Policies of the European Community toward Newly Liberated Countries

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***Holger Schmieding**, head of a research group on the transformation process in Central and Eastern Europe at Germany's Kiel Institute of World Economics, argues that the European Community could give credibility to the liberalisation of the post-communist economies of Eastern and Central Europe by expanding its internal free market into a European Economic Area.*

The peaceful revolution that swept East-Central Europe in 1989 has so far been a marvellous success. Politically, democracy is taking hold in Hungary, Poland and Czechoslovakia; economically, a courageous transition to capitalism is well under way. Nonetheless, the task is still daunting. The newly liberated countries have to re-specialise according to their genuine comparative advantages in the international division of labour and to become attractive locations for foreign investors. For both reasons, they need free economic exchanges with the advanced countries of the West. Because of geographic proximity, this means most of all an unimpeded flow of goods and services, capital and skills, ideas and technologies between Eastern and Western Europe. The demise of trade between the former Comecon members underlines the importance of free access to their major Western market. However, given the political and economic risks that the transformation process entails, Western Europe's contribution to freedom and prosperity in the eastern part of the continent needs to go even beyond liberalisation: Western Europe ought to search for ways to lend institutional stability to the emerging market economies (EMEs).

Hazards and Opportunities of an Institutional Revolution

The essence of the systemic transformation in Central and Eastern Europe is an institutional revolution: the old high-cost institutional setting (socialism) vanishes to make way for a far superior low-cost one (capitalism). However, the emergence, establishment and consolidation of the new and ultimately far superior institutional arrangements takes time. The institutional void that characterises the first phase of the transformation process presents a grave hazard and a splendid opportunity at the same time. The hazard is obvious: the length and depth of the transformation crisis depend on the rapid emergence and on the credibility and stability of the new and market-conformable institutions. The less certain economic agents are about future institutional arrangements, the less will they be willing to engage in an extended division of labour, to invest resources into specific uses and to conclude contracts that bind them over time. This aggravates the transformation crisis — which in turn adds to the widespread doubts about the stability of the new institutions. The emerging market economies may in the worst case fall victim to an institutional vicious circle.

The corresponding opportunity is enticing: as the old system had shaped almost every aspect of the body politic and the body economic, its collapse has created a situation that may be as close to an institutional vacuum as mankind may ever get. The spontaneous emergence and the conscious design of new institutions thus face comparatively few restrictions. In a similar vein, the weakness of the previous elites and of the nascent new distributional coalitions facilitates the choice of coherent first-best solutions.

Consider the opportunity for a sweeping liberalisation of external economic relations. With respect to the standard determinants of protectionism, the emerging market economies are in an almost uniquely favourable position:

- The political transformation has shattered the existing distributional arrangements. Hence, inherited claims to special treatment that make liberalisation such an arduous undertaking in mature Western market economies (take the European Community's Common Agricultural Policy as an example) are initially of comparatively little importance.
- As the need for a drastic break with the previous super-interventionism is obvious, liberal-minded politicians can get around the 'rational ignorance' (Downs, 1957:253–7) of voters comparatively easily. They need not try to attract attention to the arcane issue of changing a single policy to which the electorate has grown accustomed and which the few beneficiaries defend vigorously. As a thorough change in external economic policy is clearly on the agenda anyhow, politicians merely need to explain the overall merits of a liberal regime.

- In a similar vein, the uncertainty about how the individual welfare will be affected in the medium and long run by a liberalisation is likely to be much more pronounced during the general upheaval of the transformation process than would be the case in an established market economy. Hence, the EMEs are as close as one may ever get to a state in which decisions on allocational efficiency can be taken behind a 'veil of uncertainty' (Brennan & Buchanan, 1985:139-40) about the precise distributional consequences.
- Special-interest groups (lobbies) play only a minor role in the immediate aftermath of the revolution. The old elites are so discredited as to wield little political influence; new special-interest groups are not yet strong enough for major collective action; new distributional coalitions are still in the process of organising themselves.

