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the twentieth century via the intensive integration of newly industrialising countries via displacement competition.³⁵ Secondly, in view of the unavoidable problems of employment in the course of the re-allocation process (neo-protectionism), a satisfactory mix of substitutive and complementary industrial trade flows that can cushion the international structural changes and permit consensus in place of conflict is of great importance.³⁶ That this may be easier to achieve regionally rather than worldwide is a plausible hypothesis that is being discussed seriously in East Asia. Reservations about an undesired hierarchical division of labour, with Japan as the leading power and growth pole can be allayed partly by the argument that vertical relationships within this dynamic flying geese formation are not considered as rigid or permanent.³⁷ In broad terms, this means that the process of graduation must allow upward mobility so that all member states can

climb the ladder in the international (regional) division of labour.

There is, however, one more weighty objection based on the limitations to regional policy and processes. This is whether the flying geese model can achieve equilibrium only if there is *extra-regional* interchange, in other words whether the regional engine must also have an external "vent for surplus".³⁸ What happens if, to maintain the goose metaphor, it is no longer sufficient for the head of the bird (Japan) to stretch forwards (to the USA) but must *also* be tucked into the bird's own plumage (East Asia)? Can worldwide imbalances resulting, for example, from East Asia's export-surplus-led growth strategy be *relieved* by an intensification and differentiation of intra-regional trade? This aspect is the only one that counts; there can be no question of choosing in principle between regionalism and multilateralism.

GERMANY

Paul J. J. Welfens*

International Effects of German Unification

The merger of the two German states brings together countries with divergent economic systems, different trade orientations and a rift in terms of wealth. Transforming the East German system into a social market economy raises enormous internal and external adjustment problems in a period in which West Germany already faces the challenges of the EC 1992 project and European Monetary Union. German unification reinforces concentration tendencies and protectionist tendencies that will contribute to imperfect competition processes in Europe and the global economy.

The merger of the two Germanies is changing the European landscape and has considerable international effects. Integrating the East German socialist economy into the West German social market economy requires major internal adjustments, and Germany's existing trade orientations and policy patterns are likely to change as well in the 1990s. Moreover, in the enlarged Germany direct and indirect concentration effects in industry reinforce the tendencies for cross-border mergers and company alliances in oligopolistic markets of the EC.

Will a united Germany contribute to further EC integration in the real and monetary sphere? Will it continue the important role as a protagonist of free trade, the role West Germany has played in the postwar international order? Can Germany be an economic bridge between the EC and Eastern Europe? These are some of the questions posed following German unification, the impact of which has many economic aspects as it entails the merging of two different economic systems and regions: West Germany, a social market economy built upon private property, Schumpeterian competition in markets, and free enterprise – all incorporated in a sophisticated welfare state system; and East Germany, which represents the failure of the socialist command

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economy – not only in Germany but in Eastern Europe and the USSR as well.¹ The system design opposed individualism and political pluralism, and strongly emphasized “static” equality (hence state-administered low prices for many goods), technological progress “from above” and the virtues of the centralized state as well as the unity of economic and social policy.²

Intra-German Economic Division

The economic facts reveal the contradictions between ambition and reality as well as significant intra-German differences:³

□ The 16.7 million people of East Germany, which is less densely populated than West Germany, have a monthly income which is only about 1/3 of that in West Germany. The East German gross national product thus represented about 10 percent of that in West Germany in 1990.

□ Private households in the GDR had minimal access to modern communication and less than 10 percent of private households in the GDR enjoyed the amenity of a telephone and hence immediate access to national and international communication. Dwelling space available in the GDR was less than in West Germany, and qualitatively it was inferior to West German housing – a result of a policy which aimed to supply goods at low prices to everybody, but ended up at producing less for all.

□ In East Germany monetary wealth per capita amounted to about 19 percent of West Germany's levels, with the discrepancy being much greater if non-monetary assets (consumer durables and real estate) are included.

□ The East German manufacturing sector is not only oversized in comparison with the West German market economy, but it is also much less productive and trails behind the productivity levels of Spain and most Asian NICs. Part of this inefficiency is due to the capital stock which is much older than in West Germany, where only about 5% of the capital stock is more than 20 years old compared to 21% in East Germany: modernization is urgent.⁴

□ The savings rate of private households in the GDR was only half as high as that in the Federal Republic of Germany which implies in view of an intra-German income differential of 1 : 3 an enormous absolute divergence in the average savings, with the average West German citizen saving more than 5 times that of his East German counterpart. While the intra-German income gap can be reduced within a decade or so, the different positions in per capita wealth in West and East Germany will persist much longer.

