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## The dynamics of trade diversion: Observations on West Germany's integration into the Little European Common Market 1958-1972

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Working Paper No. 334

- The Dynamics of Trade Diversion -

Observations on West Germany's Integration into  
the "Little European" Common Market 1958-1972\*

by

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## **I. Introduction**

In the postwar history of Western Europe, the period from 1958 to 1972 stands out as the time of the economic division of this part of the world into two trading blocs: the European Economic Community (EEC), established in 1958, and the European Free Trade Association (EFTA), formed two years later. Before 1958, institutions dealing with the entire region had helped to shape trade policy in Europe; after 1972, the two trading blocs fused into one as all EFTA countries either joined the EEC or concluded free-trade agreements with the Community. This paper investigates some of the causes and consequences of the EEC-EFTA rift in the 1960s, focusing on the role played by Germany, i.e., the country which, of all EEC members, had the closest trade links to countries across the divide. Therefore, we will

- sketch out some arguments of the theory of regional liberalisation (Chapter II),
- discuss the major determinants of the actual German trade policy in the 1950s and 1960s (Chapter III),
- assess the impact of the economic division of Western Europe on Germany's foreign trade (Chapter IV).

The concluding remarks (Chapter V) will take up the question whether Germany's integration into a "little Europe" and the parallel economic division of Western Europe were a necessary stage on the way towards freer trade in this part of the world or a costly detour.

## **II. Observations on the Logic of Regional Liberalisation**

### **II.a. The Political Economy of Regionalism**

Any inquiry into the determinants of trade policy has to be based on an analysis of the paradox of protection, namely the fact that trade in the real world is severely distorted by state interventions although most economists have claimed for a long time that the abolition of almost any trade barrier would (i) be in the interest of the greater majority of individuals and (ii) result

in aggregate gains far greater than aggregate losses<sup>1)</sup>. Some explanations for this divergence between theory and practice focus on those rather special cases in which the benefits of protection might outweigh the costs, at least in the short run and in the absence of retaliation (optimum tariff argument, strategic protection, externalities that can - for whatever reason - not be internalised by subsidies).

Apart from these answers, economists have two standard explanations for the paradox of protection. Both focus on deficiencies in the political process which transforms individual preferences into collective policies:

Firstly, rent-seeking interest groups can influence the outcome of this political process through payments or equivalent favours to established bureaucrats and politicians or to candidates seeking office. True, in a state of what we may call "perfect corruption", free trade would still emerge: as the gains from liberalisation exceed the losses, a coalition of free traders could always outbid a coalition of protectionists in the "political market". Unfortunately, due to the free-rider problem inherent in collective action (Olson 1965), a lobby representing the small number of individuals who expect to gain from a particular trade barrier is much more likely to emerge, to remain stable, and to extract the required resources from its members than any collective body of prospective losers, i.e., the large number of consumers and domestic producers who would be hurt by the intricate domestic and international repercussions of the protectionist measure.

Secondly, voters fail to elect a sufficient number of free marketers. The gains from a trade barrier tend to be concentrated

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<sup>1)</sup> To put it somewhat technically: in the absence of transaction costs, beneficiaries could collectively compensate losers in such a way that, by their own standards, all individuals would end up better off than before liberalisation.

on a minority of individuals who will thus take notice and vote accordingly, while the losses are so dispersed and unnoticeable that the majority of those who lose will remain in a state of "rational ignorance" (Downs 1957).

In a typical West European democracy with a high turn-out of voters in national elections, the second argument has one important implication: protectionist lobbies and politicians can be successful only to the extent that the negative effects of a certain trade barrier do not surpass the threshold level at which it becomes rational for a majority of voters<sup>2)</sup> to take these effects into account, i.e., to devote time and effort to getting information on the costs of protectionism and to vote accordingly. This points towards the main requirement for a feasible liberalisation strategy: if the gains from liberalisation are perceived as being sufficiently large, the voters are c.p. likely to back free-trade oriented candidates, or, more to the point, re-elect politicians who have improved the lot of the electorate by a turn towards sound policies to such an extent that the majority of voters takes notice before the next election. Consequently, a rational politician who would lose votes if he abolished one particular trade barrier has an incentive to create a link between a large number of liberalisation measures. The broader the implemented package is, the more diluted and uncertain will be the losses and the more visible will be the benefits - as long as the package does not include too many genuinely unpopular measures which the majority of voters would oppose even in the absence of information costs.

Of course, issue linkage is no guarantee for a free-trade majority: as the log-rolling literature teaches, distributional coalitions may devise a bundle of measures which shifts all the costs

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<sup>2)</sup> Throughout this essay we assume the existence of generally accepted meta rules which imply that policies and rules for policy-making can be changed by majority decisions, i.e., without the need for unanimity.

of protectionism onto a minority (c.f. Frey 1985; Baldwin 1976). Although coalitions of this kind tend to be unstable, they may well command a majority of votes at any point in time. However, do not forget that the incentive to support such a coalition depends critically on what the individual voter knows about how he will be affected now and in the future: The closer a liberalisation package comes to a general and durable rule that trade shall be free, the less certain can any potential opponent be (i) that he, in his present position, will be a net loser, and (ii) that at some time in the future he might not assume a different position and turn into a beneficiary<sup>3)</sup>. The greater the uncertainty about the present and future distributional consequences of liberalisation, the more relevance will be attached to the gains in allocative efficiency: rational individuals will increasingly identify the change in their personal fortunes with the expected average per capita gains from freer trade. If the "veil of uncertainty" (Brennan and Buchanan 1985) is thick enough, general rules instead of specific outcomes will be the subject of political discussion and choice; as the benefits from liberalisation exceed the costs, protectionists are most unlikely to carry the day. Thus, even a courageous unilateral liberalisation, say in the form of a free-trade amendment to the constitution, may not be infeasible in a world of uncertainty.

The following paragraphs will assess some of the conditions which determine the relative feasibility of three kinds of packages: (i) a thorough unilateral liberalisation, (ii) global (broad multilateral) liberalisation, and (iii) regional (minilateral/bilateral) liberalisation.

Apart from its economic merits, unilateral liberalisation has one important advantage: it does not depend on the present

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<sup>3)</sup> Note that the very instability of distributional coalitions works in the same direction: it increases the uncertainty about the actual distributional effects of any deviation from the free-trade optimum.

collaboration and future reliability of foreign politicians. However, pursuing the unilateral approach means putting sweeping demands on the willingness of voters to acquire and process information about the overall effects of liberalisation. This may be a realistic option in times of a general awareness that drastic change is needed, i.e., in times of a deep crisis, or - oddly enough - in times in which the remarkable success of a recent liberalisation has drawn public attention to the issue. Under ordinary circumstances, that is in a situation in which voters have grown accustomed to the prevailing level of barriers to trade, the mere proposal of a general rule that international transactions shall be free from state interventions is unlikely to mobilise sufficient support to overcome protectionist resistance.

Unfortunately, unilateralism has further drawbacks. Besides the fact that the unilateral package by its very nature cannot be as encompassing as a plurilateral one, the main additional obstacles worth mentioning are:

- a deterioration in the terms of trade if the country is not faced with infinite elasticities of import supply and export demand on the world market,
- a reduced bargaining power in future international trade negotiations,
- the ease with which such a package can be repealed (unless it is enshrined in the constitution), and - most importantly -
- the insufficient incentive for exporters to lobby in favour of it.

Again, issue linkage may offer a way out. The task is to devise a liberalisation package which, in addition to the widespread gains, confers clearly visible benefits to a well-defined group of individuals. The most plausible way for a politician to achieve this is to link the reduction of national trade barriers to that of other countries so that domestic exporters will expect direct gains (Hauser 1986) and act as a countervailing lobby against protectionist interest groups. Although a unilateral import liberalisation would promote exports as well, the benefits



would be more dispersed and less certain than in the case of a multilateral package. This problem is aggravated if exchange rates are fixed. Instead of benefitting directly from a devaluation induced by higher imports, exporters will not feel the positive effects until their input prices finally start to fall under the pressure of increased competition (or a reduced money supply).