However, lobbies will more and more overcome their organisational problems over time and turn into lobbies that are as powerful as their Western counterparts. Protectionist pressures are thus likely to grow stronger, jeopardising the liberal regime that may have been introduced in the early phase of the transformation process. Poland's recent tariff increases underscore this danger. Liberal-minded governments in the newly liberated countries are thus engaged not only in a race against time to beat the growing impatience of large segments of the electorate but also in a race against the emerging special-interest groups. If governments do not succeed in firmly entrenching liberal principles before the lobbies have gathered strength, the consequences may be grave: After the revolutionary transformation of the entire body politic and economic, governments and administrations are likely to be weak for quite some time. The less credible the government is and the more it appears to be prone to pressure, the more will special-interest groups test its resolve to the limit and pursue protectionist negative-sum games. Those economic agents who do not join the lobby-game run the risk of being the ones on whom a disproportionate share of the overall costs is shifted. If the transformation process founders because of the lack of firmly entrenched institutions, the Central and East European states may in the worst-case scenario go down the slippery road towards the awkward political authoritarianism and the stifling economic interventionism under which major parts of Latin America suffered in the past decades (this spectre was raised by, among others, Crook, 1990).

The Importance of Joining Western Europe

Given the weakness of the nascent local institutions, a unilateral commitment to liberal economic principles does not suffice to make the new regime sufficiently stable, credible and resilient against the emerging interest groups. Ideally, the newly liberated countries would need to find

- a way to turn the liberalisation progress that can be attained now into a lasting achievement, and
- a method of ensuring that occasional deviations from the non-intervention rule that are perhaps politically inevitable in the transition period cannot turn into permanent protection and do not cast doubt on the general commitment to a liberal regime.

This is what the newly liberated countries could gain from joining an appropriately reformed European Community (EC). If the EMEs used their present scope for radical liberalisation to subject themselves lastingly to the EC discipline on external protection and to an

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enhanced EC code on internal subsidies, the final design of their commercial policy would not be in serious doubt any more — at least as long as the assumption holds that they would be highly unlikely to incur the political, economic and perhaps even psychological costs of leaving the EC once they have got in. The genuine popularity that the idea of 'returning to Europe' enjoys in Central and Eastern Europe implies that politicians and administrators in the EMEs will be particularly reluctant to seriously breach the rules of a European club to which their country has been admitted. If the EMEs can enter such an international club that puts comparatively sweeping demands on its members and for which the exit costs would be high, the incentive for time-inconsistent behaviour on the part of the government and the public uncertainty about the future institutional arrangements would be dramatically reduced. Naturally, a treaty of accession could define a transition period. The precommitment to fully accept the EC discipline a few years hence lends credibility to the announcement that any transitional protection beyond the EC norm will actually be phased out.

A similar argument applies to monetary policy. The new local central banks do not have the anti-inflationary reputation that arises from a history of resisting short-term temptations for loosening the monetary reins. Lacking credibility, they are ill-placed to exert a lasting discipline on economic agents. For this purpose, the emerging market economies would de facto have to adopt a Western currency, say in the form of an ECU-based currency board managed by the Banque de France. (On the currency board issue see also Bolfinger, 1991; Hanke & Walters, 1990; Schmieding, 1991; and Steinherr, 1991.)

By proposing an agreement on the de facto introduction of a comparatively stable Western currency, Western Europe would in effect offer the emerging market economies the most efficient technology for making a credible precommitment to external and internal monetary stability and full currency convertibility. This would have various advantages: (i) The process of establishing a modern financial system would be much quicker and smoother; (ii) convertibility could be extended to all capital account transactions immediately; (iii) as the anti-inflation policy would be highly credible, the complete monetisation of the economy would proceed rapidly; (iv) real interest rates would not contain an above-average premium for macroeconomic risks. (v) For the same reason the EMEs would have scope for non-inflationary budget deficits, i.e. for deficits that up to a point would have no negative repercussions on macroeconomic stability. The EMEs could thus run such deficits at the very time when they need to incur them most, namely, in the social upheaval of the transformation process (Schmieding, 1991).

The Present EC Approach

Association agreements. The EC has reacted to the demise of political and economic totalitarianism in Central and Eastern Europe by offering somewhat better market access and financial support to the newly liberated countries.

