other protective measures which may directly or indirectly affect U.S. producers in the EC, U.S. or world markets. This would include many of the basic industries included in category 6 of the Standard International Trade Classification, notably steel and textiles, and consumer products such as clothing, footwear and cars. Even here, there have been surprises. For example, U.S. exports of motor vehicles to the EC have now reached the $1 billion level - about ten times higher than in 1985. This is largely due to increased shipments of U.S.-made minivans and similar non-traditional vehicles. Of course, the United States remains a large net importer from the EC, but really only from Germany, which last year accounted for 75 percent of all U.S. motor vehicle imports from the EC.

Policy Implications

With respect to EC-92 and associated policies, the major implications for U.S. manufacturing interests are as follows:

-- The U.S. government and private sector must maintain and improve U.S. access to the evolving new EC system of standards, testing and certification. This would notably include EC acceptance of product testing done by exporters in the United States. NAM fully supports the continuation of the present US-EC discussions on these issues.

-- The discriminatory treatment of U.S. products under the revised draft Utilities Directive should be eliminated as soon as possible. The EC has repeatedly stated its willingness to discuss reciprocal access, preferably through expansion of the GATT government procurement code. Whatever form negotiations take, U.S. companies' customers in Europe must be assured as quickly as possible that the threat of such discrimination in all product areas and in all EC countries will be eliminated.

-- The EC 1989 rule of origin for semiconductors should not be used as a basis for determining origin of downstream products, notably computers. This threatens to affect not only U.S. exports of electronic products, but also other products which contain computer-controlled equipment or components. NAM supports the commitments made by the U.S. government and the EC to seek the establishment of GATT discipline over the use and application of origin rules.

-- But, above all, don't kill the goose that is laying the golden egg. Strong U.S. export performance across the board in the EC today outweighs any specific US-EC trade issue. Our major policy goal should be to avoid any US-EC trade war, while making sure the EC hears early and often about policy measures that may reduce U.S. exports, either inadvertently or by design. And don't forget - we're the EC's biggest export market, too.

Exchange Rates and European Monetary Union

Another policy issue addressed by this committee is the question of the proposed European Monetary Union, and its impact on U.S. interests. Last year I stated before this committee that the politically important EMU proposal and the possibility of a single EC currency were not likely to have major direct impact on U.S. companies. This remains the case. The major change, and it has already been accomplished in all the major EC markets, is the elimination of controls on capital movements.

Recently, Vice President Christophersen of the European Commission reported that a single currency could save as much as 0.5 percent of the EC's total GDP (about $25 billion) in foreign exchange transaction costs. That may well be, but this result is still several years off, and not likely to affect the US-EC relative trading position.

U.S. industry is far more directly affected by the stability and direction of exchange rates. At the time of this committee's hearing last year, we were concerned about a sudden strengthening of the dollar against the key European Monetary System (EMS) currency, the Deutsche mark (DM). In early 1989, the dollar briefly rose to over DM2.00. But following heavy coordinated intervention, the DM quickly recovered. In May 1990, the average DM value of the dollar was DM1.66, compared to DM1.95 a year ago. The present rate is much more appropriate given the continuing large U.S. current account deficit, and Germany's large surplus.

In fact, most Europeans insist that the German surplus is largely with other EC countries, rather than the United States. This overlooks the fact that the DM is undervalued against some other EMS currencies, allowing German industry to compete more strongly with U.S. exports. Both here and in Europe, there is wide agreement, if not a full consensus, that a realignment of the DM within the EMS will be necessary, at least after the completion of German economic reunification.

Developments in Eastern Europe

This brings us to the final set of questions facing the committee, the subject of Eastern Europe. NAM has now established a special working group on this subject, chaired by Kempton Jenkins, formerly of Armco. He has testified on NAM's behalf before committees of both Houses of Congress.

NAM's position, as presented by Mr. Jenkins, is that while Eastern Europe and the Soviet Union are promising markets in the long term, we do not expect a large amount of investment or exports in the short term. Both the Soviet market and those of the other Eastern European countries are faced with severe structural difficulties at the present time.

And I can add, based on some recent discussions with representatives of European industry and finance, that while there is much interest in new deals with the USSR and the countries of Eastern Europe, most European companies are moving very cautiously before making major commitments. This includes even West German companies considering moves into East Germany.

The bottom line is that, for both European and U.S. companies, we do not expect the novel markets of Eastern Europe or the Soviet Union to displace the established markets of Western Europe as the prime focus. From the U.S. perspective, a quick look at some trade numbers will show that we are starting from a very narrow base indeed.

According to the 1989 Commerce Department figures, total U.S. exports to the Soviet Union were $4.3 billion, while U.S. imports were only $700 million, netting a US surplus of $3.6 billion. The bulk of this trade, however, consisted of U.S. agricultural exports. From unpublished Commerce statistics, I have calculated that U.S. manufactured exports to the USSR only totalled about $800 million.

With Eastern Europe, our total exports were only about $1 billion, primarily manufactured goods. With U.S. imports of $1.3 billion, again primarily manufactures, we can see that the United

States, on a proportional basis, ran a significant deficit with these countries. Since most Eastern European countries (as well as the Soviet Union) are chronically short of foreign exchange, we do not see the market for U.S. exports - net of our imports from these countries - expanding very much, without some major U.S. policy steps. Some of the steps that NAM has supported include:

-- Passage of the SEED II legislation and full U.S. participation in the European Bank for Reconstruction and Development;

-- Rapid negotiation and ratification of trade and investment agreements with the nations of Eastern Europe and the Soviet Union, including approval of "most-favored-nation" trade status for the latter;

-- Beefing up Eximbank's role in trade with Eastern Europe and the Soviet Union, especially given the currency convertibility and debt problems in those markets;

-- Rapid completion of the Cocom negotiations, to place U.S. exporters on the same footing as competitors in Europe and Japan with respect to export controls and licensing requirements.

Finally, I want to close with some comments on East Germany, which ranks as a special case because of its impending unification and reintegration with West Germany. I recently gave several talks in Germany and met with a wide range of representatives of German business, government and the media. One of them told me, "We do not regard East Germany as a chasse privee (private hunting ground) for German industry."

I was skeptical on this point before I visited Germany, but am less so today. Obviously, West German industry will play the major role in reconstruction of the East German economy. But especially as East Germany will be fully integrated in the EC and endowed immediately with a strong and convertible currency (the DM), I believe that U.S. industry will find many direct and indirect export opportunities. Almost everyone with whom I spoke expects the German trade surplus to fall because of increased manufactured imports after the economic reunification process begins. U.S. manufacturers should get their share of those exports. I know from personal contacts, for example, that West Germany's industry and government are seeking U.S. companies with anti-pollution technologies and products to assist in the environmental cleanup of the East. More quickly than the other countries in Eastern Europe, I expect East Germany to add an immediate boost to U.S. export growth.

Table 1

US-EC TRADE, 1985-1990

	U.S. Exports		U.S. Imports Total		(Cars Only)		Balance
	$ bil.	% chg.	$ bil.	% chg.	$ bil.	% chg.	$ bil.
1985	49.0	- 3	67.8	13	7.3	31	-18.8
1986	53.2	9	75.7	12	9.3	27	-22.6
1987	60.6	14	81.2	7	10.8	16	-20.6
1988	75.9	25	84.9	5	8.0	-26	- 9.0
1989	86.6	14	85.1	0	6.7	-16	1.5
1990*	99.7	15	89.1	5	7.9**	18	10.6

* January - April, annual rate.
**NAM estimate from preliminary Commerce Department figures.

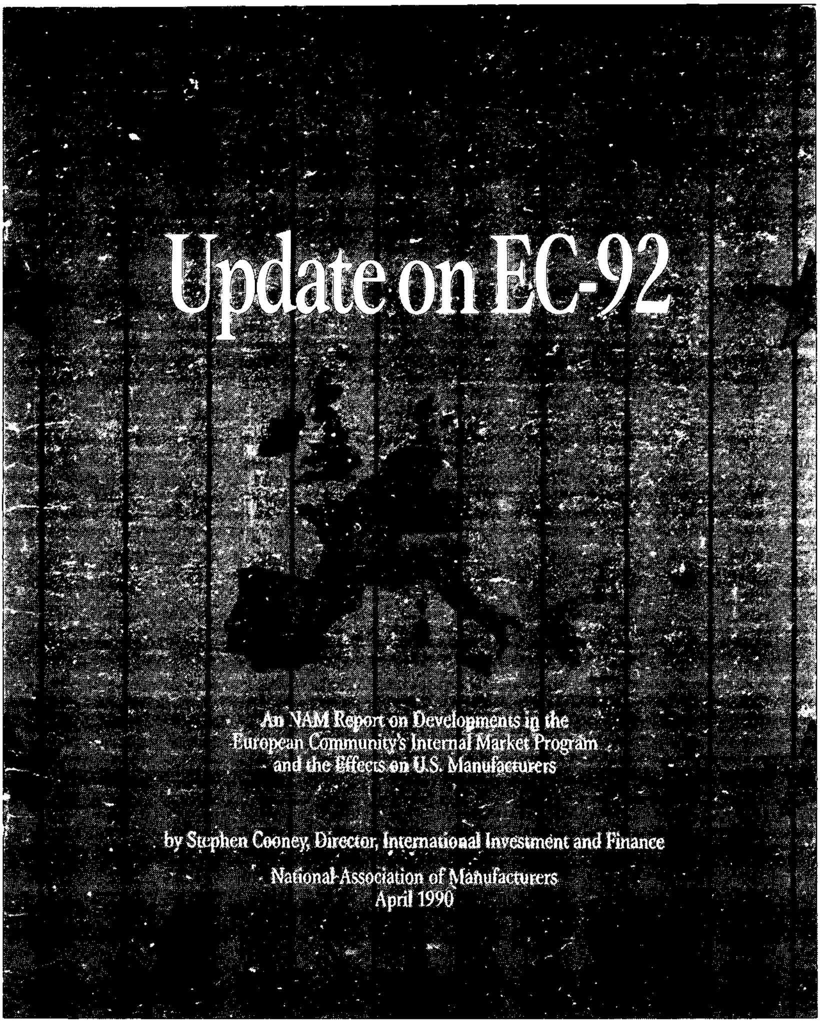
Source: NAM from Commerce Department statistics.

Table 2

US-EC TRADE IN MANUFACTURED GOODS, 1985-1989
Detailed Analysis

Product Category	1985* U.S. Exps	1985* U.S. Imps	1985* Balance	1989 U.S. Exps	1989 U.S. Imps	1989 Balance	EC Share U.S. Exps.
	($ Billions)			($ Billions)			(%)
TOTAL TRADE	49.0	67.8	-18.8	86.6	85.1	1.5	24
ALL MANUFACTURES	36.8	56.8	-20.0	71.7	75.5	- 3.8	26
CHEMICALS (SITC 5)	5.9	6.2	- 0.3	9.9	9.1	0.8	27
BASIC MFS. (6)	2.5	10.8	- 8.3	5.4	13.4	- 8.0	19
--Paper	0.3	0.6	- 0.3	0.7	0.8	- 0.1	16
--Textiles	0.4	1.4	- 1.0	1.0	1.7	- 0.7	25
--Iron and Steel	0.2	3.0	- 2.8	0.4	3.1	- 2.7	12
--Non-Ferrous Metals	0.3	1.3	- 1.0	0.7	1.3	- 0.6	15
MACHINERY & TRANSPORT EQ. (7)	20.6	27.1	- 6.5	42.7	36.2	6.5	27
--Computers & Office Machines	6.5	1.8	4.7	11.2	2.7	8.5	44
--Electrical Machy. & Parts	2.7	2.6	0.1	5.5	4.3	1.2	21
--Power Generating My (inc. Engines)	2.4	3.2	- 0.8	5.4	4.6	0.8	37
--Non-Consumer Telcom. Eq.	0.9	0.3	0.6	1.7	0.6	1.1	23
--Aircraft & Parts	3.4	2.0	1.4	9.4	3.5	5.9	39
--Construction & Spl. Purpose My.	1.7	2.7	- 1.0	2.6	4.8	- 2.2	23
--Agricultural My. & Tractors	0.2	0.9	- 0.7	0.6	0.9	- 0.3	25
--Machine Tools & Metalwork. Eq.	0.3	0.8	- 0.5	0.7	1.1	- 0.4	26
--General Indust. My	1.4	2.7	- 1.3	2.9	4.5	- 1.6	22
--Motor Vehicles	0.1	7.9	- 7.8	1.0	6.7	- 5.7	10
--Automotive Parts	0.5	1.5	- 1.0	1.0	2.5	- 1.5	8
MISC. MFRS. (8)	4.6	9.7	- 5.1	11.0	13.2	- 2.2	31
--Prof., Science & Control Instrs.	2.2	1.1	1.1	4.1	2.0	2.1	36
--Photo. Eq & Supp.	0.6	0.9	- 0.3	1.4	1.4	0.0	40
--Clothing	0.1	1.8	- 1.7	0.3	1.7	- 1.4	14
--Footwear	0.0	1.1	- 1.1	0.1	1.3	- 1.2	24
--Toys & Games	0.1	0.3	- 0.2	0.4	0.4	0.0	25

*1985 data includes Spain and Portugal.
Source: NAM from Commerce Department data.


Update on EC-92
An NAM Report on Developments in the
European Community's Internal Market Program
and the Effects on U.S. Manufacturers
by Stephen Cooney, Director, International Investment and Finance
National Association of Manufacturers
April 1990

The National Association of Manufacturers is a voluntary business association representing approximately 13,500 member companies and subsidiaries—large and small—located in every state. Members range in size from the very large to the more than 9,000 smaller manufacturing firms, each with fewer than 500 employees. NAM member companies employ 85 percent of all workers in manufacturing and produce more than 80 percent of the nation's manufactured goods. An additional 158,000 businesses are affiliated with NAM through its Associations Council and the National Industrial Council.

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Foreword

For a country that is increasingly supposed to be looking West -- toward the Pacific, for its markets of the future, the United States still seems to spending a lot of time looking across the Atlantic. And with good reason.

In the past year, we have seen extraordinary changes in the governments of Eastern Europe, changes that have created an entirely new set of social, political and economic dynamics on the European continent. At the same time, we have seen continued progress in the European Community toward the creation of a single internal market by 1992 (EC-92).

All of this adds up to enormous potential change in a market to which the United States exported $86 billion last year and in which intra-EC sales of U.S. firms amount to well over half a trillion dollars. Clearly, what happens in the European market has enormous consequences for the U.S. manufacturing community.

Last year, in our first report, we examined how U.S. manufacturing interests were affected by EC-92. This wasn't clear to us at the time, which is why we wrote the original report. Since then, through the work of NAM's Task Force on EC-92, the American business community really has begun to get a better handle on what's at stake in the EC-92 process.

Our new report is intended to provide an update on the important issues for U.S. manufacturers in EC-92. As such, it is designed as an information document and not as an NAM policy statement. A full list of all NAM publications and policy statements on this subject is provided at the end of the report. Development of NAM policy positions on specific EC-92 issues will continue to be coordinated by NAM's Task Force on EC-92, chaired by Glen J. Skovholt, Director for Policy and Strategy, Corporate Public Affairs, Honeywell Inc.

It should also be noted that NAM's work on the issue of product standards and certification, perhaps the single biggest concern of American firms regarding EC-92, is handled by an EC-92 Task Force subcommittee chaired by Bernard H. Falk, President of the National Electrical Manufacturers Association. We are indebted to both Bernie and Glen for the time and effort they have given to NAM work on EC-92.

Also, the writing of this report and the entire work of our EC-92 Task Force have been greatly aided by the cooperation of both the European Commission and the U.S. government. We have appreciated the cooperation at all levels that we have received in both Washington and Brussels, even when we have been critical on some policy issues. We believe that the openness on both sides is a good indication of the positive and open relations between the United States and the European Community.

As always, we would encourage any comments on this NAM report. We would be glad to answer questions or hear comments about how EC-92 affects U.S. manufacturing interests.

Howard Lewis
Vice President
International Economic Affairs
National Association of Manufacturers

UPDATE ON EC-92

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Executive Summary

Both economically and politically, a lot has happened in Europe over the past year. NAM's *EC-92 AND U.S. INDUSTRY*, published in February 1989, was the first detailed U.S. private sector analysis of how specific European policies and proposals associated with the European Community's 1992 Single Internal Market Program (EC-92) would affect U.S. industry. Despite all of the turmoil and change in Europe, the program is still on track. This *UPDATE ON EC-92* reviews the major new developments in an EC-92 program that has accelerated, as the EC has continued to boom economically and the liberation of Eastern Europe from communist rule unfolds.

This report features a completely new text. Readers desiring more background on the EC-92 program and the major issues covered in *UPDATE ON EC-92* should consult *EC-92 AND U.S. INDUSTRY*, which is also being reissued.

I. US-EC RELATIONS: OVERALL SITUATION

From the U.S. side, there are some serious concerns and problems with specific EC policies that will affect U.S. manufacturing industry. But they are overshadowed by the growth opportunities presented by the EC market, stimulated in part by EC-92. Over the past two years, the EC has been on a much stronger growth path than the U.S. economy. With the more competitive exchange value of the dollar, U.S. exports to the EC have boomed, eliminating the U.S. trade deficit with the EC. The $20 billion-plus trade turnaround has accounted for about half of the total improvement in the U.S. trade deficit since 1987. In 1990, U.S. exports to the EC will exceed $90 billion; compared with other foreign markets, the EC is both open and booming.

The EC-92 program is irreversible. More than half the proposed list of 279 directives have now been adopted. Where there are major impediments to progress in EC-92 programs -- harmonization of fiscal policy and free movement of persons -- US-EC relations are not directly affected. And the political debate on European Monetary Union and the Social Charter, important as they are to the future shape of the EC, should not divert corporate attention from the operational policies that are continuously going into effect on a piecemeal basis. Similarly, it does not appear that the political and economic developments in Eastern Europe -- even the unification of East and West Germany -- will slow down or reverse EC-92. EC-92 is clearly a set of policies that will affect the conditions for U.S. business in Europe in the near future and over the longer term.

II. MAJOR ISSUES FOR U.S. COMPANIES: RECENT DEVELOPMENTS

While U.S. industry sees major opportunities resulting from EC-92, even developments that are, on the whole, positive have some features that could disadvantage U.S. companies. In this update, the list of major issues for U.S. industry has been expanded somewhat from the number reviewed in *EC-92 AND U.S. INDUSTRY*. All areas have major policy developments over the past year.

1. Technical Standards, Testing and Certification

This subject continues to be of concern to more companies than any other issue associated with EC-92. U.S. companies support the concept of expedited EC-wide harmonization. U.S. access to the EC standardization process has been enhanced. There is now an EC commitment to early publication of standards proposals and discussions of problems on specific products. The U.S. channel of access on standards issues is the U.S. private sector body that is our official representative to international standards organizations: the American National Standards Institute. On the subject of testing and certification, the EC is moving ahead with its Global Approach. It has softened its reciprocity requirements regarding mutual recognition agreements and procedures with non-EC bodies.

2. Public Procurement

The major development has been the recent adoption of a Council of Ministers "common position" on the directive opening to EC discipline the heretofore excluded utilities sectors (telecommunications, energy, water and transportation). But this draft Utilities Directive keeps the discriminatory provisions against non-EC source products that have been criticized by U.S. industry.

3. Rules of Origin, Local Content and Sectoral Issues

Some EC policies in these areas tend to create politically induced investment in the EC, especially in the context of certain other EC-92 policies and programs such as the Utilities Directive. This is particularly true of the rule of origin decision of 1989 regarding semiconductors, which may also have important downstream effects in other industries. The EC has sought to counter this view by its policy statement of November 1, 1989 and its agreement to negotiate the possible establishment of GATT discipline over origin decisions.

This report reviews the semiconductor decision and other sectoral policies affecting the electronics, telecommunications and automobile industries.

4. Reciprocity

Concern over the EC's definition of reciprocity has faded somewhat with the final adoption of a Second Banking Directive, in which the reciprocity language was considerably changed. The EC has also softened the reciprocity language used in the area of testing and certification mutual recognition policy. In both cases, insistence on "mirror image" reciprocity has apparently been eliminated.

5. Subsidies

In 1989 the EC published its first survey of "state aids" and the European Commission announced a policy of aggressively seeking to reduce a broad range of national government subsidies. The report looks at both the new enforcement priorities and the revised approach to regional aid, which may affect both U.S. companies operating in the EC and U.S.-based competition.

6. Intellectual Property

The major development in US-EC relations is that the GATT panel on Section 337 of the U.S. Trade Law found in favor of the EC position. President Bush unblocked the GATT report, but will continue to enforce Section 337, pending adoption of effective international rights of protection by the GATT, a concept supported by both the United States and the EC.

7. R&D Programs and Science Policy

The EC, in late 1989. adopted a revamped five-year, $7 billion "framework" program of support for cooperative, "pre-competitive" R&D projects. The EC has also announced a new offer on joint R&D with comparable U.S. efforts. But U.S. companies have continued concerns regarding "second-class" status in access to existing EC programs.

8. Defense and Security Issues

Two U.S. concerns stand out in this area. First, the European NATO countries are intensifying their defense procurement cooperation through the Independent European Program Group, a program being developed by national defense ministries separately from EC-92. It has increased concerns of U.S. defense and dual-use products exporters regarding future access to the EC market.

Second, the progress in the EC internal market and developments in Eastern Europe are increasing all U.S. exporters' concerns with respect to effects of continued differences in U.S. and European export control policies. Currently, the United States, the European countries and other members of the COCOM group are seeking to liberalize and harmonize export control rules, in a manner that would alleviate this problem.

9. Social Dimension

At the December 1989 EC summit, eleven of the heads of government (excluding Prime Minister Thatcher of the United Kingdom), agreed on a "Social Charter," declaring certain fundamental rights for workers throughout the EC. This is only a declaration without immediate legal effect, but it is linked to a European Commission "work program" on specific social policies. Some of the policies and directives proposed, if adopted, could hinder the efficient operation of U.S. companies both within and outside Europe.

10. Mergers and Takeovers

In December 1989, the Council of Ministers completed the adoption of an EC regulation on mergers having an EC dimension. This major step, which had to be agreed on unanimously, for the first time places control over large-scale mergers effectively in the hands of the EC rather than member governments. The regulation takes effect September 1990.

11. European Monetary Union

President Delors of the European Commission has strongly and persistently pushed for adoption of a policy that would create a monetary union, centralizing policy at EC level. At the 1989 heads of government meeting, all the member countries endorsed a program that would prepare a series of proposals by the end of 1990 to amend the Treaty of Rome, for the purpose of creating closer monetary policy coordination. This policy was agreed on despite the continued opposition of the U.K. government to any form of actual monetary union and continued reservations by the German government regarding loss of national monetary policy control.

UPDATE ON EC-92

An NAM Report on Developments in the European Community's Internal Market Program and the Effects on U.S. Manufacturers

by
Stephen Cooney
Director, International Investment and Finance
National Association of Manufacturers

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Introduction

One year ago, NAM published *EC-92 AND U.S. INDUSTRY*, the first in-depth look at issues in the EC-92 Internal Market Program that would have the most impact on U.S. manufacturers. The report attempted to be comprehensive and objective, an effort in which NAM was assisted by the participation and comments of its very active EC-92 Task Force. It found a large and diverse audience -- not just among business readers who were the primary target, but also among the press, academic groups, government officials, legislators and the general public, both in the United States and abroad.

Much has changed since the initial report, including--

- the level of U.S. awareness toward EC-92 and how we define the issues;
- the progress of the EC-92 program itself, and changes in the program;
- the change in the European political and economic context of the program, following the collapse of Communist systems in Eastern Europe.

We at NAM believe that it is important to update our initial report. The goal is to summarize for business readers some of the major changes and developments in the key EC-92 issues affecting U.S. industry.

Focus of This Report

As it stands today, the Internal Market Program remains the central economic driving force in the new Europe that is emerging from the epochal political turmoil of the past few months. Any American company that wishes to do business -- in Eastern or Western Europe -- will increasingly have to take account of the rules and policies that comprise EC-92.

In *UPDATE ON EC-92*, we will not repeat the basic background information on the EC-92 program that was provided in the initial NAM report; that report will be reissued and made available to readers who want this information. The update instead carries forward from the issue date of the first NAM report. It focuses primarily on the progress of the EC-92 program and the U.S. response over the past year. Thus, *UPDATE ON EC-92* brings the reader up-to-date on issues we covered in *EC-92 AND U.S. INDUSTRY.* These are also issues that have been the focus of NAM's EC-92 Task Force, which was just beginning its activity at the time of the first report.

On many of these developments, NAM prepared public statements and testimony during the past year. A complete list is appended to the report. The advantage of this report is that it will summarize in one place these evolving issues and their impact on U.S. manufacturers, as well as cover more recent developments. The latter includes the major developments at the end of the French Presidency of the Council of Ministers in December 1989, such as the Social Charter, the commitment to establish a European Monetary Union and adoption of an EC merger control regulation. The report analyzes what these developments could mean for the future of U.S. industry in the EC market.

The report is organized in a similar manner to *EC-92 AND U.S. INDUSTRY.* Part I is a review of the general development of EC-92 and the overall US-EC trade pattern. Part II is an analysis of the specific issues.

I. US-EC Relations: Overall Situation

THE TRADE BALANCE

The rate of U.S. export growth to the EC in 1989 was 14 percent, or well over $10 billion. While less than the spectacular 25-percent growth rate of 1988, this still represented a continuation of the strong growth in U.S. exports to the EC, which has been a main feature of U.S. trade performance since the mid-1980s (see table,). Serious structural problems persist in the domestic U.S. economy despite overall continued growth. It is, therefore, becoming more apparent every year that neither individual U.S. companies nor the U.S. economy as a whole can ignore the growth potential offered by the rejuvenated EC economy.

The growth in EC demand for U.S. exports should continue. American exports to the EC will almost certainly top $90 billion in 1990. That is because official EC economic analyses indicate strong and continued growth in investment in industrial equipment -- more than 10 percent for 1989 and another 6 percent in 1990, according to recent estimates and forecasts. This strong investment growth has been directly stimulated by the EC-92 program and industrial restructuring in anticipation of its impact. It plays directly to the greatest U.S. trade strength: manufactured capital goods.

US-EC TRADE, 1985-1989

	U.S. Exports		U.S. Imports				Balance
			Total		Cars Only		
	$ bil.	% chg.	$ bil.	% chg.	$ bil.	% chg.	$ bil.
1985	49.0	- 3	67.8	13	7.3	31	-18.8
1986	53.2	9	75.7	12	9.3	27	-22.6
1987	60.6	14	81.2	7	10.8	16	-20.6
1988	75.9	25	84.9	5	8.0	-26	- 9.0
1989	86.6	14	85.1	0	6.5*	-18	1.5

**NAM estimate from preliminary Commerce Department figures.*

Sources: NAM from U.S. Department of Commerce, *UNITED STATES TRADE PERFORMANCE IN 1988: HIGHLIGHTS OF U.S. EXPORT AND IMPORT TRADE* (1984-1988); and *U.S. MERCHANDISE TRADE (FT-900,* December 1989).

At the same time, because of no net growth in imports from the EC in 1989, the U.S. trade position with the EC swung into surplus by a small margin ($1.5 billion). This is the first surplus that the United States has enjoyed with any major trading partner or region since the early 1980s. The U.S. surplus compares with deficits of more than $20 billion as late as 1987; indeed, the $22 billion improvement in the U.S. trade balance with the EC since then has accounted for half of the overall improvement in the total U.S. trade deficit. As the table shows, the lack of growth in U.S. imports from the EC was due to continuation of the two-year fall in car imports, primarily luxury cars from Germany. But the general slowdown of the U.S. economy, plus the lagged impact of the lower dollar exchange rate, means that even non-car imports grew only about 2 percent.

PROGRESS OF THE EC-92 INTERNAL MARKET PROGRAM

With respect to the overall internal progress of the EC-92 program, three major points need to be made. First, the rapid progress in proposing and adopting directives in 1989 confirms the view of NAM's earlier report that U.S. companies cannot afford to ignore the reality of EC-92. The U.S. General Accounting Office report of February 1990 stated that 142 out of 279 draft internal market proposals had been finally adopted, with only 18 remaining to be proposed.

Second, the *PROGRAMME OF THE COMMISSION FOR 1990* notes two major priority areas where new proposals are necessary if further progress is to be made. One area involves the free movement of persons and the other is the removal of tax frontiers. Significantly -- under Article 100a of the amended Treaty of Rome -- both require unanimous consent by the Council of Ministers. In the latter case, particularly, the original Commission approach of applying VAT at source throughout the EC, based on agreed rates or bands, has been shelved. The EC still intends to move to a system of paying VAT in the country of origin, but the transitional system will remain in effect through 1996, while the whole issue is reviewed and studied. Different member state VAT policies and levels will continue to be applied, subject to a process of "gradual approximation." And purchasers of large-ticket items, such as motor vehicles, outside their home country, will still have to pay the home-country VAT rate.

Moreover, as noted in chapters 9 and 11 of Part II, there are ongoing and acrimonious disputes between the British government and other members of the EC on two other politically very important questions. These are whether EC-92 should contain a "social charter" that guarantees certain worker rights and whether the program should be linked to movement toward a European Monetary Union (EMU).

But such highly publicized political issues should not distract U.S. companies too much. While they may determine the overall shape of the future EC, the conditions under which companies will operate are being determined on a piecemeal and daily basis.

This leads to the third and final point under this section, the question of implementation. In a September 1989 report, *IMPLEMENTATION OF THE LEGAL ACTS REQUIRED TO BUILD THE SINGLE MARKET*, the Commission noted a generally poor member state record in this area, especially when contrasted with the accelerated approval record of the principal EC institutions. Only six internal market directives, all dealing with border formalities, had actually been implemented fully in the national laws of member states. (This total had increased to 14 fully implemented directives by the end of 1989.) Ironically, given their highly vocal opposition to some of the more politically controversial EC-92 issues, the British government appears to have the best general implementation record. But, as the report notes in commentary on its summary tables on implementation, virtually all governments have gaps in particular sectors, with the worst records generally posted by Spain, Portugal and Italy.

European Parliament Elections. 1989 was also a year for European Parliament (EP) elections. Although the EP's role is still less determinative than that of the EC's real legislature -- the Council of Ministers -- it plays an important amending and advisory role. Its input is taken seriously. And this role may increase if the Treaty of Rome is amended to accommodate a European Monetary Union.

It is conceded that EP elections are really "mid-term" referenda on national governments, and there was a predictable swing in some cases against long-term conservatively-oriented national governments, especially in Britain. There, Prime Minister Margaret Thatcher's strident attacks on some EC policies, plus the growing unpopularity of her own government, led to a loss of 32 seats for the British Conservative Party's European Democratic Group. By contrast, the European People's Party, the large and more moderate center-right Christian Democrat alliance, made a small net gain of 11 seats. The most notable trend, however, was the strengthening of the EP's "greens," the Rainbow Group, which doubled its seats from 20 to 39. This was a larger absolute gain than for any other party, especially when considering that the gain of 14 Socialist seats on the left was somewhat offset by the loss of seven Communist seats.

The results of the June 1989 EP elections were not particularly good news for business. One experienced observer notes that the EP is dominated by a centrist "secret coalition" of the European People's Party and the Socialists. This dominant pair of centrist groups will be strengthened. The Socialists will have 180 seats, and the EPP 123 seats out of 502. On workers' rights issues, these groups will probably tend to push the Commission toward pro-labor compromise positions. And the rapid growth of the Greens' total means that both the Commission and the Council of Ministers may become more hawkish regarding environmental and consumer concerns.

EASTERN EUROPE

No analysis of US-EC relations today can ignore the subject of Eastern Europe. The momentous events of 1989 have reshaped the European political and economic environment more dramatically than any other developments since 1945, except perhaps the Treaty of Rome and the founding of the EC. All indications are that this pace will continue in 1990, particularly with respect to the unification of Germany. Many people have questioned the continued relevance of EC-92 under these circumstances. Is the program outdated by events?

The answer almost certainly is no, for a number of reasons. First, having witnessed a recovery in their own economic vitality through the adoption of liberalizing, market-oriented policies at both the EC and national levels, the EC member countries do not appear likely to reverse course now to accommodate the failed policies and programs of Eastern Europe, including the Soviet Union. Rather the EC model of an integrated economic community is likely to set the standard, with the other European countries becoming gradually more integrated with this central attractive market. In February 1990, Commission Vice President and External

Relations Commissioner Frans Andriessen indicated that the EC would now seek to negotiate limited association agreements on a bilateral basis with the countries of Eastern Europe.

Second, the scale of potential gains in trade with Eastern Europe is not sufficient to tempt the EC into such a significant policy slowdown or reversal of the EC-92 program. According to the IMF's *DIRECTION OF TRADE STATISTICS*, total EC exports to the Soviet Union, Eastern Europe and all Communist centrally-planned economies in 1988 was $32 billion. That compares with $633 billion worth of exports among the EC members themselves, $122 billion of exports to other nonmember European countries and $85 billion to the United States.

Third, the EC has made a policy determination not to accept any new members until the EC-92 program has been completed, that is, until after 1993. This hold on new memberships would probably not be further delayed to accommodate some of the "stretched out" EC-92 programs (such as VAT or the common commercial policy on cars, discussed later), but it does mean that the bulk of EC-92 will be in place before any changes in the composition of the Community will be considered.

The major exception to this third point could be East Germany. Since the establishment of relations between the two Germanies in the early 1970s, East Germany has had special access to the EC market through its West German trading partner. Inter-German duty-free trade is not counted with the international trade of the EC, for example. Because of the inconvertible East German currency and other structural distortions in the East German economy, the economic relationship between East and West Germany had limited impact on the economies of both partners and little impact on the EC as a whole.

This situation could change with the rapid political and economic integration of East and West Germany that is now foreseen. The EC's founding Treaty of Rome does not envision territorial expansion by a member through absorption of another country, but the constitution of the German Federal Republic is designed for all of Germany. Juridically, it might be a fairly simple matter to extend the West German constitution to East German territory. Even this straightforward solution to the unification problem might well necessitate some amendment to the Treaty of Rome, at least to establish certain transitional measures. At this time, however, both the government of the German Federal Republic and the European Commission apparently wish to avoid protracted negotiations, including special compensation and derogations, that normally accompany the admission of a new member to the EC.

A more general issue is the EC's developing relationship with the other countries of Eastern Europe. We have already noted the proposal for EC association agreements with these countries. Already, the individual members of the EC have many times the amount of trade credits outstanding with Eastern Europe as does the United States. They have also in many cases signed comprehensive new bilateral investment agreements with the new Eastern European governments. One major example is Germany's November 1989 agreement with Poland. And the European Community, through the European Commission, was specifically assigned at the July 1989 Paris Economic Summit the lead role in organizing multilateral aid cooperation for Poland and Hungary.

Since then, the rapid succession of events in Eastern Europe has broadened this task. This has included a lead role in establishing a new European Bank for Reconstruction and Development. The United States and Japan have in principle agreed to participate in this bank, but the countries of the EC will provide the majority of the capital, and the major role in deciding on projects.

The U.S. government has not discouraged either a stronger EC or an enhanced EC role in Eastern Europe. Secretary of State James Baker, in his address at Berlin on December 12, 1989, spoke of a "Europe whole and free." Baker explicitly supported a stronger and more integrated EC framework, because of the EC's historic representation of western democratic social and economic values. Despite some sharp disagreements with specific aspects of EC trade and other policies, noted in Part II of this report, the U.S. government sees the EC as providing a strong and stable partner for the redevelopment of Eastern Europe and its reintegration into the global market economy.

GATT URUGUAY ROUND

During 1990, the EC and the U.S. government are committed to seeking a successful conclusion to the GATT Uruguay Round. The EC has even offered to host the final signing ceremony in Brussels in December of this year, although at this stage it is far from clear what there will be to sign.

In the balance of this report, the author occasionally refers to possible future agreements in the multilateral GATT context, which may cover some of the points at issue between the United States and the EC. The general subject of US-EC relations in the GATT negotiations, however, will not be covered in this report. NAM will later prepare detailed analyses of GATT issues of relevance to U.S. manufacturers.

II. Major Issues for U.S. Companies: Recent Developments

1. TECHNICAL STANDARDS, TESTING AND CERTIFICATION

Concerns over this subject continue to affect a broader group of U.S. industries than any other aspect of EC-92. As we noted last year, an acceleration of the European standards harmonization process should be an encouraging development for U.S. companies doing business in Europe, and should facilitate U.S. exports to the EC market. But during 1989, NAM and a wide range of cooperating associations representing different sectors of U.S. industry also raised a number of concerns regarding this process.

During the past year, considerable progress has been made in opening the CEN/CENELEC standard-setting process, at least in principle, to non-European bodies. In large part, this was due to the high priority placed on US-EC standards issues by incoming Secretary of Commerce Robert Mosbacher, and the active role played by his agency in discussing U.S. concerns with the EC and encouraging greater flexibility in standards policies. At this point, U.S. industry must evaluate the degree to which the transparency and accessibility of CEN/CENELEC have improved and whether further steps must be taken.

