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cc PC

Foreign and Commonwealth Office

London SW1A 2AH

19 February 1990

Already submitted to PM. CDP 20/2.

Dear Charles,

**German Unification**

In the light of the Cabinet discussion on 15 February, and his talk with the Prime Minister (recorded in your letter of 15 February to me) about recent developments over German unification, the Foreign Secretary has asked me to send you the enclosed copy of the paper by FCO officials to which he referred. It will be discussed under Cabinet Office auspices on 21 February. Some refinement in the light of the views of other Departments is likely, but it provides a useful initial analysis of the issues which will have to be covered in intra-Community negotiation.

On 15 February, Sir David Hannay pressed Delors on the need to keep member states in touch with developments on German monetary union. Delors has agreed to have a private discussion with COREPER Ambassadors next week. This will provide a good opportunity to press for adequate preparations for the impending negotiations.

I am copying this letter to John Gieve (HMT), Martin Stanley (DTI), Michael Harrison (MAFF) and Sonia Phippard (Cabinet Office).

Yours,

Stephen Wall

(J S Wall)
Private Secretary

C D Powell Esq
10 Downing Street

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15 February 1990

**CABINET**

**STEERING COMMITTEE ON EUROPEAN QUESTIONS**

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**EC IMPLICATIONS OF GERMAN UNIFICATION**
**Note by the Foreign and Commonwealth Office**

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## Introduction

1. This paper examines:

(a) the probable Community procedures (paras 2-8); and

(b) the practical Community consequences, sector by sector (paras 9-31)

if the territory of the GDR becomes part of the EC. Throughout, "unification" means the political unification of the FRG and GDR into one state, and "integration" means the incorporation of what is now the GDR in the European Community. The paper assumes that the goal of integration would be a single member state, whether achieved by creating a single new state called "Germany", or simply by incorporating the GDR-Länder into the Federal Republic, under Article 23 of the Federal Constitution. It does not deal with the alternative, but now very unlikely, possibility that the GDR would join the EC as a 13th member state and remain separate from the FRG for a substantial period.

**Overall Analysis**

2. The Community as such does not have any veto over German unification, nor would it be entitled to participate in any negotiations between the two Germanies and the Allies over unification. But this does not mean that the Community has no say over the consequences of unification. On the contrary, the Community is entitled to argue - and all in Bonn agree - that those consequences should form the subject of negotiation either prior to or following unification.

3. The GDR is a small country: its population is 5% of the EC's; its GNP no more than 10% of the FRG's. Its size alone should therefore not be a problem in incorporating it into the EC. But precise assessment is complicated by three factors. First, statistics on the GDR economy are unsatisfactory, and comparisons made unreliable by an unrealistic exchange rate and a lack of market prices inside the GDR. Second, the centrally-planned economy has been run in a completely different way from Western economies. The transition to a free market economy will be difficult and disruptive. We do not know the pace or extent of the change that would have been accomplished by the date of unification. Third the political crisis in the GDR and the loss of skilled manpower through emigration is now causing considerable damage to the GDR economy: its effects are no easier to predict than are the effects of all-German monetary union (GMU), which could produced increased inflation and unemployment and therefore the very emigration it is intended to slow or stop. On the other hand, some in Bonn believe it could produce real GDR growth of as much as 10% in year one. In the short term, unification is likely to slow the rate of growth in the FRG: current GMU plans to rescue the GDR could cost the FRG the equivalent of one year's growth of GNP.

4. In practice the two processes of unification and integration of the GDR into the EC are likely to take place in parallel and have considerable implications for each

other. With some form of GMU now likely to be installed shortly after the 18 March GDR elections, the unification process, and the streamlining of the GDR economy on free market lines, will then be on train. The effects of economic restructuring in the GDR, and whether emigration continues, will dictate whether the transition is managed smoothly, or messily. A smooth transition would be preferable, but the accelerating collapse of the GDR may make a messy one more likely, with unification coming first, and Community negotiations sorting out the consequences. Two scenarios are conceivable:

(a) political unification could happen very quickly, without much preparation. In this case Germany would find itself unable to fulfil many of its EC obligations as far as the five ex-GDR-Länder were concerned, because the economy and administrative systems of the ex-GDR-Länder were not yet physically capable of complying with EC law. (Ex-)GDR firms and individuals would start to demand Treaty rights and money from the EC budget. There would need to be very urgent negotiations to get some kind of standstill agreement on the EC acquis in place. This would be followed by negotiations on transition, to be set out either in a Treaty (which would require an IGC, common accord of the member states and ratification), or by political agreement (though this would not prevent individuals or firms taking legal action);

(b) regardless of the timing of political unification, de facto economic integration of the GDR and FRG could continue to take place piecemeal, with consequences for the EC. This has already happened over free movement of people (para 22) and seems likely to happen as GMU leads to diminished GDR sovereignty in wide areas of economic policy (para 31). There would need to be ad hoc negotiations to agree derogations and transitions in each area, against the background of an economic collapse. Formal unification and integration would take place in stages, more or less coordinated.

5. Much less likely, particularly in view of GMU, is a smooth transition, under which the necessary transitional arrangements were negotiated as a package, designed to fit with the timetable of unification. This would mean that formal unification would take place late in the integration process, either by agreement to delay it until the modalities of integration had been fully worked out and enshrined in a Treaty; or by the Germans themselves postponing unification until they had ensured that that the GDR fully complied with EC law and that the GDR-Länder could take on the full acquis from the moment of unification. This now looks a highly implausible scenario; and self-evidently it would be difficult for the FRG's Community partners to argue that unification must be delayed to permit a tidy negotiating timetable. Nor is there any need to make the attempt, for, in practice, the detailed content of negotiations would be much the same whatever the political path to integration.

6. Few, if any, of the consequences of integration would require amendment of the Treaty of Rome and the other Treaties, and the mood in Bonn is at present to avoid Treaty change as far as possible. The other consequences (see paras 10-31) would require either amendments to existing, subsidiary instruments of EC law, not requiring Treaty amendment; or transitional periods for the application of Treaty powers and rights (eg Articles 52-58 on freedom of establishment, 85 and 86 on competition policy, 92-4 on state aids). Amendments to existing legislation could in principle be made seriatim, with the relevant instruments amended one by one in accordance with whatever majority was required, but would more neatly be made in a single treaty instrument. Derogations from the Treaty, either permanently or for a transitional period, would need to be enshrined in

a formal treaty instrument, which would need to be adopted by a conference of representatives of the Governments of the member states and would enter into force when ratified by all. A single hybrid instrument covering all aspects would be the most straightforward solution: it was the one adopted in all the accession Treaties.

7. The number of amendments to EC legislation needed to create the necessary derogations and transitional periods might be very large: for example, over 1200 Directives (to say nothing of Regulations and Decisions) have been adopted since the UK joined the EC in 1973. The Single Market and other programmes are adding more. There would also have to be very many changes in the legislation applying to the GDR. The task would be eased for the GDR by the existence of laws in the FRG which could be taken over, extended or adapted (especially if unification took place through incorporation in the FRG by means of Article 23). But full implementation would depend on the effectiveness of the administrative, legislative and legal systems in place. Existing systems are weak, and being further weakened by daily migration which is now running at a level (up to 3,000 per day) similar to that of the months before the building of the Berlin Wall in August 1961.

8. Though the Community negotiating process will be messy, the FRG will not be able to avoid it, as they can on GMU, since it has no effect on EC laws/regulation. Nor can they short-circuit it. It is also worth noting that the UK interest will be better served by negotiating transitional arrangements with the German government than they would have been by a classical accesssion negotiation, with the GDR applying as a separate state, the FRG arguing for generous terms and a speedy settlement, and unification post-GDR-accession resulting in the combination of the Council voting strength of the two Germanies - which would have been hard to resist if they had, however, briefly, occupied separate Council seats, but should now be

avoidable. We do however need to ensure that the Commission and member states are well-prepared for the negotiations; and in particular that we have clearly identified the UK interest, sector by sector, particularly on the length of transition periods which would best suit the UK (there is no reason to expect a standard length across the board).