Between 1988 and 1990, the EC and the emerging market economies concluded 'first generation' trade and cooperation agreements. These accords ended those import quotas that the EC used to apply specifically to products from Europe's centrally planned economies, suspended some non-specific restrictions and extended the EC's tariff preferences for developing countries to East-Central Europe.

At present, the EC is negotiating association agreements with Hungary, Poland and Czechoslovakia. The 'second generation' accords were supposed to come into force at the beginning of 1992. The EC intends to lift most tariffs and import quotas within five years (in some cases within ten years). However, the fine print of the draft that the EC (1991) proposed to Poland in March 1991 reads like a liberal's nightmare: special arrangements will severely restrict market access for textiles, coal and steel, and agricultural products, i.e. for products that the EC deems sensitive — and in which Poland's export potential is particularly promising. Furthermore, the EC anti-dumping policy will be applied and a variety of safeguard clauses against an unwarranted increase in Polish exports will enable the EC to unilaterally 'adopt the measures it deems necessary to remedy the problem' (Art. 31,3,b). Safeguard measures may for instance be taken 'where an increase in imports . . . occurs in quantities or under conditions which are, or are likely to be seriously detrimental to any production activity . . . (or) to cause serious disturbances in any sector . . . or difficulties which bring about serious deterioration in the economic situation of a region' (Art. 29). In other words, imports may be restricted if they threaten to do what inter-industry trade is supposed to do, namely, to induce a noticeable welfare-enhancing (re)specialisation in production according to comparative advantages. No wonder that the Polish government noted that 'should this proposal be implemented, there would be practically no improvement in the current conditions of access to the EC market' (Republic of Poland, 1991:2).

The draft makes no reference to an eventual accession to the EC; instead it suggests regular political consultations and some further technical and financial assistance. In the words of Martin Wolf (1991), the EC aims for 'exclusion with side-payments'. With regard to the free movement of labour, the EC intends to be most restrictive. The Community merely wants 'to examine . . . the possibility of improving the situation of Polish workers' who are already legally employed in the EC (Art. 38). After five years, 'ways of improving the movement of workers' may be examined 'provided that economic and social conditions in Poland have been largely brought into line with those in the Community' (Art. 39).

Migration. The migration issue illustrates how ill-conceived and even contradictory the EC stance is. One of the best-established economic theorems states that factor movements can be a substitute for trade in goods; the more trade is subject to restrictions, the greater the incentive to relocate factors of production. By objecting to free trade in those goods in which the newly liberated countries have a clear comparative advantage, the EC may inhibit the very economic and social progress that the EC stipulates as a condition for being more open to the East. The EC may thus trigger what it wants to avoid: it may force people yearning for opportunities to earn a decent living to go West.

The migration policy toward the newly liberated countries seems to be inspired by the fear that Western

Europe would be swamped by an undesirable influx of workers from the East if it were to open its gates. This view is anti-liberal — and probably mistaken. The recent German experience points to the opposite: In the 1980s, West Germany attracted 1.5 million immigrants. In the same period, however, more than 80 000 people left Germany for Portugal and Spain, i.e. for those traditional emigration countries that had joined the EC and succeeded in putting their economies on a sound footing in this decade. Even in 1989 when strong growth and some political factors served to draw 600 000 people into West Germany in a single year, only 200 of them came from the Iberian peninsula.

The statistics on Polish-German migration corroborate the view that opportunities for future economic progress at home matter more than present differences in the level of living standards for the entrepreneurial and mobile segments of the population. Migration from Poland into Germany soared to 212 000 in 1988 and even 309 000 in 1989. Once the transition to a market economy opened up a wealth of new opportunities in Poland itself, the number dropped to 150 000 in 1990 and an estimated 25 000 in the first seven months of 1991 (all migration figures in this paper are net of immigrants and exclude Eastern Germans).

If the transformation process founders because of the lack of firmly entrenched institutions, the Central and East European states may in the worst-case scenario go down the slippery road towards the awkward political authoritarianism and the stifling economic interventionism under which major parts of Latin America suffered in the past decades.

