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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

An Expanded European Community: Some Economic Implications For The United States

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
August 1971

INTELLIGENCE MEMORANDUM

An Expanded European Community: Some Economic Implications For The United States

Introduction

1. An expanded European Community 1/ (see the map) will pose new economic challenges and opportunities for the United States. Community commercial policies already affect US economic interests, and claims of EC protectionism have grown. Moreover, the Community's Common Agricultural Policy (CAP) is said to have adversely affected our trade in an area where we have a clear competitive advantage. The almost certain extension of Community policies to a larger group of countries, the continued proliferation of preferential trading arrangements, and the planned increase in the degree of economic integration in the Community may impair US economic interests, but the dynamic effects of enlargement could offset resulting US losses.

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1. The term European Community *(EC) is used as a collective for (1) the group of six countries constituting the European Community, and (2) the three treaty organizations now referred to as the European Communities -- the European Economic Community (EEC), the European Coal and Steel Community (ECSC), and the European Atomic Energy Community (EURATOM).*

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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2. This memorandum surveys in a general way the economic implications for the United States of an expanded EC. It considers the impact Community policies have had to date, and the likely impact of an enlarged Community on US agricultural and non-agricultural exports, US overseas investment, and our role in the international monetary system. The memorandum also assesses the impact on US economic interests of an extension of preferential trading arrangements to the European Free Trade Area (EFTA) 2/ non-applicant countries, and to the developing Commonwealth countries in Africa and the Caribbean.

Discussion

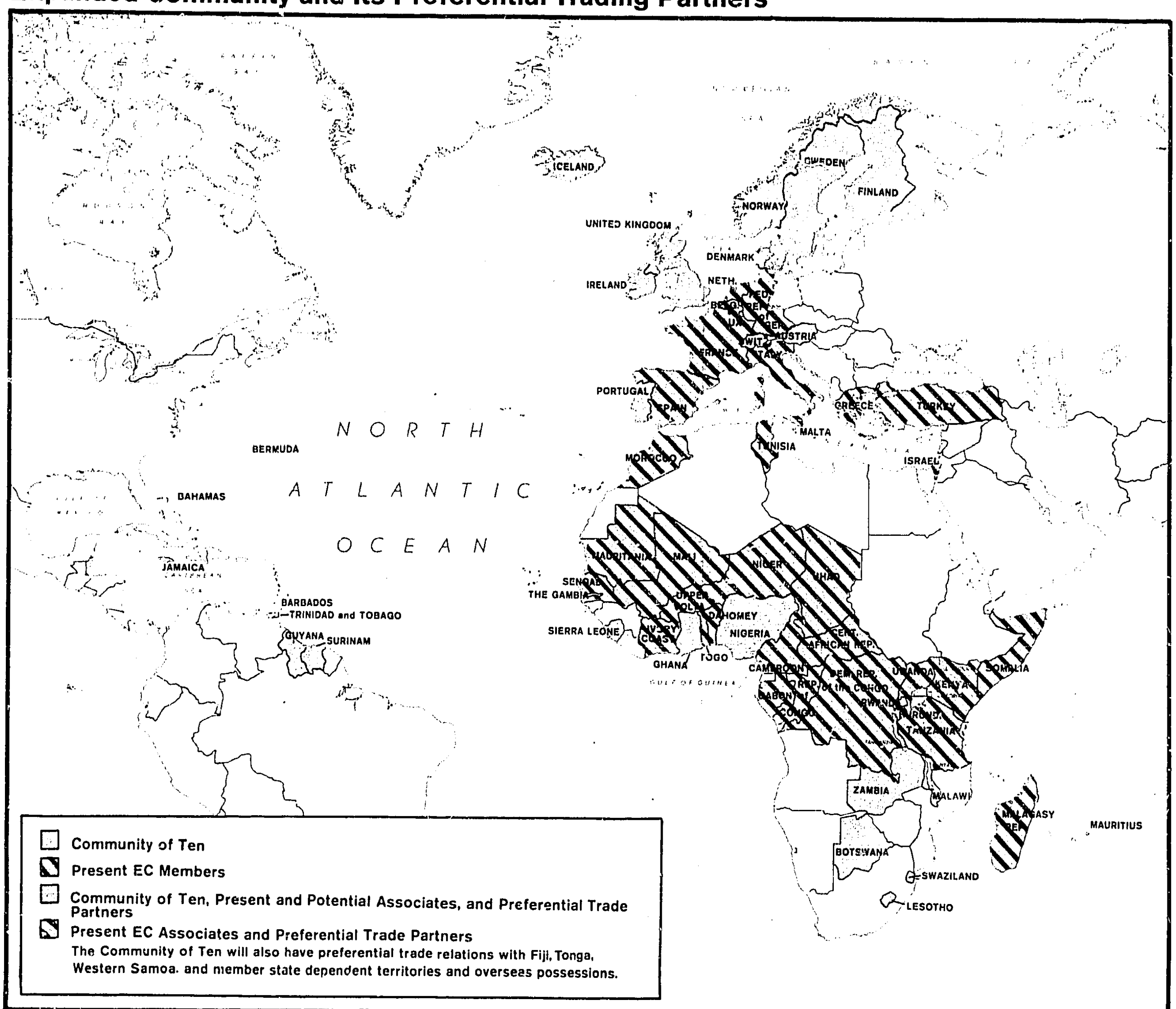
Background

3. It is highly likely that the EC will soon be enlarged. The EC-UK accession negotiations are virtually concluded and negotiations with the three other applicant countries -- Denmark, Ireland, and Norway -- are well advanced. Despite continuing opposition in Britain and opposition in Denmark and Norway, where referendums on the issue are planned, the EC probably will be enlarged to a Community of ten, on or near 1 January 1973.

4. This opens up prospects of eventual far-reaching changes in the international economic balance of power. Even now the Community of six carries a substantial economic clout. In 1970 the ten had a gross national product (GNP) of $628 billion (see Figure 1), roughly 65% of our GNP and about three times larger than Japan's, the next largest Free World economic power. The entire group's trade (including intra-group trade) -- $226 billion in 1970 -- was about 38% of total world trade, compared with the US share of 14%.

2. The present EFTA members are Austria, Denmark, Finland, Iceland, Norway, Portugal, Sweden, Switzerland, and the United Kingdom. Of the EFTA members, only Denmark, Norway, and the United Kingdom have applied for membership in the European Community.

