The Economic Unification of Germany
- The Collapse of the East German Economy and Prospects for Germany’s economic Integration -

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I. The Unification of Germany: Supremacy of Politics over Economics

In face of the economic problems in the aftermath of Germany’s unification one must take into consideration that the unification of the two German states, the FRG and the GDR, was primarily a political objective; its economic effects were neglected. Thus the logic of the - external and internal - unification process was political: The acceleration of unification vis-à-vis the “Four” World war II allies, USA, Britain, France and the Soviet Union, and vis-à-vis the East German population.

Germany - a United Country with a Divided Economy

Until now the two German states are only “formally” united; substantially the country is still divided in two German societies and in two German economies. The two economies develop into contrary directions; upward in West Germany, downward in East Germany.

II. The East German Economy before Unification

Population and Employment

In the year before unification, 1989, the population of the GDR amounted to
roughly one fourth of that of the FRG, numbering 16 mio\(^*\) vs. 62 mio. With an economic activity rate of about 55% labour participation in the GDR was considerably higher than in the FRG, where it came to 45% only; in rounded absolute figures the economically active population of the GDR was 9 mio, that of FRG 25 mio persons.

According to data published in April 1991 by the Federal Statistical Office on the 2\(^{nd}\) half of 1990 for the territory of the former GDR the number of economically active persons amounted to 8,361,000 on the average. This figure reflects migration in 1990 as well as early retirement.

Whereas the FRG registered over 2 mio persons as unemployed, the GDR counted next to none. Actually, under the existing institutional conditions and at the given productivity of labour the exodus of East Germans to West Germany in 1989 caused serious labour shortage.

**Production and Productivity**

In 1989 the population of the FRG produced a GDP of 2,250 Bio\(^{**}\) DM (at current prices); that is 36,500DM per capita. Income per capita per month was 4,000 DM before tax and 2,100 DM after tax. According to official figures the GDR produced a GDP in the amount of 350 Bio GDR Marks. Income per capita per month was 1,270 GDR Marks before and 950 GDR Marks after tax.

In April 1991 the Federal Statistical Office in Wiesbaden, West Germany (Statistisches Bundesamt), published for the first time calculations of GNP of the former GDR for the 2\(^{nd}\) half of 1990 corresponding to the same concepts applied to the FRG, according to which the existing rough estimations of the GDR’ GNP in DM of 200 to 250 Bio DM for the year 1989 are confirmed.

Productivity of labour, measured in GDP per gainfully employed person, in the GDR before unification is estimated at one fourth to one third of that of FRG. (In 1950 it was considered to be 50% of the FRG).

**Capital Stock and Investment**

In 1989 the FRG’s Gross Capital Stock amounted to 10,725 Bio DM, resulting in a capital output ratio of 4.6. The equivalent capital output ratio for the GDR was 5.2, based on official figures.

\(^*\) mio=million  
\(^{**}\) bio=billion
The former GDR’s capital stock in industry and infrastructure is over-aged and technologically obsolete. Between 50% and 100% requires immediate replacement. 75% of total industrial capital (buildings and equipment) is older than 10 years. For infrastructure capital the age structure is even worse; for example, 45% of the telecommunication equipment is older than 45 years. Industrial capital is highly energy intensive. Its technological level is determined by the comparatively low quality requirements of COMECON.

Qualification of Labour

Basic technical qualification of the labour force is the only valuable inheritance of the GDR. However, labour requires further qualification in modern technology. At the start of economic integration the “commercial” qualification in market economic functions was next to nothing.

External Economic Relations

In comparison with other economies of similar size the share of exports of 25% of GNP is small. The share of COMECON in the GDR’s trade amounted to 70%, half of which with the Soviet Union; in comparison COMECON’s share in the FRG’s trade was only 4.5%.

In the GDR’s exports to Western industrialized market economies natural resources played a prominent part. Quality of industrial products corresponded with COMECON standards; they were not competitive on the World Market.

As a member of COMECON the GDR had agreed to a certain division of labour. Nevertheless, the GDR ambitiously endeavoured to duplicate the industrial structure of the FRG, that is to say, to produce the complete spectrum of the World Market.

Ⅲ. Monetary Union - the Starting Point for Economic Integration

The Rate of Conversion: a Political Fix

Starting the process of economic integration with monetary union on July 1, 1990, resulted from the political calculation that it would accelerate the unification process of German. Most economists argued in favour of gradual economic integration - with a market rate serving as shock absorber - and an economic determination of the eventual
rate of conversion.

Under political compulsion the rate of conversion of the GDR Mark to the Deutsche Mark of the FRG was politically set at 1:1 and at 2:1 for a certain part of savings and debts.