If the EC does not modify its stance on trade and migration, the Community will deny to the people in East-Central Europe the two major ways in which Europe's diversity and the East-West differences in factor endowments can be turned into mainsprings of prosperity: the free movement of goods and people. Under the impact of protest from Poland, Hungary and Czechoslovakia, the EC may be about to correct its position in the negotiations and offer somewhat enhanced market access (the eventual elimination of steel quotas and a rise in textile quotas) and at least acknowledge in the preamble the right of East-Central European countries to eventually accede to the EC. By mid-August 1991, however, the EC was still not ready for a substantial liberalisation.

The internal market and harmonisation. An assessment of the EC's policies toward the newly liberated countries cannot be confined to the present bilateral negotiations. As the EC is more and more emerging as Europe's pole of attraction, its internal evolution matters to neighbouring non-members almost as much as to the members themselves. The EC intends to abolish its internal frontiers completely by the end of 1992. The internal rules and regulations that the EC adopts now in the run-up to 1992 create facts that the neighbouring non-members will by and large be forced to accept if they want to get free access to their major market.

The completion of the internal market has two very different aspects, namely, a genuine opening of national markets and an adjustment of national regulatory systems to the abolition of internal frontiers. Despite a liberal-sounding rhetoric of mutual recognition of national practices, the construction of the internal market 1992 proceeds mostly via harmonisation. Mutual recognition would allow members to maintain their diversity; the respective norms, regulations, tax systems and public services of the various countries would be put to the test of the market, the search for welfare-enhancing institutional innovations would not be restrained. A harmonisation by decree tends to restrict the choice of consumers and producers, may be misused as a protectionist tool and necessitates a higher degree of political cohesion. The harmonisation approach turns economic issues into matters of politics. The more such decisions have to be taken and the more local affairs are settled by a supranational body in Brussels, the greater is the need for a tight political consensus that becomes less feasible if the number of members increases further. Hence, the reluctance of the club to admit new members grows with the number and importance of the economic matters to be decided at the club level. By the same token, the need for the neighbouring non-members to join the EC becomes more pressing.

Initially, almost all members of the second West European integration club, the European Free Trade Association (EFTA), would have preferred to partake in the EC internal market without joining the political club. The model for such an arrangement would have been the agreements on free trade in manufactures that the EFTA countries and the EC had concluded in 1972. Because of the EC's harmonisation approach to the internal market 1992, this option has lost its appeal. Most EFTA countries now want to get into the EC as soon as possible so that they can at least marginally influence the future evolution of the rules of the internal market. A further reason for EFTA countries to apply for membership is the EC demand for substantial contributions to its costly redistributive policies as a price for non-discrimination. Spain and Portugal are insisting on annual grants of 1.5 billion ECU from EFTA. If the EFTA countries have to pay anyhow, they might as well join the EC and participate in the decisions on how the money is used.

Whereas the comparatively rich members of the present EFTA may ultimately be able to afford all the follies of common Euro-regulations, the much less advanced countries of Central and Eastern Europe might be the real victims of Euro-harmonisation. If the newly liberated countries were forced to adopt the entire *'acquis communautaire'* in order to partake fully in the internal market, they would have to choose between two great evils, namely, between staying outside despite the great advantages of membership outlined above, and accepting the costs of even the worst-suited EC regulations. Admittedly, common accounting standards and banking regulations may not be very harmful. The EMEs may anyway want to adopt such rules, which are at least familiar to foreign investors. However, any step towards harmonised social policies and labour laws might have devastating consequences for the newly liberated countries. They need labour market flexibility and low non-wage labour costs even more than more advanced regions.

In a similar vein, the newly liberated countries may be hurt by any link between free market access and participation in the EC redistributive policies. The more firmly the EC insists on such a link in the present negotiations with the rich EFTA countries, the more wary the EC may become of granting poor outsiders from the East free access to the internal market — who might then be entitled to further financial support according to the Community's own criteria.

