

European Commission views on German unification (1990)

Caption: In 1990, the European Commission examines the possible implications of the integration of a reunified Germany into the European Community.

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I. The Community and German unification (1990)

Introduction

1. At the Strasbourg European Council on 8 and 9 September 1989, the Heads of State or Government reaffirmed their commitment to German unification through free self-determination in a peaceful and democratic process, in full respect of the relevant agreements and treaties and of all the principles defined by the Helsinki Final Act, within a context of dialogue and East-West cooperation.

Elections have now been held. The German people have delivered a clear verdict in favour of unity. The conditions have therefore been met for a dynamic and orderly process of unification to go ahead. This process is compatible with the goals of European integration, as was also emphasized at the Strasbourg European Council. Integrating the German Democratic Republic within the Community will call for solidarity and a balanced approach.

2. The step-by-step integration of more than 16.5 million people into a united Germany and hence into the Community — a *de facto* enlargement — poses a major challenge to the German authorities and the Community.

The unreliability of the economic data and the uncertainty surrounding currency conversion make any comparisons between the two Germanys — whether in terms of GDP, per capita GDP, or balance of trade — difficult and speculative, and any attempt to compare the German Democratic Republic with the other Community countries all the more so. The macro-economic aggregates calculated on these bases have to be treated with great caution to take account of the qualitative aspects (the mediocre state of services and infrastructures, and serious environmental problems) as well as the purely quantitative aspects.

The German Democratic Republic's economy may appear relatively strong in broad terms, with per capita GDP markedly higher than in the other CMEA countries and approaching the Community average. Closer inspection reveals severe structural shortcomings and deficiencies in production plant but also real growth potential that could no doubt be quickly stimulated by the need to catch up and modernize.

Looking at the shortcomings and deficiencies, notable effects include the woeful state of housing and the roads and the manifest inadequacy of the rail network and communications system. The environmental situation, too, is extremely grave and the effect of this is felt well beyond the German Democratic Republic itself.

As for the potential for lasting growth, the level of both general and technical education among East Germans is good and certain sectors (chemicals, optics, electronics, machine-tools) still retain some industrial and technological advantages. There is also a substantial reservoir of untapped productivity gains in terms of labour, capital and business organization, as well as a strong attraction for foreign capital and direct investment, in particular from the Federal Republic, the other Member States and the EFTA countries.

The Commission considers that the unification of Germany represents not only a challenge but also a major opportunity for the Community as a whole because of the additional investment, growth, trade and contacts it will generate at all levels.

Unification procedure

3. Federal constitutional law offers several avenues towards unification. The choice between the procedure laid down in Article 23 of the Basic Law and that of -Article 146 is a matter for the Federal Republic and the German Democratic Republic.

Both procedures allow for prior negotiations between the two Germanys on the conditions for unification

and would make it possible to take into account developments as they occur during talks on the external aspects of unification. But it should be stressed that the Article 23 procedure is simpler as far as the Community is concerned.

As stated on several occasions, the integration of the territory of the German Democratic Republic into a unified Germany and hence into the Community constitutes a “special” case. For this reason Article 237 of the EEC Treaty — which relates to the accession of other States — does not apply.

The integration of the German Democratic Republic into the Community through German unification, therefore, does not amount to accession in formal terms. However, the practical problems involved are on a par with those posed by the most recent enlargements of the Community. Now, as then, integration into the Community will proceed by stages, requiring transitional measures to facilitate the gradual application of the “*acquis communautaire*”.

One of the first major differences by comparison with a “normal” accession is that the initial stage of the German Democratic Republic's integration into the Community will take place within the framework of the German unification process, in other words ahead of formal integration into the Community. A second difference lies in the special nature of the case and the absence of the usual negotiations on the conditions of accession. At Community level the similarities noted above and these special features will have to be taken into account to ensure optimum integration of the German Democratic Republic into the Community from the very outset of the interim phase.

As far as the Commission can tell at the moment, it should be possible to integrate the German Democratic Republic in the Community without the need to amend the Treaties. This, of course, is assuming that the body of new legislation applicable in the territory of the German Democratic Republic is compatible with the Treaties as a whole and in particular with those provisions that are directly applicable.

Integration scenario

4. The Commission sees the integration of the German Democratic Republic into a unified Germany, and hence into the Community, taking place by stages:

- (i) The first will be the interim adjustment stage, beginning with the introduction of inter-German monetary union, accompanied by a number of social and economic reforms (*Währungsunion, Wirtschafts- und Sozialgemeinschaft*).
- (ii) The second, transitional stage will begin with the formal unification of the two Germanys.
- (iii) The full application of the “*acquis communautaire*” will not take place until the final stage.

During the interim adjustment stage, the German Democratic Republic will gradually bring in the legislation necessary for step-by-step integration into the Federal and Community system. Consequently, the integration of the German Democratic Republic into the Community will partly take place ahead of formal unification of the two Germanys.

The start of the transitional stage will coincide with the formal unification of the two German States. Community legislation, both primary and secondary, will then automatically apply in the territory of the German Democratic Republic except where the Council specifically decides otherwise (temporary exceptions) on a proposal from the Commission.

Decisions to allow these exceptions will be taken by the competent institutions, sector by sector, on the basis of the relevant Treaty articles. The European Parliament will be involved in the Community's decision-making process under either the consultation or the cooperation procedure. After taking the initiative of setting up an *ad hoc* committee, Parliament called for this in the resolution it adopted.

Problems arising during the interim adjustment stage

5. This stage comprises:

- (i) the introduction of inter-German monetary union;
- (ii) the parallel introduction of the economic and social reforms essential for the progressive introduction of a social market economy in the German Democratic Republic;
- (iii) the progressive integration of the German Democratic Republic into the economic system of the Federal Republic and gradual adjustment of the German Democratic Republic's legislation to bring it into line with Federal and Community law.

A large part of the German Democratic Republic's integration into the Community, then, will take place during this stage, and this will affect the working of the Community and will substantially influence the transitional arrangements applicable once formal unification has taken place.

Care will therefore already have to be taken at this stage to ensure that the process of German unification is compatible with Community law, by facilitating the German Democratic Republic's gradual integration into the Community and preparing the transitional arrangements in good time. Provisions to this effect should be included, as necessary, in any treaty between the Federal Republic and the German Democratic Republic covering this initial stage.

6. The introduction of inter-German monetary union — and in particular the question of what conversion rates will apply — is essentially a political and economic choice which rests with the two Germans. Nevertheless this choice will involve both macroeconomic and monetary consequences for the Community as a whole. The gradual transformation of the East German economy to the social market model will go hand in hand with large-scale industrial restructuring, which will involve substantial aid from the public purse. The Commission will have to be able to assess such aid in the light of the Community rules on competition. This implies that the Commission will have to be informed in advance in order to ensure that all aids granted are compatible with the Community's objectives and do not discriminate between Community firms and distort competition.

The same attention should be given during the interim period to arrangements between enterprises, State monopolies and public procurement procedures. Lastly, the Commission feels that VAT will have to be introduced in the territory of the German Democratic Republic during this stage.

7. The introduction of the Deutschmark in the German Democratic Republic and the transfer of monetary sovereignty to the Bundesbank constitute the basic elements of German monetary union. A crucial point will be the conversion rate(s) of East German marks into Deutschmarks. The choice of the rate(s) must hold the balance between the need to avoid creating excessive purchasing power, weakening the competitiveness of East German enterprises and causing unemployment as a result, and the need to take account of the German Democratic Republic population's expectations that wages and pensions will catch up with West German standards.

Decisive and immediate economic reforms will have to take place in the German Democratic Republic. To overcome the adjustment problems, investment on a massive scale and additional social transfers are required. Opening up the goods and services, labour and capital markets, together with considerable private investment (from the Federal Republic, other Member States and the rest of the world) and public transfers will build a base for a catching-up process which could be fairly rapid. But this adjustment period must be able to rely on a labour market that works, an employment, training and conversion policy and the introduction of a social policy for the unemployed.

Exports to the German Democratic Republic could provide a strong boost for demand in the Federal Republic of Germany and the Community, which could translate into a higher growth rate in the medium term.

As far as the Commission can see at present, the most likely prospect is that of a significant positive impact on growth in the Federal Republic and the Community in general. The Federal Republic could enjoy a one percentage point higher growth rate in the next couple of years. This would in turn stimulate Community growth on average by an additional 0.5 percentage points.

To limit the risk of inflationary pressures in the Federal Republic and to help stimulate growth throughout the Community, it will be important for all the Member States to have the same ease of access to the market in the German Democratic Republic to enable them to participate in the restructuring process.

It is likewise important that the Government of the Federal Republic inform and consult the Community about all the steps it takes in the context of German monetary union. The further adjustment of the policy mix within the Community must be coordinated with the competent Community institutions and in the framework of the process of multilateral surveillance at the first stage of economic and monetary union.

8. Parallel to German monetary union, some decisive and immediate reforms towards a social market economy will be introduced in the German Democratic Republic. They will include:

- (i) a comprehensive reform of the price system, which is distorted by subsidies and does not reflect the relative scarcities of goods;
- (ii) a reform of the money and credit system;
- (iii) a reform of the tax and social security system in the direction of the Federal Republic's system;
- (iv) the establishment of an economic and legal framework allowing free enterprise, private property and privatization of public enterprises.

The Commission considers these reforms to be totally in line with preconditions for the German Democratic Republic's integration into the Community order.

9. The interim period should be used to the utmost to prepare for the application of the basic Treaty provisions guaranteeing free movement of goods and services via the principle of mutual recognition and of secondary legislation on harmonization in the areas of public health and technical safety. During the interim period, the Protocol on German internal trade and the existing controls will continue to apply.

The current volume of German internal trade is not very large: somewhat less than ECU 3 500 million in both directions. Trade with the other Member States amounts to around ECU 1 400 million. Re-export of East German goods from the Federal Republic is negligible. It seems probable that initially, during the interim phase, the trade flow from the Federal Republic to the German Democratic Republic will increase more rapidly than in the opposite direction. The Commission considers that the use of all the instruments available under the Protocol on German internal trade should be sufficient to avoid any distortions of trade, including agricultural trade, during the interim phase. It will make sure that this is the case throughout that phase.

Likewise, in respect of Member States' exports to the German Democratic Republic, equality of access will need to be ensured.

10. From the outset of the interim period, the restructuring of the East German economy will require the input of capital from private and public sources. To begin with, there is the possibility of help through the various instruments available under the scheme for coordinating international economic and financial assistance, in particular through the European Bank for Reconstruction and Development (EBRD).

The German Democratic Republic would also be eligible for aid under the Tempus programme and for assistance from the future European Training Foundation.

The Commission takes the view that the German Democratic Republic should be given access to Community loan facilities (EIB, Euratom, ECSC) from the outset.

Whether, during the interim period, there should be a special Community aid programme (as for Portugal) along the lines suggested by Parliament is a question which the Commission intends to put to the European Council.

11. To sum up, the Commission wishes to stress the need for the full involvement of the Community from the outset in this phase of German unification. Because of the expected impact on Community life, there will have to be a move from information and consultation to real concerted action. This will require an active Commission presence on the inter-German scene and appropriate procedures to ensure maximum transparency as the interim adjustment stage progresses, with due regard for the need for continuous dialogue with the European Parliament and the Council.

Involving Community bodies in this stage will of course mean that there must be contacts between the Commission and the authorities in the German Democratic Republic.

Problems arising during the transitional stage

12. The problems of adaptation to a market economy and of integration into the Community are under active examination by the two Germanys and the Commission as well. They concern both the external commitments of the German Democratic Republic and the application of the internal policies of the Community.

On the external side there is the question of the unified Germany taking over German Democratic Republic commitments. The application in the unified Germany of the Community's external policy and commitments will take place from the date of unification, subject to any transitional measures of a technical kind.

An important principle of the application of the internal policies of the Community — in particular the internal market, structural policies, environment and transport — in the unified Germany from the date of unification should be that this should take place with as few exceptions and transitional arrangements as possible. Until 1 January 1993 controls could, if necessary, be operated within the unified Germany. From that date only end-use control will be possible.

13. The question of external agreements falls into two categories: on the one hand, the application by the unified Germany of agreements already concluded by the German Democratic Republic and, on the other hand, the application of the Community's external agreements in the territory of what is now the German Democratic Republic. The German Democratic Republic has a large number of international agreements which fall mainly into three types: cooperation agreements, framework agreements normally of five-year duration, and annual commercial arrangements — and reflect very closely the present pattern of the German Democratic Republic's trade.

Sixty-five per cent of the German Democratic Republic's current trade is with CMEA countries (of which 40% is with the Soviet Union alone and 25% with other CMEA countries), 20% with OECD countries (including about 8% intra-German trade) and 5% with developing countries. The Commission will study these agreements in consultation with the Federal Republic and the German Democratic Republic in order to establish how far they are consistent with Community rules and practice or whether they may require some transitional or other exceptions.

It is important also to recognize that continuation of traditional trade flows has a role to play in maintaining good political and commercial relations with other East European countries. In many cases also, it will be in the interest of the unified Germany that production which is geared to export to some East European countries should continue. The current pattern of trade between the German Democratic Republic and the Soviet Union, in particular, is based mainly on imports of energy and raw materials from the Soviet Union

and the export of manufactured goods directed especially to the needs of the Soviet market.

The Commission has also examined the question of the application of the Community's existing international commitments in the whole territory of a unified Germany. Technically, the changes necessary in order to ensure the full respect of the regime at the external frontiers and when goods have passed into free circulation are complex and need close examination. Obviously, once unification is effected the Community, as a legal personality within international organizations, will cover the whole territory of a unified Germany.

14. On the internal side the questions which require the most careful attention are:

- (i) the best means of integrating the German Democratic Republic into the Community's internal market;
- (ii) respect for competition policy;
- (iii) the application of common policies, notably those in agriculture and fisheries, to the current territory of the German Democratic Republic after unification;
- (iv) the application of the structural policies of the Community, notably in the absence of a fully reliable statistical basis for their application and in the light of the very different economic structure of the German Democratic Republic;
- (v) the application of other policies — notably those in the environment and transport sectors, where the needs of the German Democratic Republic are evident;
- (vi) the financial consequences of unification for the Community.

15. As far as the internal market is concerned, it is not excluded that from the date of unification, on a temporary basis, some differential treatment might be required for goods and services from the current German Democratic Republic territory in respect of technical regulations or other harmonized provisions.

The Commission does not foresee any major difficulty as far as the free movement of persons, services and capital is concerned. From the date of unification at the latest, German Democratic Republic territory will be part of the customs union, which implies integral application of CCT and commercial policy arrangements except for the necessary transitional measures which may be adopted to take account of the external arrangements of the German Democratic Republic.

The Commission considers, however, that it would be highly desirable if the number of transitional arrangements and exceptions in relation to the internal market after 1 January 1993 should be limited as far as possible. From that date the internal frontiers in the Community will be removed and the form of control will have to be adapted.

Linked with the progressive application of the internal market to the current territory of the German Democratic Republic will be strict attention to the avoidance of distortions of competition. It is probable that there will be a very high level of investment in the current territory of the German Democratic Republic in coming years. It will be necessary to ensure that it does not give rise to serious distortions of competition in goods and services.

The authorities of the Federal Republic of Germany have agreed to inform the Commission of all aid measures designed to rebuild the German Democratic Republic's economy. The Commission will examine the likely effect of such measures on intra-Community trade in order to prevent any distortions of competition and to ensure non-discriminatory access for all Community firms irrespective of their place of establishment.