□ East Germany will have to integrate into the international division of labour which implies reduced trade links with the Council of Mutual Economic Assistance. Under the socialist regime a strong CMEA orientation of trade was observed. About 70 percent of exports was with the countries of the Council of Mutual Economic Assistance, the lion's share going to the USSR. The CMEA practised a monopolistic intra-bloc division of labour – emphasizing static economies of scale – which was neither conducive to intra-industry trade nor allowed for dynamic structural change in which market entry and industry exit would have been observed.

□ West Germany's exports were strongly oriented towards the EC which accounted for nearly 55 percent of exports and 2/3 of the trade surplus in the late 1980s. The East German trade orientation towards the EC was weak, and only 6 percent of exports went to this region. Bilateralism and multiple exchange rates dominated and distorted the trade relations among CMEA members. With unification East German industry becomes subject to the EC framework and the rules of GATT and IMF.

The implications of German unification for internal economic policies in Germany and the formation of EC policies in Bonn and Brussels respectively could be considerable. As regards the perception of the EC Commission the problems of German unification are not considered to be serious; moreover, the stimulative impulses for EC growth – already fostered by EC 1992 – are emphasized, while the financial net burden for the EC member countries is estimated to reach manageable amounts, that is about ECU one billion per year. Finally, the integration of East Germany into the EC is even viewed as

¹ On the demise of the socialist system cf. K. Bolz (ed.): *Die Wirtschaft der osteuropäischen Länder an der Wende zu den 90er Jahren*, Hamburg 1990; D. Cassel, (ed.): *Wirtschaftssysteme im Umbruch*, München 1990; UN Commission for Europe: *Economic Reforms in the European Centrally Planned Economies*, New York 1990; P. J. J. Welfens, L. Balcerowicz (eds.): *Innovationsdynamik im Systemvergleich*, Heidelberg 1988.

² A detailed comparative analysis of the GDR and the FRG is given in *Ministerium für Innerdeutsche Beziehungen: Bericht zur Lage der Nation im geteilten Deutschland*, Bonn 1986. For a comprehensive analysis of German unification see P. J. J. Welfens (ed.): *Economic Aspects of German Unification*, Baltimore 1991.

³ See P. J. J. Welfens: *EC Integration and Economic Reforms in CMEA Countries: Germany as a Bridge Between East and West?*, paper presented at the conference on Economic Aspects of German Unification, American Institute for Contemporary German Studies, Washington D.C., Nov. 13-14, 1990.

⁴ For further analysis see C. Schnabel: *Structural Adjustment and Privatization in East German Industry*, paper presented at the conference on Economic Aspects of German Unification, American Institute for Contemporary German Studies, Washington D.C., Nov. 13-14, 1990.

providing a new bridge for East-West trade. The EC Commission notes: "The macroeconomic impact of German monetary, economic and social union on the rest of Europe will be significant and positive. The changing balance between demand and supply within the Union will affect trade flows and savings in partner countries ... In the longer run, it can be expected that the beneficial effects anticipated from the single market will be reinforced ... Given the relatively high integration of the GDR economy into the East European economies, the GDR can act as a bridge between the Community and Eastern Europe."⁵

Indeed the question arises whether German unification does not contribute to increased EC protectionism in various fields and to specific economic problems within Europe at the same time. The international community will watch closely whether the new Germany means to sustain West Germany's positive role in Europe.

In the postwar period West Germany has played a vital role: it has been (i) a politically stable ally, notably for France; (ii) a major source and host country of foreign direct investment – hence a prime contributor to internationalizing competition; (iii) a defender of free trade and capital flows in the international economic summits; (iv) an eager protagonist of real and monetary EC integration, where the Bundesbank's monetary leadership provided the basis for the EC-wide downward inflation convergence and the success of the European Monetary System after 1982; (v) an early advocate of detente as well as economic reforms in the CMEA countries, where most governments expect support in their difficult market-oriented reform processes and positive impulses from German unity – high economic growth as an impulse for higher growth, an easing of technology trade in a less strict Cocom framework and the opening up of markets for new suppliers from the East.

Less Industrial Dynamics?