**The rate of Conversion: A Potential Force of Inflation**

Economic discussion on the appropriate rate of conversion was concerned with inflation. The conversion of the Mark of the GDR into the Mark of the FRG was to increase the money supply in terms of DM. In order to avoid inflationary effects economic rationality required a conversion rate that would be neutral in its effect upon the level of prices.

According to generally accepted monetary theory the stability of the price level is secured if monetary policy keeps the growth of money supply in step with the growth of production capacity. Consequently-argue Prof. Dr. Horst Siebert, Institut für Weltwirtschaft Kiel - the conversion rate had to be oriented at the production capacity of the GDR, which was to be integrated into that of the FRG.

The production capacity of the FRG in 1989, the year before unification, measured in GNP, was 2,250 Bio DM. The production capacity of the GDR was estimated at 10% of that of the FRG: 225 Bio DM.

Disregarding official figures of the GDR Government Prof. Sieber estimated this figures as follows: The population of the GDR was a little over one fourth of that of the FRG. Supposing the same productivity of labour the GDR’s GNP would have been a little over one fourth of the FRG’s GNP that is roughly 600 Bio DM.

However, the GDR’s productivity is estimated at one third of that of the FRG, which would imply a production potential of 200 Bio DM. Since the labour participation rate in the GDR was considerably higher than the one in the FRG (55% vs. 45%) the GDR’s GNP can be safely estimated at around 225 Bio DM in 1989, which is 10% of the FRG’s GNP.

A production potential of the GDR of 10% of that of the FRG would require a conversion rate, which would increase money in terms of DM by 10%.

Money supply in the “old” FRG in 1989 was 420 Bio DM in terms of M1 and 1,255 Bio DM in term of M3. Thus a neutral increase of money supply would have been 42 Bio DM in terms of M1 and 125 Bio DM in terms of M3 respectively. Monetary assets (M3) of the GER were 255 Bio GDR Mark in 1989.

In line with Prof. Siebert’s argument an increase in the supply of money to the
amount of 125 Bio DM was permissible: 130 Bio out of 255 Bio GDR Marks had to be neutralized through an appropriate rate of conversion.

In political reality a split conversion rate was agreed between the Governments of the FRS and the GDR: A certain amount per capita in total 65 Bio GDR Mark, was converted at the rate 1:1.

The remaining 190 Bio GDR Mark-out of 255 Bio - were converted at the rate 2:1, resulting in 95 Bio DM.

Thus money supply in terms of DM has increased by this conversion operation by 160 Bio DM (65 Bio plus 95 Bio); this is an increase of 35 Bio DM above the “neutral” amount of 125 Bio DM.

The conversion of the GDR Mark into MD created additional demand in East Germany for West German products; the East German demand for East German products decreased correspondingly. The theoretically resulting inflationary pressure from monetary union was absorbed without difficulty. Inflationary pressure is now emanating from the capital market in consequence of the capital requirements of East Germany.

The Collapse of the East German Economy

The politically fixed conversion rate had a disastrous effect upon the East German economy’s price competitiveness, while an economically determined flexible exchange rate could have functioned as a buffer between the East German economy on the one hand and the West German economy and the World Market on the other.

The “Economic Disaster” in East Germany

The essential reason for the collapse is the instant exposure of a highly protected, economically inefficient, technologically retarded economy to the competition of the World Market through monetary union with West Germany, one of the best performing economies worldwide. No adaptation period and no supply side support were granted to the East German economy after the economic barriers were eliminated on July 1, 1990. Monetary union revealed the almost complete incompetitiveness of an economy that was proud to be “No. 1” in the camp of socialist economies and claimed place “No. 10” in international statistics. Literally overnight, from June 30 to July 1, 1990, monetary union depreciated the East German industry and - if not to the same extent - the qualification of industrial labour.
The collapse of an entire industrial economy with a population of 16 million in times of peace is historically a unique event. Structural crises in market economies are limited to a few sectors, to a few mono-structured regions. In East Germany the structural upheaval affects all sectors, all firms at once. The term “crisis” is not appropriate; it implies time. What happened to the East German economy was a “crash”. It was not economic emergency measures that prevented the passengers of that aircraft from being killed. It was because the tightly knit West German “social security net” was quickly spread out underneath the East German population that their landing was relatively “soft”. And what is happening now is not structural “change”; the East German economy is falling into decay.

The chairman of the German Central Bank (Deutsche Bundesbank), Karl Otto Pöhl, characterized this event as a “disaster”; any other description would be euphemistic. In contrast to other socialist economies in Eastern Europe—which are all “in transition” to a market economy—the East German economy had no transition period. The shift from one system to the other was instantaneous.

IV. The Breakdown of the Product Markets

Internal demand: East German consumers’ preference for “west-ware”

The conversion of the East German currency into West German abruptly stopped the demand of East German consumers for East German products; a minor West German demand had only existed for heavily subsidized goods. The conversion of deposits in GDR Marks into West German DM turned the - partly rational, partly irrational - East German consumers’ pent-up desire for “west-ware” into effective demand for Western products.