The new context of a unified Germany will also require a re-examination by the Commission of certain existing aid schemes in the Federal Republic (Zonenrandgebiet, West Berlin).

The same attention should be given to the application of competition rules applying to agreements between firms. It may be necessary to apply these rules in a sensitive and flexible way to take account of new market realities. Such agreements should not distort competition or affect trade between Member States.

16. When new members have joined the Community in the past, the question of the gradual application of the price system of the common agricultural policy has given rise to detailed and specific exceptions. The pattern of agriculture in the German Democratic Republic differs very considerably from that in the Federal Republic of Germany. Its agriculture is dominated by agriculture cooperatives (LPG) or State farms (VEG), which cover almost 95 % of the cultivated land. The average size of farms is very large — over 4 500 hectares on average for arable farms — and thus represents in general a form of paid employment rather than of family farms.

Notwithstanding satisfactory technical performance, overall productivity in the German Democratic Republic's agriculture is below West European standards, mainly owing to its organization and excess labour force.

The trend of produce prices in the German Democratic Republic will depend largely on how its agricultural system is phased into a market economy as from the entry into force of Inter-German monetary union.

The Commission is of the opinion that the introduction of Community agricultural prices and support systems, at least by 1 January 1993, should not be excluded at the level of production.

For certain products there are very substantial consumer subsidies in operation in the German Democratic Republic at the present time, and these must be phased out. The structural changes which may be expected over a period of time in the German Democratic Republic's agriculture depend on the decisions of those engaged in that production, but the complications, including the question of land ownership, are considerable and may take some time.

The integration of the German Democratic Republic into the fisheries policy will pose some awkward problems. German unification will result in a substantial increase in the capacity of the Community fleet, whereas resources are already very limited. The capacity of the German Democratic Republic's fleet (which is roughly twice the size of that of the Federal Republic) is out of all proportion to the resources to which it can have access.

As regards markets, fundamental adjustments to the production and marketing structures in the German Democratic Republic are clearly essential. The integration of the German Democratic Republic's fleet into the fishing industry's structural arrangements will also require adjustments to the existing set-up.

In terms of internal resources, unification would mean a small increase in the Community fishing zone in the Baltic. Allowing the German Democratic Republic's fleet access to the other zones could jeopardize the balance in fishing capacity currently in use and the existing balance between Member States. This is especially the case with precautionary TACs, which are not shared out between Member States, given the size of the German Democratic Republic's fleet and its tendency to concentrate on certain stocks (blue whiting, horse mackerel, etc.).

On the external front, the Community will have to take over the bilateral agreements concluded by the German Democratic Republic, and this may entail complex negotiations.

17. As from unification, the Community structural policies will apply to German Democratic Republic territory. By that time the massive and urgent task of economic and social restructuring in the German Democratic Republic will be under way.

Reorganization and restructuring will affect all sectors of the economy and imply vast investments in capital and human resources. The financial burden of these investments will necessarily be a shared one. A large part of the investment effort in the productive sector will be undertaken by the private sector. Additional funding will be necessary from public sources, mainly from the Federal authorities.

German Democratic Republic territory will also be entitled to Community assistance in accordance with the structural Fund regulations. The criteria contained in these regulations pose certain problems of applicability to the German Democratic Republic in addition to the difficulty caused by the absence of reliable statistics. It can, however, be assumed that the territory of the German Democratic Republic is beset by the same type of problems as are encountered by other regions of the Community and that it will therefore be eligible under one or more of the structural policy objectives.

As far as the European Social Fund is concerned, emphasis should be put on those interventions which enable the German Democratic Republic to meet the challenges of the market economy (vocational training and occupational integration).

The total volume of Community aid will depend on the classification of the regions of the German Democratic Republic with reference to the various objectives of the structural policies.

18. Among the other policies, technical adjustments and transitional measures will probably be required in transport policy and the social sphere (health and safety).

In the field of transport it should also be noted that there is a considerable need for infrastructure improvements.

However, the area which calls for the most particular attention — because of the gravity of the situation in the German Democratic Republic and the urgency of the problem — is the environment.

The roots of the problem go back to the effort made by the German Democratic Republic from its very beginnings to achieve maximum economic autarky, which led to the development and retention of very highly polluting and technologically outdated industries, with a heavy toll in terms of their impact on the environment and public health. For example, the German Democratic Republic is one of the last countries still running a major coal-based chemical industry based on massive use of brown coal.

First, a distinction has to be made between plants where pollution is too high for them to be adapted (which will have to be closed down) and those where anti-pollution equipment could be fitted to bring them closer into line with Community levels. For the latter, it is clear that transitional, and in some cases long-term, exemptions from Community standards will be necessary.

Second, the new investment sectors will have to meet Community requirements. Account will have to be taken of the cross-frontier aspects of pollution (e. g. Elbe, Baltic).

Massive economic investment will be required to retrieve the environmental situation. This applies both to the adaptation of existing plant and to the construction of new plant.

The grave environmental situation is a phenomenon common to all the countries of Central and Eastern Europe. In this connection, the Commission warmly welcomes the special conference due to be held in Dublin in June to consider this whole problem. It believes that the Community, together with the other Western nations, should demonstrate solidarity in the search for solutions.

More generally, a new energy policy for the German Democratic Republic will have to be defined, based on the exploitation of new sources and improved energy efficiency. In this context the problem of nuclear safety will also have to be tackled.

19. As far as the budgetary impact of the German Democratic Republic's integration into the Community is

concerned, the Commission's view is that any figures are bound to be guesswork at this stage. The position will, of course, become clearer once the arrangements for inter-German monetary union are settled. But even that will not remove all uncertainty.

On the expenditure side, the cost will largely be determined by the impact of integration on the CAP and the scale of intervention under the structural policies.

On the revenue side, too, much will depend on the transitional arrangements and the macroeconomic impact.

In general terms, we are likely to see vigorous economic growth in the German Democratic Republic, generating higher demand throughout the Community, and an increase in imports from the other Member States. This additional growth will be reflected in additional revenue.

Conclusions

The entry of the German Democratic Republic into the group of democratic countries and the forthcoming unification of the Federal Republic of Germany and the German Democratic Republic are among the most important historical events of postwar Europe and should be given a warm and unreserved welcome. The Community shares the joy of the German people at finding their new place within the unified Germany and within the European Community.

This unification will need to take place under the Community roof. It is therefore imperative that the process of consultation between the two Germanys and the Community should be fully and actively engaged as from the interim phase. On the basis of its extensive contacts so far the Commission is confident that this will be the case.

The Commission considers that German unification offers an opportunity for reinforcing and speeding up European integration.

The Commission sees no reason whatsoever for concluding that the process of German unification and the place of the unified Germany in the European Community will hold back the development of the Community's relations with other countries in Central and Eastern Europe or with the Community's other neighbours or with the Third World. On the contrary, the new developments point to a more prosperous and more open Community, confident in its own democratic values and its increased role in the world.

[...]

III. The Community and German unification

I — General explanatory memorandum

Introduction

1. Background

1.1. In its communication of 19 April to the European Council, the Commission stated its view that the conditions had been met for a dynamic and orderly process of German unification to go ahead. It also felt that unification should take place under the Community roof and that it offered an opportunity for reinforcing and speeding up the process of European integration.

The Commission views the integration of the German Democratic Republic into a united Germany, and hence into the Community, as a special case. It will have to be done by stages. However, it does not necessarily require any amendment of the Treaties.

Working from these premises, the Commission considered the unification arrangements and put before the European Council a suggested scheme for the integration of the German Democratic Republic.

1.2. At its special meeting in Dublin on 28 April, the European Council gave a warm and unreserved welcome to the process of German unification taking place under the Community roof. It expressed the view that the integration of the territory of the German Democratic Republic into the Community should be accomplished in a smooth and harmonious way. In particular it stated that integration would become effective as soon as unification was legally established, subject to the necessary transitional arrangements, and confirmed that it would be carried out without revision of the Treaties.

As regards the transitional arrangements, the European Council noted that the Commission would, as soon as possible and within the context of an overall report, submit to the Council proposals for such measures as were deemed necessary. It went on to state: "These measures, which will enter into force at the moment of unification, will permit a balanced integration based on the principles of cohesion and solidarity and on the need to take account of all the interests involved, including those resulting from the "acquis communautaire". The transitional measures will be confined to what is strictly necessary and aim at full integration as rapidly as possible."

1.3. In its resolution of 17 May the European Parliament welcomed the conclusions of the European Council, in particular its unambiguous support for the German unification process and its recognition of the need for this to take place within the European Community context. Parliament also took note of the European Council's statement that the integration of the German Democratic Republic into the Community could take place without revision of the Treaties.

Since then Parliament and especially its Temporary Committee on German Unification, working in close consultation with the Commission and the German authorities, has looked carefully at the implications of German unification for the Community.

In the light of an interim report by the Temporary Committee, Parliament adopted a further resolution on 12 July, in which it particularly welcomed the efforts being made to bring about European integration in parallel with German unification. It believed that German unification must contribute to strengthening the Community politically and economically and considered that any derogations and transitional measures should not weaken central Community objectives, in particular completion of the single market and the achievement of economic and monetary union. It also set out its views on the substance of the measures required during the interim adjustment phase and after formal unification.

Parliament, then, has already spelled out its position on the nature and content of the transitional measures in advance of the Commission's presenting its proposals.

1.4. This communication sets out the Commission's entire package of proposals for legislation effecting the technical adjustments and transitional measures necessary to ensure the harmonious integration of the territory of the German Democratic Republic into the Community.

Following the European Council's special meeting in Dublin on 28 April the process of German unification gathered pace appreciably. This prompted the Commission to speed up its own preparations so as to be able to present proposals for transitional measures in September. With the recent further acceleration in the pace of unification the Commission has decided to bring forward presentation of its proposals to the month of August.

Since the integration of the German Democratic Republic into the Community is a special case, and in view of the planned timetable, these preparations have been conducted in close association with the German authorities, Parliament being kept constantly informed. In drawing up its proposals, the Commission has been especially grateful for the guidance offered by Parliament's resolution of 12 July.

This communication is in four parts:

- I. General explanatory memorandum;
- II. Sector-by-sector explanatory memorandum;
- III. Financial aspects;
- IV. Annex: proposals for legislation.

1.5. The communication confines itself to the direct consequences of German unification in terms of Community competence and secondary Community legislation.

The economic impact of the integration of the German Democratic Republic into the Community is assessed in the light of the first Staatsvertrag and on the assumption that Community law will be applied in full, subject to the necessary transitional measures.

The assessment of the financial implications covers both the overall impact of integration as well as its impact by sector (or group of sectors) and is accompanied by some indications regarding the financial perspective and the repercussions on the 1991 budget.

The communication does not consider how German unification will affect the internal and external development of the Community nor its geopolitical implications for the construction of a greater Europe.

The fact is, however, that it has already made a substantial contribution:

- (i) internally the process of economic and monetary union has gained momentum, as testified by the latest European Council's decision to convene the two intergovernmental conferences;
- (ii) on the international stage we are witnessing the end of the cold war and the laying of firm new foundations for peace, security and cooperation and for a strong Community that will play its full part in the process.

2. Unification arrangements and integration scenario

2.1. In its communication of 19 April to the European Council the Commission noted that Federal constitutional law offers several avenues towards unification. It pointed out, however, that the procedure in Article 23 of the Grundgesetz is simpler as far as the Community is concerned. It is now clear that German unification will proceed along these lines.

The accession of the new *Länder* under Article 23 will take effect with their declaration of accession (Beitrittserklärung). That, then, is the date on which the German Democratic Republic will become an integral part of the Community and on which Community law will begin to apply there.

2.2. The Commission's suggested scenario for the integration of the GDR into a unified Germany and the Community involved several stages, the first of which began on 1 July with the introduction of monetary, economic and social union on the basis of the Staatsvertrag.

The first chapter (p. 30) summarizes the main points of the Staatsvertrag and analyses the economic and monetary impact both on the German Democratic Republic and on the Community and the Federal Republic of Germany.

During the interim adjustment phase, the German Democratic Republic has been progressively introducing the legislation needed for its gradual integration into the Federal and Community system. Although formally the German Democratic Republic remains outside the Community until unification takes effect, its gradual integration with the Federal Republic of Germany in advance of formal unification gives it "unofficial membership" of the Community already. The Community and the German authorities (Federal Republic of Germany and German Democratic Republic) have already acted accordingly, on trade and competition. The second chapter (p. 37) analyses the compatibility of the Staatsvertrag with Community law and summarizes the effects ahead of integration. It also takes stock of the way the interim phase is being managed in this respect and of access by the German Democratic Republic to loan facilities prior to formal unification, as

decided by the European Council. Lastly, it outlines the Commission's plans to provide information for people and firms in the German Democratic Republic, in line with Parliament's resolution of 12 July.

The gradual integration of the German Democratic Republic into a unified Germany will culminate in a Treaty of Union (Einigungsvertrag), which will have to lay down the constitutional and institutional provisions needed to effect the German Democratic Republic's transition and integration into a unified Germany. These provisions will also have to deal with the application and, where necessary, the incorporation of Community law in the new *Länder* following formal unification.

The third chapter (p. 42) summarizes the main points of the Einigungsvertrag, considering in particular the provisions affecting Community competence and those dealing with the application of Community law.

2.3. Formal unification will mark the beginning of the transitional phase. Community law, both primary and secondary, will then automatically apply in its entirety in the present territory of the German Democratic Republic.

Any technical adjustments or temporary derogations will therefore have to be decided by the appropriate institutions in good time so that they can take effect from the date of formal unification.

The fourth chapter (p. 44) sets out the general principles for adjustment to secondary legislation.

3. Timetable for the institutions

3.1. The package of legislative proposals which the Commission is putting before Parliament and the Council is the outcome of a major technical exercise on much the same scale as for the formal accession of a new Member State.

The Commission has carried out a detailed review of the entire body of existing Community law to identify where there are objective grounds warranting technical adjustments and/or transitional measures. This required the active assistance of the German authorities to enable it to compare their respective legislation, to pinpoint the economic possibilities and constraints, and to verify the factual data. In carrying out its review the Commission also had the benefit of Parliament's active assistance and ideas.

Since the probable deadline for German unification has been brought forward, Parliament and the Council will both have to complete their second readings as soon as possible.

3.2. In its resolution of 12 July Parliament felt it essential to be consulted on all the transitional measures and derogations as well as other adjustments of secondary legislation. It considered itself entitled to give its opinion both on the package as a whole and on the detailed proposals contained in it. It therefore suggested that there should be an interinstitutional arrangement on the timetable and working method to ensure that no decision could be taken without the opinion of Parliament on the package as a whole.

3.3. The Commission shares Parliament's view that the proposed measures constitute a single comprehensive package.

It also believes that Parliament must be able to discuss and give its opinion on the proposed legislation as a whole. The logic of the procedure being followed dictates that Parliament should state its position both on the package as a whole — in other words on the integration of the German Democratic Republic into the Community — and on the individual proposals.

The Commission therefore backs Parliament's call for consultations between the institutions to settle practical arrangements on the timetable and working method to be followed so as to meet the need for swift and effective action and to ensure Parliament's full involvement in the legislative process for the integration of the territory of the German Democratic Republic into the Community. The fact that the Germans have decided to bring forward the date of unification makes this all the more vital.

3.4. The German decision means that unification may take place before the institutions have had time to take the necessary final decisions. Hence the Commission proposal to the Council and the European Parliament for a decision-making procedure authorizing it to apply provisional measures. In this way a potential legal vacuum between German unification and final adoption by the Council of the necessary transitional and technical adaptation measures can be avoided. Details of the two proposals for legislation are to be found in the chapter on adjustment of secondary legislation (p. 44).