Expanded Community and Its Preferential Trading Partners



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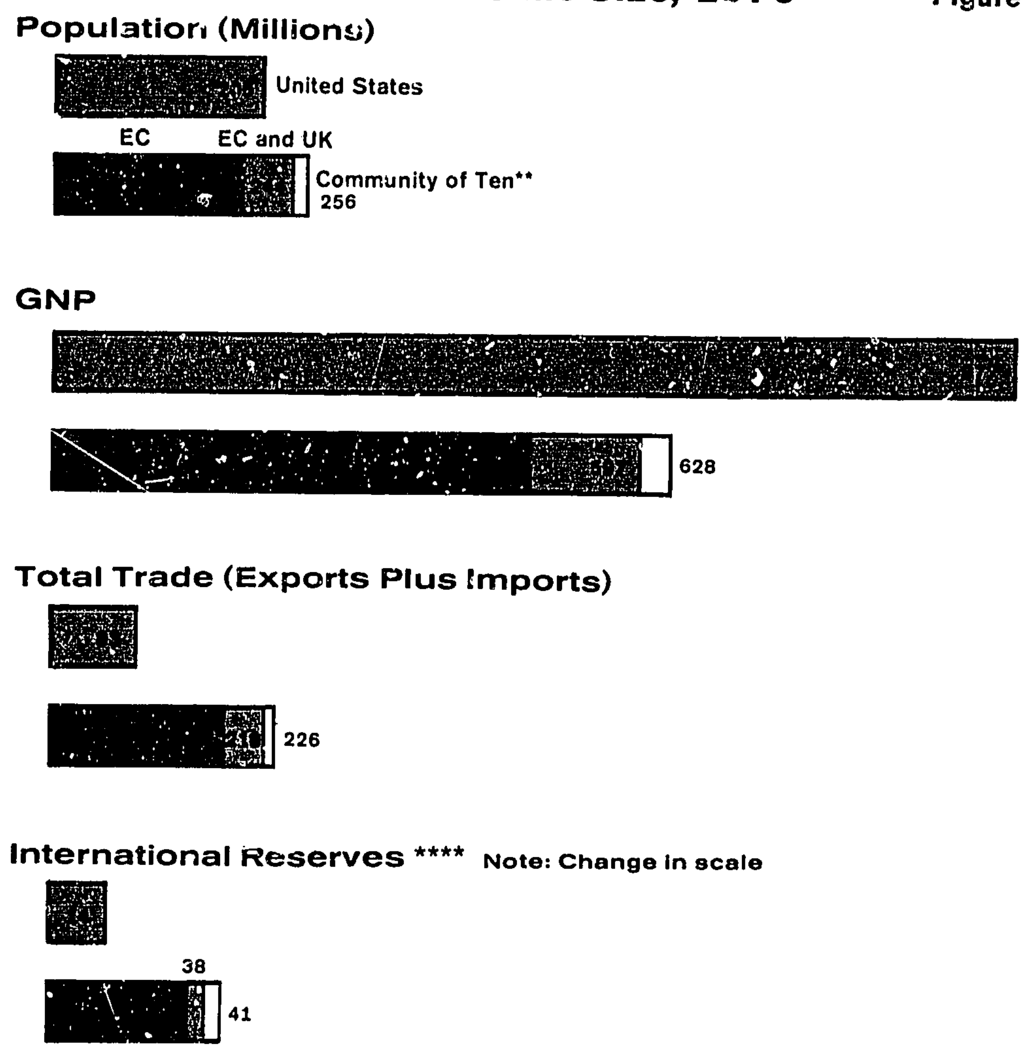
EC and US: Relative Economic Size,*1970

Figure 1



*In billion US dollars unless otherwise indicated

**EC, UK, Denmark, Ireland, and Norway

***Includes intra-EC trade

****April 1971. Gold, SDR's, reserve position in the IMF and foreign exchange

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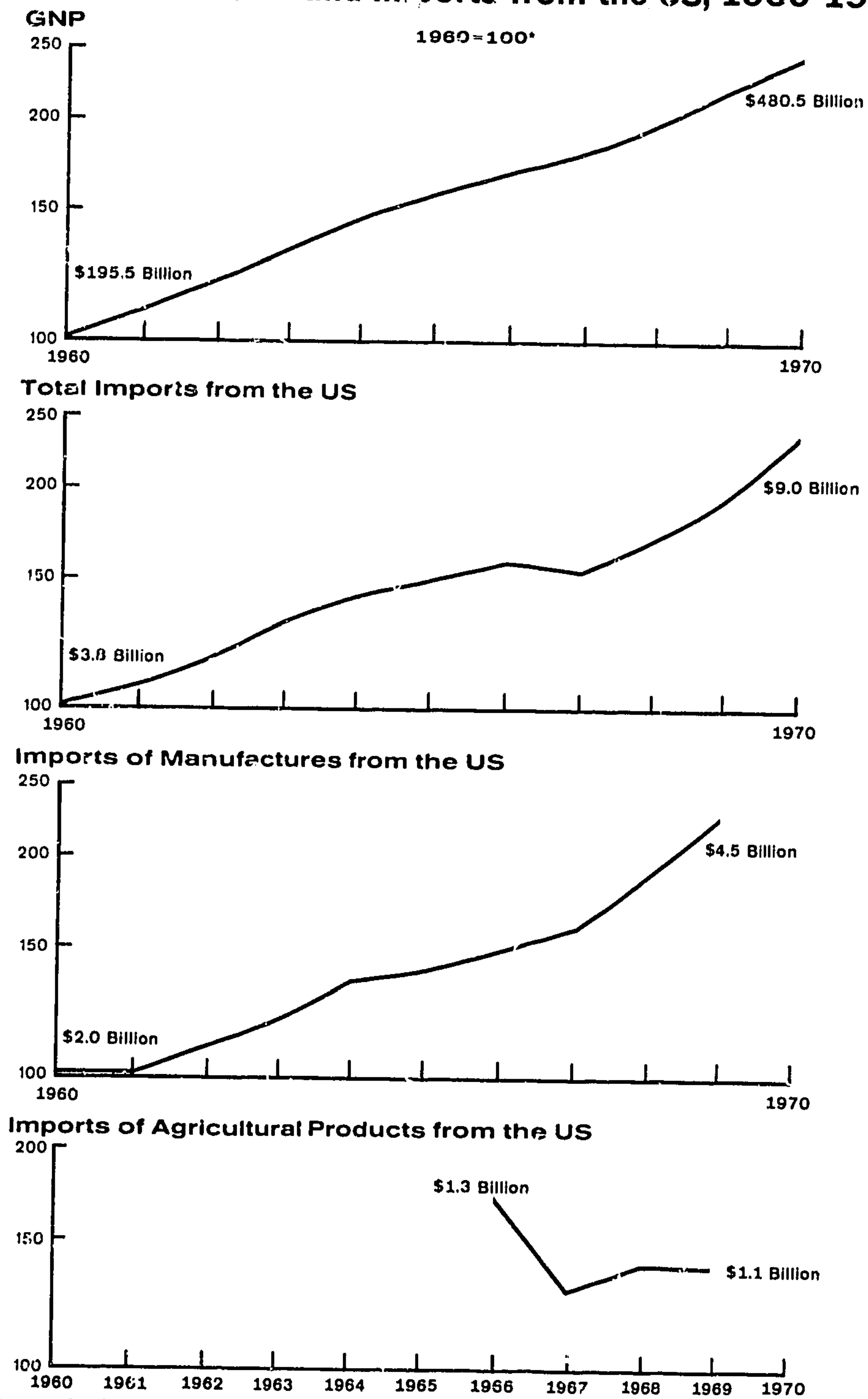
Figure 2

EC: Growth in GNP and Imports from the US, 1960-1970



*Except for imports of agricultural products, where 1966=170, the GNP index for that year. 1966 was the last year before widespread implementation of the CAP.