<u>Sectoral Analysis</u>

9. The following paragraphs therefore examine, sector by sector, the main areas of EC activity which will have to be addressed. Most arise from the Treaty of Rome, but the ECSC and EURATOM Treaties also need to be taken into account. (For the purposes of analysis, the paper assumes that the GDR economy will liberalise rapidly, moving from state to private ownership, from command to market systems and to a stable hard currency; and that this process will take place without political disruption which would prevent foreigners investing with confidence. There will in practice be a substantial economic dislocation, though the indications are that outside investors, at least from the FRG, are already moving in.)

<u>Single Market</u>

10. The ex-GDR-Länder would have to allow greater competition in financial services, (banking, insurance, investment), transport (air, sea and land, public purchasing (by government, local government and utilities) intellectual property, recognition of qualifications, telecommunications, energy and research. Legislation would not take very long: the brake could be fear of the impact of competition, for some sectors (eg financial services) are very underdeveloped.

11. The ex-GDR would need to meet the requirements of standards directives. Goods exported from the GDR to the EC already have to do so, but the standards would apply within the GDR. This would mean extensive retooling of industry (which will of course be necessary anyway for successful

exports to Western Europe). The GDR would also have to apply new rules on animal, plant and fish health; on pharmaceuticals; and food labelling. All will require investment to meet the new standards.

12. The necessary economic adjustments would be large, but will in any case be required, and driven, by unification with the FRG economy. The necessary transitions could in principle be provided for by amendments to secondary EC legislation. Some form of continuing control of Inner German Trade could be appropriate, unless the ex-GDR-Länder were ready at once to accept all goods in free circulation in the EC, and did not seek time to cope with the competition.

<u>Agriculture</u> (Articles 38-47 EEC)

13. Agriculture is of relatively greater importance for the GDR than for most other EC countries. It accounted for 8.5% of the GDR's GDP in 1985 (FRG 1.8%, UK 1.6%, EC12 5.4%) and occupied 10.8% of the workforce (FRG 6.6%, UK 2.5% and EC12 11.1%). The main adjustments the GDR would have to make are:

(i) applying the range of EC support mechanisms, which differ greatly from those currently in place. They involve intervention arrangements, subsidies and external tariffs to hold domestic prices up. GDR farmers would no doubt welcome this - but consumer prices would have to rise considerably: they are currently subsidised by up to 80%;

(ii) detailed regulations on quality and health. Investment would be needed to meet the standards.

(i) would be very disruptive, and the Germans would no doubt seek longer harmonisation periods, as in earlier accessions. (ii) should be less problematic: GDR animal and plant health standards are relatively high, but not much below the FRG's.

14. Preliminary calculations of what the GDR might expect from FEOGA guarantee funds, necessarily based on several uncertain assumptions and to be treated with great caution (particularly as trade patterns would alter substantially), suggest that in 1992 the ex-GDR-Länder might expect net FEOGA Guarantee receipts of some under 500 mecu: the agricultural levy would be about 50 mecu, and the sugar levy about 100 mecu. These funds would probably start to flow quickly and automatically once the application of CAP price levels was agreed in principle: the build-up would depend on any phasing of adjustment in price levels. There might in due course be resultant pressure for revision of the FEOGA Guideline.

15. GDR production of major CAP products in 1988 was:

| | GDR | EC |
|---|---|---|
| Cereals | 9.9m tonnes | 163.2m |
| Beef | 0.73m tonnes | 7.6m |
| Pigmeat | 1.74m tonnes | 12.8m |
| Sheepmeat | 0.04m tonnes | 1.1m |
| Milk | 8.05m tonnes | 95.8m |

Exports to the UK are negligible, but considerable quantities of pigmeat are exported to the FRG; and barley is imported from the EC for animal feed. The GDR's main imports are animal feed and cereals; they are (like the EC) trying to curb excess production of milk, meat and eggs.

16. The difficulties and expense of integrating GDR agriculture with the FRG and the EC could strengthen FRG opposition to any further CAP retrenchment. But when the profit-motive spreads, GDR agriculture has potential for large-scale low cost production, which could have uncomfortable implications for small-scale high-cost Bavarian agriculture: it is not inconceivable that the overall German interest in high production-related support

could diminish. But the short term effect of GDR integration into the CAP would undoubtedly be higher CAP costs, and there is no realistic chance of imposing artificial transitional delay in ex-GDR receipts from the CAP (in addition to the natural delay caused by the phasing of price increases).