The economy of the German Democratic Republic: main features and possible impact of German economic, monetary and social union

I. Main features of the economy of the German Democratic Republic: an overview

1.1. The population

At the end of 1988, 16.6 million people were living in the German Democratic Republic. Since then 600 000 have emigrated to the Federal Republic of Germany. Although the average density of population is fairly low, its concentration is high. More than 50% of the population lives in East Berlin and in the centres of the South (Halle, Leipzig, Dresden and Chemnitz). Significantly, some of these centres are near the border of the Federal Republic.

The age pyramid shows that the proportion of the population below 18 years of age (24 %) is larger than in the Federal Republic (19 %), while all other age groups are somewhat lower — in particular the age group above 60 years (18 % in the German Democratic Republic, 23 % in the Federal Republic of Germany). Nevertheless, the German Democratic Republic is also faced with a growing number of elderly compared to working age groups. This problem is accentuated by emigration concentrated in the younger age groups.

Labour force participation is extremely high by international standards (almost 90 % of the working age population compared to just over 60 % in the Federal Republic of Germany) owing mainly to a much higher participation rate of women. Total employment amounts to almost 9 million (55 % of the population) compared with 26 million (41 % of population) in the Federal Republic.

The level of professional qualification is relatively high. Three quarters of the labour force have received professional training. However, to the extent that education has been ideologically influenced, in particular in the academic professions — economists, law-yers, general administration — shortcomings have to be expected. Engineers should, in general, be in a position to meet the new challenges. As for skilled workers, considerable adaptation to new Western technology will be necessary. Moreover, a crucial condition for successful integration of the East German economy into the Western market economy will be the regeneration of entrepreneurship and market-oriented management methods.

The standard of living in the German Democratic Republic is undoubtedly the highest in Eastern Europe. Comparison with Western countries is fraught with uncertainty, but per capita income is probably higher in the German Democratic Republic than in Ireland, Greece and Portugal, though below that of Spain.

1.2. Industry: a sectoral overview

The orientation of the economy of the German Democratic Republic hitherto has been characterized by the lowest possible dependence on imports from Western countries. This was partly motivated by a permanent shortage of foreign currency. There is thus a low degree of specialization. Compared to Western industrialized countries, the structure of the East German economy has changed relatively little over the past few decades. Industry is by far the most important sector, while in Community countries the service sector is the largest.

Labour productivity in the German Democratic Republic is generally considered to be about one third of the

level in the Federal Republic of Germany, depending, however, on the specific sector under consideration. Three main factors are held responsible for this productivity gap: organization (bureaucratic central planning), motivation (lack of incentives) and technology (outdated capital stock). The latter factor was accentuated during the 1980s as the share of investment in national income fell considerably. Integration in Comecon's static trade pattern, together with marginal integration in the world economy, contributed to the obvious inefficiency of the economy of the German Democratic Republic.

Energy production is mainly based on the only mineral resource available to the German Democratic Republic: lignite. With 310 million tonnes (25% of world production), the German Democratic Republic is by far the world's largest producer of lignite. 85% of electricity generation is lignite-based, as is most household heating. Consequently, over two thirds of primary energy inputs consist of brown coal. Nuclear energy currently provides about 10% of the German Democratic Republic's electricity requirements. However, security standards are below acceptable levels.

Energy consumption per head of population in the German Democratic Republic is very high relative to international standards (15% above the level of the Federal Republic of Germany). High energy input in industry, low efficiency of power stations, absence of realistic energy pricing and of home insulation are the major reasons.

The German Democratic Republic developed its own steel production capacity after the war, mainly based on scrap iron. The prevailing Siemens Martin technique, abandoned completely in 1982 in the Federal Republic of Germany, makes for high production costs. High-quality steel cannot be produced and labour productivity is below 50% of the level in the Federal Republic of Germany.

The German Democratic Republic's chemical industry is largely based on coal-fired plants built before the Second World War. The synthetic materials industry is far behind Western standards. Production in this strongly growing sector is only 10% of production in the Federal Republic of Germany and there are quality problems. As regards fertilizers — generally a low profit area — the German Democratic Republic is an important net supplier on the world market. Modernization of existing firms is necessary to reinforce their market position but faces serious environmental constraints.

Mainly for quality reasons, statistics on the machine and car industries, the most important sectors after chemicals, are hardly comparable with those in Western countries. Almost 1 million persons are employed in this sector. The machine-tool industry is less important than in the Federal Republic of Germany. However, this is one area where the German Democratic Republic could be competitive on the world market. The machinery sector suffers from a lack of the electronic control mechanisms (Cocom list), which are becoming increasingly important in the production of machinery (industrial robots). Nevertheless, East German exports in this sector amount to 30% of all Comecon exports to Western countries. Despite the key position which the car industry has in Western countries, it is of minor importance in the German Democratic Republic. A symptom of the very low efficiency of the industry is that lorries can barely be exported even to Eastern countries.

Investment in microelectronics has been extraordinarily high. The aim was to build up a monopoly position in Eastern countries. Competition with Western countries will probably render these industries obsolete. Developments are much more favourable in the software sector because of highly skilled programmers. In the traditional industries of precision engineering and optics, East German industry is relatively well prepared for international competition.

The construction sector is mainly orientated towards large-scale housing construction. It employs 6.6% of the labour force. Although the technique of prefabricated housing construction is quite advanced, it is highly doubtful whether large blocks of flats will meet demand in this area. Instead, the modernization of the existing housing stock and the building of small housing units will require more craftsmen. So, although demand will certainly grow, restructuring is required.

The production of textiles (6% of total GDR production) is concentrated on the mass market, where there is

strong competition with developing countries in markets abroad. Shortage of capital has prevented companies from introducing automatic and flexible production lines. Most of the capital stock still stems from the pre-war period.

The main problem for the food industry (15% of total GDR production) is lack of variety and low quality. High-quality products are not available as a consequence of self-reliance and import avoidance. Productivity is particularly low.

Agriculture contributes about 10% to GDR (employment 10.8%). However, given important price distortions, this figure is unreliable. About 95% of the agricultural sector is socialized. The ratio of agricultural acreage to population is twice as large as in the Federal Republic. Nevertheless, labour productivity (per head) is below 50% of the level in the Federal Republic of Germany. This is mainly the consequence of shorter working hours. Productivity of land is therefore much higher, i.e. about 75% of the level in the Federal Republic of Germany.

Before recent economic reforms, only 458 000 people (5.3% of the total working population) were employed in the private sector, producing 3.6% of the net national product. This figure excludes services. The private economy is concentrated in the trade and handicraft sector, i.e. repairing, trade and construction.

The German Democratic Republic has adopted the two-stage banking system. Nevertheless, some kind of specialization will prevail, mainly because of past experience and historically established relations. Within the banking sector, the Kreditbank is responsible for most credits to industry. The Kreditbank obtains most of its funds from Sparkassen which currently hold about 80 % of all savings. Without some guarantee of loans to the industrial sector (e.g. by the Treuhandanstalt), the Kreditbank will probably go bankrupt, since many firms, once privatized, will not be able to service debts in Deutschmarks. A further problem for the commercial banking system overall is that the capital base is very thin; at present the capital adequacy ratio for Sparkassen seems to be about 1 % of total assets.

A major problem for the Sparkassen is staffing — 95 % of the personnel have not even completed secondary education, their jobs limited to registering deposits. Initially, the Sparkassen will therefore not be equipped to provide loans on a commercial basis.

1.3. The trade pattern

Autarky having been a prime objective, the German Democratic Republic is poorly integrated into the international trade system for a country of its size. Despite the almost complete lack of reliable statistical information, estimates suggest that the German Democratic Republic's export share is in the order of 25% of GDP. This would indicate a comparatively small participation in the international division of labour for a country of its size (the Netherlands, for example, with a population of approximately the same size, has an export share of 55 to 60% of GDP). At present, about two thirds of the German Democratic Republic's trade is with other CMEA countries, notably with the Soviet Union (around 37% of total trade). The CMEA division of labour, however, has been characterized by non-economic considerations. As trade with developing countries plays a minor role, most of the remainder is with Western industrialized countries (of which one third is with the FRG).

In analysing the product profile of GDR trade, it is useful to distinguish between different destinations. GDR exports to other CMEA countries (especially the USSR) largely consist of machinery and equipment (two thirds of exports), while imports contain a high share of energy products and raw materials. This complementary trade pattern offers relatively small welfare gains (typically related to substitutable trade). Normally such trade patterns are found in relationships between (highly industrialized) core countries and (much less industrialized) peripheral zones. Exports to Western industrialized countries show a very underdeveloped pattern with a certain emphasis on simple consumer goods. Investment goods are exported to Western countries to a considerably lesser extent.

An analysis of GDR trade flows with the Community reveals that the German Democratic Republic is a net

exporter of energy and labour-intensive products (the production of which also causes a high level of pollution) and a net importer of products with a high raw materials, R&D and technology content. In light of the fact that the German Democratic Republic has little fossil fuel deposits except lignite and given the alleged high quality of GDR employees, it is unlikely that this trade pattern is to East Germany's comparative advantage.

Overall, it is noticeable that GDR trade is still dominated by inter-industry trade (i.e. imports and exports belong to different product groups) while Community countries are characterized by a high degree of intra-industry trade.

1.4. Infrastructural and environmental characteristics

Infrastructural and environmental problems could prove a major impediment to private investment in the German Democratic Republic. Rail is the most important means of transport. Although the network is only half as dense as in the Federal Republic, the railways achieve roughly the same transportation performance. About one third of all rail transport is devoted to the carriage of lignite. Preferential treatment of the railways was not based on environmental considerations or on reasons of economic efficiency, but on the need to save crude oil. Repair and modernization of the existing rail network will be a high priority.

In terms of coverage, the road network is fairly good by European standards. However, the state of the road network is far below West German standards. Road transport is thus very slow — not least because of the many railway crossings! In future, bottlenecks will increase as private traffic intensifies through increased tourism from the West and more cars per inhabitant. Public transport within cities is provided mainly by tramways.

With the exception of East Berlin, telecommunications systems are very bad. The telephone system is overburdened despite the very low number of connections. Modernization will probably mean the complete rebuilding of the communications system. On the positive side this will prove an opportunity to introduce the most advanced technology. Private investment will doubtless produce a higher level of efficiency in the new system.

In other areas of vital public infrastructure, investment needs are also substantial. This is particularly the case for sewerage facilities as only 50% of house-holds are connected to purification plants. Although the German Democratic Republic is only half the size of the Federal Republic of Germany (25% of the population) sulphur-dioxide emission is more than twice as large. Many rivers are polluted and the availability of drinking water is a problem. Forests have suffered severe damage. Deforestation is very advanced, particularly in the south.

2. Economic, monetary and social union: main elements of the Staatsvertrag and accompanying measures

2.1. Economic union

The German Democratic Republic has introduced the basic rules governing market economies, e.g. contract freedom between economic agents, abolition of administered prices, wage autonomy on both sides of industry, introduction of private property rights.

The conditions of German-German trade in goods of German origin have been normalized and treated as interregional trade. There are no border and customs controls for goods of German origin. Exports to other parts of Germany do not initiate special VAT procedures. Goods of non-German origin are treated as normal imports.

Special quantitative rules were introduced with limited success in agricultural trade with the Federal Republic of Germany. Now, however, the German Democratic Republic is introducing Community regulations, including the producer price support system.

Financial support by the East German Government for the structural adjustment of companies during a transition period is possible. Support is, however, dependent on the state of the German Democratic Republic's budget and the consent of the Government of the Federal Republic of Germany.

2.2. Monetary union

The main points of the monetary union part of the Staatsvertrag concern the conversion rate, the treatment of enterprise debt and restrictions on public finances.

Since 1 July 1990, the Deutschmark has become the only means of payment in the German Democratic Republic. Sovereignty in the conduct of monetary policy has been taken over by the Bundesbank. The prevailing regulations on bank supervision in the Federal Republic of Germany also apply in the German Democratic Republic. Wage and pension levels at 1 May were converted at a rate of 1:1. In general, debts and claims were converted at a rate of 2:1. However, for residents of the German Democratic Republic, the conversion rate for savings including cash was 1:1 within the following limits: children (age group 0 to 14) DM 2 000; adults (age group 15 to 60) DM 4 000; elderly (age group over 60) DM 6 000. Remaining money in circulation and savings — with some macroeconomically minor exceptions — have been converted at a rate of 2:1.

2.3. Public finance

Regulations affecting public finances in the budgets of both the Federal Republic of Germany and the German Democratic Republic concern (1) transfer payments from West to East, (2) budget and borrowing rules for the German Democratic Republic's budget, (3) the German Democratic Republic's public debt after unification, (4) revenue and expenditure structure of the budget of the German Democratic Republic.

Public transfers in particular have to balance the German Democratic Republic's budget and finance the State pension and unemployment insurance schemes (Anschubfinanzierung).

As regards budget procedures, the German Democratic Republic has generally introduced West German methods, including the tax system. Strict borrowing requirements prevail for the various budgets, excluding social security. Approval by the West German Minister for Finance is required for a budget deficit.

Public debt still existing at the time of political unification will become public debt of the GDR-Länder to be created. This will relieve the Federal budget of any additional debt burden associated with a unified Germany.

On the revenue side the German Democratic Republic has introduced the West German tax system. On the expenditure side subsidies for private households, industrial products, public transport, energy used by private households and rents will have to be reconsidered or abolished. However, in agriculture, CAP regulations have been introduced. Salaries for civil servants will take account of general economic and financial conditions in the German Democratic Republic.

2.4. Social union

Pension, health, accident and unemployment insurance are administered by self-governing bodies under the legal supervision of the State. These are mainly financed through contributions by employers and employees (normally 50% each). The German Democratic Republic has introduced an unemployment insurance scheme comparable to that of the Federal Republic of Germany. A health insurance scheme has been established. In the case of sickness, wages are paid by employers in accordance with West German rules. Pensioners contribute to the health insurance system.

Pensions are fixed at a level representing 70% of the average net wages in the German Democratic Republic (after 45 years of contributions to the pension system). If the pension should fall below the previous East

German pension, the amount of the previous pension would be paid in DM. Pensions are adjusted according to the development of net wages. If, during a transitional phase, regular contributions to the pension and unemployment schemes do not fully cover expenditure, the Federal Republic of Germany will make special contributions (Anschubfinanzierung).

West German labour market rules and laws have also been copied — bar some important modifications, namely in the Labour Promotion Act. These modifications allow the classification of unemployed workers as short-time workers attending training courses. Consequently, registered unemployment will not rise as fast and as obviously as predicted.

2.5. *Accompanying measures of the Federal Republic of Germany*

The central government's Finance Minister and the *Länder* agreed to set up a German Unity Fund (Fonds Deutsche Einheit) to help finance the German Democratic Republic's budget. The total amount of DM 115 billion in financial aid is to be spread over the next four and a half years as follows:

billion DM

1990	1991	1992	1993	1994
22	35	28	20	10

DM 20 billion will be met by cuts in some lines of the central government's budget, while the major part of DM 95 billion is to be raised on capital markets by issuing bonds. Liabilities are shared 50:50 by Bonn and the *Länder* governments.

The Fund's aim is to balance the German Democratic Republic's budget. Financial aid to launch a Western social security system is to be financed directly by the central government's budget.

As regards trade, the Federal Government will subsidize imports of goods from the German Democratic Republic to the Federal Republic of Germany during the interim stage. Firms in the Federal Republic of Germany will be allowed to deduct from the invoiced price of goods imported from the German Democratic Republic — in addition to the normal VAT rate (14 or 7 %) — 11 or 5.5% respect respectively.