The massive financial transfer from West Germany stabilized demand in East Germany - not supply. Actually, it created additional demand for West German products - a Keynesian super-program for West Germany’s economy. The Stock of East German consumer products could only be sold off at highly discounted prices.

East German supply was quickly replaced by West German. West German retail trading companies quickly moved into East Germany. The East German population even rejected agricultural products from East Germany - frequently simply because the packaging was not as attractive as that of Western goods. A protective intra-German import charge to be levied on the border, was taken into consideration, but quickly dropped as an absurdity in an economically unified country.
East European markets: Ties severed

East European markets broke away, since the main trading and bartering partners simply lacked the convertible currency, in which East German products were invoiced since monetary union-instead of settlement in the artificial “Transfer-Rubel”. Thus after July 1, 1990, orders from COMECON countries were cancelled at short notice. By the end of the year 1990 total exports had shrunk to one fourth; exports to East European countries including the Soviet Union to one third. The rest of exports to COMECON countries is being held because the Federal Government guarantees export credits covering these transactions through the “Hermes” scheme. The products which the GDR exported to her COMECON partner countries are not marketable in Western market economies.

The Drop in Production

The economic situation in the former GDR had begun to deteriorate already before monetary union on July 1, 1991. At the beginning of 1990 industrial production had fallen below the level of the previous year - due to the emigration of qualified labour before and after the opening of the border - and also because of the beginning dissolution of the centralized planning system. The decline accelerated as the prospects of a monetary union with the FRG became more concrete.

The drop in industrial production after July 1 was dramatic; in July 1990 it fell by 35% against the previous month of June and fell another 15% the following month. Thus, in August 1990 industrial production was 50% below the level of August 1989.

The food industry was hit particularly hard - and consequently agriculture. But even construction was 15% below the level of the previous year in August 1990.

V. The Break-down of the Labour Market

One year after unification: 50% unemployment in East Germany?

Economists foresaw the dramatic effects monetary union would have upon employment. The German Institute of Economic Research (Deutsches Institut für Wirtschaftsforschung/ DIW) estimated in April 1990 unemployment for the second half of 1990 at 1 million - as it turned out a rather optimistic prognosis. Addressing a
conference of labour market experts of the GDR and the FRG in Nürnberg in May 1990
the President of the Federal Labour Office (Bundesanstalt für Arbeit), Heinrich Franke,
denounced such warnings as negative propaganda against unification instead of
preparing countermeasures.

Until March 1991, when it finally reacted to the consequences of economic
unification, the Federal Government relied on predominantly social policy instruments
instead of intervening with economic, industrial structural policy measures. In June
1990, the month before monetary union, 140,000 persons were registered as
unemployed; in September 1990 the figure had shot up to 445,000.

Employees on short-time work numbered 655,000 in July; by September the number
was already 1,770,000. The average loss of work for persons on short-time was 50%.
Consequently, the loss in work time (working hours) because of unemployment plus
short-time work was equivalent to 1,330,000 persons employed full-time-that is 15% of
the labour force-in September 1990, 3 months after monetary union. At the same time
there were 5.5 vacancies for 100 unemployed.

In face of the enormous amount of work to be done in order to rehabilitate the East
German cities, it is particularly alarming that even in the construction sector hailed as
“bearer of hope”, as the “support sector”, as the “locomotive for economic reactivation”
from January to March 1991 150,000 jobs were lost.

Around 500,000 persons - 50% of the workforce employed in the metal industry -
expect their dismissal on July 1, 1991, when the dismissal protection agreement runs
out, which was concluded before July 1, 1990.

The Institute of Labour Market and Vocational Research in Nürnberg (Institut für
Arbeitsmarkt und Berufsforschung/IAB) is expecting 4 million unemployed persons in
East Germany by the end of the year 1991; that is 50% of the workforce.

The official figures on registered unemployment represent only one fourth of all
persons affected. In March 1991, six months after economic unification, 800,000
persons were officially registered as unemployed - drawing unemployment insurance
benefits. By that time between 400,000 and 500,000 - willing to work - had been sent
into early retirement in order to relieve the labour market. Between 600,000 and
700,000 public officials were put on the “waiting list” (“Warteschleife”) for political
reasons. Most of them will definitely be dismissed on July 1, 1991.

Around 100,000 persons are employed under the employment creation scheme
(“Arbeitsbeschaffungsmaßnahme/ABM). Their wage is paid by the Federal Labour
Office, that is to say, 63% of their last monthly net earnings. These persons would
otherwise not be employed at all. The same is true for around 200,000 persons that are
participating in “qualification programmes”; their income, too, - 63% of the last monthly net earnings - is paid by the Federal Labour Office out of unemployment insurance funds.