Towards a New Europe

The abortive putsch in Moscow in August 1991 may well be a major turning point in the history of Europe. It has accelerated the dissolution of the erstwhile Soviet Union and may finally shock top politicians in Western Europe to think again about the future shape of Europe. Given the importance that the West may now attach to economic progress and political stability in the eastern half of the continent, it is even conceivable that the objections of Scottish raspberry growers and German coal miners against competition from the East may no longer be the major arguments that count in the EC. Change is on the agenda. Even the number of sovereign states in Europe increases. The more complex Europe thus becomes, the greater is the damage that a simple continuation and extension of old-fashioned interventionism would do and the greater is the need for an abstract order that enshrines the negative liberties of citizens. The time has come to discuss liberal visions of the new Europe.

Political vs economic union. From the very beginning in the 1950s, economic integration in the EEC had been supposed to be an intermediate step toward a political union. This blurring of politics and economics had two rather unfortunate consequences. First, as economic decision-making was seen as a trial-run for uniform politics, harmonisation usually prevailed over more liberal approaches to integration. Second, the political aspirations served as a hurdle for outsiders who would otherwise have liked to partake in the common market. With the increasing numbers of sovereign countries in Europe and the growing desire of European non-members to join the club, this approach becomes ever more untenable. Europe needs a clear separation of economics and politics. More precisely: it needs two distinct clubs, a somewhat narrow political club and a broader economic club.

A revised and enlarged 'internal market 1992' could be the basis for such a European Economic Area (EEA). An arrangement of this kind would offer all European countries two different options of enjoying the benefits of free economic exchanges in Europe: either within the emerging political union (the revamped EC) or without having to coordinate foreign policy with other European countries.

The citizens in a number of European states seem to genuinely favour the evolution of a common foreign and defence policy in the context of the EC and within NATO. Hence, those EC members who want to do so should turn the EC into such a political club — and define the terms on which those EC non-members who are willing to go along with this political deepening can join them.

A European Economic Area. Independent of this political club, the present EC members and all other European countries who can subscribe to some common economic principles should establish a purely economic club. A revised and enlarged 'internal market 1992' could be the basis for such a European Economic Area (EEA). An arrangement of this kind would offer all European countries two different options of enjoying the benefits of free economic exchanges in Europe: either within the emerging political union (the revamped EC) or without having to coordinate foreign policy with other European countries. The political rationale of this separation of economics and politics is that no country should be compelled by considerations of market access to join a political club. If some countries, say Sweden, Poland or Latvia, want to enter the new political EC, they should do so for the proper reason: because they want to become part of an emerging political union about to develop a common foreign and defence policy. Without such an arrangement, the present EC would either have to dilute its own political substance by admitting new members who do not favour such a political cooperation, or deny to its citizens the advantages of free economic exchanges with those European countries that remain outside the political club.

The typical European nation state in which all decisions ranging from the economic order to the closing hours of shops are taken at the national level cannot serve as a model for the future economic integration of Europe. Instead, the parallel processes of geographic widening and economic deepening necessitate an appropriate assignment of tasks to the various levels of decision making within Europe (supra-national, national, regional and local). The EEA would have to be quite different from the present EC. The less the supranational institutions of an EEA meddle with the content of Euro-jam and the width of the driver's seat on Euro-combines, the more will they be able to concentrate efficiently on their proper duty, namely, the evolution and enforcement of common basic principles on the free movement of goods and services, capital and labour in Europe, including minimum principles of external economic policy, an internal anti-subsidies code and the mutual recognition of the various national, regional or local regulatory systems.

The power to shape tax and regulatory systems should be allocated to the lowest conceivable level in the EEA. Europe's traditional strength is its diversity; the more local and regional units have the freedom to choose their own mixes of taxes, regulations and public services, the more can the ensuing competition for internationally mobile resources serve as a discovery procedure for optimal institutional arrangements (to borrow a term from Hayek, 1968).

The Common Agricultural Policy of the present EC is a major stumbling block on the way toward European economic integration (and multilateral liberalisation in the GATT framework). The recent attempts of the EC commission to move from price support to income support already point into the right direction. Ideally, all meddling with prices and production quantities should be ended in an EEA; the regions of Europe should be free to design — and finance — their own alternative schemes to support farmers if they want to do so.

