Germany's Economic Wall Remains

By **Volker Nitsch** | Monday, November 30, 2009

Despite all political efforts to the opposite effect, Germany has not yet become a unified market, even 20 years after reunification. This will remain so for a long time to come, argue Volker Nitsch and Nikolaus Wolf, Professor of Economics at Darmstadt University of Technology, and Associate Professor of Economics at the University of Warwick, respectively.

The Berlin Wall fell 20 years ago — and with it the symbol for the division of Berlin, Germany, Europe and the world. Within only a few months, the once strictly controlled border posts were completely dismantled.

It takes quite some time before political integration actually leads to tangible economic integration. This insight is of remarkable significance to integration in the European Union.

The German Unification Treaty in late 1990 saw the final disappearance of all remaining administrative barriers. Conventional wisdom has it that, virtually overnight, two regions previously separated for decades (once again) became a single market.

However, the fall of the Berlin Wall also marked the beginning of an almost unique experiment for economists. Only rarely do they have the opportunity of studying the reaction of economic systems to comprehensive and unexpected changes in the overall economic conditions.

A crucial question in the field of international economics concerns the role of political barriers in trade relations in the age of globalization.

Recent research findings appear to show that — despite all free trade areas and currency unions, all modern communication technology and logistics — political borders continue to have a sizable effect in distorting trade flows.

Even if there is occasional talk of a world without borders: The exchange of goods within countries exceeds comparable cross-border trade by a wide margin.

The insights gained in the reunification process between East and West Germany can be of help in examining the plausibility of various approaches to explain this observation.

Results from our study show that the Iron Curtain in intra-German trade relations was lifted only very slowly — and by no means overnight.

To measure progress, we analyzed trade flows between all 101 German transport regions during the period from 1995 until 2004 — and did so for the road, rail and waterways modes of transportation, and for all categories of goods traded. Our results indicate that, for the most part, trade between the two formerly divided parts of Germany did indeed grow more quickly than within the previously divided territories.

However, even in 2004 — the end of our period under observation — the former border is still clearly seen in the data: A full 15 years after the fall of the Wall trade intensity between the former East and West German states was still some 30% below that of comparable trading partners within the former states of the old East and West Germany.

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The study also shows that the massive public investments in the upgrading of East Germany's infrastructure have had only a marginal effect on accelerating the integration process.

If we extrapolate these results, it ought to take about 33 to 40 years, that is a generation or so, before the effects of the former intra-German border have completely disappeared. Accordingly, in the year 2022 at the earliest and perhaps even as late as 2030, Germany will have reached the stage where it can be spoken of as a truly unified market.

This result can be mainly attributed to the inertness of economic and social networks, which only react to a change in the overall political framework after a considerable period of time.

Even if the barriers which led to a distortion of trade relations in the first place have once more ceased to exist, a swift return to the *status quo ante* is hardly likely.

Against this backdrop it seems quite reasonable to differentiate between a *de jure* and a *de facto* extent of trade liberalization.

The more general lesson to be drawn from the research results is that although political borders continue to have a major effect on trade, this cannot actually be attributed first and foremost to politically motivated barriers (such as customs duties or non-tariff barriers), even when the latter prevail, but is in fact caused by other, more deeply rooted factors.

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Conversely, the results point to the fact that the influence of political intervention on trade is really quite limited — especially where the initiation of trade relations is concerned. Apparently it takes quite some time before political integration actually leads to a corresponding and tangible economic integration.

The gradual growth of networks requires time. If nothing else, this insight is of remarkable significance for the process of integration in the European Union.

Bearing this in mind, the greatest obstacle to both globalization and European integration is not to be found in technological barriers or political borders. Rather, it is of a more fundamental nature.

Infrastructure can be upgraded, border posts can be abandoned. It will, however, take at least one generation to tear down the Berlin Wall in our collective German minds.

Editor's Note: Nikolaus Wolf has also contributed to this article. He is an Associate Professor of Economics at the University of Warwick. Previously, he was Assistant Professor at the Free University Berlin. Mr. Wolf is also a Research Affiliate at CEPR (International Trade and Economic History), a Research Affiliate at the the Centre for Economic Performance (Globalisation Programme) at the London School of Economics and a Research Affiliate at the CESifo Institute Munich (Global Economy). He holds a Ph.D in Economics from Humboldt University Berlin, a MSc. in Economics from Humboldt University Berlin and a M.A. in Modern History from Free University Berlin.

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