With regard to testing and certification, the structure and operation of the new EC system are not yet finalized. One U.S. standards expert has therefore described US-EC relations on testing and certification today as being equivalent to where relations over standards issues were one year ago. Here again, however, considerable progress has been made. The EC has recognized U.S. concerns and has altered some policy principles to reflect those concerns.

The European Commission has recently issued an authoritative summary of the current status of the EC standardization process, especially with respect to the implications for non-EC businesses. The new paper is entitled *COMPLETING THE INTERNAL MARKET: THE REMOVAL OF TECHNICAL BARRIERS TO TRADE WITHIN THE EUROPEAN COMMUNITY -- AN INTRODUCTION FOR FOREIGN BUSINESSMEN*, and was issued on January 8, 1990 by Directorate General III. U.S. companies with concerns on this issue should be familiar with this brief and readable paper. The following more detailed account of US-EC standards issues draws on this document, as well as other documents issued during 1989.

The Standard Setting Process

As frequently testified by NAM and other business organizations, the primary concerns of U.S. industry regarding the harmonized and expedited standard-setting procedures of the EC involved:

- Transparency of the EC standard setting process to non-EC companies;
- Accessibility of the process to non-European producers, if they believed that new standards had the potential effect of excluding their products from the EC market.

An early step to improve transparency was the publication by CEN/CENELEC of a monthly listing of standards projects at all stages of development. This review, *ONGOING ACTIVITIES IN EUROPEAN STANDARDS*, is available directly for a nominal charge from the CEN/CENELEC secretariats in Brussels. A subscription can also be obtained through the American National Standards Institute in New York. While this report is intended to be authoritative and comprehensive, it is also extremely skeletal. It provides only a listing of projects by title and stage of development. Moreover, there are persistent reports that some early drafts of standards documents are not available for comment. Business users will need further follow-up information from ANSI, U.S. standard setting bodies, the Commerce Department and EC sources.

But though a public list of standards projects has been welcomed, this does not resolve the main concerns that U.S. industry has voiced regarding EC technical standards. The two questions U.S. companies ask most often about CEN/CENELEC standards involve two main paradoxes. Formally, these standards are strictly voluntary, but for the U.S. producer and exporter, they may take on a virtually mandatory character. Second, CEN/CENELEC are under a general EC mandate to adopt international standards where they exist, but in some cases it may be necessary to exceed international standards, in order to assure that "essential requirements" mandated by the EC are satisfied.

Voluntary Standards and "Essential Requirements" in the EC. CEN/CENELEC (as well as the specialized European Telecommunications Standards Institute, ETSI) may undertake standard-setting activities in any area that they wish and, strictly speaking, any standards they set are voluntary. The report *INTRODUCTION FOR FOREIGN BUSINESSMEN* asserts also that CEN/CENELEC does not represent a new layer of standards activity between national and international activity: "Rather, it is a substitute for one of the existing levels, that is, national standardization. The prospect of a Single European Market has made the idea of further national standardization largely irrelevant..." The paper emphasizes that foreign companies need not be concerned in the future that new national standards within Europe will deviate from standards at the EC level.

The paradox is that conformity to CEN/CENELEC "voluntary" standards can also provide companies with a "fast track" to compliance with *mandatory* essential requirements established by the European Community. Any product for which the EC adopts a directive regarding minimum essential requirements becomes a "regulated" product, within the meaning of the EC "new approach" to technical harmonization. But the EC itself in general does not subsequently adopt the detailed specifications implied by the minimum safety requirements set in these product directives. This function is turned over to CEN/CENELEC through "order vouchers" for new European standards. The major exceptions to this "new approach" are those areas where EC regulations are already well advanced; primarily, this includes motor vehicles and parts, pharmaceuticals, metrological instruments and foodstuffs.

Annex I of the *INTRODUCTION FOR FOREIGN BUSINESSMEN* contains a list of all products for which standardization order vouchers have been issued since the "new approach" went into effect since 1986. This list includes all "regulated" products, plus product areas, mainly information technology, where the EC believes harmonization essential for industrial policy reasons. It must be scrupulously noted that even "regulated" products do not have to conform with the standards subsequently developed by CEN/CENELEC. If a product does conform and carries the new "CE" mark, however, it is presumed to be in compliance with all relevant EC essential requirements; no further testing or certification can be required within the EC. This is true whether the CE mark was applied by the manufacturer or by a third-party certification body. A regulated product can still carry the CE mark and be circulated in the EC, even if it does not meet relevant product standards. But, the burden of proof will be on the manufacturer to prove compliance with all essential requirements, typically through third-party certification. If a product is unregulated, no minimum standards can be required by law for the product to be sold within the EC. This was the thrust of the 1979 *Cassis de Dijon* decision, discussed in last year's report. But customers, insurers, public purchasing authorities and others may require conformity to applicable CEN/CENELEC standards.

EC and International Standards. The EC has consistently maintained that new EC standards are to be based on existing international standards. Moreover, again quoting the *INTRODUCTION FOR FOREIGN BUSINESSMEN*, "...CEN/CENELEC have agreed to consult [the international standards bodies] ISO/IEC before starting on new work in order to see whether the same work could be carried out by at the international level instead." This instruction, it should be noted, has been tempered by the qualification that reference to the international level should not incur any undue delay in achieving new EC standards, generally within a two-year time frame.

At the same time, the EC may establish essential requirements that will result in standards exceeding international norms. Often, international standards themselves are relatively vague and imprecise. In effecting "a high level of protection," as exacted in the 1987 amendments to the Treaty of Rome, the EC may establish "essential requirements" that are more specific than existing international minimum standards. This is implicitly recognized in the *INTRODUCTION FOR FOREIGN BUSINESSMEN:* "Harmonized European standards...are voluntary technical specifications which are custom-made to reflect the legally-imposed essential requirements. In other words, *they are to be specific to EEC legislation, although based as closely as possible upon international standards*" (emphasis added).

The Department of Commerce has undertaken not only to provide U.S. companies copies of draft and final directives that provide the basis for new EC standards, but it has also compared EC essential requirements with U.S. and international product standards in specific cases and analyzed the possible effects on U.S. interests. In 1989, the department's International Trade Administration issued the first two volumes of a three-volume set of analyses of the 1992 directives. Entitled *EC 1992: A COMMERCE DEPARTMENT ANALYSIS OF EUROPEAN COMMUNITY DIRECTIVES*, this publication is available at nominal charge from the U.S. Government Printing Office. The first volume focuses on manufactured products. Using input from Commerce Department industry specialists and private industry sources, it contains thumbnail sketches of each final or draft directive it believes be of potential concern to U.S. companies. Another extremely detailed source of information is the ongoing study of the U.S. International Trade Commission. Its initial document was released in July 1989, with a more detailed follow-up study published in April 1990.

The "Fourth Criterion." A different type of issue that may start to affect US-EC relations on standards issues is the so-called "fourth criterion" or, more suggestively, the "fourth hurdle." Indeed, the still-unresolved dispute over the beef hormone ban could be a preview of the type of issue that may become more frequent if the results of the 1989 European Parliament elections portend a larger role for "Green" parties and environmental concerns within the EC.

Briefly, concerns have been voiced in the European Parliament that, when determining whether a product can be brought to the market, a "fourth criterion" -- the socio-economic impact -- should be used in addition to the traditional criteria of safety, efficacy and quality. Such concerns may particularly affect biotechnological products and biochemical additives which may alter productivity and the balance of production in the food industry. The first major skirmish over this issue was the European Commission decision to declare a one-year moratorium in 1989 on the introduction of bovine somatotropin (BST) in EC dairy herds, even though there is no evidence that the production-boosting injectable substance will have any harmful effects on animals or human consumers of dairy products. If it achieves the promised effects, however, BST will increase EC dairy production from the existing level of EC herds, a problem that already has created difficult budgetary and trade problems.

There has not yet been a US-EC confrontation on this issue. But if the fourth hurdle becomes a legitimate standards criterion in EC environmental or biotechnological regulatory affairs, U.S. products using the banned substances may themselves be prohibited from the EC market, if only for economically defensive reasons.

Access to EC Standard Setting. A major US-EC agreement of the past year has been the achievement of *de facto* non-EC access to the EC standards process. The terms of this access are far from perfect and it remains to be seen from continued experience how effectively U.S. companies will be able to influence EC standards proposals. But, at this point, it must be conceded that the EC did respond to specific U.S. concerns and alter its policies accordingly.

Early in 1989, Commerce Secretary Mosbacher commented that United States should have a "seat at the table" in developing of EC standards. Not only will the accelerated EC standards process directly affect U.S. companies' access to the EC market, but it will also have a profound effect on the general process of international standardization. The U.S. government did not propose for itself any formal role in negotiation of EC technical directives or implementing standards. But, during the first half of the year, proposals were advanced for some type of non-European "observer" role in the CEN/CENELEC standards process; indeed, ETSI, the telecommunications standards body, already allows a limited observer role for non-European manufacturers and standards bodies. Ultimately, the proposal was refined to nonvoting participation in CEN/CENELEC by the technical committee chairmen of the International Standards Organization (ISO) or the International Electrotechnical Committee (IEC).

On May 31, 1989, Commerce Secretary Mosbacher and EC Internal Market Commissioner Martin Bangemann met and issued a joint statement of principles regarding international standardization and certification policies. The EC confirmed its adherence to the use of international standards insofar as possible, and nondiscrimination with regard to the testing and certification of imported goods. The two Cabinet-level officials also announced the beginning of a US-EC dialogue on standards and testing issues, to include representatives of both official and private sector bodies.

The Mosbacher-Bangemann statement was almost immediately followed by CEN/CENELEC announcement of a major change in policy regarding access by nonmember bodies. In a June 13 letter to all technical committee chairmen, the presidents of the two organizations stated that technical committees were to give due consideration to all comments or proposals on standards projects from outside

Europe when made *"through the relevant national member body of the ISO/IEC..."* (emphasis in original). Moreover, the technical committees were authorized to hold joint *ad hoc* meetings with non-European bodies, providing that no undue delay resulted in the adoption of EC standards.

This solution established both an opening and a limitation on non-European input. There was no "seat at the table" -- even the ISO/IEC observer proposal was subsequently rejected -- but CEN/CENELEC now consented to foreign involvement in what had hitherto been considered an exclusively European process. Limiting foreign access to the official ISO/IEC national representative presumably was adopted to prevent CEN/CENELEC from being besieged by a wide range of non-European national standards bodies, or even individual companies.

The ANSI Role. In the U.S. case, this means that access is funneled through ANSI, which is the official U.S. member of the ISO and also the IEC, through the U.S. National Committee. ANSI is a private body that does not set standards itself, but includes in its membership industry bodies that establish more than 90 percent of the standards used by U.S. industry. ANSI is thus a central registry of U.S. standards as well as the conduit for U.S. relations with the international standards community. ANSI has now established an independent office in Brussels, to monitor CEN/CENELEC activities and assist U.S. standards and industry organizations in obtaining information on EC standards developments. ANSI's role and the evolution of the EC standardization process are described in a special issue of *ANSI GLOBAL STANDARDIZATION NE\ :* (September 1989) and a second issue released in January 1990.

In summary, we now know both the general outline of EC standards policy and how U.S. companies and trade associations can gain access to EC standards-setting procedures. Unless standards development under the new approach simply fails or, from the U.S. perspective, the EC manifestly and consistently fails to live up to its self-imposed obligations regarding non-European access to the process, the system probably will not change much as the EC-92 program is implemented. It is now critical for U.S. companies and associations to test the system. Either the process will work for U.S. interests, or, if it does not, the case can be built for a greater degree of U.S. access.

As for the overall process, within the EC it is clear that the actual establishment of new standards is already beginning to lag the schedule demanded by the timetable set by the "new approach" directives and the EC's standards mandate for CEN/CENELEC. The Commission is now planning to review progress in a "green paper" that it plans to publish in mid-1990.

Product Testing and Certification

The same is not yet true for testing and certification. The EC Council of Ministers took a major step forward on December 21, 1989 by approving in principle the Commission's proposed "Global Approach to Testing and Certification," which is the basic framework policy. But this policy must still be reviewed by the European Parliament, before the specific testing and certification modules are implemented, mutual recognition becomes an established fact within the EC and mutual recognition agreements can be signed with non-EC bodies. Despite the unfinished status of this process, however, it appears that some major decisions have been made regarding the testing and certification of products outside the EC.

The Global Approach to Testing and Certification. The Global Approach was formally proposed by the European Commission in July 1989; the final version was essentially similar to the draft previewed last year in *EC-92 AND U.S. INDUSTRY.* Through a series of eight "modules," this approach purports to provide a comprehensive framework for all the permissible approaches to product testing and certification that will be allowed within the EC in the regulated product sectors. This includes "a clear and coherent philosophy for the use of conformity assessment procedures in future [binding] EEC technical directives" and the "establishment of a new organizational framework in Europe for testing and certification arrangements in the private sector..." where no such network has existed before (both quotes from *INTRODUCTION FOR FOREIGN BUSINESSMEN).* Completion of any of these modules allows a product to receive the "CE" mark guaranteeing access throughout the Community.

Thus the Global Approach provides the universe of options for testing and certification procedures. Moreover, because both levels of sophistication and modes of approach to testing and certification vary widely within the EC, the EC intends to also play a role in promoting coordination of national accreditation systems and development of improved competence in the "less-favored" member states. The key agency in achieving this goal in the private sector may be the new European Organization for Testing and Certification (EOTC). Moreover, it is possible that the EOTC will provide a body of expertise upon which the Commission may call in evaluating the technical competence of laboratories within Europe, and in non-EC countries, for the purpose of negotiating mutual recognition agreements with non-member countries.

Under the general principle of "subsidiarity," meaning implementation of policy at the national level, if possible -- a guiding principle of the EC-92 program -- it is the member states themselves that will notify to the Commission those public or private testing bodies that are to serve as accredited testing and certification agencies. The standards for evaluating and accrediting these agencies will be the new European EN 45000 Series standards. According to the ANSI special issue of *GLOBAL STANDARDIZATION NEWS* (September 1989):

> These standards are based on the ISO/IEC guides on certification and testing which were prepared by ISO'S Council on Conformity Assessment (CASCO), which received substantial input from ANSI's International Certification Subcommittee, which serves as the U.S. Technical Advisory Group for CASCO. The criteria set forth in the standards would apply to testing, certification and accreditation organizations, manufacturers as well as third parties.

Similarly, in developing standards for quality assurance programs for self-certification by manufacturers, the EC has established the EN 29000 Series, which according to ANSI's September 1989 report is identical to the ISO 9000 Series, and thus also to the ANSI/ASQC 90 Series. The ANSI report continues, "Manufacturers who wish to use [EC] modules to demonstrate compliance with EC Directives must have their quality system 'registered' by a 'notified body' or other accredited or recognized organization."

Access to the EC Testing and Certification System for Non-EC Manufacturers and Testing Bodies. From the above discussion, it can be seen that the nascent EC-wide testing and accreditation scheme is, in fact, based on international standards and principles of testing and certification. Indeed, the embarrassing fact is that testing agencies in some of the more industrialized EC countries (especially the U.K. and Germany) may already have more mutual recognition agreements with non-European bodies, such as their U.S. or Japanese counterparts, than with similar bodies in other parts of Europe. It is EC policy to allow these existing national-level mutual agreements to continue in place, subject to eventual renegotiation at the EC level. And EC private sector bodies are free to negotiate any mutual recognition agreements that they wish covering unregulated products.

But, over the longer term, there remains the difficult question as to how regulated products produced outside the EC will obtain access to the EC market, under the new system established by the Global Approach. There are three avenues of approach to resolving this issue, so that U.S. products can be certified for the EC market, with minimum disruption of existing testing programs.

1. **Nondiscriminatory Access to EC Testing.** The clearest current strategy, though not necessarily the most convenient in many cases, is to have products tested in the EC. By both the GATT Standards Code of 1979 and the Mosbacher-Bangemann agreement of May 31, 1989, the EC has confirmed that there should be no discriminatory barriers in testing products manufactured abroad.

2. **Delegation or Subcontracting of Testing Abroad by EC Notified Bodies.** This may be the most efficacious means of maintaining existing mutual recognition arrangements, while the new EC-wide testing and certification system is developed, and perhaps even over the long term. Note that while testing may be done outside the EC, products would have to meet any new minimum EC "essential requirements." Under this approach, the EC notified body may delegate testing in nonmember countries to recognized and competent local laboratories, which would operate under the ultimate certification authority of the EC notified body. Similarly, there is no reason why manufacturers outside the EC meeting the EN 29000 (ISO 9000) quality assurance standards noted previously could not register directly with an EC notified body, or perhaps with a local registration body that was subcontracted to an EC notified body.

This option has been described in the unpublished but circulated minutes of the December 21, 1989 Council of Ministers meeting that endorsed the Global Approach, and confirmed elsewhere. However, the conditions under which this approach may be used and the degree of testing that may have to be done in the EC are still to be decided.

3. **Mutual Recognition Agreements Between EC and Non-EC Bodies and the Issue of Reciprocity.** The hardest but most complete way of resolving the issue is the negotiation of new mutual recognition agreements at the EC level. This would include products that are closely regulated by governments in both the EC and the United States -- on the U.S. side, involving agencies such as FDA and EPA. But where products are regulated in the EC sense and covered by voluntary industry standards in the United States, negotiation of such agreement may be more difficult.

In part, this is because the EC has adopted a modified form of its reciprocity policy. Not only must the technical competence of the non-EC body be assured, but "in cases where the Community wishes to have its own bodies recognized, the agreements [must] establish a balanced situation with regard to the advantages derived by the parties in all matters relating to conformity assessment for the products concerned" (Council Resolution of December 21, 1989).

On the EC side, concern has been expressed that agreements with one or more U.S. private certification bodies do not guarantee acceptance of EC certifications throughout the U.S. market, as it would on the EC side. The EC may also require that any private bodies with which it concludes such agreements be independently audited on a periodic basis with respect to technical competence, and accept financial liability with respect to the failure of certified products. On the U.S. side, there is concern that mutual recognition agreements with the EC would mean broad acceptance of certifications from countries not before covered by private mutual agreements and whose certification system is an unknown quantity in the U.S. market.

Finally, we have the difficult issue of the degree to which the U.S. system itself needs to be modified to ensure that U.S. products are not disadvantaged in the EC market. As we noted above, the new EC systems of quality assurance, testing and certification are generally based on international standards, but for many specific products, international standards are based on existing European standards rather than those adopted or used by U.S. manufacturers. Another issue is the degree to which increased centralization of standards, testing and certification is required in the United States -- under either government or private auspices -- for the purpose of "enhanced" participation in the global standardization process. U.S. assessment of its own performance will thus proceed even as both the U.S. government and private sector bodies are engaging in discussions with the EC and European private sector bodies on standards, testing and certification issues.

2. PUBLIC PROCUREMENT

The establishment of an EC framework for open public procurement continues to make substantial progress, with the updated public supply and public works directives now adopted and in force. The internationally controversial draft directives for the previously excluded sectors have, on the advice of the European Parliament, been combined into one directive, now generally known as the Utilities Directive because of its application to telecommunications, water supply, energy and transportation. On February 22, 1990, the Council of Ministers agreed in principle to a "common position" on this directive and altered some language. But from the U.S. perspective, nothing has changed regarding the continued commitment of the EC to include in this directive a discriminatory provision against non-EC source products in company bids.

There are mixed reports on how much these directives -- either already in force or anticipated -- are actually affecting the public procurement market. In one case, for example, the French construction company Bouygues claimed irregular procedures in award of a Danish bridge-building contract. The company at least won the recovery of its bidding costs. Also, a recent *FINANCIAL TIMES* article cited examples of intra-EC public works contract bidding successes, such as the winning of the Marseilles metro contract by a German firm and of a road-building contract in the Lyons region by an Italian company. On the other hand, the latest edition of the American Chamber of Commerce EC Committee's *BUSINESS GUIDE TO EC INITIATIVES* states that, "...Difficulties continue to be encountered in the opening up of local and regional tendering. To date, for example, most of the County Councils of the United Kingdom, the Departments in France and the Laender in Germany have ignored the Community publishing requirements."

Utilities Directive

The definitive text for the Council of Ministers' common position has just appeared with only some details changed in the provision relating to tenders with a majority of non-EC content (Article 29). This article provides that "Any tender may be rejected where the proportion of the products manufactured outside the Community in the total value of the manufactured products constituting the tender exceeds 50 percent. For the purpose of this article, software used in the equipment of telecommunications networks shall be considered as manufactured products."

For purposes of consistency, Article 29.4 indicates that origin shall be determined in accordance with the basic 1968 Council regulation on the common concept of the origin of goods, establishing the principle of last substantial transformation. Even so, this directive appears to be different from the definition of EC content in the 1988 anti-dumping circumvention regulation, in that it focuses narrowly on the content of the particular product offered, and does not allow, for example, the value and location of production facilities to be taken into account.

Even should a government purchasing authority or other covered utility entertain a non-EC source bid, it must apply a 3 percent price penalty to that bid, under the terms of the directive. That is, any competitive EC-sourced bid that comes within 3 percent of the price of the lowest non-EC bid must be awarded the contract.

This discriminatory provision, which was originally proposed in the first Commission drafts, has now been reviewed and approved by the European Parliament, so it is likely to stay in the final directive.

But the Utilities Directive in Article 29.5 does contain a waiver from these discriminations against non-EC bids in the event of a negotiated agreement, through GATT or bilaterally, with nonmember countries. The Commission is now required to prepare a report on progress on bilateral and multilateral negotiations related to this directive. This confirms the stated policy of the EC to seek a multilateral agreement opening up these procurement areas on a reciprocal basis.

Three other major developments are included in the common position. First, by a new Article 3, member states are allowed to request alternative procedures for private companies engaged in oil and gas exploration and extraction. This remains an issue of concern to some U.S. oil companies and equipment suppliers. The terms involve Commission monitoring of the conditions under which contracts are awarded and operated. In effect, the Commission will "guard the guardians," particularly the U.K. Offshore Supply Office, which has used its influence to ensure that over 80 percent of all British sector North Sea procurement occurs in the U.K.

Second, the Commission's proposal to exclude private water supply concessionaires from the directive was not accepted by the Council. In recent years, the powerful French private water companies have successfully prevented the establishment of foreign companies in France, that would compete with them in providing engineering services for water treatment and waste disposal, for both public and private clients. This has included some major U.S. companies, which have sought to enter the market. The French government subsequently voted against the directive, which nevertheless carried on a qualified majority basis.

Third, the date of entry into force was the subject of substantial debate. While the deadline for transposing the directive into national law was set at July 1, 1992, only nine of the EC member states must apply the principle of the directive from January 1, 1993. Spain has been allowed to delay application until January 1, 1996, and Portugal and Greece a further year's delay, to January 1, 1997.

Other Procurement Directives

The Utilities Directive, similarly to the previously adopted Public Supply and Works Directives, does not provide for procedures under which a bidder may question the awarding of a contract or protest alleged irregularities in the contract process. The Commission is nearing completion of its first proposal for a directive to cover remedies in the area of utilities procurement. Of great interest to U.S. companies is whether suppliers of non-EC source bids, as defined in Article 29 of the Utilities Directive, will have standing to invoke provisions of the Remedies Directive, respecting procedural irregularities or inequitable treatment.

Finally, the last remaining procurement area for a Commission proposal is in the public procurement of services. A proposal is expected in 1990.

3. RULES OF ORIGIN, LOCAL CONTENT AND SECTORAL ISSUES: THE QUESTION OF "FORCED INVESTMENT"

In this updated report, all of these issues are being combined because, in practice, they are frequently linked together. That is, the sectors discussed here are the ones where U.S. industry critics most frequently comment that either EC or national government policies may be aimed at forcing or inducing investment in the EC, by encouraging local production.

As commented in *EC-92 AND U.S. INDUSTRY*, the EC has no general "local content" policy, though there are specific instances where a reference to content of a product is used. The application of EC content rules in the public procurement utilities directive has already been discussed in detail in the previous section. Other specific instances may be related to the development of common commercial policies regarding specific products or industrial sectors, especially as the EC-92 process continues and internal market barriers among EC members are eliminated. This will lead not only to the elimination of many remaining formal or informal national import quotas, but also will make the operation of national industrial policies increasingly difficult.

During 1989, probably the most widely followed US-EC public debate over rules-of-origin or local content issues involved the unsuccessful attempt of the U.S. government to roll back the EC content provision in the Television Broadcast Directive adopted October 4. This provision will have little or no effect on U.S. manufacturing companies, but it did indicate that the EC was determined to adopt such measures when it felt them necessary to secure the viability of EC interests in a more internationally open EC market. The EC side emphasized that this was a "special case" because of cultural considerations, and noted the "cultural" exception negotiated in the U.S.-Canada Free Trade Agreement.

The areas of interest to U.S. manufacturing companies that will be most affected by new or redefined policies are--

- Semiconductors
- Other Electronic Products
- Telecommunications
- Automotive Vehicles

Both the U.S. government and U.S. industry have pointed out that certain policies established or being considered by the EC, especially in these areas, will have the effect of inducing investment in the EC, as a substitute for imports from the United States. This is not necessarily the intended effect of such policies. But even where rules against "screwdriver" plants are applied in antidumping cases against violators from Japan and East Asia, the result could be a reduction of U.S. content in the products affected. Allegations of "forced investment" are sometimes difficult to prove, since U.S. investment will tend to increase in open and growing overseas economies. But as long as EC content rules remain in effect for any purpose, U.S. manufacturers will feel some political pressure to locate production in the EC, as opposed to continuing to export to the EC.

Semiconductors and EC Rules of Origin

The most intensive trade policy debate between the United States and the EC regarding any industrial product concerned the new EC rule of origin for semiconductors.

On February 3, 1989, the Commission announced the finding of its Origin Committee that, henceforth, the "wafer fabrication" stage of production would have to be completed in the EC, to confer EC origin. Previously, testing and assembly in the EC were considered adequate.

The EC has justified its decision on the grounds of "last substantial transformation," which, in conformity with agreed international tariff rules under the Kyoto Convention, has been the basis for EC origin rules since 1968. Clearly, wafer fabrication is the stage of most substantial transformation and greatest value added, but it is technically arguable whether this stage represents the last substantial transformation. In justifying its decision, the EC has pointed out that the United States has decided under the U.S.-Canada Free Trade Agreement that fabrication should also determine origin with respect to Japanese semiconductors that arrive in the United States by way of Canada.

This decision has two effects: an immediate import-substituting effect and, combined with other EC policies, a potential downstream effect. The EC maintains a 14 percent tariff on imported semiconductors, compared to a zero tariff in Japan, the United States and Canada. This tariff is substantial enough to divert production. Wafer fabrication plants are far more costly to build than testing and assembly operations, and in recent years there has been an oversupply of the product in greatest commercial demand. At least one major U.S. producer, Intel, has announced its intention to build a fabricating plant in Ireland, since the EC rule of origin decision. With respect to the U.S. trade impact, the EC is the biggest export market for U.S. semiconductor chips, a product for which total exports last year were nearly $9 billion, according to Commerce Department estimates.

The downstream or cascade effects could affect a wide range of industries. First, the EC is currently considering a rule of origin for printed circuit boards (PCBs), of which the primary component is semiconductor chips. It is possible that the EC will base this decision on the value-added content of the PCB. Origin may be based on value-added content under international Customs Cooperation Council (CCC) rules, and the EC has a long-standing principle that 45 percent or more EC content in a product may be used as a basis for conferring EC origin. By comparison, the United States currently confers origin on PCBs according to where they are "stuffed" (mounted). If the EC does apply the 45-percent rule to PCBs, it means that the location of semiconductor wafer fabrication may determine the origin of PCBs. In turn, this will influence EC and non-EC content levels of a wide range of products containing large or increasing amounts of electronic circuitry and for which relevant EC content rules have been or may be developed. Computers, telecommunications equipment and cars are outstanding examples.

U.S. and EC GATT Proposals. The European Commission and the U.S. government have held a number of discussions on the semiconductor rules of origin decision and the probable ensuing decision on rules of origin of printed circuit boards. In September 1989, the United States subsequently submitted to the GATT Uruguay Round Negotiating Group on Non-Tariff Measures a proposal for extending

GATT discipline over rules of origin decisions. The EC announced its agreement to the principle of international discipline in its November 1, 1989 statement and, on February 14, 1990, submitted its own detailed proposal.

The two approaches are different. The EC recommends that the GATT agreement start by confirming that last substantial transformation should be the sole basis for origin rules, and that last substantial transformation be based on the current alternatives provided in the Kyoto Convention: value added, change of tariff heading, or specified operations. The EC notes that the United States has never adhered to the Kyoto Convention annex, where this is defined. The U.S. approach would be based on GATT assigning the CCC the task of determining problem areas for origin decisions, given the criteria for existing tariff headings. Substantively, both proposals concentrate on the need for improved transparency, with the EC also proposing criteria of consistency, nondiscrimination among trading partners and an exemption for origin rules applied under preferential trade agreements (the EC's extensive preferential trade agreements and origin rules were summarized in *EC-92 AND U.S. INDUSTRY*).

The Brother Decision and the Basis of Origin. Whatever the outcome of the GATT round regarding these proposals, the EC's own Court of Justice (ECJ) on December 14, 1989, issued an important decision which may restrict the Commission's interpretation of origin, both retrospectively and prospectively. The ECJ reviewed the Commission's application of its antidumping circumvention policy to imports of typewriters made in Taiwan by the Brother Company of Japan. In this case, as reported in the *FINANCIAL TIMES*, the ECJ held that "an 'intellectual transformation' is not necessary to confer origin." That is to say, the ECJ found that the Commission should not single out the location of the technologically advanced elements of the manufacturing process as part of the criterion for determining where the last substantial transformation occurs. This decision will be significant not only for determining origin in antidumping cases, but also for the general application of rules of origin.

Electronic Products and Anti-Dumping Rules of Origin

One of the most confusing issues to emerge during the development of EC-92 is the "screwdriver" plant rule. As noted in last year's *EC-92 AND U.S. INDUSTRY*, the screwdriver rule, which many people believe applies to any establishment of a non-EC owned factory in the EC, is used only for products subject to anti-dumping enforcement. The screwdriver rule is thus not a general principle of origin or local content. Rather, it establishes that a product must contain a minimum level of *nondumping country content* (40 percent), if it is to avoid antidumping penalty duties, after the producer has been found guilty of dumping by the EC. Note that the EC does not demand that all of this content be added in the EC itself, but only outside the country named in the original complaint. As confirmed by the ECJ in another aspect of the Brother case, the European Commission may also determine that a factory or product line was established in the EC or a third country subsequent to the initiation of an EC dumping investigation, for the purpose of avoidance of antidumping enforcement.

The most controversial application of EC antidumping rules has been directed at electronic products from the Far East and in some cases, have involved U.S. trade interests as well. Most notably, in the 1989 Ricoh case, the EC accused the Japanese company of circumventing its antidumping order on photocopiers by assembling the products in the United States and shipping them to the EC. The EC found that all major parts were produced in Japan, and that no substantial value or further processing and manufacturing were contributed at the U.S. facility. Japan has appealed this case to the GATT and the issue is presently before a GATT panel. Recently published reports indicate that the GATT panel has found the application of the EC "screwdriver rule" contrary to the GATT.

In the meantime, however, EC officials have also indicated that the Japanese company has undertaken the transfer of a substantial share of the manufacturing process to the affected Ricoh plant in the United States. Penalty duties on products from this facility may be eliminated in the near future. More recently, a separate EC investigation determined that a new Ricoh fax equipment plant in Colmar, France, was not a "screwdriver" facility. The EC found in this case that less than 60 percent of the content of the copiers made at this plant came from Japan. Coincidentally, until January 1990, France Telecom had not given its technical approval to use of the Colmar fax machines and they had been built solely for export. After the reversal of France Telecom's policy and on the same day as the EC decision, Ricoh announced plans to add a new fax paper factory in Colmar.

Telecommunications

Telecommunications equipment and services are simultaneously the subject of major intra-EC and national deregulatory policies linked to EC-92, EC content provisions under the EC public procurement directive, and a USTR finding against the EC under the 1988 Trade Act.

The EC's own telecommunications policy was defined in the 1987 "green paper" (described in *EC-92 AND U.S. INDUSTRY*) and in subsequent directives. The recent agreement between the Council of Ministers on the liberalization of services and Open Network Provision (ONP) directives advanced this policy considerably.

On the other hand, the ECJ has not yet issued its opinion regarding the challenge by a number of member state governments to the Commission's use of Article 90 of the Treaty of Rome in adopting the 1988 directive on terminal equipment. This is a critical directive for U.S. companies that seek to sell equipment to private customers within the EC. It means that national telecommunications administrations (PTTs) are, in principle, unable to block private customers' use of equipment of their own choosing in upgrading private telecommunications facilities and data transmission networks. Member state governments have stated that they agree in principle with the policy, but not its approval through the use of Article 90, which allows the Commission in certain circumstances to enact policy directives or regulations without approval of the Council of Ministers. The directive is now in force, pending the decision of the ECJ. The court's chief legal adviser, the Advocate General, has issued an opinion opposing the Article 90 approach, but the ECJ has not issued its final judgment.

The Commission has stated its intention to issue its services liberalization directive using the same Article 90 approach. The Commission adopted a text in June 1989 but timed its notification to the member states to the adoption by the Council of the Open Network Provision directive. Several member states opposed both the substance of the services directive as well as the use of Article 90. Italy and Belgium have challenged this directive in the ECJ. But in the meantime, the Commission and the Council of Ministers have negotiated a resolution of the differences in substance.

The Council adopted a "Common Position" on the ONP directive in February 1990; the Commission is therefore expected to notify its directive on the liberalization of services to the member states when the Council adopts the final text of the ONP directive, possibly in June 1990. It remains to be seen whether the Commission will actually do so before the ECJ rules on the use of Article 90 in the terminal directive.

According to the official memorandum of February 5, 1990 on the ONP directive common position and the services directive, "The special rights of the PTTs in the field of telecommunications services have to be abolished, with the exception of voice telephony and network infrastructure." With the entry into force of the directive ("probably mid-1990"), "...Private service providers will be able to offer value-added telecommunications services in competition with the PTTs throughout the European Community." In principle, basic data transmission services will also be open to competition from January 1, 1993. But some member states gained the additional provision that the simple resale of leased lines capacity, a key issue in EC telecommunications services liberalization, could be delayed for a transitional period that could last until 1996. The sole basis of the granting of such delays by the Commission, however, is supposed to be that the member state's "network for packet-switched or circuit-switched data transmission services is not yet sufficiently developed."

Another change won by the member states is that their PTTs could impose some types of obligations ("cahier de charges") on private service providers of data transmission services. Such obligations are supposed to be limited to the safeguarding of tasks performed by the national PTT relating to the general economic interest. The Commission has the right to review such obligations and must thus be notified of PTT plans by mid-1992 at the latest.

The ONP directive is timed to go into effect simultaneously with the services directive. This directive creates an obligation on the part of public networks by harmonizing technical interfaces through ETSI standardization agreements, and seeking to eliminate divergent conditions of use and discriminatory tariff principles. The ONP provisions do not apply to private services providers, except insofar as they are operating public common carrier networks (e.g., on the U.S. model of privately-owned common carriers -- British Telecom is the prime example).

U.S. Manufacturing Companies' Interests and USTR Policy Under the 1988 Trade Act. The ongoing developments of EC policy have created something of a quandary for USTR. *EC-92 AND U.S. INDUSTRY* discussed the designation of the EC as a whole as a "priority country" under the terms of the 1988 U.S. Trade Act. This is because the full package of EC telecommunications policy decisions, if they work as intended, will almost certainly have a positive effect on both U.S. trade and U.S. company operations in the EC. The goal of EC policy is both to lower the operating costs of manufacturing companies within the EC and to reduce the monopoly powers of the PTTs. Achievement of this dual goal will be to the advantage of U.S. companies providing telecommunications equipment and services, because it will place a premium on price and performance, areas where the PTTs have in the past proved uncompetitive. Similarly, while the Public Procurement Utilities Directive is flawed by the EC content rule (including the telecommunications sector) establishment of EC jurisdiction over these sectors opens both the possibility for international negotiations and for budget-conscious EC member countries to choose non-EC sources of supply. Thus the USTR and President Bush decided, on February 22, 1990, that sufficient progress is being made for any further action under the Trade Act provisions to be deferred for later decision. U.S.-EC discussions are scheduled to continue over the coming year.

A strong possibility exists that U.S. exports are already reflecting the increased openness of this market. Although a regional breakdown for specific 1989 exports is not yet available, Commerce Department estimates published in the *1990 U.S. INDUSTRIAL OUTLOOK* indicate that total U.S. telephone equipment exports nearly doubled since 1987, from less than $1 billion to about $1.7 billion, and increased from 6 percent to 10 percent of total U.S. production.

Automotive Vehicles

The EC decision on quotas for passenger cars and other vehicles imported from Japan has been perhaps the most widely followed trade issue related to EC-92. During the course of 1989, for example, the French and German industry confederations came down on opposite sides of this issue in major public statements.