If the members of the economic club do in fact favour some redistribution of income from the richer to the poorer regions, a panoply of regional and structural policies and further implicit transfers would be an inefficient and paternalistic way of doing so. Instead, members may agree on a general and transparent rule for a limited redistribution between regional authorities, for instance with each region paying or receiving (per capita) a fixed percentage of the difference between its own per capita GDP and the overall average. Remember however that any redistributive scheme is an excuse to keep poor outsiders out.

The systemic changes at least in Hungary, Poland and Czechoslovakia have progressed far enough to make them eligible for full participation in an EEA on economic grounds and a revamped EC on political grounds. Others like Slovenia and the Baltic states are set to follow soon. Once the major steps toward democracy and a market economy have been taken, there is no further economic rationale for any discrimination against the newly liberated countries. They should in principle be treated like Western European states. The oft-cited differences in the level of economic development are no valid counter-argument. On the contrary: such differences — once economic agents are allowed to take full advantage of them — are a major source of economic progress. The present EC already includes regions as diverse as Amsterdam and the Algarve, as Edinburgh and Extremadura. The example of Spain and Portugal shows that freer economic exchanges with the more developed parts of Western Europe offer the poorer regions the best opportunity for catching up.

Possible transitional arrangements. The liberal vision outlined above may well turn out to be politically infeasible for the time being. In this deplorable case, Western Europe should still offer EC membership or at least full economic inclusion in the internal market. But the newly liberated countries would then need special arrangements. Remember that the institutional credibility and reliability and not the precise content of the EC and its *acquis communautaire* makes the EC so attractive for the newly liberated countries. Hence, these countries should at least be allowed to benefit from the negative freedoms that EC membership entails (liberal aspects of 1992, binding of external economic policy, internal code on subsidies, enforcement of obligations via the European Court of Justice) without having to adopt all EC norms and regulations. Such a solution need not be restricted to a period of transition. Instead, it could then constitute a first major step toward a lasting deregulation within the EC.

In a similar vein, the emerging market economies need the opportunity to opt for a considerably simplified and liberalised version of the EC laws and regulations: for the basic content but not necessarily for the complicated details of these arrangements. The East German experience underscores the importance of this point. The very region of the former socialist camp that by courtesy of German unification became part of the EC and adopted wholesale the institutions and the money of a successful West European country is engulfed in a slump which, in terms of the decline in production, is far deeper than the crisis in Poland, Hungary and Czechoslovakia. The major reason lies in the substantial increase in East German production costs. Sparked by premature political promises to quickly narrow the gap in living standards between East and West Germany, East German wages — measured in convertible currency — have risen roughly five- to sixfold. As the high level of labour costs has rendered most existing capacities for the production of tradable goods unprofitable, the East German economy has to be rebuilt largely from scratch. Unfortunately, the intricate complexities of West German laws and regulations that have been introduced in East Germany severely impair this process.

If the EC does not modify its stance on trade and migration, the Community will deny to the people in East-Central Europe the two major ways in which Europe's diversity and the East-West differences in factor endowments can be turned into mainsprings of prosperity: the free movement of goods and people.

As long as the present EC is unwilling to admit new members from East-Central Europe, well-designed agreements of association could be a valuable intermediate step. If they were to impart almost as much institutional credibility on the EMEs as immediate EC membership would, such agreements would need to spell out that the EMEs will finally be admitted to the EC (or to the broader and non-political EEA) and to specify a date at which the EMEs become eligible for full membership.

In the coming years, European politicians will have to devise a way in which Russia and the other European successor states of the erstwhile Soviet Union can be incorporated into the European mainstream. The argument that integration with the West is a major factor to ease the pains of adjustment to market conditions and reduce the hazard of political turbulences applies to Russia, Ukraine and Belorussia as well as it does to, say, Hungary, Poland and Latvia. As the rest of Europe may be unwilling politically to welcome the atomic superpower Russia (or a slimmed-down Eurasian Union) to a political EC even in the long-run, it would be convenient to have at hand a second option of enjoying free economic exchanges with the West: the European Economic Area.

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This article is an edited reproduction of a paper delivered at the Mont Pelerin Society regional meeting 'In Search of a Transition to a Free Society', Prague, 3–6 November 1991.