**Employment Creation**

The Employment Promotion Law was enacted in the pre-unification FRG with the objective to reduce a relatively “normal” unemployment Creation Measures” (Arbeitsbeschaffungsmaßnahmen / ABM) and Qualification Programmes.

This policy instrument is controversial also in West Germany, where it is only of marginal importance and limited to municipal and social services; even in the “social sector” it may have contributed to the reduction of regular work places. It reduces unemployment in West Germany by around 500,000, while the officially registered number of unemployed persons persists in the magnitude of 2 Mio.

This ABM scheme instrument is now - in a more generously endowed form - used as the Government’s main labour market policy instrument to control rampant unemployment, which will reach the magnitude of 3 Mio, perhaps 4 Mio people by mid 1991. ABM is an extra-ordinary, temporary measure. It cannot be a substitute to ordinary permanent employment; but it is certainly preferable for the Federal Labour Office to finance work for the public benefit than paying for idleness.

By March 1991 around 50,000 ABM positions had been created. The Federal Labour Office has assigned 5,5 Bio DM for the Employment Creation Measure in 1991 and 1992 for the creation of 300,000 ABM places.

The organization of work for such a large number of persons requires professional project management. For that purpose so called “employment companies” are to be form by totally or partially shut down firms for their own dismissed personnel. The “employment (and qualification) companies” manage the employment of these persons in the demolition of obsolete production equipment and decontamination of the respective firm’s site.

Such alternative concepts were discredited by the Federal Government as social impediments to market forces. Now, with unemployment threatening to rise up to 50%, “employment companies” are “a glimmer of hope”, as an advisor to the Federal Ministry of Finance put it.

Employment promotion measure are creating a “second labour market”, on which wages are paid by the Federal Labour Office. Although this labour is to be employed for public benefit, potential friction with private business is an ingredient of the programme.
When the Federal Minister of Labour, Dr. Norbert Blüm, advised local governments to make use of the Employment Creation Measure in the rehabilitation of their cities he provoked protest from craft business.

The regional labour office is obliged to examine, whether a certain ABM competes with or even replaces regular economic activities. There is, however, an inherent tendency in the “second labour market” to impede the “first”, the regular labour market. The labour office “hires” the persons dismissed by firms.

“Zero Hours Short-time Work”

The most distortive effect upon these figures on unemployment is the short-time work scheme (Kurzarbeit) - a reduction in weekly working time. Short-time work is a labour market policy instrument originally conceived to bridge a temporary shortage of work due to a slowdown in a firms’ business activity. Short-time work benefit is paid by the Federal Labour Office as a subsidy to the employer who agrees to maintain employment despite lack of work. The original objective of this policy instrument was to avoid the negative social and economic consequences of too close an adaptation of employment to the business cycle.

In March 1991 around 2 mio persons were on short-time work in East Germany; 25% of them were working less than 10 hours a week. The short-time work scheme, until economic unification applied for stabilization in a cyclical downswing in one or the other sector, is now being applied on a broad scale in East Germany in a situation of radical structural change as psychological placebo. It has been so broadly redefined for East Germany that even “zero hours short-time work” is possible - and paid by the Federal Labour Office. Optimistically the short-time work scheme for East Germany was originally limited until July 1, 1991; it has already been prolonged until the end of the year 1991.

The Federal Labour Office pays 63% of the last monthly net earnings as short-time work benefit; however, in the metal and chemical industries a collective agreement obliges the employer to pay the difference up to 90% of monthly net earnings. As a consequence the difference between the normal wage for full-time work and the income obtained when working short-time is minimal; the effect is that is has become not the question who must - but who may work short-time. Only the prospect of imminent dismissal dampens the joy over paid holidays. One day off in a five working days week constitutes 20% short-time work. For employees covered by the collective agreement on compensation payment loss in income is only 10% of 20%, that is 2% per week. The
collectively agreed topping-up of the short-time work benefit has an outright counterproductive effect on the Federal Labour Office’s qualification programme. No supplementary payment by the employer on top of the 63% which the Federal Labour Office pays, has been agreed for those who participate in re-qualification and further qualification programs. The number of persons that has renounced part of their normal income in order to qualify for the future is small - only 50,000 by March 1991 - with detrimental effect upon the prospective employability of East Germany’s industrial labour force.

**Commuters and “Emigrants”**

Around 300,000 East Germans are commuting daily or weekly to West Germany and to West Berlin respectively. The number of East Germans that have definitely moved West is not exactly known; intra-German migration is not registered since the two German states were unified. Around 400,000 East Germans left the GDR from October 1989, the beginning of the end of the GDR, and October 1990, when the GDR joined the FRG. During the year of hope, 1990, the number of people that migrated to West Germany is estimated at 180,000. The current figure for East-West migration is 15,000 persons per month.

