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The EFTA option for Eastern Europe: Towards an economic reunification of the divided continent

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**The EFTA Option for Eastern Europe:
Towards an Economic Reunification of the
Divided Continent***

by
Wojciech Kostrzewa and
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Institut für Weltwirtschaft an der Universität Kiel
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I. Outline

Eastern Europe is in the midst of a radical change. In order to increase the chances of success of their "Perestroika", the reformers, especially those from Hungary, Poland and the Soviet Union, are striving for closer links between their countries and the economically-advanced Western Europe. Thus, an economic reunification of the divided continent has become a real possibility - unless a misconceived "Internal Market 1992" dashes this chance and leads instead to an isolation of Western Europe from the East.

The purpose of this article is, firstly to demonstrate the importance of the economic relations with the West for the East European reform states, secondly to describe the dangers of a "Single Market 1992" limited to the EC only and thirdly to show a way to a pan-European economic integration. The proposal to overcome the economic division of Europe consists of three key-points: (1) the European Community refrains from the construction of a "Fortress EC" and gives a liberal character to its "Internal Market 1992"; (2) the EC and the European Free Trade Association (EFTA) extend their current mutual free trade agreements for industrial products to the trade of services and to factor movements in such a way that the "Internal Market 1992" includes the EFTA and the EC in all economically relevant domains; and (3) the EFTA invites all the reform states from Eastern Europe fulfilling certain economic conditions to secure themselves free access into the whole west European market by means of joining this revitalized EFTA.

II. The Importance of the West for the Reform States of the East

The reform-oriented states of Eastern Europe are nowadays dependent on an intensive exchange of goods and services, labour and capital, ideas and innovations with the West. A dramatic economic and psychological change has happened during the last thirty years in the socialist countries. At the end of the 1950s, after the "Sputnik shock" had hit the Western world, the ascent

of the "second" communist world and the displacement of the so far "first" capitalist world to a back bench only seemed to be a matter of time. In 1961, the communist party of the Soviet Union even predicted in its programme that the prosperity of the Soviet citizens would already exceed the prosperity of North Americans in 1980 [KPSS, 1961].

However, world communism fell into decline instead of enjoying an economic expansion. Nothing renders this evolution better than the western foreign trade data that cannot be ornamented with tricks. The importance of the East European states in trade with the Western world has been decreasing since the end of the seventies. The decline of the market shares of the Comecon states in exports of "research-intensive" goods of a high technological standard was particularly great [Kostrzewa, 1988]. The already relatively small market shares of Eastern European suppliers in this field fell by one third from 1965 to 1985. Instead of taking the technological lead, the socialist states became technologically backward countries with a commodity structure of foreign trade typical for underdeveloped countries.¹ Even the old position as the "second" world got lost when the Asian newly industrialized countries also proved to be competitive suppliers, especially of research-intensive goods.

The effects of the falling competitiveness of the East European suppliers, of their unfavourable trade structure, and of the slow technological change in Eastern Europe are still being reinforced by the effects of West European integration. The extension of the EC to the south to include Greece, Spain and Portugal as well as the free trade agreements for industrial products

¹ Concerning Comecon exports into the EC and EFTA countries, raw material and raw materials intensive products are dominant; on the other hand, research intensive goods accounted for less than 20 per cent in 1987. For West European exports into the East European countries the situation is very different: the part of the research intensive goods amounted to more than 50 per cent.

between the EC and the EFTA states that came into force at the beginning of 1973 have already caused numerous trade-creating and diverting effects that have had a great influence on the imports from the partner countries outside Western Europe [ECE, 1989]. The East European countries have become the principal victims of the West European integration. In 1986, the trade diversion to the disadvantage of Eastern Europe (without the Soviet Union, with Yugoslavia) amounted to \$ 3.8 billion or 27 per cent of the total East European exports of manufactures into the West European states.²

The danger of a further trade diversion through the completion of the EC Internal Market by the end of 1992 as well as the economic changes in Eastern Europe during the last years explain why reform movements in Eastern Europe see their future in closer links with the West.³

III. The Dangers of a Misconceived Internal Market

Closer economic collaboration between Eastern and Western Europe, which the reformers in the East envisage, requires that Western Europe does not set up any new obstacles for East European exports and abolishes existing trade barriers. Unfortunately, this is not guaranteed at all.

Because of the great importance of EC internal trade, the economic relations between the Community on the one hand, and EFTA and Comecon on the other are far less important for the EC than for its trade partners. Only 10.7 per cent of the exports from EC countries go into the EFTA region and just 2.7 per cent

² However, these figures reflect, apart from the pure trade diversion in a narrow sense, the consequences of the decreasing competitiveness of East European supplier and of exchange-rate modifications [ECE, 1989].

³ Aganbegian (1988), Saslawskaja (1989), Inotai (1989).