As the gains from mutual liberalisation depend on the scope of the package, a global or at least a broad multilateral approach would be best. However, the problems of finding like-minded partners, striking a deal and devising ways to make it stick increase with the number of countries concerned. The essence of a package deal is to alter expected pay-offs from specific policy options by creating a link between issues. Hence, the whole package deal could unravel if one participant were to defect, causing sunk costs for those agents who had already adapted to the expected new trade regime.

Unless he can bank on a genuine multilateral consensus that free trade is and will remain best, or unless a hegemon or a powerful supra-national authority exists to enforce an international agreement, a more feasible approach for a liberalisation-minded politician might be to strive for a deal with a limited number of his country's major trading partners, at least as a first step towards a more far-reaching liberalisation. If the deal is struck between countries with a high degree of interdependence in a variety of fields, the problems of negotiating an agreement and the potential incentives to abrogate the deal in later years are reduced (Axelrod and Keohane 1986).

Opposition from protectionist lobbies will be comparatively weak if the preferential trade area is formed between industrial countries on a roughly similar level of development and with a roughly similar factor endowment. In this case, the intensification of the division of labour will be of the intra-industry rather than the inter-industry type (Balassa 1966, Giersch 1986). This implies the following:

- relative factor prices will not change significantly to the detriment of labour, i.e., the Stolper-Samuelson argument does not apply (Krugman 1981);
- structural adjustment can to a large extent take place within firms so that factor mobility requirements are low and few investments in human or physical capital will be rendered obsolete (few sunk costs);
- there will be a sizeable number of beneficiaries even in those few sectors of the economy which, as a whole, might be adversely affected.

Therefore, neither labour as a whole nor lobbies of workers or capital owners organised along sectoral lines will be strongly incited to oppose the package. Furthermore, in a preferential trade area between a limited number of similar countries, producers might frequently be able to form cross-border cartels and thus mitigate the effects of increased competition (Machlup 1976).

- although this is clearly a disadvantage from a welfare point of view.

The arguments sketched out above lead to the following conclusions: The incentive for politicians to pursue a regional rather than a broad multilateral approach to liberalisation is a positive function of

- the importance attached to the Stolper-Samuelson argument,
- the importance of sunk costs in the expected adjustment process,
- the degree of regional and sectoral factor immobility,
- the expected gains from intra-industry specialisation relative to the overall gains from freer trade,
- the divergence of interests and of perceptions of economic reality between politicians of different countries, and
- the length of the time lag until import liberalisation is seen to enhance the competitive position of exporters.

Politicians can make their mutual commitment to uphold the free trade agreement more binding for themselves and their successors by altering the expected pay-offs of defection, for instance (i)

by creating institutions which cannot be ignored or resolved without stirring up public interest in the matter, (ii) by attaching a genuinely popular label to the liberalisation package (say "the uniting of Europe"), or (iii) by linking it to other fields where the states involved share common interests (say the strengthening of the "free West" in general and of a military alliance in particular).

## **II.b. The Economics of Preferential Trade Areas**

Apart from the special cases listed above (p. 2), the welfare gains of a removal of trade barriers clearly exceed the costs. A liberalisation induces a more efficient allocation of resources (including the exploitation of economies of scale), diminishes the scope for X-inefficiencies and increases the competitive pressure on all producers so that the rate of productivity growth might even be permanently higher than before. Even in a simple and static partial analysis, the replacement of a domestic producer by a cheaper foreign supplier is beneficial because the additional consumer surplus is greater than the losses in tariff revenue and producers' surplus.

However, the establishment of a customs union (or any other kind of preferential trade area) has two main effects: it removes the discrimination between suppliers from within the area; at the same time, it introduces a discrimination between suppliers from partner countries and from outside which did not exist before. Therefore, additional imports from partner countries may replace either less efficient domestic production ("trade creation") or, if the tariff wedge exceeds the cost differential, imports from more efficient extra-area producers ("trade diversion"). In the latter case, the increase in the surplus of domestic consumers may be smaller than the loss of producers' surplus and the foregone tariff revenue.

As theorists of second-best solutions in general and customs unions in particular have demonstrated, the net effect on the

welfare of members of the union may thus be negative (for surveys see Pelkmans 1984, Grubel 1977, Ch. 27). However, even if the balance of static effects is not entirely clear, one has to add the dynamic gains from trade creation. Therefore, the aggregate gains are likely to exceed the conceivable losses from trade diversion.

This does not apply to the countries outside the area. The partial replacement of their exports by intra-area trade induces all the static and dynamic welfare losses which arise from any voluntary or, as in their case, involuntary move away from the free-trade optimum<sup>4)</sup>. The discrimination against their exports will show up in both prices, i.e., as a deterioration of their terms of trade vis-à-vis the customs union, and quantities, i.e., as trade diversion, with the relative importance of the second effect being a positive function of the elasticity of their export supply and the elasticity of substitution between intra-area and extra-area producers in the customs union. As elasticities increase over the course of time, the relative importance of the quantity effect will rise. In the same vein, trade diversion will be especially pronounced if intra- rather than inter-industry trade is affected most because of the high elasticity of substitution between different variants of roughly the same product.

Furthermore, owners of internationally mobile capital, reluctant to bear part of the losses from trade diversion and eager to participate in the gains from trade creation, will invest less in these countries and more in the free-trade area. Incidentally, if

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<sup>4)</sup> This analysis presupposes that the common external tariff is not reduced so as to compensate outsiders for the replacement of their exports by intra-area trade. Kemp has demonstrated that a customs union could always adjust its common external tariff in a way which would leave no outsider worse off than before (Kemp 1976, p. 179 ff.). Furthermore, to the extent that the formation of the union stimulates economic growth, member countries may increase their demand for imports. If this effect is very pronounced it may overcompensate the reduction of trade with non-member countries that is caused by trade diversion.

this effect is very pronounced, countries outside the free-trade area may experience such a sharp devaluation of their currencies that they may even end up exporting more than before. In this case, the losses from discrimination will show up in a substantial deterioration of their terms of trade, in higher real interest rates and an investment slump.

Because of the harmful effects of discrimination, countries outside the area now face a different set of alternatives than before: they can no longer opt for the status quo ante. At the same time producers, consumers and politicians in extra-area countries may watch the example of successful trade creation, more investment and hence faster growth within the area.

Therefore, they now have a strong incentive to strive for multi-lateral tariff reductions or for their country's entry into the regional club<sup>5)</sup>, even if they had originally opposed the particular liberalisation package on offer. Thus, a limited regional liberalisation may initiate a much broader move towards freer trade, a result which would not have been attainable in global negotiations. Because of these "dynamics of trade diversion", even economists who are aware that a regional arrangement is but a second-best solution may welcome it as one step in the desired direction (c.f. Giersch 1957).

### III. The Economic Division of Western Europe

#### III.a. The Emergence of "Little Europe"

From 1948 onwards the American-inspired Organisation for European Economic Co-operation (OEEC) skillfully used its share of the Marshall Plan aid to promote the abolition of quantitative restrictions on intra-European and - with a delay - on

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<sup>5)</sup> For a further discussion of open regional liberalisation clubs see Giersch (1985) and Klepper (1986).

cross-Atlantic trade (Schmieding 1987). Early attempts to establish a Western European customs union as well had but two meagre results: (i) the customs union between Belgium-Luxemburg and the Netherlands, and (ii) the standardised Brussels tariff nomenclature of 1950. As quotas and not tariffs were the main impediments to trade in the early fifties, the OEEC's choice of priorities was quite understandable.

The issue of mutual tariff cuts was taken up at two very distinct levels:

- (1) The General Agreement on Tariffs and Trade (GATT) convened three rather ineffective rounds of multilateral negotiations: Annecy 1949, Torquay 1950-51 and Geneva (2) 1955-56, with mutual tariff cuts of 2 %, 3 % and 2 % respectively (Müller 1983).
- (2) The idea of a customs union became an ingredient of politically motivated attempts to create close links between France, Germany and those neighbours willing (or invited) to join them.

On May 9, 1950, the French foreign minister, Robert Schuman, proposed a common market for coal and steel - mainly as a device to ensure supra-national control over German coal and steel without having to deny indefinitely to Germany the degree of national autonomy enjoyed by other states. The European Coal and Steel Community (ECSC) was established in August 1952 by France, Germany, Italy and the Benelux countries; Britain decided to abstain because of her opposition to the supra-national features of the ECSC (Haas 1958).