**VI. The “Treuhand” - the Economic Unification Board**

**The economic super ministry**

Privatization of the so-called “people’s property” is an essential precondition for the reconstruction of the East German economy as a market economy. For this purpose a fiduciary holding institution was created, the “Treuhand”. The Treuhand Anstalt was established by law already on June 17, 1990, before monetary union, by the democratically elected People’s Chamber of the GDR.

The Treuhand assumed the ownership of the “means of production” which up to then were “people’s property”. The “people’s own firms,” (“Volkseigene Betriebe”) were transformed into public stock corporations or limited liability companies-creating, by the way, 15,000 vacancies on their supervisory boards.

The primary objective of the Treuhand was - and still is - to sell East German firms to private investors. In cases where immediate privatization, that is, the sale of the respective firm is not possible without prior reorganization of that firm, “revitalization”
(Sanierung), that is assistance to the firm to achieve competitiveness, is the secondary task of the Treuhand.

In hopeless cases the respective firm is to be liquidated. The consequence in any case of this threefold task - Privatization, Revitalization, Liquidation - (Privatisierung, Sanierung, Liquidierung) is massive dismissal of personnel.

On July 1, 1991, the date of monetary union, the Treuhand was subordinated to the Federal Ministry of Finance of the FRG - and not to the Federal Ministry of Economic Affairs - a basic mistake, which implicitly conferred to the Treuhand a fiscal mandate, not an economic objective. And in fact, until March 1991 the Federal Government’s interest was limited to the proceeds from the sales of firms - and denounced the “secondary” task of the Treuhand, revitalization of firms, as interventional industrial policy incompatible with the new market economic order.

The top posts are held by West Germans, while the staff consists mainly of East Germans - many of them incompetent bureaucrats taken over from the former Government’s economic administration and therefore not qualified for their new task. The Treuhand is assisted by a team of 90 West German consultants.

President of the board of administration is Jens Odewald, head of “Kaufhof”, a retailing corporation. President of the Board of Directors, the chief executive officer, is Birgit Breuel, former State Minister of Economic Affairs of the Federal State of Lower Saxony. Mrs. Breuel succeeded Mr. Detlef Carsten Rohwedder who - out of patriotic duty - (he himself called it “patriotic eros”) had volunteered to take the most difficult job in Germany.

Mr. Rohwedder, a member of the Social Democratic Party, possessed social sensibility, a quality which had not impaired his success in reorganizing the ailing Hoesch Steel Company. Mrs. Breuel, a member of the Christian Democratic Party, preaches free market economic ideology; but in practice she has demonstrated pragmatic flexibility.

Ironically, the Treuhand has its seat in the “house of Ministries” in (East) Berlin, and occupies the same offices which were used by the 12 ministries of the communist Government of the GDR, which controlled the 12 sectors of economy. There are 15 regional offices. The Treuhand is an institutional monstrosity, which, in fact, reproduces the centralized economic system of the former GDR which it is supposed to abolish. Under the GDR regime firms obtained detailed instructions for their operations from Berlin; not much has changed in that respect under the “Treuhand regime”.

The economic power the Treuhand holds in East Germany almost equals that exerted by the fallen regime; its decisions - and non-decisions-affect the life of almost
everybody in all sectors and on all levels of society in East Germany. As a matter of fact, the Treuhand in a universal economic entity performing all economic functions from selling off firms to renting out homes. It functions as an investment bank, as a rehabilitation agency, an auditing institution, a business consultancy, a social assistance department and as a labour office. Within half a year the Treuhand doubled its personnel from 1,000 in October 1990 to 2,000 in March 1991: by the end of 1991 it is expected to employ 3,000 persons.

**The Treuhand under Cross Fire**

The Treuhand soon came under fire from all sides - potential West German investors, East German entrepreneurs anxious to set up their own - independent - business, local governments and - of course - labour.

Prospective buyers from West Germany willing to invest in East Germany criticized the Treuhand’s apparent disinterest, the incompetence of its officials, the delay in processing applications which smacked of sabotage, of deliberate obstruction of the new order by adherents of the old system.

East German entrepreneurs, the old ones, whose firms were expropriated, and new ones, who - following the lure of the “Market” - want to take over the establishments, in which they were employed before; the founders of new businesses, all complain about incomprehensible decisions (such as the denial of credit guarantee for a reorganization program) about the imposition of unbearable social conditions (such as the obligation to employ a minimum of 20 persons); about bureaucratic harassment and about the Treuhand giving priority to West German applicants; the Treuhand actually was accused of deliberately driving East German firms into bankruptcy for the benefit of West German investors.