2.6. *Accompanying measures of the German Democratic Republic*

In order to foster new investment in the German Democratic Republic, an investment allowance of 12% is granted for new investment in equipment during the period from 1 July 1990 to 30 June 1991. Thereafter, the investment premium will be reduced to 8% for the following 12 months. Special regulations in favour of East German enterprises (special depreciation allowances, favourable tax treatment of reinvested profits, tax-free periods for new companies) have been announced.

Several sectors in the German Democratic Republic will still be eligible for subsidies, in particular energy, transport and housing. The amount of these subsidies is estimated at more than DM 12 billion for the second half of 1990.

3. **Macroeconomic impact on the economy of the Federal Republic of Germany and Europe**

The economic unification of Germany will trigger a positive growth effect on the economy of the Federal Republic (about 1% of GDP). This is mainly the result of a shift of internal demand in the German Democratic Republic towards imports from Western countries and the way in which fiscal policy in the whole German public sector will be handled. All Community countries will participate in the import pull of the East German economy, given the high rate of capacity utilization in the Federal Republic and the potential for all EC countries to establish a similar market share to that held in other EC countries. Thus, the overall German current account surplus may shrink considerably, while the current account balances of the other EC countries may improve. This will contribute to more convergence in the external balances of

Community countries.

The labour market in the Federal Republic of Germany has been influenced by significant emigration from the German Democratic Republic and other East European countries. Integration of these new workers into the labour force may lead to new kinds of working patterns. Despite the obvious difficulties of finding accommodation in the Federal Republic of Germany, the shortage of qualified labour in the Federal Republic of Germany will continue to attract people from the German Democratic Republic. In these circumstances short-term working contracts during seasonal or holiday periods should prove attractive to residents of the German Democratic Republic. Cross-border contracts will also become attractive to GDR residents, as they can combine high salaries in the Federal Republic of Germany with low rents in the German Democratic Republic. In the long term, the impact on the labour market of the Federal Republic of Germany should be positive, with the regional and sectoral mobility of labour improving considerably and downward pressure on wage costs.

All in all, the overall macroeconomic impact of economic, monetary and social union on the economy of the Federal Republic of Germany will be enhanced by capital mobility, a single currency and labour mobility, which will probably be larger than elsewhere in the Community in the foreseeable future. It will therefore be more and more difficult to disentangle the economic interrelationships of the two German economies. In particular, macroeconomic performance within German monetary union will have to be looked at in a whole German context. A number of likely features of macroeconomic policy in German economic, monetary and social union are clear:

- (i) overall fiscal policy will be less tight; given that the credibility of German fiscal policy in controlling future trends in public finances is to be maintained, this fiscal loosening will have only conventional demand-expansionary effects;
- (ii) for Germany as a whole, there will be a period in which the pace of increase in demand outstrips that of supply; at a later stage, supply will accelerate;
- (iii) in short, the overall German economy is likely to be subject to successive periods of excess demand. These problems can be eased by immediate measures to increase foreign supplies. The East German market should be open to all Community countries and measures should be taken to promote imports, thereby reducing the gap between demand and supply. Nevertheless, the likely pattern of supply and demand may pose difficulties for monetary policy, in particular with regard to preserving the goal of price stability.

The macroeconomic impact of German economic, monetary and social union on the rest of Europe will be significant and positive. The changing balance between demand and supply within the union will affect trade flows and savings in partner countries. The significant reduction of the current account surplus of unified Germany will stimulate demand in the whole Community. Thus, GDP in the whole Community may be stimulated by half a percentage point during the first two years.

In the longer run, it can be expected that the beneficial effects anticipated from the single market will be reinforced. Moreover, to the extent that the other East European economies progress towards a market economy, the advantages of a progressive division of labour within Europe may increase further. Given the relatively high integration of the GDR economy into the East European economies, the German Democratic Republic can act as a bridge between the Community and Eastern Europe.

Nevertheless, fears have been expressed as to whether rapid economic developments in Germany might displace the catching-up process in other, relatively poor, Community countries, notably Spain, Portugal and Ireland, by reducing investment in those countries. However, investment in these countries is based on an expected high real rate of return. So, because German economic, monetary and social union will not change this and because of the integration of world financial markets, financial constraints should not be overemphasized.

Integration of the German Democratic Republic into the European Communities will also raise some questions regarding external trade and market access. In general, problems exist only for those products where East European countries are very competitive on world markets and where access to the Community

market is restricted, while access to the East German market has not been affected by quotas or tariffs. For other products, affected by tariffs or quantitative restrictions, it is doubtful whether there will remain demand for East German goods at all. For sub-EC-standard products from East European countries, demand from East Germany will shrink considerably. Trade relations between the German Democratic Republic and East European countries could decline significantly in the short run, while the potential for EC countries to export to the former territory of the German Democratic Republic will significantly increase.

4. Implications for the economy of the German Democratic Republic

The introduction of the DM and economic and social union have triggered an important adjustment process in the economy of the German Democratic Republic. The pressure for adjustment may be higher than in other countries moving from a planned economy to a market economy because the German Democratic Republic has to compete immediately on the world market. However, the consequences are cushioned by important financial support from the Federal Republic. Nevertheless, it is important for the GDR economy rapidly to transform its economic structures and the behaviour of economic agents. Adopting market economy rules will facilitate the catching-up process in the medium term and minimize the danger of long-lasting economic instability. However, the short-term implications for the GDR economy will be significant.

In the short term German economic, monetary and social union has important macroeconomic consequences for economic development in the German Democratic Republic. Providing GDR residents with hard currency has led to an important shift towards consumption of imports. Consumption is generated not only by additional transfers and foreign investment, but also by the convertible currency income of GDR residents. Price competitiveness is only one factor attracting GDR residents to consume imported products. There are two others. First, the inappropriate product-mix provided by GDR suppliers may prove even more important. Second, the modernization of GDR industry requires Western technology, so increased foreign investment and investment by viable GDR enterprises will further boost imports.

The conditions for external trade are fundamentally altered by the introduction of the DM. This holds especially for trade with East European countries. As demand in the German Democratic Republic shifts to Western products, special trade structures with Comecon countries will disappear. Comecon exports to the German Democratic Republic will soon begin to follow the pattern of trade with other West European countries. GDR exports to both West and East European countries may diminish quite considerably. This holds especially for exports to East European countries in hard currency payments.

The effective fusion of the labour markets of the German Democratic Republic and the Federal Republic of Germany, and by extension integration into the Community's, will have a profound impact on wages in the German Democratic Republic. The agreed conversion rate of 1:1 may be consistent with prevailing levels of productivity. However, the price reform and newly-introduced indirect taxes have already led to upward pressure on wages. The need for wage differentiation to provide greater incentives for certain sections of the labour force will push average wages further upwards. To the extent that GDR workers will have the choice between working in the German Democratic Republic or in the Federal Republic of Germany, cross-border work contracts will have spill-over effects on GDR wage levels. Lower rents in the German Democratic Republic will not, in principle, exert a dampening effect on wages as both the advantages of high wages and low rents can be combined. Productivity of new investment will be similar to West European levels. Thus, wages will probably have to be higher than current GDR levels in order to attract the most qualified labour. Sooner or later this will affect the general wage level. Moreover, to the extent that top and middle management comes from West Germany and receives West German wages, perhaps even with a supplement, wage differentials between the various sectors of the labour force may ultimately prove unacceptably wide. Finally, trade unions in both regions may seek to promote wage parity between the Federal Republic of Germany and the German Democratic Republic.

However, two factors may reduce the mismatch of wage level and labour productivity. First, high unemployment will have a dampening effect on wages both in the German Democratic Republic and to the extent that labour markets are integrating, in the Federal Republic of Germany as well. Second, considerable room exists to increase labour productivity in the short term. Reducing labour hoarding, improving the

organization of the production process and a more flexible use of capital stock are ways to increase productivity even in the short term.

Company investment will, in future, be undertaken in an integrated German or European context in anticipation of the single market. Although the effect on net investment will probably be positive, it is uncertain whether new investment will shift from the Federal Republic of Germany to the German Democratic Republic or, alternatively, if production capacities will simply be enlarged in the Federal Republic of Germany with a view to exploiting the GDR market. So, if capital is to be attracted to the German Democratic Republic, it is important to create a positive investment climate in the German Democratic Republic relative to the Federal Republic of Germany.

Prospects for public finance in the German Democratic Republic are very uncertain as the entire structure of expenditure and revenue will be changed. On the one hand, the abolition of major price subsidies together with taxes on consumer goods will lead to higher net revenues. On the other, the abolition of production levies together with the introduction of a new tax system will inevitably lead to a substantial deficit, at least temporarily.

Given these short-term problems, it is important to create a positive climate for new investment as soon as possible. This could be done, for example, by a regional development plan for the German Democratic Republic aimed at fostering investment, new business creation and greater labour market flexibility. It is of crucial importance to strengthen the productive capacity of the German Democratic Republic. Infrastructure investment is a major precondition for such a strategy but the whole framework of subsidies in the Federal Republic of Germany basically works to the detriment of the German Democratic Republic. Moreover, likely temporary, regionally unfavourable developments in the former German Democratic Republic will necessitate a general review of regional policies. Finally, the revival of private entrepreneurship and rapid privatization of existing industries will be preconditions for the promotion of the efficient allocation of factors of production and thus a successful catching-up process in the GDR economy.

Interim adjustment stage

1. Staatsvertrag: compatibility with Community law

The Treaty of 18 May 1990 establishing a monetary, economic and social union between the Federal Republic of Germany and the German Democratic Republic is compatible with Community law. This was noted by the Commission in its communication of 14 June entitled "The Community and German unification: implications of the Staatsvertrag¹". Parliament came to the same conclusion in its resolution of 12 July on the implications of the unification of Germany for the European Communities².

This compatibility is explained by the fact that Community law already made allowance for the special situation of Germany and that the objective of the Staatsvertrag is gradual alignment of the law and policy of the German Democratic Republic to ensure application of Community law after unification. This objective is reflected in the preamble and a number of provisions of the Staatsvertrag. It is given substance, in particular, by application of the principle of equal treatment to Community nationals and firms in areas of the Staatsvertrag within the Community's jurisdiction³.

2. Staatsvertrag: effects ahead of integration

Under the Staatsvertrag the German Democratic Republic undertakes to carry out far-reaching legislative reform to underpin the creation of monetary, economic and social union. This legislative reform will have major consequences for the gradual integration of the German Democratic Republic into the Community's legal order. The Commission analysed these consequences in its communication of 14 June⁴.

First, it should be noted that the German Democratic Republic has given Community goods free access to its territory on a reciprocal basis since 1 July. GDR trade in both industrial and agricultural products with non-

member countries is treated in the same way as regards customs rules and procedures as trade between the Federal Republic of Germany and non-member countries, subject to observance of the German Democratic Republic's obligations under agreements concluded with non-member countries. In the case of imports into the German Democratic Republic under such agreements, the Federal Republic of Germany is cooperating closely with the Commission, to devise, with the German Democratic Republic, measures to ensure that Community provisions relating to non-member countries are not evaded.

In addition, on 1 July the main features of the common agricultural policy came into effect in the German Democratic Republic in accordance with Article 15 of the Staatsvertrag. The agricultural policy measures adopted are described in Section 3, pp. 80 and 81.

Secondly, the Staatsvertrag ensures the introduction of private ownership and freedom of establishment for all Community nationals and firms. These provisions are supplemented by measures adopted by the German Democratic Republic pursuant to Annex IX to the Staatsvertrag to enable foreign investors to acquire the land necessary to exercise the right of establishment.

The key provisions of the commercial code, the law, on public limited liability companies (Aktengesetz) and the law on private limited liability companies (GmbH-Gesetz) of the Federal Republic of Germany have been put into effect in the German Democratic Republic. This means that investors can operate in the German Democratic Republic using legal forms consistent with company law directives adopted by the Community to protect members and others.

Thirdly, the German Democratic Republic has taken over the Federal German law on restrictions of competition. The German Democratic Republic authorities have undertaken to apply this in the light of Community competition policy.

3. Trade arrangements

3.1. The Community has adopted legal instruments to allow the rapid adjustment of Community external trade arrangements to the gradual integration of the German Democratic Republic into the customs system of the Federal Republic of Germany and the Community legal order in advance of formal unification.

Council Regulation N° 1794/90 of 28 June 1990 on transitional measures concerning trade with the German Democratic Republic⁵ gives goods other than agricultural products and products covered by the ECSC Treaty free access to the Community on condition that the German Democratic Republic allows free access to Community goods, aligns its legislation governing trade with non-member countries on Community regulations and adopts measures to ensure that Community law is not circumvented.

Commission Decision No 1796/90 ECSC contains parallel provisions for products covered by the ECSC Treaty.⁶

Commission Regulation (EEC) No 1795/90 of 29 June 1990⁷ was adopted in application of these two instruments. The Commission noted that the conditions for free access for non-agricultural goods from the German Democratic Republic to the Community had been met and adopted the appropriate implementing measures with effect from 1 July.

Agricultural and fisheries products are subject to similar arrangements under Council Regulation (EEC) No 2060/90 of 16 July 1990⁸. This gives East German products free access to the Community provided the Community is satisfied that the German Democratic Republic is giving free access to Community goods and has introduced mechanisms similar to those of the common agricultural policy.

By Regulation (EEC) No 2252/90⁹, the Commission noted that these conditions had been met and adopted the appropriate implementing measures. The Regulation came into force on 1 August 1990.

Since then, all GDR goods have had free access to the Community. It can therefore be said that a *de facto*

customs union has existed between the Community and the German Democratic Republic since 1 August 1990.

The Community Regulations adopted include appropriate safeguard clauses to ensure that liberalization does not create serious difficulties in any economic sector in the Member States.

3.2. The introduction of a *de facto* customs union has made the provisions of the Protocol on German internal trade redundant. It was achieved thanks to considerable assistance from the Federal customs authorities and joint management by the Commission following practical administrative cooperation with all the Member States.

3.3. The abolition of frontier controls inside Germany does not have the effect of leaving a “gap” at the external borders of the Community for such trade. The German Democratic Republic applies the same measures as the Federal Republic, i.e. Community trade measures, to industrial and agricultural trade with third countries.

The German Democratic Republic applies import and export formalities on behalf of the Federal Republic both to third-country goods destined for the Community (and thus not put into free circulation in the German Democratic Republic) and to Community goods exported via the German Democratic Republic to these countries (i.e. one could already speak of a *de facto* extension of the Community border as far as formalities go). The EC rules on the *de facto* customs union with the German Democratic Republic provide that industrial imports in free circulation in the German Democratic Republic may move freely within the entire Community.

4. Indirect taxation

4.1. By the Staatsvertrag, VAT and excise duties were introduced in the German Democratic Republic on 1 July 1990 in accordance with the tax legislation of the Federal Republic of Germany. This implies not only identical legal texts (with minor modifications) but also identical tax rates, as well as application of the principles of the common customs regulations for the application and calculation of VAT on GDR imports.

Furthermore, a customs and tax administration similar to the Federal administration was created and — as a logical consequence of German economic and monetary union — fiscal frontiers between the Federal Republic of Germany and the German Democratic Republic were abolished (tobacco and tobacco products excepted as the fiscal stamps (*banderoles*) will continue to be different during the transitional period). Abolition of fiscal frontiers meant introducing a clearing system for indirect tax revenues.