In the following years, i.e. in the aftermath of the war in Korea, politicians of the six ECSC countries worked out (i) statutes for a European defence community (EDC) and a European political community (EPC), both of which implied a far-reaching transfer of powers to common institutions, and (ii) a plan for a customs union. After the rejection of the EDC and - implicitly - the EPC by

the French National Assembly in August 1954, prominent supporters of political unification changed their strategy and opted for an indirect approach: a common market was to become the nucleus of political integration (Küsters 1982, Dankert 1982). On March 25, 1957, representatives of the six ECSC states signed the Rome Treaties to establish a European Economic Community (and a European Atomic Energy Community, Euratom). According to these treaties, which went into force on January 1, 1958, the member states were to

- (i) abolish all restrictions on intra-union trade in industrial goods and services,
- (ii) lift all restrictions on the free movement of capital and labour within the union,
- (iii) organize a common market for agricultural products, the details of which were to be decided by 1962,
- (iv) introduce a common external tariff<sup>6)</sup>, and to
- (v) secure some harmonization of economic and social policy.

These objectives were to be attained within a transition period of twelve years - which could be prolonged for three years in case of difficulties (Küsters 1982).

Initially, Britain had participated in the expert committee. However, she left the negotiations at an early stage because the British government (i) resented even mild versions of supranationalism, and (ii) did not take the talks very seriously. In early 1957, the British government presented the idea of an OEEC-wide free-trade area for non-agricultural goods as a substitute for, or at least a complement to, the EEC (Küsters 1982). This was finally rejected by the EEC in late 1958. Consequently, Britain, three countries with close links with Britain (Denmark,

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<sup>6)</sup> For most products the new duties were to be calculated as the arithmetic average of the 1.1.1957 tariff rates of the four customs areas within the EEC: high tariff France, high tariff Italy, low tariff Germany and low tariff Benelux. For some products, the duties were to be fixed closer to the original French rates (Auerbach 1965, Küsters 1982).

Norway and Portugal) and three countries committed to political neutrality and thus unwilling to join the EEC (namely Switzerland, Austria and Sweden) formed the European Free Trade Association (EFTA) for non-agricultural products on May 3, 1960<sup>7)</sup>. Thus, Western Europe was divided into two trading blocs.

### III.b. The Predominance of Politics

Theories of political economy suggest analysing the attitudes of organised interest groups in order to explain the actual course of trade policy. However, it has to be emphasized that neither German trade unions nor German industry had favoured the "little Europe" which finally materialised.

Sure enough, the German Federation of Trade Unions (DGB)<sup>8)</sup> and the Federation of German Industry (BDI)<sup>9)</sup> differed with regard to concepts of economic integration. While the unions favoured an integration from above, i.e., the establishment of strong supra-national institutions, industrialists emphasized the need for an integration from below, i.e., the integration of markets without a fusion of state institutions. However, subject to the introduction of some escape clauses for branches which felt particularly threatened, both trade unions and industry supported a free-trade area encompassing at least the entire OEEC area. Unlike the BDI, German unions even welcomed unilateral tariff cuts. The rapid growth in GNP and the equally impressive reduction in

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<sup>7)</sup> For an excellent survey of what the EEC and the EFTA had in common and where they differed see Krämer (1968).

<sup>8)</sup> From 1952 onwards, the "Gewerkschaftliche Monatshefte", the theoretical journal of the trade unions (DGB), published quarterly surveys on "The State of European Integration" ("Der Stand der europäischen Integration"). For further statements and analyses of union attitudes see Haas (1958), Friedrichs (1957), Haferkamp (1964), Riess (1955).

<sup>9)</sup> See Haas (1958), Braunthal (1965, p. 317 ff), Zigan (1964), Berg (1966).



unemployment during the 1950s had made them willing to adopt a long-term rather than a short-term orientation, implying a readiness to accept broad rather than narrow liberalisation packages. Prominent trade unionists perceived liberalisation as an opportunity to raise productivity and thus real wages (Kühne 1957). Therefore, they would probably have backed the removal of some barriers to trade vis-à-vis non-industrialized or industrializing countries as well. With regard to sunk costs, i.e., the debasement of the value of some human and physical capital which is caused by structural change, at least some union leaders were ready to opt for state subsidized retraining rather than the artificial preservation of unprofitable lines of production. Incidentally, retraining is no option for owners of activity-specific physical capital and resources (say, coal mines) and a less attractive one for farmers, who - in the course of structural change to their detriment of agriculture - would lose via falling land prices even if they could easily find a new job.

All in all, arguments of political economy alone cannot explain why Germany consented to the "little European" solution instead of vigorously promoting a more encompassing package. Politics played the decisive role.

A closer look at the attitude of Fritz Berg, president of the BDI from 1951-71, is quite revealing in this context. Berg was willing to accept a European Economic Community even in the absence of a free-trade agreement with the rest of the OEEC mainly because of two considerations:

- (1) The smaller the number of countries, the easier the cross-border cooperation of firms would be. According to Berg, not supra-national dirigism, but a healthy and continuous understanding among industrialists across national frontiers was going to integrate the European economy (Haas 1958, p. 173 f.; Berg 1966). Here, the trade unions, who were afraid that cartels might stifle the increase in competition that would otherwise result from liberalisation (Saternus 1959), clearly had a case in point.

- (2) Berg was genuinely committed to the idea of close political collaboration between France and Germany, even if this implied some economic sacrifices. A free trade agreement between the ECSC six and the rest of the OEEC, although economically desirable, should not be pursued if it jeopardized the political substance of the EEC (Berg 1966, p. 397) and the Franco-German reconciliation.

The second point describes exactly the position which the German representatives adopted in the negotiations on the founding of the EEC and the subsequent unsuccessful talks on an OEEC-wide free-trade agreement. Not Erhard, but Adenauer and Hallstein determined the principal elements of the German bargaining position (Küsters 1982). They perceived economic integration as a means to the end of closer political cooperation or even integration in Europe. Adenauer was willing to disregard economics in order to further his political aims, the binding of West Germany to Western Europe in general and Franco-German friendship in particular. Therefore, the Germans accepted a variety of French demands, the most important of which was the termination of talks on a free-trade agreement between the EEC and the other OEEC members in November 1958.

Because of Germany's readiness to yield to French demands, French rather than German politics have to be put into focus in order to explain the course of events. The decisive years of 1957 and 1958 were a time of political and economic crisis in France. Besides great farmers, all organized economic interest groups were sceptical of trade liberalisation. Both industrialists (DIHT 1956) and trade unions (Haas 1958) emphasized that French industry would be at a competitive disadvantage due to higher labour costs in general and her generous social security benefits in particular. Therefore, labour costs and social security systems should be harmonized before intra-European tariffs could be abolished. Furthermore, a preferential trade area should not be extended beyond the ECSC six (including colonies) in order to delimit the perceived threat to French industry. As if to prove this point, a balance of payments crisis compelled France in June 1957 to

reintroduce the import quotas for most industrial goods which she had lifted in the previous years.

To evaluate the attitudes of French industry and trade unions, two issues have to be clearly distinguished: (i) the issue of the overall cost level and (ii) the issue of structural change. If - at the going exchange rate - the overall level of production costs in one country is above that of its neighbours, a move towards freer trade will induce a surge of imports in this country which is not matched by a corresponding export growth - at least not until internal factor prices have fallen sufficiently. The balance of payments will exhibit a substantial deficit. French anxieties focused on such a cost level differential - i.e., a problem that could have been solved by a devaluation - and not on the genuine consequence of liberalisation, i.e., pressure for structural adjustment that would result from an increased intra-European division of labour.

Consequently, the attitudes of French industry changed after de Gaulle had implemented a liberal reform in 1958. This "Plan Rueff" combined fiscal austerity with a devaluation of the franc by 17.55 % and a removal of most import quotas on intra-European trade. It paved the way for the introduction of currency convertibility by almost all OEEC members on December 27, 1958. From now on, opposition to the EEC weakened. Soon there were even hints that important parts of French industry were no longer opposed to a free-trade agreement encompassing Western Europe as a whole (Donner 1959).

The last governments of the Fourth Republic had been too weak to reform the French economy profoundly enough to make France ready for freer trade in a broader framework, a step which these governments would presumably not have opposed for political reasons. Unfortunately, the very politician who finally removed the obstacles to an ambitious liberalisation of trade preferred a "little Europe" without the United Kingdom for political reasons - and thus caused the economic division of Western Europe.