With the merger of the two Germanies much is at stake for the international position of Germany and its relations with major partners in Europe. This is due to enormous economic adjustment burdens and a shift of political preferences as a consequence of integrating East German citizens in their roles as voters, consumers, entrepreneurs and civil servants respectively. East Germany's 16 million inhabitants – representing about 22 percent of the all-German electorate – are primarily protestant, often inward-oriented and so far rarely exposed to international influences, be they in the form of multinational companies, tourism, trade or migrant workers. With a share of 11 percent of the labour force working in agriculture (compared with 4.5 percent in the FRG) and 47.1 percent

in industry (39.6 in 1989 in the FRG), the former GDR was a country in which industry and agriculture were still dominant.

With about 25 percent of the labour force working for one of the 8000 firms grouped in the state holding agency "Treuhandanstalt", the required structural adjustment in East Germany will be a tremendous internal problem as well as an international challenge. Most firms are non-competitive in terms of productivity, product diversity and output quality, so that considerable start-up and adjustment financing from the German government will be needed if the envisaged dismemberment of the huge combines (conglomerates) and the privatization of firms is to be achieved. Will the privatization schemes adopted discriminate against foreign investors and thereby contribute to reduced competition in Germany which in turn could trigger defensive mergers and acquisitions in other OECD countries such that global competition and Schumpeterian innovation dynamics are impaired?

Without a rapid privatization of manufacturing industry in Eastern Germany, its inherent inefficiencies cannot be overcome, nor can a viable service sector be created similar to that which has been growing in OECD countries not only because of the modern welfare state, but even more so because of the rapid outsourcing of sophisticated industry-oriented services.

In East Germany – and in Eastern Europe and the USSR – a modern service industry was lacking, as were differentiated products, which are so important for the international competition process in the OECD countries. Even more important: due to systemic reasons entrepreneurial behaviour in the sense of dynamic decentralized adjustment and active marketing or pricing strategies were largely unknown in East Germany and in the remaining CMEA countries. With the German-German economic, social and monetary union of July 1, 1990, East German consumers were free to spend their new convertible DM on goods from the GDR, West Germany and any other country in the world. The better quality and greater variety obtainable in the West led to rapidly rising import penetration rates in East Germany and forced East German firms to sell their narrow range of products at lower prices.⁶ Consequently, there was an acceleration of the liquidity crisis in most East German firms, which have

⁵ EC Commission: The Community and German Unification, Vol. 1 (COM (90) 400), Brussels, August 21, 1990, p. 15.

⁶ In a Lancaster approach to consumer satisfaction individuals will accept a differentiated "non-ideal" product only at a lower price compared to a brand which exactly matches the desired characteristics. See K. Lancaster: A new Approach to Consumer Theory, in: Journal of Political Economy, Vol. 74 (1966), pp. 132-157.

to modernize rapidly in a new internationally open market environment. External competitive pressure is enormous, since German unification is occurring in a period in which the single EC market is being created, so that any market in the EC—including now those in Eastern Germany—can be served from any production location in the EC.

In the intra-EC quest for jobs and economic growth Spain, Portugal and Ireland enjoy growing productivity but wages that are as low, or lower, than in the former GDR with its increasing wage pressure after German unification on October 3, 1990. If Eastern Germany does not become an attractive production location for domestic and foreign investors, high and sustained unemployment in the former GDR and politico-economic tensions in the whole of Germany are to be expected.

Fear of Inflation

The State Treaty that established German monetary union on July 1, 1990 between two structurally different economies means that the state-independent Deutsche Bundesbank assumes full responsibility for monetary policy control. The Bundesbank can be expected to attempt decidedly to maintain its long record of low inflation rates. German unification might, however, change political preferences in the sense that in a conflict between price stability and full employment, the latter goal may receive higher priority. Ambitious to close the East-West intra-German income gap, East German voters and public authorities will emphasize creating and maintaining employment and increasing incomes.

The introduction of internal market competition, the elimination of very high excise taxes on luxury items—a common price strategy in the former GDR—and full access to world markets will reduce the prices of many consumer goods in Eastern Germany. However, an increase in many traditionally low prices to the higher West German level is to be expected soon because certain price subsidies are being phased out, wage claims are rapidly rising and asset prices as well as interest rates are increasing. Labour and consumer mobility will contribute in combination with price arbitrage to an increasing price level in Eastern Germany—not to be confused with inflation in the whole of Germany.