The German Democratic Republic adopted Community legislation in the fields of harmonized indirect taxation before German unification, while remaining for the other Member States, as far as indirect taxation is concerned, a third country. For this reason, there will be some divergences in the relations between the German Democratic Republic and the other Member States (the Federal Republic of Germany excepted) in the area of indirect taxation in the transitional period. These divergences, which are of minor importance, concern the application of the principles of the Sixth Directive and travellers' allowances.

4.2. As far as the Sixth Directive is concerned, there will be such divergence on the supply of services (Article 9.2a). Supplies of services from a Member State to non-taxable persons established in the German Democratic Republic will not be taxed (in compliance with the Directive) either in the Member State supplying these services or in the German Democratic Republic. Supplies of the German Democratic Republic to non-taxable persons established in a Member State will be taxed in the German Democratic Republic. However, in accordance with Article 93b of the Directive, the Member State, for reasons of competition, could also impose VAT. To avoid double taxation it has been suggested in discussions with the Federal Ministry of Finance that GDR VAT should be refunded on a case-by-case basis.

Travel agencies in the German Democratic Republic are to be taxed. Services of travel agencies established in a Member State are — in compliance with the Directive — not to be taxed (Article 26.3).

4.3. As far as travellers' allowances are concerned, purchases of goods by GDR residents visiting a Member State and returning to the German Democratic Republic are to be "detaxed" in the Member State of export, according to the common provisions for residents of third countries. However, for importation of such purchases into the German Democratic Republic, the GDR resident will not have to pay VAT if these purchases do not exceed the amount of DM 810 (intra-Community limit). In other words, during the transitional period there is a possibility for GDR residents to make some tax-free purchases in other Member States.

On the other hand, purchases by residents of a Member State effected in the German Democratic Republic and imported by the traveller into the Member State will be taxed in the Member State if they exceed the amount of ECU 45 (third-country limit). However, tax refunds for exports will be granted in the German Democratic Republic only for purchases exceeding the amount of DM 810 (ECU 390). Therefore, for purchases less than DM 810 double taxation will be possible. To avoid this, the GDR fiscal authorities will refund the GDR VAT, if the traveller provides evidence of taxation in his/her Member State.

4.4. As far as VAT relations between the Federal Republic of Germany and the German Democratic Republic are concerned, the following changes in West-German VAT law are worth mentioning, most of them being necessary because of the abolition of fiscal frontiers:

(i) *Special provisions:* the existing provisions (taxation of supplies to the German Democratic Republic without tax refund, VAT reductions for East German supplies to West German taxable persons) based on the "Berliner Abkommen" were abolished by the end of June 1990.

(ii) *Supplies to the German Democratic Republic:* these supplies are to be taxed at the existing rates of 7 and 14 %.

(iii) *VAT deduction:* GDR VAT on purchases and imports by West German taxable persons is deductible in the Federal Republic of Germany. Correspondingly, West German VAT is deductible in the German Democratic Republic. For this reason, tax refunds to taxable persons in the German Democratic Republic by virtue of the Eighth or Thirteenth Directive are no longer allowed.

(iv) *Place of supply of services:* by derogation from Article 9(2) of the Sixth Directive, the place of supply is now the place where the taxable person is established (in the Federal Republic of Germany or in the German Democratic Republic). As far as passenger transport is concerned, in cases of taxable persons established outside the two territories, VAT is imposed once at the relevant border, even if transport extends over East and West German territory (or vice versa).

(v) *Travel agencies:* West German travel agencies using supplies of goods and services in the German Democratic Republic when providing travel facilities are now to be taxed.

(vi) *Travellers' allowances:* no limits to be applied between the Federal Republic of Germany and the German Democratic Republic.

For the period ending with German unification these changes in West German VAT law are covered by the German declaration to Article 3 of the Sixth Directive and do not necessitate Community legal action.

5. Competition

5.1. State aid

There is a clear need for State aids in order to support the adaptation and restructuring of the East German economy, while at the same time the potentially distortive effects of such aids must not be ignored.

The Commission took the view that the Community State aid rules had to apply from an early date in order

to guarantee a balance between the needs of the German Democratic Republic's economic conversion and established policies.

The Commission therefore agreed with the Federal authorities that they inform the Commission of any measures taken to develop the East German economy. Where such measures constitute or contain State aids the Commission examines them for their compatibility with Article 92 of the EEC Treaty. A series of such schemes, including the extension of the interest subsidies available under the European recovery programme to activities in the German Democratic Republic, have already been approved. This allows the Commission to ensure that all aid measures are in conformity with Community objectives and do not unfairly distort competition.

Article 14 of the Staatsvertrag requires coordination between the Governments of the Federal Republic and the German Democratic Republic on the content of certain structural measures proposed by the German Democratic Republic, and Article 28 provides for financial grants from the Federal budget to compensate for budget deficits in the German Democratic Republic. In so far as the application of these Articles leads to aid measures in the German Democratic Republic which can only be implemented after the agreement of the Federal authorities and will be directly or indirectly funded from the Federal budget, the Commission considers that these aids must also be assessed under Articles 92 and 93 of the EEC Treaty. The Commission is in contact with the Federal authorities to agree on the appropriate practical implementing arrangements to ensure control by the Commission of State aids granted by both German authorities.

5.2. Agreements/mergers

A large number of operations have taken place in the German Democratic Republic, particularly cooperation agreements and proposed West German acquisitions of holdings in East German firms. There is a danger that some of these may lead to the strengthening or the abuse of dominant positions on the German market and affect intra-Community trade. For this purpose the Commission has kept a close eye on developments from the outset. It has initiated one formal proceeding which is being actively pursued and will not hesitate to initiate others should the situation warrant this.

As to the application of competition rules in the German Democratic Republic, the East German authorities have assured the Commission that the German Democratic Republic would be prepared to deal with competition policy as if the Treaty were already in force. Moreover, the German Democratic Republic Government would ensure non-discrimination against non-German companies while specific complaints about mergers or acquisitions which appeared anti-competitive would be looked at carefully in the light of the first point above. Commission officials will keep in close touch with officials of the German Democratic Republic.

6. Access to borrowing facilities and operation Phare

6.1. On 11 June 1990, in the wake of the special European Council on 28 April 1990, the Council requested the European Investment Bank (EIB) to provide the German Democratic Republic with loans for investment projects which satisfy the usual conditions governing the operations it finances from its own resources.

Since then, the EIB has begun work by assessing a number of projects and giving the German Democratic Republic access, with immediate effect, to global loans currently being managed by various German, Spanish, Dutch and British financial institutions.

6.2. Again in line with the European Council's conclusions, the Council has adopted decisions giving the German Democratic Republic access to borrowing instruments under the ECSC and Euratom Treaties. Borrowing requirements for restructuring the German Democratic Republic's steel industry are considerable. Substantial recourse to ECSC loans can therefore be expected. There are likely to be similar heavy financial requirements for the energy sector in the German Democratic Republic.

Talks are in progress with the East German authorities to identify the projects and financing needs under

these financial instruments.

6.3. The Council has not yet adopted a decision extending economic aid to the German Democratic Republic under operation Phare. The Commission has however initiated exploratory talks to identify projects that could be completed in a short time. These tend to be concentrated in the area of the environment and transfrontier regional development.

As soon as the Regulation extending economic aid is adopted by the Council, the Commission will notify the Management Committee of its programme for the German Democratic Republic. Decisions on projects and necessary financial commitments should be made before unification.

The Commission would point out that the German Democratic Republic would be eligible prior to unification under the Tempus programme and European Training Foundation operations. Projects initiated under this heading would have to be incorporated into Community programmes (Erasmus, Comett and Lingua) at a later stage.

7. Information

7.1. As far as general information policy is concerned, the Commission has adopted a specific action programme concerning the German Democratic Republic.

Priority themes in the Commission's information effort in the German Democratic Republic include general information on the purpose, scope and function of the Community. Information on key policy areas, such as the common agricultural policy, the internal market, the environment, the social dimension and the financial support programmes will form part of a major information drive. This will target key sectors of the media, the new administration in the *Länder*, the social partners and institutions of education and training.

In practice, this means strengthening existing methods of information. The Commission's Office in Berlin is being expanded and preparation is under way for the extension of the Euro-Info-Centres network and European Documentation Centres. Publicizing Community policy priorities will involve the provision of material to public libraries, contributions to television, radio and the print media, the organization of information visits to Brussels, speaker panels and touring events, exhibitions and seminars. A special brochure on the impact of German unification is being prepared.

7.2. The Euro-Info-Centres project is specifically designed to provide enterprises, and particularly small and medium-sized enterprises, with access to information relating to the European Community. The establishment of such Centres in the German Democratic Republic will therefore play an important part in the integration of the territory into the Community. In particular, they will provide information relating to Community legislation and standards, participation in Community programmes, and a network permitting the exchange of information with other regions of the Community.

It is intended to establish progressively eight to ten Euro-Info-Centres in the German Democratic Republic. In accordance with the philosophy of the project, the Centres will be distributed geographically and based in existing organizations already providing services to local businesses. Initial steps have already been taken to identify such organizations and to prepare for the establishment of the Euro-Info-Centres.

7.3. More generally, the Commission is in favour of the development of small and medium-sized enterprises (SMEs) in the new *Länder* of the German Democratic Republic just as in the Community as a whole. Support for SME development must come in three forms: establishing a favourable legal and administrative environment for business, developing the services required to support SME development and providing resources to encourage investment and to improve the physical environment in which SMEs operate.

Einigungsvertrag

1. General outline

1.1. The Commission welcomed the opportunity to participate directly in the negotiations between the two Germanys on the second Staatsvertrag (Einigungsvertrag). This enabled it to play a part in formulating provisions which could have a bearing on the Community's powers and others governing the transposition of Community law into the legislation of the new *Länder* of the unified Germany. On a number of occasions the Commission was able to report on the negotiations between the two Germanys to Parliament's Temporary Committee on German Unification and the Chairmen of the Standing Committees. As far as the Community aspects are concerned, discussions on the Einigungsvertrag were thus conducted in a transparent manner and in full consultation with the Commission.

1.2. Negotiations on the Einigungsvertrag are still under way at government level¹⁰.

The purpose of the Einigungsvertrag is to lay down the constitutional, technical and organizational conditions in which the process of unification is to take place with due regard for the objectives already reached by the first Staatsvertrag.

After unification, the Vertrag will continue to operate as Federal law. The rights of the German Democratic Republic under the Vertrag will devolve upon the newly formed *Länder* after the German Democratic Republic has disappeared.

The main provisions concern:

- (i) the newly formed *Länder* and their interim status;
- (ii) the entry into force of the Basic Law of the Federal Republic of Germany in the territory of the former German Democratic Republic;
- (iii) the changeover to the Federal Republic of Germany's public finance system in the former German Democratic Republic;
- (iv) the general adaptation of the law (transition to Federal law, continued operation of GDR law, European Community law);
- (v) international treaties of which the two countries are signatories (including references to Community legislation);
- (vi) public administration and the administration of justice in the former German Democratic Republic;
- (vii) the treatment of the public property and debts of the German Democratic Republic including the powers of the Treuhandstelle;
- (viii) economic development (in particular the setting up of a special programme for the entire territory of the former German Democratic Republic involving preferential treatment);
- (ix) the existing foreign trade relations of the German Democratic Republic (see details below);
- (x) a section on labour, social affairs, the family, health and the protection of the environment;
- (xi) a section on culture, science and education;
- (xii) arrangements (to apply until elections are held) for seating members of the Volkskammer in the Bundestag.

2. Application and transposition of Community law

2.1. The draft Einigungsvertrag contains provisions referring to Community law and to German law adopted (or to be adopted) in application of Community law.

The principle of succession means that Community law as a whole — whether based on unilateral measures or treaties, directly applicable or not — will apply to the territory of the former German Democratic Republic from the date on which unification takes effect provided that the Community institutions do not adopt specific provisions affecting secondary legislation (primary legislation being unaffected by unification; see the following chapter on adjustment of secondary legislation). Since this principle derives from Community law itself, it should not be necessary on purely legal grounds to reaffirm it in the Einigungsvertrag (or any other national legal act). It seemed advisable nevertheless to clarify this principle in the Einigungsvertrag, which will include the following provision:

“The Treaties establishing the European Communities, amendments and additions thereto and international agreements and treaties which have been brought into effect in connection with these Treaties shall apply in the area referred to in Article 3 with effect from the date of accession.

The legal acts based on the Treaties establishing the European Communities shall apply with effect from the date of accession in the area referred to in Article 3, save where exceptions are made by the relevant institutions of the European Communities. The purpose of such exceptions may be to take account of administrative requirements or to help avoid economic difficulties.”

2.2. As regards the introduction of Federal law in the territory of the former German Democratic Republic, the draft Einigungsvertrag proceeds on the principle that Federal law will come into effect in the said territory save where otherwise provided in the Einigungsvertrag itself. Adjustments will be laid down in the Einigungsvertrag and its annexes (negative list). Provisions of Community law (including amendments and adaptations) do not need to be annexed to the Einigungsvertrag, since they will be introduced *ipso jure* into the territory of the former German Democratic Republic on the grounds of the principles of Community law itself mentioned above.

The draft Einigungsvertrag also contains provisions on the continued application of GDR law. This will continue in operation either as Federal law or as law of the *Länder*, only where this is expressly provided in the Einigungsvertrag and its annex (Article 9 of the draft; positive list). It is expressly stated that GDR law will continue to operate where it is consistent with directly applicable Community law.

2.3. It should be pointed out that the term “Rechtsakte” (legal acts) in paragraph 2.1 above includes all the Community's international agreements, whether bilateral or multilateral.

There is no need to refer in this context to decisions and agreements of the Representatives of the Governments of the Member States meeting within the Council, agreements concluded under Article 220 of the EEC Treaty and those relating to the Community's legal order, or declarations, resolutions and other positions adopted by the Council. Since these decisions and other acts apply automatically as a result of the transposition of Federal law into the law of the former German Democratic Republic or via commitments entered into by the German Democratic Republic *vis-à-vis* the Community or the other Member States, a clause similar to those found in Acts of Accession (Article 3, identical) is unnecessary.

2.4. Legal acts adopted or to be adopted by the Federal Republic of Germany to transpose or implement Community law (notably directives) apply in former GDR territory too, in accordance with the principle set out in the draft Einigungsvertrag.

The Federal Government is to be empowered, in accordance with Community law, to make the adjustments needed for accession by statutory instruments. Such instruments will require the assent of the Bundesrat where they refer to laws which require the assent of the Bundesrat.

Despite these procedural arrangements, practical difficulties could arise in the case of Community

provisions which need to be amended/adapted by the Community's institutions. Even if matters progress quickly, the German legislator will have very little time to amend national transposition/implementation legislation in advance of unification. Close cooperation between the German authorities and the Community's institutions will be required if a satisfactory outcome is to be guaranteed within the time allowed.

There is a particular problem here as regards the adoption of legislation which falls within the jurisdiction of the *Länder*, because the new *Länder* will presumably not be constituted until 14 October 1990. Special efforts will be needed here to prevent the emergence of gaps at national level.

2.5. The Einigungsvertrag is to contain a reference to the issue of “Vertrauensschutz” (legitimate expectations) with regard to the German Democratic Republic's “gewachsenen ausenwirtschaftlichen Beziehungen”, with similar wording to that of the (first) Staatsvertrag (Article 13.2). It will probably read as follows:

“The existing foreign trade relations of the former German Democratic Republic, in particular its contractual obligations towards the countries of the Council for Mutual Economic Assistance, shall be respected. They shall be further developed and extended, taking into account the interests of all involved and with due regard for free-market principles and for the jurisdiction of the European Community.