Fisheries

17. The GDR had a large fishing fleet in the 1970s, with catches of over 300,000 tonnes per annum; we do not know the current level of catches but the fleet has since declined greatly, reducing the difficulty of applying the CFP. GDR territorial waters in the Baltic will not bring signficant new stocks, so the overall effect is likely to be some increased demand for existing Community fish resources.

Environment (Article 130 r-t EEC)

18. The GDR is part of the worst-polluted region in Europe with life expectancy in some areas falling as a result. There currently are no effective environment controls. Existing EC legislation covers inter alia drinking and bathing water quality; car exhaust emissions; power station emissions; and waste disposal. Meeting the standards (which many existing member states already find difficult) would require heavy investment and even structural changes in the GDR economy, because of its dependence on brown coal for power generation and the preponderance of heavy industry with out-of-date plant. GDR per capita $SO_2$ emissions (300kg) are almost ten times those of the FRG (31kg): one power station currently under construction will, if completed, discharge twice as much as the whole of Sweden. $CO_2$ production is nearly twice the FRG's (5.5t per capita as against 3.06). Long derogations from environmental directives will be required, and there will be bids, which we should clearly resist, for EC budget help with the costs. We shall not lack for allies in resistance: the French, for

example, share our view that it will be for the Germans to clean up their own industry; and Bonn is already allocating funds.

Social (Articles 117-122 EEC)

19. Existing legislation covers:

(i) health and safety: investment would be needed in new equipment and training;

(ii) equal treatment in pay and social security: the main pressure for change is likely to be demands from ex-GDR citizens for harmonising with the FRG's high standards of social provision - which in most cases are well above EC minima. Meeting EC obligations would be a lesser problem within that, though social legislation is a moving target and the Commission's Action Programme may well result in new obligations during the '90s.

In both cases, all costs would be for the Germans to pay; and our interest would lie in their being required to do so fairly quickly, to ensure that ex-GDR business is forced to compete on equal terms.

Immigration/Frontiers

20. GDR nationals' entitlement to FRG nationality is stated explicitly in the German declaration on nationality annexed to the Treaty of Rome, and is accepted by all EC member states. Indeed, there is nothing in present arrangements to prevent the FRG authorities from issuing FRG identity papers (and thereby Treaty rights) to all GDR citizens. This rules out the kind of transitional arrangements made with Greece, Portugal and Spain for free movement of people. But the end of the Inner German border for immigration purposes would mean the Community's external perimeter becoming established at the Oder-Neisse: the EC 11 would want to ensure that this border was as tightly policed (for immigration, drugs,

terrorism, etc) as the Inner German border has been in the past. This would be the counterpart for the removal of visa requirements on GDR nationals, which is automatic under the Treaty as soon as they become EC citizens. But with increasing numbers acquiring FRG passports, the visa requirement is already of diminishing utility. A unified Germany would need to apply visa and asylum arrangements very different from those now operated by the GDR: TREVI discussions could be tricky for the new Germany for a while. We might also want to address the issue of access to the Community by ethnic Germans from the Soviet Union and elsewhere in Eastern Europe.

<u>Customs Union</u> (Articles 110-116 EEC)
21. Trade within Germany is currently covered by the IGT arrangements. These would lapse on completion of unification, but in the short term the growing interdependence of the FRG and GDR economies during the transitional period would substantially alter trade flows: the arrangements for policing leakage would need careful attention. As part of the transition the GDR would have to abolish tariffs, quotas and measures equivalent to quantitative restrictions against the EC 11, and introduce a new set against the outside world, including its CMEA partners. The 11 would have to abolish tariffs etc against the GDR. This would not be a major problem for the 11, but since it would mean a major reorientation of the GDR's trade - 61.8% of which was with the CMEA in 1988 and only 32.6% with the EC - a transitional period will no doubt be sought. Based on existing trade patterns (see Annex A), customs duties payable to Brussels might amount to about 500 mecu a year. However, as the orientation of GDR trade switches increasingly towards the EC (the UK's trade with the EC has risen from 30% to 50% of our total trade since we joined) this figure would decline significantly.