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The ten's international reserves now exceed $40 billion, a sum more than 2.8 times the US level.

5. The Community is not a supra-national state with the ability to marshal all its economic resources in support of supra-national objectives. It is, however, a virtually complete customs union with a common external tariff (CXT), complete internal free trade among members, and a Common Agricultural Policy. It has also gone part way toward becoming a common market and since July 1968 the free movement of labor has been guaranteed. After a five-year transitional period the four new members would be fully integrated.

6. In addition to broadening geographically the EC plans to substantially deepen the degree of its economic integration. The six have embarked on programs to harmonize their indirect taxation systems, to abolish restrictions on capital movements, and to insure the right of establishment and to provide services. The members are also seeking to develop European-wide industrial policies and to harmonize their energy policies. The Community hopes to ultimately achieve the long-range goal, agreed to at the Hague Summit in December 1969, of economic and monetary union. Bonn's decision to float the mark, however, has temporarily halted progress in the latter area, although some of the parallel steps toward coordination of policies for business cycles have been initiated.

How American Interests Have Fared

7. Intra-EC trade grew from $20.3 billion in 1960 to $86.1 billion in 1970, or from 10% to 18% of Community GNP. Trade with non-Community members has also grown rapidly. Community imports from the United States grew from $3.8 billion in 1960 to $9 billion in 1970 (see Figure 2). The Community's share of world trade, excluding intra-EC trade, has remained relatively constant at about 17%.

8. How American non-agricultural exports -- crude materials and fuels and manufactured products -- to the six member states would have fared in the Community's absence cannot be determined,

but it does not appear that a substantial trade loss has occurred. Community tariffs on minerals and fuels are generally very low, and for many products the member states have little productive potential. US mineral and fuel exports consequently have probably not been adversely affected by the Community's formation.

9. US manufactured exports -- about 65% of our sales to the six -- clearly benefited from rapid growth in the six, which may, in part, be attributable to the existence of the Community. They grew from $2 billion in 1960 to $4.5 billion in 1969 -- a substantially faster growth than for total US manufactured exports. As a consequence, the EC's share of our exports of manufactures rose from 15% in 1960 to 17% in 1969.

10. The strong US export performance for manufactures also reflects tariff reduction in the six member states. The relatively high French and Italian tariffs were adjusted downward to conform with the requirement of Article 24 of the General Agreement on Tariffs and Trade (GATT) that a customs union's external tariff be no higher than the weighted average of the pre-union tariffs of the member states. For non-agricultural products, the CXT itself was reduced by about one-half as a result of the Dillon (1958-60) and Kennedy Rounds (1962-67) of tariff negotiations. When the very substantial Kennedy Round cuts become fully effective in January 1972 the CXT for non-agricultural items will average only about 8% -- approximately the US level and about 2 percentage points less than UK tariffs. Moreover, Community tariffs also tend to be concentrated in the range below 10%. Only 17% of the Brussels Tariff Nomenclature (BTN) product categories will be covered by Community tariffs higher than 10%, once the Kennedy Round cuts are fully implemented, and only 0.2% of the product categories will be covered by tariffs above 20%. In contrast, 32% of the BTN product categories will be covered by US tariffs in excess of 10%, and 7% will be covered by US tariffs above 20%.

11. EC policy has had a marked impact on US agricultural exports. The CAP, implemented for

most products by 1967 although continuing to be expanded, provides a high level of protection for most temperate zone agricultural products, but without production controls. For most of these products, particularly grains, there is a complex system of internal support prices. Import levies apply to most CAP products to shield the domestic market from competition. These levies essentially raise import prices to a level well above world market prices. Although general inflation and an implicit freeze in the support prices for the three-year period 1967/68-1970/71 reduced the spread, Community prices are still substantially above UK and world market prices (see Figure 3). Moreover, the Community increased prices for the 1971/72 crop year, and the spread will again widen. The effect of high support prices is to raise farm income, increase output, reduce imports, and shift consumption patterns. Community surpluses are often disposed of through subsidized export in normal commercial channels.

12. According to one estimate, US agricultural exports to the Community were about $250 million 3/ smaller than they would have been if the existing national systems had continued. EC agricultural imports from the United States declined from $1.3 billion 4/ in calendar year 1966 to $1.1 billion in calendar year 1969. Although exports recovered in 1970 to the 1966 level, this was largely due to unfavorable weather conditions in Europe. US exports to the United Kingdom and other developed countries also declined in the period as subsidized EC exports displaced US sales.

13. The CAP's effect on our agricultural exports has been concentrated in a few products. US grain exports were hard hit, declining from

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3. This widely quoted estimate was developed in a Brookings Institution study.

4. Standard International Trade Classification (SITC) sections zero, one, and four; excludes certain products classified by the Department of Agriculture as agricultural products. The Department of Agriculture estimates that US exports of agricultural products to the EC declined from $1.6 billion in 1966 to $1.3 billion in 1969.