The Federal Government and, where appropriate, the Government of a united Germany shall agree with the relevant institutions of the European Communities on the transitional exceptions which are necessary in the field of foreign trade for the purposes of the first paragraph.”

As it stands, this provision is only binding on the contracting parties, that is to say, the Federal Republic of Germany and the German Democratic Republic. The second paragraph emphasizes their concern that the Community should adopt a number of transitional exceptions in the area of commercial policy to take account of this principle. However, the paragraph is drafted in such a way as to avoid any interference in an area of exclusive Community competence.

2.6. The draft Einigungsvertrag contains other references to the European Communities as well — to the effect that their powers and legislation have to be taken into account. Note in particular the Article in the draft concerning GDR treaties, which requires the powers of the Communities to be taken into account in discussions regarding the continued operation, adjustment or termination of such treaties. These references usefully reinforce the principle that Community law will apply *ipso jure*.

Adjustment of secondary legislation

1. Adjustment criteria

The unification of Germany entails the incorporation of the German Democratic Republic *ipso jure* into the Community legal order. In other words, the entire panoply of Community law will automatically apply in the territory of the former German Democratic Republic as soon as unification takes place. This legal integration will not involve any amendment of the Treaties or other acts which constitute primary law. By contrast, the immediate, across-the-board application of secondary legislation is not feasible. As with any accession, various technical adjustments will first be needed on account of the specific features of the former German Democratic Republic's socioeconomic and legal system. Equally, the particular difficulties in some sectors mean that there will have to be transitional arrangements to allow the former German Democratic Republic's legislation to be gradually adapted to the Community system, especially in such areas as safety and quality standards, environmental legislation and structural policy. These adjustments and transitional arrangements will have to be in line with the Treaties. However, their legal basis need not differ from that of secondary legislation involved, providing a certain number of conditions are met:

- (i) acceptance of the “acquis communautaire” must be both the starting point and the ultimate objective;

- (i) (ii) any transitional arrangements must be warranted on objective economic, social, or legal grounds;
- (ii) any exceptions or derogations must be temporary and cause as little disturbance as possible to the functioning of the common market (proportionality).

These were the criteria applied by the Commission when framing the accompanying legislative proposals. The Commission believes that the adjustment of secondary legislation can be achieved without departing in any way from Community law, relying in particular on the principle of equality, so often held up by the Court of Justice as a general principle of Community law. Thus Community rules can — and indeed should — be modulated to take account of objective differences between economies. However, since the Single European Act, the principle is now enshrined in Article 8c of the EEC Treaty.

2. Horizontal problems

In preparing the package of measures contained in Part IV of this report, the Commission aimed for a simple but comprehensive and coherent presentation, containing uniform solutions for horizontal problems.

2.1. The required technical adjustments and transitional arrangements have, as far as possible, been grouped by sector and by legal basis. For example, although there are a hundred or so directives on the harmonization of technical rules whose implementation will require transitional arrangements of some sort, only one legislative instrument has been proposed on the basis of Article 100a of the Treaty.

2.2. The adjustment arrangements fall into two broad categories:

(i) *technical adjustments*: these take account of the former German Democratic Republic's particular economic, legal and other circumstances; since much of the German Democratic Republic's economic legislation has already been brought into line with that of the Federal Republic of Germany, mainly in the wake of the Staatsvertrag, this category is less important than the second;

(ii) *transitional arrangements*: this category is by far the more important of the two; as a general rule, the application of Community rules in the territory of the former German Democratic Republic will need to be phased in by 31 December 1992, although some sectors, such as the environment, will require a longer time-scale; in other sectors, provision has been made for extending the initial transitional period should this be necessary.

2.3. Delegation of powers to the Commission to adapt legislation (flexibility clauses)

The proposed legislation for adjustments and transitional arrangements in the various sectors should also include provision for the delegation of implementing powers so that any adjustments needed in the light of new information or developments in the former German Democratic Republic can be made promptly.

The delegation arrangements may vary depending on each sector's needs.

Most of the acts proposed in this communication confer implementing powers on the Commission using the regulatory committee formula (procedure IIIa of Council Decision No 87/373 of 13 July 1987¹¹). However, where management committees (procedure II) already exist, the Commission has proposed that formula instead.

Purely technical adjustments (additions to the lists of national authorities responsible for a given sector, for example) do not, in the Commission's opinion, require recourse to a committee.

In each case the scope of the powers delegated is limited to what is required to ensure the consistent application of all the Community rules covered by the proposed act, taking into account the situation in the former German Democratic Republic and the particular problems of the sector in question.

Any measures taken under these delegated powers must, of course, comply with the basic principles of Community law and will not apply beyond 31 December 1992, except in the case of ongoing technical

adaptation. Any derogations extending the time-limit will therefore be decided following the normal legislative procedure.

2.4. In some sectors (e.g. the environment and technical standards), the application of transitional measures will result in products being marketed which do not meet the conditions laid down by Community law. Although the German Democratic Republic's present situation does not permit the immediate wholesale application of Community rules, it is neither necessary nor in the public interest to allow the marketing of sub-standard products outside the region concerned. Consequently, under the transitional scheme envisaged, the German authorities would have to take steps to ensure that such products did not reach other parts of the Community, while at the same time respecting the rules of the Treaty and in particular the restrictions imposed by Article 36 and the "Cassis de Dijon" ruling. Appropriate arrangements will be needed to ensure that Community standards are met outside the former German Democratic Republic when such products are sold and that penalties are imposed in cases of non-compliance (end-use control).

The external relations sector is a case in point. The transitional system proposed is designed to avoid sudden disruption to trade with East European countries ("Vertrauensschutz") and only grants tariff concessions to products released for free circulation in the former German Democratic Republic. Such products will enjoy all the advantages of the internal market, notably free movement. However, the tariff concession will only be granted if they are consumed (or processed before re-export) in the former German Democratic Republic, so that the scope of the measure is limited to what is needed to achieve the objective in question ("Vertrauensschutz").

2.5. The package of legislative measures set out in this report only covers those requiring adoption by the Council. In some cases, technical adaptations and transitional arrangements will be decided by the Commission alone, in so far as the powers conferred on or delegated to it allow. The Commission will act as necessary before the official date for German unification.

3. Provisional measures

3.1. As indicated in the introduction, in case unification takes place before the institutions have had time to take the necessary final decisions the Commission is proposing two legal instruments authorizing it to apply provisional measures, thereby avoiding a potential legal vacuum between German unification and final adoption by the Council of the necessary transitional and technical adaptation measures.

3.2. From a legal point of view, this authorization should take the form of two texts, to be adopted in accordance with different procedures. The first text would be a proposal for a Directive on interim measures to be applied in anticipation of the transitional measures laid down in the proposals for Directives to be adopted by the Council under the cooperation procedure. The aim would be to grant a temporary derogation from the Directives to be covered by the transitional measures proposed on 21 August. The legal basis would be the bases chosen for the four proposals for Directives laying down transitional measures to be adopted under the cooperation procedure, namely Articles 49, 57 and 66 on the one hand and Articles 100a and 118a on the other.

The second text would be a proposal for a Regulation on interim measures to be applied in anticipation of the transitional measures to be taken by the Council under the consultation procedure. The aim would be to grant a temporary derogation from the Regulations, Directives and Decisions covered by the other transitional measures presented on 21 August. The legal basis would be the legal bases chosen for each of these proposals.

3.3. The substance of the two texts would be broadly similar. The Commission would be empowered to authorize the German authorities, on a provisional basis, to retain existing legislation applicable in the territory of the former German Democratic Republic which did not conform to Community law but which would be covered by transitional measures proposed by the Commission.

A safeguard clause would make it possible to surmount any difficulties arising from the retention of such

legislation. It would also make it possible to adapt Community law, where appropriate, to bring it into line with this provisional authorization. This would be particularly necessary in the case of legislation relating to agriculture and fisheries. It is proposed that the Commission be empowered to make these adjustments under the regulatory committee procedure (procedure IIIa) except in the case of rules and regulations affecting the markets in agricultural and fisheries products where the management committee procedure would apply.

3.4. The two texts would not cover transitional measures or technical adaptations for any granting of aid to the ECSC sector nor planned structural Fund operations. Interim measures do not appear to be necessary in these fields, given the long-term effects of the measures to be introduced.

II — Sector-by-sector explanatory memorandum

External aspects

The external aspects of German unification pose the Community a number of problems:

- (i) the applicability of treaties concluded by the Community to the new Community territory,
- (ii) the extent to which the Community is a legal successor to the international rights and obligations of the German Democratic Republic (GDR) in the areas of Community competence,
- (iii) the economic impact on the German Democratic Republic's neighbours and major trading partners,
- (iv) legitimate trade expectations of these trading partners (“Vertrauensschutz”, an explicit principle contained in the two State treaties between the two German States).

These and related questions are analysed below in terms of legal, economic and political implications.

Finally, the adoption of specific measures is suggested, providing for a transitional period allowing both East German and East European businesses to adapt to the new framework of external economic relations.

1. Legal implications

1.1. Succession to GDR treaties

There is no reason why the applicability of Community treaties to the territory of the former German Democratic Republic should be approached differently from the applicability of Community law in general. Thus all Community treaties apply immediately on unification, unless specific exemptions are granted by Community legal acts. At present no such exemptions from the full effect of Community treaties are foreseen for the territory of the former German Democratic Republic. However, some Community treaties may need to be adapted to the new situation, e.g. the Community textile agreements.

The preceding paragraph describes one aspect of the rule of moving treaty boundaries, a rule of international law applied in the field of succession of States to treaties. This field of public international law is in a state of flux. There is no inherent reason, however, why the basic rules of succession to treaty rights and obligations should not apply to an entity having international personality and having been granted extensive treaty-making power, such as the Community, in so far as the treaties concerned fall within its recognized sphere of competence.

The Commission rejects the application of the so-called negative aspect of the abovementioned rule of moving treaty boundaries, which would lead to the automatic extinction of all GDR treaties with third States. The Community is bound by the legal principle of the continuity of treaty rights and obligations. A fundamental exception is to be made for so-called personal treaties, i.e. those which are inextricably linked with the political “persona” of the former German Democratic Republic. Moreover, as it is likely that inherited treaty rights and obligations will conflict with Community law, including Community treaties, it is clear that their continuity must be subject to (re)negotiation.

If the subject-matter of a GDR treaty is within the exclusive competence of the European Community, the

Community succeeds directly. It alone should carry out any necessary renegotiation with the third country concerned, in accordance with normal Community procedures.

In cases of treaties of mixed competence, the Community and the united Germany each succeed in respect of their own competence. (Re)negotiation should be carried out jointly, subject of course to careful coordination.

Both in cases of mixed and of exclusive competence the possibility of a temporary authorization to a united Germany to exercise rights and obligations under the inherited treaty should not be excluded. This may, indeed, provide a practical solution to difficult situations in practice. Such authorization should clearly be subject to safeguards, for example Commission supervision.

An alternative, relatively simple, way to avoid conflict between GDR treaties in the area of Community competence and Community law, is to request the German Democratic Republic, where possible, to denounce such treaties.

The fact that the present law of succession in respect of treaties may open the possibility of restricting inherited treaty rights and obligations to the territory to which they formerly applied, is noteworthy. This may well be reasonable, and be perceived as such by former GDR treaty partners, in the case of economic obligations of a limited duration and of economic rights specifically geared to GDR capacities (e.g. fishing rights). Thus, a solution to a treaty succession problem could only be the result of an understanding with the treaty partner concerned. It should only be suitable for a brief period, since the former GDR territory could not be effectively isolated from the rest of the common market for any length of time.

Finally, the technique of autonomous adaptation of Community law may also reconcile incompatibilities of inherited treaty obligations with Community law.

Moreover, this may be the most convenient legal technique where the Community wishes to meet justified economic or political requests from third States, outside the realm of legal obligation.

To sum up, therefore, where the German Democratic Republic does not unilaterally rescind treaties, the Community has the following instruments at its disposal with regard to legal rights and obligations inherited from the German Democratic Republic:

- (a) renegotiation of the relevant treaty, according to normal Community procedures;
- (b) temporary authorization of a united Germany to exercise the rights and fulfil the duties under the relevant inherited treaty;
- (c) restriction of the territorial scope of an inherited treaty to the former German Democratic Republic;
- (d) autonomous adaptation of Community law.

The choice of which instrument or combination of instruments will depend on the nature and scope of the treaties concerned. The following analytical inventory of GDR treaties potentially affecting Community law, including Community treaties, gives an indication of which instruments to use in which cases.

1.2. Analytic inventory of GDR treaties

The following inventory contains only those GDR treaties which affect Community competence. A distinction is made between multilateral and bilateral treaties and these are each divided into a number of separate categories, each with specific problems and solutions.

(a) Multilateral treaties

This group of treaties includes multilateral treaties which establish international organizations.

(aa) Multilateral treaties to which the Federal Republic of Germany, the German Democratic Republic and

the Community are parties

This category of treaty (which includes international organizations in which the Community is an observer) poses no particular problems. In mutual agreement and depending on the Community's status in such treaties or organizations, Germany or the Community will notify the fact of unification to the depositary of the treaty or to the organization concerned.

(ab) Multilateral treaties to which the Community and the German Democratic Republic are parties, but the Federal Republic of Germany is not

In these cases the Community will notify the treaty depositary or the organization concerned that the territory to which the Community treaties apply has been extended as a result of German unification. This applies to multilateral fisheries organizations, such as NAFO, and to the international Sugar Agreement. In accordance with the internal rules of these organizations, this will have consequences for the Community's voting rights and financial contribution.

(ac) Multilateral treaties to which the German Democratic Republic is a party, but the Community and the Federal Republic of Germany are not

These are treaties concluded within the framework of the CMEA but independent from membership in the organization. There are 64 such agreements between governments. Only 14 of these affect Community competence. Seven of these are normative agreements, of which four are in the field of standards and certification. It would be logical to allow continued application of these treaties to the former GDR territory for as long as exemptions are granted from Community standards and certification. Concrete proposals for a Community view with respect to these treaties are contained in Annex I. There are 76 such agreements concluded at ministerial level. It is hoped that the large majority of these can be maintained by private firms. Proposals for the eight remaining agreements are also contained in Annex I. Finally, there are 25 agreements setting up multilateral economic organizations of the CMEA countries. Current information indicates that Community law is only tangentially affected by three such organizations (Nuclear Research Institute Dubna; Organization for the Cooperation between Railways; Organization of Post and Telecommunications). No immediate action is proposed on these.

(b) Bilateral treaties

(ba) Treaties running parallel to the five-year plan 1986-90

Such treaties have been concluded with all CMEA countries and with a number of LDCs. They provide a framework for trade between the partners. Lists of goods in which trade may take place are attached to them. The goods and the quantities in which trade will actually take place are laid down in yearly protocols. Obviously these treaties and the protocols for 1990 have no legal consequences for the Community beyond 31 December 1990. However, for the time between formal unification and the expiry of these treaties the Commission proposes to allow trade on the terms of the yearly protocols. Moreover, the yearly protocols for 1990 (for Poland: 1989) could serve as a reference point for any measures the Community might wish to take in favour of the East European CMEA members for a transitional period (see below, point 4). The German Democratic Republic is discussing new annual protocols for 1991 (with indicative product lists) with the USSR and probably also with others.