Table 1 - The Importance of Intra-European Trade, 1984 and 1988 (in per cent) (a)

	Imports from					
	EC(12)		EFTA(6)		Comecon(7)	
	1984	1988	1984	1988	1984	1988
EC(12)(b)	51,0	57,9	9,4	9,9	4,9	3,1
EFTA(6)	56,9	60,4	13,3	13,1	8,3	4,5
Comecon(7)(b)	15,4	15,9(c)	4,9	5,0(c)	54,3	59,0(c)
	Exports to					
	EC(12)		EFTA(6)		Comecon(7)	
	1984	1988	1984	1988	1984	1988
EC(12)(b)	54,1	59,9	9,8	10,7	3,2	2,7
EFTA(6)	53,6	56,1	13,4	14,1	6,2	5,4
Comecon(7)(b)	19,7	16,3(c)	5,6	4,4(c)	50,1	56,3(c)
(a) Share in total imports/exports. - (b) Including intra-German trade. - (c) 1987, preliminary results.						

Source: GUS [1988]; IMF [var.iss.]; OECD [var.iss.]; SEV [var.iss.]; Statistisches Bundesamt [var.iss.]; VICES [var.iss.]; own calculations.

into the Comecon. By comparison, the EC absorbs 56.1 per cent of the total EFTA exports and 16.3 per cent of the total EFTA exports (Table 1). These imbalances support the wide-spread worry in the Comecon and EFTA states that the EC may pursue its 1992 project without considering the effects on the neighbouring countries, especially on those in Eastern Europe.

Three dangers for the East European reform process would arise from an exclusive internal market reaching no further east than the river Elbe:

- 1) Even if the EC policy towards third countries does not change the Internal Market will inevitably lead to a trade diversion at the expense of the outside world. The abolition of the remaining internal trade barriers for goods and services within the EC will make the partners' markets more easily accessible to suppliers from member states only. Therefore, suppliers from outside will lose market shares.

- 2) Although the White Paper of the EC Commission on the Internal Market (which was approved by the European Council in June 1985) contains a general declaration of mutual recognition of the different national practices and regulations by the member states (Commission, 1985), the Council of Ministers and the Commission are unifying numerous product norms and market regulations within the EC. Nearly 70 per cent of the "1992" directives that the Council of Ministers has adopted so far provide for such a harmonization [Dicke, 1989]. Uniform standards and norms, that are imposed from above without having proven their worth on the market, can easily be misused as barriers to trade.
- 3) Moreover, it is quite possible that the EC will turn itself into a fortress. It is very likely that the lobbies of many branches will make vigorous efforts to cushion the fiercer internal competition through less competitive pressure from outside, i.e. through external protection and internal subsidies from Brussels.

One does not even need to assume that the EC may have been intending from the very beginning to shield itself against competition from Eastern Europe and other countries. The danger is rather that the EC, due to wrong shunting, is putting itself into a situation where protectionist interest groups will easily succeed in getting their wishes accepted. The concrete contents of the "social dimension" of the EC are not yet clear. If this dimension were not to go beyond a "social charter" without any binding obligations, there would be few negative consequences [Paqué, 1989]; on the contrary, if social minimum norms such as the federal union of the German employers' associations and the German federation of trade unions demanded on 26th July in a common declaration [FAZ, 1989] are fixed, the consequences could be grave. For minimum regulations about, for instance, working hours, non-wage labour costs, social charges, dismissal conditions and work protection standards would considerably increase the total labour costs in the poorer EC member countries. To prevent this cost pressure at the periphery of the EC from causing unemployment and the collapse of enterprises, these countries will then forcefully demand (i) protection against external

Table 2: Export competition (a) between EC new members (b) and Comecon countries (c) 1986

	Bulgaria	Czecho-slovakia	GDR	Poland	Romania	Hungary
Greece	39.5	33.6	20.5	41.3	46.2	45.9
Portugal	44.8	46.5	32.9	60.8	60.3	57.4
Spain	31.9	49.9	45.2	51.3	41.7	49.6

(a) Similarity of the commodity structure in the export of manufactured goods in the EC. The coefficients were calculated using: $PS_{ij} = \sum_1 (\min. p_{i1}, p_{j1})$.
The similarity of the product structure (PS) for each pair of countries i and j is derived from the comparison of the share of product 1 in the export from both countries to the EC (9); 95 products (SITC triple-digit of the groups 5 to 8, excl. sub-group 68) were included; a similarity index of 30 is regarded as "relatively high". - (b) Greece, Portugal, and Spain. - (c) excl. USSR.

Source: ECE [1989, p. 68]

competitors and (ii) internal subsidies from the Brussel's regional fund.

Such protectionism would deal a severe blow to those East European countries that need an intensive division of labour with the EC to further their market-orientated reforms. Their level of development and their comparative advantage in the international division of labour correspond to a surprisingly large extent to those of the poorer states of the Community (Table 2).