### III.c. Integration Efforts during the 1960s

The development of the EEC during the 1960s closely resembles the pattern of the integration efforts from 1954 to 1959.

- (1) Like the European Defence Community and the European Political Community in 1954, all ambitious plans for a political union failed. France was not ready to strengthen the supranational character of the EEC; the German Bundestag (unlike Adenauer) was not willing to endorse the anti-Anglo-American features of de Gaulle's scheme for a close Franco-German collaboration; and the smaller EEC states were afraid that a Franco-German coalition might neglect their interests. Once again, the political emphasis was put on economic integration - not merely as an end in itself, but rather as a necessary detour on the way to eventual political unification.
- (2) The attitudes of industrialists and trade unions remained more or less the same but for two changes: Industrialists were more willing to endorse a common stabilization policy than before (Zigan 1964), while some trade union leaders detected a need "to balance the interests" of consumers, i.e., free trade, with those of workers in declining industries, i.e., protection (Haferkamp 1964).
- (3) Still, the liberalisation of intra-EEC trade in industrial goods posed no major problem. Rapid growth (Table 1) made it possible to accelerate the planned tariff reductions and complete the customs union on July 1, 1968, 18 months ahead of schedule<sup>10)</sup>.
- (4) As during the negotiations of the fifties, agriculture turned out to be the main problem of "little European" integration. France insisted on taking the first steps towards a

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<sup>10)</sup> The remaining duties on intra-EFTA trade were abolished even six months earlier (Krämer 1968).

common market for agriculture by 1962, if possible coupled with a system of subsidies to be financed mainly by the richer member countries, while farmers and government in Germany wanted to preserve their comparatively interventionist national market orders ("Marktordnungen") for as long as possible. The compromise reached in early 1962 provided for the gradual introduction of a common market with politically determined prices, rigid market orders and variable import levies and export duties for most products (von der Groeben 1982).

The dynamics of trade diversion had a strong impact on European and American politicians in the sixties. Both the U.S. and some non-EEC states of Europe launched initiatives to mitigate the effects of the EEC on their exports. Throughout the fifties the U.S. government had strongly encouraged various attempts at European economic integration. However, as the U.S. post-war trade surplus gradually turned into a deficit in the late fifties and early sixties, U.S. business started to perceive a European economic community as a substantial threat to its exports (von der Groeben 1982). Consequently, the U.S. convened two GATT rounds of multilateral tariff reductions. In the Dillon-Round<sup>11)</sup> (1961-62) the EEC agreed to lower the basis for the calculation of the common external tariff by 20 % for most industrial goods while other participants were to reduce their tariffs by 7 % on average. The Kennedy-Round (May 1964-June 1967) was more successful, although the result fell short of the initially envisaged 50 % target: tariffs for industrial goods were to be reduced by 35 % to 40 %

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11) The beginning of the Dillon-Round was dominated by an argument between the EEC and the other participants who claimed that the EEC's common external tariff would be higher than the average of the national pre-integration tariffs. Thus, the EEC should cut its tariffs unilaterally to comply with the GATT rule that the establishment of customs unions should not lead to an increase in external protection. The EEC had made its offer to reduce the future common tariffs by 20 % contingent on equivalent "concessions" by other participants (Donner 1961).

on a mutual basis until January 1, 1972<sup>12)</sup>. Due to the Kennedy-Round, the average 1972 tariffs on Germany's extra-EEC imports of manufactures were once again below their 1958 level (7.3 versus 9.0 %), down from 11 % in 1964 (Donges et al. 1973).

Already in mid-1961, the U.K., Denmark and Ireland had applied for entry into the EEC, followed by Norway in April 1962 (EEC, Sprecher der Kommission, 1967). Agriculture and the future trade relations between the U.K. and the Commonwealth were the most important issues in the negotiations (von der Groeben, 1982). However, when the talks with all four applicants were adjourned in January 1963, the reason was not an economic but a political one: de Gaulle perceived the entry of the U.K. as a threat to his idea of close Franco-German collaboration. In spite of this set-back, the same four countries renewed their applications four years later. Once again, de Gaulle forced the EEC to interrupt the negotiations without fixing a new date. Finally, in the early 1970s, de Gaulle's successor, Pompidou, agreed to the first enlargement of the EEC as of January 1, 1973.

From 1973 to mid-1977 tariffs between the original EEC six and the EFTA seven<sup>13)</sup> were gradually abolished as all original EFTA members had either joined the Community (U.K. and Denmark) or concluded parallel free trade agreements with the EEC (Austria, Sweden, Switzerland, Portugal and - with a delay - Norway). Thus, the economic division of Western Europe ended. Incidentally, a few months after the two Western European trading blocs had

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12) The EEC implemented these cuts in four steps: 40 % of the reduction was enacted on July 1, 1968, the day of the introduction of the common external tariff, and 20 % each at the beginning of 1970, 1971 and 1972.

13) Unless stated otherwise, the term EEC always refers to the original EEC six and the term EFTA always to the original EFTA seven in this paper.

Table 1: Population, GNP, Exports and Imports of Major OECD Members 1950 - 1984(a)

	Population			G N P			Exports			Imports		
	1950- 1960	1960- 1972	1972- 1984	1950- 1960	1960- 1972	1972- 1984	1950- 1960	1960- 1972	1972- 1984	1950- 1960	1960- 1972	1972- 1984
EEC 6												
W. Germany	1,0	0,9	-0,1	8,7	4,4	1,9	15,1	7,5	5,0	16,1	9,6	3,5
France	0,9	1,0	0,5	4,5	5,6	2,4	7,0(b)	9,2	5,8	6,6	10,5	5,6
Belgium	0,6(b)	0,5	0,1	3,1(b)	4,9	2,0	7,6(b)	9,0	4,2	8,3(b)	8,2	3,8
Luxemburg	0,6	0,8	0,5	.	3,7	2,2	.	5,7	3,0	.	5,9	3,0
Italy	0,6	0,7	0,4	5,7	5,2	2,3	13,7	10,8	5,5	11,5	10,5	4,2
Netherlands	1,3	1,3	0,7	4,6	4,8	1,8	9,7	8,7	3,6	7,4	9,1	2,8
EFTA 7												
United Kingdom	0,3	0,6	0,1	2,4	2,8	1,6	3,0	4,6	3,6	4,3	4,5	3,0
Denmark	0,7(c)	0,7	0,2	3,8(c)	4,4	1,9	7,6(c)	6,3	4,1	9,5(c)	6,6	2,0
Norway	0,9	0,8	0,4	3,6	4,3	3,9	6,7	6,4	4,4	5,4	6,6	3,3
Sweden	0,5	-0,7	1,2	3,4	4,1	1,9	5,4	7,2	4,1	6,9	6,0	2,1
Switzerland	1,3	1,5	0,2	4,5	4,5	0,7	7,3	6,8	3,3	7,5	8,2	3,5
Austria	0,2	0,6	0,0	6,0	4,9	2,6	13,2	8,8	5,3	11,6	8,5	5,0
Portugal	0,6	1,5	1,0	4,1	4,3	3,0	5,6	10,1	4,6	5,4	10,4	2,0
United States	1,7	1,3	1,0	3,2	3,9	2,6	5,3	5,9	4,0	13,5	8,0	5,6
Japan	1,1(c)	1,1	1,0	8,0(c)	9,8	4,1	13,5(c)	14,5	9,6	16,1(c)	13,4	3,8

(a) Average annual rates of change; GNP, exports and imports in constant prices.

(b) 1953 - 1960.

(c) 1952 - 1960.

Source: Dicke et al. 1987, p. 15.

started to fuse<sup>14)</sup>, the U.S. proposed a new round of multilateral trade negotiations in the GATT framework (Tokyo-Round 1973-79).