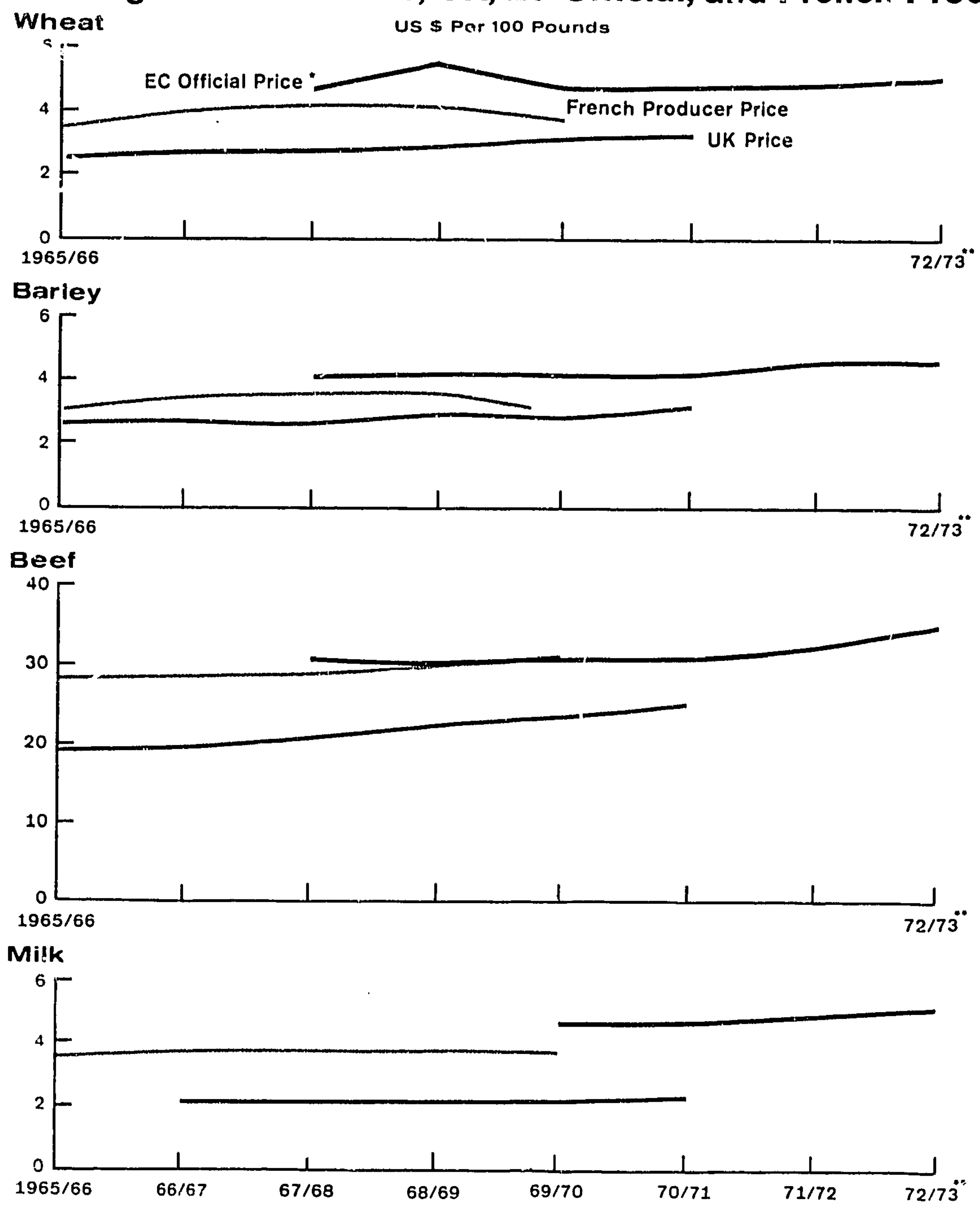
$503 million in 1966 to $316 million in 1969. Poultry exports have dried up, and like wheat, third market sales were hurt by subsidized EC exports. US soybean sales, however, have been sustained since high Community grain prices encourage the substitution of high-energy feed and protein supplements such as soybean for grain in animal feed. There is no internal support price for soybeans (the Community produces few soybeans) and duty free entry is guaranteed under a GATT binding. US soybean exports to the Community were approximately $277 million in 1969.

14. In the aggregate, our trade, current account, and basic balances with the Community have been favorable (see Table 1). In 1970 the United States had a merchandise trade surplus with the six of over $1.7 billion, compared with a $1.2 billion deficit with Japan and a $1.4 billion deficit with Canada (see Figure 4). 5/ The US current account balance with the Community was not as large as the trade balance because of US deficits on transportation and travel accounts and US military expenditure in Europe, which more than offset investment earnings of over $1.1 billion. The current account surplus with the six accounted for 52% of the total US current account surplus in 1970. The flow of US investment to the Community has tapered off in recent years, in part because of US controls, and in 1970 there was a net inflow of long-term capital from the Community to the United States. The US bilateral basic balance with the Community consequently showed a surplus in 1970 of $532 million, in contrast to our very substantial world-total basic balance deficit of $2.3 billion.

15. It is very difficult to arrive at a net
25X6 judgment as to the past impact of the EC on US economic interests. Estimating the future impact

Figure 3

Selected Agricultural Prices, UK, EC Official, and French Producer



*EC target price. Absence of an entry in earlier years indicates that single market stage not yet begun.

**EC Commission proposal, not yet approved by EC Council

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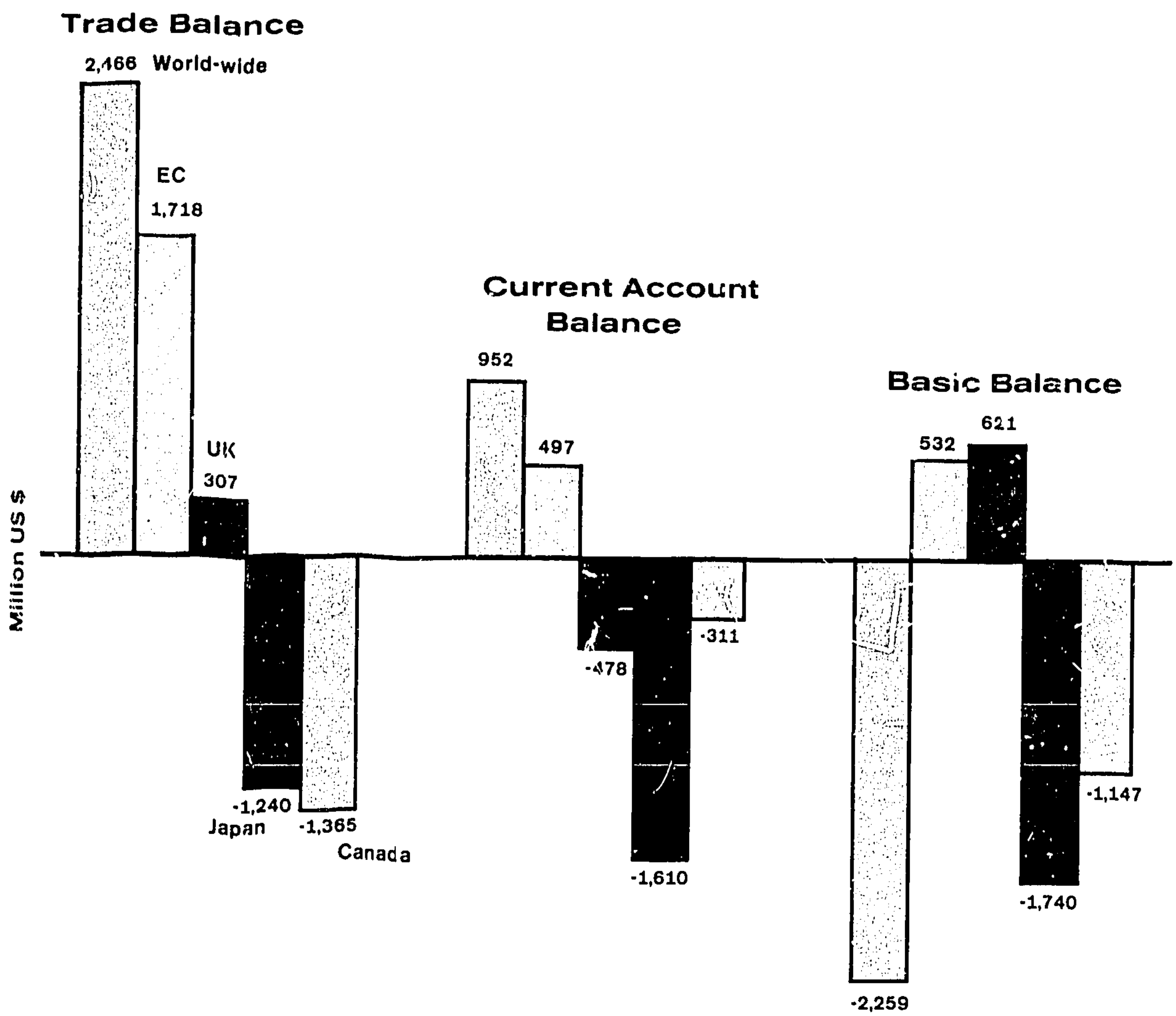
US Trade, Current Account and Basic Balances, World-wide and with EC, UK, Japan, and Canada,* 1970