The traditional anxiety of West Germans, who consider an annual inflation rate of 3-4 percent as the maximum tolerable inflation, will hardly change after German unity, although medium-term conflicts between the unemployment goal and the goal of price stability are more likely to emerge. Moreover, a shift in the position of the

median voter could raise the politically acceptable inflation rate in Germany for quite some time. The other EC countries always considered the strong anti-inflation priority of German central bankers and the German public to be exceptional. But it is also true that the disappointing experiences with inflationary demand policies in the 1970s have generally supported policy views in the OECD that emphasize the various advantages of low inflation rates and consistent supply-side policies.⁷ The Bundesbank enjoys a high reputation in West Germany and the government in Bonn has always been active in seeking good relations with the central bank. But the unification process might shift the balance of power in favour of the Ministry of Finance in Bonn, whose expenditure decisions might become increasingly important in a period of economic restructuring.

Growing Inward Orientation

Fear of unemployment is widespread in East Germany, which not only faces the problem of outdated state enterprises but also has to reduce the number of civil servants. With a labour force of about 8.5 million and huge structural adjustment pressures resulting from the transition to a market economy a rise in the number of unemployed from 1.8 million (figure for the FRG in mid-1990) to more than three million could result in Germany in the 1990s. This will not only strain Germany's financial resources but could lead to new social conflicts. Moreover, in the course of rising unemployment German politics could become more inward-oriented, protectionist and unstable.

At stake is the social consensus in (West) Germany which has always been a particular asset of the social market economy model. With a successful legacy of postwar reconstruction and the integration of some 12 million refugees and expellees in the 1950s, the German market economy should, however, be capable of coping with the problems at hand.

With labour productivity reaching one-third of West German levels and with working attitudes shaped by socialism, the transformation to a market economy will be both a shock and an opportunity. The privatization of outdated East German industry will entail lay-offs of more than one million workers. The provision of new jobs by creating additional enterprises in industry and the service sector is therefore crucial. Moreover, public investment is badly needed to modernize East Germany, and most of this will have to be financed on credit.

⁷ G. Fels, G. von Furstenberg (eds.): *A supply-side Agenda for Germany*, Heidelberg 1989; P. J. J. Welfens: *Theorie und Praxis angebotsorientierter Stabilitätspolitik*, Baden-Baden 1985.

A rapid rise of public deficits in Germany will raise interest rates not only in Germany, but in all financial markets worldwide. Politico-economic instability in Germany is a long-term risk faced by Europe; the medium-term impact is, rather, a greater volatility in international capital flows – reacting to changes in Germany and potential unrest in Eastern Europe – and changing international trade orientations.

Opportunities for Trade and Investment

In a situation in which East Germans want to catch up with the level and patterns of West German consumption and in which there will be a huge demand for public and possibly less so, for private investment in East Germany countries with strong trade and investment links with West Germany are in a good position (see Table 1).

Those countries which are major exporters to West Germany so far are the ones which stand to benefit most from German unification. In the EC the Netherlands, Denmark, Belgium, France, Portugal, Greece and Italy expect positive growth effects, as do Austria and Switzerland. If Eastern European growth benefits from German unification in the medium term, countries with a relatively high CMEA share of trade will benefit as well, whereby Italy, Greece and Austria – along with Germany – are the countries that can be expected to gain the most.

In the very long term, one might hope that Eastern Europe would not diverge too much from Western Europe, so that prospective winners from a successful East European transition to a market economy could be identified from the present ranking of market shares in Western Europe. Since capital requirements in East Germany are enormous, net exporters of capital goods in Western Europe stand to gain considerably. West Germany, Ireland, the UK, Italy and Switzerland will benefit from the extra investment demand in Germany in the 1990s.

Since East Germany will adopt the FRG's political and economic system, knowledge about West German markets, business practices and institutions is most valuable, so that German and foreign firms producing in West Germany are most likely to benefit from the switch to the social market economy in East Germany. The restructuring and development of East Germany will therefore also involve subsidiaries of foreign multinationals in (West)Germany. If one assumes that they will maintain their per capita capital stock in Germany they would have to provide within a once-and-for-all adjustment move (over several years) DM 29 billion and would create some 420 000 jobs directly, bringing the total

number of employees in foreign controlled firms to 1.9 million.