IV. The EFTA Option for a Pan-European Economic Integration

In the capitals of the East European reform states, politicians and economists are now looking for a way to avoid the danger of a "Fortress EC" and to partake instead of the advantages of the "Internal Market 1992". However, a direct entry of East European countries into an EC with explicit political ambitions is impossible as long as a military antagonism persists between East and West. The Soviet Union's reservations against the entry of neutral Austria into the EC have illustrated this once more [SZ, 1989b]. Therefore, a way of integrating Europe's markets (integration from below) must be found without forcing

governments into a continual cooperation (integration from above). The relation between the EC and the EFTA after 1973 can serve as an example: since the free trade agreements for manufactures in 1973, the EFTA⁴ has become a group of states that can to a large extent enjoy free trade with the EC, without having to take part in the EC's "European Political Cooperation" and the economically and ecologically absurd EC agricultural policy.

An economically vital EFTA without any political ambitions of its own therefore offers the best starting point for the concept of an economic reintegration of Europe: the reform states of Eastern Europe could join such an EFTA a long time before the current political and military differences between the Atlantic and Pacific have completely disappeared one lucky but far-off day.

If the EFTA is to build a bridge between the "Internal Market 1992" and the East European reform movement, both the EC and the EFTA have to prepare the ground today. For the EC, it means the following:

1. The completion of the single market must not lead to any discrimination between suppliers from EC and EFTA states. For this purpose the existing free trade agreements for manufactures between the EC and the EFTA must be extended to factor movements and trade in services⁵, i.e. to those domains in which the Internal Market will imply the greatest progress in comparison with the previous regime.
2. The EC integration must not proceed via a pre-harmonisation of product norms, market regulations and labour laws. An economically nonsensical compulsory harmonisation can already hardly be achieved within the Community; it will not be applicable at

⁴ At present: Austria, Switzerland, Sweden, Norway, Finland and Iceland.

⁵ Senti (1988) has already proposed an "EFTA-EC free trade agreement for services".

all to a multitude of third countries. The EC states should instead opt for the economically sensible country-of-origin principle, i.e. for the mutual recognition of all national norms and rules, provided that the label clearly shows which national standard the offered product or services meet [Giersch, 1987; Siebert, 1989]. The EC should apply the country-of-origin principle to EFTA states as well. If the political opposition against this ambitious Euro-deregulation is too great, the EC should, as the second-best solution, demand from its imports no more than the least restrictive national standard of a member country as a minimum norm.

3. The EC should commit itself to extend these agreements automatically to all the states that are going to join the EFTA in the future.⁶

With this liberal solution the Internal Market would not only include the EC but also the EFTA states in every economically important field - to the advantage of all the participants. As it concerns an unconditional mutual market opening, the reproach of "picking the best of the bunch" towards the EFTA members would be unfounded on economic and trade policy grounds. If these states do not want to partake of the advantages of an "European Political Cooperation", there is no reason to burden them with the costs of programmes with purely political motives (Common Agricultural Policy, EC Social Fund).

V. Minimum Conditions for the EFTA Entry of East European Reform States

The EFTA should on its part define clear conditions as to how far the economic reforms must have progressed in an East European state before this state can join the EFTA. The aim of these conditions should be the compatibility of the economic

⁶ However, special provisions for products for military use are possible and sensible in some cases if these exceptions are known by everybody and applied in a foreseeable way.

system of the old EFTA countries and those of the new members from Eastern Europe. Furthermore, these conditions should promote interest groups within Eastern Europe that are, on the one hand, interested in the continuation and extension of the economic reforms and could, on the other hand, secure the market economic bases of the new economic order by means of accelerating the liberalization process. The private enterprises in services and in industry, the private farmers as well as the enterprises of the public and cooperative sector that are outward oriented belong to such interest groups.

The four indispensable minimum conditions are:

- (i) currency convertibility, at least for trade in goods and services, i.e. on current account;
- (ii) the abolition of the foreign trade monopoly of the state;
- (iii) the legal and factual non-discrimination between private, cooperative and public enterprises; and
- (iv) the freeing of prices at least for internationally tradable goods.

The national currencies of the countries wishing to enter EFTA must become convertible, because "the transition to convertibility is the surest anchor of the market economy" [Röpke, 1954, p. 82]. The domestic convertibility for payments concerning the international trade of goods and services should be guaranteed as the minimum of convertibility. In the long run complete convertibility ought to be striven for. The introduction of convertibility would give rise to important positive effects: (a) a better allocation of scarce foreign currency in the national economy; (b) a productive use of the resources that have so far been used for unproductive "rent seeking" by the enterprises under the regime of exchange controls; (c) better access to imports that is no longer limited by the central allocation of foreign exchange; and (d) the creation of export incentives in line with actual market conditions.

