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ECONOMIC REFORM IN THE GDR : POSSIBLE LONG TERM IMPLICATIONS

SUMMARY
1. IF THE GDR UNDERTAKES ECONOMIC REFORM, IT CAN EXPECT MASSIVE ASSISTANCE FROM THE FRG. THE GDR MIGHT TAKE 10 YEARS OR MORE TO CATCH UP. ONE DAY, THE COMBINED ECONOMIC WEIGHT OF THE TWO GERMANIES MIGHT BE UP TO 30 PER CENT GREATER THAN THAT OF THE FRG ALONE AND MIGHT REPRESENT 30 PER CENT OF THE EUROPEAN COMMUNITY'S GDP. THE PRESENT SWING CREDIT SYSTEM OF INNER GERMAN TRADE SEEMS UNLIKELY TO CONTINUE AFTER REAL ECONOMIC REFORM. AT SOME STAGE THE SPECIAL EUROPEAN COMMUNITY CONCESSIONS FOR INNER GERMAN TRADE WILL NEED TO BE LOOKED AT AGAIN, BUT WE CAN AFFORD TO LET FRANCE AND THE BENELUX MAKE THE RUNNING. POTENTIAL OPPORTUNITIES FOR BRITISH EXPORTS.

DETAIL
2. THE DEBATE HERE ON PROSPECTS IN THE FIELD IS ONLY NOW BEGINNING. THIS TELEGRAM SUMMARISES AN INITIAL ANALYSIS WHICH WE HAVE SENT BY BAG.

3. THE FRG IS UNIQUELY WELL-PLACED TO HELP THE GDR. A MAJOR INCREASE IN COMMERCIAL LINKS IS DESIRED HERE. HOW FAST THIS CAN HAPPEN WILL DEPEND ON HOW FAR THE GDR REGIME UNDERTAKES ECONOMIC REFORM (MY TELNO 1105). IF THE GDR DOES REFORM, IT CAN EXPECT MASSIVE ASSISTANCE FROM THE FEDERAL GOVERNMENT AND GREAT INTEREST BY THE FRG PRIVATE SECTOR IN INVESTMENT AND INCREASED TRADE. THE CONDITIONS FOR ECONOMIC GROWTH IN THE GDR ARE BETTER THAN IN POLAND AND HUNGARY. BUT MOST WEST GERMAN EXPERTS THINK THERE IS A LONG WAY TO GO BEFORE THERE ARE REAL PROSPECTS OF RAPID ECONOMIC GROWTH THERE. ESTIMATES FROM LEADING POLITICAL FIGURES HERE OF AN ECONOMIC MIRACLE IN THE GDR IN 5-10 YEARS' TIME ARE PROBABLY OPTIMISTIC.

4. FROM A BRITISH PERSPECTIVE THERE ARE THE FOLLOWING QUESTIONS:

(I) HOW FAR WOULD THE COMBINED WEIGHT OF THE TWO GERMAN ECONOMIES,

IF CLOSELY INTEGRATED, BRING AN ADVANTAGE/POSE A THREAT TO OUR (A) ECONOMIC, (B) COMMERCIAL INTERESTS?

(II) MIGHT THE SPECIAL ARRANGEMENTS IN THE TREATY OF ROME GOVERNING INNER GERMAN TRADE (IGT) CREATE DIFFICULTIES WITHIN THE COMMUNITY UNDER THE NEW CIRCUMSTANCES OF A REFORMING GDR?