Under this assumption, the USA, Switzerland, the Netherlands, the UK, Japan and France would be the major investors if the country shares for Germany in 1988 persist: 32.6, 14.7, 12.1, 10.3, 7.3 and 6.3 percent were the respective shares for these six countries, which account for more than two thirds of Germany's inward FDI. A mirror aspect related to Germany's FDI is that subsidiaries abroad will undertake less new investments and instead support higher investment in Germany by transitorily increasing profit transfers to the parent company (or drawing less on intra-company loans).

East Germany should not be expected to become a permanently disadvantaged German Mezzogiorno. With massive public investment, the full mobility of production factors in Germany and the prosperous West Berlin, located in the midst of East Germany, as an economic growth pole, no long-term economic division of Germany is to be expected. The continuous long-term wage pressure to be expected from German trade unions will help to accelerate productivity growth in East Germany, but it remains unclear whether or not additional unemployment risks will be created by rapidly rising unit labour costs. The quest for employment has intensified in the whole of Europe since the EC adopted the 1992 programme to create a single market and since the East European countries turned to market-based systems which will end

Table 1
Trade and Investment Links with
West Germany 1988/89*

	% of total exports to West Eastern Germany Europe		Net exports of capital goods (% in GDP)	Share in FDI stock in FRG
West Germany			5.0	3.9
EC				35.1
Netherlands	27	1.8	-1.6	12.1
Denmark	18	2.0	0.0	1.0
Belgium ¹	18	1.2	-2.2	2.1
France	17	2.0	-0.3	6.3
Portugal	17	3.3	–	–
Greece	17	6.5	–	–
Italy	16	7.1	1.0	2.1
UK	12	1.8	0.2	10.3
Spain	12	2.8	–	0.3
Ireland	11	1.3	6.3	–
Switzerland	21	4.1	4.1	14.7
Austria	31	11.9	-0.4	1.4

*Shares for FDI (foreign direct investment; stock values) are for 1988.

¹Including Luxembourg.

Sources: Statistische Beihefte zu den Monatsberichten der Deutschen Bundesbank, Reihe 3, April 1990; OECD: Internal Data Sources, Paris; own calculations.

the system-endemic tendencies of socialist economies to create excess demand for labour.

The EC Facing Germany's Unification

If one takes into account the relative dimensions of the EC and the former GDR, the integration of East Germany into West Germany and the Community should not be considered a major problem. However, German unification takes place at a very critical stage of EC integration. Since July 1990 all major countries have removed capital controls, which makes intra-EC capital flows generally more "foot-loose"; the first stage of the economic and monetary union is being realized and with the inclusion of the UK into the exchange rate mechanism of the EMS significant exchange-rate risks are no longer separating European capital flows. Capital flows are, not least, accelerated by further technological progress, the institutional integration of national markets and the increasing role of "Euronationals" with their competitive financing schemes designed to support the build-up of cross-border networks of production for the EC market.

The quest for jobs, investment and taxes is now taking place in an EC-wide context because the 1992 project implies that the whole EC market can be served from each EC country or each region in Western Europe. EC 1992 will have considerable microeconomic and macroeconomic effects, where intensified intra-EC competition and a greater importance of economies of scale in integrated markets are major medium-term changes to be expected.⁸

The high German current account surplus recorded mainly vis-à-vis other EC countries has temporarily benefitted from the increasing demand for investment goods, which represent about 50 percent of West German exports, and the highest demand coming from countries with great competitive adjustment pressures. Due to the huge restructuring needs in East Germany, exports from West Germany will decrease and imports by united Germany increase. East German imports from Eastern Europe are likely to shrink for some time because the whole CMEA trade network was centered around Soviet needs, shaped by political interference and distorted by socialist systems which misread the international division of labour as growing monopolistic specialization among CMEA countries.

For the EC countries with high public debts – Italy, Belgium, Portugal and Greece (as well as Spain, but to a lesser degree) – higher interest rates will have considerable impacts. Restructuring their economies, which face the adjustment pressures caused by the EC 1992 project, will become more difficult as both

government and private investors face higher credit costs. One can imagine that these countries regard German unification with reservation. This holds all the more because they face new competitors in East Germany and because they already fear that German unification means a drag on EC regional funds in favour of East Germany.