For East Germans who have just shed the GDR’s bureaucratic centralism it is particularly frustrating to be again confronted with the same old practices - and the same old faces; to say nothing about the abuse of influence for personal interests of Treuhand officials, of “functionaries of the old system roped together” (“Seilschaften”) for economic survival after their political deposition and who - in some cases - are forming parties for personal enrichment with West German accomplices.

On the other hand, what may appear as bureaucratic obstruction to an applicant with good intentions; is an indispensable investigation of motifs, because some investors simply speculate with land - having no productive objective, intending to shut down operations and dismiss personnel.
Despite the ruling party’s professed belief in the “Mittelstand” (literally ‘middle class’), referring to small and medium sized business, as the protagonist of the market economy, nothing has been undertaken to create favorable conditions for respective initiatives. A survey reveals that 65% of all the firms with less than 1,000 employees feel that they are not taken care of by their step mother, the Treuhand. (Karlheinz Reuß, Institut für angewandte Wirtschaftsforschung, Berlin). On the contrary, in practice the bureaucratic procedures of the Treuhand on the one hand - and of local administration on the other - are deterring and actual or potential entrepreneur.

**Treuhand - the “Butcher”**

No matter whether the Treuhand sells off a firm, shuts it down or keeps it until recovery - either case means massive reduction of personnel. The Treuhand is perceived as the cause of the massive unemployment that came over the people in East Germany - and its former boss, Rohwedder as the “butcher” of jobs, who was held personally responsible.

The institutional monstrosity Treuhand became itself regarded as the principal obstruction to investment, impeding investment through intransparent bureaucratic procedures; withholding property from local governments, thus depriving them of potential revenue; pursuing institutional - if not personal - interests running counter to its public commission.

Thus the call for the dissolution of the Treuhand became the demand of the radical protagonists of labour, investors and local governments alike. Thus was the atmosphere when its chief executive official, Rohwedder, was assassinated by terrorists.

**Jonit Project “Upswing East” (“Gemeinschaftswerk Aufschwung Ost”)**

By March 1991

- one year after a democratic government in the GDR had opened the books of account for inspection of the state of the East German economy;
- three quarters of a year after monetary union;
- half a year after the unification with the FRG

The Federal Coalition Government realized that the idolized “market” alone would not salvage the East German economy from the ruins left by 45 years of Communist economic mismanagement, that left to itself the shocked East German economy would not be revived; that by a policy of laissez-faire, laissez aller the East German economy
would not be raised to the level of West Germany. The Federal Government finally became aware that private investment would not flow from West to East and that the government itself had erected institutional barriers to investment. The Federal Government recognized that something had to be done about the rapidly deteriorating situation in East Germany - after it had just sat back to wait and see.

In face of the disastrous consequences of unification for the East German economy, afraid of looming social unrest, under massive pressure from all political quarters - particularly from the governments of the newly formed Federal States predominantly composed of members of the ruling Christian Democratic Party, the Federal Government adopted - under the slogan “right of way for investment” (Vorfahrt für Investitionen) a package of emergency measures to stimulate private investment - measures that had been recommended by economists and politicians not blinded by ideological exaltation of the market forces already a year before. The investment incentives consist of

- investment premium of 23% of the private investment amount;
- extra-ordinary depreciation of an investment project for the first year of acquisition (or construction respectively);
- property tax (Vermögenssteuer) and business capital tax (Gewerbekapitalsteuer) levied on production capital by local governments in West Germany will not be introduced in East Germany.

The Ifo-Institute in Munich estimates that all the direct and indirect assistance measures - investment subsidies, special depreciation allowances, tax concessions - add up to 50% increase in the profitability of investment in East Germany. The conjuring name “Upswing East” reveals an economically wrong perception of the task to be done; it is not a matter of cyclical “upswing,” but of a fundamental structural transformation, which requires conceptual orientation.

All the decisions taken in March 1991 should have been taken 9 or at least 6 months earlier. The time lost may appear short; it is long in terms of psychological economics. The psychological momentum of unification, the enthusiasm indispensable for a new beginning, for the great task of reconstructing the East German economy, has been lost, sank into resignation. The re-start now out of a state of frustration requires increased effort.

Ⅶ. Change in Policy - Intervention Replaces “Laissez-Faire”

East German Industry - the “Sour Stock”
Contrary to euphoric expectations interest of West German firms in taking over East German firms was and is very low. Potential investors are not only deterred by institutional barriers, but not at all attracted by the economy prospects of investment in East Germany.

As it turned out many firms in East Germany have a negative market value (capitalized value of potential earnings); their production equipment is not worth more than its scrap value.