Figure 4



*CIA Estimates. 25X1

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Table 1

US Balance of Payments with the European Community

Million US $

	1966	1967	1968	1969	1970
Trade balance	1,305	803	150	1,045	1,718
Exports	5,412	5,278	6,066	6,873	8,369
Imports	-4,107	-4,475	-5,916	-5,828	-6,651
Transportation (net)	-227	-211	8	15	39
Travel and passenger fares (net)	-303	-283	-497	-582	-676
Investment earnings (net)	70	15	290	164	314
Other service receipts and transfers (net)	665	694	414	484	387
Current account balance, excluding military	1,510	1,018	365	1,126	1,782
Military expenditure (net)	-1,127	-1,109	-1,087	-1,172	-1,285
Current account balance	383	-91	-722	-46	497
Long-term capital (net)	-369	-240	1,641	1,771	35
Basic balance	14	-331	919	1,725	532

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of Community enlargement is, of course, even more difficult. Some forces set in motion by enlargement are likely to hinder, whereas others are likely to help US exports, investment, and other interests.

Impact of Enlargement on US Trade

16. As a consequence of enlargement, the United Kingdom and the three other applicant countries, will adopt the commercial policies and regulations of the EC. Tariffs among the United Kingdom, the three other applicants, and the EC, will be reduced in stages and complete internal free trade will exist in a Ccommunity of ten by 1978. Simultaneously, British external tariffs will be adjusted downward to the generally lower CXT; Danish, Irish, and Norwegian tariffs will be adjusted upward; and some further adjustment may be made in the CXT itself to conform with the GATT Article 24 requirement that a customs union's tariff be no higher than the average of the pre-union tariffs. The British will also phase out their Commonwealth preferences and lose the reverse preferences they now receive in the developed Commonwealth countries. With enlargement, the CAP will also be extended to a Community of ten and the applicants will adopt the agricultural prices and import levies of the EC.

17. The problem in estimating the impact of these changes on US trade is that the magnitude, and even the direction, of some of the more important potential changes is unknown. The principal clearly defined commitments of the new members concern tariffs and acceptance of the CAP. History and economic analysis indicate that the net impact of these well defined changes on US exports (see Table 2) will probably be relatively small. For US exports of crude materials and fuels there should be little if any impact, because EC tariffs on such products are generally very low. For manufactured products it is unclear whether the net impact will be positive or negative, although some machinery and chemical exports may be hard hit. For agricultural products the impact will be more serious, but still not large in the aggregate. The trade loss will likely be concentrated in grains and possibly tobacco. EC enlargement

Table 2

US Balance of Trade with the European Community, the United Kingdom, and Community of Ten a/
1969

Million US $

	EC	United Kingdom	Community of Ten
Total US exports (f.o.b.)	6,873	1,970	9,106
Of which:			
Exports of crude materials and fuels b/	1,189	188	1,448
Exports of manufactures	4,501	1,435	6,245
Exports of agricultural products	940	331	1,349
Total US imports (f.o.b.)	-5,828	-2,121	-8,454
Trade balance	1,045	-151	652

a. The European Community, the United Kingdom, Denmark, Ireland, and Norway.
b. Standard International Trade Classification (SITC), sections two and three, including under crude materials certain products classified by the Department of Agriculture as agricultural products.

does have potentially serious implications for US trade (and our other economic interests) but only in the long term and under certain conditions. The development of an EC industrial policy, for example, could seriously impair US exports of high technology manufactures. These are areas, however, in which enlargement involves no policy commitment. Wide differences exist among the present EC members, and the evolution and influence of UK policy is uncertain.

Impact on US Non-Agricultural Exports

18. US exports of many manufactures may be hurt by the elimination of tariff barriers between the six and the new members but the overall net impact will almost certainly be small, probably even smaller than the past effect of the very substantial tariff discrimination caused by the formation of the EC and EFTA.

19. US net losses in manufactured exports to a Community of ten due to the tariff changes brought about by enlargement are estimated to be about $150 million annually at the end of the transitional period. 6/ This low estimate reflects the low CXT average tariff level, the low incidence of high tariff rates in the CXT, and the downward adjustment in UK tariffs as part of the alignment to the CXT. This adjustment should stimulate US exports to the United Kingdom just as the adjustment in French and Italian tariffs stimulated US exports to France and Italy. The phasing out of UK preferences to the developed Commonwealth countries should provide a further boost to US sales. Danish, Irish, and Norwegian tariffs, however, will increase with the alignment to the CXT, and US manufactured exports to these markets will probably be hurt somewhat.

20. The $150 million trade loss estimate does not include the impact of tariff changes on US

6. This estimate was prepared by the Department of State in conjunction with National Security Study Memorandum (NSSM) 79. Although sensitive to the assumptions made about the effect of price changes on the quantity demanded, we believe the estimate to be reasonable.

manufactured exports to non-EC countries. As indicated below, US exports to the present EFTA countries which are not applying for EC membership 7/ could be affected rather severely by a free trade arrangement for industrial products. On the other hand, US exports to developed Commonwealth countries are expected to increase as the reverse preferences these countries grant the UK are phased out.

21. The estimate also does not consider the possibility that EC enlargement will stimulate growth in the member countries of an enlarged Community, particularly in the United Kingdom. The expectation that UK growth will accelerate is indeed one of the main reasons why the British government has opted for entry. Higher income will mean greater total imports of manufactures, including greater imports from the United States. US gains from more rapid economic growth in an enlarged community thus could offset US losses resulting from greater tariff discrimination.

22. Although the net overall effect should be small, specific US exports will be hard hit. About half of the estimated trade loss will occur in the machinery sector, and another 40% in chemicals. US exports of paper and paperboard products could also be seriously damaged, depending on the arrangement worked out with the EFTA non-applicants.

23. After enlargement, EC competitiveness both in the United States and in third markets is likely to grow. The enlarged Community will permit manufactures to realize increased economies of scale. To the extent that the productivity increases result in decreases in product prices, enlargement will make European manufacturers more competitive with US producers in the US market and in third-country markets. Britain's introduction of a value added tax (VAT), similar to that employed in the EC, 8/ should boost British exports because

7. Austria, Finland, Iceland, Portugal, Sweden, and Switzerland are not applying for membership.
8. Although facilitating entry, the VAT was to be introduced in the United Kingdom regardless of the outcome of the accession negotiations.

the tax, unlike the direct taxes on which Britain mainly relies at present, may be rebated to exporters under GATT rules. Part of the resulting stimulus, however, will be offset by the inflationary effect in the United Kingdom of higher food prices directly related to the adoption of the CAP.