Higher economic growth in West Germany as a consequence of GEMU and unification as well as the proceeds to be expected from privatizing East German industry will help limit the borrowing requirements of public authorities to 3-4 percent of GNP. But the privatization of the some 8000 East German companies that are grouped in a state holding company ("Treuhandaanstalt") is proceeding only slowly. Less than 10 percent of these firms will have been privatized by mid-1991. To date foreign firms have faced particular obstacles in their attempts to buy into some major East German companies. In dealing with a state holding company domestic firms often exploit their superior contacts to the government bureaucracy. Finally, the privatization of East German industry is difficult because dynamic efficiency gains can be expected only if the average firm size is reduced. The dismemberment of the former state combines will take time and would be endogenously supported by a process in which newly created enterprises would make outsourcing profitable on the one hand, and, on the other hand, create attractive jobs and positions to be filled by those which would have to be laid off in industry.

Consequences for European Monetary Integration

A more powerful and more inward oriented Germany could become especially hesitant to support further monetary integration. This would be a serious drawback to EC integration because a common monetary policy under a government-independent EC central bank could be the only visible integration process that could in principle be achieved at all in the 1990s.

The Bundesbank and its monetary policy in the EC's fixed exchange rate system play a crucial role at present. Low inflation rates and a strong economy allowed the Bundesbank to exert monetary leadership in the EC and to contribute to a strong downward inflation rate convergence in Western Europe in the second half of the 1980s.⁹ This was welcomed by most EC central banks

⁸ H. Siebert (ed.): *The Completion of the Internal Market*, Tübingen 1990. On the dynamics of the EC integration process and the internationalization of industry see also P. J. J. Welfens: *Internationalization of the Economy and Economic Policies*, Heidelberg 1991; O. G. Mayer, H.-E. Scharrer, H.-J. Schmahl (eds.): *Der Europäische Binnenmarkt*, Hamburg 1989.

⁹ Cf. P. J. J. Welfens (ed.): *European Monetary Integration. From German Dominance to an EC Central Bank*, Heidelberg 1991; M. De Cecco, A. Giovanni (eds.): *A European Central Bank?*, Cambridge 1989.

which followed the restrictive policy of the Bundesbank in the early 1980s, but fearing higher unemployment and weaker polls, not all governments were happy with the loss of policy autonomy resulting from this arrangement.

If the politically acceptable inflation rate should rise in Germany, this might help to achieve monetary convergence in Europe to the extent that a harmonization of inflation goals is an important element of policy convergence. At the same time East German voters – who gladly embraced the stable and convertible DM in exchange for their GDR mark – are likely to reinforce the resistance of those in (West)Germany who oppose the establishment of an EC currency and the loss of national policy autonomy in such major fields as monetary and fiscal policy. Fortunately, inflationary domestic pressures resulting from high capacity utilization are counter-balanced by the real appreciation of the DM, the competitive pressure of EC 1992 and – in the short term – moderate wage pressures in those industries in which cheap labour from East Germany has an impact upon trade union behaviour. The European Community embarked on July 1, 1990, on the first stage of EMU, where the objective is to coordinate more strongly the economic and monetary policies of the EC member countries. After the Rome EC summit of October 28, the second stage of EMU is envisioned to be realized in 1994.

In October 1990 the UK joined the exchange rate mechanism and thereby became a full-fledged member of the European Monetary System (EMS). For the British economy – as well as other EC countries – the adjustment pressure is the heavier, the stricter Germany sticks to its goal of price stability.

After German unification it is an open question whether or not inflation rate convergence will be achieved at higher average EC inflation rates. The EMS now has two major currencies: the DM which might increasingly become subject to speculative capital inflows focusing on Germany's particular exposure to Eastern Europe, and the British pound which is a major international vehicle currency that is subject to the high volatility of international capital flows going through London. The small ± 2.25 percent standard exchange rate margin (± 6 percent for the pound and the peseta) could turn out to be too narrow in the 1990s so that a transition to parity interlocking and the switch to a convertible ECU issued by an EC central bank could become more difficult. The Bundesbank's monetary leadership could be eroded in such a situation. Indeed, Germany-related uncertainties could lead to speculative

attacks on the DM, and new fears of higher inflation and rising interest rates could lead to a new increase in exchange rate volatility.