On December 19, 1989, the Commission itself finally issued its statement of general policy, in which it indicated that it would seek an EC-wide limitation on Japanese passenger car imports for a transitional period. The Commission has endorsed the policy of an open market as its ultimate goal. This careful statement of policy, *A SINGLE COMMUNITY MOTOR-VEHICLE MARKET*, did not, however, resolve many of the specific questions of interest to the U.S. manufacturing community, though it makes an important commitment that the EC will not establish local content rules for cars produced by Japanese companies in the EC.

The statement addresses all aspects of EC motor vehicle policy, including technical harmonization, taxation and environmental issues. Part 3, "Commercial Policy Aspects," deals with the international trade issues. Noting the great diversity in levels of penetration of Japanese cars within the EC and the existence of quotas at the national level, the Commission comes to two basic conclusions. First, differential national quotas within the EC must be eliminated. Second, there is a "need to avoid a sudden shock to EC industry," a conclusion that leads to the policy decision that some agreement must be reached with Japan, by which that country's exports to the EC are restrained during a "transition period" of unspecified length, but extending beyond 1992, for a period of it least five years.

The most important specific commitments in this statement are in the section dealing with "transplants," the EC term for Japanese-nameplate cars produced outside of Japan and, in this case, specifically those produced in the EC. The Commission statement had earlier noted that in addition to pressure from Japanese exports, EC car companies had to face production of possibly 1.5 million units by Japanese companies within the EC by 1993, with the possibility of a sharp escalation thereafter. While noting that "account must be taken of this form of production in defining future solutions," the Commission committed itself to resolve the issue "while abiding by its international commitments and without resorting to compulsory local content formulas." The Commission further committed itself to guaranteeing implementation of Article 9 of the Treaty of Rome, which promises free movement within the EC for products of both member and nonmember countries.

This statement leaves open the future treatment of cars produced by or with Japanese companies in North America, which could potentially be exported to the EC. But if the EC stands by its "no local content" approach, the statement does seem to indicate that Japanese cars sold in the EC could contain parts made in the United States or elsewhere, without discriminatory trade treatment.

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4. RECIPROCITY

In 1988 and early 1989, the most passionately debated US-EC trade question was whether the EC was moving toward a general and unilaterally defined reciprocity policy. This issue was of particular concern to U.S.-owned banks and financial institutions, because of the nature of the reciprocity provisions originally proposed in the Second Banking Directive. But as discussed in *EC-92 AND U.S. INDUSTRY*, there was also broad concern among other U.S. companies, because reciprocity policies appear in a number of other EC-92 policies and because, in its early form, the Second Banking Directive called into question rights acquired under Article 58 of the Treaty of Rome by non-EC companies long established in the EC. Finally, the novel and unilateral EC definition of reciprocity also placed in doubt the future of the EC commitment to the GATT Uruguay Round.

Over the past 18 months, this issue has been largely defused, if not entirely resolved. The October 1988 Commission statement, "Europe 1992 - Europe World Partner," had already alleviated some U.S. concerns by the time of the previous NAM study. This statement clarified that the EC would not require "mirror image" reciprocity in foreign treatment of EC companies. Instead, it was seeking for its companies "a guarantee of similar opportunities -- or at least non-discriminatory opportunities..." The statement also indicated that there would be no derogation from national treatment in the EC for established companies. In 1989, concerns over the EC application of reciprocity have been further moderated by the final text of the Second Banking Directive, and by redrafts in some other policy areas. But these concerns have not been eliminated.

In this chapter, we will review the final treatment of the reciprocity issue in the Second Banking Directive, because of its importance as a precedent. Then we will summarize developments in other areas of significance to U.S. industry where the EC has indicated that it intends to apply principles of reciprocal treatment, namely testing and certification, public procurement and takeover policy.

Second Banking Directive

On April 13, 1989, Sir Leon Brittan, Vice President of the Commission and the Commissioner responsible for financial services policy, announced major changes in the reciprocity provisions of the Second Banking Directive, in keeping with the redefined reciprocity policy of October 1988. These changes were finalized and codified in the final version of the directive, as approved on December 15, 1989.

Articles 8 and 9 deal with the issue of third country reciprocity. These articles provide that the Commission is to make periodic reports on treatment of EC financial service institutions which seek to operate in nonmember countries, with a view to determining if they receive national treatment and comparable access opportunities. If they do not have comparable access or national treatment in a non-EC country, the Commission is authorized to begin negotiations with that country's government. Also, the Commission may suspend for specified periods of time "new authorizations or acquisitions" in any EC member country "by a parent undertaking governed by the third country in question." Institutions already established in the EC, however, were grandfathered from any future limitation on establishment of new subsidiaries in the EC or the acquisition of new holdings (per Article 9.4).

Testing and Certification

As mentioned in the first chapter in Part II, extension of "notified body" status to non-EC certification bodies will depend not only on competency but on the degree of comparable EC access. For regulated products, the Commission must negotiate on behalf of the EC any mutual recognition agreements, which will be binding in the EC, with all non-EC bodies.

This concept has remained a constant element within the EC Global Approach to Testing and Certification as it has evolved through the policy process. The specific degree of reciprocity that will be sought, however, seems to have softened considerably.

In the final text of the Global Approach proposed by the Commission in July 1989, the reciprocity condition of a mutual recognition agreement was defined as "mutual benefits...[that] are equivalent and guaranteed in an identical manner." Further language in this provision confirmed that what was sought was virtually "mirror-image" treatment, not national treatment. This point, however, has been considerably modified in the Council of Ministers resolution of December 21, 1989, which approved the policy. The Council would require only that, "In cases where the Community wishes to have its own bodies recognized, the agreements establish a balanced situation with regard to the advantages derived by all parties in all matters related to conformity assessment..."

Public Procurement

As mentioned in the second chapter above, the EC has maintained that it would negotiate the opening of public procurement in the previously excluded utilities sectors to non-EC competition. This would depend, however, on the willingness of trade partners to open procurement to EC companies. These negotiations may be bilateral or multilateral; in the latter case, through additional negotiations on the GATT Procurement Code in the Uruguay Round. But, as the Public Procurement Utilities Directive has not yet been formally adopted, no proposals have yet been forthcoming from the EC.

Takeovers and Merger Control

One of the major achievements of the French Presidency of the Council of Ministers was the final adoption of an EC Regulation on Merger Control (see below, Chapter 10). This regulation contains no references to reciprocity regarding acquisitions by non-EC companies, although some concerns have been expressed in the United States regarding differential treatment depending on EC industrial policy goals. But the establishment of a merger control regulation that in effect places sole control of large ("Community dimension") mergers in EC hands increases the likelihood of a harmonization of takeover rules within the EC.

In its October 1988 statement on the external aspects of EC-92, the Commission indicated that reciprocity would be one component of EC takeover policy, as applied to acquisitions by non-EC companies. Subsequently, however, the Commission issued a draft Thirteenth Company Law Directive on takeovers, with no provisions regarding reciprocity on takeover bids by non-EC companies. According to the American Chamber of Commerce's *BUSINESS GUIDE TO EC INITIATIVES*, the Commission has dropped the idea of reciprocity with respect to such takeover bids.

5. SUBSIDIES

Subsidies ("state aids" in EC terminology) did not feature as a major topic in *EC-92 AND U.S. INDUSTRY.* But a chapter on this issue has been inserted here because of the very active policy undertaken by Commission Vice President and Competition Commissioner Sir Leon Brittan, and in view of the strong U.S. call for modification and strengthening of the Subsidies Code in the GATT Uruguay Round.

During 1989, the European Commission published its first comprehensive survey of national subsidies *(FIRST SURVEY ON STATE AIDS IN THE EUROPEAN COMMUNITY).* The fact that the EC waited more than 30 years before implementing and completing such a task is remarkable. Subsidies have always potentially had a major market distorting effect. To quote from a major policy speech of Brittan's entitled "A Bonfire of Subsidies?" "Policy toward national government subsidies...has always been an important instrument in creating the common market...Left to themselves, there is always the risk that Member States would use aids to export some of their own problems."

-- Publication of this report indicated that, among major industrial countries in the EC, Italy was the largest and most persistent provider of subsidies: Italian state subsidies were the equivalent of more than 15 percent of manufacturing production (and this excluded steel and shipbuilding). Subsidies in other EC industrial countries ranged between about 3 and 5 percent of production, with Germany on the low end of the scale. Virtually all members, however, engaged in some type of large-scale and anticompetitive subsidization. For example, in the early 1980s, subsidization to the steel industry in major producers ranged from 18 percent of gross value added in Germany, to more than 40 percent in Belgium, nearly 60 percent in France and the U.K. and more than 70 percent in Italy. Or, in another example, national subsidization of the coal-mining industry during the same period ranged from about 10,000 ECUs annually per employee in the U.K.; to 26,000 ECUs in Germany; 43,000 ECUs in France and 53,000 ECUs in Belgium. Overall, total national subsidies within the EC were estimated at four times the total contributed by the EC itself.

As Vice President Brittan noted, the onset of EC-92 and the opening of markets to enhanced intra-EC competition meant that the impact of such subsidies had to be curbed if the concept of fair competition were to be meaningful. And, more than coincidentally from the U.S. point of view, aid levels of this magnitude adversely affected both import-competing U.S. industries (steel) and competitive exports (such as coal).

Subsequent to release of the report, Vice President Brittan indicated the types of subsidies which would be most carefully studied by the Commission and against which action would most likely be taken under Article 93.1 of the Treaty of Rome. They included --

- Subsidies to Exports Outside the EC. Subsidies to exports within the EC were long held illegal, of course, but it is extremely interesting that the Commission concluded that export subsidies for products outside the EC equally had distortive effects on competition within the EC. France was singled out as the primary nation reliant on this approach.

- "General Investment Aids." These are defined as policies that generally allow government intervention and support in all areas of the economy, with no specifically targeted or defined objective.

- Nationalized Industries, Holding Companies and Capital Injections. "...This intervention is usually concentrated in loss-making industrial enterprises which might otherwise disappear from the market." Italy was singled out as the leading provider of such aid, and the massive public holding company IRI is notorious for its absorption of state funds. In a recent and highly publicized case, however, the EC has condemned as illegal secret side payments by the British government to British Aerospace, to encourage the latter company's acquisition of the state-owned car manufacturer, Rover Group. A similar issue is the attempt of the French government to write off over $1 billion in old debt from the state-owned car maker Renault.

- Interventionist Industrial Policy Aids. Primarily, this refers to government support of "national champions." This has also long been a major complaint of U.S. companies competing head-to-head with major EC companies, both in the EC and in third countries.

Permissible or Encouraged National Subsidies. The newly redefined EC policy represented in Brittan's "Bonfire of the Subsidies" speech and the first state aids report should not be interpreted as being wholly negative toward all forms of subsidies. The key is whether subsidies perform a "Community purpose," as defined by the EC itself. In fact, a major goal of the more aggressive enforcement policy is, in addition to achieving a reduction of subsidies, to concentrate both EC and national government funds on mutually agreed policy purposes:

- R&D and High Technology Support. One of the major positive purposes of subsidies as reviewed under the new policy is support for R&D enhancement programs. For example, the Commission report had no negative comments regarding the continued and massive amounts of support provided by member governments for Airbus. Presumably, such aid achieves the Community purpose of maintaining EC world competitiveness in a critical high technology industry. And the Brittan "Bonfire of the Subsidies" speech made a positive reference to Germany's concentration of subsidization on R&D support, particularly for small and medium enterprises.

- Regional Development. But the major thrust of both the EC's own development spending and its reorientation of subsidy enforcement policy will be toward equalizing the ability of the regions to benefit from EC-92. Commissioner Bruce Millan, responsible for Regional Policies, and DG XVI announced in early 1989 a comprehensive regional aid plan for distribution of the European Regional Development Fund (ERDF). About 80 percent of the fund is to be expended in areas covered by the "objective 1" category -- regions lagging in development. These areas are on the EC periphery: all of Ireland (both Northern Ireland and the Irish Republic), Greece, Portugal, most of Spain (excluding the Madrid and Barcelona regions), southern Italy and Sicily. "Objective 2" areas are "declining industrial areas," especially old iron and steel-based areas such as the German Ruhr valley, northern France and southern Belgium, the north and midlands of England and the industrial areas of Scotland.

With respect to their own company strategies, U.S. companies can draw two basic conclusions from this reassessment of subsidy policies. First, in terms of their own investment locations within the EC, effective locational subsidization is likely to become even more focused than heretofore on the "objective 1" and "objective 2" regions. A number of sources have noted, for example, a recent tendency of Japanese investors to prefer the declining industrial areas of England as investment sites, in part to take advantage of this phenomenon. Second, and conversely, while EC policy may help reduce the overall level of subsidization of competing EC companies, it is likely that those subsidies that are part of a regional or technology development program are likely to become even more entrenched.

6. INTELLECTUAL PROPERTY

The major trends in EC intellectual property issues were covered in last year's NAM report. Basically, the EC is seeking to move in the same direction as the United States, with respect to enhanced intellectual property rights protection in a more integrated EC market. And both the United States and the EC support establishing GATT discipline over trade-related intellectual property rights issues (the so-called "TRIPs" negotiation).

As we pointed out last year, the basic European agreement on patents is the European Patent Convention of 1973; many U.S. companies now initially register their patents with the European Patent Office in Munich. The EPC is now in force in ten of the member states. The remaining two (Ireland and Portugal) are expected to join by January 1, 1992. The Community Patent Convention, which was signed by all the member states on December 10, 1989, is expected to enter into force by January 1, 1993, although Ireland and Denmark continue to cite constitutional problems which may prevent their ratification.

With respect to obtaining patent and trademark protection, Don Linville of the Commerce Department, writing in the special EC-92 section of the January 15, 1990 issue of *BUSINESS AMERICA* summarizes the present situation as follows:

> For now, U.S. exporters and investors must seek patent protection in individual member states. This can be accomplished through registering under the European Patent Convention and then designating member states where protection is sought. This is important, because the costs of registering and reviewing patents in Europe are very high.
>
> Protection of trademarks differs widely among member states and there are major differences from the system used by the United States. For example, in the EC corporations may apply for a trademark based on intention to use the mark. This means that many companies must register their marks before using them or risk losing protection of the mark to another firm...Currently, firms must register in individual member states and register early in an effort to protect their marks

There have also been a number of major developments in specific US-EC intellectual property rights issues or questions over the past year. The following is a brief summary of some important developments:

Directive on the Legal Protection of Computer Programs. This proposed directive was formally published by the Commission on April 10, 1989. It would base EC legal protection on the principles of the Berne Copyright Convention. Both U.S. and EC business groups have responded favorably to this approach, but many have expressed concerns that the directive would exclude from protection algorithms, logic and program language. As presently drafted the proposed directive has the effect of prohibiting reverse engineering. Some U.S. and Japanese companies, together with some European companies, would like to see this prohibition removed. Other U.S. and European companies do not agree with this suggestion.

United States, Japan, EC Differences on the International Semiconductor Protection Agreement. In May 1989, the world's two leading semiconductor producers -- the United States and Japan -- refused to join the EC and nearly 50 other countries in supporting the text of the world's first treaty on the protection of integrated circuits intellectual property rights. Details of the final text were negotiated during a three-week session in Washington under the auspices of the World Intellectual Property Organization (WIPO), a United Nations specialized agency. The goal of the treaty was to establish international protection through mutual recognition of national laws, such as the 1984 U.S. Semiconductor Chip Protection Act.

According to the report on the agreement in NAM's *HIGH-TECH PROGRESS*, "The main U.S. objections to the treaty were its overly broad compulsory licensing provisions (Article 6), its shortened -- eight years instead of 10 -- term of protection (Article 8), the lack of an effective dispute-settlement mechanism and other shortcomings...U.S. delegation leader Ralph Oman noted the United States would continue to work both multilaterally and bilaterally for increased protection of mask works."

As the United States and Japan together produce nearly 80 percent of the world's semiconductor chips, the treaty signals the failure to establish a broad consensus among producer and importing nations on minimum levels of protection. The EC was reportedly not enthusiastic about the treaty terms, but saw the agreement as crucial to keeping WIPO and the developing nations involved in this activity.

US-EC Section 337 Dispute. This issue involved a US-EC dispute over Section 337 of U.S. trade law. Under this provision, there is differential treatment before the International Trade Commission for imports alleged to infringe U.S. patent rights, as opposed to alleged domestic violations. The EC claimed that the Section 337 process does not provide full legal redress and, therefore, violates GATT guarantees of national treatment for imported goods.

As reported in *EC-92 AND U.S. INDUSTRY* last year, the GATT panel found against the U.S. position on this issue. After considerable deliberation, President Bush unblocked the GATT report. The presidential statement, however, also indicates that the United States will continue to enforce this law during the present Uruguay Round negotiations. The United States is seeking an international agreement under the GATT, which would recognize violation of intellectual property rights as an unfair trade practice and allow effective protection of such interests by GATT members, including border enforcement.

7. R & D PROGRAMS AND SCIENCE POLICY

In *EC-92 AND U.S. INDUSTRY*, the interests and concerns of U.S. companies regarding these programs were covered under sectoral trade issues, particularly information technology. Since then, however, the EC has announced its third five-year "Framework Program," including some major shifts in budgeted spending priorities.

Besides these major substantive developments, EC R&D programs and science policy were the subject of a March 1990 conference hosted by the U.S. National Research Council, with participation by Commission Vice President Filippo Maria Pandolfi and other high-level EC officials. In addition to analysis of the details of the Framework Program, much of this chapter is based on the discussion of US-EC issues at that conference.

Third Framework Program

The Council of Ministers in December 1989 reviewed and approved the third Framework Program, covering EC activities in the field of research and development for the period 1990-94. Three major developments resulting from the EC's review are --

- Greater focus and streamlining of the EC Framework Program;
- Changes in budgetary priorities within the program; and
- Effectively, a substantial increase in budget, though not as much as requested by the European Commission.

The number of diverse activities funded by the EC has been radically restructured and regrouped into six activities, as shown in the table following. The overall level of budgetary authorization is about the same as for the second Framework Program: -- 5.7 billion ECUs, as opposed to 5.4 billion ECUs for the second program, and 7.7 billion ECUs requested by the Commission. But in reality, the budget has been substantially increased in two ways.

First, the initial two years of the program will overlap with two "carryover" years of the second Framework Program, that had been approved for 1987-91. As shown in the table on page 37, the "carryover" total is 3.1 billion ECUs. Also, from the U.S. perspective since the last funding decision in 1986, the dollar has fallen substantially against the ECU currency basket. Consequently, the combined budgeted total expenditure for 1990-94 is now 8.8 billion ECUs, or about $10 billion, roughly double the dollar rate of the second Framework program at its outset. Moreover, approval of the program is now on a "rolling" basis, meaning that more funding may be possible, when the program is reviewed and the fourth framework program is developed for 1993-97.

The other significant aspect of the third Framework Program is the major shift in priorities. "Information and communications technologies" continue as the largest single activity by comparison with the shares of carryover budget from the second program, around 40 percent of the total. This is because "informatics," to use the term introduced by the French, is seen as the key "enabling technology," the area of improved EC competitive performance that must improve enhance competitiveness in all other industries. Otherwise, however, there are major shifts toward budgeted spending for programs in life sciences and technologies (including biotechnology), environment, and human capital, and a major cut in the share for R&D in the energy field.

FRAMEWORK PROGRAM OF EC ACTIVITIES IN THE FIELD OF RESEARCH AND TECHNOLOGICAL DEVELOPMENT, 1990-1994

Activity	3rd Framework Program ECUs	3rd Framework Program % Share	2nd Framework Program % Share
I. Enabling Technologies			
1. Information and Communication Technologies	2.2 bil.	38	37
2. Industrial and Materials Technologies	0.9	16	15
II. Management of Natural Resources			
3. Environment	0.5	9	6
4. Life Sciences and Technologies	0.7	12	7
5. Energy	0.8	17	31
III. Management of Intellectual Resources			
6. Human Capital and Mobility	0.5	8	4
TOTAL BUDGET	5.7 bil.	--	(3.1 bil.)*

*Second Framework Program Budget carried over for 1990-91.

Sources: European Commission Proposal of August 28, 1989 (COM(89) 397), and remarks of European Commission Vice President F.M. Pandolfi and Director General Paolo Fasella (DG XII), March 5, 1990, Washington, DC.

Impact on U.S. Companies and Their Participation

It has been repeatedly noted that the major impact of this program is not its gross economic impact, although any five-year, $10 billion program is certainly a significant bundle of research projects. At present, however, the EC's research support budget represents only 3 percent of all EC R&D spending, and this may rise only another point to 4 percent with the third Framework Program. In Germany, the leading EC industrial country, private industry funds more than 80 percent of R&D, the German government another 17 percent (civilian and military), and the EC less than 1 percent. And in the United States, the FY 1991 budget proposes a total of $27 billion support for basic research and applied R&D in the civilian sector, and this total is for just one year.

The main significance of the EC program is its strategic role. First, EC research projects require industry matching funds, so the total level of research is twice the share indicated by the EC figure alone. More significant is that, in choosing among competing projects (and only 10 to 20 percent of worthwhile projects are ultimately selected for support), the EC uses as one of its criteria "prenormative" research, having a "European dimension," e.g., projects that may develop new materials, technologies or standards, to be used across the EC as a whole. One U.S. chemical company, for example, systematically participates in such programs with one or more joint venture partners in the EC, to make sure it stays fully abreast of the latest EC research developments, which might affect future standards, safety or environmental policies.

It is in this context that U.S. companies are hurt by relegation to an important, but still second-class role with respect to participation in EC programs. Many U.S. companies participate in the various EC programs outlined in *EC-92 AND U.S. INDUSTRY.* IBM, to cite one well-known example, has been designated the prime contractor in an EC R&D program involving superconductors. But no U.S. company, including IBM, which has extensive research facilities in the EC and publicly states that it sources more than 90 percent of EC sales from the EC, has been appointed to the program selection boards, or to the program advisory committees that control the direction of the major projects.

EC Concerns Regarding Access to U.S. Programs. On the other side the EC states that foreign company access to U.S. federally-funded programs is non-existent. The EC primarily points to exclusion of all foreign-owned companies from the federally-funded Sematech (semiconductor manufacturing technology) precompetitive research project. More pervasive, the EC claims, is the exclusion of foreign participation in many U.S. defense research projects. Finally, another serious problem noted by the EC is the constraints placed on research cooperation by U.S. export control policies and procedures.

To avoid a series of retaliatory exclusions, Vice President Pandolfi at the Washington conference proposed five priority areas for possible US-EC official cooperation:

1. Information technology; noting a recent private IBM-Siemens agreement on semiconductor research, Pandolfi suggested a strong need to collaborate work done by publicly-supported programs in the United States and the EC.

2. Biotechnology and bioengineering research, where US-EC cooperation in "prenormative" research was particularly important in view of the need to establish agreement on common rules and approaches.

3. Energy and environmental protection.

4. Cooperation on research and technological development for Eastern Europe.

5. Large-scale scientific projects, such as research on nuclear fusion and global change.

White House Science Adviser Allan Bromley noted in response to this last point that the U.S. *Freedom* space station project already contained plans for $7 billion worth of contributions in terms of laboratory modules and other components from Japan, Canada and the European Space Agency, compared to an estimated total projected U.S. commitment of $16 billion. He also commented, however, that the congressional annual funding review procedure tends to narrow the possibilities for U.S. commitments to such long-term international "mega-projects."

8. DEFENSE AND SECURITY ISSUES

In *EC-92 AND U.S. INDUSTRY*, these subjects were covered under the heading of "potential" issues, that is, issues that may develop with future EC-92 policy. The events of the past 12 months, particularly in Eastern Europe, have brought these issues dramatically into the foreground, for every U.S. company that has defense contracts or sales on both sides of the Atlantic and also for every U.S. company whose future sales in Europe are influenced by export controls. As in the previous report, these two major questions will be reviewed separately.

Defense Procurement

It is probable that the primary vehicle for advancing intra-EC defense procurement cooperation will not be the direct extension of the EC-92 public procurement directives to the defense sector, but rather increased intra-EC sourcing through the Independent European Programme Group (IEPG). Many of the same principles, however, that are driving EC-92 public procurement policy directives are also to be found in IEPG initiatives. In February 1990, for example, it was confirmed at an IEPG conference in Gleneagles, Scotland, that nine IEPG member countries, including all the major European arms manufacturing and exporting countries, had agreed in principle to open contract bidding to manufacturers from other member countries.

IEPG was founded in 1986, with two main goals: to increase common defense procurement within Europe and military staff interaction among member countries. IEPG consists of 13 European countries that are members of NATO, including France, which two decades ago opted out of the common command structure. All members except Norway and Iceland are also members of the EC. But under Article 223 of the Treaty of Rome, defense purchases may be excluded by members from common market trade rules. Under both the public procurement directives and IEPG policy, however, this area of exclusion is being narrowed, notably through promotion of common EC technical standards and application of civilian open procurement policies to purchases of non-military hardware and services by defense agencies. The United Kingdom and France, for example, have pioneered the development of public "contract bulletins" to make procurement more accessible to non-national competition, and the U.K. has reportedly established a 20 percent non-U.K. EC procurement set-aside as a general military procurement rule.

The Gleneagles agreement of 1990 is aimed at enhancing intra-EC military procurement competition in the area of military hardware itself, by requesting defense ministry officials of member countries to draw up a set of common, open market rules for weapons procurement. The mandate includes a provision for the principle of the *juste retour* (offsets), demanded especially by the southern EC members with less competitive arms industries, but inclusion of this principle may only be on a transitional basis. Nine of the 13 IEPG members have agreed to proceed on the basis of the Gleneagles accord, with only Spain, Portugal and Greece delaying acceptance, and Luxembourg opting out because of its small amount of defense procurement.

The U.S. Perspective and Bilateral MOUs. The movement toward common European defense procurement has created uncertainty and concern in the U.S. defense industry. These attitudes are heightened by the probability that the political and strategic developments of the Gorbachev era signal major defense budget cutbacks in both the United States and Europe. These concerns are bolstered by two specific aspects of the European cooperation program. First, IEPG is specifically designed to create a more competitive EC defense industry, perhaps oriented more to common European defense policy, either within the NATO framework or within a new European defense structure. U.S. companies will not only have to compete with EC companies for a declining budget pie, but there will be worldwide competition with an EC industry that will be more integrated, as indicated, for example, by the GEC takeover of Ferranti in the U.K., the Daimler Benz acquisition of MBB and Deutsche Aerospace in Germany, and the expansion of France's Matra, which has now acquired Fairchild Aircraft and become the tenth largest U.S. defense contractor.

Second, the EC is considering elimination of individual national duty suspensions on defense imports from non-EC sources. The current practice has benefited exporting U.S. defense equipment companies. One knowledgeable European commentator, however, has said that establishing a common external tariff and commercial policy on defense-related items is more likely to be a "loose end" of EC-92 public procurement policy than a major new agreement to be determined by 1992. But other reports indicate that the EC members have already accepted in principle that a common external tariff, set at a zero rate, should be applied to defense items. Now they are attempting to define which items should be on the zero-rate list.

There have been suggestions that the U.S. government would use the renegotiation of bilateral memoranda of understanding with individual European nations to promote access of U.S. companies both to the EC defense market and to public procurement in the EC more generally. Coincidentally, the bilateral MOUs with France, Italy and the Netherlands expire this year and must be renegotiated. But at this point, the policy of the Defense Department and the U.S. government is not to link these renegotiations to more general issues.

Export Controls

As noted in *EC-92 AND U.S. INDUSTRY*, differing export control policies and control lists already impede U.S. commercial relations with the EC. This problem will intensify unless U.S. policies fully take into account what is rapidly becoming an open market situation within the EC. This has already occurred to some extent with 1989 regulations affecting re-exports of parts and components and regulations on re-exports within CoCom, the multilateral western industrial countries' export control coordinating body. But U.S. companies could still face licensing burdens in selling to Europe which would not exist for their European competitors. And U.S. companies could be at an even greater disadvantage with respect to Eastern Europe, if more U.S. products and technologies are controlled with respect to direct and third-party exports to Eastern Europe.

For the present, the main strategy for dealing with this problem is through CoCom. EC countries participate as individual members, rather than through EC-coordinated policy structures. At present, CoCom members are participating in a major policy review, aimed at broadening the scope of agreed, decontrolled dual use products and otherwise reducing divergences in member practices, especially with respect to export controls on goods to Eastern Europe.

As of March 1990, the CoCom policy review had agreed to focus on two questions. The first was the reduction of processing time for products on the "core list:" those generally agreed to be of critical strategic importance and therefore subject to controls. Second, the CoCom review established a set of priority sectors for liberalization of controls: telecommunications, computers and machine tools. The mandate was to achieve a comprehensive liberalization package by June 1990, with the existing "green line" for exports to the People's Republic of China as the "base line" for the present review. To clarify its contribution to this process, the U.S. government was undertaking a comprehensive strategic review. Both within the U.S. government and the overall CoCom review, it is generally accepted that exports to Eastern Europe should receive favorable treatment. The extent of this liberalization is still being debated.

9. SOCIAL DIMENSION

As in *EC-92 AND U.S. INDUSTRY*, the final three substantive chapters of this report cover policy areas that are not directly the subject of US-EC relations, but may be considered primarily as political issues within the EC itself. The outcome of the policy debates in these three areas, however, could strongly affect the operations of U.S. companies within the EC, as well as the relationships between U.S. companies worldwide and their EC subsidiaries. Moreover, in all three policy areas, major political decisions were taken by the EC Council of Ministers in 1989.

EC Social Charter

In 1988, the issue of the EC's "social dimension" sparked a political confrontation between British Prime Minister Margaret Thatcher and European Commission President Jacques Delors that continues to influence both the politics of the EC and British domestic politics. The battle over this subject culminated at the EC heads of government meeting in December 1989 with the approval of an EC Social Charter by 11 member governments and the continued opposition of the United Kingdom.

As widely noted, the legal character of this instrument is hazy, especially since the Single European Act explicitly exempts workers' rights issues from majority voting rules used for other internal market policies. It is probably accurate to consider this document as a declaration that the 11 signatory governments intend to see some further EC policy actions in the covered areas, as the EC-92 process continues forward. To quote from the official statement on the Social Charter, "It will serve [the member states] as a reference point for taking fuller account in future of the social dimension in the development of the Community."

The Social Charter in itself, therefore, does not establish any new requirements on member governments. But, in its statement on the Social Charter, the heads of government explicitly took note of the "Action Program" of the European Commission on the application of the Social Charter. This Action Program, adopted by the Commission in November 1989, indicates new Commission initiatives that will be proposed. The following section links some of these Action Program proposals with appropriate Social Charter headings.

Action Program

The following review is not a comprehensive summary of the Social Charter or the Action Program, but a survey of some of the major policy areas where proposals could have major effects on U.S. companies' employee relations, if such proposals are adopted. The text and analysis of the EC Social Charter published in the February 1990 supplement to *INDUSTRIAL RELATIONS EUROPE* has been an extremely useful summary guide in preparing this list.

Before examining these detailed proposals, we should look first at the overall approach of the Action Program. There are a total of 47 different initiatives of various kinds, with a target date of completion by the end of 1991. Unlike past procedure, the Commission plans to start by posing specific questions to UNICE, the EC-wide employers confederation, and ETUC, the trade unions' equivalent body.

Some of the proposals incorporated in the Action Program have already been drafted and are in an advanced stage of discussion. Also, the comments below focus primarily on proposals which may be of concern to U.S. companies. Overall, the Action Program gives high priority to other matters, such as education, training and regional developments.

Employment and Remuneration. The Social Charter provides that, "Workers shall be assured of an equitable wage (i.e., a wage sufficient to enable them to have a decent standard of living)." Moreover, the Social Charter also addresses the situation of part-time and temporary workers, by providing that they "shall receive an equitable reference wage."

The Action Program contains no provision for actions binding on members regarding minimum wages. As the Commission states, "It is not the task of the Community to fix a decent reference wage. This...should be defined at the level of the Member States." The Commission plans to confine itself to an "opinion" on this issue, which would have legal status as a reference document.

More significantly, perhaps, the Action Program previews a strong focus on setting minimum standards relating to part-time or temporary employment, such as the hiring of temporary or part-time labor from or in the poorer EC members or from non-EC labor sources:

> Unless safeguards are introduced, there is a danger of seeing the development of terms of employment such as to cause problems of social dumping, or even distortion of competition at Community level. This proposal would therefore lay down at Community level minimum requirements, concerning working conditions and social protection in particular, which would have to be complied with in contracts or employment relationships of this nature in all countries of the Community.

This initiative is already in its second draft, and may be submitted for final adoption during the current Irish presidency of the Council of Ministers.

Improvements of Living or Working Conditions. Under this heading, the Action Program envisions a number of specific draft directives and other actions. One draft directive to be proposed relates to the nature of the contractual relationship, linked to concerns with the abuse of temporary and part-time employees, as mentioned immediately above.

Another major proposal is to amend the 1975 directive on collective redundancies (layoffs). It could have an impact on the legal consultation and information rights of U.S. companies' employees. This proposal would seek to close the "legal loophole" that companies with a "decision-making center" in one country need not inform workers in a different EC member country regarding impending collective redundancies.

The most comprehensive and far-reaching subject under this heading of the Social Charter and the Action Program concerns major divergences among members regarding such matters as working hours, night and weekend work, overtime and holidays. The Commission is proposing a directive on this subject, though the Action Program states, "For the Commission it would be a matter of proposing minimum reference rules without entering into details as regards their implementation." These "reference rules" could nevertheless create the basis for employees' cases against member governments before the ECJ. This is another directive on which a final decision could be made in the first half of 1990.

Social Protection – Social Security Benefits. The Social Charter undertakes a broad commitment to insure for workers adequate social protection (e.g., job security and unemployment benefits) and other Social Security benefits. But the only proposals envisioned in the Action Program are two non-binding recommendations to member governments on "convergence of objectives" and development of common criteria regarding sufficiency of resources devoted to social security.

Freedom of Association and Collective Bargaining. The Social Charter has an extensive list of guarantees under this heading, but no specific proposals are included in the Action Program, beyond a proposed "communication" reviewing the development of collective bargaining within the EC.

This chapter of the Social Charter has already stirred a controversy within the U.K. Labour Party. In its desire to cast itself as the mainstream "European" party on labor relations issues -- in contrast with Prime Minister Thatcher's unilateral opposition -- Labour has decided to conform its own policies to those in the Social Charter. But the Social Charter would require that "...Every worker shall have the freedom to join or not to join...[workers'] organisations..." This conflicts with Labour's traditional support for the (pre-entry) closed shop, and the party executive has decided to amend its policy accordingly, with strong opposition from some union leaders and domestic MPs.

Information, Consultation and Participation. This has been the most controversial area of EC social affairs policy among U.S. companies. The Social Charter establishes a right of information and consultation "in due time," in the following cases:

- "Technological changes..." having major implications for "working conditions and work organisation..."
- "Restructuring operations...and mergers..."
- Collective redundancies (layoffs).
- "When transfrontier workers in particular are affected by employment policies pursued by the undertaking where they are employed."

To implement this right, the Commission Action Program proposes a "Community instrument" of unspecified nature to replace the modified "Vredeling directive" shelved by the Council in 1986. This instrument "could" be based on the following principles:

- "Establishment of equivalent systems of worker representation in all European-scale enterprises."
- "General and periodic information" on the development of the enterprise.

- "Information *must* be provided and consultation *should* take place *before*...any decision" affecting employees' interests, notably closures, transfers or curtailment of activities, changes in organization and joint ventures (emphasis added).

- Information to be provided by the "dominant associated undertaking" (headquarters parent company) to the employer, for the employer to inform the employee.

While these provisions revive concerns about a new Vredeling directive, the terms of the proposal do not in themselves indicate that there would be any discriminatory application of the provision to non-EC controlled companies, which was the case in the original Vredeling proposal.

In addition to this proposal, there is a second "instrument" of undetermined nature, to be proposed regarding equity-sharing and financial participation by workers. Though the nature of the proposal is not specified, reference to a European Parliament resolution requesting a draft Commission recommendation in this area indicates that such a proposal would probably be nonbinding.

Health, Protection and Safety at the Workplace. This brief section of the Social Charter is correlated with a number of Action Program proposed directives, mostly relating to specific industries or problems (mining industry, protection from asbestos, etc.). The Commission also announces the attention of establishing an EC safety, health and hygiene agency. The mandate for this agency would appear to be primarily in the area of coordination and training, rather than in the enforcement of policies at the national level.

European Company Statute

After lengthy discussions with EC industry, trade unions, member states and other EC bodies, the European Commission has finally published an official draft European Company Statute (August 25, 1989). Since 1959, the EC has been considering the concept of company organization and registration as a specifically European company, not as a company registered in one or more member states.

The most controversial aspect of the proposal is the requirement that a European company (SE, from the Latin *Societas Euopaea)* must allow worker participation at the management level. This provision would take the form of a separate directive, attached to the underlying organizational regulation. This requirement exists in some form in some member states. But as industry representatives have noted, it does not exist in many of them, so this policy is not a true harmonization. Moreover, the characteristic forms of worker representation are widely different in the member states where the concept does exist, notably, the legally-mandated Dutch work councils, German codetermination by law through supervisory (two-tier) boards and Scandinavian collective bargaining models.