24. Possible moves of the Community toward a more integrated system including the development of an industrial policy could eventually have a large impact on US exports, particularly exports of high-technology manufactures. We depend partly on growing exports of high-technology products (roughly half of our total world exports), particularly aircraft and computers, to maintain our international trade position. The economic size of an enlarged Community and its enhanced technical capabilities as a result of enlargement, will encourage the trend toward greater self-sufficiency in advanced manufactures. Spokesmen in the United Kingdom and the six have emphasized that enlargement will facilitate the development of European companies with the capability to challenge American technical superiority.

25. A closely related potential problem is government and quasi-government procurement policy in the Community. Substituting a "buy Europe" program for existing "buy national" programs and implementing plans to provide a technology development subsidy in government procurement contracts, would seriously impair US exports of high-technology manufactures. If an element of discrimination is introduced against European companies that are American owned, US investment earnings would also be reduced.

26. But these problems, while potentially serious, may not become so. In the past, member states have found it extremely difficult to effectively cooperate in the production of high-technology manufactures. Problems have arisen over the division of responsibility and the allocation of contracts. Even if the organizational problems are overcome, there is a great difference between decision and implementation. Relative technical backwardness will continue to hinder a European challenge to American technical superiority.

27. More basically, it is far from certain how Community policies will evolve. The long-run impact of Community industrial policy, and the resulting non-tariff barriers on US exports of manufactures, will depend on the focus the Community chooses in the face of US initiatives -- whether it will be outward or inward looking. An outward-looking industrial policy -- a policy that standardized industrial practices but without discrimination -- would probably benefit US sales. In the past, the United States has counted on British accession strengthening the outward-looking forces in the Community, but this result is not certain, particularly for industrial policy.

28. The Community has attempted to allay US fears over enlargement. The last US-EC consultation on 10 and 11 June was certainly the most productive to date. The EC Commission reported on the status of the proposed EC industrial policy, emphasizing the non-discriminatory intent and content of the policy being considered. The Commission also indicated that government procurement linked to development contracts would only be used on a temporary and limited basis to foster development of an infant industry or specialized product. Although specific attention in the US-EC consultation was focused on bilateral problems over agricultural trade, the Community did express a willingness to negotiate with the United States on the removal of non-tariff barriers for manufactured goods. The United States has asked that industrial policy be on the agenda for the next round of US-EC talks, which will probably take place this fall, and expects that the new high-level trade committee of the Organization for Economic Cooperation and Development (OECD) will also consider the issue in an effort to develop a negotiating strategy (probably within the GATT framework) for negotiations on the removal of non-tariff barriers to trade.

Impact on US Agricultural Exports

29. Extension of the CAP to the United Kingdom and the three other applicant countries will have an adverse impact on US agricultural exports during the transitional period, but over the long run

the impact will depend on the level and pattern of Community agricultural prices. The principal effect will be in grains, where higher Community prices (see Figure 3) will lead to increased production and reduced consumption in the applicant countries. Although extension of the CAP is also likely to reduce meat and dairy imports into an enlarged Community, US exports of these products are small. Recently adopted EC regulations on tobacco and inclusion of Greece and Turkey in a protected market with the United Kingdom could endanger US sales of tobacco in the important UK market after enlargement. US fruit and vegetable exports to the ten are likely to be little affected.

30. The trend in continental Europe since World War II has been toward increased self-sufficiency in grain and livestock production. The EC's CAP has perpetuated this trend. Since the early 1960s, UK policy has been to selectively expand domestic farm output to displace imports. The recent British decision to rely more on the variable import levy for price support, facilitates the transition to the CAP as well as serving other objectives. Total grain production has been rising steadily in the applicant countries and the EC, and grain imports into the ten will decline with or without entry. Intra-European grain trade has increased substantially, especially exports from France to other European countries.

31. The net annual loss in third-country grain exports as a consequence of an unadjusted extension of the CAP to Denmark, Ireland, Norway, and the United Kingdom is estimated to be about 6 million metric tons of grain at the end of the transitional period ($360 million in grain exports, at $60 a ton). In the absence of enlargement, the ten member states would be expected to import about 3 million tons of grain in 1978. With enlargement the ten will have a grain surplus of about 2 to 3 million tons. The 6-million ton swing in their net grain trading position as a result of enlargement is due both to increased production and to reduced consumption. Because of higher grain prices, oilseed products will be substituted for grain in animal feed, and grain consumption will decline by about 3 million tons.

32. US grain exports to the ten -- about 7 million tons valued at $400 million in 1969 -- will decline substantially as a result of the projected shift in the grain trading position, although the United States will continue to export some hard wheat and other specialized grain varieties in which the enlarged Community will have a production deficiency. US grain exports to third markets, particularly in Europe, will also be reduced, as the Community is likely to seek to dispose of its surpluses through subsidized export. The United States will also face increased competition from other grain exporters.

33. The loss in US grain sales will be partly offset by gains in sales of soybean and other protein supplements for use in animal feed. EC imports of oilseeds are expected to increase by about 1.3 million tons after enlargement. If US exports grow in proportion to the present US market share, the United States will be exporting about 4.8 million tons of soybean, valued at $465 million, to the ten member states in 1978, compared with $340 million in 1969.

34. The recent introduction of a tobacco CAP appears to have damaged US tobacco exports to the six (319 million pounds valued at $330 million were exported in 1969; this declined 11 million pounds in 1970); its extension to an enlarged Community and inclusion of Greece and Turkey -- two prime competitors -- in a protected market with the United Kingdom is consequently viewed with concern. The Community maintains that the tobacco CAP, which provides for a buyer's premium on purchases of EC tobacco, will not lead to increased production. Evidence indicates, however, that Community tobacco production, including production of burley tobacco, is likely to increase significantly in 1971. US-EC consultations on tobacco have so far failed to resolve US difficulties with the tobacco CAP. Although the issue could be resolved before enlargement, this seems unlikely. The United States has the option of seeking recourse through GATT. If the problem is not resolved, and the tobacco CAP is extended to the United Kingdom, $147 million in

tobacco exports to the United Kingdom will be potentially endangered. 9/

35. Enlargement *per se* is likely to have little net adverse impact on US fruit and vegetable exports -- US sales to the ten totaled $143 million in 1969 -- although extension of Community preferences may damage the US position somewhat. Enlargement is likely to lead to increased US exports of certain canned fruit products, since South Africa and Australia, the United States' leading competitors in the British market, will lose the Commonwealth preferences they now receive in the United Kingdom. US exports of certain fresh fruits and frozen and dehydrated vegetables, however, are likely to be reduced, as growing Spanish, Greek, Turkish, and Israeli competition -- aided by preferential trade arrangements -- displace US exports.

36. The impact on US trade of the CAP's extension to a Community of ten will depend, over the long run, on the level and pattern of Community agricultural prices. British entry will probably strengthen the forces in the Community that favor a more open agriculture, with prices closer to world market prices, although the expected growth in British agricultural production could generate increased internal political pressures in the United Kingdom to maintain farm income. The EC Commission had, until last year, been relatively successful in avoiding substantial increases in EC agricultural prices. Therefore, a commission decision on 16 June to propose that agricultural prices be increased by about 3% for the 1972/73 crop year is disturbing. In the long run, however, the divergence between EC and world agricultural prices could narrow as the size of the European farm population continues to decline and possibly its political influence wanes.