The transition to currency convertibility must be accompanied by a liberalization of foreign trade. The aim of the liberalization measures should be to abolish the foreign trade

monopoly of the socialist state and to forbid the quota restrictions for exports and above all for imports. The greater intensity of competition would speed up the structural change on the strongly monopolized supply side and give an incentive to increase research and innovation activities. An opening of markets would also mean that the conservative interests groups which benefit from the present system (state monopolies, parts of the bureaucracy), would be considerably weakened.

The third minimum condition is the legal and factual non-discrimination between enterprises of every form of ownership (that is to say state, cooperative and private). Private and quasi-private enterprises would react with a considerable expansion to the creation of new export-orientated fields of activity that arise from convertibility plus foreign trade liberalization. Equal treatment of all forms of ownership before the law and in the administrative practice would be an important contribution to enhance the macro-economic elasticity of supply in the Eastern European reform states. The larger this elasticity is, the better the economic reforms can take effect; if this elasticity were small, an improved incentive mechanism could not have much impact either. A large reprivatisation programme of public enterprises could furthermore directly contribute to the diminution of the inflationary pressure ("repressed inflation") [The Economist, 1989]. A sale of small and medium-sized public firms in the industrial and services sectors, a transformation of large state-owned firms into private companies owned by shareholders or a denationalization of the housing market would also enhance efficiency and would at the same time direct financial flows from consumption into investment.

A reform of the price structure, concretely a transition to world market prices for tradable goods and services, is the fourth minimum condition. Without prices that value mobile national resources at their real opportunity costs and imported inputs at their world market price, other reform steps could even lead to a welfare loss to the whole economy. As long as the relative prices differ widely from the factual relative scarcities, the distorted price signals give an incentive to

waste resources. If the enterprises could, without a change in the price structure, adapt themselves better than they have up to now to the prices relevant for them they would, out of their rational calculation, also expand those activities that are profitable for the individual firm but wasteful for the economy as a whole.

VI. Between West Integration and Comecon Interests: The Finnish Example

From the present point of view, the option of joining a revitalized EFTA would be interesting especially for Poland and Hungary and maybe for non-aligned Yugoslavia too. It could furthermore be of considerable interest to the Baltic republics in case they are granted a far-reaching economic autonomy by the central government in Moscow. A status of "special economic zones" could, for instance, turn those states into the places where the Soviet Union experiments with a radical liberalization and privatization. At the same time, this step could enable these states to forge closer economic links with Scandinavia and Western Europe and to become (associated) members of the totally unpolitical EFTA. A substantial economic autonomy from Moscow coupled with an entry into EFTA could thus accommodate the national aspirations of the Baltic republics without jeopardizing the political and military cohesion of the Soviet Union as a whole.

However, one first has to discuss the question if East European countries wishing reforms would actually be able to accept a Western proposal of entry into a liberal integration club. The main objection could be that the entry into the EFTA would harm the interests of the other Comecon countries. The consequence could be that the Soviet Union, as long as it could not or would not want to accept the EFTA-option for itself, would not allow other countries to draw out of the socialist integration club Comecon. Naturally the reactions of the Soviet Union to a possible application of entry made by Poland or Hungary, for instance, cannot be foreseen with certainty. However, one can imagine a possible and plausible scenario by

Table 3: Finland's Integration Policy after 1945

Area of Integration	
Western Europe	Eastern Europe
GATT entry 1950	trade agreement with USSR 1947
EFTA association (FINEFTA) 1961	customs agreement with USSR in 1960 with the extension of the most-favoured-nations clause to the Finnish free-trade areas.
Free-trade agreement with the EC 1973	agreement of co-operation with the Comecon 1973
Full EFTA membership 1985	Bilateral free-trade agreements with Hungary, Bulgaria, Czechoslovakia, the German Democratic Republic, and Poland 1974-1976

Source: Segert [1985]; own compilation

examining the economic relations between the EFTA member Finland and the Soviet Union more closely.

A short time after the end of World War II, Finland, as the very first market economy, signed an unlimited trade treaty with the Soviet Union [Segert, 1983]. With this treaty and the following ones, Finland was in the clearly-defined interests sphere of the Soviet Union. The Finnish foreign trade policy had to take this circumstance into account. Thus, Finland stayed out of every (West) European integration process until 1957 [Oblath, Pete, 1986]. After 1957, the Finnish policy was torn between the wish of West European integration and the consideration for Soviet interests and sensitivity. Until 1985, Finland did the splits between the West and the East (Table 3): the special status of the associated EFTA member and of the collaboration treaty with the Comecon⁷ states secured the interests of the

⁷ The Council for Mutual Economic Assistance (Comecon) consists of seven European states (the USSR, Poland, Romania, contin. footnote

Soviet Union and its consent to the integration plans. Finland's initiative to extend the trade preferences that it had so far granted to the Soviet Union and the EFTA and EC countries and to some of the other (European) Comecon states also went in the same direction [Kivikari, 1983]. In 1985, Finland became a full member of the EFTA without damaging its trade relations with Comecon.