(bb) Specific treaties GDR-USSR, to which the Community should not necessarily succeed, but which will have consequences for Community law

The GDR authorities have submitted a specific list of bilateral treaties with the USSR which they are asking to maintain, principally for economic reasons. Since most of these treaties concern investment projects and other cooperative ventures between the two States, it is for the united Germany to decide whether to maintain them. However, the cooperation of the German Democratic Republic in these projects is in many cases compensated by deliveries from the USSR to the German Democratic Republic of raw materials, semi-

finished goods and energy goods. These are of extreme importance to the GDR economy and the Community will allow the import of these goods into the territory of the former German Democratic Republic during a transitional period on the same terms as before unification. A list of these agreements can be found in Annex II.

(bc) Specific treaties between the German Democratic Republic and various third countries with consequences for Community law

The GDR authorities have submitted a list of agreements with various third countries which pose the same problems as those mentioned under (bb). For the European/CMEA countries concerned, the Community will provide for specific transitional measures (see below, point 4). The agreements are also contained in Annex II. For some LDCs involved their ACP status gives them free access to the Community market for their deliveries in compensation for GDR projects. But in the case of the countries which do not have this status or whose deliveries are in agricultural products, the Community is willing to entertain requests for renegotiation.

(bd) Trade agreements (Eastern Europe and Asia)

The German Democratic Republic has concluded trade and navigation treaties with its neighbours in Eastern Europe (Albania, Bulgaria, Czechoslovakia, Poland, USSR) and with two Asian countries (China, North Korea). These agreements can be rescinded by the German Democratic Republic with six months' notice. In consultation with both Germanys, the Commission has asked the German Democratic Republic to avail itself of this possibility in the cases of Albania, China and North Korea.

The Commission is willing to take the existing agreements with East European CMEA countries into account in future talks on the Community's relations with these countries. These agreements essentially ensure most-favoured-nation (mfn) treatment, but in coverage go somewhat beyond the Community's present mfn-treaties with these countries, and even beyond Community competence (mfn treatment of individuals; recognition and execution of arbitral awards, etc.).

(be) Trade agreements (other States)

The German Democratic Republic has trade agreements with countries from the following groups: EFTA States; Mediterranean and Middle Eastern States; ACP States; States of Asean and South Asia; States of South and Central America and some OECD countries (Australia, New Zealand, Canada and Japan). All of these treaties are essentially pure mfn-treaties (although some include shipping), except for the agreement with Japan. The large majority of these treaties can be terminated by unilateral denunciation before 30 September 1990. The German Democratic Republic has expressed its readiness to denounce them all¹². The Community can agree to this, since the Community treaties with the countries concerned, or the Community trade policy in conformity with GATT, guarantee at least the same or better treatment than that granted by the German Democratic Republic treaties.

The agreement with Japan, which goes beyond trade, should be carefully studied by the Community and the united Germany.

(bf) Agreements on economic and technical cooperation

In so far as cooperation by the Community is concerned, there are sufficient instruments available (Lome Convention, Mediterranean agreements, other agreements on trade and cooperation) to ensure further Community cooperation with the countries broadly covered by the GDR treaties in question. The Community has always admitted that its Member States may also have economic and technical cooperation treaties with third countries; hence a united Germany must have the right to succeed to GDR treaties of this kind, if it so wishes. Obviously such German cooperation treaties will be subject to the consultation procedure of Council Decision No 74/ 393/EEC of 22 July 1974.

(bg) Transport agreements

Air transport: in view of the specific situation created by unification, the Commission proposes to authorize the united Germany to succeed to GDR air transport agreements.

Shipping agreements: these are for Germany to succeed to. However, in so far as the GDR agreements include cargo sharing and cargo reservation clauses — and many of them do — these are fully subject to the disciplines of Regulation (EEC) No 4055/86.

Road transport agreements: for commercial and technical road transport agreements as for the air transport agreements, the Commission envisages an authorization for Germany to succeed to this type of agreement. Clearly, these agreements remain subject to existing EC disciplines.

(bh) Agricultural agreements

Here a distinction can be made between:

- (i) agreements on scientific and technical cooperation in the agricultural sector,
- (ii) agreements on veterinary matters and plant health,
- (iii) development aid agreements in the agricultural sector.

The first and third category of agreements should not be subject to succession by the Community. The second category falls in principle within the framework of Community competence. However, the German Democratic Republic has announced that its Government intends to denounce the multilateral CMEA agreement and to terminate bilateral treaties in this area.

(bi) Fishing agreements

Some GDR fishing agreements (notably with the Faeroes, Norway and Sweden) have been concluded along the same lines as Community fishing treaties with the same countries. With the permission of the GDR authorities, the Commission proposes that the GDR quota agreed pursuant to these agreements should become part of the negotiations for the Community quota with these countries for 1991. Other GDR fishing agreements contain particularities or are with States which subject the Community fleet to certain restrictions. In these cases the Commission will need to explain to the treaty partners of the former German Democratic Republic that succession does not imply a recognition of such peculiarities and restrictions, but seeks to guarantee that these fisheries can continue to be exploited by former GDR fishermen. That is to say that the fisheries treaties, which for the moment are not integrated into Community agreements, will have a continued validity only for the “East German” fleet (for concrete proposals, see the chapter on the common fisheries policy).

(bj) Textile agreements

Although the Community will have to take account of some GDR agreements on trade in textiles, the primary task here is to adapt the existing Community textile agreements to the new situation of a larger Community market. Where hitherto trade was nonexistent, this operation would be restricted to an autonomous technical adaptation of these agreements given the absence of a general legal obligation flowing from the MFA (Multifibre Arrangement) or the GATT and not lead to a wholesale renegotiation of the textile regime with third countries. A proposal for a Directive for negotiations to this effect is included.

(bk) Steel agreement

The German Democratic Republic has concluded a steel arrangement with the USA which runs parallel to the Community steel arrangement with the USA both as to form and to duration but not as to products covered. The Commission believes that arrangement should be allowed to continue to benefit steelworks within the former GDR territory alone until the expiry date in March 1992.

The above inventory of GDR treaties to which the Community will succeed or by which Community law is affected is far from complete. The Commission departments, in spite of the effective help they have received from Federal and GDR authorities, have not been able to analyse all possibly relevant treaties in depth. Nor can it be entirely excluded that some treaties have been overseen.

To take account of this, the Commission reiterates its basic willingness to succeed to GDR treaty rights and obligations which fall within the Community's sphere of competence, but on the other hand subjects such willingness to (re)negotiation.

2. Economic assessment

The impact on foreign trade of German unification and integration of East German territory into the Community is difficult to assess. No reliable estimates quantifying the decline in trade exist. But trade decline has already been observable since 1 July, the date of German economic and monetary union (GEMU).

The Commission's economic assessment is therefore limited first to a short description of the GDR's traditional patterns of foreign trade to 1990 and second to an analysis of their macroeconomic importance both for export industries in the German Democratic Republic and for the German Democratic Republic's main trading partners in the Council for Mutual Economic Assistance (CMEA). These patterns have traditionally been fixed by multiannual foreign trade treaties (see paragraph (b), (ba), p. 49) and the corresponding annual trade protocols. This will no longer be the case from January 1991.

The structural and political changes in the CMEA countries affecting the future trade of the former German Democratic Republic are also analysed below. In conclusion, the potential effects of the application of the Community's commercial policy are described.

2.1. Historic trade patterns

With autarky a prime objective, for a country of its size the German Democratic Republic has been comparatively unintegrated into the international trade system. In 1988, about two thirds of GDR trade was with other CMEA countries, notably with the Soviet Union (around 37 % of total trade)¹³. As trade with developing countries plays only a minor role, most of the remainder is with Western industrialized countries (of which, depending on the statistical source, one quarter to one half is with the Federal Republic of Germany).

The GDR's small share of world trade is illustrated by its overall volume of foreign trade which, in 1988, at USD 58.7 billion accounted for a share of somewhat more than 1% of world imports and exports. By comparison, the Federal Republic of Germany with a trade volume of USD 551.9 billion scored an average share of world trade of 10%.

The GDR's foreign trade is characterized by:

- (i) low level of involvement in the international division of labour,
- (ii) one-sided orientation towards the CMEA countries, and
- (iii) a product pattern inappropriate to a highly industrialized country.

These characteristics derive from the politically determined compensatory function of the GDR's foreign trade:

- (a) Goods were only imported to obtain scarce resources and to fill gaps in the range of goods available. Goods were only exported in order to finance import requirements.
- (b) Until the beginning of 1990, the State monopoly of foreign trade determined the orientation of external economic relations towards the socialist countries.
- (c) An attitude of self-sufficiency, non-convertibility of the currency and lack of competitiveness are further adverse limiting factors.

The table below provides a brief overview of the GDR's foreign trade with its CMEA trading partners.

Breakdown of GDR-CMEA trade volume for 1990 (Estimates based on annual trade protocols for 1990)
(CMEA trade represents about 65 % of total GDR trade)

Trade partners	Total trade volume (mio TR) %	
USSR	13200	55,4
Czechoslovakia	2900	12,2
Poland	2500	10,5
Hungary	2000	8,4
Bulgaria	1400	5,8
Romania	1100	4,6
Cuba	568	2,4
Vietnam	140	0,6
Mongolia	30	0,1
	23838	100

Annex III contains a more detailed overview of trade with CMEA member countries by product group and separate information on the GDR's foreign trade flows. The Annex also provides country-based information on existing long-term obligations and issues requiring particular attention.

The structure of the GDR's trade with the CMEA countries has remained relatively constant. Stable export and import patterns have been established with a number of partners. A good 60% of the GDR's exports to the CMEA countries are accounted for by machinery and equipment while on the import side raw materials are the major group with 40 to 50%.

The compensatory function of the GDR's foreign trade is clearly reflected in this basic pattern. The Soviet Union is the GDR's main supplier of energy and raw materials (covering, for example, 100% of its natural gas, lead, pig iron, wood and phosphate requirements). This is matched by the fact that the German Democratic Republic, with its principal exports in the area of machinery, industrial equipment and transport facilities, is the Soviet Union's main supplier (it accounts for approximately 20% of all Soviet imports in this area). Trade with the other socialist countries is characterized by a greater degree of substitution.

The USSR is the GDR's main trading partner. In November 1989 a level for 1990 of 6.8 billion transferable roubles (TR) was agreed for the GDR's exports and a figure of 6.4 billion TR for imports.

Since 1987, however, there has been an unmistakable downward trend in the volume of trade with the USSR. In 1986 this still accounted for 70.6 billion transferable marks (VM). In 1987 it fell to 68.4 billion VM and again in 1989 to 65.4 billion VM.

Recently, the USSR has stepped up its purchase of microelectronics products, equipment for light industry and the foodstuffs sector and for commerce and public utilities. The raw materials package accounts for some 50 % of deliveries and purchases in trade with the USSR. The USSR has been making efforts to ensure that this aspect of trade will continue to enjoy a State guarantee (possibly through State contracts with firms).

Trade links with the other CMEA countries differ in volume and structure from those with the USSR. The total volume of trade is approximately 1.5 billion TR less than with the USSR, accounting for 44.6 % of total GDR trade with CMEA countries. The differences from one country to another arise primarily from the different levels of economic development of the countries concerned and their progress towards economic reform. Since 1990, there has been a dramatic decline in trade with several East European countries. The introduction of a market economy has meant that Hungary and Poland could no longer guarantee to purchase GDR products. Firms have terminated purchases previously made from the German Democratic Republic.

The 1990 protocol with Hungary contains no State guarantees of purchases on the part of the Hungarian Government and no provisions on pricing. In the case of Poland, it was decided not to conclude an annual protocol for 1990 but merely a loose agreement. The agreement provides only for a volume of approximately 20% of the previous years' trade, this being the amount for which the Polish Government considered it could provide a certain guarantee. On the other hand, Poland has recently expressed interest in greater supplies of consumer goods, including cars. These are products which the German Democratic Republic will find increasingly difficult to sell on its domestic market.

2.2. Structural changes affecting foreign trade

Much of business in the German Democratic Republic (and even more in its CMEA trading partners) depends on a continuation, in some form, of existing trade relations. Severance of existing relations, even after short-term contractual obligations have been met, could lead to the disappearance of entire businesses and to wide-spread unemployment. About 1.8 million people are employed in export-related jobs, 480 000 (15 % of total employees in GDR industry) of which are directly or indirectly related to exports destined for the USSR.

The GDR foreign trade reflects the high level of self-sufficiency. As a result, the range of products manufactured has been far too large measured in terms of a single country's opportunities on the world market, if the German Democratic Republic is exposed in the short term to the full pressure of competition on the world market, without fundamental changes to the pattern of production, many of its companies may not survive.

The Soviet, Polish and Hungarian Governments have expressed similar concerns about the fate of industries wholly or partially dependent on exports of the German Democratic Republic. Their potential losses have been attributed to German unification and the future application of the Community's commercial policy.

However, German unification and the subsequent integration of the GDR's territory into the EC is taking place simultaneously with several other important structural economic changes. In most Central and East European countries there is a clear transition to market economies, linked with a shift towards trade in convertible currencies at world market prices. The principle was formally adopted by the CMEA Sofia Summit in January 1990. There thus would have been major changes to the intra-CMEA trade pattern even without German unification. It is likely that the very swift process of German unification will reinforce these changes. Reliable quantification of this additional factor is impossible.

These radical changes are bound to call into question existing foreign trade patterns and will inevitably alter the structure of production. Since 1987, there has already been a decline in the volume of intra-CMEA trade, as described above. This process will now accelerate substantially in the remainder of 1990 and in 1991. Intra-CMEA trade volumes are likely to contract significantly as importers who previously bought within the CMEA have to pay in hard currency and may switch to other sources. The only way for CMEA exporters to avoid this is to lower their prices substantially. This may not work in all cases. Some of the CMEA's traditional exports could have problems finding a buyer at any (hard-currency) price.

However, these effects are the short-term results of the structural changes brought about by German unification. In the medium term new areas of cooperation will open up (e.g. cooperation in reconversion, transfer of GDR production specialized in exports to the USSR to East European countries, expansion of the tourist industry, cooperation of small and medium-sized businesses). The reform process in Central and East European countries, strongly supported by the Community, is creating new business opportunities. They will now be enhanced by the economic growth resulting from German unification. Additionally, the Central European CMEA countries will swiftly become very attractive for foreign investors looking for low production costs for new industries exporting to Germany and the EC.

2.3. Prospects for GDR exports to CMEA countries

GDR exports to CMEA countries fall into two categories: those products exported only to CMEA countries

and those also exported to Western countries.

Basically, if products have only been exported to CMEA countries, they are not competitive on the world market. This holds mainly for investment goods and for protected markets such as those for agricultural goods and mining products, except where the CMEA has not been the only market for these goods. Consequently, exports of the German Democratic Republic to CMEA countries are soon likely to decrease substantially unless GDR producers either have had a monopoly position on these markets, or prove to be competitive or their exports are heavily subsidized.

If products have also been exported to Western countries, prospects for exports to CMEA countries are favourable. This will, however, depend on the development of production costs in the German Democratic Republic. This holds especially for those goods which have not depended on export subsidies to be competitive on world markets. For all other products, subsidies may be necessary to maintain prevailing export flows.

2.4. Prospects for CMEA exports to the German Democratic Republic

A parallel distinction between goods exclusively exported to the German Democratic Republic and those also exported to Western countries must be made for CMEA exports to the German Democratic Republic — which in principle also means to the European Community after German unification.

Goods only exported to CMEA countries but not to Western countries are obviously not competitive on the world market in convertible currency. Consequently, these exports to the German Democratic Republic will soon disappear, probably already in 1990. An exception might be exports processed in the German Democratic Republic and then re-exported to CMEA countries. But this will hold only as long as the GDR processing industry remains competitive.