Eastern Europe is undergoing risky market-oriented reforms and comprehensive opening up efforts.¹⁰ For Germany's East European neighbours, Poland, Hungary and Czechoslovakia, high interest rates could be a particular problem in the transition stage to a market-based system; on the other hand, the Polish economy and the whole of Eastern Europe will benefit from increasing demand from East Germany, where prices are approaching the high West German level. Prices and wages in Eastern Europe are still relatively low, which improves export prospects. If East German per capita incomes could reach the West German level in the 1990s Germany's imports from Poland and the other East European economies should rapidly increase. In the long term a united Germany could be a most attractive market for both West and East European countries; it certainly will remain a leading world exporter.

The Soviet Union's regional trade structure – long distorted by the socialist command economy approach – will become more focused on the EC. This will happen for two reasons. First, as of January 1, 1991, the settlement of balances between CMEA countries will be in convertible Western currencies instead of "convertible rubles"; the USSR's persistent lack of hard currency earnings will reduce CMEA trade. Second, the transition to a market economy in East European countries means that trade patterns will no longer be shaped by political considerations but by the nations' comparative advantages – trade with OECD countries will therefore increase.

The GDR accounted for roughly 10 percent of Soviet exports and imports, slightly less than the whole EC in which West Germany accounted for nearly half the trade volume. Even if East German trade with the USSR should decline, the EC and a united Germany in particular would be by far the most important trading partner for the Soviet Union; this holds for the small Eastern European countries as well.

Integration of Eastern Europe

The European Community has just embarked upon an ambitious internal liberalization programme that will create a single EC market by the end of 1992 and intends to realize the free intra-EC flow of goods and services, capital and labour. Even if the East German economy catches up only gradually with West Germany, one can expect an increasing economic division of Europe for quite some time. The economic frontier will run along the German-

¹⁰ D. Lipton, J. Sachs: Creating a Market Economy in Eastern Europe: The Case of Poland, paper presented at the Brookings Institution, forthcoming; UN Commission for Europe, op. cit.

Polish border. Modernizing East German industry will lead temporarily to high unemployment rates and an intensified quest for jobs and incomes within Germany. At the same time the Polish economy (among others in Eastern Europe) is undergoing a transformation towards a market economy in which many jobs in agriculture and industry will be lost, and in which privatization and currency convertibility will create new opportunities for investment and employment growth.

The EC 1992 principles of a free flow of capital and labour pose a specific German-Polish problem with considerable international side-effects. While Poland is not ready to accept the free inflow of German capital ("fear of German dominance") – unavoidable in the case of Polish EC membership – Germany is not ready to accept the mass immigration of Polish workers which would certainly be triggered by the combination of geographic proximity, existing large Polish expatriate communities in Germany and high income differentials.

Fear of unemployment will create a climate that is not receptive to foreigners coming into (East)Germany. British support in favour of integrating East European countries in the EC will face strong German resistance in the medium term, so that an intra-EC conflict is looming. Fear of mass migration from the Mediterranean countries of Africa (common in France and Italy) and from Eastern Europe could induce the EC to erect higher barriers to immigration in the 1990s.

Trade policies in the EC are quite important for the heavily indebted countries in Eastern Europe and for the USSR because higher exports to Western Europe could become the engine of growth which is so much needed in economies undergoing a complicated period of transformation. Therefore the question is important whether the traditionally relatively liberal EC traders Germany, Denmark, the UK and the Netherlands – blocking protectionist initiatives in the EC – can be expected to continuously support liberal trade in manufacturing goods, the service sector and, possibly, in agriculture.

West Germany has traditionally been an advocate of free trade in the EC. One must, however, not overlook that non-tariff forms of protectionism of industry have spread in Germany no less than in other market economies and that German unification will strengthen protectionism as a consequence of structural adjustment problems in East Germany in the medium term. Moreover, in Germany state-run service providers in the fields of energy, telecommunications and transport represent protectionist forces which may be reinforced with even greater service operations in the context of German unification. Finally,

agricultural protectionism is deeply rooted in West Germany.

German unification will mean adding to the existing agricultural protectionism of West Germany and the EC, respectively, the protectionist impulses that will emanate from the integration of a non-competitive East German farming system. With around 20 percent of their labour force employed in agriculture Poland, Hungary, Rumania and the Soviet Union face a major and increasingly important problem in agricultural exports.