The Finnish trade and currency policy towards the Soviet Union is characterized by the following features: (i) the Finnish administration can steer the business transactions between domestic firms and her Soviet partners by means of granting licences. In this way she can guarantee that the obligations from the bilateral trade contracts are fulfilled; (ii) trade between both countries is carried out via two clearing accounts in the respective countries. According to new settlement regulations agreed upon in 1988 interest must be paid on any balance exceeding 100 million roubles.⁸

The Finnish example shows that it is possible to modify the bases of the economic relations between the reform countries and the rest of the Comecon states without endangering the vital economic interests of the partner countries. The following steps would be especially appropriate for this aim:

- The reform countries join the EFTA and, at the same time, offer their old partners all the free trade privileges that they also grant to their new West European partners.
- Foreign trade within the Comecon will go on on a bilateral basis if the partners really wish so. The settlement modalities via a clearing account can be worked out according to the model of the Finnish-Soviet clearing system.
- Any obligations the government of each reform country may agree upon with the rest of the Comecon in the course of possibly

contin. footnote

Czechoslovakia, Hungary, and Bulgaria) plus three non-European ones (Vietnam, Cuba, and Mongolia). This essay deals with the European Comecon members only.

⁸ If this balance exceeds 200 million roubles, it must be compensated by corresponding foreign exchange payments.

prolonged treaties of several years' duration can be met by the independent enterprises. The state authorities could ensure that the trade contracts are honoured by means of their trade and/or tax policy.

- The full Comecon membership of the reform countries could be transformed into an association if all Comecon members favoured this step.

VII. The Advantages of the EFTA Option

Some politicians in Hungary and Poland sight the entry into the EC as the long-term objective of their economic and political reorganization. Since the EFTA has already proven to be an intermediate station on the way to the European Community for many countries (Denmark, Portugal and the United Kingdom) in the past, these long-term strategic reflections are quite compatible with the EFTA option outlined above.⁹

An alternative to the entry into the EFTA, that should be taken seriously, could be the conclusion of bilateral free trade contracts between all the East European countries wishing reforms and the European Community. In the previous history of East-West relations, there are even some treaties that can be characterized as precursors of such bilateral free trade contracts. The trade and co-operation treaty between the EC and Hungary in September 1988 or the contract with Poland signed on 8th August 1989 should be mentioned here. In these contracts, the European Community obligates itself to abolish progressively most of the current quantitative restrictions for Hungarian and Polish exports of industrial goods by 1995 at the latest [Hungaropress, 1988;

⁹ On the 22nd June 1989, the new President of the Hungarian socialist labor party, Rezső Nyers, advocated Hungary's entry into the EFTA to draw closer in this way to the EC [Süddeutsche Zeitung, 1989a]. Since March 1989, Nyers has had an outline of this article [Schmieding, 1989].

Latoszek, 1989].¹⁰ Most of the agricultural sector however as well as such fields as the steel and textile sectors, for which other less liberal treaties already exist, are not affected by either contract.

At first sight, a bilateral solution seems to have several advantages. Each country could prevent its being excluded from the European Internal Market. This would undoubtedly favour the advanced reform states in Eastern Europe. An offer to open markets on a mutual basis could certainly awaken the interest of the EC and induce it to accept this solution. In spite of these attractive elements, the drawbacks of a bilateral procedure must not be neglected. One of the most important disadvantages is the fact that a bilateral free trade contract can hardly be linked to the fulfilment of politico-economic minimum conditions of a general nature. Without these minimum conditions that serve to strengthen the market elements in the economic systems in the East European reform states, the free trade agreements could, in contrast to the original intention, even contribute towards conserving the current economic system.¹¹ The political significance of a "normal" (free) trade treaty with the European Community would be relatively small.

The option of the entry of East European reform countries into the EFTA avoids the shortcomings of the bilateral solution without renouncing its advantages. Similar to the bilateral trade treaty, each country would be independent from its old Comecon partners. In this way, the considerable differences in the willingness to reform within Eastern Europe can be taken into consideration. The signature of a treaty of entry into an international organization, bound to the fulfilment of politico-economically

¹⁰ Furthermore, Poland is granted tariff preferences for exports of a few agricultural products into the European Community.