External Trade

22. Apart from the Customs Union, the GDR would have to take on other EC external trade obligations, including preferential access for exports from Lomé and GSP countries. This would be another source of competition for its industries and agriculture. They might also have residual obligations to current partners, as well as their continuing need to import fuel and materials.

State Aids and Competition Policy (Articles 85-94 EEC)

23. The process of introducing market forces in the GDR is likely to require large-scale privatisation, restructuring and closure of plants. There would be strong pressures for state aids and for freedom to create firms able to compete in the Single Market, particularly given the freedom of GDR labour to move to the FRG in response to job losses, low pay or poor conditions. Unless there were a transitional period, EC rules on State Aids and Competition would apply in full from the moment of unification. The GDR might therefore seek to have the existing rules (derived from Articles 85 and 86 of the Treaty for competition policy and Articles 92-94 for state aids) applied less rigorously.

24. Clearly the UK interest would lie in securing the shortest possible transitional derogations. FRG firms, which would want to exploit the GDR's lower labour costs while they lasted, might otherwise seek to evade controls they would face in the rest of Germany. We would need to ensure that they did not gain any unfair advantage from non-application of the Treaty. Similar considerations would apply in the specific case of coal and steel, which are governed by the ECSC Treaty. (It would also be necessary to decide how to handle Article 92.2.c, which provides for "aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division.")

Structural Funds (Article 130 a-e EEC)

25. Receipts from the Regional Fund are closely related to GDP per capita, for which GDR data are extremely poor. An estimate, based on purchasing power parity, of GDP per head in the GDR at 62% of that of the FRG, gives the following comparisons:

| | |
|---|---|
| US | 100 |
| FRG | 74 |
| UK | 69 |
| Spain | 48 |
| GDR | 45 |
| Portugal/ Greece | 36 |

A case could therefore be made for the GDR to receive expenditure similar to the four southern member states: 170 ecu per capita = 2720 mecu p.a. The bulk of Structural Funds money available up to end 1992 has already been allocated, but a total of 3 becu remains to be allocated at the Commission's discretion. This could in theory be given to the GDR - but there would be fierce competition from the Southern recipients. And in practice, the FRG will have to cope with many of the consequences of GMU without waiting for the outcome of a negotiation in the Community which would be slow and inherently difficult, given their simultaneous need to seek large transitional derogations. In any case, we shall have good non-German company in resisting early claims on the Structural Funds: the Commission may however be more enthusiastic than most member states.

26. Decisions on the level of funding after 1992, or on increasing funding before 1992, would require unanimity in the Council under Article 130 a-e of the Treaty, and might require adjustment to the IIA. It is difficult to see the GDR being excluded from funding after 1992 - and other recipients will press for an increase in the overall size of

the Funds to ensure that spending on the ex-GDR does not mean less for them.

<u>Budget</u>

27. There would be major administrative problems to overcome in arranging for Budget contributions from the ex-GDR-Länder. Customs dues and agricultural levies would in principle be payable from the moment of unification, as would the Fourth Resource. How effectively this happened would depend on the administrative and statistical base available. As for VAT, the tax itself would take some time to introduce; and, as in earlier accessions, a negotiated contribution would be required until the full system was in place.

28. Tentative estimates of the budgetary effects of integration, necessarily making very large assumptions (including the artificial assumption that the GDR were to join as a separate state) suggest that the ex-GDR might, in 1992, be a net beneficiary to the tune of up to 2 becu, or a little over 1[illegible]% of GDP, cf net receipts of circa 4% for Ireland and Greece. The main receipts would be from the Structural funds (para 25) and FEOGA Guarantee (para 14). On this assumption, the net increase in the UK contribution after abatement would be between 100 and 150 mecu. The overall German contribution, even cut by up to 2 becu, would remain much the largest.