Perspectives

The EC in general, and Germany in particular, has developed a system of variable import levies and large export subsidies which make agricultural exports by Eastern Europe and the USSR (and Latin America) very difficult. The major would-be agricultural exporters in Eastern Europe are also the countries with the highest foreign debt problems in which Germany is involved because of government loans extended to Poland, Hungary and the USSR and because of heavy lending activities by German banks in the 1980s.

In Eastern Europe and the USSR the transformation towards a market economy can hardly succeed if a modernized agricultural sector is not progressively allowed to export its products to the nearest high-income markets: those in Western Europe. The 4 to 9 percent of the labour force employed in agriculture in major EC agricultural exporters have powerful lobbies in the respective capitals as well as in Brussels. German and EC protectionism in textiles and the shoe industry as well as in the automotive industry are areas of concern for potentially higher exports from Eastern Europe's industries. An EC-CMEA free trade agreement for industrial goods – similar to the existing one between the EC and EFTA – could be a first step to liberalizing East-West trade decisively.

Moreover, Western Europe should accelerate structural adjustment towards the higher-valued, technically more sophisticated and specialized industries. Only then could internal market-based reforms plus increasing exports of agricultural products and standardized goods in Eastern Europe and the USSR generate sufficient long-term growth momentum to bring about prosperity and politico-economic stability. The dynamic structural adjustment triggered by EC 1992 should be extended by further European initiatives in the high-tech sector: less by industrial policy programmes of, for example, the ESPRIT type but by creating innovation-conducive market environments, namely by privatizing state-run services and by liberalizing market access for new entrants.

The only advantage of state-owned enterprises might be that East-West technological cooperation might be easier to organize in the service industry if state-owned companies in EC countries and state-run firms in Eastern European economies collaborate. A serious counter-argument would emphasize the dynamic backward linkage and forward linkage effects that could be realized in the reforming CMEA countries if governments decided to embark upon a market-based system by immediately allowing private competition in telecom, energy and water supply, and mass transportation. Thereby, the neglected service industry – in which Western economies face deeply entrenched bureaucratic and business interests – could generate impulses for the modernization of industry whose improving competitiveness would encourage growing East-West trade. To combine economies of scale and dynamic competition the smaller CMEA countries need to cooperate in many fields and might strive for a common regulatory framework.

From a Soviet point of view the German economy is the only major EC country with which reliable long-term relations can be developed. The risk of political preference shifts in the UK and France, most likely in the context of changing security policies and global power rivalry, encourage Gorbachev and any other Soviet leader to first

seek improved relations with a unified Germany. German industry offers nearly all the know-how and products a Soviet Union trying to modernize its economy needs. And finally, one may note that resource-poor Germany provides a huge market for the export of Soviet natural resources, whose share in German commodity imports might rise even further as East-West political antagonism declines while Arab oil sources at the same time become increasingly more problematic.

In a long-term process German unification could ultimately help to lead Russia back to Europe and into the world market economy. However, a comprehensive reform of the CMEA itself would be a necessary element for such a process. The triangular trade EC-Eastern Europe-USSR should be embedded in a true multilateral framework in accordance with GATT principles which, however, should leave room for overlapping regional integration schemes that help to overcome economic nationalism.

While Germany is likely to support "EC deepening" it will almost certainly block any comprehensive EC widening, i.e. a further enlargement of the EC. Since Poland and the other East European countries will have to be treated equally, the German-Polish problems could prevent EC widening for decades. From this perspective one might recommend stronger ties between the EFTA and these countries and possibly the formation of a Baltic Free Trade Area.¹¹ Such a BAFTA might comprise some republics of the USSR as well and could re-establish historical links between the Scandinavian countries, the central European economies and Russia.

After decades in which the integration and internationalization of Western Europe increased while the East-West technological and economic divide accentuated, the formation of a united German state in central Europe raises new fears of nationalism, protectionism and political conflicts in Europe. The German unification process creates adjustment problems in the EC and is likely to lead to a transitory economic policy shift in German politics which will become more inward-oriented, less supportive of rapid monetary integration in the EC and more involved with East European problems. Although desired by the smaller Eastern European countries, access to the EC in the sense of full membership is unlikely for many years to come – and Germany will play a key role in this regard. If EC protectionism is not seriously addressed, increasing new trade distortions will result in the reforming CMEA countries.

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¹¹ Cf. P. J. J. Welfens: Economic Reforms in Eastern Europe: Problems, Options and Opportunities, paper prepared for testimony before the US Senate, Small Business Committee, March 23, 1990.