¹¹ The GDR can be considered as proof for this thesis. The GDR enjoys the advantages of a de facto free trade zone with the FRG thanks to the special arrangements for intra-German trade. This privileged treatment of the GDR that was and is not bound to politico-economic minimum conditions is one reason for the weakness of the reform movement in the GDR.

important minimum conditions, would lead to a larger irreversibility of the reforms than would be the case with bilateral treaties. The consequence would be a growing confidence in the durability of the orientation towards the West. Through the strengthening of the respective reform lobby, a supplementary liberalisation pressure that would even speed up the reform processes in the concerned Eastern European states would furthermore appear. After all, the entry into the EFTA would ensure free access to an almost pan-European market. On the contrary, a bilateral contract with the EC would only provide for the abolition of the market entry barriers of the twelve EC member countries.

The old and new EFTA members would constitute a European free trade zone with the EC states and would at the same time be a connecting link between the more integrated West European countries and the still not reformed parts of Eastern Europe. The new politico-economic role of the EFTA would also lead to a revitalization of this organization and, furthermore, make staying in the EFTA more attractive to countries like Austria and Norway. When the possible options for linking East European states to the economic and political evolution in Western Europe are weighed up, the EFTA option in the presented form seems to be the most favourable solution.

The advantages of integration could already in the initial phase be surprisingly large for the East European states that join the EFTA. With the prospect of less bureaucracy and free access to the entire West European market fixed by treaty, Eastern Europe could very quickly become a preferred location for new investments. In other words: the East European states that accept the proposition of joining the EFTA would, with this step, increase their attractiveness for mobile capital and consequently their credit-worthiness in such a way that they could cushion the inevitable adjustment crisis with imports financed abroad. If this factor is completed by a more favourable investment climate as a consequence of the internal reforms and by a protection of the investments from political risks (investment guarantee treaty), rapid growth of foreign economic activity in the East

European states concerned can be expected.¹² The recent experiences with joint-venture enterprises¹³ in Poland, for instance, show that such expectations have a realistic basis. There are two reasons for regarding the further development of the foreign investments in Eastern Europe rather optimistically: (i) the East European countries are competing among each other for the most favourable conditions for foreign investments [Ginsburg, 1989]. This competition will go on increasing and the countries that wish to join the EFTA would probably go the furthest in the liberalisation process; and (ii) the transition to the convertibility of currency will settle the important problem of profit transfer for Western investors.

An entry into the EFTA would not have an influence only on the economic situation, but also on other domains of the East European reform states. Besides sciences, culture and politics, the environment must be especially mentioned here. A lot of socialist countries are in a pronounced environmental crisis. The general inefficiency of the planned economies and the inherent lack of incentives to use resources economically and to implement modern technologies and practical environment innovations can be considered as the main cause [Welfens, 1986]. The result is a very high resource and environment intensity of production. The socialist countries have never participated in the turning away from resource and environment-intensive technologies that has

¹² Measures of liberalization in Eastern Europe should also lead to a wave of founding new firms in the private sector. Poland, where nearly 180,000 private enterprises have been established since the beginning of this year, is at present giving an outstanding example [GUS, 1989].

¹³ Only 37 joint ventures were founded in this way in Poland from 1986 to 1988, that is to say under the old joint-venture statute. However, the new statute that has made foreign investments much easier and, among other things, allowed foreigners a majority stake since the beginning of 1989 is having a tremendous impact. Within less than six months, from mid-January to the end of June 1989, 203 joint-venture enterprises were established. More than half of them were mainly owned by foreigners [Tekielski, 1989].

taken place since the first oil shock in 1973/74 in the Western industrial states.

This presages the changes that could and should follow the market-oriented reforms, the fulfilment of the formulated minimum conditions and the entry of the reform countries into the EFTA: (i) changes in the ownership of the means of production and, consequently, clearly-defined "property rights"; (ii) the separation of the proprietor function from the controlling role of the state, turning away from the short-term time-horizon of the bureaucrats; (iii) the positive pressure of the price mechanism and of international competition to reduce the raw material intensity (and so the environment intensity) of the production drastically. All these factors should bring a decisive turn in the previous practice of environmental policy and stop the march towards an "environmental catastrophe", at least in some parts of Eastern Europe.

VIII. Outlook

For Western Europe trade with the East offers an almost untapped potential for an intensive division of labour among close neighbours, for an increase in prosperity that may even be comparable with the economic miracle that the Federal Republic enjoyed in the 1950s and 1960s as Germany switched from a policy of economic autarchy under the Nazis to one of opening markets vis-à-vis the Western industrial countries. And the more the citizens of Eastern Europe are allowed to heed market signals and to sell the fruit of their efforts in Western Europe, the less they will feel compelled to offer their labour services directly in the West. It is no coincidence that the sizeable decrease of the importance of the West Germany's trade with the East after 1983 went along with pronounced swelling of the inflow of people coming from Eastern Europe to the Federal Republic.