In effect, Articles 4, 5 and 6 would allow companies to choose from one of three options that approximate to aspects of these models, but a company must choose one of these options. In its report on the proposal, the Commission explicitly notes that given worker representation in some countries, to allow establishment of an SE without such a rule, would encourage companies already in the states with such plans to adopt the SE organizational approach, for the purpose of escaping worker participation at the highest management level. Its views were strongly supported by the European Parliament, which even proposed an alternative approach that would have also required consumer representation.

Since the SE will remain strictly voluntary as a form of organization, the Commission is hoping that, if its proposal is finally adopted, the tax benefits that may accrue from balancing losses and earnings throughout the EC will encourage selection of this form of organization, a point being given serious consideration by some U.S. companies. One problem from the U.S. perspective, as raised in recent congressional hearings, is that U.S. companies could be denied the tax benefits of SE organization, because of U.S. tax laws. The U.S. Tax Code in Subpart F would penalize international companies which restructure on a transborder basis, instead of maintaining separate company structures in each EC country where they operate.

10. MERGERS AND TAKEOVERS

The New EC Merger Control Regulation

On December 21, 1989, the EC ended 16 years of debate as the Council of Ministers decided to give the European Commission sole authority to approve or block large EC mergers and acquisitions. This piece of legislation takes the form of a regulation, which directly becomes law throughout the EC, and supplants or amends any existing laws at the national level. Technically, it was not a part of the internal market package, therefore, it had to be approved by all members of the EC. Hence, the regulation contains a number of compromises to secure unanimous agreement. But the final version maintains the principle of sole EC control over large-scale mergers, which had been the essential principle sought by the current competition policy Commissioner, Commission Vice President Sir Leon Brittan, and his immediate predecessor, Peter Sutherland.

The primary compromise in the final regulation is also the one having the most impact on potential U.S. investors: the threshold for determining if a merger has a "Community dimension" that falls under the EC's sole authority. According to an EC memorandum on the regulation, there will be three criteria for determining whether the regulation applies to a transaction:

- Combined worldwide turnover of companies involved of at least 5 billion ECUs (for banks and insurance companies, this threshold is measured against one-tenth of total assets).
- Turnover in the EC of at least 250 million ECUs, for at least two of the firms involved.
- An EC distribution criterion: "If each of the parties concerned derive two-thirds of their Community business in one and the same Member State, the merger will not be subject to Community control."

The EC anticipates that these thresholds will limit EC involvement to about 50 cases per year, once the regulation takes effect in September 1990. But revision of the threshold is provided for within four years; at this revision the Commission anticipates proposing reduction of the gross turnover threshold to 2 billion ECUs and a corresponding reduction in the EC threshold.

U.S. companies should note a number of other important implications for their merger and acquisition policies. The regulation will cover "partial mergers and merger-like joint ventures," an important consideration given the number of major strategic alliances currently being planned, proposed or considered. Also, there is no provision that one or more parties to the transaction must be headquartered in the EC; in other words, the regulation applies to "indirect acquisitions," wherein EC approval must be obtained for the merger of EC operations of two non-EC companies.

But the major implication and prime goal of the policy is to establish "one-stop shopping" with respect to major company mergers and acquisitions in the EC. In most cases, national government approval can no longer be required for such deals to go ahead. If a merger is covered, the Commission has one month after notification to initiate proceedings, and, if it undertakes to do so, another four months to issue a final decision. There are two possible exceptions to the exclusivity rule:

- Impact of a merger concentrated in one member state. Germany did not want to surrender the right for its Federal Cartel Office to review and proscribe any merger in Germany, but also did not want to block final agreement on an EC policy. The Commission therefore conceded that it would consider deferring to member government review on any merger, if it found that the proposed merger had a major market impact in only one EC country.

- Other exceptions. Because of Treaty of Rome limitations, the regulation will still allow member state review of mergers in limited instances on other policy grounds, notably public security, "plurality of the media" and prudential rules. There is also a fourth catch-all category of "other legitimate interests," which may be construed to include industrial policy, especially if "protected by relevant provisions in national law." The member state can act to prevent or modify such mergers, but only if the Commission finds that the basis for member state action is compatible with EC law. In such cases, the member state can never authorize a merger that has already been rejected by the Commission.

Takeover Policy

The run-up to EC-92 is leading, as predicted, to a rapid increase in mergers, acquisitions, joint ventures and other forms of business cooperation, both between companies in the EC and between EC and non-EC companies. For example, a recent Peat Marwick study found 669 new European "corporate partnerships" just in the last three months of 1989. This includes all deals where some form of equity holding is involved. By comparison, there were fewer than 1,000 such deals in Europe for the 10 years prior to 1986, according to the same source.

Under these conditions, the diversity of EC national takeover rules is considered by some governments to be a barrier to efforts of their companies to expand competitively in other member countries. As noted in *EC-92 AND U.S. INDUSTRY*, the legal environment for hostile takeovers is relatively permissive in the U.K., but almost prohibitive in countries such as France, Germany and the Netherlands, though there has been a recent revision of French investment rules.

As part of its policy of harmonizing company law, the Commission on March 10, 1989, published the draft Thirteenth Company Law Directive, which deals with takeovers. This draft directive primarily addresses the technical aspects of takeovers, ignoring the big question of national government interventions to block takeovers. It sets time limits for acceptance or rejection of an offer, provides for equal treatment of all shareholders and notably requires any person bidding for shares -- which would give that person control of one-third of the outstanding equity of a company -- to make a bid for the entire enterprise. Employees' representatives must also be notified of the offer.

In its review of the proposal, the European Parliament in January 1990 proposed a number of major amendments, at least four of which are likely to be accepted by Internal Market Commissioner Martin Bangemann. These amendments would --

- limit the application of the directive to companies quoted on stock exchanges;
- require bidders to explain how bids are to be financed and the financial implications for the targeted company after a takeover;
- allow companies to call an "extraordinary general meeting" during the offer period and suspend the bid until after conclusion of the EGM;
- establish nonmandatory "guiding principles" for supervisory authorities in the member states.

As noted earlier, this proposal contains no reciprocity provision regarding bids from non-EC companies, although it is possible that this subject may be revisited in future discussions on corporate defensive tactics.

11. EUROPEAN MONETARY UNION

Of all the issues covered in this report, none has generated a higher ratio of heat to light than the subject of European Monetary Union (EMU). Primarily, this is because the EMU proposal is viewed not as a technical economic issue, but as a test of commitment to a certain political vision of Europe: not only more harmonized, but more fully integrated, with national governments committed to surrendering their sovereign control over national monetary policy.

Also, and like the debate over the Social Charter, the main supporters of the two different approaches were British Prime Minister Thatcher and European Commission President Delors, with the latter strongly supported by French President Mitterrand, whom he had once served as finance minister. The German government was somewhere between, with Chancellor Kohl and Bundesbank President Karl-Otto Poehl supporting the EMU concept, but with reservations regarding the impact on the Bundesbank's constitutional priority of maintaining price stability.

Unlike the Social Charter, however, a compromise plan was developed, which allowed the EMU concept to move forward on a unanimous vote of approval. While the U.K. remains out of the current European Monetary System, in principle it will join at some point in the future. And Thatcher indicated no opposition in principle to "Stage One" of the program, which is now fixed to start in mid-1990.

Proposal of the Delors Committee

In 1988, the EC heads of government appointed a "committee of experts" to study and propose the concrete steps that would lead to European monetary union. The committee was headed by President Delors and included central bank governors from a number of EC countries, all serving in their "personal capacities." The Delors Committee published on April 12, 1989, its *REPORT ON ECONOMIC AND MONETARY UNION IN THE EUROPEAN COMMUNITY.*

This report envisaged a three-stage process:

- Stage One. Beginning with the establishment of free capital movement in the EC, member governments and central banks are to increase the level of cooperation, moving from maintaining exchange rate parities under the EMS to close cooperation on underlying macroeconomic policies. This stage is to coincide with the amendment of the Treaty of Rome, for the purpose of allowing establishment of a full monetary union. Stage One may not be completed by 1992, but it is envisioned that it will be completed before the next European Parliament elections, set for 1994.

- Stage Two. This is the stage in which the new European financial and economic structures are established, notably a European System of Central Banks (ESCB), which will serve to monitor and coordinate national monetary policies, particularly with respect to levels of money supply. At the same time, the proposal reflects concern with what Thatcher and other critics call the "democratic deficit," the lack of institutionalized parliamentary control over economic policy now shifting to the EC level. This is the period during which stronger EC supervisory powers are to be established, notably in the European Parliament and the Council of Ministers.

- Stage Three. At this stage, exchange rate parities are "irrevocably fixed"; indeed, the Delors Report anticipates that, during this stage, national currencies will be replaced by a single European currency, be it the ECU or some other vehicle. Full authority for establishing economic and monetary policy is at the EC level, and the EC will participate in international economic, monetary and financial only as a single bloc.

Decision of the EC Strasbourg Summit

The conclusions of this report established at least the essential timetable and framework for discussions. That is probably why, without agreement on the report's ultimate goals and directions, Thatcher supported the joint statement issued by the heads of government at Strasbourg on December 9, 1989. The decision taken at that meeting accepts the Delors framework and timetable, so that "Stage One" will start with the implementation of the capital movements directive on July 1, 1990. The heads of government also decided on an intergovernmental conference to consider the requisite alterations to the Treaty of Rome, to be held at the end of the Italian Presidency of the Council of Ministers, in December 1990. The Commission presented its first official report on the various policy options by April 1990.

This report, prepared under the leadership of European Commission Vice President and Commissioner for Economic and Financial Affairs Henning Christophersen, proposed a European Central Bank ("EuroFed"), and a single EC currency. Under this proposal, the EuroFed would determine a common monetary policy, to be implemented by the twelve member state central banks. The report also noted major changes to be proposed to the Treaty of Rome, which would constrain national monetary and budgetary policies. This would include the banning of monetary financing of public deficits and elimination of priority access to financial markets for public authorities. There would also be no EC bailouts of countries with budget deficits, although, as in the Capital Movements Directive, exceptions may be made for "*ad hoc* conditional assistance." The Commission is proposing a "transitional" period of submission of national medium-term financing strategies to EC review, and a "definitive system," under which EC budgetary rules or guidelines would be incorporated into national law. The report strongly endorsed establishment of a single EC currency, as Vice President Christophersen noted estimated savings in currency transaction costs of about 15-20 billion ECUs annually.

Problems of the British and German Currencies. Prime Minister Thatcher not only disagreed with other heads of government, but also with her own chancellor of the Exchequer, Nigel Lawson, over the issue of U.K. participation in the EMS -- which ultimately led to Lawson's resignation. But Thatcher, in principle, has never said that the U.K. will *never* join the EMS, only that it will not do so until the time is right. In her view, this will require a downward convergence of U.K. inflation toward the norm in other major EC industrial countries, reduction of the U.K. trade deficits, the full implementation of the Capital Movements Directive and the implementation of the other major elements of EC-92.

This means, as she has said, that the United Kingdom is committed to enter the EMS aligned currency system during the "stage one" period. Beyond that, however, her government has offered an alternative approach to currency union, the approach of "competing currencies." Under this plan, which gained no support from other member countries, and has been rejected by the Commission, all currencies, including the ECU, would become equally valid as transaction instruments within the EC, leading to a "free market" selection of the preferred transaction currencies.

The Deutsche mark is beset by a different problem. Originally, Bundesbank President Poehl was especially concerned that in a tighter "Stage One" EMS, the DM would be dragged toward instability by the political pressures emanating from countries such as France and Italy for a somewhat looser monetary policy. But Germany accepted the Strasbourg proposal, as a means of proving Germany's commitment as "good Europeans." (An excellent presentation of German concerns on this issue is provided by the German Confederation of Industry report, mentioned in Appendix II.)

Since then, German monetary policy has been overtaken by the controversy over how to deal with the monetary aspects of reunification with East Germany. As part of the unification package, the Bundesbank and the German government have indicated that they are considering an exchange of currency at the official value of equal parity at least for savings. But there is an international debate over what this will do to the international stability of the DM, the EMS and the ECU.

Impact on U.S. Interests

As discussed last year in *EC-92 AND U.S. INDUSTRY*, the freeing of capital movements -- already decided by the EC -- will be the most important result for U.S. companies of the EC's initiatives. The remaining French exchange controls were removed as of January 1, 1990 (six months ahead of schedule), while the Italian controls will remain in force until the entry into effect of the Capital Movements Directive on July 1, 1990.

The larger question for U.S. industry is what will happen with the closer integration of EMS, and the probable downward pressure on the DM, from both the pull of weaker EMS currencies and the uncertainties over currency integration with East Germany. The answer is not yet certain, of course, but it is highly significant that the U.S. Federal Reserve and foreign central banks have intervened strongly in two periods over the past year, when the DM weakened significantly against the dollar. The first episode was in spring 1989, as the dollar briefly rose to over DM 2.00, and also strengthened against the yen. In May-June 1989, the Fed stepped in with an unprecedentedly high level of purchases ($12 billion) in yen and DM.

The DM then strengthened for the balance of the year, at one point moving close to 1.60 per dollar. Again, however, recent concerns over integration with East Germany started to drive the DM down, occasioning another round of coordinated intervention, apparently on a more limited scale. By the early spring of 1990, the DM stabilized against the dollar, even while the yen fell sharply.

The message for U.S. trade interests appears to be clear. Whatever the uncertainties of the present period in international monetary policies, the U.S. Treasury and other cooperating governments are determined not to allow an untoward and premature rise in the U.S. dollar negatively affect the continued reduction of the politically sensitive U.S. trade deficit.

Appendix I

A COMPLETE LIST OF
NAM STATEMENTS, PUBLICATIONS AND LETTERS ON EC-92
(1989-1990)

(Documents are listed in chronological order.)

EC-92 AND U.S. INDUSTRY: AN NAM REPORT ON THE MAJOR ISSUES FOR U.S. MANUFACTURERS IN THE EUROPEAN COMMUNITY'S INTERNAL MARKET PROGRAM, by Stephen Cooney, NAM Director of International Investment and Finance (February 1989).

U.S. House of Representatives, Committee on Small Business. Testimony of Stephen Cooney on *THE IMPLICATIONS OF THE EUROPE 1992 PLAN FOR AMERICAN TRADE AND COMPETITIVENESS* (February 9, 1989).

"EC-92: What It Means for U.S. Manufacturers," by Alexander B. Trowbridge, *SIEMENS REVIEW* (March 1989).

Letter to Secretary of Commerce Robert Mosbacher, from NAM President Alexander B. Trowbridge, on EC-92 Technical Standards Issues (March 6, 1989).

U.S. House of Representatives, Committee on Ways and Means -- Trade Subcommittee. Testimony of Glen J. Skovholt, Director - Policy and Strategy, Corporate Public Affairs, Honeywell Inc. and Chairman, NAM Task Force on EC-92, on *EUROPE 1992: THE IMPLICATIONS FOR U.S. TRADE AND INDUSTRY* (March 20, 1989).

U.S. House of Representatives, Committee on Foreign Affairs -- Subcommittee on International Economic Policy and Trade. Testimony of Joseph Greenwald, Consultant - Unisys, Inc. and Chairman, NAM Working Group on GATT Negotiating Round, on *RECIPROCITY AND THE EUROPEAN COMMUNITY INTERNAL MARKET PROGRAM* (April 5, 1989).

U.S. International Trade Commission Public Hearing. Statement of Stephen Cooney on *THE EFFECTS OF GREATER ECONOMIC INTEGRATION WITHIN THE EUROPEAN COMMUNITY ON THE UNITED STATES* (April 11, 1989).

U.S. House of Representatives, Joint Economic Committee. Testimony of Stephen Cooney on *THE IMPLICATIONS OF THE EUROPEAN COMMUNITY 1992 PLAN* (April 26, 1989).

RESOLUTION ON THE EUROPEAN COMMUNITY 1992 INTERNAL MARKET PROGRAM, adopted by the NAM Committees on International Trade Policy and International Investment and Finance (May 10, 1989).

U.S. Senate, Committee on Finance. Testimony of Richard E. Heckert, formerly Chairman of the Board and Chief Executive Officer - E.I. du Pont Nemours and Co., and Chairman of the NAM Board of Directors, on *THE INTERNAL MARKET PROGRAM OF THE EUROPEAN COMMUNITY* (May 10, 1989).

U.S. House of Representatives, Committee on Science, Space and Technology. Testimony of Stephen Cooney on *THE IMPACT OF THE EUROPEAN COMMUNITY 1992 INTERNAL MARKET PROGRAM ON U.S. COMPETITIVENESS IN SCIENCE AND TECHNOLOGY* (May 17, 1989).

"Europe 1992 and U.S. Industry," speech presented to the National Economists Club, Washington, DC, by Stephen Cooney (June 19, 1989).

U.S. Department of Commerce, International Trade Administration Public Hearing. Statement of Stephen Cooney on *EUROPEAN COMMUNITY STANDARDS, TESTING AND CERTIFICATION ISSUES* (July 26, 1989).

"EC 1992: The Opportunities for U.S. Companies," by Stephen Cooney, *BUSINESS FORUM* (XIV:4), Fall 1989.

Letter to U.S. Trade Representative Carla A. Hills, from Glen J. Skovholt on NAM Task Force Visit to European Commission in Brussels, Belgium (October 23, 1989).

Letter to Assistant Secretary of Commerce for International Economic Policy Thomas Duesterberg from Stephen Cooney on the proposed EC "Global Approach" to Testing and Certification (November 17, 1989).

"Europe 1992: The Opportunity and Challenge for U.S. Economic Interests," by Stephen Cooney, *SAIS REVIEW* (X:1), Winter-Spring 1990.

Letter to European Commission Vice President and Commissioner for External Relations Frans H.J.J. Andriessen from Glen J. Skovholt, NAM EC-92 Task Force Chairman and NAM President Jerry J. Jasinowski, on EC Rules of Origin, Local Content and Forced Investment (January 12, 1990).

U.S. House of Representatives, Committee on Ways and Means. Testimony of Glen J. Skovholt on *EUROPE 1992: THE IMPLICATIONS FOR U.S. TRADE AND INVESTMENT* (January 30, 1990).

Letter to Charles M. Ludolph, Director - Office of European Community Affairs, Department of Commerce, from Stephen Cooney on proposed Industry Advisory Committee on EC-92 Standards-Related Issues (February 16, 1990).

Joint Letter to European Commission Vice President and Commissioner Frans Andriessen, from NAM, U.S. Chamber of Commerce and U.S. Council for International Business on Rules of Origin and Forced Investment Issue (March 12, 1990).

U.S. Department of Commerce, National Institute of Science and Technology Public Hearing. Statement of Stephen Cooney on *U.S. PARTICIPATION IN INTERNATIONAL STANDARDS ACTIVITIES* (April 4, 1990).

Appendix II

FURTHER READING AND SOURCES OF INFORMATION

NOTE: This listing covers a selection of important publications from public and private sources, that have appeared since the publication of *EC-92 AND U.S. INDUSTRY.* For a more comprehensive description of information sources, please refer to that earlier NAM report.

European Community

The European Commission's own newsletter, *TARGET 92*, is published by:

Commission of the European Communities
Directorate General - Information, Communication and Culture
Rue de la Loi 200
B-1049 Brussels, Belgium

In addition to other documents and publications mentioned in the text of this report, business readers should consult the overview in:

PROGRAMME OF THE COMMISSION FOR 1990, Commission of the European Communities (January 10, 1990).

U.S. Government Official Sources

Two outstanding summary guides to the present situation and U.S. government resources are:

EUROPE 1992: A BUSINESS GUIDE TO U.S. GOVERNMENT RESOURCES (Revised January 1990), U.S. Department of State -- Bureau of Public Affairs (Order from U.S. Government Printing Office, Washington, DC 20402; Stock no. 044-000-02276-1).

"European Community: The Single Market Takes Shape," special section in U.S. Department of Commerce, *BUSINESS AMERICA* (January 15, 1990).

Some basic information excerpts from this source are reprinted in this report as Appendix III.

For a concise survey of major issues to U.S. exporters, see:

U.S. General Accounting Office, *EUROPEAN SINGLE MARKET: ISSUES OF CONCERN TO U.S. EXPORTERS*, Report no. GAO/NSIAD-90-60 (February 1990).

Office of the U.S. Trade Representative, *EUROPE 1992: REPORT OF THE ADVISORY COMMITTEE FOR TRADE POLICY AND NEGOTIATIONS* (November 1989).

Excellent detailed analyses are:

U.S. Department of Commerce -- International Trade Administration, *EC 1992: A COMMERCE DEPARTMENT ANALYSIS OF EUROPEAN COMMUNITY DIRECTIVES* (2 vols., ed. by Debra L. Miller; Vol. 3 is to be released shortly).

U.S. International Trade Commission, *THE EFFECTS OF GREATER ECONOMIC INTEGRATION WITHIN THE EUROPEAN COMMUNITY ON THE UNITED STATES* (Publication 2204, July 1989). This is a continuing study, with a follow-up report scheduled for release soon.

Private Sector Sources

This subject has encouraged the publication of many detailed periodical reports and news letters by private organizations, which are too numerous to mention here. It should be noted that most of the major accounting firms now have published excellent summary reports, and maintain consulting services on most aspects of EC-92.

Once again, we must cite the most reliable and detailed continuing source of private organization information on EC developments from the U.S. perspective:

BUSINESS GUIDE TO EC INITIATIVES, published by the EC Committee of the American Chamber of Commerce in Belgium (latest ed. - Autumn 1989).

Other good U.S. private sector overviews are also provided by --

Chamber of Commerce of the U.S. -- International Division, *EUROPE 1992: A PRACTICAL GUIDE FOR AMERICAN BUSINESS* (1989, with updates to be published periodically).

U.S. Council for International Business, *THE EUROPEAN SINGLE MARKET* (First revision, March 1990).

We are continually contacted for information on ongoing standards developments. Besides the superb and concise EC paper mentioned in Part II - Chapter 1 of this report, we would again refer readers to two definitive private sector sources:

AMERICAN NATIONAL STANDARDS INSTITUTE

Brussels Address:
Avenue des Arts 50 - Bte. 5
1040 Brussels, Belgium

U.S. Address:
1430 Broadway
New York, NY 10018

As mentioned earlier, readers should refer to ANSI's *GLOBAL STANDARDIZATION NEWS*, Volume 1 (September 1989) and Volume 2 (January 1990) for overviews of general developments.

CEN/CENELEC

For a subscription to the EC standards organizations' monthly release on standards progress, *ONGOING ACTIVITIES IN EUROPEAN STANDARDS*, contact:

CEN/CENELEC
Rue Brederode 2 - Bte. 5
1000 Brussels, Belgium

__Publications of EC Business Organizations__

There are some extremely interesting publications of EC business associations, on either the general topic of EC-92 or specific subjects.

If your company has subsidiaries in the U.K. or is considering a location there, you should subscribe to the comprehensive information services of the Confederation of British Industry. Their major overview report is the 1990 revised version of *EUROPE SANS FRONTIERES* (no need for alarm, it is written in English). For further information, contact:

Confederation of British Industry
Centre Point
103 New Oxford St.
London WC1A 1DU United Kingdom

Other EC national business organizations have translated some useful and interesting reports into English. Particularly notable are the following.

Bundesverband der Deutschen Industrie. *COMPLETION OF THE SINGLE EUROPEAN MARKET - CONSEQUENCES FOR THE EUROPEAN COMMUNITY'S EXTERNAL RELATIONS: GERMAN INDUSTRY'S VIEW* (January 1989, English translation from German original).

ECONOMIC AND MONETARY UNION: A CHALLENGE FOR EUROPE (January 1990).

For both documents, contact:

Bundesverein der Deutschen Industrie
Gustav-Heinemann-Ufer 84-88
Postfach 51 05 48
D-5000 Koeln 51 (Bayenthal)
Federal Republic of Germany

U.S. Address:

Representative for German Industry and Trade
One Farragut Square South
1634 Eye Street, N.W.
Washington, DC 20006

A must for companies doing business in France is the paper of the French industry federation CNPF:

EXTERNAL DIMENSION OF THE EUROPEAN SINGLE MARKET AND COMMON TRADE POLICY (September 1989).

This is a translated looseleaf version of a brief, bound report in French, published under the title: *VOLET EXTERIEUR DU MARCHE UNIQUE EUROPEEN ET POLITIQUE COMMERCIALE COMMUNE.* For either version, contact:

Conseil National du Patronat Francais
31 Ave. Pierre 1er de Serbie
75116 Paris, France

Finally, U.S. companies are also well advised to be familiar with the views and publications of the officially-recognized EC-wide employers confederation, headquartered in Brussels. Contact:

UNICE
Rue Joseph II, 40 - Bte.4
1040 Brussels, Belgium

Appendix III

Excerpts from:
EUROPEAN COMMUNITY: THE SINGLE MARKET TAKES SHAPE
(U.S. Department of Commerce, *BUSINESS AMERICA*, January 15, 1990)

1992 at a Glance

By 1992, the European Community intends to have implemented 279 regulations to create a single internal market. The following specific changes represent the major part of the 1992 program.

(1) Adopted (2) Mostly Adopted
(3) Proposed (4) Proposal Due

In standards, testing and certification
Harmonization of standards for:
- Simple pressure vessels (1)
- Toys (1)
- Construction products (1)
- Machine safety (1)
- Agricultural & forestry tractors (1)
- Cosmetics (1)
- Quick frozen foods (1)
- Flavorings (1)
- Food emulsifiers (1)
- Food preservatives (1)
- Jams (1)
- Fruit juices (1)
- Food inspection (1)
- Definition of spirited beverages & aromatised wines (1)
- Coffee extracts & chicory extracts (1)
- Food additives (1)
- Materials & articles in contact with food (1)
- Tower cranes (noise) (1)
- Household appliances (noise) (1)
- Tire pressure gauges (1)
- Hydraulic diggers (noise) (1)
- Detergents (1)
- Lawn mower (noise) (1)
- Radio interferences (1)
- Automobiles, trucks, and motorcycles and their emissions (1)
- Telecommunications (2)
- Earth moving equipment (2)
- Liquid fertilizers & secondary fertilizers (2)
- Medicinal products & medical specialities (3)
- Lifting and loading equipment (3)
- Global Approach to Testing & Certification (3)
- Personal protection equipment (3)
- Measuring instruments (3)
- Medical devices (3)
- Gas appliances (3)
- Extraction solvents (3)
- Infant formula (3)
- Modified starches (3)

New rules for harmonizing packing, labelling and processing requirements
- Ingredients for food & beverages (1)
- Irradiation (1)
- Nutritional labelling (1)
- Classification, packaging, & labelling of dangerous preparations (1)
- Extraction solvents (3)

Harmonization of regulations for the health industry (including marketing)
- Medical specialities (1)
- High technology medicines (1)
- Pharmaceuticals (2)
- Veterinary medicinal products (2)
- Implantable electromedical devices (3)
- Non implantable, active medical devices (4)
- Non active medical devices (4)
- In-vitro diagnostics (4)

Changes in government procurement regulations
- Coordination of procedures on the award of public works & supply contracts (1)
- Extension of E.C. law to telecommunications, utilities, transport (3)
- Services (3)

Harmonization of regulation of services
- Mutual Funds (1)
- Broadcasting (1)
- Tourism (1)
- Air transport (1)
- Electronic payment cards (1)
- Information services (2)
- Life & nonlife insurance (2)
- Banking (2)
- Securities (2)
- Maritime transport (2)
- Road passenger transport (3)
- Railways (4)

Liberalization of capital movements
- Long-term capital, stocks (1)
- Short-term capital (1)

Consumer protection regulations
- Misleading definitions of products (1)
- Indication of prices (1)

Harmonization of taxation
- Value added taxes (3)
- Excise taxes on alcohol, tobacco, and other (3)

Harmonization of laws regulating company behavior
- Trademarks (2)
- Accounting operations across borders (2)
- Protection of computer programs (3)
- Transaction taxes (3)
- Company law (3)
- Mergers & acquisitions (2)
- Copyrights (3)
- Cross-border mergers (3)
- Bankruptcy (4)

Harmonization of veterinary & phytosanitary Controls
Harmonization of an extensive list of rules covering items such as:
- Antibiotic residues (1)
- Bovine animals and meat (1)
- Porcine animals and meat (1)
- Plant health (1)
- Fish & fish products (3)
- Live poultry, poultry meat and hatching eggs (3)
- Pesticide residues in fruit & vegetables (3)

Elimination and simplification of national transit documents and procedures for intra-EC trade
- Introduction of the Single Administrative Document (SAD) (1)
- Abolition of customs presentation charges (1)
- Elimination of customs formalities & the introduction of common border posts (1)

Harmonization of rules pertaining to the free movement of labor and the professions within the EC
- Mutual recognition of higher educational diplomas (1)
- Comparability of vocational training qualifications (1)
- Specific training in general medical practice (1)
- Training of engineers (1)
- Activities in the field of pharmacy (1)
- Activities related to commercial agents (1)
- Income taxation provisions (3)
- Elimination of burdensome requirements related to residence permits (4)

Is Your Business Ready for 1992?

The European Community plans to complete its Internal Market and remove substantially all physical, technical and fiscal barriers to the exchange of goods and services within the Community by 1992. This initiative will radically alter competitive conditions in our largest market. U.S. business should become aware of the opportunities and the risks the E.C.'s program poses for established market access.

For information on the 1992 Internal Market Program, copies of the Single Internal Market regulations, background information on the European Community, or assistance regarding specific opportunities or potential problems, contact:

Single Internal Market: 1992 Information Service
Office of European Community Affairs
U.S. Department of Commerce
Room 3036
14th and Constitution Ave., NW
Washington, D.C. 20230
Charles Ludolph or Mary Saunders, tel. (202) 377-5276

In addition, Trade Development industry experts assigned to this 1992 program are indicated below. Write to the U.S. Department of Commerce, Washington D.C. 20230:

Textiles and Apparel, Michael Hutchinson, Office of Textiles and Apparel, Room 3119, tel. 377-2043

Service Industries, Fred Elliott, Office of Service Industries, Room 1128, tel. 377-3734

Information Technology, Instrumentation and Electronics, Myles Denny-Brown, Office of Telecommunications, Room 1001A, tel. 377-4466

Chemicals, Construction Industry Products, and Basic Industries, Maryanne Smith, Office of Basic Industries, Room 4045, tel. 377-0614

Autos and Consumer Goods, Bruce Miller, Office of Automotive Affairs and Consumer Goods, Room 4324, tel. 377-2762

Construction Projects and Industrial Machinery, Kay Thompson, Office of the DAS for Capital Goods and International Construction, Room 2001B, tel. 377-2474

Aerospace, Marci Kenney, Office of Aerospace Policy & Analysis, Room 6877, tel. 377-8228

Office of Industrial Trade, Debra L. Miller, Director, Outreach Program to Industry Trade Associations, Room 2800 A, tel. 377-3733

If you want advice or information about any aspect of exporting to the EC, contact your ITA District Office (see inside back cover) or speak to an ITA European country desk officer: Belgium, Luxembourg—(202) 377-5401, Denmark—(202) 377-3254, France—(202) 377-8008, Federal Republic of Germany—(202) 377-2434, Greece—(202) 377-3945, Ireland—(202) 377-4104, Italy—(202) 377-2177, Netherlands—(202) 377-5401, Portugal—(202) 377-3945, Spain—(202) 377-4508, United Kingdom—(202) 377-3748.

Free brochures can be obtained by writing the Delegation of the Commission of the European Communities, 2100 M St. N.W., Washington, D.C. 20037. EC official publications and studies on the EC 1992 program can be obtained by contacting UNIPUB, 3611-F Assembly Drive, Lanham, Md. 20706-4391, or tel. (301) 459-7666, or (800) 274-4888.

For further information on European standards, the National Institute of Standards and Technology has prepared a more extensive summary of the EC initiatives on standards and other related materials. These can be obtained by contacting: **GATT Inquiry Point/Technical Office, Office of Standards Code and Information, National Institute of Standards and Technology,** Administration Building, Room A629, Gaithersburg, Md. 20899, tel. (301) 975-4040, and National Center for Standards and Certification Information (NCSCI), National Institute of Standards and Technology, Administration Building, Room A629, Gaithersburg, Md. 20899, tel. (301) 975-4040 (GATT Hotline: (301) 975-4041).

Additional U.S. Government contact points are Michael Brownrigg, U.S. Department of State, Europe/Regional, Political and Economic Affairs, Room 6519, Washington, D.C. 20520, tel. (202) 647-2395; Mark Orr, DAUSTR for Europe and Mediterranean, USTR, 600 17th Street, N.W., Washington, D.C. 20506, tel. (202) 395-3320.

The U.S. and Foreign Commercial Service: Fast Track to EC 1992

By Alain de Sarran
US&FCS, Office of Foreign Operations

Since 1980 the United States and Foreign Commercial Service (US&FCS) has been helping American business people find export markets for their products. With 1,200 employees in some 200 cities worldwide, the US&FCS manages 48 district offices and 18 branch offices in the United States and is represented at U.S. embassies and consulates in 65 countries. Operating under a Congressional mandate to protect and promote U.S. business interests abroad, the US&FCS functions as a service-oriented agency, rather than administrative or regulatory, dedicated to increasing the participation of small and medium-sized U.S. firms in international trade.

To deliver on this commitment, the US&FCS provides:

- one-on-one counseling with business representatives, American and foreign, at district offices and U.S. missions;
- numerous programs and services aimed at bringing together seller and buyer, from trade-opportunity reporting to "matchmaker fairs";
- market information on "best prospects" and other industry sectors of importance to American business.

In Europe, the US&FCS is present in 22 countries, including all the EC members except Luxembourg. The US&FCS also has officers participating in the work of the Organization for Economic Cooperation and Development (OECD) in Paris and the negotiations taking place under the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) in Geneva. The US&FCS is planning to assign additional officers to Brussels, where they will be closely involved in monitoring the EC 92 process, as well as to Eastern Europe. Throughout the world, US&FCS posts offer a "core" of primary services, described below. Businesses can arrange for country-specific services through their nearest district office (see the list of US&FCS district offices on the inside back cover of this magazine).

The US&FCS corps of 150 officers combines expert knowledge of host-country markets and U.S. business conditions with outstanding foreign-language skills. Our officers have been company presidents and vice presidents, marketing managers, and financial, legal and business consultants. In addition, 94 percent are proficient in one foreign language, 30 percent in at least two, and among them they speak 33 languages other than English. The US&FCS also employs 470 bilingual nationals who provide advice and services to business people interested in representing U.S. firms and distributing their products.

The following services are especially representative of the assistance offered by the US&FCS:

Counseling—The US&FCS offers one-on-one counseling on every phase of the exporting process. We identify trade and investment opportunities abroad, foreign markets for U.S. products and services, international trade exhibitions, aid available for export financing and insurance, tax advantages of exporting, export documentation and licensing requirements, import requirements, and so on.

Business facilitation services—The US&FCS will help make your overseas business travel more successful by providing preparatory market information, business-contact lists, language and secretarial support when you reach your destination, and assistance in making appointments in-country.

Trade opportunity reporting—U.S. missions' commercial sections report potential foreign importers' interests as "trade opportunities" or "TOPS," advertised in New York's daily *Journal of Commerce* and entered into several electronic data bases with many business subscribers. US&FCS officers also are active participants in the foreign branches of the U.S. Chamber and in other local business groups.

Commercial News USA—The export magazine of the US&FCS, CNUSA promotes new and state-of-the-art products and technology. Published ten times a year, CNUSA is distributed by overseas posts to more than 110,000 agents, distributors, government officials and end-users.

World Traders Data Reports—Under the WTDR program, US&FCS commercial officers prepare concise background evaluations, including creditworthiness and suitability, on U.S. firms' potential trading partners, such as agents, distributors and licensees.

Agent Distributor Service—The ADS is a customized search for interested and qualified foreign representatives of a client firm's product. Within 90 days, the client firm is sent names and addresses of up to six contacts, with brief comments on each. The US&FCS will also assist U.S. firms in approaching these representatives.

Comparison Shopping Service—The CSS is a custom market survey on a U.S. client firm's specific product in a selected country. It provides the firm with concise answers regarding product marketability, competitors, prices, entry/distribution/promotion practices, and trade barriers. The CSS is now available in 52 countries.

Trade missions—

- Specialized Trade Missions organized and led by Commerce Department staff bring groups of U.S. business people into direct contact with potential foreign buyers, agents and distributors for selected product lines.

- Seminar Missions coordinated by Commerce Department staff and led by industry representatives promote sales of sophisticated products and technology through technical presentations.
- State/Industry-Organized Government-Approved (S/IOGA) Trade Missions are cooperative efforts between the US&FCS and States, chambers of commerce, trade associations and other export-oriented groups.

Matchmaker events—Matchmaker Trade Delegations introduce U.S. companies to new markets by matching each U.S. firm with a prospective joint venture/licensee partner sharing a common product or service interest.

Catalog/video catalog exhibitions—These low-cost, flexible events, organized as displays of product literature or videotapes of equipment in operation, generate product exposure, sales and representation leads. They are especially useful in promoting U.S. exports in remote or small markets.