#### IV. The Impact of "Little Europe" on West Germany's Foreign Trade

The effects of the EEC (and the EFTA) on trade in manufactures have been investigated in numerous empirical studies (see Balassa, 1974, for a survey). The main task of all these studies has been to deduce hypothetical non-integration trade flows which can then be compared to the actual ones. Some authors (i.a. Balassa 1967, EFTA 1972) use pre-integration times series (i) to establish a non-integration trend of real imports (or import shares in income or apparent consumption) or (ii) to estimate the parameters of import demand functions. However, the development of trade flows in the pre-integration years, i.e. the second half of the 1950s, was affected by a variety of special features like the removal of quantitative restrictions under the auspices of the OEEC, the French balance of payments crises of 1957 and 1958 and her subsequent reliberalisation, and - in the case of Germany - by the inclusion of the Saar region from July 1959 onwards, a region which had previously been part of the high tariff French customs area.

Therefore, other authors (i.a. Kreinin 1972) have normalized the development of European post-integration imports (or income elasticities of imports or import shares in apparent consumption respectively) by the changes in the corresponding variables in third countries over the same period, taking for instance the U.S. or the entire rest of the world as the control group. However, doubts remain whether either the rest of the world -

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<sup>14)</sup> This perspective, namely to view the first EEC enlargement and the parallel free trade agreements with the remaining EFTA countries as the fusion of two trading blocs, has been suggested by Kreinin (1981).



consisting mainly of countries at a different stage of economic development - or the United States alone - which in the relevant post-integration period of the late sixties and early seventies suffered from the economic repercussions of the Viet Nam war - can serve as a normalizer for European countries.

This paper tries to illustrate the effect of the EEC on West Germany's foreign trade in a different way. It contrasts the relative importance of two roughly comparable groups of countries as trading partners for Germany: the original EEC and the original EFTA countries. Data for the non-discrimination years of 1960<sup>15)</sup> (for some purposes data for low-discrimination 1962 has to be used for statistical reasons) and 1980 (or 1984 respectively) is compared to data for 1972, the last year of full discrimination between suppliers of manufactures from EEC and EFTA countries on the German market.

Sure enough, this approach cannot yield any estimate of static trade diversion proper, i.e., the replacement of more efficient EFTA suppliers by less efficient EEC producers in the German market: After the fusion of the two European trading blocks, EFTA producers themselves benefitted from the redirection of trade to

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<sup>15)</sup> Intra-EEC tariffs had been cut by 10 % on January 1, 1959, and by the same amount on July 1, 1960, vis-à-vis the January 1957 level. However, this implied no major change in German import duties because West Germany had already reduced her tariffs unilaterally in mid-1957 for cyclical reasons. Discrimination between EEC and EFTA suppliers began in earnest on January 1, 1961, with a further cut in intra-tariffs by 10 percentage points and the first step of the adjustment to the future common external tariff (30 % of the entire adjustment). Intra-tariffs for manufactures were cut again on 1.1.1962 (to 60 % of the national 1957 rates), on 1.7.1962 (to 50 %), 1.7.1963 (to 40 %), 1.1.1965 (to 30 %), 1.1.1966 (to 20 %), 1.7.1967 (to 15 %) and were finally abolished by July 1, 1968 (Krämer 1968). Once again, Germany had moved faster than the other countries by reducing her intra-tariffs to 20 % on July 1, 1964, already in order to mitigate inflationary pressures during a cyclical boom (EEC, Sprecher der Kommission, 1967). Further adjustments of Germany's external tariffs to the higher common rates took place on 1.1.1963 (by 30 % of the original gap) and on 1.7.1968 (by 40 % of the original gap minus the Kennedy-Round tariff cuts).

the detriment of non-Europeans. However, this approach may illustrate the export opportunities which European countries did forego by not forming an OEEC-wide free trade area in the late fifties in the first place. Thus, this approach is well-suited to shed light on the incentive to non-EEC countries to tear down the trade barriers between them and the EEC, i.e., to highlight the economic mainsprings of the liberalisation process which was initiated by the establishment of the "little European" customs union.

Unsurprisingly, the economic division of Western Europe had a profound impact on trade flows. Tables 2a) and 2b) demonstrate that the importance of intra-EEC and intra-EFTA trade in manufactures relative to trade across the divide increased in the period from 1960-72 and decreased in the following period from 1972-80 for all EEC and EFTA countries. Invariably, exports to and imports from the own trading block grew at a much higher rate than trade across the divide in the first period, while the opposite happened in the second period, i.e., during and after the fusion of the EEC and EFTA to one free trade area. The only exception<sup>16)</sup> to this rule is the United Kingdom, whose exports to the EEC already grew slightly faster than those to the EFTA members in the 1960-72 period. Obviously, this demonstrates a genuine trend away from imperial long-distance trade towards an increased division of labour with her immediate neighbours across the Channel. In 1960, the U.K. had sent a much smaller share of her manufactured exports to Europe and especially to her immediate neighbours than any other country in the sample.

In a different way, West Germany is a special case as well. As the EEC member with the lowest share of imports from the Community and the highest share of imports from EFTA countries, the

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<sup>16)</sup> Data on Norway's 1980 exports are indicative only because the destination of some 25 % of her manufactured exports could not be specified (OECD, Foreign Trade, Series B, No. 4, Jan.-Dec. 1980, p. 68).

Table 2: Trade in Manufactures<sup>a</sup> between EEC and EFTA Members 1960, 1972, 1980

Table 2a: Imports

	Share <sup>b</sup> of Imports from						Ratio of Import Shares <sup>c</sup> (EFTA/EEC) x 100			Growth Rate Differential <sup>d</sup>	
	1960	EEC 1972	1980	1960	EFTA 1972	1980	1960	1972	1980	1960-72	1972-80
EEC 6	51.4	63.9	54.6	21.4	14.3	17.5	41.5	22.3	32.1	+5.9	-5.5
W. Germany	41.1	57.0	45.3	26.9	16.7	22.0	65.4	29.3	48.5	+7.6	-7.6
France	51.9	65.4	56.0	16.1	13.3	14.2	31.0	20.4	25.4	+4.1	-3.4
Belgium-Lux.	57.6	71.2	63.7	18.0	12.8	15.3	31.2	17.9	24.1	+5.2	-4.4
Italy	48.1	61.9	57.0	23.7	13.2	15.5	49.2	21.2	27.3	+7.9	-3.8
Netherlands	65.9	71.5	63.4	18.1	12.8	17.2	27.5	18.0	27.1	+3.9	-6.1
EFTA 7	45.4	42.6	46.9	21.0	25.6	18.0	46.4	60.2	38.3	-2.5	+6.7
United Kingdom	28.9	32.4	39.8	11.6	16.6	9.5	40.2	51.4	24.0	-2.3	+11.4
Denmark	50.7	40.0	44.9	35.6	43.2	33.9	70.3	107.9	75.4	-3.9	+5.2
Norway	39.4	30.7	32.8	42.6	45.1	41.9	108.0	146.7	127.9	-2.8	+2.0
Sweden	48.9	38.5	39.7	28.0	34.9	28.2	57.2	90.7	70.9	-4.3	+3.5
Switzerland	68.2	63.2	60.9	13.7	20.0	18.1	20.1	31.7	29.7	-4.4	+1.0
Austria	72.0	66.4	76.2	15.5	21.4	14.1	21.6	32.2	18.4	-3.8	+8.2
Portugal	58.8	42.0	48.5	27.5	30.7	25.7	46.7	73.1	52.9	-4.2	+4.7

Table 2b: Exports

	Share <sup>b</sup> of Exports to						Ratio of Export Shares <sup>c</sup> (EFTA/EEC) x 100			Growth Rate Differential <sup>d</sup>	
	1960	EEC 1972	1980	1960	EFTA 1972	1980	1960	1972	1980	1960-72	1972-80
EEC 6	30.3	46.5	42.9	21.4	17.5	19.7	70.7	37.7	45.9	+6.0	-2.9
W. Germany	25.7	37.7	37.1	28.4	23.5	24.5	110.4	62.3	65.9	+5.4	-0.8
France	25.9	45.2	39.2	14.0	14.5	15.6	54.2	32.0	39.9	+5.0	-3.3
Belgium-Lux.	48.3	68.4	62.0	15.2	10.4	16.9	31.5	15.3	27.3	+6.8	-8.7
Italy	26.6	44.6	40.8	17.1	12.6	15.8	64.3	28.3	38.8	+7.9	-4.7
Netherlands	41.2	59.5	55.9	20.6	15.8	17.8	50.0	26.5	31.8	+6.0	-2.6
EFTA 7	20.3	24.3	32.4	15.9	25.0	18.9	78.6	102.9	58.2	-2.5	+8.5
United Kingdom	13.8	22.1	29.7	9.5	14.6	14.3	68.6	66.0	48.3	+0.4	+4.7
Denmark	21.4	20.6	30.3	34.5	47.0	37.7	161.1	228.1	124.7	-3.3	+9.0
Norway	24.2	22.7	12.8	45.8	45.2	25.5	189.5	198.7	198.8	-0.5	0
Sweden	23.2	20.5	28.3	33.2	39.7	31.7	142.7	193.0	111.9	-2.9	+8.1
Switzerland	38.6	34.6	41.8	16.2	21.7	15.9	42.1	62.7	38.0	-3.8	+7.5
Austria	39.4	32.6	46.8	14.6	30.8	17.8	37.2	94.4	38.1	-8.9	+13.4
Portugal	16.0	16.2	38.3	19.4	44.4	32.7	121.4	274.1	85.2	-8.0	+17.8

<sup>a</sup>SITC sections 5-8.