One could object to the EFTA option for a pan-European economic integration that it could happen to the disadvantage of non-European states. But if the option is realized in the

outlined form, then the danger of a "Fortress Pan-Europe" is very small. Both key points, that is to say a liberal EC Internal Market and the inclusion of the East European states that have sufficiently liberalized their economy, correspond to an almost world-wide trend toward freer markets. An Internal Market where mutual recognition of national practices is introduced for EC members and extended to EFTA members would have a much more liberal character than a little European community with an internal harmonization by decree. The experiences gathered from former liberalization successes, for instance those of the West Germany in the 1950s, permit the conclusion that this more liberal Europe would quickly gain adjustment flexibility and growth dynamism. It would be easier than before for it to abolish its trade barriers for non-European states as well, either unilaterally or on a mutual basis in the framework of the General Agreement on Tariffs and Trade (GATT). A pan-European economic integration based on market principles would therefore be no threat to the multilateral world trading system. Instead, it would be a promising step towards a general abolition of barriers to trade.

Table A1 - Regional Composition of Western Europe's Imports 1960-1988

	Share ^a of Imports from											
	1960	EC (12) 1972	1984	1988	1960	EFTA (6) 1972	1984	1988	1960	Comecon (7) 1972	1984	1988
EC (12) ^b	38.0	53.6	51.0	57.9	9.3	8.4	9.4	9.9	3.7	3.7	4.9	3.1
Belgium-Lux.	56.9	72.4	68.3	73.1	6.1	4.5	5.5	5.8	1.9	1.7	4.1	2.0
Denmark	59.3	47.8	47.9	51.1	18.9	27.9	24.6	23.5	4.3	3.3	5.0	2.7
France	35.2	58.5	54.4	60.4	5.4	5.6	6.0	7.0	2.5	2.7	3.7	2.7
W. Germany ^b	38.6	55.1	49.4	51.0	13.0	9.9	12.2	15.0	5.9	5.6	7.0	5.1
Greece	45.1	55.8	48.6	60.9	6.7	6.3	4.7	5.8	7.8	5.3	8.4	5.1
Ireland	64.1	70.5	66.3	66.2	4.2	5.2	4.3	4.1	1.1	1.9	1.5	1.1
Italy	37.0	51.0	45.2	57.6	9.8	6.1	7.9	9.1	5.6	5.7	7.2	4.0
Netherlands	54.1	63.6	55.1	64.4	7.7	4.8	6.7	6.6	2.1	1.8	4.7	2.1
Portugal	52.1	51.3	43.1	66.4	8.2	10.2	5.2	7.4	1.3	0.0	1.3	0.6
Spain	35.4	43.1	34.2	73.4	7.7	7.2	4.3	6.9	1.5	1.9	3.1	3.3
United Kingdom	22.5	34.3	47.7	52.5	8.8	13.3	13.5	12.4	3.0	3.5	2.2	1.5
EFTA (6)	60.2	59.3	56.9	60.4	9.9	15.8	13.3	13.1	6.4	5.5	8.3	4.5
Austria	63.2	66.4	61.4	68.1	6.4	11.0	7.6	7.4	11.2	8.5	11.6	6.3
Finland	51.8 ^f	43.6	37.1	43.5	15.2	24.5	17.3	18.9	18.9	15.5	26.2	14.6
Iceland	44.0	52.6	51.4	51.5	12.6	18.6	18.5	22.2	22.4	10.3	11.0	5.6
Norway	53.3	46.3	47.2	46.2	19.3	25.1	24.7	23.9	3.1	3.1	3.6	2.3
Sweden	58.7	56.7	54.6	63.8	8.3	17.1	17.2	18.8	4.2	4.5	5.7	4.2
Switzerland	69.2	70.3	69.0	71.3	5.6	9.5	6.3	7.2	2.1	1.9	3.1	1.2

^aIn % of total imports; ^bincluding German-German trade; ^c1961.

Source: OECD, various issues; Statistisches Bundesamt, various issues; own calculations.