According to Mr. Koch, the Treuhand’s chief of finance, the substantial value of industrial production equipment is in many cases below zero, justifying only a symbolic price of 1-DM. Their markets in the East have collapsed and their product is not marketable in the West; they are burdened with debt converted in DM. Their only real value - if ownership is clarified - is the site on which they operate; however, that land is contaminated, and the legal obligation to bear the cost of ecological rehabilitation carries an unpredictable financial risk.

In line with its fiscal mandate the Treuhand attempted to sell its firms as quickly as possible at the highest possible price - and even subject to a reappraisal of the purchase price after two or three years. Interested investors were tempted to wait for the breakdown of the firm concerned, harbouring dubious intentions to acquire land at a discount price or to eliminate a potential competitor.

The Treuhand’s policy of rapid privatization failed. By March 1991 only 1,250 establishments out of 40,000 belonging to 8,000 “combines” had been sold for 4 Bio DM, securing employment for 300,000 persons. 300 establishments were closed - mainly for ecological reasons (as Uranium and copper ore mining and carbochemical processing of brown coal).

The failure of the Treuhand’s policy of rapid privatization, and the pressure from all political quarters including Bonn finally brought about a change of mind in the Federal Government, which had tended to hide behind the Treuhand, and cleared the way for a change in the Treuhand’s policy. The assassination of the Treuhand’s chief executive official, Rohwedder, by an underground terrorist group, that deeply shocked the political establishment in Bonn, confirmed that change in attitude. “Active Reorganization” (Aktive Sanierung”) of firms, which Rohwedder himself had already announced before his death, became now a fully accepted goal of the Treuhand - which before it was not.

The revaluation of the Treuhand’s second objective, reorganization of firms which cannot be sold immediately, by no means excludes privatization; Mrs. Breuel, Mr. Rohwedder’s successor, wishes to accelerate the sale of firms.
By mid May 1991 1,660 establishments had been sold for 8.7 Bio DM, securing employment for 420,000 persons. According to Mrs. Breuel the new owners plan to invest an amount of 59 Bio DM.

The Treuhand’s “other” Objective: Reorganization of Firms

Whereas until March the Treuhand was preoccupied with selling firms, now all possibilities to rescue firms - and to preserve employment - are to be made use of; this means, that firms have to be temporarily subsidized instead of liquidated if a buyer cannot be found. Even the final take-over of firms that eventually cannot be sold by the State is not a taboo anymore.

The Federal Government’s initial policy of laissez-faire itself is now passé. The Treuhand has been changed into an agent of industrial policy. Its task is now to halt the fall of the East German economy in order to defuse the explosive social situation. Total privatization of the “people’s property,” the Treuhand’s apparently unique objective until March 1991, was given a time dimension: in an internal paper was pragmatically declared “the final goal.”

The Treuhand is now permitted to take all the extraordinary measures is should have taken right from the beginning:
- assume the liabilities of firms to be sold, remit old debts;
- extend and guarantee modernization credits, finance exports;
- subsidize interest payments
- pay off dismissed employees (compensation schemes, “Sozialplan”)
- limit the financial risk for ecological decontamination
- cooperate with the state governments in defining “regional economic policy”; for this purpose so-called “economic cabinets” were formed;
- give preferential treatment to “middle Business,” small and medium sized enterprises, simplifying and standardizing procedures.

For its new function as a “Development Bank” the Treuhand requires 400 Bio DM until the year 2000 - according to Mr. Horst Köhler, the Federal Vice Minister of Finance. The Treuhand decided to raise funds on the international capital market issuing commercial papers with maturities between 30 to 270 days; it plans to float loans in the future.

One of the major problems the Treuhand faces in its effort to reorganize firms is the lack of market oriented management capacity. West German managers are reluctant to assume posts in East German firms; probability of failure is high, dismissal after
successful reorganization by the purchaser imminent. And living conditions in East Germany are unacceptable.

As a solution to the management problem “loan management agencies” or “management leasing companies” are to be called in to operate East German firms, with the preemptive right to buy them after a period of 5 years, while the Treuhand is to finance investment and to bear the risk for it.

The Treuhand’s supreme chief, the Federal Minister of Finance, Theo Waigel, himself declared, that the Treuhand’s “entrepreneurial responsibility” should be emphasized, that is to say, the Treuhand itself should “manage” firms that are not yet ripe for sale, “without fiscal of ideological blankers.”

The “combines” will now be dismantled and broken up into marketable portions. Operating units of the combines are turned into independent companies; so far only minor maintenance units and social institutions of firms were separated.

Still Missing: A Structural Policy Concept

The economic - "liberalist” Federal Government considers industrial policy an “original sin”, although the Federal Government itself indulges in this sin in its mortal form - keeping death bound industries artificially alive in intensive care on the drip of enormous amounts of subsidies.

Coal mining alone is subsidized with 22 Bio DM p.a. German coal cost 287 DM per ton whereas the world market price is 97 DM per ton.