<sup>b</sup>Share in total imports (exports); manufactures only.

<sup>c</sup>Imports from (exports to) EFTA countries divided by the respective imports from (exports to) EEC countries; manufactures only.

<sup>d</sup>Average annual growth rate of imports from (exports to) EEC countries minus the respective growth rate of trade with EFTA countries; manufactures only.

Source: OECD (OEEC) Foreign Trade, Series B, 1960, 1972, 1980.

abolition of tariffs on intra-trade and the - albeit temporary - rise in duties on extra EEC imports led to an above average distortion of the regional composition of her imports. The same does not hold for exports, especially not in the 1972-80 period in which Germany's EFTA exports grew only slightly faster (by 0.8 percentage points) than her exports to the original EEC members. One reason for this feature might be that a comparatively high share of German EFTA exports went to countries which had imposed only low import duties before 1972 in the first place (most notably Switzerland).

A closer look at German exports and imports reveals that the EEC-EFTA rift distorted not only the level but also the commodity structure of trade. Employing Balassa's 1966 formula to distinguish between inter- and intra-industry trade, the following results emerge: While in 1960 the intra-industry share in Germany's trade with the EEC and the EFTA had been about even, this share rose rapidly vis-à-vis the EEC and remained almost unchanged with regard to the EFTA (Table 3). Afterwards, the gap narrowed con-

**Table 3: Relative Importance of Intra-Industry Specialisation  
in West Germany's Foreign Trade**

Share of intra-trade in total trade <sup>a</sup> with:	Manufactures <sup>b</sup>			All Commodities <sup>c</sup>		
	1960	1972	1980	1960	1972	1980
EEC	62.3	75.8	81.3	59.8	71.6	72.9
EFTA	59.6	60.7	72.4	56.3	58.2	66.8
N. America	48.5	57.5	66.9	39.4	45.6	50.2
World	55.9	68.6	74.0	46.4	58.6	66.0

<sup>a</sup>Computed by the use of the formula  $(1 - \frac{1}{n} \sum_{i=1}^n \frac{|X_i - M_i|}{X_i + M_i}) \cdot 100$

$X_i, M_i$ : exports, imports of commodity i.

<sup>b</sup>SITC-sections 5-8; two-digit level; n=28.

<sup>c</sup>SITC-sections 0-9; two-digit level except for SITC 0, 4, 9 (one-digit level); n=46.

Source: Own calculations based on data from OECD (OEEC) Foreign Trade, Series B, various issues.

Table 4: Relative Importance of Imports from EEC and EFTA Countries for West Germany

	Apparent Consumption of Manufactures <sup>a,b</sup> (ACM)	Import Share in ACM by Source of Imports			Ratio of Imports from EFTA to Imports from EEC	
		World	EEC	EFTA	Manufactures <sup>a</sup>	All Commodities
1952-58	.	.	.	.	.	64.9 <sup>c</sup> (81.0) <sup>d</sup>
1959	.	.	.	.	.	68.7 <sup>c</sup> (71.8) <sup>d</sup>
1960	255	9.89	3.77	2.72	72.1	66.0
1961	272	9.75	3.91	2.72	69.6	62.4
1962	285	10.09	4.29	2.81	65.6	58.9
1963	289	10.42	4.43	2.89	65.3	55.6
1964	319	11.31	5.01	2.97	59.2	52.4
1965	344	12.60	5.86	3.04	51.9	45.5
1966	345	12.12	6.32	2.97	46.9	43.0
1967	326	13.31	6.49	2.88	44.4	39.9
1968	355	15.17	7.58	3.16	41.8	37.9
1969	425	15.85	7.96	3.23	40.6	36.0
1970	458	16.19	8.24	3.14	38.2	34.3
1971	466	16.39	8.87	3.03	34.1	30.3
1972	480	17.06	9.40	2.97	31.6	28.2
1973	491	17.22	9.15	3.05	33.3	29.5
1974	464	18.27	9.49	3.40	35.8	30.9
1975	481	17.69	8.99	3.34	37.1	31.8
1976	477	20.88	10.38	3.99	39.3	33.6
1977	493	21.45	10.37	4.25	41.0	36.9
1978	510	22.09	10.44	4.63	44.3	41.5
1979	540	23.43	10.80	5.03	46.6	45.2
1980	536	24.99	10.79	5.54	51.4	52.6
1981	500	26.03	11.07	5.78	52.2	54.7
1982	469	26.88	11.67	5.94	50.9	53.5
1983	490	27.47	11.85	6.16	52.0	53.7
1984	505	29.32	11.99	6.68	55.7	57.3
1985	525	29.80	12.07	7.00	58.0	58.9
1986	549	29.24	11.84	6.95	58.7	56.6
1987	576	29.35	11.70	6.99	59.7	57.0

<sup>a</sup>Excluding food processing and petrol products.

<sup>b</sup>In billion DM at 1972 prices (deflator: producer price index).

<sup>c</sup>Including the Saar region which changed from the French to the German customs area in July 1959.

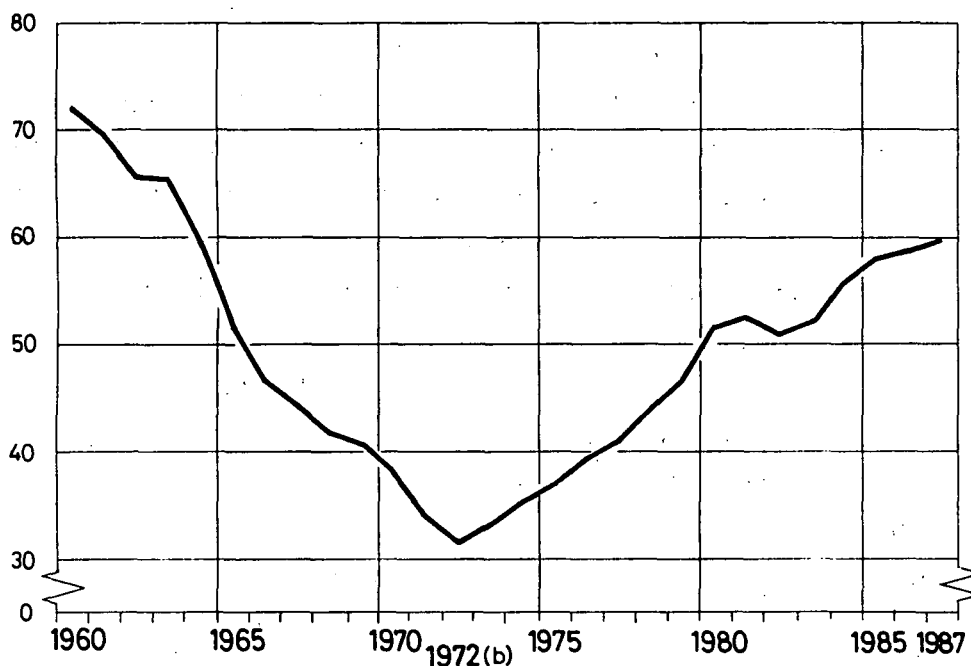
<sup>d</sup>Excluding the Saar region until June 1959.