9. Although the British market has a taste preference for Virginia flue-cured tobacco (grown primarily in the southern United States and Southern Rhodesia) prospective changes in UK legislation will permit the use of additives in non-Virginia tobacco to duplicate Virginia flue-cured taste.

Impact of Enlargement on US Investment

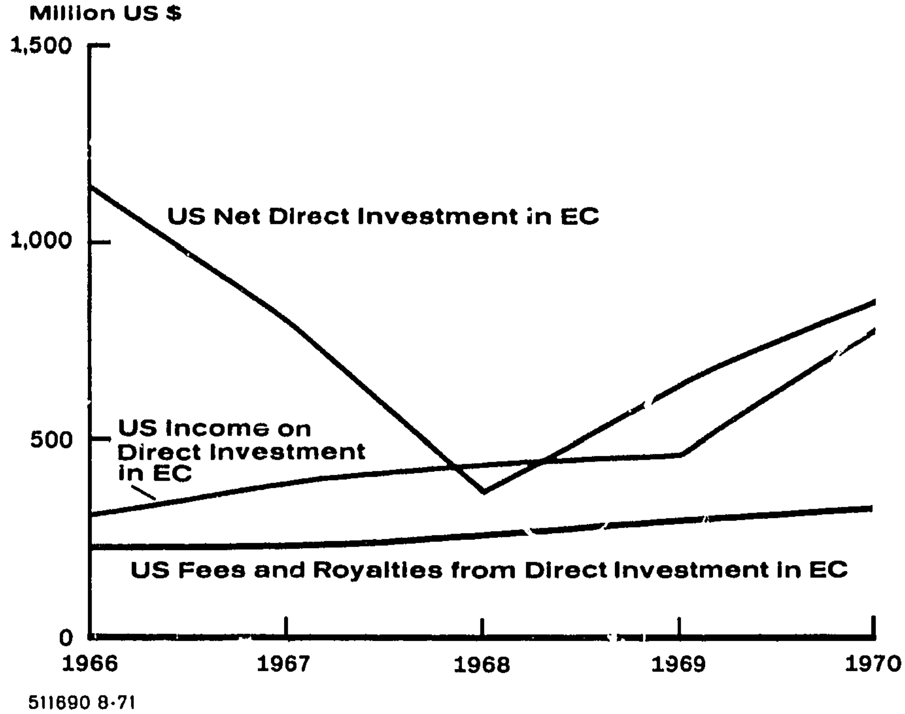
37. A Community of ten should boost US investment earnings. American affiliates in the EC and the applicant countries are particularly well placed to take advantage of enlargement. US multinational firms have existing plants and facilities both in the United Kingdom and in the EC so they will be able to realize gains in efficiency through specialization and exploitation of economies of scale. US multinational corporations -- firms such as IBM, Xerox, IT&T, and Ford -- should have a competitive advantage over West European firms in operating in a larger market.

38. But the greater economic size of an enlarged Community and its enhanced technical capability could encourage discrimination against US investment, and consequently inhibit the growth in earnings. The French would like the EC to place restrictions on third-country investment where this investment does not bring in new technology, and, as noted above, third-country access could become a problem in government procurement and the granting of government development contracts. The EC Commission, however, is challenging third-country discrimination, and the provision in the Treaty of Rome -- that all companies duly registered in any member state (including third country subsidiaries) be treated equally throughout the Community -- will be extended to the applicant countries upon enlargement. British accession will probably reinforce the Commission's position as well as the relatively liberal attitude toward foreign investment prevailing in Germany, Belgium, and the Netherlands.

39. Although US investment in the EC and the applicant countries has continued to grow, the investment outflow is now more than offset by earnings from previous investments. Income from previous investment, including interest, dividends, and branch earnings has risen steadily, while the outflow of new investment has been inhibited by restrictions designed to improve US balance-of-payments performance. US income on direct investment in the EC, including fees and royalties, totaled more than $1.1 billion in 1970, compared with a net outflow of new direct investment of about

$850 million (see Figure 5). US income on direct investment in the United Kingdom totaled $624 million, and the net outflow of new direct investment equaled $642 million.

EC and US: Investment Flows **Figure 5**



40. US firms are embarking on a new round of expansion in Europe, the magnitude of which will depend partly on the dynamism of the enlarged market, and on European attitudes and policies towards such investment. Although the formation of the EC stimulated a flow of American investment in the early 1960s, the situation now is not analogous. American firms already have substantial resources in Europe, and will probably make use of their retained earnings to expand plant capacity.

41. Enlargement is likely to reduce the flow of investment from the Community of ten to the United States as European firms seek to consolidate their position in an enlarged market. In the long run, however, the experience these firms acquire in multinational operation could increase their interest in investing here.

<u>Impact of Enlargement on the US Role in the International Monetary System</u>

42. The impact of enlargement on the US role in the international monetary system will depend on the specific accords still to be reached by the United Kingdom and the six and on the subsequent course for monetary integration charted by an enlarged Community. During the transitional period the principal monetary consideration is whether sterling will be able to withstand the short-run balance-of-payments cost of UK entry. In the long run the decline in the reserve role of the dollar could be accelerated by moves toward a common Community currency.

25X6 43. If sterling should come under pressure because of the foreign-exchange cost of entry -- [redacted] the United Kingdom would have to consider defensive measures, both external and internal, which would affect US, as well as Community, interests. 25X6

44. In the long run, enlargement will create international pressure for monetary reform. 10/ London has agreed in the enlargement negotiations to gradually run down foreign, officially held, sterling balances, now totaling about $6 billion (less than 7% of total official world liquidity), although sterling's role as a reserve currency would decline in any event. A successful withdrawal of sterling as a reserve currency could increase the demand for dollars but it also could

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[redacted]

generate added pressure to devise a new monetary system not dependent on either sterling or the dollar.

45. The EC has embarked upon a program designed to attain economic and monetary union by 1980. Under the program, money and capital markets are to be integrated, a common currency (*de facto* or *de jure*) developed, and possibly a federal central bank created. Difficult problems remain, however, since monetary union involves close economic coordination and a consequent loss of national autonomy. An enlarged Community, making use of the facilities and expertise of the British financial market (the City), could probably operate a common reserve currency at least within the EC and associated states. The ultimate merging of the City and the financial markets of the six member states, will create a large European market, with facilities rivaling those available in the United States. Any common currency unit that would be constructed on this broader economic base would compete with the US dollar as an international transactions currency as well as a reserve currency. Moreover, an enlarged Community -- if it speaks with one voice -- will be even a more powerful influence in international negotiations to reform the monetary system. A major question will be how to reconcile increased monetary integration in the Community with the apparent need for greater flexibility in the international monetary system.