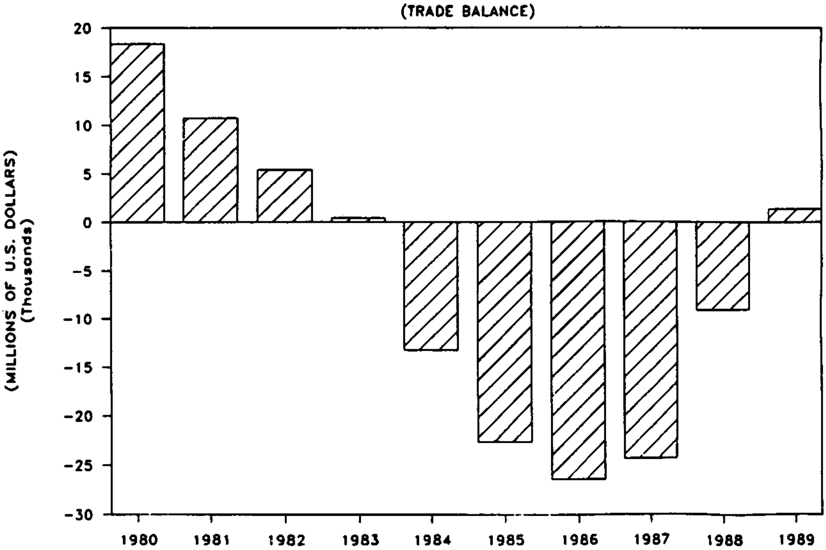
Trade fair certification—This US&FCS program offers private-sector trade fair organizers Commerce Department recognition and support, as well as official endorsement of the U.S. pavilions in their exhibitions.

Trade dispute assistance—Through their close contacts with key foreign officials, US&FCS staff are able to advise host governments of U.S. Government and industry concerns about trade barriers hindering U.S. access to a national market. Using these connections, US&FCS staff will intercede on behalf of U.S. firms in trade disputes directly or indirectly involving the host government. The US&FCS also acts as mediator in disagreements between private trading partners.

To receive more detailed information on the full range of US&FCS services, contact the nearest district office of the Department of Commerce, where an international trade specialist will speak or meet with you and help you choose the most rational approach to exporting your product successfully.

U.S. MERCHANDISE TRADE WITH THE EC

(TRADE BALANCE)



Representative HAMILTON. Mr. Aho, please proceed.

STATEMENT OF C. MICHAEL AHO, DIRECTOR, ECONOMIC STUDIES, COUNCIL ON FOREIGN RELATIONS

Mr. AHO. Mr. Chairman, it is a pleasure to be here today. Along with my prepared statement, I would like to include for the record a longer article by Bruce Stokes, the international economics correspondent for the National Journal, and myself, on "Euroshock: The Impact of European Developments on the American Economy."

Representative HAMILTON. Without objection, it is so ordered.

Mr. AHO. Most of this has been discussed, so I am going to try to comment a little bit on Mr. Hormats' and Mr. Cooney's comments before going on to talk about European economic and monetary union and what it means for the United States.

When I look at German unification in the 1992 effort and at Eastern Europe, particularly the Eastern Europe which, in listening to Mr. Hormats, yes, there is a problem of absorptive capacity, the ability to absorb the amount of investment that they are going to need. It will be an ongoing and continuing need for capital, and it's going to last throughout this decade and well into the next century.

But the bigger thing, it seems to me, in terms of demands for capital internationally, is part of the EC 1992 effort. The forecast that I have seen is that people expect business demand for investment to double during the 1990's, or by 1995 business demand for investment might be three times what it was at an earlier period.

As to the forecast for interest rate increases, certainly interest rates are not going to come down very much. I do agree, though, that global savings are down at the same time that investment demand is up, and what we need to do is do everything we can to increase global savings, including reducing government dissavings.

Another aspect of that, though, Mr. Hormats mentioned the financing internationally, it turns out over the last 2 years we have been more dependent upon inflows of European capital to the tune of $153 billion compared to inflows of Japanese capital. Japanese capital over the last 2 years has only been coming into the United States to the tune of $104 billion.

So as you get this increasing demand for investment in Europe, an awful lot of European savings are going to stay at home. The Japanese savings may be diverted from coming to the United States. And a principal casualty, it seems to me, along with the developing countries of what I might call this Euroshock is going to be the United States because we have become so dependent upon inflows of foreign capital.

Some simulations I saw from London were that a 1-percent rise in global interest rates would have a more profound effect in slowing U.S. growth than in slowing European or Japanese growth, again because of our deficient savings and our dependence upon foreign capital.

With that, though, I will leave some of the numbers and comments on the rest of this for the question period. And let me turn to European economic and monetary union.

Mr. Chairman, in your letter to me you asked about the apparent emergence of Europe as a world power and the implications of a common European currency. Now, if I look around, the European Community is the only entity that has the potential and the resources to challenge the United States for center stage among the great powers. But the European Community right now lacks a common language, lacks a common currency, lacks a common culture with generations of people with an experience of working together.

What's more, Brussels lacks the substantial power to tax and spend that Washington possesses. And people in the European Community are much more well rooted than in the United States. Our labor mobility is one of our underappreciated sources of strength.

Nonetheless, the EC is moving forward, and there is a dynamic at work here in Europe. You go back to the mid-1970's and going into the 1980's, Europe suffered from incomplete market integration, and so what comes along in the mid-1980's is they passed the Single European Act to improve their decisionmaking processes. As a result, what do we get? The European 1992 program, which is tearing down the internal barriers and increasing their integration.

The next step is going to be institutional reform, and they have an intergovernmental conference which starts this December, and beyond that is this European economic and monetary union, where you may end up with a European central bank, a Euro-Fed, if you will, and perhaps a common currency. They struck an agreement in March among the central bankers, and the commission staff that said, in fact, this Euro-Fed could come into being in a couple of years and you might have a common currency sometime in the second half of the decade.

But let me point out that European economic and monetary union was implicit in the narrower 1992 effort. Economic policymakers in the European Community are faced, in effect, with an inconsistent triple. You cannot have freedom of capital movements, fixed exchange rates, and independent monetary policy at the same time. In 1988 they started to remove the controls on capital movement. They have fixed-exchange rates among the major currencies in the European monetary system, and that made it difficult for them to practice independent monetary policy. And in fact most countries have been tracking the Bundesbank as far as money supply increases. I find it quite credible today, given the tracking in the 1980's, that France has a lower inflation rate than Germany does over the course of the last year or so.

But now let me consider some of the big questions about the future of EMU before turning to what I think are extraordinarily significant implications for the United States.

First, will German monetary union help or hurt European monetary union? And here I want to echo Mr. Hormats that German monetary union was drive by political circumstances, and I think European monetary union will also be driven by the political process and circumstances. Already, Italy and France are trying to push forward an EMU faster in order to anchor the European Community, anchor Germany within the European Community.

Granted, there will be difficulties. The monetary union in Germany, with its competitiveness effects in that, will last and linger on for years. But what is going to happen within Germany is the German current account surplus is going to diminish and perhaps disappear. And that was the biggest obstacle to European economic convergence. Germany was like an elephant inside the European Community, with these huge current account surpluses. Those are going to disappear.

The second question, though, is will the politicians go for it? I mean, we are talking about, in the view of many politicians, the ultimate sacrifice of authority. You're giving up, you know, the ability to print your own currency. But again, remember they have already been constrained by the Bundesbank's anti-inflationary stance.

But there is a very trenchant statement in the middle of the Delores report which laid out this plan for European economic and monetary union that says the European central bank will "be properly embedded in the democratic process."

Now, I have a hard time figuring out what that means, given the different countries have different systems for making decisions, different preferences over inflation versus unemployment. And I must say that if you talk to the French behind the scenes, one of the reasons the French are pushing for EMU is they would get greater symmetry with the Germans in determining what the rate of growth of money supply will be in the European Community.

Nonetheless, I suspect that any European central bank will be Bundesbank dominated, but the politicians still remain to be heard from, and they may slow the process.

The third question is that you may set monetary policy, but what happens to fiscal policy? You know, it's the monetary-fiscal mix that determines interest rates which determines unemployment, which determines the exchange rate in the external position. And there had been some discussion around the time of the release of the Delors report that there would be binding restraints on budgetary policy. Now, I dare say that if giving up the ability to print your own money is a sacrifice of automony, the ability to spend money during an election when you're trying to be reelected as prime minister would be the ultimate sacrifice of autonomy.

It seems to me they have a sequencing problem. No one in the European Community right now that is pushing for EMU wants to talk about what it means for fiscal policy because you will need ultimately an assessment, a common assessment, of fiscal policy, and a Europeanwide fiscal policy, if you are going to make EMU work, because there is the danger of what happened in the United States in 1981. We had a very restrictive monetary policy, and all of a sudden we burst the budget and we get this huge fiscal policy, you know, deficit in the United States and what happened to the exchange rate and our interest rates over time. How are you going to control fiscal policy?

Well, the fourth question is that to go along with EMU, countries have to be giving up, if you are going to have a common currency, the ability to change the exchange rate. You know, the exchange rate depreciation is a weapon for combating declining economic activity or rising unemployment. But the European Community, as I already mentioned, suffers from having a low degree of labor mobility. People don't even move north and south in Belgium much less pick up and go to Portugal. Now, you and I could probably go and get a job in Texas or elsewhere if economic conditions were to warrant it.

The second, more important, thing here, though, is the European Community at a nation-state level does not have the same sorts of automatic stabilizers that the United States does. You know, if the demand in Texas were to decline by $1, if sort of the gross national product of Texas declined by $1, Texas income would only decline by some 55 to 60 cents. The reason is tax revenues to the Federal Government would decline and unemployment insurance expenditures in Texas would go up.

But again, Brussels lacks that ability to tax and spend. So the automatic stabilizers aren't there. That means the European Community, with its tight budgetary constraints, is going to have to buy off the poorer countries with some sort of compensation, and that will be a contentious debate for some time to come. It is very likely there will be a two-tier or a two-speed European Community, with the poorer countries and maybe the U.K. going slower and the richer ones going further faster.

A couple of other just potential stumbling blocks before the implications for the United States. How long can this process go on? There are countries that are knocking at the door right now to broaden European Community membership, whereas EMU is a deepening of commitments in the European Community. I don't know how long they can keep those countries at bay. Are European institutions up to this new EMU, with the coordination it implies? No, they aren't, and they are going to have to improve and narrow that democratic deficit. And always there is the possibility of a recession coming along and throwing a real wrench into the works.

But I think the question now about EMU is not "if" but "how and when." I used to say that my 7-year-old David would probably be out of graduate school before EMU came about. Now I think David will probably be getting out of high school, somewhere around the turn of the century.

Briefly, the external implications for the United States, because it has not heretofore gotten enough attention:

First, a united European Community will definitely be a stronger negotiating partner in the G–7 or in other international forums. And in fact, that is part of, if you talk to European politicians, part of the driving force behind EMU. They would like to negotiate as one, from a stronger position. They are becoming more confident, and in fact this is a self-fulfilling prophecy.

In the G–7 process, the United States in the past has been able to play one European country off against another. You know, when we were pushing hard on Germany in 1986 to increase domestic demand, the French and the Italians were standing by cheering, "Please, please get them to start inflating." We won't be able to do that in the future. And what it will give is the EC more macroeconomic leverage to achieve its objectives on trade, agriculture, the environment, or whatever.

The second implication, though, is, with greater symmetry—and you could think of three elephants on the world's economic stage:

the European Community, the United States, and Japan—comes the potential for greater instability. You know, there will be a greater temptation to use exchange rates for domestic purposes in a beggar-thy-neighbor fashion. But that implies that the need for and the benefits from coordination, international macroeconomic coordination, will increase in the future.

But my third point here is that the negotiations over macroeconomic coordination are going to become tougher in the future, not easier. Now, some might say when you've only three to negotiate among, that's easier. Transactions costs are reduced. The European Community would have a better sense of where it's coming from. But EMU implies, with a common monetary policy, that you will have greater national pressure in the European Community member countries to use fiscal policy to meet domestic needs, and EMU monetary policy will be conditioned upon whatever the aggregate result of these separate fiscal policies will be.

You know, the EC may end up with one central banker, but it's going to have 12 finance ministers for some time to come. And I think that the European Community will be less flexible in negotiating with Japan and the United States. It has already proven incredibly inflexible in trade negotiations. It takes them so long to reach an internal agreement, by the time they get to the bargaining table internationally their position is almost set in concrete and it's immutable. On fiscal policy they will even be tougher.

That brings me to the last point, and it seems that if we have a common currency in Europe, the dollar's role as a key currency will continue to have—more transactions will be made and reserves will be held in ecu or whatever they're going to call it, and in yen, than ever before.

There is that potential for a tug-of-war among the major currencies, and, hopefully, Gresham's law won't come into play. But if the dollar should continue to exhibit continuing weakness, the process of the dollar's ebbing will be accelerated. And it seems to me that's yet another reason to work harder on getting our fiscal house in order but also to work harder to strengthen the process of international coordination while we still have—that is, the United States still has—the clout that it can now maintain and employ.

Thank you.

Representative HAMILTON. Thank you, Mr. Aho.

[The prepared statement of Mr. Aho, together with the article referred to for the hearing record and an additional article entitled "U.S. Trade Policy at a Critical Juncture," follows:]

PREPARED STATEMENT OF C. MICHAEL AHO

Mr. Chairman and members of the committee---it is an honor and a pleasure to appear here today to discuss the implications of developments in Europe for the United States economy. Along with my statement, I would like to include for the record a longer article on the topic entitled, Euroshock: The Impact of European Developments on the American Economy, by myself and Bruce Stokes, the international economics correspondent of the National Journal. It is a preliminary version of a chapter from our forthcoming book on how the United States should respond to Europe in flux.

This committee should be commended for addressing the critical developments in Europe that could have a profound effect upon the U.S. economy. West Germany's planned monetary union with East Germany will dramatically expand the demand for D-Marks and investment capital to rebuild the East. More important, plans to create a barrier-free internal market in Western Europe by 1992 (EC '92) are expected to more than double European business' demand for capital over the next decade. And, in the near future, the investment-starved economies of Eastern Europe are likely to begin soaki up funds like a dry sponge.

As with any scarce commodity, rising demand for money will drive up i cost. And, thanks to the relaxation of controls on international capital flows over the last decade that have created one global financial market, su action can reverberate around the world, driving up interest rates everywhere. The principal casualty of a Euroshock could be the United States because it has become too dependent upon foreign capital.

The unification of Western Europe and the introduction of capitalism into Eastern Europe have long been American goals and widely viewed as a net plus economically, but not enough attention has been given to the potential downside for the United States of the macroeconomic developments in Europe.

For example, in a world of higher real interest rates, the United States---as the world's largest debtor nation, borrowing $300 million a day internationally---would be in a vulnerable position. With the slowest economic growth and the highest inflation rate of the major industrial powers (except for the United Kingdom), America's economic woes may be aggravated by having to pay more to balance its books. To keep the foreign capital coming, the United States will have to bid up interest rates to attract capital from overseas. But as long as higher interest rates persist, the dollar is likely to remain overpriced crimping exports and U.S. companies will find it more costly to make the investments they need to improve their international competitiveness.

Finally, as governments inexorably ratchet up interest rates in the future there will be growing pressure from the international business community for industrial nations to better coordinate monetary and fiscal policies to keep things from getting out of hand.

When that happens, the United States will not necessarily dominate the process. The planned creation of a European Central Bank, with the power to negotiate for a single European economic and monetary union (EMU) fundamentally changes the power relationship between the United States and Europe on monetary issues. In the future, the United States will have less influence and will face a united European Community with enhanced leverage because of a common macroeconomic policy.

Before these changes are set in concrete, the United States should consider launching a macroeconomic dialogue with the Europeans, at best to insure that their economic decisions accommodate American interests and at least to keep the Europeans mindful of the international consequences of their actions.

West Germany's increase of its interest rate in the spring of 1990, in anticipation of the coming demand for D-Marks, underscores the volatility of the current situation. The hike was quickly mimicked in Tokyo, helping precipitate the May collapse of the Tokyo stock market, as Japanese investors adjusted their portfolios from low return equities to higher yielding bonds.

The United States dodged this ricocheting financial bullet. But the economy's luck may not hold. It won't be long before events in Europe leave their imprint on U.S. economic policies. Ultimately, European macroeconomic developments will place almost irresistible pressure on the United States to increase savings (reduce government dissavings) by raising taxes and/or cutting public spending. And it will force American companies to redouble their efforts to improve their international competitiveness.

AN ECONOMIC SHOCK WAVE

The impending reunification of Germany will generate the first economic shock wave to emanate from Europe. The costs of absorbing the GDR into West Germany will be staggering. The first bill comes due July 2, when the Bonn government will begin exchanging nearly worthless East German marks for D-Marks. A tug of war went on between Chancellor Helmut Kohl and the Bundesbank over the exact exchange rate. Eventually, they agreed that individual savings, up to a certain limit, will be converted 1-to-1, with a higher rate for other transactions. Getting the mix right obviously matters because it will represent an expansion of the German money supply creating inflationary potential and it will determine the ability of firms in the GDR to compete.

By the end of 1990 German inflation could be as high as 5 per cent compared with 2.7 per cent in the last year and 4.3 per cent in the 1978-1982 period, in the wake of dramatic oil price rises. But this should only be a one shot increase in the price level as long as the Bundesbank holds down the rate of growth in the money supply in the future.

If the past is prologue, outside observers should have great confidence in the Bundesbank's ability to keep price rises within these manageable ranges. But even then, inflation of that magnitude implies a significant rise in real German interest rates. And real interest rates around the world have tended to move in tandem since 1986, suggesting that German reunification-induced inflation may have at least a minor influence on the cost of money in the United States.

A potentially more threatening development for financial markets will be the cost of rebuilding East Germany. Although the East German economy is the strongest among the former Soviet bloc nations, it trails far behind its Western cousin. Productivity, once thought to be half Western levels, may be only a third that in the West, according to Theo Waigel, West Germany's Finance Minister. As uncompetitive plants are forced to close, the German unemployment rate could soar into double digits for a 2-3 year transitional period, compared with West Germany's current 7.4 per cent unemployment.

To stem the exodus of East Germans, which is already causing friction in the West, Bonn must quickly turn around East Germany's problems. Initial estimates put the annual price tag for rebuilding the East at about $60 billion, roughly 100 billion D-Marks at the current exchange rate, but to raise income levels of the 9 million East German workers to the point at which immigration might be choked off might involve spending around DM 150 billion per year on income support. To put this in perspective, total federal expenditure this year is scheduled at DM 300 billion. Unemployment benefits might cost an additional DM 25 billion and new pensions obligations DM 50 billion annually. These three expenditures alone would more than double the initial estimates, with public infrastructure costs for new telephone lines, electrified railroads and pollution cleanup still to be added on.

The benefits of reunification can finance some of these outlays. Anticipated faster growth, probably a full percentage point higher than the current 3.7 per cent figure, will generate more revenue. Current subsidies to West Berlin and border areas can be cut, as can the defense budget.

But most of the cost can only be met through deficit financing. The 1989 West German federal deficit was at a fifteen year low of DM 19 billion. In 1990 it is expected to rise to at least DM 33.5 billion. As a portion of the German GNP, it would only be about 1.5 per cent this year, which is still a far cry from the more than 6 per cent level experienced during the 1975 recession. But with the projected spending increases because of East Germany it could easily double or triple in the next few years, unless taxes are raised. If the deficit just pushed back up to, say, 4 per cent, historical experience suggests that would put nearly 50 basis points on bond yields.

SHIFTING INVESTMENT PATTERNS

Such interest rate moves are the stuff of headlines. But their impact could be dwarfed by the effect developments in Europe, East and West, are likely to have on global savings and investment patterns and the subsequent redirection of capital flows around the world.

The economies of Eastern Europe have foreign investors salivating. Double digit economic growth in East Germany is possible in the next few years. And the prospects for the rest of the region are only slightly less optimistic because of its skilled work force, large domestic market and proximity to the European Community. Anticipating a higher real rate of return for their money in the east than in the west, firms are already flocking in.

But before these firms can cash in substantial investment is required. To raise the East German capital investment per worker to West German levels, for example, will require approximately DM 1,000 billion ($5.8 billion). And East German firms are probably the best prepared in the Soviet bloc to compete on a world level.

The impact on world financial markets of this diversion of capital depends on the rate of investment. Projecting capital needs is one thing, projecting business investment expansion is another. That depends upon the voluntary decisions of tens of thousands of individual enterprises. However, if anticipated Eastern European growth rates materialize, these economies will rapidly begin to generate substantial funds for reinvestment, easing the demand for western capital.

But Eastern Europe is only one source of the increased demand for capital. Over the next decade, Western Europe's demand for investment is likely to have the more significant influence on world capital markets and on the future of the U.S. economy. DRI/McGraw-Hill estimates that fixed investment by business in Europe will grow an average of 8.3 per cent per year from 1990 through 1995. By the end of that period, companies' annual capital demand will be more than triple what it was in 1985.

This investment will come from U.S. businesses expanding their European operations and American firms trying to gain a foothold in Europe. U.S. direct investment in the European Community has already been growing by 15 per cent per year over the last four years. It will come from Asian investors: Japanese investment in the Community grew substantially last year. And, most important, it will come from European companies keeping their money at home.

This increased demand for capital will make it much harder for the United States to attract the capital to finance its deficits.

This should be of concern to the United States because, contrary to popular misconceptions, the U.S. Treasury is more dependent on borrowing European capital to balance its books than on Japanese capital. Over the last two years $153 billion in EC capital flowed into the United States compared to Japan which supplied the United States with only $104 billion in capital over the same period.

This dependency makes the United States particularly vulnerable to the dropoff in exports of German capital expected in the early 1990s. For years West Germany has run a mounting current account surplus. Unable to absorb all this capital at home, some went to the United States, but most of it went to Western Europe, where, in turn, it freed up French and British capital for investment in the United States.

But this flood of German capital may soon slow to a trickle and could reverse direction. Because of reunification, more investment will be made at home in Germany and the German propensity to consume may rise because of higher spending levels by East Germans. Last year's surplus of DM 99 billion could be eliminated within a few years.

The Germans turning off their capital spigot does not mean the United States will be unable to balance its books. There is no scarcity of capital in the world, if the price is right. But it probably does mean higher interest rates for quite some time in order to attract that capital.

This would be particularly damaging for the United States. According to simulations by the London office of Robert Fleming Securities Ltd. A one percent rise in world interest rates will more adversely affect American economic growth than European growth slowing U.S. growth by .4 per cent in the first year and .6 per cent in the second year, but slowing German growth by only .1 per cent in the first year and .3 per cent in the second year.

The United States also stands to suffer on the trade side from developments in Europe. The United States ran a slight trade surplus with the European Community last year, but as the D-Mark has appreciated against other European currencies and the yen in the last year, it has depreciated against the dollar. As a result, the growth of U.S. exports to Germany and to Europe will slacken off over the next few years.

And the sales Americans don't make to Germany, the Japanese will. In 1989, U.S. companies sold $4.5 billion worth of electrical equipment to Germans, the largest single U.S. export to West Germany. At the time, the United States had 13.1 per cent of the German import market, while Japan had 19.8 per cent. By 1995, DRI expects U.S. producers to have only 9.9 per cent of that key German import market, while Japanese makers have 22 per cent. Over all, DRI projections show the U.S. share of total German imports peaking in 1990 while the Japanese share continues to grow inexorably until 1995.

EMERGING MONETARY UNION

The planned creation of a European economic and monetary union (EMU) also poses a challenge to traditional post-war U.S. leadership in global economic affairs. Most members of the Community already synchronize exchange rates among themselves. Starting July 1, 1990, EC members began formally coordinating macroeconomic policy and central bank decisionmaking. Over the next few years economic coordination will intensify, currency fluctuations will narrow and groundwork will be laid for a European system of central banks.

The drive toward monetary union stems from actions taken in the narrower 1992 effort to create a unified European Community by eliminating internal barriers . With the abolition of capital controls agreed upon in June 1988 and phased in over 4 to 7 years, economic policymakers in the EC are faced with an inconsistent triple -- free movement of capital, fixed exchange rates and independent monetary policy. With free capital movements and fixed exchange rates in the European Monetary System, it is virtually impossible for national authorities to conduct an independent monetary policy.

In the Delors Report, published in 1989, three stages in the movement toward economic and monetary union were laid out. The first stage to begin in July 1990 calls for the initiation of the process with movement toward greater convergence of economic performance through the strengthening of policy coordination.

In the second stage, the basic organs and structure of EMU would be set up following approval of a new treaty to be negotiated at an intergovernmental conference beginning in December 1990. The new institutional framework would monitor while macroeconomic developments and promote a process of common decisionmaking . National authorities retain their own policy instruments for regulating economic activity. The third stage would see the move to "irrevocably" locked exchange rates and the assumption of monetary policy competence by the Community.

The momentum towards EMU accelerated in mid-March 1990 with the agreement to adopt a "EuroFed", that is, a European central bank. The agreement envisions moving to a single European currency sometime in the second half of the decade. Under the proposal drafted by the Commission and national bank authorities, the twelve central bank heads of the EC member countries would serve as a council that would decide monetary policies for the Community as a whole. A smaller group of appointed directors would implement the council's decisions. To ensure that they are independent of the day-to-day pressures of national politics, the directors would be appointed for long terms, perhaps 8 to 14 years.

The "EuroFed" would establish a central banking system with a structure somewhere between the Federal Reserve System and the Bundesbank. The new monetary authorities would enjoy autonomy but not as much as the Bundesbank. Just as the chairman of the Fed must appear before Congress, some accountability would be built in by requiring periodic testimony before the European Parliament and meetings with EC and national economic officials.

Oddly enough, the drive toward European monetary union may have been accelerated by the reunification of Germany. Certainly German reunification is putting strains on the European Monetary System, but the prospect of a united Germany has caused France and Italy to exert pressure to speed up EMU in order to anchor Germany within the European Community. Politics is driving the EMU process just as politics drove German monetary unification. And as unification reduces or eliminates Germany's current account surplus, macroeconomic convergence could be accomplished sooner than before. Nonetheless, the Bundesbank will play a critical role in determining how fast EMU moves forward.

Another important development agreed to in March was the downplaying of the need to have "binding restraints on budgetary policy" as called for in the Delors Report. Rather than central restraints on budgetary policy, the agreement left the discipline to the marketplace. Although politicians running for reelection will often be tempted to increase government expenditures and/or reduce taxes to maximize their chances for reelection, they will be held accountable by financial markets. The central bank authorities pledged not to print money to cover any budgetary shortfall and promised no guarantee of a bailout for countries that get into financial difficulties. Like the states of Massachusetts and New York, countries with inadequate fiscal discipline might suddenly find their credit rating lowered and the costs of borrowing raised. Nonetheless, some oversight and scrutiny of national fiscal policies will be necessary because the market does not always operate smoothly or incrementally but instead can signal a change in confidence suddenly and dramatically. Since national governments will retain substantial power to tax and spend compared to Brussels, this will be a source of constant concern. How well the process will work, will not be known until one or two countries are subjected to the harshness of financial market discipline.

The speeded-up timetable to converge economic performance and to strengthen central bank coordination means Washington will have to deal with EMU's consequences sooner rather than later. Both the Delors committee and the EC Commission agree that the EuroFed will be "explicitly committed to price stability," an anti-inflationary bias now shared by governments of all major industrial nations, but most identified with the Bundesbank. Current exchange rate coordination has already led to a marked convergence of inflation rates among most European economies. EMU will only amplify this process.

To date, European inflation fighting has had little influence on American economic policy. But the United States faces the prospect of a global economy in which both a united Europe and Japan are more successful than Washington at controlling inflation.

The cost of being out of step in controlling inflation could be declining relative competitiveness. But the price of getting in line could be higher unemployment. While this is a tradeoff all economies face, in the future it may be a particular problem for the United States. The Japanese, with low inflation and low unemployment, seem to have minimized the problem. And there is an impending demographic force that will make it easier for Europeans to have lower unemployment with lower inflation. The nine richest EC countries, excluding Greece, Portugal and Spain, had to absorb a million new entrants into the job market in 1981. By 1993, estimated new job seekers for the nine will total 11,000.

It is still too soon to be certain of the consequences of creation of a

EuroFed. It is not clear that a EuroFed will insure a rock solid fight against inflation at any cost. One of the reasons the French are pushing for a EuroFed is to attain greater symmetry in monetary policy decisionmaking. Now they must follow the Bundesbank. Nonetheless, the Bundesbank, with its anti-inflationary bias, is likely to dominate.

But an anti-inflationary bias is not the only fallout of EMU. Since a single currency means individual countries will lose their ability to improve their competitiveness through currency depreciation, Brussels has already begun a massive program of regional aid, which for some countries could soon equal 4 per cent of their GNP. Such financial transfers may have to be increased even further to minimize the political opposition to monetary union. The poorer EC member countries are already lobbying for more compensation in the form of structural adjustment funds.

But the EC's regional subsidies have already caused trade disputes with the United States. Such grants could easily come up in countervailing duty cases brought by U.S. companies, especially if there is a recession.

The EuroFed's creation will mean that a lot of the world's money supply will be coming under a single, new manager. The EMU is likely to transform the international economic coordination process industrial nations have fitfully been pursuing over the last decade and a half. The emergence of a Big Three---Europe, Japan and the United States---places a higher premium on coordination. The United States is no longer the only elephant on the world's economic stage and now it must learn how to get along with other elephants. At the technical level, creation of the EuroFed will presumably make that coordination easier---transaction costs will be reduced. But, in fact, macroeconomic adjustment could at times become more difficult. Greater symmetry could generate more instability if it creates more of an incentive to manipulate exchange rates for domestic reasons.

If the EuroFed has a clearly stated mandate in its charter of price stability above all else, it could hinder its ability to ease monetary policy when conditions might require that for international coordination.

And, if the EuroFed is truly independent of the political process, the it may be even harder for governments to insure that the international economic agreements they reach are put into practice. Because Brussels lacks substantial power to tax and spend, fiscal outcomes in the member states will condition the EMU monetary policy. But central monetary policy under EMU wil put greater pressure nationally on fiscal policy to achieve domestic objectives. A situation like in the United States in the early 1980's---tigh monetary policy and loose fiscal policy---is entirely possible with its adverse effects on interest and exchange rates. International coordination o fiscal policy then becomes more important but also more difficult. The head of EMU's central bank might be able to agree with his counterparts in the United States and Japan, but who will serve as the EC's finance minister to negotiate on fiscal policy? The EC might agree on one central bank authority but it is likely to have twelve finance ministers for some time. The United States and Japan could find negotiating macroeconomic policy with the EC as difficult as negotiating trade where the Community position is almost immutable after it has negotiated internally.

THE OBSTACLES AHEAD

Despite the progress on European monetary union in March, several potential problems still loom. The Delors Report assures that the European central bank will be "embedded in the democratic process." But how? What is the nature of the democratic compromise? Are periodic appearances before the European Parliament or consultations with EC and national economic officials, enough to satisfy demands for accountability? How do the different central bankers agree upon the rate of growth of the Community's money supply? What instruments of monetary policy will be adopted? Who are eligible market participants and what is the nature of the regulatory framework? If national currencies are retained, how can "irrevocably" locked exchange rates be assured? How does the EC arrive at a common position for international coordination of macroeconomic policy? If exchange rate intervention is needed, who intervenes and on what basis? The details remain to be worked out.

The answers to these questions are of great importance to the United States. If the EuroFed is not accountable to political authority, tensions could arise in Europe that would trigger instability in world financial markets and higher interest rates in the United States. A EuroFed judged too subservient to politicians would lack credibility in the marketplace.

As much as the March agreement is a step forward, the politicians in member states still need to be heard from. Different countries have different preferences over the course of macroeconomic policy and different decisionmaking processes. Giving up the ability to conduct their own monetary policy is likely to be viewed by them as the ultimate sacrifice of sovereignty. There is also a question of the Bundesbank's willingness to push ahead on European monetary union at the same time it is struggling to move forward on German monetary union. The acrimony over the exchange rate chosen to convert the two currencies is just the beginning. The real effects on living standards and competitiveness will linger for years. Only when these problems have been sorted out will the EuroFed have the credibility it needs.

The next big public step will be the intergovernmental conference now slated for December. If the central bankers have their way, it will only have to deal with the institutional aspects of European economic and monetary union, not the substantive aspects. They are trying to negotiate all of the substantive problems before the conference begins. What is unknown at this time is whether the intergovernmental conference will go for a "small treaty" merely to implement the institutional structure of EMU or a big treaty to try to tackle the "democratic deficit" of the Community. A push for a bigger treaty could bog down progress over EMU.

Even if the European Commission and some national authorities should wish to go further, faster on monetary union, it is highly probable that not all countries will go along. Under Thatcher, the United Kingdom remains the odd island out although pressure from the City of London is sure to increase if financial market activity were to start to move to the continent. The Southern countries -- Greece, Portugal, and possibly Spain -- might have a difficult time accepting the central discipline of monetary union and might prefer to retain the option of adjusting the exchange rate. If so, a two-tier or two-speed Community may result.

But whatever transpires, the question of EMU is no longer if, but how and when.

EBBING DOLLAR INFLUENCE

As the new European currency comes into its own it will challenge the dollar's role as the world's key currency. Already, more and more trade and assets are yen and D-Mark denominated. And in a symbolic gesture, at least some of the assets of the new European development bank will be denominated in ECU, the first truly multilateral institution to make this move. The use of other currencies to denominate transactions could accelerate if the dollar were to display continuing weakness. The evolution of a European currency block is now imaginable and with it U.S. leverage as the key currency country may also ebb.

EMU means the United States will have less influence through the market. In the past, the United States could rely on currency market forces to induce allies to change their economic policies in ways that the United States wanted. For example, in the Reagan Administration then Treasury Secretary James A. Baker III talked down the value of the dollar to force

Germany and Japan to begin expansionary domestic economic policies. After monetary union in Europe, the arm-twisting effects of dollar depreciation will be diffused over a broader economy and will therefore be less effective. Thus, EMU fundamentally changes the power relationship between the United States and Europe on monetary issues. Indeed, some in Europe consider the changed power relationship one of the primary driving forces behind EMU. A united Europe through EMU would have greater negotiating leverage and would increase European confidence perhaps as a self-fulfilling prophesy. The EC could then trade off macroeconomic changes for other objectives on trade or security issues.

The full ramifications for the United States of these macroeconomic developments in Europe have only begun to come into focus. But it would be short-sighted if the United States did not realize that the growing global demand for investment will increase competition for savings. Now is the time for the United States to reduce its reliance on external savings. That means cutting the federal budget deficit, which may be slightly easier in the future because recent events in Europe will justify reduced defense spending. If the breathtaking events in Europe finally force action on the U.S. budget deficit, so much the better.

But cutting the U.S. deficit is not the only necessary consequence of developments in Europe. The United States should also contemplate taking some initiatives about how the world economy should be organized, in the wake of German reunification, Western European unification and Eastern European liberation. Closer international economic coordination is an inevitable necessity in light of Europe's growing economic influence. The only question is will the coordination be led by the United States. Only such an initiative now can protect the United States while it still has sufficient clout, before Europe feels its weight and the U.S. role has declined even further.

EUROSHOCK:
THE IMPACT OF EUROPEAN DEVELOPMENTS ON THE AMERICAN ECONOMY

C. Michael Aho
Director of Economic Studies
Director of the International Trade Project
Council on Foreign Relations

and

Bruce Stokes
International Economics Correspondent
National Journal

In May 1990 when President Bush called a weekend meeting of congressional leaders to propose a budget summit, he conveyed a sense of urgency about the budget not seen during his administration. Something had changed and his lips appeared to quiver. By late June, he abandoned his campaign pledge of no new taxes and said that tax revenue increases were needed to reduce the budget deficit. Projections of future U.S. budget deficits were almost $100 billion over previous estimates and his advisors convinced him that more trouble might lie over the horizon---not just because of a possible recession but because of unfolding events in Europe.

The advisors' reasoning was simple. West Germany's monetary union with East Germany will dramatically expand the demand for D-Marks. More important, plans to create a barrier-free internal market in Western Europe by 1992 are expected to more than double European business' demand for capital over the next decade. And, in the near future, the investment-starved economies of Eastern Europe are likely to begin soaking up funds like a dry sponge.

As with any scarce commodity, rising demand for money will drive up its cost. And, thanks to the relaxation of controls on international capital flows over the last decade that have created one global financial market, such action can reverberate around the world, driving up interest rates everywhere.

"This will be the third great shock to the world economy since Vietnam," warned David Hale, chief economist for the Chicago-based Kemper Financial Services Inc., comparing what lies ahead to the oil embargoes of the 1970s and the Third World debt crisis of the 1980s.[1] The only difference is, this time a principal casualty of a Euroshock could be the United States because it has become too dependent upon foreign capital.

The unification of Western Europe and the introduction of capitalism into Eastern Europe have long been American goals and widely viewed as a net plus economically. But American public officials, who came of age in the Cold

War when an economically vibrant Europe was needed to fend off communism, and investment bankers, who stand to benefit from European dynamism, have often given short shrift to the potential downside for the United States of macroeconomic developments in Europe.