Source: Own calculations; data taken from Statistisches Bundesamt (SB), Statistische Jahrbücher, various issues; SB, Fachserie 7, Reihe 7, various issues, SB, Fachserie 7, Reihe 4.1.1., various issues; SB, Fachserie 18, Reihe S.7, 1950-84; OECD Foreign Trade, Series B, 1960-62; SVR 1987; S. 357.

siderably. Clearly, the "little European" customs unions had accelerated the trend towards intra-industry specialisation between Germany and her partner countries in the EEC and delayed this trend vis-à-vis the EFTA. The corresponding figures for trade with the U.S. indicate a growing importance of the intra-industry type of specialisation in both periods, a development, though, which started at a much lower base.

**Chart 1: Discrimination and Re-Integration**

Germany's EFTA imports as % of her EEC imports 1960-1987<sup>a</sup>



<sup>a</sup>Manufactures only, excluding food processing and petrol products; EFTA 7, EEC 6.

<sup>b</sup>Last year of full tariff discrimination between EEC and EFTA suppliers.

Source: See table 4.

A direct comparison of Germany's manufactured imports from EEC and EFTA countries yields the clearest evidence of the impact of the economic division and subsequent reuniting of Western Europe (Table 4, Chart 1). In 1960, German manufactured imports from the EFTA countries amounted to 72.1 % of those from the EEC. This ratio fell continuously until it had more than halved by 1972 (31.8 %). From 1973 onwards, i.e., concurrent with the first

steps towards a fusion of both trading blocs, the share rose again to 55.7 % in 1984<sup>17)</sup> and 59.7 % in 1987 (Chart 1). If the imports of all commodities are taken into account, the swing is even slightly more impressive: from 66 % in 1960 to 28.2 % in 1972 and back to 57.3 % in 1984 (57.0 % in 1987) (Table 4).

Obviously, the distortion in the regional composition of West Germany's imports can be attributed to the tariff wedge between EEC and EFTA suppliers. Table 5 presents further evidence to corroborate this hypothesis. Firstly, the differences in the growth rates of imports from EEC and from EFTA countries are calculated for the periods 1962-72 and 1972-84, disaggregated according to the German industrial classification of manufactured products. All but one of the growth rate differentials show the expected sign: imports from the EEC grew faster than those from the EFTA countries in the first period and slower in the second. The odd industry out is the aircraft industry. Here, producers from the original EEC gained market shares relative to their EFTA competitors even in the second period - presumably a consequence of the subsidies to Airbus Industrie which is still mostly an affair of the original EEC six. As a second step, the swing in growth rate differentials between the two periods is calculated. A comparison of these figures with the 1972 effective rates of tariff protection for the products concerned reveals the following: the swing in growth rate differentials was most pronounced for products subject to comparatively high rates of effective protection (clothing, plastic products, petrol products, paper products) and least pronounced for products with low rates of effective protection (stone goods, mechanical engineering, printing). The Spearman rank correlation between the difference in pre- and post-1972 growth rate differentials and the corresponding 1972 effective tariff rates yields a highly significant coefficient of 0.54 (Table 5). Clearly, the height of the respective tariff barrier is

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<sup>17)</sup> As 1972 is the twelfth year after the economic division of Western Europe had begun in earnest in 1961, 1984 is the twelfth year after the start of the fusion of the two trading blocs in 1973.

**Table 5: Tariffs and Trade Distortion**

Growth Rates of German Imports of Manufactures from EEC  
and EFTA countries before and after 1972

	Growth Rate Differentials <sup>a</sup>		Swing in Differentials (I minus II)	Effective Tariff Rates 1972 (in %)
	62-72 (I)	72-84 (II)		
Semi-Manufactures <sup>b</sup>	8.82	-3.01	11.83	
Stone Goods	6.51	-0.51	7.02	2.9
Iron and Steel	5.17	-9.30	14.47	5.1
Foundries	8.20	-8.95	17.16	13.2
Rolling Mills	14.95	-5.70	20.65	9.2
Non-ferrous Metals <sup>c</sup>	6.66	-3.17	9.83	9.3
Petrol Products	14.50	-8.15	22.65	13.6
Chemicals	11.32	-4.81	16.13	16.9
Wood	5.29	-4.02	9.31	18.9
Pulp and Paper	11.90	-0.79	12.70	24.7
Rubber	12.23	-2.70	14.93	8.6
Investment Goods <sup>d</sup>	7.75	-4.70	12.44	
Steel Construction	10.04	-6.73	16.78	5.1
Mechanical Engineering	5.33	-2.62	7.95	2.9
Road Vehicles	4.97	-12.24	17.21	6.8
Shipbuilding	5.48	-7.03	12.50	-9.3 <sup>e</sup>
Aircraft	2.66	10.93	-8.27	5.2 <sup>e</sup>
Electrical Engineering	4.70	-7.27	11.96	6.9
Precision Mechanics, Optics	13.94	-2.80	16.72	5.9
Metal Products	9.00	-6.29	15.29	7.3
Consumption Goods	9.61	-8.30	17.91	
Precision Ceramics	11.57	0.96	10.61	10.6
Glass	10.66	-6.01	16.67	13.4
Wood Products	14.42	-7.27	21.69	10.5
Musical Instruments, Toys	3.17	-6.92	10.09	10.1
Paper Products	14.87	-7.61	22.47	29.6
Printing	6.87	-1.62	8.50	5.0
Plastic Products	13.26	-9.48	22.74	22.3
Leather, Leather Goods, Shoes	11.00	-9.86	20.86	9.7
Textiles	10.39	-9.74	20.13	13.4
Clothing	16.32	-10.09	26.42	27.4
All Manufactures <sup>b,d</sup>	8.30	-4.80	13.10	9.1

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Spearman rank correlation coefficient between swing in differentials and 1972 effective tariff rates: 0.5432, significant at the 0.1 % level; for 1972 nominal tariff rates: 0.487, significant at the 0.2 % level.

<sup>a</sup>Growth rate of German imports from EEC countries minus respective rate for imports from EFTA countries; in %.

<sup>b</sup>Including nuclear industry products, which are not listed separately for lack of data on 1962 imports.

<sup>c</sup>Including NfM-products.

<sup>d</sup>Including steel shaping and data processing equipment which are not listed separately for lack of data on the effective tariff rates and on 1962 imports respectively.

<sup>e</sup>Tariff code excepts all inputs from duties.

Source: Own calculations; tariff data taken from Klepper et al. 1987; for trade data: see table 4.



**Table 6: Trade Distortion**

**Actual vs. Hypothetical Share of EFTA Imports in  
German Apparent Consumption of Manufactures 1972**

	Actual Share AS (in %)	Hypothetical Share HS (in %) <sup>a</sup>	Divergence (AS-HS)	"Trade Foregone" <sup>b</sup>
Semi-Manufactures <sup>c</sup>	3.27	4.57	-1.30	-2443
Stone Goods	1.75	2.44	-0.68	-161
Iron and Steel	2.61	4.54	-1.93	-565
Foundries	0.68	1.20	-0.51	-27
Rolling Mills	2.01	2.30	-0.29	-14
Non-ferrous Metals (NFM)	9.68	12.84	-3.16	-438
NFM-Foundries	0.59	0.56	0.02	0
Petrol Products	0.64	1.45	-0.81	-249
Chemicals	2.59	3.75	-1.16	-639
Wood	6.14	8.59	-2.45	-187
Pulp and Paper	14.68	15.78	-1.10	-88
Rubber	2.65	3.62	-0.98	-75
Investment Goods <sup>d</sup>	2.86	3.43	-0.68	-1156
Steel Construction	0.95	1.19	-0.24	-30
Mechanical				
Engineering	5.02	5.74	-0.72	-335
Road Vehicles	1.13	1.31	-0.18	-86
Shipbuilding	8.48	1.58	6.90	219
Aircraft	5.05	13.89	-8.84	-313
Electrical				
Engineering	2.15	2.92	-0.77	-442
Precision Mechanics,				
Optics	7.65	8.03	-0.38	-25
Steel Shaping	1.35	1.84	-0.49	-32
Metal Products	2.78	3.37	-0.59	-111
Consumption Goods	1.80	3.05	-1.25	-1453
Precision Ceramics	3.53	3.11	0.41	9
Glass	1.63	2.11	-0.48	-27
Wood Products	1.31	2.41	-1.09	-190
Musical Instruments,				
Toys	5.93	7.32	-1.39	-49
Paper Products	1.07	1.77	-0.70	-58
Printing	2.06	2.14	-0.08	-8
Plastic Products	1.63	1.89	-0.26	-27
Leather	2.93	4.82	-1.89	-23
Leather Goods	0.69	1.07	-0.38	-7
Shoes	1.36	1.93	-0.57	-28
Textiles	2.19	4.86	-2.67	-822
Clothing	1.17	2.21	-1.05	-215
All Manufactures <sup>c,d</sup>	2.77	3.77	-1.00	-5052
Excluding Petrol Products	2.90	3.91	-1.01	-4803

<sup>a</sup> Assuming a constant growth rate of the share of EFTA imports in German apparent consumption between the base years 1962 and 1984.