<u>Freedom of Establishment</u> (Articles 52-58 EEC)

29. Quite apart from specific measures in the Single Market programme, GDR firms will have Treaty rights to freedom of establishment in other Member States, and outside firms will have the same rights in the GDR. Either side could seek transitional arrangements.

<u>Transport</u> (Articles 74-84 EEC)

30. The GDR would have to adjust to the Common Transport Policy, including rules opening up competition in road, sea

and air transport; technical standards; and safety legislation (eg on tyre tread depths). Much of the technical change would no doubt in practice be accomplished through cooperation with FRG companies (eg the replacement of Trabant and Wartburg cars by West German cars). There might also be pressure for the EC budget money for transport infrastructure links between the two parts of Germany.

Institutional Consequences

31. The Treaty of Rome and the other Treaties were signed by the "Federal Republic of Germany", so Treaty amendment to nomenclature at least would be required if unified Germany had a new name (ie if the Article 23 route were not used). On voting weights in the Council (see para 6), a maximalist German bid might be for 15 votes (on the grounds that the GDR on its own might rate 5 votes ie parity with the Netherlands), and a minimalist bid might be for 12 votes (taking account of the precedent of giving Spain two votes fewer than the other large states), but all the current indications are that there will be no bid, which suits us well. To avoid increasing partners' fears of the increased influence of a united Germany, the Bonn authorities appear to envisage no early institutional change, though in the longer term the Germans will no doubt want greater representation in the European Parliament, reflecting their increased population.

**Conclusion**

32. Covering all of these issues would mean a large and complex negotiation, comparable in many ways to a normal accession negotiation. The key as ever would be the length of derogations and transitional periods. The precedents are: UK and Denmark 5 years; Greece generally 5 but 7 years for free movement of workers; Spain and Portugal generally 7, but 10 years for agriculture. The pace now is however likely to be quicker, and the UK interest will in most cases lie in short transitional periods, for level playing-field reasons. Our general aims should be to ensure:

a. that the process of integration is as orderly as can be contrived, despite the collapse of the GDR economy;

b. that all derogations and transitions are properly negotiated, with the Community as a whole, as if for an accession negotiation, and subsequently strictly monitored by the Commission;

c. that transitional periods and derogations should be as short as possible in order to open GDR markets; and prevent GDR or FRG firms gaining unfair advantages from looser regulation and lower compliance costs;

d. that disbursement of Structural Funds and CAP money is delayed to the extent feasible in order to limit costs to the EC Budget: in the former case, postponement of any substantial costs until at least 1992 may be possible, but <u>eligibility</u> for CAP funding will be harder to postpone;

e. that as much as possible of the transitional cost of integration, eg the large environmental costs, are borne by the FRG.

33. The support of like-minded member states for these aims should be actively sought. On <u>procedures</u>, particularly close liaison with the Commission and the FRG will be required. On <u>substance</u>, we should work closely across the board with the French, the other substantial net contributor, building alliances elsewhere on particular issues - eg with Southern Europe on Structural Funds spending.

FCO

15 February 1992

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ANNEX A

COMMODITY STRUCTURE OF THE GDR'S TRADE

| EXPORTS | 1988 % shares |
|---|---|
| All Commodities | 100.0 |
| - Machinery and Equipment | 47.6 |
| - Fuels and Metals | 15.1 |
| - Agricultural Raw Materials and Food | 7.0 |
| (- Food, Beverages and Tobacco | 3.9) |
| (- Agricultural Raw Materials | 3.1) |
| - Industrial Consumer Goods | 16.4 |
| - Chemicals, Fertilizers, Rubber, and Construction Materials | 13.9 |
| (- Chemicals (SITC 5) | 11.1) |

| IMPORTS | |
|---|---|
| All Commodities | 100.0 |
| - Machinery and Equipment | 37.0 |
| - Fuels and Metals | 33.5 |
| - Agricultural Raw Materials and Food | 14.1 |
| (- Food, Beverages and Tobacco | 8.2) |
| (- Agricultural Raw Materials | 5.9) |
| - Industrial Consumer Goods | 5.7 |
| - Chemicals, Fertilizers, Rubber, and Construction Materials | 9.7 |
| (- Chemicals (SITC 5) | 6.5) |