For example, in a world of higher real interest rates, the United States---as the world's largest debtor nation, borrowing $300 million a day internationally---would be in a particularly vulnerable position. With the slowest economic growth and the highest inflation rate of the major industrial powers (except for the United Kingdom), America's economic woes may only be aggravated by having to pay more to balance its books. To keep the foreign capital coming, the United States will have to bid up interest rates to attract capital from overseas.

And as long as higher U.S. interest rates persist, the dollar is likely to remain overpriced crimping exports and U.S. companies will find it more costly to make the investments they need to improve their future international competitiveness. Hamstrung in this way, American exporters may be less well positioned to take advantage of emerging business opportunities in Europe than their counterparts in Japan.

Finally, as governments inexorably ratchet up interest rates in the future there will be growing pressure from the international business community that must operate in this uncertain environment for industrial nations to better coordinate monetary and fiscal policies to keep things from getting out of hand. When that happens, the United States will not necessarily dominate the process as it has in the past. The planned creation of a European Central Bank, with the power to negotiate for a single European economic and monetary union (EMU) fundamentally changes the power relationship between the United States and Europe on monetary issues. In the future, the United States will have less influence and will have to offer policy concessions of its own to get reciprocal concessions from other governments.

Before these changes are set in concrete, the Bush Administration should consider launching a macroeconomic dialogue with the Europeans, at best to insure that their economic decisions accommodate American interests and at least to keep the Europeans mindful of the international consequences of their actions. To date, the Administration is taking a wait-and-see attitude. Months after the first announcement of EMU, an interagency task force on EMU in Washington was still busy analyzing the implications of monetary union.

How long the Administration can be a passive observer of European economic developments remains to be seen. West Germany's increase of its interest rate in the spring of 1990, in anticipation of the coming demand for D-Marks, underscores the volatility of the current situation. The hike was quickly mimicked in Tokyo, helping precipitate the May collapse of the Tokyo stock market, as Japanese investors adjusted their portfolios from low return equities to higher yielding bonds.

The United States dodged this ricocheting financial bullet. But the economy's luck may not hold. It won't be long before events in Europe leave their imprint on U.S. economic policies. Ultimately, European macroeconomic developments will place almost irresistible pressure on the United States to increase savings (reduce government dissavings) by raising taxes and/or cutting public spending. And it will force American companies to redouble their efforts to improve their international competitiveness.

Such initiatives are long overdue and should be welcomed. But the fact that they may be forced on the United States by events beyond American control is unlikely to sit well with most Americans. This psychological shock may be the most difficult and abiding consequence of Euroshock. It is yet another indication of America's declining dominance and a sign that American economic policies will have to begin to be reshaped accordingly.

AN ECONOMIC SHOCK WAVE

The reunification of Germany will generate the first economic shock wave to emanate from Europe. The fact that reunification is even contemplated should convince even the most cynical that in the affairs of state, the heart dominates the pocketbook. For in the short run, the marriage of these two economies makes little economic sense.

The costs of absorption will be staggering. The first bill came due July 2, when the Bonn government began exchanging nearly worthless East German marks for D-Marks. A tug of war went on between Chancellor Helmut Kohl and the Bundesbank over the exact exchange rate. Eventually, they agreed that individual savings, up to a certain limit, will be converted 1-to-1, with a higher rate for other transactions. Getting the mix right obviously matters. A 1-to-1 conversion across the board would have increased the German money supply by more than 15 per cent over night. (Exact estimates are hard to come by because of inadequate measures of East German money in circulation.) A less generous rate would have held down the money supply increase to as little as 3 per cent. (By comparison, the U.S. money supply grew 2.3 per cent in the last year.) The eventual agreed upon rate still boosted buying power enormously, with East German consumers, long starved for cars, color televisions and blue jeans, bidding up the price for goods and services.

By the end of 1990 German inflation could be as high as 5 per cent. By comparison, German prices rose 2.7 per cent in the last year and inflation averaged 4.3 per cent in the 1978-1982 period, in the wake of dramatic oil price rises. But this should only be a one shot increase in the price level as long as the Bundesbank holds down future growth in the money supply.

If the past is prologue, outside observers should have great confidence in the Bundesbank's ability to keep price rises within these manageable ranges. But even then, inflation of that magnitude "implies a significant rise in real [German] interest rates."[2] And real interest rates around the world have tended to move in tandem since 1986, suggesting that German reunification-induced inflation may have at least a minor influence on the cost of money in the United States.

A potentially more threatening development for financial markets will be the cost of rebuilding East Germany. Although the East German economy is the strongest among the former Soviet bloc nations, it trails far behind its Western cousin. Productivity, once thought to be half Western levels, may be only a third that in the West, according to Theo Waigel, West Germany's Finance Minister. As uncompetitive plants are forced to close, the German unemployment rate could soar into double digits for a 2-3 year transitional period, compared with West Germany's current 7.4 per cent unemployment.

To stem the exodus of East Germans, which is already causing friction in the West, Bonn must quickly turn around East Germany's problems. Initial estimates put the annual price tag for rebuilding the East at about $60 billion, roughly 100 billion D-Marks at the current exchange rate, but as more careful analysis of the state of the East German economy has been taken into account, the price tag has escalated. "To raise income levels of the 9 million [East German] workers to the point at which immigration might be choked off might involve spending around DM 150 billion per year on income support," noted a recent study by Barclays Bank.[3] "To put this in perspective, total federal expenditure this year is scheduled at DM 300 billion." Barclays' economists think that unemployment benefits might cost an additional DM 25 billion and new pensions obligations DM 50 billion annually. These three expenditures alone would more than double the initial estimates, with public infrastructure costs for new telephone lines, electrified railroads and pollution cleanup still to be added on.

The benefits of reunification can finance some of these outlays.

Anticipated faster growth, probably at least a full percentage point higher than the current 3.7 per cent figure, will generate more revenue. Subsidies to West Berlin and border areas can be cut, as can the defense budget.

But most of the cost can only be met through deficit financing. The 1989 West German federal deficit was at a fifteen year low of DM 19 billion. In 1990 it is expected to rise to at least DM 33.5 billion. As a portion of the German gross national product (GNP), it would only be about 1.5 per cent this year, which is still a far cry from the more than 6 per cent level experienced during the 1975 recession. But with the projected spending increases because of East Germany it could easily double or triple in the next few years, unless taxes are raised.

As a recent analysis by Shearson Lehman Hutton notes, "if the deficit just pushed back up to, say, 4 per cent, historical experience suggests that would put nearly 50 basis points on bond yields."[4]

SHIFTING INVESTMENT PATTERNS

Such interest rate moves are the stuff of headlines. But their impact could be dwarfed by the effect developments in Europe, East and West, are likely to have on global savings and investment patterns and the subsequent redirection of capital flows around the world.

The economies of Eastern Europe have foreign investors salivating. Double digit economic growth in East Germany is possible in the next few years. And the prospects for the rest of the region are only slightly less optimistic because of its skilled work force, large domestic market and proximity to the European Community. Anticipating a higher real rate of return money in the east than in the west, firms are already flocking in. The Japanese plan to build auto plants in Hungary and Poland. Some 140 West German companies are committed to 1,100 joint ventures in East Germany alone.

But before these industries can cash in on the expected bonanza, the piper must be paid. Barclays Bank estimates that to raise the East German capital investment per worker to West German levels, for example, will require approximately DM 1,000 billion ($5.8 billion).[5] And East German firms are probably the best prepared in the Soviet bloc to compete on a world level.

The impact on world financial markets of this diversion of capital depends on the rate of investment. Projecting capital needs is one thing, projecting business investment expansion is another. That depends upon the voluntary decisions of tens of thousands of individual enterprises. Moreover, if anticipated Eastern European growth rates materialize, these economies will rapidly begin to generate substantial funds for reinvestment, easing the demand for western capital.

But Eastern Europe is only one source of the increased demand for capital. Over the next decades, Western Europe's demand for investment is likely to have the more significant influence on world capital markets and on the future of the U.S. economy. DRI/McGraw-Hill estimates that fixed investment by business in Europe will grow an average of 8.3 per cent per year from 1990 through 1995. By the end of that period, companies' annual capital demand will be more than triple what it was in 1985.[6]

This investment will come from U.S. businesses expanding their European operations and American firms trying to gain a foothold in Europe to take advantage of the soon-to-be-unified market. U.S. direct investment in the European Community has already been growing by 15 per cent per year over the last four years. It will come from Asian investors: Japanese investment in the Community grew substantially last year. And, most important, it will come from European companies keeping their money at home. This increased demand for capital will make it much harder for the United States to attract the capital it needs to finance its trade and budget deficits.

This is of concern to the United States because, contrary to popular misconceptions, the U.S. Treasury is more dependent on borrowing European capital to balance its books than on Japanese capital. Over the last two years $153 billion in net EC capital flowed into the United States as direct investment in plant and equipment, for the purchase of government notes, corporate bonds and stocks and as bank deposits. By comparison, Japan supplied the United States with only $104 billion in capital net over the same period.[7]

This dependency makes the United States particularly vulnerable to the dropoff in exports of German capital expected in the early 1990s. For years West Germany has run a mounting current account surplus. Unable to absorb all this capital at home, some went to the United States, but most of it went to Western Europe, where, in turn, it freed up French and British capital for investment in the United States.

But this flood of German capital may soon slow to a trickle and could reverse direction. Because of reunification, more investment will be made at home in Germany and the German propensity to consume may rise because of higher spending levels by East Germans. In addition, higher interest rates and the promise of EC '92 will drive up the D-mark, leading to a decline in the German current account surplus. Last year's surplus of DM 99 billion could be eliminated within a few years.

The Germans turning off their capital spigot does not mean the United States will be unable to balance its books. There is no scarcity of capital in the world, if the price is right. But it probably does mean higher interest rates for quite some time in order to attract that capital.

This would be particularly damaging for the United States. Simulations by the London office of Robert Fleming Securities Ltd. suggest that a one percent rise in world interest rates will more adversely affect American economic growth than European growth, slowing U.S. growth by .4 per cent in the first year and .6 per cent in the second year, but slowing German growth by only .1 per cent in the first year and .3 per cent in the second year.[8]

The United States also stands to suffer on the trade side from developments in Europe. The United States ran a slight trade surplus with the European Community last year and American officials have high hopes that the rapidly growing European economies will suck in even more U.S. products in the future. But as the D-mark has appreciated against other European currencies and the yen in the last year, it has depreciated against the dollar. Little wonder that DRI projections show the growth of U.S. exports to Germany and to Europe slackening off through 1992.

And the sales Americans don't make to Germany, the Japanese will. In 1989, U.S. companies sold $4.5 billion worth of electrical equipment to Germans, the largest single U.S. export to West Germany. At the time, the United States had 13.1 per cent of the German import market, while Japan had 19.8 per cent. By 1995, DRI expects U.S. producers to have only 9.9 per cent of that key German import market, while Japanese makers have 22 per cent. Over all, DRI projections show the U.S. share of total German imports peaking in 1990 at 6 per cent, while the Japanese share continues to grow inexorably from 4.3 per cent in 1985 to 6.7 per cent in 1995.[9] This is not quite what U.S. economic planners had in mind.

EMERGING MONETARY UNION

The planned creation of a European economic and monetary union (EMU) also poses a challenge to traditional post-war U.S. leadership in global economic affairs. Most members of the Community already synchronize exchange rates among themselves. Starting July 1, 1990, EC members began formally coordinating macroeconomic policy and central bank decision making, under a plan devised by a special committee headed by EC president Jacques Delors. Over the next few years economic coordination will intensify, currency fluctuations will narrow and groundwork will be laid for a European system of central banks. At some yet to be determined date in the future, the ECU (or a new currency with a different name) will become the single European currency and a European central bank, comparable in structure and powers to the American Federal Reserve System, will take over control of European monetary policy and exchange rate intervention.

The drive toward monetary union stems from actions taken in the narrower 1992 effort to create a unified European Community by eliminating internal barriers . With the abolition of capital controls agreed upon in June 1988 and phased in over 4 to 7 years, economic policymakers in the EC are faced with an inconsistent triple -- free movement of capital, fixed exchange rates and independent monetary policy. With free capital movements and fixed exchange rates in the European Monetary System, it is virtually impossible for national monetary authorities to conduct an independent monetary policy except in the very short run. They must constantly be aware of what other monetary authorities -- especially in the larger countries -- are doing. As a result, in 1988, the European Council called for an examination of the issues under Delors' chairmanship.

The Delors Report, published in 1989,[10] called for three stages in the movement toward economic and monetary union. The first stage to begin in July 1990 calls for movement toward greater convergence of economic performance through the strengthening of policy coordination.

In the second stage, the basic organs and structure of EMU would be set up following approval of a new treaty to be negotiated at an intergovernmental conference beginning in December 1990. The new institutional framework would monitor and analyze macroeconomic developments and promote a process of common decisionmaking . National economic authorities would still retain their own policy instruments for regulating economic activity. The third stage would see the move to "irrevocably" locked exchange rates and the assumption of monetary policy competence by the new Community institutions.

The momentum towards EMU accelerated in mid-March 1990 with the agreement among European central bank authorities to adopt a "Eurofed", that is, a European central bank. The agreement envisions moving to a single European currency sometime in the second half of the decade. Under the proposal drafted by the Commission and national bank authorities, the twelve central bank heads of the EC member countries will serve as a council that would decide monetary policies for the Community as a whole. A smaller group of appointed directors will implement the council's decisions. To ensure that they are independent of the day-to-day pressures of national politics, the directors will be appointed for long terms, perhaps 8 to 14 years.

The "Eurofed" will establish a central banking system for the European Community with a structure somewhere between the Federal Reserve System and the Bundesbank. The new monetary authorities will enjoy autonomy but not as much as the Bundesbank. Just as the chairman of the Fed must appear before Congress, some accountability will be built in by requiring periodic testimony before the European Parliament and meetings with EC and national officials.

But as much as the agreement is a step forward, the politicians in member states still need to be heard from. Different countries have different preferences over the course of macroeconomic policy and different decisionmaking processes. Giving up the ability to conduct their own monetary policy is likely to be viewed by them as the ultimate sacrifice of sovereignty. There is also a question of the Bundesbank's willingness to push ahead on European monetary union at the same time it is struggling to move forward on German monetary union with all of its attendant difficulties, both politically and economically. The acrimony over the exchange rate chosen to convert the two currencies is just the beginning. The real effects on living standards and competitiveness will linger for years. Only when these problems have been sorted out will the Eurofed have the credibility it needs.

Oddly enough, the drive toward European monetary union may have been accelerated by the reunification of Germany. Certainly German reunification is putting strains on the European Monetary System, but the prospect of a united Germany has caused France and Italy to exert pressure to speed up EMU in order to anchor Germany within the European Community. Politics is driving the EMU process just as politics drove German monetary unification. And with the increased investment spending in East Germany and the higher propensity to consume by residents of East Germany, total German absorption will rise, thereby reducing or eliminating its current account surplus. Without the persistent imbalances of recent years, macroeconomic convergence in the EC could be accomplished sooner than before. Nonetheless, the Bundesbank will play a critical role in determining how fast EMU moves forward.

What is significant about the agreement in March was the desire to push ahead faster, perhaps even skipping the second stage of the Delors Report when each country would retain its separate monetary instruments. Skipping the second stage would reduce the confusion and minimize the delay caused as national monetary authorities and politicians carefully scrutinize the coordination and harmonization process. To avoid undue delay and debate, EC officials and central bankers are talking behind the scenes about a quick and comprehensive move to a single currency or "irrevocably" locked national currencies after the separate economies converge on macroeconomic policy. Many favor a single currency to avoid the ambiguity inherent in having separate "irrevocably" locked national currencies.

Another important development in March was the downplaying of the need to have "binding restraints on budgetary policy" as called for in the Delors Report. Rather than central restraints on budgetary policy, the agreement left the discipline to the marketplace. Although politicians running for reelection will often be tempted to increase government expenditures and/or reduce taxes to maximize their chances for reelection, they will be held accountable by financial markets. The central bank authorities pledged not to print money to cover any budgetary shortfall and promised no guarantee of a bailout for countries that get into financial difficulties. Like the states of Massachusetts and New York, countries with inadequate fiscal discipline might suddenly find their credit rating lowered and the costs of borrowing raised. Nonetheless, some oversight and scrutiny of national fiscal policies will be necessary because the market does not always operate smoothly or incrementally but instead can signal a change in confidence suddenly and dramatically. Since national governments will retain substantial power to tax and spend compared to Brussels, this will be a source of constant concern.[11] How well the process will work, will not be known until one or two countries are subjected to the harshness of financial market discipline.

The speeded-up timetable to converge economic performance and to strengthen central bank coordination means Washington will have to deal with EMU's consequences sooner rather than later. Because of Germany's economic preeminence in Europe and the leadership role the D-mark and the Bundesbank already play and because the proposed Eurofed structure mimics that of the Bundesbank, it is likely that the Eurofed will be led by Germans and dominated by German economic philosophy.

Both the Delors committee and the EC Commission agree that the Eurofed will be "explicitly committed to price stability," an anti-inflationary bias now shared by governments of all major industrial nations, but most identified with the Bundesbank. Current exchange rate coordination has already led to a marked convergence of inflation rates among most European economies. EMU will only amplify this process.

To date, European inflation fighting has had little influence on American economic policy. But the United States faces the prospect of a global economy in which both a united Europe and Japan are more successful than Washington at controlling inflation. In the past, Washington could ignore such international pressure because foreign trade accounts for only a small portion of the U.S. economy. But in the future, with the growing importance of international capital movements and the expansion of world trade, it may not be so easy to remain aloof.

The cost of being out of step in controlling inflation could be declining relative competitiveness. But the price of getting in line could be higher unemployment. While this is a tradeoff all economies face, in the future it may be a particular problem for the United States. The Japanese, with low inflation and low unemployment, seem to have minimised the problem. And there is an impending demographic force that will make it easier for Europeans to have lower unemployment with lower inflation. The nine richest EC countries, excluding Greece, Portugal and Spain, had to absorb a million new entrants into the job market in 1981. By 1993, estimated new job seekers for the nine will total 11,000.

It is still too soon to be certain of the consequences of creation of a Eurofed. It is not clear that a Eurofed will insure a rock solid fight against inflation at any cost. There will still be arguments, just as there are in the U.S. FED open market committee, on how to strike the balance. Clearly, the balance will not be struck always on the side of price stability. Even in the German case it has not always been struck in that way, as German inflationary problems of the 1970's testify.

But an anti-inflationary bias is not the only fallout of EMU. Since a single currency means individual countries will lose their ability to improve their competitiveness through currency depreciation, Brussels has already begun a massive program of regional aid, which for some countries could soon equal 4 per cent of their GNP. Such financial transfers may have to be increased even further to minimize the political opposition to monetary union. The poorer EC member countries are already lobbying for more compensation in the form of structural adjustment funds.

But the EC's regional subsidies have already caused trade disputes with the United States. Such grants could easily come up in countervailing duty cases brought in the future by U.S. companies, especially if there is a recession. This new tension will directly put U.S. economic interests against EC political needs.

The Eurofed's creation will mean that a lot of the world's money supply will be coming under a single, new manager. Until now the United States has led the effort to define the accounting and fiduciary rules for the new global financial system. But, in a Eurofed the central banking and regulatory functions will go together. If Europe is working together on future international financial negotiations, they will have a much greater influence in terms of regulating the international banking system. Who knows, the reform of banking regulations on a Community-wide basis might finally stimulate Congress to pass a bill reforming U.S. financial regulation including Glass-Steagall.

Finally, the EMU is likely to transform the international economic coordination process industrial nations have fitfully been pursuing over the last decade and a half. The emergence of an industrial world Big Three---Europe, Japan and the United States---places a higher premium on coordination. The United States is no longer the only elephant on the world's economic stage and now it must learn how to get along with other elephants. At the technical level, creation of the Eurofed, with one currency and one bureaucracy, will presumably make that coordination easier---transaction costs will be reduced. But, in fact, coordination could at times become all the more difficult. Greater symmetry could generate more instability if it creates more of an incentive to manipulate exchange rates for domestic reasons

If the European central bank has a clearly stated mandate in its charter of price stability above all else, it could hinder its ability to ease monetary policy when conditions might require that for international coordination. Moreover, so much depends on the personal chemistry of the decision makers. U.S. officials have long found Bundesbank personnel much more difficult to get along with than the leaders of the Bank of Japan. An emboldened Bundesbank leadership, newly confident in its leadership of the Eurofed may be even less likely to cooperate with Washington.

And, if the Eurofed is truly independent of the political process, like the Bundesbank and the FED, then it may be even harder for governments to insure that the international economic agreements they reach are put into practice. Because Brussels lacks substantial power to tax and spend, fiscal outcomes in the member states will condition the EMU monetary policy. But central monetary policy under EMU will put greater pressure nationally on fiscal policy to achieve domestic objectives. A situation like in the United States in the early 1980's---tight monetary policy and loose fiscal policy---is entirely possible with its adverse effects on interest and exchange rates. This means that international coordination of fiscal policy becomes more important but also more difficult. The head of EMU's central bank might be able to agree with his counterparts in the United States and Japan, but who will serve as the EC's finance minister to negotiate on fiscal policy? The United States and Japan could find negotiating macroeconomic policy with the EC as difficult as negotiating trade policy where the Community position is almost immutable after it has negotiated internally.

Despite the progress on European monetary union in March, several potential problems still loom. The Delors Report assures that the European central bank will be "embedded in the democratic process." But how? What is the nature of the democratic compromise? Are periodic appearances before the European Parliament or consultations with EC and national economic officials, enough to satisfy demands for accountability? How do the different central bankers agree upon the rate of growth of the Community's money supply? What structure and instruments of monetary policy will be adopted? Who are eligible market participants and what is the nature of the regulatory framework? If national currencies are retained, how can "irrevocably" locked exchange rates be assured? How do the central bank authorities arrive at a common position for international coordination of macroeconomic policy? If exchange rate intervention is needed, who intervenes and on what basis? The details remain to be worked out.

The answers to these questions are of grave importance to the United States. If the Eurofed is not accountable to political authority, tensions could arise in Europe that would trigger instability in world financial markets and higher interest rates in the United States. A Eurofed judged too subservient to politicians would lack credibility in the marketplace.

Similarly, the Eurofed's mode of operations will be graded by the financial markets. If its procedures are cumbersome and deemed ineffective, the actions of this big elephant on the world's economic stage will cause big problems for the United States.

The next big public step will be the intergovernmental conference in December. If the central bankers have their way, it will only have to deal with the institutional aspects of European economic and monetary union, not the substantive aspects. Efforts are now underway to negotiate all of the substantive problems including the form and policy instruments of monetary policy before the conference begins. What is unknown at this time is whether the intergovernmental conference will go for a "small treaty" merely to implement the institutional structure of EMU or a big treaty to try to tackle the "democratic deficit" of the Community, including enhanced powers for the Parliament to provide greater checks and balances over the unelected European Commission. A push for a bigger treaty could bog down progress over EMU.

Even if the European Commission and some national authorities should wish to go further, faster on monetary union, it is highly probable that not all countries will go along. Under Prime Minister Margaret Thatcher, the United Kingdom remains the odd island out although pressure from the City of London is sure to increase if financial market activity were to start to move to the continent. The Southern countries -- Greece, Portugal, and possibly Spain -- might have a difficult time accepting the central discipline of monetary union and might prefer to retain the option of adjusting the exchange rate. If so, a two-tier or two-speed Community may result.

But whatever transpires, the question of EMU is no longer if, but how and when.

EBBING DOLLAR INFLUENCE

As the new European currency comes into its own it will challenge the dollar's role as the world's key currency. The dollar has long been the medium of exchange all over the world.[12] But more and more trade and assets are yen and D-mark denominated. And in a symbolic gesture, at least some of the assets of the new European bank will be denominated in ECU, the first truly multilateral institution to make this move. The use of other currencies to denominate transactions could accelerate if the dollar were to display continuing weakness. The evolution of a European currency block is now imaginable and with it U.S. leverage as the key currency country may also ebb.

EMU means the United States will have less influence through the market. In the past, the United States could rely on currency market forces to induce allies to change their economic policies in ways that the United States wanted. For example, in the Reagan Administration then Treasury Secretary James A. Baker III talked down the value of the dollar to force Germany and Japan to begin expansionary domestic economic policies. This influence will not be available to the United States after monetary union in Europe. The arm-twisting effects of dollar depreciation will be diffused over a broader economy and will therefore be less effective. Thus, EMU fundamentally changes the power relationship between the United States and Europe on monetary issues. Indeed, this may have been one of the primary driving forces behind EMU. A united Europe through EMU would have greater negotiating leverage and would increase European confidence perhaps as a self-fulfilling prophesy.[13] The EC could then trade off macroeconomic changes for other objectives on trade or security issues.

The full ramifications for the United States of these macroeconomic developments in Europe have only begun to come into focus. It is far to early to tell with any certainty what the consequences will be or what the United States can or should do about them. But the need for eventual action already seems clear.

It would be short-sighted if the United States did not realize that the growing global demand for investment will increase competition for savings. Now is the time for the United States to reduce its reliance on external savings. That means cutting the federal budget deficit, which may be slightly easier in the future because most people seem to think recent events in Europe justify reduced defense spending.

But few officials in Washington have the time to contemplate developments whose ramifications are several years off. Nor do they fully comprehend how investments in Leipzig could one day affect house payments in suburban Washington. The U.S. budget summit suggests that some policy makers recognize that problems do loom over the horizon. If the breathtaking events in Europe finally force action on the U.S. budget deficit, so much the better.

But cutting the U.S. deficit is not the only necessary consequence of developments in Europe. The United States should also contemplate taking some initiatives internationally about how the world economy should be organized, in the wake of German reunification, Western European unification and Eastern European liberation. Greater symmetry among the major countries means that the need for and benefits from closer economic coordination have swelled. The only question is will the coordination be led by the United States. Target zones for exchange rates may still be out of the question but the adoption of objective indicators to guide macroeconomic coordination could be the next step.[14] Only such an initiative now can protect the United States while it still has some clout, before Europe feels its weight and the U.S. economic role has declined even further.

ENDNOTES

[1] David Hale, personal interview.

[2] AMEX Bank Review, March 1990, vol. 17, no. 3.

[3] "German Unification: Issues and Answers," by Barclays Bank PLC, Economic Department, Spring 1990.

[4] Shearson Lehman Hutton, "International Economic Monitor," Spring 1990.

[5] Barclays Bank, op cit.

[6] DRI/McGraw-Hill, personal interview with economist David Blond.

[7] U.S. Treasury Bulletin, 1990. For an analysis of U.S. dependence on foreign capital, see C. Michael Aho and Marc Levinson, After Reagan: Confronting the Changed World Economy, 1988.

[8] Simulations by Robert Fleming Securities Ltd. London, internal study, pending publication.

[9] DRI/McGraw-Hill, op cit

[10] J. Delors, Report on Economic and Monetary Union in the European Community, European Community, 1989

[11] The fiscal arrangements in the European Community could prove to be a problem in moving forward on EMU. The lack of sufficient power by Brussels to tax and spend could cause difficulties in gaining the assent of the poorer countries for EMU. By sacrificing the ability to change their exchange rate, countries are giving up a policy instrument that could be used to address declining economic activity and unemployment. The poorer countries are now lobbying for significant compensation -- in the form of structural adjustment funds -- for going along. As integration proceeds, industrial restructuring will inevitably cause layoffs and plant shutdowns. Lagging regions will complain to national parliaments. Poorer countries will complain to the EC. The relative lack of labor mobility contributes to regional imbalances. Unlike the United States, the European Community's labor force is not very mobile. Europeans tend to be well-rooted. People don't often move north and south in Belgium much less move from Belgium to Portugal. Furthermore, the EC member countries do not have the same cushion available to U.S. states during economic decline because of the lack of a strong federal role. When economic demand declines by $1 in Texas, Texas income only declines by $.60 because of smaller federal taxes and higher unemployment insurance expenditures.

[12] The European Commission has estimated that the seignorage---the monopoly rent from printed money---could be worth $10 billion to the United States.

[13] George Alogoskoufis and Richard Portes, "International Costs and Benefits of EMU," Centre for Economic Policy Research, Discussion Paper Series, No. 424, London, June 1990.

[14] For a discussion of objective indicators and target zones, see John Williamson and Marcus Miller, Targets and Indicators: A Blueprint for the Intended Coordination of Economic Policy.

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Foreword

American trade policy stands at a crossroads. Since the mid-1980s the United States has been simultaneously pursuing three different approaches—unilateral, bilateral, and multilateral—to trade policy. Its multilateral initiative—the Uruguay Round of trade negotiations—is scheduled to be completed by December 1990; but even if concluded by then, the agreement is likely to prove disappointing to Congress and influential constituents. Lacking a viable multilateral option, the United States may choose aggressive unilateral and bilateral measures that could end up fragmenting the trading system, causing hardship for all countries.

In this essay, C. Michael Aho, Director of Economic Studies at the Council on Foreign Relations, assesses what he considers to be the most critical factors that will influence future U.S. trade policy, particularly the behavior of the European Community, and makes some specific recommendations that he believes would preserve and improve the multilateral trading system.

Nicholas X. Rizopoulos
Vice President, Studies

June 1990

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U.S. Trade Policy at a Critical Juncture

The early 1990s will mark a critical juncture for U.S. trade policy. Having embarked upon a new, multifaceted policy in the mid-1980s, the United States is still groping to find its way by employing a mixture of unilateral, bilateral, and multilateral approaches for resolving its trade problems.[1] But in the next year or two, the future course of U.S. trade policy may well be established—for better or for worse. Meanwhile, the world's trading system is in disarray, and multilateralism hangs in the balance.

Future U.S. trade policy will depend upon four unknown factors: how the 1988 trade bill will be implemented; whether additional bilateral free trade agreements (following those with Israel and Canada) will be negotiated; how much is accomplished in the Uruguay Round of multilateral trade talks, being held under the auspices of the General Agreement on Tariffs and Trade (GATT), which are due to be completed in December 1990. But the biggest unknown of all—and one which will also play a crucial role in determining the outcome of the Uruguay Round—is the European Community's (EC) 1992 unification effort. That effort, along with the breathtaking events unfolding in Eastern Europe and in Germany, is preoccupying EC policymakers. According to the Italian trade minister, the EC is "distracted" from the Uruguay Round.[2] If the EC blocks progress in the GATT talks, the pressures for the existing multilateral trading system to fragment into regional trading blocs could become overwhelming.

Indeed, the emergence of some form of regional blocs is probably inevitable in the 1990s; but how benign—as opposed to belligerent—they will be will depend upon the outcome of the Uruguay Round. If it fails to achieve major progress on trade issues of importance to influential American domestic constituents, as seems likely, the United States will be faced with difficult decisions of its own. Lacking a viable multilateral option, the United States may choose aggressive unilateralism and/or additional bilateral agreements that could hasten the fragmentation of the global trading system, thus causing hardship for all.

This paper sets out how the United States arrived at this juncture, analyzes the unknown factors that will influence future U.S. trade policy, and concludes with some policy recommendations to preserve and to improve the multilateral trading order.

The Legacy of the 1980s

The U.S. trade deficit began the last decade, in 1980, at $24 billion and grew to a record $160 billion in 1987 before declining to $108 billion in 1989. (At $160 billion, it was larger than the gross national product of all but twelve countries in the world.) The deterioration of the trade deficit resulted from both the appreciation of the dollar (especially during the years 1982–1985), which acted like a tax on U.S. production and a subsidy for foreign production, and the overall strength of the U.S. economy relative to that of the rest of the world.

Widespread industrial restructuring, due to increased international competition and technological change, caused massive worker layoffs and plant closings across most congressional districts. Private sector complaints from import-competing industries increased to unprecedented levels and demands for import protection echoed through the halls of Congress. Firms in export industries—normally in favor of freer trade—had grievances as well, and, as a result, no longer weighed in as a countervailing force to the import-competing firms seeking protection. By the mid-1980s, few U.S. firms outside of the service sector were lobbying in Washington on behalf of freer trade. Those that did were pushing specific agendas like greater protection of intellectual property rights. As pressures mounted, legislators had little to lean on to deflect requests for protection; in the eyes of Congress, GATT—the international agency for resolving disputes—was viewed as inadequate: too limited, too slow, and too timid. To Congress, GATT lacked credibility.

Unprecedented pressures breed unprecedented responses. The record trade imbalance, widespread layoffs and plant closings, and vociferous private sector complaints spawned unprecedented executive and legislative action on trade. By mid-1985, over 300 trade-restricting bills were submitted in Congress that were meant to send a simple message to the president—trade problems deserve greater attention! In September 1985, after four years in which it repeatedly argued that the trade deficit was a sign of economic strength, the Reagan administration changed course by initiating over a dozen unfairness complaints against countries accused of maintaining barriers to U.S. exports. Soon thereafter it negotiated quotas on imports of carbon steel and machine tools and a cartel-like agreement with Japan on semiconductors. According to then Treasury Secretary James A. Baker III, the Reagan administration, despite its free trade rhetoric, provided more import relief than any of its predecessors during the past 50 years.[3]

Actually, the Reagan administration's record on trade was not entirely negative. It was U.S. pressure that was crucial in launching the Uruguay Round.[4] In addition, it successfully concluded a historic and far-reaching free trade agreement with Canada in 1988. But, on balance, U.S. trade policy became more tit-for-tat and protectionist during the Reagan years.

For its part, Congress passed a trade bill in 1988, itself unprecedented in scope as well as in scale. Running to almost 500 pages, it covered everything from trade law reform to developing country debt. The bottom line is that the new bill has made it easier for firms to obtain import relief, and it has reduced the president's discretion in resolving trade matters. By mandating action and establishing deadlines, Congress has forced future administrations to take steps to resolve festering trade problems.

As a result, trade frictions are certain to multiply, especially with the other two pillars of the trading system, Japan and the EC. Japan remains the central focus of U.S. trade policy activity. Despite the decline of the dollar since 1985, the U.S. trade deficit with Japan is stuck at about $50 billion, and the cries from American industries (often loudest from the least successful firms) are more shrill than ever. And there is always the chance that a "coalition of the frustrated" will emerge. Legislators representing those industries that have endured negotiations with Japan—beef, citrus, rice, telecommunications, and automobiles, among others—may one day band together to vote for unilateral action against that country. Those legislators are anxiously awaiting positive action from Tokyo, yet increases in Japanese imports of U.S. products have come only slowly and grudgingly.

U.S. impatience with Japan has led recently to numerous proposals for "managed" trade and has caused the domestic debate over what actions to take to grow even more acrimonious. As proposals are increasingly cast in nationalistic terms, the debate seems less about trade and more and more about America's pride and standing in the world.

Japan, for its part, may be progressively less able or less willing to accede to American demands. With the ruling Liberal Democratic Party suffering setbacks at the polls during 1989, which reduced its majority in the Diet, the Japanese government has little room to maneuver. And nationalistic sentiments are not unique to the United States. An intense resentment is building up among many younger Japanese who are growing tired of being threatened—and "bashed"—by Americans. The publication of *The Japan That Can Say No*—by the chairman of Toyota and a conservative Japanese politician—has fueled frustration in both countries. In any event, extreme positions in Japan and the United States are currently poisoning the atmosphere needed for the promotion of good trade relations.

As a means to defuse the frictions, the two governments have launched the Structural Impediments Initiative talks, through which they are examining societal factors that are thought to influence trade patterns. The United States is urging Japan to overhaul its distribution system and reform its land policy, among other things. Japan advises the United States to improve its educational system and increase domestic savings. These steps are needed in both countries, but they would require fundamental transformations of the two societies and are not likely to yield concrete results in the short or even the medium term. Policymakers placing great hopes on these talks are bound to be disappointed.

American trade relations with the EC are not much better and could get even worse than they are with Japan. For years, the EC has gotten off lightly as U.S. frustrations were vented principally at Japan. But as its 1992 unification effort moves forward, the Community is incrementally changing its rules of the game governing trade and domestic regulations. The U.S. trade policy process cannot ignore changes in laws and regulations abroad that discriminate against U.S. interests. Moreover, the EC portends to be a frustrating footdragger in the Uruguay Round. Ideally, the Community could eliminate barriers among its members while simultaneously liberalizing market access for foreign firms. Yet it is more likely to continue to protect against foreign interests while it liberalizes internally. For example, the EC stubbornly resists reforming its Common Agricultural Policy, claiming it is the glue that holds the Community together. In short, the EC's actions could have a profound influence on the future course of U.S. trade policy by creating frictions that precipitate an American response or retaliation.

Another source of international trade frictions could be the substantial deterioration in other countries' trade balances that is necessary for the United States to service its mounting foreign debt. As the United States shifts from a trade deficit of over $100 billion in 1990 to a surplus of as much as $50 billion before the turn of the century, other countries may resist suffering such a large deterioration in their trade balances. If so, trade frictions could get much worse. A swing of this magnitude would be easier to accomplish if world trade were expanding; but if a worldwide recession occurs, trade tensions would be further exacerbated.