<sup>b</sup> Divergence multiplied by German apparent consumption; in million DM at 1972 prices.

<sup>c</sup> Excluding nuclear industry (no 1962 data available).

<sup>d</sup> Excluding data processing equipment (no 1962 data available).

Source: Own calculations; data: see table 4.

one important factor to explain the development of market shares. However, there is no reason to expect a perfect correlation between tariffs and import growth rates as the price elasticities of supply and demand may differ considerably between products.

Table 6 presents a rough estimate of the opportunities for exporting to Germany which the EFTA countries had to forego because of the EEC-EFTA rift. The actual 1972 share of EFTA imports in German apparent consumption of manufactures (ACM) is contrasted with a hypothetical one, the calculation of which assumes that, in the absence of discrimination, the share of EFTA imports in German ACM would have grown at a constant rate between the base years 1962 and 1984. For most products the actual share is considerably below the hypothetical one. This time, the odd industry out is shipbuilding - which is not altogether surprising as the 1972 effective rate of protection of this industry had been -9.3 % (Table 5). All in all, the export opportunities foregone by the EFTA countries amount to 1 % of German ACM for the year 1972, equivalent to 5.052 billion DM in 1972 prices (excluding petrol products: 4.803 billion DM).

Unfortunately, these figures can be no more than a first rough indicator of magnitude: due to the lack of sufficiently disaggregated data for the initial period, low discrimination 1962 instead of non-discrimination 1960 had to be taken as the first base year for the product-by-product estimates shown in Table 6. Therefore, a somewhat more sophisticated estimate of the aggregate losses employs 1960 and 1987<sup>18)</sup> as base years (see Table 7). Furthermore, an attempt is made to eliminate any distortion of the results that might arise from cyclical or exchange rate effects. We proceed as follows: as a first step, the determinants of the actual ratio of all imports to German ACM in the period 1960-1987 are estimated by four alternative regression analyses, assuming that the development of these shares can be explained by

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<sup>18)</sup> Taking 1987 instead of 1984 as the second base year hardly alters the results at all.

a constant trend rate of growth of these shares over time (equation 1, Table 7), a constantly declining rate of growth (equation 2) plus changes in the degree of capacity utilisation in Germany (equation 3) plus movements of Germany's real effective exchange rate in the current and the previous year (equation 4). All parameters display the expected sign, equation 4 fits the data best.

**Table 7: Alternative Estimates of Trade Distortion**

Equations:

- (1)  $\ln Y_T = \beta_0 + \beta_1 T$   
(2)  $\ln Y_T = \beta_0 + \beta_1 T + \beta_2 T^2$   
(3)  $\ln Y_T = \beta_0 + \beta_1 T + \beta_2 T^2 + \beta_3 \ln K_T$   
(4)  $\ln Y_T = \beta_0 + \beta_1 T + \beta_2 T^2 + \beta_3 \ln K_T + \beta_4 \ln E_T + \beta_5 \ln E_{T-1}$

Results:

	$\beta_0$	$T^a$	$T^2{}^a$	$\ln K_T^a$	$\ln E_T^a$	$\ln E_{T-1}^a$	SE	$\bar{R}^2$	DW	Trade Foregone <sup>b</sup>
(1)	-2.372 (-123.51) <sup>c</sup>	0.0449 (38.79) <sup>c</sup>					0.049	0.982	0.917	6718.29
(2)	-2.434 (-92.71) <sup>c</sup>	0.0573 (13.73) <sup>c</sup>	-0.00043 (-3.06) <sup>c</sup>				0.043	0.986	1.235	8100.64
(3)	-4.870 (-2.41) <sup>c</sup>	0.0582 (13.84) <sup>c</sup>	-0.00046 (-3.26) <sup>c</sup>	0.531 (1.21)			0.043	0.987	1.142	6739.73
(4)	-6.622 (-3.81) <sup>c</sup>	0.0668 (15.57) <sup>c</sup>	-0.00074 (-5.28) <sup>c</sup>	1.223 (3.19) <sup>c</sup>	-0.679 (-3.92) <sup>c</sup>	0.367 (2.29) <sup>d</sup>	0.033	0.992	1.748	6986.68

Y: Share of imports in apparent consumption of manufactures; T: time, 1960=1; K: change in capacity utilisation over previous period, in percentage points; E: real effective exchange rate, 1960=100; SE: standard error;  $\bar{R}^2$ : adjusted R<sup>2</sup>; DW: Durbin-Watson statistics; n = 28.

<sup>a</sup>Shown are the respective parameters, ( ): t-statistics; <sup>b</sup>in million DM at 1972 prices; <sup>c</sup>significant at the 1% level; <sup>d</sup>significant at the 2.5% level.

Data sources: see table 4.

In a second step, we employ these parameters to compute what the 1960 and 1987 import shares would have been if the degree of capacity utilisation and the real effective exchange rate had not differed from their 1972 levels. Thirdly, we assume that Germany's EFTA imports react to changes in the degree of capacity utilisation and exchange rates in the same way as her overall imports. Therefore, the actual 1960 and 1987 shares of EFTA imports in ACM are adjusted by the same proportion by which the actual overall import shares differ from the normalised ones<sup>19)</sup> calculated in step two. In a further step, these adjusted figures for 1960 and 1987 serve as the basis for the calculation of a hypothetical 1972 share of EFTA imports in ACM, assuming a constant (equation 1) or a constantly declining trend rate of growth of these shares (equation 2-4).<sup>20)</sup> The difference between the hypothetical and the actual 1972 figure yields the estimates of trade foregone displayed in the last column of Table 7. The most plausible figure, i.e., the one derived from equation 4, is 7.0 billion DM. In other words, without the economic division of Western Europe, Germany's 1972 imports from the EFTA countries would have exceeded their actual level by 7 billion DM or 49 %.

This number is still likely to underestimate the real losses incurred by EFTA exporters (and German consumers). Without the EEC-EFTA rift, growth in Western Europe might have been faster, implying a higher level of ACM i.a. in Germany and thus more German imports from all countries including the EFTA seven.

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19) The figures derived from equation 4 are adjusted for the lagged effect of the exchange rate on imports and for the divergence in the development of Germany's overall effective exchange and the external value of the DM vis-à-vis the EFTA seven as well. Furthermore, all figures are adjusted for the respective error terms.

20) We assume that the ratio between the two trend parameters  $\beta_1$  and  $\beta_2$  calculated for the growth of the overall import share holds<sup>2</sup> for the EFTA share as well.

## V. Conclusions

Regional liberalisation clubs can serve as catalysts for a much broader removal of barriers to trade. Trade diversion to their detriment and the example of successful trade creation within a club provides economic agents in non-member countries with an incentive to accept a liberalisation package which they might otherwise have rejected. These dynamics of trade diversion were clearly at work from the late 1950s onwards. The establishment of a "little European" club called EEC in 1958 initiated a process which culminated in the abolition of almost all remaining tariffs on manufactures between most Western European states twenty years later. However, the economic division of Western Europe from 1958 to 1977 was not a necessary and thus economically justifiable stage on the way towards freer trade in Europe. The conditions under which a small rather a more encompassing club is the most feasible first step towards liberalisation were not given at that time. German industry and trade unions had favoured a more multi-lateral approach while French anxieties could have been - and eventually were - resolved by a devaluation. Instead of making a more ambitious liberalisation package feasible, politics got in the way. The result was a severe distortion of trade flows within Europe. Germany paid a high price for a Gaullist Europe which - incidentally - did not even materialize.

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