Some goods exported to Western countries, e.g. oil, gas and coal, have proved competitive on the world market at current prices. Despite the prevailing preference of GDR consumers for goods of Western and mainly West German origin, such CMEA exports may be maintained or even extended in the medium term as long as they fulfil EC standards. If not, GDR demand for these products will probably soon decline.

In the absence of significant interventions on the market, CMEA exports to the German Democratic Republic (excluding raw materials) may fall in 1991 to less than one third of their 1989 level. CMEA raw material exports (oil, gas) will be maintained or even increased, assuming a phasing-out of nuclear energy production and plants based on lignite.

2.5. Potential effects of the application of the common commercial policy

Germany has to adopt the Community's common external tariff (previously the German Democratic Republic conducted tariff-free trade with CMEA countries) and apply Community and GATT rules to the territory of the former German Democratic Republic. Federal Republic of Germany quantitative restrictions will extend to GDR territory, as well as EC standards and quality norms.

(a) USSR

The Commission has noted that exports of the USSR to the German Democratic Republic follow approximately the same general pattern as USSR exports to the EC. Owing to the high percentage of raw material (particularly energy) exports, the current average rate of duty on such exports is 2.3% and may drop to 1.7% if the Uruguay Round tariff offer is maintained. The tariff impact will therefore be moderate (86% of goods at 5% duty or less). However, the USSR has noted that though market access is likely to be maintained, the pricing of currently price-balanced CMEA trade arrangements will be affected and cause problematic imbalances.

Technical barriers based on the adherence to EC norms and standards by the German Democratic Republic

will also adversely affect trade in various sectors such as machinery and equipment.

Under the EC-USSR Trade and Cooperation Agreement, all quantitative restrictions (QRs) for which it was agreed liberalization would take place, were liberalized by Regulation (EEC) No 1434/90. Only 67 have been maintained, of which 18 are agricultural. In the agricultural sector only coffee and vegetables, particularly potatoes, are involved. Therefore, none of the QRs in the agricultural sector would be likely to have a great impact on trade with Germany. In the non-agricultural group, the QRs are mostly for intermediate products such as fibre-board and ferrosilicon, and for a variety of finished goods with a limited importance in USSR-GDR trade.

(b) Other East European CMEA countries

The impact of the application of the tariff will be greatly alleviated for the other countries of the CMEA. Romania has had the benefit of the generalized system of preferences (GSP) on a limited basis for a long time. Poland and Hungary benefit from the full extension of the GSP in the framework of the G-24 Phare programme for a temporary period of five years from 1 January 1990. The Community intends to extend this on the same basis to Czechoslovakia, Bulgaria and Yugoslavia from 1 January 1991. This will certainly ensure that there is no adverse impact as far as industrial goods are concerned.

However, Regulation No 3420/83 and Regulation No 288/82 should be taken into account. These Regulations provide for regional quantitative restrictions (QRs) on certain imports on a regional basis in the Community. German unification implies the extension to the former GDR territory of those restrictions applied by the Federal Republic of Germany against the CMEA countries.

However, the impact of these restrictions will be minor, since the number applied by the Federal Republic of Germany is relatively small and covers a small range of products. Furthermore, the Federal Republic of Germany has reduced its impact almost totally under the system known as "Testausschreibung" which has permitted, on an experimental basis, the unrestricted entry of industrial imports from the countries concerned. In the case of Poland and Hungary the impact of QRs was reduced to zero on a Community-wide basis by the liberalizing Regulations of late 1989. ⁽¹⁴⁾ The same measures are planned for Czechoslovakia, Bulgaria, Romania, and Yugoslavia. A proposal to this effect is with the Council. For Yugoslavia no QRs are maintained by the Federal Republic of Germany and there will therefore be no effect after unification.

In sum, Community measures already taken or being taken to improve the access of certain countries of Central and Eastern Europe to the Community market will greatly diminish the potentially adverse effects of the application of tariffs and of QRs.

2.6. Conclusions

The current structure of the external trade of the German Democratic Republic is seriously distorted by the special division of labour within the CMEA and by accounting in non-convertible currencies. As both distortions will disappear in 1990, the present trade structure cannot be maintained. For market reasons, trade flows among CMEA countries, in particular between the German Democratic Republic and the other countries, will diminish significantly. GDR trade with the CMEA will adjust to the pattern of trade flows between CMEA countries and Western countries.

If the countries of Central and Eastern Europe undertake serious efforts to catch up, there will be significant trade and current account surpluses in EC countries vis-à-vis these countries, including the former GDR territory. This should prepare the ground for suspending remaining EC tariffs and quantitative restrictions vis-à-vis these countries during a transitional period. Trade relations should be extended on a market basis and East European countries should be helped to improve their competitiveness on the world market.

3. Political considerations

Legally, the Community is affected by an important number of existing foreign obligations of the German

Democratic Republic. However, from an economic point of view it appears doubtful whether these obligations will be honoured, given the structural changes taking place and the introduction of world market competition.

Against this background, the Commission had to evaluate carefully whether a transitional period should precede the full implementation of the Community's commercial policy. This would allow both the German Democratic Republic and its main trading partners to adapt to the additional change. The process of internal change towards market economies and external adaptation to world market prices and hard currency puts the CMEA economies under enormous pressure to restructure industry. This pressure has already been greatly increased by German economic and monetary union since 1 July 1990. Any additional strain on these countries resulting from the indiscriminate and immediate application of the common commercial policy which could result in subsequent economic and social destabilization ought to be avoided.

Even if the economic effect of possible derogations is likely to be limited in the case of CMEA exports to the former GDR territory (since the market will not be very responsive), the potential political and psychological impact could negatively affect EC relations with its Central and East European neighbours and the USSR.

Any destabilization from, or perceived as stemming from, the immediate application of EC commercial policy would run the risk of contradicting other major EC initiatives in Eastern Europe (Phare, association agreements, aid to the Soviet Union), which aim at establishing a pan-European free trade area in the long term.

Finally, it is declared policy of the EC to support the process of German unification. Since the principle of legitimate expectation ('Vertrauensschutz') is contained in the two State treaties between the German States and constitutes one of the external cornerstones of the unification process, it is a politically relevant factor for the Community as well.

Ways had therefore to be found to reconcile traditional trade patterns with the legal, political and economic integration of the German Democratic Republic into the Community. They combine transitional exemptions with the necessity rapidly to transform the German Democratic Republic into a market economy fully integrated into the EC. The application of the different measures proposed may be the beginning of very close economic cooperation between the EC and Central and East European countries. The GDR's external commitments will thus have served as a catalyst for pan-European economic cooperation.

Clearly, the European Community's interest is limited to providing its Central and East European neighbours with this framework. These countries benefit from other efforts of the EC to stabilize their economic and political transition processes and negotiations on far-reaching association agreements with them are currently being prepared. Specific transitional measures of the Community are therefore limited to the active European member States of CMEA and Yugoslavia, the GDR's main trading partners.

Clearly, however, these measures can obviously not ensure actual market shares. Unified German and/or individual East German businesses may therefore have to guarantee the sales of certain products for the transition period.

4. Adaptation measures during the transition period

4.1. Application of common commercial policy

In principle, the common commercial policy applies from the day of formal unification. In fact, the principle is already in force since Council Regulation No 1794/90 establishing "accelerated customs union" simultaneously with the creation of German economic and monetary union. However, during the interim phase preceding German unification, a general clause stated that the customs union "shall apply without prejudice to the German Democratic Republic's obligations under agreements concluded with third countries" (Art. 2 (2)). Such indiscriminate preferential treatment was only justified for the short period

before unification and applied to a country which was not even a member of the EC. The Community now has to define a more differentiated policy.

In the following section only adaptation measures for the import regime are discussed, since no major problems exist for the Community in the export field. As to the export side the possible granting of State aids to East German businesses is mainly a matter for Germany. Such aids will need authorization by the Commission in order to avoid distortive effects on the common market.

4.2. Exceptions during the transition period for trade with European CMEA countries

Legal, economic and political considerations led to the conclusion that a transitional period of adaptation was needed. During this period, a set of policies are to be applied, which fulfil the objectives of:

- (i) implementing the principles and instruments of the common commercial policy within a clearly defined time horizon;
- (ii) taking due consideration of the potentially serious effects on the economies of several Central and East European countries;
- (iii) promoting necessary structural adjustments in East Germany and its traditional main trading partners in Europe.

A variety of different measures are to be applied in order to meet these objectives. They are outlined below. But there is one common provision which has to be applied to all transitional measures envisaged, except for quantitative restrictions (bdb), namely application only to products of which final consumption takes place in the territory of the former German Democratic Republic. Despite its practical disadvantages, this approach can be justified in GATT and *vis-à-vis* economic sectors in the Community possibly affected by exceptions to Community rules.

The Commission will require commitment to this provision from the German Governments as well as from benefiting countries.

(a) Renegotiations

(aa) Immediate renegotiation of EC agreements with third countries

The EC has concluded a number of bilateral agreements with third countries limiting market access (textile and steel). The Commission is seeking a mandate from the Council for the adaptation of these agreements in order to increase EC quotas and add the increases to the share of the Federal Republic. Traditional trade flows of the German Democratic Republic ought to be taken into account in this exercise.

A proposal for a Council Directive for negotiations to adapt the bilateral textile agreements can be found in Part IV. GDR rights and obligations should be honoured until adaptation of existing EC agreements with third countries is complete.

(ab) Treaty succession and renegotiation of GDR treaties with third countries

As stated in Part I, the Community will succeed to the rights and obligations of the German Democratic Republic in areas of EC competence. However, a simple takeover of these treaties is impossible, owing to the differences between the legal nature and competences of the EC and those of a former socialist country with a State monopoly in trade. The EC can only provide a favourable framework for the necessary adaptation of these treaties to the new international economic environment. This point could be integrated into the negotiations on the conclusion of association agreements with the countries concerned.

Long-term investment projects and cooperative ventures involving deliveries to the German Democratic Republic in the industrial sector (1.2 (bb)) and in agriculture (1.2 (be)) are of particular importance in this context. Most of these treaties have to be renegotiated by Germany (with the Commission associated).

(b) Exemption from application of common commercial policy instruments

(ba) Time horizon

Any exception has to start on the day of German unification and should be limited in time. The ultimate time-limit for any transitional measure should coincide with the end of preparations for the internal market, in order not to hamper its realization with external commitments not corresponding to internal market requirements. For the moment, the transitional period ends on 31 December 1991. After evaluation, extension may prove possible.

(bb) Beneficiaries

As already noted the USSR, Poland, Hungary, Czechoslovakia, Romania, Bulgaria and Yugoslavia should be the beneficiaries of any exemptions. It is clear that the USSR will gain most since it is not included in the Phare liberalization measures and does not have access to the GSP.

(bc) Trade volume covered

The maximum volume of goods covered by the transitional measures are those contained in

(i) the annual protocols agreed between the German Democratic Republic and the countries mentioned under (bb) for 1990 (1989 in the case of Poland);

(ii) long-term cooperation agreements contained in Annex II.

(bd) Instruments

(bda) Tariff quotas for products originating in European CMEA countries and Yugoslavia

This solution is formulated in a proposal for a Council Regulation (see Part IV). It suspends all duties for amounts identical with the quantities/values contained in the treaties mentioned under (bc).

(bdb) Quantitative restrictions

The Community has already liberalized or is currently undertaking efforts to eliminate or suspend remaining quantitative restrictions *vis-à-vis* East European countries included in operation Phare (see above, 2.5 (a) and (b)).

GDR imports from the USSR should also benefit from suspension of QRs applied by Germany until 31 December 1991. This is valid for specific QRs. Suspension of non-specific QRs is under consideration.

(bdc) Anti-dumping measures

The Commission prefers to stay within the terms of anti-dumping regulations, so a review of undertakings and anti-dumping duties is the most appropriate action. The Commission will ensure that the revision procedures requested in connection with German unification are treated as expeditiously as possible.

(c) Agricultural products

Given the high percentage of food exports to the German Democratic Republic from Hungary, Bulgaria and Romania (see Annex III), it is not possible to exclude agricultural products from transitional measures. However, duty-free tariff quotas should be limited to agricultural products subject to tariffs, excluding products subject to levies. Community provisions on minimum and reference prices would continue to apply.

(d) GATT notification

The Community should notify GATT of its intentions to implement the abovementioned arrangements to either respect or phase out previous preferential agreements of the German Democratic Republic with third countries. It is important that the Community makes clear that:

- (i) the measures are limited to a very brief period;
- (ii) they are intended to solve very specific economic problems;
- (iii) there is no serious and viable alternative to this solution;
- (iv) the arrangements are undertaken within the framework of an overall liberalization of trade agreements.

(e) Norms and quality standards

The Commission proposes a two-year derogation period from the application of norms and standards in the sphere of the internal market (see the Chapter on the internal market, p. 68). Parallel to the provision for an adaptation period for domestic (GDR) industries, a similar period is proposed for export products to the former German Democratic Republic. The respective legislative provision is contained in the proposal for a Council Regulation on the introduction of a transitional period for the harmonization of technical rules (Article 1(3), see Part IV).

4.3. Additional measures

Even a more generous transition scheme could not guarantee sales. Efforts will therefore be made to offer concrete help for the improvement towards world market competitiveness, particularly with regard to quality and marketing. Possible methods could be:

- (i) the design of management training products in the most affected exporting industries;
- (ii) the establishment of a "cooperation stock exchange" where GDR enterprises could find West European partners willing to share rights and obligations with regard to East European business partners, thus offering promising long-term cooperation to non-German as well as German firms;
- (iii) increased cooperation in research and technology projects geared to innovative product development.

The Soviet Union has also expressed interest in closer customs cooperation (e.g. facilities for stepping up drug traffic control).

5. Legislative measures

There will be not more than three legislative measures to be adopted at this stage. The most important is a Council Regulation on the introduction of a transitional tariff quota (see above, 4.2 (bda)). This Regulation provides for the exemption from the application of the Common Customs Tariff for all goods covered by the annual trade protocols (Poland: 1989) and the long-term cooperation treaties with the European CMEA countries and Yugoslavia. The proposal covers both industrial and agricultural products.

The second proposal is for a Council Directive for negotiations to adapt the existing bilateral textile agreements to take account of German unification (see above, 1.2 (bj) and 4.2 (aa)).

The third proposal is for a Commission Decision exempting ECSC products imported from the European CMEA countries and Yugoslavia which are covered by the annual trade protocols and the long-term cooperation treaties between the German Democratic Republic and the countries in question, from customs duties and taxes having an equivalent effect.

[...]

- 1 SEC(90) 1138 final, points 8 to 12.
- 2 Minutes of 12.7.1990, Part II, p. 3, point 12.
- 3 SEC(90) 1138 final, point 11.
- 4 SEC(90) 1138 final, points 16 to 20.
- 5 OJL 166,29.6.1990.
- 6 OJL 166,29.6.1990.
- 7 OJL 166,29.6.1990.
- 8 OJL 188,20.7.1990.
- 9 OJL 203,31.7.1990.
- 10 The particulars given below refer to the draft at 21 August 1990.
- 11 OJL 197,18.7.1987, p. 33.
- 12 Even those which have different deadlines for denunciation, but with an exception for those which form the ultimate legal basis for continuing barter payments to the German Democratic Republic (notably Brazil).
- 13 According to more recent publications, trade with the USSR was only one quarter of total trade. These discrepancies in official figures are the result of a modification of the exchange rate of the transfer rouble. At present, it is not possible to quantify trade on the basis of market economy indicators. This makes it difficult to compare analyses of the GDR's foreign trade with CMEA countries with its trade with Western countries.
- 14 Regulations Nos 3381/89 and 3691/89.