EC Enlargement and the EFTA Non-Applicants

46. Enlargement of the Community to include the United Kingdom, Denmark, Ireland, and Norway would break up EFTA. Barring special arrangements, new Community members would raise duties against their former partners, and thus some kind of special accommodation between an enlarged EC and the EFTA non-candidates has been envisioned from the outset of the enlargement negotiations.

47. The EC Council of Ministers almost certainly will elect to establish free trade with the EFTA non-applicants, although a decision is not likely until fall. The free trade arrangement would probably include industrial products, but exclude

arrangements in the agricultural sector, harmonization of commercial and economic policies, and any institutional links. The arrangement would run for five years at which time it would be reviewed.

48. To establish free trade, agreements will be negotiated between the enlarged Community and the non-applicants. Special arrangements could be made to deal with the specific trade interests of each of the non-applicants. Several of the non-applicants, particularly Sweden and Switzerland, had hoped for an agreement with broader scope, so it is likely that further special arrangements outside the industrial trade field may also be negotiated on an individual basis. The EC and several of the non-applicants are particularly interested in establishing preferential arrangements for agriculture.

49. US manufactured exports would be adversely affected by a free trade arrangement for industrial products. The net adverse effect on US manufactured exports to a Community of ten of the tariff changes concomitant with enlargement and the establishment of an industrial free trade area is estimated to be about $300 million annually at the end of the transitional period, 11/ nearly twice the trade loss as in the case of enlargement alone. US exports to the present Community members would decline the most as tariffs are eliminated for the first time between the six and the non-applicants. US exports to the EFTA non-applicants would also decline, because the exports of the six would have preferred access in the Austrian, Finnish, Icelandic, Portuguese, Swedish, and Swiss markets. US losses resulting from greater tariff discrimination, however, could be offset in part by US gains from more rapid economic growth.

50. A free trade arrangement for industrial products would have little or no adverse impact on US exports of agricultural products and of minerals and fuels, on US investment earnings, and on the US role in the international monetary system, because the existing policies and attitudes of the EFTA non-applicants, in this area, would probably be unaffected.

11. This estimate was prepared by the Department of State in conjunction with NSSM 79.

An industrial free trade arrangement, however, could generate pressure for even closer economic ties between the non-applicants and an enlarged Community, particularly in agriculture. If closer economic ties were to develop, this could impose additional costs on the United States.

Impact of Enlargement on Preferential Trade 12/

51. The EC has entered into preferential trade agreements with a widening group of developing countries (see the map). Agreements are now in effect with 30 states (see Table 3). Under the agreements, the signatory nations mutually reduce tariffs and quantitative restrictions applicable to trade between them. The United States has opposed most of these agreements on the grounds that they are inconsistent with the most favored nation (MFN) principle -- a key tenet both of GATT and of US trade policy.

52. The Community denies that its preferential arrangements conflict with GATT and has indicated that it will maintain the current agreements and continue to make new ones. No formal GATT Council decision has been taken on the legality of any EC preferential agreement. Working parties' reports and GATT Council discussions concerning the agreements have only taken note of various countries' criticisms and reservations. Working party reports on the Spanish and Israeli agreements are now being prepared for the GATT Council's consideration, but only the US and a few others are likely to raise strong objections to continued proliferation.

53. Thus far, the preferential trade agreements have not led to widespread or serious dislocation of US trade. The special preferences have not significantly reduced total US sales to the EC, since the United States competes against the present preferential trading partners with regard to only a few products. US sales of items subject to damage from EC special preferences and the reverse preferences the EC receives, it is estimated, accounted for less

25X1

Table 3

European Community: Preferential Agreements

	Date of Initial Agreement
AASM a/ (18 independent African countries that were colonial dependencies in 1958)	Provided for in Rome Treaty
Netherlands Antilles	
Surinam	
Greece	9 Jul 1961
Turkey	12 Sep 1963
Morocco	31 Mar 1969
Tunisia	31 Mar 1969
East Africa (Kenya, Uganda, and Tanzania)	26 Jul 1969
Israel	29 Jun 1970
Spain	29 Jun 1970
Malta	5 Dec 1970

Candidates for Agreements Under Terms of UK Accession

Barbados	Mauritius
Botswana	Nigeria
Fiji	Sierra Leone
The Gambia	Swaziland
Guyana	Trinidad and Tobago
Ghana	Tonga
Jamaica	Western Samoa
Lesotho	Zambia
Malawi	

a. Associated African States and Malagasy; Burundi, Cameroon, Central African Republic, Chad, Congo (Kinshasa), Congo (Brazzaville), Dahomey, Gabon, Ivory Coast, Malagasy Republic, Mali, Mauritania, Niger, Rwanda, Senegal, Somali Republic, Togo, and Upper Volta.

than $1.3 billion in US sales to the EC and its current preferential trading partners in 1969. 13/ The actual US trade loss has been significant only for a very small portion of the items potentially affected by preferences.

54. The special preferences granted by the enlarged Community will not significantly reduce total US sales to the ten, since the United States competes against the preferential trading partners with respect to only a few products. Only US exports of semi-tropical agricultural products, particularly citrus, are likely to be damaged. Moreover, the Community has made special arrangements favorable to US citrus fruit during the US export season. A problem for US trade interests, however, would arise if the enlarged Community insisted on receiving reverse preferences from its new preferential trading partners. Our exports -- mainly manufactures and temperate zone agricultural products -- to the Commonwealth Caribbean countries total about $500 million annually, and are growing. If the exports of an enlarged Community received discriminatory preferences in this market, traditional US sales of manufactures and temperate zone agricultural products would probably be damaged.

Conclusions

55. The impact on the United States of an EC expanded to include the United Kingdom, Denmark, Norway, and Ireland will largely depend on the long-term evolution of European policies, and can be influenced by the United States. The economic changes to which the new members will be committed should not in themselves have much overall effect on US trade. Particular US exports, however, may be adversely affected, notably grain, perhaps tobacco, and possibly a variety of machinery and chemical products.

56. EC expansion is unlikely to cause serious economic problems for the United States in the next

13. CIA estimate. [redacted] 25X1

25X1 [redacted]

few years. As has been the case since the Treaty of Rome was signed, the impact of European integration will be mixed. Tariff discrimination will hurt some US exports, but if the Community grows faster, this will help US exports. The extension of the Community's Common Agricultural Policy will induce shifts in production and demand, the net affect of which will be to reduce US agricultural exports somewhat.

57. The economic implications of a deepening of the degree of economic integration in an enlarged Community are potentially serious but may not become so. Clearly, however, development of a common EC industrial policy could impair US exports of high technology manufactures. Financial cooperation among Community members will doubtless play a role in further reducing the international role of the dollar. Moreover, the very size and strength of an expanded Community will encourage other policies designed to achieve greater independence from the United States.

58. Community enlargement will contribute substantially to the proliferation of Community preferential trade agreements. A free trade area for industrial products will probably be established with the EFTA non-applicants, and special preferences will be extended to the developing Commonwealth countries in the Caribbean and Africa. Aside from weakening the MFN principle, this proliferation will probably impair some US trade interests.