In short, the legacy of the 1980s is growing impatience with traditional multilateral approaches for resolving trade problems at a time when developments in the EC and in Japan could contribute to heightened trade frictions that evoke an aggressive American response.

Unilateral Initiatives: The 1988 Trade Bill

The GATT is the multilateral institution that provides the rules and procedures under which international trade is conducted. When those rules and procedures are followed, uncertainty is reduced, and this in turn allows international investment, trade, and growth to expand.

Today, however, the rules embodied in the GATT are no longer adequate. A shrinking portion of world trade, primarily that in manufactured goods, falls under GATT jurisdiction, and even that portion is not regulated well. Governments no longer abide by, or even agree upon, the rules that should regulate trade. Important issues, like services, investment, and intellectual propery, are not covered.

Not only are the rules inadequate, but a proper enforcement mechanism is lacking or is too slowly applied in those areas where the rules are reasonably clear. GATT lacks stiff, swift, and sure sanctions. Business interests and politicians seeking to resolve trade disputes have little confidence that GATT can help them. Increasingly, American politicians prefer a unilateral approach—where the United States accuses a country of "unfairness" and demands that its objectionable practices be changed.

Unfairness has indeed become a central trade policy issue worldwide. The integration of separate national economies into a unified, global one has proceeded to such an extent that the distinction between domestic and foreign economic policies has been rendered almost meaningless. The effects of internal conditions are quickly transmitted across national borders through trade, technology, and financial flows. Borders are becoming blurred. But different countries have different institutional arrangements and policy processes that influence the allocation of resources. As Sylvia Ostry, Canada's former chief multilateral trade negotiator, recently asked, "How much divergence in policy systems can an ever-more interdependent international economy sustain?"[5]

If the microeconomic, "domestic" policies of one country injure firms or workers in another, the second country promptly claims unfairness and demands redress. But there is no multilateral agreement defining which practices are fair and which are not. In the absence of such an agreement, countries are unilaterally defining unfair trade practices in ways that are, to say the least, inconsistent. Unfairness is in the eye of the beholder.

The most widely publicized unilateral policy adopted by the United States is the "Super 301" provision included in the 1988 trade bill, which is an expanded version of Section 301 of the Trade Act of 1974. The 1988 provision calls for the identification of unfair trading countries and sets out timetables for negotiation and possible retaliation. "Super 301" has been roundly ridiculed by the financial press, academic economists, and foreign observers.[6] Although it does appear to create additional foreign policy frictions and makes the United States look like a bully, the provision is now on the books and therefore needs to be evaluated on the basis of how it is actually used. As one analyst put it, one needs to look "beyond good and evil" and "attack United States legal performance under the standards of its own (Super) Section 301."[7] Such an examination would, in fact, expose U.S. trade policy as schizophrenic: for it preaches one trade policy for others while it practices a very different policy for itself. Under such scrutiny, the United States might moderate its unilateral demands, and might even be willing to raise the level of its own compliance with accepted international norms. Ideally, Section 301 (Super or the 1974 version) could be useful as a means to illuminate the inadequacies of the present GATT system. As such, it could encourage other countries to remedy the deficiencies of that system.[8]

The first use of Super 301—in May 1989—was a judicious application of the provision. Three countries—Japan, Brazil, and India—were singled out. Japan almost certainly had to be named because much of the trade bill debate in the 1980s was motivated by problems with that country. (In the draft Senate trade bill in 1986, under a section entitled "Adversarial Trade," one sentence began, "When trading with adversaries, like Japan. . . ." So much for due process.) Japan was cited in three sectors—timber, satellites, and supercomputers—rather than in the ten to fifteen demanded by some members of Congress. India and Brazil have been footdraggers in the Uruguay Round, especially over the negotiation of the new issues of services and intellectual property. Their citation could be seen as an effort to prod progress in those talks. Over the past year, the negotiations with Brazil and Japan seem to have achieved American objectives. Brazil has elected a new government that is more forthcoming on the new issues. And agreements with Japan to open up the three sectors were announced in the spring of 1990. Only with India—which refused to negotiate under the threat of sanctions—did the Bush administration fail to make progress. As a result, India was again named an unfair trader in April 1990. However, in an effort not to derail the Uruguay Round, no other countries were so named. Apparently, the Bush administration is putting all its eggs in the multilateral basket—at least for now.

The Bush administration's credibility on trade is now on the line. If the multilateral talks fail to produce agreements that satisfy domestic constituents and Congress, the demands for new unilateral initiatives could become overwhelming. After all, the Bush administration has demonstrated that Section 301 can produce results.

Compared to a multilateral solution with well-defined rules and sanctions, unilateral action under Section 301 is clearly inferior because it tends to politicize trade issues. It carries with it the risk of retaliation and counterretaliation. The alternative, however, may not be a multilateral solution but a bilateral or regional one, which would hasten the fragmentation of the trading system.

More Bilateral Free Trade Agreements?

Several proposals for other bilateral trade agreements have come on the heels of the negotiation of a free trade agreement with Canada, America's largest trading partner.[9] (A less comprehensive agreement was negotiated with Israel in 1985.) The Reagan administration deserves credit for successfully negotiating the pact with Canada, because it did signal that trade liberalization is still possible and that international negotiations can still bear fruit. The Canada–U.S. agreement has gone further, faster than the multilateral Uruguay Round, and has been a catalyst for those talks. The agreement was comprehensive, spanning virtually the entire GATT agenda, including most of the new issues—services and investment, but not intellectual property.[10] It also broke new ground by establishing a bilateral dispute resolution process.

Yet, rather than being a model to be replicated, the Canada–U.S. agreement helps to expose the special character of bilateral free trade agreements. It is a good agreement, but it failed to address many of the central difficulties of trade between the two countries, including subsidies, trade remedy actions, and government procurement. And, despite the vast similarities in both countries' legal and business environments, the agreement took almost two years to negotiate and the talks came perilously close to collapsing on several occasions. Before launching another bilateral, the United States should stand back and take stock of this Canada–U.S. agreement. The signing of the agreement in January 1989 was not the end of the process, only the beginning. Thorny legal, institutional, and political problems still need to be resolved.[11]

Bilateral free trade agreements are justified only in special cases.[12] Israel, for political reasons, and Canada, because of proximity and interdependence, are special cases. The EC, in the development of its internal market, is also a special case on the latter score. President Reagan in his 1988 State of the Union address spoke of including Mexico in a North American accord, and in March 1990 both countries agreed to begin discussions if not negotiations. Mexico is also a special case, but after Mexico other countries would surely protest if the United States tried to negotiate additional bilateral agreements. Furthermore, if other countries were to follow the U.S. lead by trying to negotiate through bilateral agreements offering mutually incompatible privileges, predictability would be destroyed for all countries. Such discriminatory bilateral agreements cannot combine to form a globally consistent, stable system of national trade policies.

To put it bluntly, a succession of bilateral trade agreements is a recipe for RIBS—resentment, inefficiency, bureaucracy, and stupid signals. Resentment would prevail among outsiders. Inefficiency would be spawned by the fragmentation of markets. Bureaucratic nightmares would result for governments and private firms trying to cope with the consequences of discriminating among countries. And stupid signals would be sent to those policymakers in developing countries who are proponents of markets and multilateralism.

The arguments against a series of bilaterals are both political and economic. The essence of bilaterals is to play favorites, thus creating foreign policy problems with those that are discriminated against. Inevitably, some countries will be left out. How will they be chosen and who will decide? In the United States, Congress will have to play a role. Thus, domestic political problems are created as well. Consider how members of Congress will be whipsawed by foreign countries and individual industrial interests before agreements are approved. Then, once agreements go into effect, Congress will be pressured to withdraw trade preferences or withhold further liberalization from countries deemed to be acting inconsistently with U.S. foreign policy objectives or to be increasing competition for politically powerful domestic sectors. Trade policy would spring from "low-level" to "high-level" foreign policy. Do members of Congress want to get involved in such micromanagement of trade and foreign policy initiatives? Does Congress want to devote the time, resources, and political will to review, oversee, and legislate a series of bilaterals with all of the attendant political pressures that they entail?

The economic argument is that if the trading system fragments as a result of a misguided bilateral strategy, the United States would be unable to generate trade surpluses of up to $50 billion to service its trillion dollar foreign debt in the 1990s. Without an open multilateral trading system, that will be next to impossible to achieve.

In order to appreciate the drawbacks of additional bilateral agreements, it is instructive to examine a bilateral free trade agreement with Japan that has been proposed by some observers. Proponents of such an agreement with Japan cite the corrosive effect of disputes on the U.S.–Japan relationship and the ineffectiveness of the piecemeal approach to resolving them. But without internal reforms in the United States—to balance the budget, to establish trade priorities, and to give trade issues the greater attention they deserve—it is hard to see how a bilateral with Japan would overcome these difficulties. And why should the United States assume that on contentious issues (such as agriculture, construction, etc.) Japan would be any more able or willing to accede to American demands in a negotiation to establish a bilateral agreement? Multilateral pressure would probably prove more effective as well as more politically palatable within Japan.

Another reason cited for pursuing a bilateral accord with Japan is the EC's 1992 unification effort. The assumption is that the EC will discriminate against outside interests as it liberalizes internally, which may in fact turn out to be a reality, but isolating the EC because of it would only create more problems than it resolves. Community policymakers may react by turning to Eastern Europe and the Soviet Union for markets and support. Now is not the time to begin exploring bilateral options with Japan. (The appropriate responses to European unification efforts are dealt with below.)

A bilateral trade agreement with Japan would tie the hands of American trade negotiators. The launching of the Uruguay Round demonstrated the importance of coalition formation as a means for making progress.[13] But coalitions shift from issue to issue. For instance, on market access, the United States might agree someday to unite with the EC to gang up on Japan in a multilateral forum;

while the United States and Japan may have to join together to ensure that the EC does not use its unification effort as a means to discriminate against outside interests. It is better to retain the flexibility to form different coalitions, using unilateral retaliatory measures to prod the process, than to limit options by committing to a bilateral with another major pillar of the trading system. And if other bilaterals are contemplated, it is not at all obvious which is the most appropriate partner, Japan or the EC. Each has been proposed by a different member of Congress.[14]

Granted, new options are needed in this highly pluralistic world to bring more pressure on free riders and footdraggers. One such option is adoption of conditional most-favored-nation treatment. This approach was utilized in the Tokyo Round codes (e.g., subsidies, government procurement), in which only signatories got the benefits of abiding by the additional discipline. Since the recalcitrant countries will vary from issue to issue, the conditional most-favored-nation approach will allow greater flexibility.[15]

Bilateral agreements are only useful as a threat, and to be credible the administration and Congress must be willing to carry them out. The only other possible bilateral agreement that is clearly in the long-run interest of the United States (and one that the outside world, save Canada, could not object strongly to) is with Mexico for reasons that range from debt to demography to drugs. If the Bush administration is serious about threatening further bilaterals, it should continue to explore the option with Mexico and weigh the costs and consequences such an agreement would entail. To move beyond Mexico would create significant foreign policy problems. Besides, could the United States really contemplate giving preferential access to other major trading partners while denying it to Mexico? Even still, negotiations with Mexico should wait until the multilateral talks have been concluded.

The Uruguay Round and the Future of Multilateralism

Seven rounds of multilateral trade negotiations have been conducted since the GATT was founded, and through them the member countries have been able to liberalize trade and integrate more fully with one another. The eighth round, the Uruguay Round, named for the country that hosted the meeting of trade ministers at which it was launched, began in September 1986. Progress in these negotiations is necessary to begin to restore confidence in the fairness and efficacy of the trading system. But these talks are the most ambitious undertaken since the GATT was founded. They are different and more difficult and could prove more disappointing than any that preceded them.[16] According to the formal declaration announcing the round, the talks are to be completed by the end of 1990. Achieving that timetable will prove troublesome. The last multilateral talks, the Tokyo Round that concluded in 1979, exceeded their deadline by more than two years.

The issues being discussed in the Uruguay Round include the unfinished business of previous rounds, such as subsidies and nontariff barriers; strengthening the system, by bringing sectors such as agriculture, textiles, and steel more fully under the auspices of the GATT; extending GATT rules to new areas such as services, investment, and intellectual property; and institutional reform, such as improved dispute-settlement procedures. The United States is one of the foremost proponents of agreements on most of these issues, particularly extending the GATT to cover new areas.

But a successful resolution of all of these problems is unlikely. Apart from the decline in U.S. influence and willingness to take the lead in opening markets, which makes cooperative action imperative, several other factors will make the current negotiations more difficult than earlier trade rounds. First, a larger number of countries are playing a critical role in the negotiations. Second, growing interdependence has made the distinction between domestic and international economic policies obsolete, but domestic policies are off limits for negotiation in many countries. And, finally, trade negotiators lack the political authority in their own countries to strike deals in many of the areas, such as agriculture and services.

To its credit, the Bush administration has stood firmly behind the effort to enhance and update the GATT. It has pushed to get the difficult problems that are now handled outside of the GATT accommodated within it. They know that, otherwise, confidence in the system will continue to erode. Several institutional reforms are being advanced, including more timely dispute settlement, greater surveillance of national trade policies, and streamlined decision making.

Achievement of institutional reforms to ensure that trade issues are dealt with more promptly would be a significant accomplishment, but it will not be sufficient to quell growing disdain on Capitol Hill for the GATT and multilateralism. A stronger system cuts both ways. The United States will have to agree to adhere to GATT rules and principles when they go against U.S. interests, as well as when they support them.

To restore the credibility of multilateral negotiations as a way of solving problems, concrete results will be needed on subsidies, agriculture, services, investment, and intellectual property, or on some portion of the same. In order to obtain agreements in these areas, the United States will probably have to permit greater market access for textiles, steel, footwear, and apparel from developing countries, and it may be asked to revise its trade remedy laws—for example, by curbing Section 301 actions. If a sufficiently large package of trade-liberalizing measures and new rules cutting across most of these issues cannot be developed, and if the ultimate package does not enjoy widespread support in the private sector, the administration will have a hard time winning congressional ratification. Several key questions loom.

First, how long will the negotiations last? If the talks were to drag on for another three years without concrete results, Congress will likely lose patience and urge the Bush administration to adopt other unilateral or bilateral approaches. But if the talks are to be completed by December 1990, as currently scheduled, then the administration will almost certainly be forced to make tough choices among the major U.S. objectives. There is not enough time to achieve them all. Agriculture—the "Beirut" of trade negotiations—is the most likely to fall off the table given its political sensitivity in Europe. Subsidies go to the heart of the fairness question, but defining what is unfair and measuring the extent to which trade is distorted have bedeviled negotiators for decades. Agreements in services and intellectual property are more likely, but the developing countries will try to minimize progress in these areas.

Second, which countries will be actively engaged and how are the tradeoffs among issues to be structured? The biggest gains could come from a far-reaching bargain that exchanges liberalization in services and new rules covering intellectual property for greater market access for manufacturing products exported from developing countries. But the developing countries have been left outside of the bargaining framework of the GATT, and liberalization in sensitive sectors like textiles and steel may be needed to get them to negotiate seriously. Will the Bush administration be willing to put the sensitive sectors on the table?

Third, how active will the proponents of freer trade be in the domestic negotiation over trade? The Uruguay Round is, after all, as much a domestic negotiation as it is an international one. If business leaders who advocate freer trade want progress in the round, they are going to have to take on the representatives of the heavily protected industries such as textiles and steel, by waging a major lobbying effort in Washington to convince lawmakers that restrictions in these politically sensitive sectors must be relaxed in order to gain liberalization of trade in services and new rules covering intellectual property protection. In addition, other countries will request modifications in U.S. trade remedy laws to eliminate or modify the changes in recent years that have made import relief, in some form, almost an entitlement for complaining firms. A widespread lobbying effort will be needed to convince Congress to amend its laws because, in many cases, the authors of those provisions are still in office and have pride in authorship.

Finally, how active will George Bush be on trade issues? The president will have to take the initiative if he wants to stem congressional frustration and open foreign markets. Trade can no longer be treated as a stepchild of domestic economic policy at home and of foreign policy abroad. It must be a continuing priority. For if U.S. leadership on trade waivers or falters, other countries will pick up the cue and efforts to move forward will be undermined. Overseas, President Bush should encourage the involvement of other heads of state because far-reaching bargains can only be struck at the highest levels. At home, he must mobilize private sector support and keep Congress constantly apprised of the negotiations as he pushes hard for progress in the multilateral talks.

But even with these efforts, it now seems safe to assume that for the Uruguay Round to be completed on deadline, some high-priority U.S. objectives will not be accomplished and influential domestic constituents are going to be disappointed. If agriculture falls off the table, then the next farm bill will certainly include provisions for unilateral measures to boost farm exports. If services or intellectual property are sacrificed, key components of the coalition in favor of freer trade will be annoyed and may push for more limited bilateral and regional agreements or for aggressive unilateral action.[17] But apart from how hard the Bush administration pushes the multilateral talks, the other critical factor in determining how much is achieved in those talks will be the behavior of the EC.

European Unification and European Preoccupations[18]

Politicians, trade policy officials, and businesspeople in the United States are too focussed on Japan. Their myopia could leave them unprepared for the policy challenges and business opportunities that will be greater in Europe than in Japan and the Far East in the 1990s.

Europe is in flux. The EC has embarked upon an ambitious program—the 1992 unification effort—to achieve what was not attained 30 years ago; that is, a unified, dynamic common market. But EC policymakers are currently distracted from this endeavor. The unshackling of restraints in Eastern Europe and the imminent reunification of Germany that are occurring simultaneously have raised fundamental questions about the future shape of Europe. The premises of the NATO alliance have been shattered; the perception of a common threat has diminished and the United States is less dominant today.

These geopolitical issues will obviously dominate the debates in Washington, but trade problems and the prospects for profits should also motivate policymakers and business interests to turn their attention toward the Atlantic and away from the Pacific.

The United States certainly has a host of trade problems with Japan, but the Japanese distribution system and old-boy network are long-standing issues. The EC—through its 1992 unification effort—is changing the commercial rules of the game. And the possible entry of new members into the Community would increase the size of that bloc to the detriment of outside interests. Meanwhile, the EC is proving to be a stumbling block in the multilateral trade talks, particularly on agriculture but perhaps also on services and intellectual property. There is no question that Europe will be a major source of U.S. trade friction in the years to come.

Businesspeople should not allow the trade tensions with the EC or the competitive challenge from Japan to blind them to the enormous opportunities that lie across the Atlantic. The 1992 unification effort has gotten its share of attention, but most businesses have yet to recognize the size and richness of the emerging European market.

The EC has a population of 325 million. Add to that the 113 million in East Germany, Poland, Hungary, Czechoslovakia, Romania, and Bulgaria, plus the 32 million in Sweden, Austria, Norway, Finland, and Switzerland, and you have a total of 470 million people. This is almost twice the population of the United States and two and a half times that of Japan and the "four Asian tigers"—South Korea, Hong Kong, Singapore, and Taiwan—combined.

What's more, the total gross national product (GNP) of these three geographical components of Europe—approximately $6 trillion in 1988—is twice that of Japan and the "four tigers" together. If Europe were to grow at 3 percent per year until the year 2000, as it has for the last two years, the increment in GNP, in 1988 dollars, would be approximately $2.5 trillion. To achieve a comparable increase, Japan and the "four tigers" would have to grow by 5.5 percent annually. This is unlikely since Japan's growth rate throughout the past decade was 4 percent annually and it accounts for 90 percent of the combined GNP.

With the 1992 unification effort and the movement of capital from West to East and labor from East to West, Europe could achieve even higher growth ratios in the 1990s. If it grows by 4 percent, GNP would increase by $3.5 trillion, which could only be matched across the Pacific with a whopping 7 percent growth rate.

Leaving prospects for growth aside, Europe does pose substantial trade problems to the United States and the 1992 unification effort, which has undoubtedly picked up momentum, has compounded them. The process may not be completed by December 31, 1992, in part because of the difficulties posed by German reunification, but Europe will be completely transformed. European businesses (and outside ones as well) perceive the process to be irreversible and are beginning to act upon that perception. When businesses change behavior, perception becomes reality.

What might unification by 1992 mean? The economic effects could be substantial if all or most of the program is completed: European national income could increase by 9 to 30 percent over the medium term[19]; up to 5 million more jobs could be created; consumer prices would be lower and a wider variety of products would be available; twelve different sets of regulations and standards would be harmonized; economies of scale could be achieved on a European-wide basis, thus enhancing competitiveness; and national cartels could be broken up providing for greater flexibility.

But the Community is also apprehensive. It fears that U.S. and Japanese firms may be in a better position to take advantage of 1992 than EC firms; that labor standards will be eroded to the lowest level permitted among member states; that regional imbalances will be accentuated; that the dislocations will be significant; and that a two-tiered (or two-speed) Community will result, with the original six members moving further, faster than the United Kingdom and the newer member countries of the south.

How much will be accomplished? The road to unification is littered with a wide variety of obstacles. The most significant is surely fiscal harmonization because establishment of a Europe without borders would see the removal of customs agents at internal frontiers. And of course there is always the possibility of national objections to giving Brussels additional authority; past efforts have foundered on resistance to the sacrifice of autonomy. National parliaments could be expected to react negatively to widespread dislocations or the potential demise of their champions (e.g., Fiat, Peugeot). The member states are likely to disagree over issues such as inconsistent immigration policies due to colonial preferences, widely differing labor standards, and the possibility of the poorer countries claiming to be unequal partners. Finally, of course, the impending reunification of Germany has created new concerns, and has revived the debate over whether EC membership should be broadened or if stronger commitments should first be obtained.

The odds against achieving economic—and ultimately political—union are formidable. Optimists are fond of looking at the United States as a model of integration. But unlike the United States, the EC lacks a common currency, a common language, a common culture based on 200 years of shared experiences, a strong federal government with the power to tax and spend, and a high degree of labor mobility among its regions.

The process will indeed be difficult, but the potential for change in Europe should not be underestimated. A slumbering giant is waking up, and the United States had better pay attention.

What should the U.S. policy responses be? In order to keep Europe open, or indeed, to open it further, some would prefer to use the 1988 trade bill as a crowbar and to brandish retaliation. But security and alliance concerns may take precedence, as has been the case in the past. Historically, U.S. commercial policy responses to actions by other countries have been constrained by broader security issues and by the desire not to alienate allies. Even as late as May 1989, the EC was not named as an unfair trader under Section 301, in part, because President Bush was to attend a sensitive NATO meeting the following week. Extensive discussions with the allies are needed on a whole range of security issues, including the future of NATO following the reunification of Germany, the reduction of conventional forces, and the Western response to reform in Eastern Europe. Until these broader security issues are resolved, the United States will probably find itself more constrained in pushing Europe on trade than it did in the 1960s and 1970s.

There is, however, one policy instrument that is available to influence the Community in the implementation of its directives—the Uruguay Round. Emphasis on multilateral pressure confined to trade matters would help to minimize misunderstandings because more countries than the United States would be involved. Many of the key issues in the Uruguay Round and the 1992 effort are the same—services, telecommunications, government procurement, and voluntary restraints. Can this coincidence be used advantageously by bringing international pressure to bear on EC internal decisions? Or, will the Uruguay Round be held hostage to the EC's restructuring—crowded out because of limited time and resources, pushed into the background with internal directives taken first? With the internal rules of the game changing, creating uncertainty and new competition, many EC firms would probably prefer to hold off liberalizing vis-à-vis the rest of the world. This is not to argue that the EC will raise new barriers, but it may not be eager to take on new commitments and to lower barriers. After all, signing on to substantial agreements in the multilateral talks would limit their flexibility in reaching internal agreements.

One factor that has always proved nettlesome in the past is the EC's cumbersome decision-making process on trade policy. Since negotiations over trade policy in the EC take place between the Commission and the separate nation states (because they are the entities that must be coopted much like the Congress in the United States), the decisions are usually reached with difficulty, rendering the EC's position inflexible and, often, based on the lowest common denominator. Gardner Patterson, a former deputy director-general of the GATT, states that "the Community's behavior creates serious problems and threatens [the] international trading system.... It can be traced to the structure of the EC decision-making process, which is slow, hard to predict and has a protectionist bias."[20] Martin Wolf of the *Financial Times* has argued, "Another consequence of the [EC's] negotiating process is to externalize internal conflict. If, for example, the West German steel industry is hurt by subsidies from the Italian Government to Italian producers, the natural response is a combination of some limit on those subsidies with greater protection against outsiders. Furthermore, because of the nature of the European Community, it is only rarely that it can agree on any far-reaching initiatives in global arrangements, where the running has been left almost entirely to the United States."[21]

An additional problem is that in the EC business interests cannot be relied upon to promote trade liberalization. Unlike in the United States, business interests in Europe do not lobby extensively. Perhaps this is because at the EC level businesspeople must deal with bureaucrats, not elected officials, who are more likely to side with particular sectors. The limited influence of business, however, has not been evident in the 1992 process, where much of the impetus has come from an activist private sector. What is unknown is how EC business interests will react as the Uruguay Round approaches its critical, final stage. Businesses planning and operating on a global basis share a common interest in greater stability and reduced uncertainty, but you would not know that from their attitude toward the Uruguay Round. The private sector appears to be preoccupied with 1992 and things closer to home.

Nonetheless, the battles over the external consequences of the 1992 unification effort have yet to be fought. They will be waged issue by issue, directive by directive, with alliances shifting from one issue to the next. The outside world should not let the EC lose sight of the implications for the multilateral system. Instead, it should be on the look-out to see: if EC directives call for a narrow application of reciprocity and establish European preferences to discriminate against outsiders; if the directives provide long phase-in times and safeguards for lagging sectors or for the poorer European countries; who negotiates regulatory standards for the EC, and on what basis outsiders can get mutual recognition; if local content provisions are established and how rules of origin are drafted; how bilateral quotas on cars and textiles at the national level are converted to ones that are EC-wide; how competition policy is revised and antidumping laws are used; and whether the directives are produced in a transparent manner or behind closed doors with maximum uncertainty, which would have the same effect on outside firms as an increase in trade barriers.

The external consequences will not be known for some time, but the outside world cannot wait until 1992 for the results because by then the EC's position will be set in stone, with no room to maneuver. Therefore, now is the time for other governments and firms both to pressure the EC to open up its 1992 deliberations to comments and criticism and to make certain that outsiders are not discriminated against. The 1992 effort should be made a focal point of multilateral discussions including at the Uruguay Round so that the EC feels constrained when reaching internal decisions. If it is not constrained, the world risks willy nilly evolving into an economic order characterized by economic blocs. How benign these blocs could be will depend upon the strength of multilateral discipline. Greater multilateral discipline is on the table in the Uruguay Round, but if the round is to be completed by the end of 1990, the EC may not be constrained and what little multilateral discipline now exists in the world trading system may not be preserved.

Conclusion: Some Policy Recommendations

Contrary to widespread commentary by American politicians and some businesspeople, the major trade policy problems for the United States over the next few years will not be with Japan but on how best to respond to a "new" Europe very much in flux. More specifically, the challenge of the first order will be how to keep Europe, particularly the EC, actively engaged in seeking multilateral trade solutions.[22]

Americans, of course, will not and should not forget the Japanese. The United States must actively push Japan, both unilaterally and multilaterally, to open its markets. Nor can we forget that trade liberalization benefits most the country that practices it. Much of the energy now focused upon threatening and bashing Japan would be better spent on improving the quality and performance of U.S. products, and to an all-out effort on the Uruguay Round. It is in the context of the Uruguay Round that Japan and the United States share a common interest in keeping the EC open for business and getting it to agree to a stronger multilateral discipline.

As the Uruguay Round enters its decisive stage, the Bush administration should stand back and ask a few critical questions before settling for an inadequate agreement. Why stop the multilateral process just when valuable momentum has been developed? Why take the risk of not having a viable multilateral option for resolving pressing trade disputes? Although no one wants to discuss it now (for fear that progress in Geneva will grind to a halt), why not make provisions for ongoing multilateral talks after an interim agreement is reached late in 1990? Indeed, the United States could be instrumental in forcing continued negotiations by taking advantage of the unique role the Congress plays in international trade policy.

The Constitution specifically empowers Congress to "regulate foreign commerce." The president's ability to negotiate credibly with other countries comes from the delegation of authority to do so by the Congress. And once a package is negotiated, it must be submitted to Congress for ratification and implementing legislation. The current negotiating authority for the Uruguay Round was passed as part of the 1988 trade bill and lasts until May 31, 1991. Under its "fast track" provisions, Congress agrees to consider any agreement within 90 days and no amendments are in order. If no agreement is reached, the fast track could expire but only if one house of Congress votes a resolution of disapproval with the administration's conduct of the negotiation. In that case, the negotiating authority would continue for two additional years.

At this point, it is safe to assume that some agreement will be reached in the Uruguay Round late this year, but that it will also be by and large unsatisfactory. The president should then try a different approach. When submitting the trade legislation to Congress to implement the Uruguay Round results, he should ask Congress to approve the package only on a contingent basis—contingent upon further progress. This will require prior consultation between Congress and the executive branch before the implementating legislation is submitted, but it could be done. Such an approach would encourage other countries serious about negotiating to return to the bargaining table and would provide for a viable multilateral option after the Uruguay Round is "concluded." The administration's hand at the ongoing talks would be strengthened and a firm deadline of May 1993, when negotiating authority expires, could be established. These additional two years would be sufficient time to negotiate substantial agreements, and would also furnish a venue for continued multilateral scrutiny of the EC's internal restructuring.

In the interim, the Bush administration should mobilize those domestic interests that benefit from open trade and stand to gain from trade liberalization. How active these interests are in pushing for liberalization in sensitive sectors like textiles will determine how far-reaching the multilateral agreement will be. How satisfied those interests are with the agreement reached this year and how willing they are to lobby for its ratification will determine how well it is received by Congress. Nonetheless, some influential domestic interests are bound to be disappointed. They should urge the Bush administration and Congress to indicate that the U.S. government will approve the negotiated agreement only until further progress is achieved. The administration should welcome such pressure because otherwise the disappointed domestic interests will surely push for aggressive unilateral action.

If, as a result, multilateral negotiations continue for another two years but other countries still continue to frustrate efforts to achieve a substantial multilateral accord on key issues, such as services and intellectual property, Congress and the administration should not agree to the minimum acceptable to those countries. Instead the U.S. government should opt for stronger agreements among a more limited number of countries. Such agreements—

achieved on a conditional most-favored-nation basis—should be open-ended, including provisions for others to accede to the agreement if they are willing to accept its disciplines. Only then, if this extension of the multilateral talks does not produce concrete results, should additional bilateral free trade agreements be explored. If negotiations with Mexico have not already begun, it is the obvious country with which to start. But after Mexico, there are no other obvious candidates. Whatever country is chosen, resentment on the part of those not chosen is inevitable. The fragmentation of the trading system will most likely ensue, reducing growth opportunities for all countries. Let us hope that the multilateral talks will prove successful.

Notes

1. See Chapter 5 in C. Michael Aho and Marc Levinson, *After Reagan: Confronting the Changed World Economy* (New York: Council on Foreign Relations, 1988) for an examination of unilateral, bilateral, and multilateral trade initiatives by the United States.
2. Peter Montagnon, "EC 'Distracted' from Uruguay Round," *Financial Times*, March 24, 1990, p. 3. The Italian trade minister, Renato Ruggiero, was speaking at a conference sponsored by the Confederation of British Industry and the Royal Institute of International Affairs in London. He went on to accuse the European Commission and fellow ministers of neglect and a lack of leadership on the multilateral talks.
3. Speech at the Institute for International Economics, Washington, D.C., September 14, 1987.
4. Even with that pressure, it took four years to launch the round. And in the meantime, congressional frustration grew.
5. See Sylvia Ostry, *Governments & Corporations in a Shrinking World: Trade & Innovation Policies in the United States, Europe & Japan* (New York: Council on Foreign Relations Press, 1990), p. 89.
6. For a withering attack, see Jagdish Bhagwati, "U.S. Trade Policy at a Crossroads," *The World Economy*, vol. 12, no. 4 (December 1989), pp. 439–80. Bhagwati argues that Congress is responsible for the shift to unilateralism in U.S. trade policy. But it was President Reagan who unleashed Section 301 by self-initiating over a dozen complaints in September 1985. There is more than enough blame to go around.
7. See Robert Hudec, "Thinking about Section 301: Beyond Good and Evil," paper presented at a Columbia University Conference on Section 301, New York, December 1, 1989.
8. As much as commentators complain about Section 301, it is certainly

superior to the other option of "managed" trade being advocated by many in Washington. Managed trade comes in many forms but basically involves government intervention to control market shares, quantities, and/or prices in a given sector. Examples from the 1980s include steel, automobiles, and semiconductors. Rather than actively managing trade, the key objective in most cases is to manage the political pressure building in Congress. A negotiated settlement is unavoidable because the alternative is often worse—congressional bills imposing tighter restrictions. The effects are predictable. Domestic prices rise in the restricting country, higher profits are earned by firms, while incentives for firms to innovate and invest are distorted and the nature of the government-business relationship is altered in both countries. Bureaucrats inevitably end up with more influence. And how are the sectors chosen and what criteria are used? What is the objective of the government intervention, and how can it insure that the objective is met? Can measures be designed to encourage the industry to innovate and invest or will the industry just get sluggish, fat, and lazy? If only two countries are party to the agreement, how do third countries react? Is it possible to get out of the agreement or does it become a permanent feature of the international trading system (e.g., like the multifibre arrangement in textiles)?

9. See Rudiger Dornbusch, "Is there a Case for Aggressive Bilateralism and How Best to Practice It?," paper presented at the Brookings Institution Trade Conference, Washington, D.C., September 12, 1989, for an advocacy of bilateral trade agreements but without an explicit recognition of many of the drawbacks noted below. For a proposal for a U.S.–Japan bilateral, see Senator Max Baucus, "A New Trade Strategy: The Case for Bilateral Agreements," *Cornell International Law Journal*, vol. 1 (1989), pp. 1–24.

10. See William Diebold, Jr., ed., *Bilateralism, Multilateralism and Canada in U.S. Trade Policy* (New York: Ballinger Publishing Co. for the Council on Foreign Relations, 1988) and Jeffrey Schott and Murray Smith, *The Canada–United States Free Trade Agreement: The Global Impact* (Washington, D.C.: Institute of International Economics, 1988) for analyses of the agreement and its consequences.

11. See Peter Morici, ed., *Making Free Trade Work: The Canada–U.S. Agreement* (New York: Council on Foreign Relations Press, 1990) for several articles on how the Canada–U.S. Free Trade Agreement might evolve.

12. For an extended analysis, see C. Michael Aho, "More Bilateral Pacts Would Be a Blunder: What the New President Should Do," *Cornell International Law Journal*, vol. 1 (1989), pp. 25–38, and Jeffrey J. Schott, *More Free Trade Areas?* (Washington, D.C.: Institute for International Economics, 1989).

13. See C. Michael Aho, "The Uruguay Round: Will It Revitalize the Trading System?," *The Fletcher Forum*, vol. II, no. 1 (Winter 1987), pp. 1–12.

14. In addition to Senator Baucus' proposal for a bilateral with Japan, Representative Richard Gephardt proposed a bilateral with the European Community. Address by Representative Richard Gephardt, "United State

Trade Policy for the 1990s," George Washington University Law Society, Washington, D.C., October 12, 1988. For a discussion of tactical problems of a bilateral with Japan, see Aho, "More Bilateral Pacts Would be a Blunder."

15. See C. Michael Aho and Sylvia Ostry, "Regional Trading Blocs: Pragmatic or Problematic Policy?," in William E. Brock and Robert D. Hormats, eds., *The Global Economy: America's Role in the Decade Ahead* (New York: W.W. Norton & Co., 1990).

16. See C. Michael Aho and Jonathan Aronson, *Trade Talks: America Better Listen!* (New York: Council on Foreign Relations, 1985, 1987) for a more complete treatment.

17. The president's chief advisory committee, the Advisory Committee for Trade Policy and Negotiations, chaired by James Robinson III, the chief executive officer of American Express, has already voiced its dissatisfaction and impatience by calling for a "results-oriented" trade policy vis-à-vis Japan in its report to U.S. Trade Representative Carla Hills on February 10, 1989.

18. Much of this is drawn from my testimony, "On Europe 1992" before the House Foreign Affairs Committee, February 23, 1989, and from "Asian Obsession; European Threat," *Journal of Commerce*, January 23, 1990, p. 12.

19. The wide range of estimates for growth in national income depends upon the assumptions made for investment spending. For a review of the estimates, see Richard Baldwin, "The Growth Effects of 1992," *Economic Policy*, vol. 4, no. 2 (Fall 1989), pp. 247–81.

20. See Gardner Patterson, "The European Community as a Threat to the System," in William Cline, ed., *Trade Policy in the 1980s* (Washington, D.C.: Institute for International Economics, 1983), pp. 223–42.

21. Martin Wolf, "1992: Global Implications of the European Community's Programme for Completing the Internal Market," Lehrman Institute Policy Paper, series on the United States in the global economy, no. 1 (New York, 1989), pp. 27–28.