EFFECTS OF INTEGRATING THE FRG AND GDR ECONOMIES

5. HOW LARGE MIGHT A COMBINED GERMAN ECONOMY BE IF INTEGRATION TOOK PLACE IN THE NEXT FEW YEARS, WITH OR WITHOUT POLITICAL RE-UNIFICATION? IN THE ABSENCE OF RELIABLE STATISTICS ON THE GDR ECONOMY, IT IS NOT POSSIBLE TO MAKE RELIABLE PROJECTIONS. BUT THE GAP BETWEEN THE TWO ECONOMIES IS VAST: TO CATCH UP WITH AN FRG GROWING AT 3 PER CENT PER YEAR, THE GDR WOULD PROBABLY HAVE TO GROW BY 10 PER CENT PER YEAR FOR A DECADE (THE ASSUMPTION HERE IS NECESSARILY MASSIVE). AT THE END OF THAT PROCESS THE COMBINED ECONOMY OF THE TWO GERMANIES MIGHT BE SOME 25-30 PER CENT GREATER THAN THAT OF THE FRG ALONE. IF THE GDR HAD BEEN LIBERALISED 10 YEARS AGO AND HAD NOW ACHIEVED THE SAME PER CAPUT GDP AS THE FRG THE COMBINED GDP OF THE TWO ECONOMIES WOULD REPRESENT SLIGHTLY LESS THAN 30 PER CENT OF THE EUROPEAN COMMUNITY'S GDP, STILL WELL BEHIND THE US AND JAPAN (TODAYS FIGURES IS 23 PER CENT).

6. IT IS TOO EARLY TO ASSESS THE POSSIBLE BENEFITS TO THE FRG ECONOMY OF THE PROCESS OF INTEGRATION. IN THE INITIAL YEARS, ECONOMIC ASSISTANCE TO THE GDR (AND POLAND AND HUNGARY) WOULD DIVERT CAPITAL AND MIGHT WELL HAVE THE EFFECT OF CHECKING THE FRG'S OWN INDUSTRIAL GROWTH AND INCREASE ITS PROPENSITY TO IMPORT. THE BENEFITS FOR THE FRG THROUGH THE SYNERGY WHICH SOME COMMENTATORS HAVE SUGGESTED, ARE UNLIKELY TO BE SEEN FOR SEVERAL YEARS. IN THE LONG TERM, THE FRG IS WELL-PLACED TO GAIN A POTENTIALLY VALUABLE MARKET IN EASTERN EUROPE AND CAN BE EXPECTED TO TAKE FULL ADVANTAGE OF THIS. BUT EASTERN EUROPE IS NOT IN A POSITION TO COMPETE WITH THE FRG'S WESTERN SUPPLIERS AND WILL NOT BE ABLE TO DO SO FOR MANY YEARS. ITS INABILITY TO TRADE ON EQUAL TERMS IMPLIES A CONSIDERABLE VOLUME OF CREDIT FROM WESTERN SOURCES TO FINANCE TRADE FOR AN EXTENDED PERIOD. FOR THIS REASON ALONE, WESTERN TRADING AND ECONOMIC LINKS WILL REMAIN MUCH MORE IMPORTANT TO THE FRG FOR THE FORSEABLE FUTURE.

THE GDR AS A FUTURE EXPORT MARKET.

7. THE REGENERATION OF THE GDR ECONOMOMY ON FREE MARKET LINES WOULD CREATE OPENINGS FOR OUTSIDE SUPPLIERS OF BOTH CAPITAL AND CONSUMER GOODS. IT WILL BE IMPORTANT TO ENSURE THAT THE FRG DEVELOPS THE

RELATIONSHIP IN WAYS WHICH KEEP THE EC/GDR PLAYING FIELD LEVEL. EVEN SO, THE FRG STANDS TO BENEFIT MOST BECAUSE OF EXISTING LINKS, LANGUAGE, GEOGRAPHICAL ADVANTAGE AND COMMON STANDARDS AND TRAINING PATTERNS. THE PACKAGE OF ASSISTANCE BEING DRAWN UP BY THE FEDERAL GOVERNMENT WILL ALMOST CERTAINLY INCLUDE TRAINING AND THE PROVISION OF EQUIPMENT, BOTH OF WHICH WILL BE TIED TO THE USE OF FRG MACHINE TOOLS AND OTHER CAPITAL EQUIPMENT. BUT IN DUE COURSE THERE WILL BE OPENINGS FOR BRITISH CAPITAL AND CONSUMER GOODS PRODUCERS TO SELL DIRECT INTO A REFORMED GDR, TO BECOME PARTNERS OR SUPPLIERS IN FRG PROJECTS IN THE GDR, TO SUPPLY A MARKET IN THE FRG TEMPORARILY DEPLETED BY EXPORTS TO THE EAST OR TO COMPETE IN THIRD MARKETS WHICH THE FRG MAY BE TEMPORARILY UNABLE TO SUPPLY.