Table A2 - Regional Composition of Western Europe's Exports 1960-1988

	Share ^a of Exports to											
	1960	EC (12)			1960	EFTA (6)			1960	Comecon (7)		
		1972	1984	1988		1972	1984	1988		1972	1984	1988
EC (12) ^b	40.7	55.1	54.1	59.9	12.6	11.4	9.8	10.7	3.7	4.0	3.2	2.7
Belgium-Lux.	60.6	75.9	70.1	74.3	8.5	5.6	6.1	6.0	2.5	1.7	1.8	1.2
Denmark	55.9	44.8	44.7	49.6	18.0	30.1	23.0	24.5	3.8	3.2	1.9	1.9
France	38.5	60.2	52.9	61.6	8.5	8.3	7.1	7.3	3.1	3.6	3.2	2.1
West Germany ^b	39.6	49.7	49.4	53.8	20.6	16.4	14.8	17.7	5.8	6.6	5.4	4.7
Greece	43.0	54.2	55.1	66.9	6.5	4.1	2.9	4.8	21.8	13.5	5.7	4.2
Ireland	80.4	78.5	70.0	74.2	0.8	1.7	4.7	5.5	0.0	0.4	0.5	0.5
Italy	40.1	54.7	47.4	57.2	12.9	9.2	8.3	9.7	4.6	4.2	3.4	2.8
Netherlands	61.3	75.7	73.7	74.7	10.8	6.1	5.7	6.9	1.5	2.0	1.3	1.5
Portugal	38.2	49.3	62.1	72.2	5.6	14.9	10.4	10.6	2.1	0.6	1.6	0.9
Spain	58.3	49.5	51.5	65.6	7.3	5.4	3.9	4.2	2.5	3.1	2.5	1.3
United Kingdom	23.1	34.1	47.2	50.4	9.0	12.6	9.2	8.0	2.6	2.8	1.8	1.5
EFTA (6)	55.3	51.6	53.6	56.1	12.0	18.2	13.4	14.1	7.3	6.3	6.2	5.4
Austria	56.2	49.9	55.1	63.8	9.0	18.2	10.6	10.8	13.7	11.8	12.1	9.1
Finland	58.2 ^c	46.3	38.8	44.2	8.5	24.7	18.9	20.4	17.6	15.2	20.7	16.5
Iceland	39.3	41.3	47.1	58.9	15.1	11.8	8.5	10.0	22.7	12.1	9.5	5.4
Norway	56.4	55.3	70.7	65.2	16.5	20.6	12.7	16.3	4.3	2.9	0.9	1.3
Sweden	56.4	53.4	49.4	52.2	15.7	20.6	18.0	19.9	4.2	3.8	2.6	2.1
Switzerland	51.9	51.0	52.9	71.2	8.2	11.6	3.9	8.9	3.2	4.2	2.9	4.3

^aIn % of total exports; ^bincluding German-German trade; ^c1961.

Source: OECD, various issues; Statistisches Bundesamt, various issues; own calculations.

Table A3 - Regional Composition of Comecon Foreign Trade 1960-1987

	Share ^a of Trade with											
	1960	EC (12) 1972 1984	1987 ^b		1960	EFTA (6) 1972 1984	1987 ^b		1960	Comecon (7) 1972 1984	1987 ^b	
IMPORTS												
Comecon (7)	14.3	17.8	15.4	15.9	4.8	4.4	4.9	5.0	58.4	60.1	54.3	59.0
Bulgaria	10.8	11.2	9.4	11.0	2.4	2.8	3.1	2.8	80.0	76.3	76.3	76.7
CSSR	12.7	17.3	10.5	12.9	5.3	4.1	3.5	3.5	63.5	66.1	74.8	74.0
GDR ^c	17.5	25.6	21.4	22.4	4.3	3.4	4.1	4.0	66.4	62.9	61.9	59.0
Hungary	18.0	20.7	24.0	28.9 ^d	6.0	5.7	8.5	9.9 ^d	62.1	63.3	48.1	47.6 ^d
Poland	13.8	22.9	19.1	25.1 ^d	5.3	5.6	5.1	10.6 ^d	57.9	57.7	57.4	45.5 ^d
Romania	18.7	29.7	13.0	8.7 ^d	4.7	5.5	1.9	1.4 ^d	67.8	44.9	38.2	48.4 ^d
USSR	12.9	11.9	13.5	11.8	4.8	4.3	5.3	5.2	49.7	57.4	46.7	57.4
EXPORTS												
Comecon (7)	13.9	15.2	19.7	16.3	4.5	4.0	5.6	4.4	60.6	62.5	50.1	56.3
Bulgaria	10.4	9.7	6.6	5.5	2.1	2.5	1.1	0.7	80.3	76.4	72.2	79.4
CSSR	11.3	13.6	10.7	10.7	4.3	4.1	4.0	3.7	63.2	67.0	68.8	73.3
GDR ^c	16.8	18.0	24.0	22.7	3.2	2.5	4.7	3.3	68.5	71.0	60.9	64.6
Hungary	15.1	18.4	20.8	23.2 ^d	6.5	5.0	9.7	8.4 ^d	60.8	65.8	48.3	49.7 ^d
Poland	20.2	20.9	21.1	26.5 ^d	6.6	5.3	6.9	9.9 ^d	54.7	60.2	48.2	41.3 ^d
Romania	17.3	28.3	30.7	21.6 ^d	3.4	3.4	1.7	1.6 ^d	65.5	47.5	28.8	39.5 ^d
USSR	11.8	10.9	20.4	13.8	4.6	4.2	6.1	4.4	55.2	57.8	43.6	51.8

^aShare in total imports (exports), in %; ^bpreliminary results; ^cincluding German-German trade; ^dbased on IMF data, not Comecon statistics.

Source: Comecon, various issues; OECD, various issues; IMF, various issues; Vienna Institute, various issues; GUS, 1988; own calculations.

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