22. The challenge of responding to Europe in flux may have an additional benefit as a good antidote for the overreaction in some quarters about the coming "Pacific Century." If Europe achieves its potential, it could be an "Atlantic Century" but neither is bad for the United States since it is both an Atlantic and a Pacific power. The United States can gain increased income and growth by responding positively to the challenges across both oceans.

About the Author

C. Michael Aho is the Director of Economic Studies and Director of the International Trade Project at the Council on Foreign Relations in New York, and an Adjunct Professor at Columbia University in the School of Public and International Affairs. He holds a Ph.D. in economics from the Massachusetts Institute of Technology and an undergraduate degree from the University of Michigan. Before joining the Council, Aho was the Economic Policy Adviser to Senator Bill Bradley (1983–1984); Director of the Office of Foreign Economic Research at the U.S. Department of Labor (1978–1982); and U.S. Representative to the Manpower and Social Affairs Committee of the OECD (1981–1982). He directed the President's Report on U.S. Competitiveness, 1980, has published widely on trade and labor adjustment issues, and is a frequent contributor to the media, both print and broadcast. His most recent publications include *Trade Talks: America Better Listen!* and *After Reagan: Confronting the Changed World Economy.* He is currently writing a book on the U.S. policy response to Europe in flux.

U.S. trade policy is at a crossroads. Since the mid-1980s, the United States has been pursuing three different trade policies—unilateral, bilateral, and multilateral. Its multilateral initiative—the Uruguay Round, scheduled to be completed by December 1990—is likely to disappoint Congress and domestic interests. The United States may therefore have to choose aggressive unilateral and bilateral measures that could fragment the trading system.

In this paper, C. Michael Aho, Director of Economic Studies and Director of the International Trade Project at the Council on Foreign Relations, argues that in less than two years the future course of U.S. trade policy will be established, for better or worse. He assesses the most critical influences on U.S. trade policy, particularly "Europe 1992," and makes specific recommendations designed to preserve and improve the multilateral trading system.

Council on Foreign Relations

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Representative HAMILTON. We will begin with the questions now. When Chancellor Kohl was here a few days ago, he made a comment to several of us that the decade of the 1990's will not be the decade of Asia or Japan, it will be the decade of Europe. And that was kind of the theme of his comments to us. Enormously optimistic and expansive, feeling very good about the prospects for Europe.

So I guess the first point I want to ask you is do all of you think that Europe is on the threshold of major economic development and progress now?

Mr. HORMATS. I do. I have to say I have been there very frequently. I spent quite a bit of time 2 or 3 weeks ago in the Federal Republic with the Chancellor and a few others who were really very, very optimistic. And I have the same view. There is going to be a lot of combinations of companies to make them more efficient, mergers, acquisitions. Companies are going to be stronger. They are going to be a much more dynamic internal entity and, as Mike Aho says, probably a tougher negotiator.

Representative HAMILTON. And overall do you see that as a plus for the United States?

Mr. HORMATS. A definite plus.

Representative HAMILTON. A definite plus.

Mr. HORMATS. Definite plus. We will be able to export more. They are not closing their borders. They are going to be a stronger trading partner, more competitive as an exporter, but certainly a bigger market as an importer, particularly of capital goods. And they certainly are going to take more of the economic burden of reconstruction of Eastern Europe because they are stronger economically. They wouldn't have been able to do this had they not been. They are going to take a larger portion of their defense burden. And my judgment is that what we asked for and what we hoped for immediately after World War II—a strong, democratic, militarily increasingly self-sufficient entity—is what we are going to get. And I think it's a big plus for the United States.

Mr. COONEY. We concur in that assessment. And I have a confession to make in the sense that I wrote a major trade report for NAM in 1986, looking at how we could eliminate our trade deficit at that time, which was well over $100 billion and rising.

At that time, we saw Euro-sclerosis, as the phrase became known, as being so bad that we did not see a major expansion of the European market for an indefinite period. And we felt that we would reduce some of our deficit with the EC, but the best that we could look for, forecasting around 1990, was a $5 billion to $10 billion U.S. bilateral deficit with Europe at about that time. That was the best we could hope for.

And, of course, we exceeded that already. We are already into surplus with the EC, and I think the consensus forecasts that I have seen show the four biggest European economies all growing as fast or faster than the U.S. economy for the next 2 to 5 years.

Representative HAMILTON. Mr. Aho.

Mr. AHO. Yes, if you were to put together the European Community and the EFTA countries around the edge and Eastern Europe, you end up with 470 million people and in 1988, roughly a $6 trillion gross national product. Japan and the Four Tigers are only about $3 trillion. And at any reasonable growth rates, say 3 percent in Europe, the increment in gross national product over the next 10 years will swamp what is happening, at least among Japan and the Four Tigers. That is where the bulk of the action is going to be.

Representative HAMILTON. All of you then share a fundamental optimism about that. That optimism is based really on what is going to happen in the European Community more than what is going to happen in Eastern Europe; is that correct?

Mr. COONEY. Yes. In fact, in the update of the report on EC-92 that we wrote earlier this year, where we took account of Eastern Europe, stated what has happened in Western Europe with respect to government changes within countries and the 1992 process, has had a demonstration effect and has played no small role in causing what has happened in Eastern Europe. The two halves of Europe were faced with similar problems—overly managed economies, both East and West, but of course the East much, much worse by comparison. However, Western Europe was able to change its policies to respond to the need for change. And I think this is part of the strength of its democratic institutions. Eastern Europe was not. So I think that is part of the process.

Representative HAMILTON. OK. Now let's get all of this together for me, if you can, pretty succinctly. You are all very optimistic about the impact of the developments in Europe, and let's focus now on the impact on the U.S. economy in specific terms. We are not talking about Eastern Europe, we are not talking about EC 1992, we are not talking about German unification, we are talking about all of them. And we are looking down the road for the United States.

What does it mean when you put all this together with respect to interest rates, the dollar, the U.S. deficit, trade, all of the indexes we use to measure economic progress or lack thereof? What does it mean for us? And be as specific as you can. In other words, I want the big picture here.

Mr. COONEY. Well, can I start just on the trade side, now that the other gentlemen have commented on interest rates and macroeconomics. I think it has made reducing our trade deficit 50 percent easier than we expected. That's the first point.

And second, we have calculated, and there are different ways of doing this, but we have calculated over the last 5 years that our increased exports to Europe have created a million new jobs. And if our exports continue to increase at something like the present, you're looking at roughly an estimate of 20,000 jobs for each billion dollars of new exports.

The third thing I would look at is I have heard of a recent Commerce Department calculation that 34 percent of all growth in the United States since 1986, for the whole period, has been due to increased exports. And a good chuck of that has come to the EC. To a great extent, as we have various retrenchment problems in the United States, I would say over the next 3 to 4 years perhaps as much as, say, a quarter of our future growth could come from our increased exports to an expanding total European market over the next 5 years.

Representative HAMILTON. OK.

Mr. AHO. I think certainly interest rates are going to rise, other things being given. The trade deficit with Europe probably will improve, but there are two unknowns here. One is what is going to happen to the dollar. You might need some continuing depreciation of the dollar in order for that to continue, despite the big boom in Europe.

Representative HAMILTON. Well, with the interest rates rising, that is going to have an adverse impact on us.

Mr. AHO. Yes. Well, the interest rates may be rising globally, though. It may not just be a U.S. interest rate rise; it might be a global ratcheting up of the interest rates.

The other unknown here is U.S. investment in Europe. Is there forced investment as part of the EC 1992 program, that firms that might have exported going to invest and to do their sourcing from Europe rather than from the United States? That would not help the trade deficit, other things being equal.

The other is that I think we will see strong European competitors, and so that impact upon individual firms in the United States is they are going to face not only a Japanese threat but increasingly European threat of some type of merger threat or a corporate alliance threat. And they are going to have to work a little bit harder to get up to speed.

Mr. HORMATS. I think there will be generally higher interest rates, other things being equal, because there is a greater demand for capital as a result of developments in Europe and other areas as well, unless savings rates are improved. I think we have to remember interest rates are a function of demand for capital and supply of capital. Supply of capital is going down, demand is going up, and Europe is going to be a big demander of capital, Western Europe more than Eastern Europe.

Representative HAMILTON. And how does that play out for the U.S. economy?

Mr. HORMATS. That will tend to slow down the rate of growth in the United States because we are more dependent on capital and more of our companies get more of their capital from the capital markets than they do from the banking system. And the tendency in Europe is to have a closer relationship within the banking system and companies, particularly in Germany, the same is true in Japan.

Our companies are more heavily dependent on market instruments for raising capital than theirs are. So that the trend toward higher rates tends to have a slightly different effect on ours than on theirs.

Second, a big boost for the American capital goods exporters. Demand for capital goods in Europe, American capital goods in Europe, rose by 50 percent between 1987 and 1989. It was partly a function of growth in Europe and a lot of construction, a lot of new factories, partly the result of new combinations of companies. But that is going to be strong, perhaps not as strong in the future, but very strong.

Representative HAMILTON. Would you look to see, as Mr. Cooney said, that our trade deficit is going to go down then because of that?

Mr. HORMATS. With Europe? I think it will.

Representative HAMILTON. Because of European developments?

Mr. HORMATS. I believe it will. I agree with him.

There are two slight caveats. One is agriculture. We have to remember that the countries to the east of Europe are being brought into the game, so to speak. They are big producers, if inefficient, of food products and agricultural products.

Eastern Germany, if we go back to Bismarck's Germany, was a big agricultural producer. But they were very inefficient.

When they get brought into Germany and, if they get brought under the cap, it is going to be a problem for American agriculture and a problem for other producers in Europe of food and agricultural products; probably also textile problems because the Eastern Europeans are going to want to export more labor-intensive goods to Western Europe and that could hurt the market.

Representative HAMILTON. Do you think Eastern Europe can become an agricultural exporter within a few years?

Mr. HORMATS. Oh, yes. It can be. In fact, some countries now are agricultural exporters, but to other parts of the Comecon region. They are not efficient. The problem is that, if East German agriculture is brought under the common agricultural policy, with all the benefits that they will derive from that, they could enhance German agricultural production. And even if an Eastern European nation is not an exporter, it will be more modern. Therefore those that are importers will import less. So it is, on balance, a negative effect for our agriculture and for other efficient agricultural producers in the world.

The last question, the dollar, that is very hard to determine. It depends on a whole range of things not just the trade balance and not just interest rates. So it's hard to hazard a projection.

One point that I would mention, though, is that there are going to be these three monetary blocs that Mike Aho referred to, or monetary zones, or whatever one wants to call them. Increasingly the whole debate of the G–7 will be a debate among the G–3—Japan, the United States, and the Euro-Fed—and it is going to be much more complicated to manage these. The dollar will not be as preeminent a currency as it was.

Representative HAMILTON. Now, the bottom line for politicians, of course, is always jobs here in this country. What is going to be the impact on that?

Mr. HORMATS. More jobs in manufacturing.

Representative HAMILTON. More jobs for the United States? More jobs in manufacturing?

Mr. HORMATS. More jobs in manufacturing of capital goods.

Representative HAMILTON. Do you agree with that, Mr. Cooney?

Mr. COONEY. Yes, I do, I think.

Mr. AHO. Yes, I do.

Representative HAMILTON. You do too, Mr. Aho?

Mr. AHO. Yes.

Mr. HORMATS. Reassuring, wasn't it? [Laughter.]

Mr. AHO. No, what I wanted to say is I just don't see the—I am very hopeful that the forced investment issue will be resolved and that we won't see much of that kind of displacement.

Representative HAMILTON. The what issue?

Mr. COONEY. What we call the forced investment issue, the rules of origin, the public procurement discrimination. And that's why I was hesitant. But we still see—well, the latest figures, which are now a couple of years old, show about a third of our total exports to the EC going directly to U.S. affiliates there.

So this is a problem we have discussed several times in other committees in Congress. We see investment and exports basically working together, not one substituting for the other. And we have had this pattern in Europe. If the market remains relatively open, and I think it will, I think we will see this pattern continuing.

That was my hesitation.

Representative HAMILTON. Yes. Thank you. [Laughter.]

Congresswoman Snowe.

Representative SNOWE. Thank you, Mr. Chairman.

I want to thank all of you for your testimony here this morning.

Getting back to interest rates, obviously then it is critical for the U.S. Congress to reduce the Federal budget deficit, especially because we do depend on the inflow of foreign capital.

Is there any way of judging how much we will lose in terms of getting foreign capital?

Mr. HORMATS. It's very hard to say. It's hard to quantify. Just to clarify the point on the Japanese inflow versus the European inflow that Mike Aho made, in aggregate terms, Europe is a bigger investor here.

The fact, however, is that because of the way the Treasury finances itself, which is on the capital markets, Japan is a bigger factor in buying new Treasury issues, which is what really determines interest rates in this country, than are the Europeans. That is, in the aggregate, European money is greater, the inflow is greater, but in that particular sector, the capital markets Japan's is greater.

That goes to the heart of your question. If more Japanese money decides to look elsewhere, then the cost of borrowing for the Federal Government is going to increase. It's hard to tell how much because it depends on the growth rate here, it depends on our savings rate here, and it depends on other capital requirements here. But the bias, the bias is toward higher rates of interest and, therefore, toward higher government debt service expenditures.

Now, at any given point, the absolute amount could be lower. If we have a recession, for instance, then interest rates here will decline but they would still be, on balance, higher than they otherwise would have been had there not been this proliferation of demands for capital around the world.

Representative SNOWE. So we only have a couple of years to position ourselves in responding to this deficit question toward other countries.

Mr. HORMATS. If you assume the Germans, after Japan and leaving Taiwan out for the moment because they have a unique way of investing their money, were the big lenders outside of Germany, and now the Germans are going to be absorbing internally virtually all the capital that they otherwise exported. That will have an effect. It won't hit us overnight but it's a gradual thing.

Representative SNOWE. How well positioned are American businesses to respond to EC 1992? I understand from your comments here this morning the manufacturing sector——

Mr. AHO. No.

Representative SNOWE. You aren't totally enthusiastic about the manufacturing sector benefiting from EC 1992, but how well positioned overall are American businesses to prepare for that competition?

Mr. AHO. Oh, I think we're pretty well positioned because, first of all, our major companies have been active in the European market for a long time, understand it very well.

And, in fact, there is even a reverse problem. I was astounded, I was just in Germany giving some talks on our views on 1992, and there is actually a reverse problem. American companies sometimes are so well camouflaged in Europe, so well assumed to be "European" companies, and then people read about our tremendous problems here—our trade deficit, our budget deficit, our savings-and-loan crisis—they assume that American companies—and they hear about our quality problems that we're constantly talking about—they assume that American companies are finished on the world market.

There are two reasons for that. I think one is the negative remarks they hear about U.S. economic problems. And the other is that they don't really see American-labeled consumer goods in their shops. So they go out to shop, they don't buy what they feel are American cars or American products. Some of them may be made by American companies in Europe. And they don't appreciate the big numbers.

Most Europeans are absolutely astounded to find that our manufactured exports have increased 60 percent in the last 5 years, for example. I mean, that is worldwide, and I think Europe, it's equivalent or even higher.

And so I think that is actually perhaps to a certain extent we are too well camouflaged, and that is a certain problem, a certain impression that sometimes American companies have to overcome.

But our companies are well positioned by being invested there now so they are able to integrate U.S.-source with European-source products. And what we see happening recently, and it doesn't really show up yet in the big investment numbers, but we see increasing interest in medium-size and smaller companies in exploring the European market in some combination of exporting and local production. So I think we are pretty well positioned.

Representative SNOWE. Well, what can the U.S. Government be doing in that respect? You mentioned the Eximbank shoring up and doing more in that regard.

Mr. HORMATS. Yes, Representative Snowe, that's a good point. I was thinking solely in terms of the EC. In Eastern Europe we have a lot of problems that need to be taken care of.

I would say, looking at the four or five issues that I listed in the statement, the No. 1 problem affecting more companies and more different products and range of size of companies, medium and small as well as big companies, is export controls right now.

And it's not just a problem in direct exporting to Eastern Europe, which is very small but also if a Western European company is buying a product that it wants to be able to sell in Eastern Europe, they have to say, "Now, wait, do we have to get a reexport license for this technology? What's going on here?" So these Cocom discussions that are going on are extremely critical to us.

Representative SNOWE. That has always been a source of contention.

Mr. AHO. Well, it always has been an issue, I know, because we work with your other Committee on Foreign Affairs on this. But, you know, that's probably No. 1. But Eximbank is also important that we improve that, and also that we get a new legal basis for dealing with Eastern Europe. And I think that is something that Congress really has to, you know, pay attention to. And that is something that we definitely are looking for action on from the administration and Congress this year.

Representative SNOWE. What do you mean by "legal basis"?

Mr. COONEY. Well, I mean by new commercial and investment agreements.

Representative SNOWE. What could we do that would be more beneficial to Eastern European countries? Direct government assistance, as we are providing, or eliminating trade barriers?

Mr. COONEY. Well, I heard Vaclav Havel's, you know, recently in Washington, one of Vaclav Havel's plays was performed, and Vaclav Havel's brother was there. And the audience asked questions afterward, and people said, "What does Czechoslovakia want from the United States?" And the first thing he said was "MFN." This is an audience, you know, poets and all, this was not a business audience. And that's the first thing he said.

Yes, I think that we need trade agreements that put our trade relations with Eastern Europe and the Soviet Union, bearing in mind all the other issues, on the same basis as our trade with our major, our other industrial country partners.

Representative SNOWE. What about the Uruguay Round of GATT talks, what can we be doing there to assist us in being more competitive with the European Community? I understand there is, you know, serious concern on our part regarding subsidies, that in fact they may engage in more subsidization of their domestic industries as they open up their markets to become more competitive and some of the lesser companies may not be able to survive.

Do you think they will resort to more subsidization?

Mr. COONEY. Well, I think subsidization is a serious problem, especially as the EC is going to look more toward subsidizing different regions of the EC as a way of improving what they call cohesion—I think that is the code word, "cohesion"—and improve performance in the peripheral areas such as Greece, southern Italy, Spain, and so on, Ireland.

So I think that the subsidies code issue is a key problem with the Uruguay Round, achievement of a new antidumping code, the functioning of the GATT system. These are all important issues.

And also, the issues that the EC has said they want to discuss or we have said—we and the EC both agree—we want to discuss within the Uruguay Round context or the total GATT context which includes an agreed discipline on rules of origin, and also expanding the government procurement code to sectors such as telecommunications, transportation, energy, and water, which are now included within the EC and where the United States has some very competitive products and companies which have heretofore been shut out of the EC market or parts of the EC market.

Those are some of the major issues. I also should mention getting an intellectual property agreement within the GATT-Uruguay Round is extremely important for our companies. Those are just some of the highlights on that issue.

Representative SNOWE. Yes.

Mr. AHO. Yes, the Uruguay Round is important in another sense, and I agree with Steve Cooney on the list of things. The agenda for the Uruguay Round is so ambitious that not everything is going to be completed between now and December, or at least to the satisfaction of influential domestic constituents, I am certain.

But what it provides is a multilateral venue for scrutinizing what the European Community is doing in this 1992 internal integration, and I wonder how they will behave the day after it's over. You know, I am not here to point an accusatory finger. I don't know how we will behave the day after it's over, either. But I think that it is valuable to have these multilateral talks with the discipline that they provide, to prevent us or the European Community from doing things that have detrimental effects.

Representative SNOWE. I would like to yield to the chairman.

Representative HAMILTON. May I just ask a question on the Uruguay Round. Are they going to have to extend the deadline?

Mr. AHO. That is probably up to Congress.

I do have another paper that I will submit to the committee that is coming out in a week that I don't think we are going to get everything. Some things are going to fall off the table. Domestic constituents, probably agriculture, will be most frustrated; maybe some others.

And I just wonder is there a way that we could grab what we have in December and send the folks back to the bargaining table to fill in the blanks and not leave us with that vacuum of no viable multilateral option?

Representative HAMILTON. Mr. Hormats.

Mr. HORMATS. I just wanted to make one other point on the question of how we can help them. The trade is all important, we need to give them access to Western markets quickly. They are worried, with respect to the European Community, about the sort of quantitative restrictions that could click in if they export too many, particularly labor intensive, products to the European Community.

The other thing that is very important is something to help them move toward currency convertibility. I would leave the Russians out because I don't think the Soviets are capable, in current circumstances, of having a convertible currency because there is too much of a currency overhang in the Soviet Union.

But the Poles do have a sort of currency convertibility already, and they were helped mightily by a currency stabilization fund to help them to undertake this, to sort of buffer them and give them a little bit of money if the currency started getting hit by the markets.

That would be a very valuable investment for us with respect to the other countries in Eastern Europe, to help them with some type of fund, a sort of a revolving fund. We did the same for Western Europe after World War II. It was called the European Payments Union—EPU. And it gave them currencies to help them move toward multilateral and convertible currency trade. If we could do what we have done for Poland with a stabilization fund for the others, it would be very valuable.

Now, it costs some money in the near term, and we wouldn't do it unilaterally. It could be done by all the Western countries, or the BIS, or some vehicle like that. It would be very helpful.

Representative SNOWE. I would ask you a question, Mr. Hormats. You said in April that you felt that the integration of Eastern Europe into the EC would be premature. Could you comment on that position?

Mr. HORMATS. Yes. I still believe that is the case. These countries are not ready economically to be part of the European Community. And really, only the Poles have asked for this type of relationship so far. They would like to be members.

Agriculture is one example. Their agricultural systems are grossly inefficient compared to those of Western Europe, and they would need enormous subsidies to be part of the common agricultural policy, which would be harmful to everyone.

Second, they are industrially way below standards. It would really do them no favor to bring them in. Just to give you an example, the GNP's, leaving the Soviets out, of all these countries together come to about $500 billion, very small comparatively. West Germany is more than double that. So you're really talking about small, underdeveloped economies. They are not poor, they are just poorly managed and they have been poorly managed, in some cases, for more than 40 years.

I do think that politically they need the right signal, and the signal ought to be that at some point, even if it's a far distant point, they should be welcomed as members. But it should be way down the road. And they ought to be brought into the political discussions. There ought to be association arrangements of some sort, close trade arrangements, investment arrangements, but not a seat at the table and not an ability to qualify for the sort of subsidies and other supports that the other Western Europeans get.

It is too much of a burden. One thing we don't want to do is kill the goose that laid the golden egg. The goose that laid the golden egg is the EC, the 12. And if by bringing these countries in we weaken it—we weaken it economically or politically—it's not good for Europe. It's not good for Eastern Europe either.

Representative SNOWE. All right. Thank you.

Did you want to comment, Mr. Cooney?

Mr. COONEY. Well, yes. I have one comment. That's an excellent answer, and I don't really disagree with it. Speaking personally, I have one problem with that. I was just in Switzerland, as one of the other places that I spoke recently on NAM's views on 1992. And there is a tremendously active debate in Switzerland right now about whether that country, with its historic neutrality, et cetera, should join the EC. And I was really surprised at the vigor with which that is being pursued.

Mr. HORMATS. They're not even in the U.N.

Mr. COONEY. Well, but they say that's no precedent.

My comment to them was, if we held a vote in this country on whether the United States should stay in the U.N., in a public referendum, I am not sure what the answer would be. The Swiss don't see one result as precluding the other.

And the point is that there are halfway houses now being considered, called European economic space, as some sort of halfway house, and people are saying, well, maybe the East European countries should join EFTA first and somehow get into the European economic space. And that is a halfway house between the present situation and really being full members of the EC.

Now, the problem that I see with that is, first of all, for the EFTA countries, their major trade partners are the EC, not the other EFTA countries. And this is the market the Eastern Europeans want access to. They don't want access to EFTA, they don't want access to the other Comecon countries, they want access to the EC market.

The second problem: If you are in something called the European economic space, it means that you don't get to be at the table, to use Mr. Hormats' expression, when the key decisions, not just economic, but social, political, and other policy decisions are made by the magic circle of the EC meeting in Brussels.

So the Swiss have a tremendous problem, for example, with one of the big issues there would be opening the borders and free flow of immigration from the rest of the EC in and out of Switzerland. They already have over a million foreigners living in a country of, I don't know, 5 or 6 million people.

Now, you can't be at the EC table making the key decisions on opening the borders if you're not a member of the EC. So what good is it to you to be in something called the European economic space or EFTA? You have a good trade relationship, they're in CEN/CENELEC on technical standards, but you still have that problem of lacking a seat at the table.

And I think this is the problem that the Eastern Europeans see as well. Everything that Mr. Hormats said is correct; I do not disagree with it at all—but if you're not in the charmed circle of the EC, you're not at the table when they're making those key economic, social, and political decisions.

Mr. HORMATS. Although they can consult with them, actually. Labor mobility is a big problem. We talked earlier about the East Germans coming to the West. Well, if you opened the doors in these other countries, the Romanians and others were able to go all over the EC, there would be very strong xenophobic reactions, I am afraid. They are already beginning when these countries aren't in the EC and their workers are coming over and people are coming from southern Europe. It's a very sensitive issue.

Sure, they're not at the table. And that's a price that they will pay. The EC needs to consult with them more, and bring them into the discussions. But it is a reality that they are not going to be at the table for a time.

Representative SNOWE. Thank you.

Thank you, Mr. Chairman.

Representative HAMILTON. I am informed that there will be a vote in about 15 minutes.

Mr. Hormats, I know you have to leave before long, so we will try to cover a lot of ground shortly here before the vote occurs.

I am just curious about Germany and the ability of that economy to do everything that seems to be expected of it. They're going to take over East Germany here, they're going to be a major player in Eastern Europe, they're not going to raise any taxes, according to the Chancellor, they are going to be the major contributor to the Soviet Union.

Can Germany do it all? I guess that's the question. Is that economy so strong and so good that it can absorb East Germany with relatively little impact on its own economy, can take over the burden that you were talking about earlier, Mr. Hormats, of financing Soviet troops and reintegrating those back home, can help the Soviet Union with their economic problems, and contribute to Eastern Europe as well? What about all this? Is that German economy that good?

Mr. AHO. A couple of things. I think you're right, Representative Hamilton, in expressing some of the potential frictions that are there. I mean, they may be able to do it economically, and I will come to that in a second. But we are looking at internal frictions: labor mobility, which is already a problem in the West, huge increases in social spending for unemployment insurance, for compensation.

Representative HAMILTON. Infrastructure spending.

Mr. AHO. Pensions.

Representative HAMILTON. Environmental spending is just enormous there.

Mr. AHO. That's right, and you look at, what is it, only about 10 percent of the railroads in East Germany, or 90 percent, are single track. Only about 10 percent of the households have phones. I mean the expenditures are going to be dramatic.

But I think the Germans can do it not by taxing but by borrowing from the rest of us. The German budget deficit will increase, and they will finance it through debt financing, borrowing on international capital markets. The confidence in the Bundesbank and the German economy itself is sufficient that I think they will do very well.

Representative HAMILTON. So your answer basically is, yes, they can do it?

Mr. AHO. But it's not going to be as easy as it looks right now at first blush. They're going to have a lot of political tensions internally, but they will finance it.

Representative HAMILTON. Mr. Hormats, you think they can do it?

Mr. HORMATS. I think they can do it. They certainly will have to borrow on global capital markets. They have already indicated they are going to do some bond issues in Japan, and it's not certain whether they will come to the New York bond market to get money. But certainly they will have to borrow outside of Frankfurt. And that they can do for the time being, and do reasonably well.

Mike Aho has indicated the problem. There is a social problem. And that is that there are some Germans who are not inclined to foot a very large bill.

I don't know if the Federal Chancellor mentioned this when he was here, but in some German States, some of the Länders, there are already people getting out and saying, "Wait a minute. We like unification and all this, everything's fine. But the costs are very high. If we are going to have to pay higher taxes or higher interest rates."

German interest rates have gone up 2.5 percentage points in 1989. That is higher mortgage rates, higher financing costs for a car, a whole lot of things. The social cost is going to be high.

There are plenty of Germans, not a majority, but there are plenty of Germans who don't like this, and it's going to be an important political issue.

But the answer, the bottom line, is manageable. But they are going to go through a lot of political tugs-of-war internally before they figure out just how much to pay.

Representative HAMILTON. You said earlier, jumping around a little bit here, that you didn't think there was much private investment in Eastern Europe.

Mr. HORMATS. Very little. Very little.

Representative HAMILTON. Now, of course, the whole theory of the legislation we have passed here, Seed I and the Seed II that is in progress, is that you want to encourage private investment and that's going to have to be the key.

So what are you telling us? That that's not going to work? Or it's going to take a long time, or what?

Mr. HORMATS. It's the latter. It's going to take a long time.

I am a member of the board of the Hungarian-American Enterprise Fund. We have just started. We have our $5 million, and we're hoping to get a little bit more.

Representative HAMILTON. Why are you so slow getting started?

Mr. HORMATS. We just got our money. We just got our money from AID.

Representative HAMILTON. Why are they so slow?

Mr. HORMATS. I don't know. When their Administrator comes up, you can ask. But I don't know why they're so slow.

Representative HAMILTON. I intend to. [Laughter.] But really, these enterprise funds, I don't know that this is on our topic this morning, but these enterprise funds are the key.

Mr. HORMATS. Yes.

Representative HAMILTON. And they are very slow getting going.

Mr. HORMATS. We just got our money. We have a president now, we have everything in order. The board has met three times. We meet every month. And I think we're ready to roll. We are going to get one or two, probably three by the end of this year, Hungarian board members for our group.

We meet together with the Polish board as well. The cooperation has been good. And we are working in a very efficient way. We work quite expeditiously, given what we have to work with.

Those funds can be very helpful. These countries need to deal with the following problems: They have to clarify their legal structure, and in many cases their legal structure is still very murky. They have to figure out what, politically, they want to do. There is a big debate how quickly to privatize, how to privatize, how much to privatize, what percentage foreigners can own of domestic companies—all very unclear.

They don't have the "agents in the market." They don't have accountants, except for Hungary. They don't have people who can make the basic sort of business judgments and decisions. And then, among other things, except for Poland, they don't have convertibility. In Czechoslovakia and Hungary, they don't have convertibility, so it's very hard to know, if you put $100 million in, whether you could get your money back.

Representative HAMILTON. Is there a lot of interest in the American business community in investment in Eastern Europe?

Mr. HORMATS. Interest is the word. There is interest and curiosity.

Mr. COONEY. And a lot of American businessmen traveling there.

Mr. HORMATS. They are there in droves, particularly in Budapest. But they're very cautious until these points are resolved.

There have been some good investments. GE bought a majority share in Tungstrom. Levi Strauss has a very good investment and is doing quite well in Hungary. Some of the companies are going to invest in East Germany. But still they're cautious. And the market is a very competitive market. There are a lot of other people wanting to invest in their countries, and therefore they're very cautious about Eastern Europe.

But you're right, the answer is investment. All these other things will fail and fail miserably unless the rate of investment, domestic investment and foreign investment, increases substantially. And even in Poland, with the boldest of economic reform programs, the investment is just a trickle. And if they don't get it, unemployment is going to be one big problem; and that could undermine everything they're doing.

Representative HAMILTON. Well, Mr. Aho, I think you were the witness who talked about the common currency. Is Europe now fairly on track toward a common currency?

Mr. AHO. I think they are.

Representative HAMILTON. How long is it going to take to get there? Will they do it in steps?

Mr. AHO. I think they will do it in steps. I was surprised that Pohl, the head of the Bundesbank, last week mentioned that he thought they'd go with two tiers. The French rebuked him immediately. But I think the original six plus one or two others are probably willing to go along sooner than the poorer countries, Greece and Portugal.

Representative HAMILTON. Is Britain holding out?

Mr. AHO. Britain is holding out now.

Representative HAMILTON. What's the problem with Britain on a common currency?

Mr. AHO. Margaret Thatcher. [Laughter.]

Representative HAMILTON. What's her problem? [Laughter.]

Mr. AHO. I am not a psychologist. [Laughter.] No, it's so many of the people in the city of London are concerned.

Mr. HORMATS. He'll be on BBC tonight. [Laughter.]

Mr. AHO. No, I don't get there till tomorrow morning, Mr. Hormats. [Laughter.] So many people in the city of London are concerned about, on the margin, the capital market moving from

London to the continent, and the pressure is increasing, and it sounds like they're going to join the EMS by the end of the year, and that will be the first step.

But there is this resistance to what looks like the ultimate sacrifice of authority, because she can see down the road that in fact it is going to mean fiscal discipline. It's not just giving up your money.

Representative HAMILTON. My real interest, I guess, is what the impact of that common currency is on the United States. I mean, is that a kind of a technical thing as far as we are concerned, or does that really have implications for us?

Mr. AHO. I think it does. The dollar as the key currency, its role will ebb, as I said. That's not all bad, but then you may have rival currencies for reserve holdings and for transactions, and there may be a little more instability that's bred if you don't have good coordination among the big three.

And they are going to be much tougher for us to negotiate with. So we better start thinking our strategy through and perhaps improve the coordination process with indicators and all the rest of it to strengthen G-3, if you will, because that day is coming where they are going to be a united force and harder to contend with.

Representative HAMILTON. Does a common currency mean that you're going to harmonize monetary policy?

Mr. HORMATS. Oh, yes. It means it will be, in fact, the same monetary policy.

Representative HAMILTON. Be the same?

Mr. HORMATS. Yes.

Representative HAMILTON. A common currency means you'll have a common monetary policy. Is that right?

Mr. HORMATS. Yes.

Mr. AHO. Yes.

Representative HAMILTON. So you will have a kind of a Euro-Fed, then?

Mr. AHO. Yes.

Mr. COONEY. No monetization of the fiscal deficits of member states. That's another key point.

Mr. AHO. That's right. This is where the debate on fiscal policy is creeping in, because the central bankers, they would love the autonomy that the Fed has or that the Bundesbank has. So they agree with the Euro-Fed, "Let's go that way." But the finance ministers are different individuals altogether, and I don't how much authority they're going to want to sacrifice.

Representative HAMILTON. So you'll have the situation where monetary policy is a common policy, but fiscal policies will be separate?

Mr. AHO. Will be separate. They will be held accountable, though, I should stress, by the market, just the way Massachusetts and New York are. You know, they can see their bond ratings lowered substantially, the cost of borrowing going up. But that's a brutal way to hit countries over the head. So I think they're going to need an awful lot of arm twisting in the background to get to a common assessment of fiscal policy.

But once they do, I don't think we're going to get them to move.

Mr. Cooney. Yes, I would like to add a point, if I can, from the trade deficit side and our export side, which has often been overlooked. And that is, I think the problem isn't the common currency here. What they call in basketball—well, you're from Indiana—the transition game. And the problem is in the transition period and moving toward fixed-rate currencies, because I think that we're looking at a situation now, and I don't know if Mr. Hormats, for example, would agree with me, but many people in Europe certainly do both inside and outside of Germany, that the deutsche mark currently is too weak against the other European currencies.

And I think that the European business and the other European governments have not basically complained about that situation which leads to massive German surpluses in industrial sales or mainly due to industrial exports. They don't complain about it because they like the anti-inflation effects of being linked to a deutsche mark, of not having the deutsche mark revalued higher and thereby changing that situation.

Representative Hamilton. Is Germany just going to dominate this monetary policy, this Euro-Fed? Are they just going to dominate it?

Mr. Hormats. That's the objective. They want to.

Representative Hamilton. Whose objective?

Mr. Cooney. Germany's objective.

Mr. Hormats. The German objective. Sure. The Bundesbank. That's why the deal is that the Fed is going to—the Euro-Fed—will be organized in roughly the same fashion as the Bundesbank; and the Bundesbank is run similar to the American Fed. There are some differences. It is a little bit more independent, in some ways.

But the whole idea of the Germans is that the Euro-Fed will be in Frankfurt, it will be run on a very rigorous monetary policy line. The problem is that these other European countries have not had, one, an independent central bank, none of the central banks are as independent as the Fed; and two, none of them even comes close to the degree of monetary rigor that the Bundesbank practices. And as a result of all this, I think that you're going to see a very tough time as the finance ministers realize that they have to be tough.

Look at Massachusetts. You know, when everyone else is running their fiscal policy reasonably well, their interest rate becomes much higher. They have to compete with other States for money.

The other countries in Western Europe are going to have major difficulty borrowing unless they toe the line with a relatively firm fiscal policy.

Mr. Cooney. But I think they like that. I mean, I think they like that politically now. It gives the governments in countries like Italy and France that have had problems, and Spain, with fiscal and wage discipline, it gives them an excuse.

And, by the way, I think that is part of Thatcher's opposition too. She said she will join the EMS, but she does not see it leading in the same direction that the others see.

She is not totally irrational. If she joined right away, with British inflation still running fairly high, she gets immediately into a defense-of-the-pound-type situation.

Representative HAMILTON. Well, I could keep going for quite a while here with questions. But you have been an excellent panel. We appreciate it.

Do any of you want to make a closing comment?

Mr. HORMATS. No; thank you.

Mr. AHO. No; thank you.

Mr. COONEY. No.

Representative HAMILTON. We thank you very, very much for your contributions. They have been excellent this morning.

We will stand adjourned.

[Whereupon, at 12:10 p.m., the committee adjourned, subject to the call of the Chair.]

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