INNER GERMAN TRADE

8. ECONOMIC REFORM IN THE GDR WILL CLEARLY HAVE IMPORTANT IMPLICATIONS FOR THE SPECIAL ARRANGEMENTS GOVERNING INNER GERMAN TRADE. IT REMAINS TO BE SEEN HOW MUCH IF ANY OF THE EXPECTED INCREASE IN COMMERCIAL CONTACTS BETWEEN THE TWO GERMANIES WILL FALL UNDER THE CURRENT SWING ARRANGEMENTS, BUT THE INTIAL ASSESSMENT IN BONN IS THAT THE SWING CREDIT AND ASSOCIATED MEASURES ARE NOT LIKELY TO BE THE CENTRAL PILLAR OF THE NEW ECONOMIC RELATIONSHIP. THE FEDERAL GOVERNMENT IS UNLIKELY TO WANT TO CONTINUE TO GRANT TAX CONCESSIONS TO GOODS COMING FROM THE GDR IF THESE ARE IN PRACTICE THE RESULT OF CAPITAL INVESTMENT BY FRG FIRMS, ONCE THIS IS ALLOWED. MORE IMPORTANT, FRG INDUSTRY IS FAR MORE KEEN TO BE ALLOWED TO ESTABLISH JOINT VENTURES IN THE GDR AND TO TRADE ON NORMAL HARD CURRENCY TERMS THAN TO SEE A MAJOR INCREASE IN INNER GERMAN TRADE UNDER THE PRESENT SYSTEM, WITH ALL THE MARKET DISTORTIONS ASSOCIATED WITH COUNTER TRADE.

8. THOUGHT WILL HAVE TO BE GIVEN TO HOW FAR THE EC SPECIAL ARRANGEMENTS MIGHT HAVE TO BE MODIFIED IF THERE WERE A MASSIVE INCREASE IN INNER GERMAN TRADE. THE PRESENT ARRANGEMENTS IN PRACTICE ONLY PERMIT IMPORT INTO THE FRG: GDR GOODS MAY ONLY BE RE-EXPORTED ELSEWHERE WITHIN THE COMMUNITY AFTER REPAYMENT OF THE TAX CONCESSIONS. THIS MAKES LEGAL ONWARD SHIPMENT UNECONOMIC. THE RISK OF ILLEGIAL ONWARD TRANSFER IS LESS SERIOUS THAN MIGHT AT FIRST BE THOUGHT BECAUSE GDR SUPPLIERS FREQUENTLY INFLATE THEIR PRICES TO TAKE ACCOUNT OF THE TAX AND CUSTOMS CONCESSIONS, AND BECAUSE THE PRESENT PATTERN OF GDR EXPORTS CONSISTS TO A LARGE EXTENT (SOME 50 PER CENT) OF BASIC COMMODITIES SUCH AS LIGNITE, CHEMICALS, LOW QUALITY STEEL AND MINERALS, WHICH IT IS NOT (NOT) ECONOMIC TO RE-EXPORT. BUT IF FRG/GDR TRADE INCREASED RAPIDLY THE EC WOULD NO DOUBT WANT TO RECONSIDER ITS RELATIONSHIP WITH THE GDR. FOR OBVIOUS

[But in practice this does not happen]

REASONS THE FRG WILL BE HIGHLY SENSITIVE ABOUT THIS, THOUGH IT TOO MAY BE LOOKING FOR CHANGE, AND GIVEN KNOWN ANXIETIES IN FRANCE AND THE BENELUX COUNTRIES, WHICH FEEL EXPOSED, THIS MAY BE AN AREA IN WHICH WE CAN EXPECT THEM TO MAKE THE RUNNING. FOR THE REASONS SET OUT ABOVE, IT IS NOT LIKELY IN ANY CASE TO BE A SHORT TERM PROBLEM.

9. EAST BERLIN MAY WISH TO COMMENT.

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