While the Federal Government has been strictly rejecting structural policy the Treuhand, in fact, has practicing structural policy all along - albeit without a structural policy concept - only on the basis of criteria for the individual firm, among which the DM-opening balance sheet (“DM-Eröffnungsbilanz”) plays an important role. The Treuhand has already in the past been deciding not only the fate of firms, but of whole branches of industry - and regions. Thus the Treuhand shut down the GDR’s two automobile combines, which produced the “Trabant” (Saxony) and the “Wartburg” (Thuringia).

The Treuhand’s former President, Rohwedder, himself said, that the East German economy could not be left to the market. Shortly before his death he admitted, that it was impossible to privatize the East German industry completely. Firms in such sectors as steel and ship building could only be restructured with public participation. Neither the Federal Government nor the Treuhand have advanced a concept for a transition period; a time schedule is indispensable to prevent temporary assistance from turning
into permanent protection. A democratic government lacks the independence to control a restructuring process without a legally determined perspective. The contradictory objective: nursing ailing firms back to health and simultaneously saving jobs is a burden on the Government which it can hardly throw off again.

Despite the cautious restraint of private investors, the Federal Government - still - rejects its own participation in East Germany’s firms - in certain cases firms should be taken out of the Treuhand’s holdings and carried on as public sector corporations. The Federal Government may be deterred by the fact that it took 20 years to privatize the numerous corporations on West German soil - like VEBA, Preußag, Salzgitter - which it inherited after World War II. However, the present “post-war” situation may require similar procedures.

**Unclarified Property Rights - Principal Obstacle to Investment**

The economic factors - labour, and since March 1991 public capital - are abundantly available or standing on the alert; but there are no indications of an economic take-off in East Germany. Barriers blocking the mobilization of economic forces along a wide front are institutional conditions - the main one being the settlement of property rights.

Private property is recognized as the most intense motivational factor for the efficient use of scarce resources - and for the preservation of produced values, as a quick look at East Germany’s cities proves.

Uncertainty concerning the right of disposal of property is paralyzing investment. And this is exactly the situation, “unclarified property rights”, that was created with the unification treaty; the adoption of the principle of “restitution before compensation” for the privatization of the “people’s property” is a fundamental structural defect of the unification treaty, which paralyzes the stirring market forces in East Germany.

There existed basically two possibilities to transform the ambiguous people’s property into definite private property - either by restituting the expropriated property to its former owners, respectively to their heirs, or by assigning the proprietary rights to other private entities, combined with the financial compensation of the former owners. In the critical matter the fatal decision “restitution before compensation” (Rückgabe vor Entschädigung) was taken by the Federal Government and imposed upon the Government of the GDR in the unification negotiations.

The foreseeable consequences of this short sighted political settlement are one million applications for restitution, concerning 1.5 million objects of property. There are more than 9,000 applications for the restitution of 12,000 small and medium sized
business establishments which were expropriated in 1972. In many cases competing claims have to be settled by legal proceedings.

In addition 16,000 applications for the assignment of more than 1 mio objects to local governments have been filed according to the municipal property law of the GDR, dated July 6, 1990.

The weight of the immense procedural problem would break even a fully functioning public administration; under the present condition of a public administration, which has yet to be built up, it will take many years for this task to be performed.

The “restitution principle” impedes the Treuhand’s task to privatize the “people’s property”. The Treuhand is obliged to settle hundreds of thousands individual cases. As a consequence private investors are being deterred, local governments cannot dispose of sites to attract business, infrastructure projects are impeded. Under these circumstances any emerging market force is stifled; the economy cannot get off the ground after the crash.

The “Investment ‘De-Obstruction’ Act”

Among the “March measures” is a law, passed by the Federal Parliament (Bundestag), on March 22, with the revealing name “Investment De-obstruction Act”.

The Unification Treaty blocks the Treuhand’s entitlement of disposal in cases of objects for which restitution is claimed. Thus firms may not be sold without the consent of persons who are entitled to restitution of these firms. This restriction of the Treuhand’s power has been temporarily suspended though in an amendment to the “property law”, (the “law on the settlement of proprietary rights”; Gesetz zur Regelung offener Vermögensfragen). The new legal provisions are aimed at bypassing the legal barriers to investment the Federal Government itself has raised.

Their purpose is to facilitate investment, that is to say, the sale of land and buildings to private investors of firms or part of forms or their transfer to local governments or other public institutions. Precedence over the rights of those persons entitled to restitution have now - until the end of 1992 - investment projects that secure employment and housing projects including infrastructure projects for that purpose. Filing legal objections has no postponing effect. In order to secure the intention of the law the respective object will have to be reverted to the Treuhand if the investment project is not implemented. The former owner will be compensated out of the proceeds from the sale of his property.

Thus temporary exceptions to the main investment barrier, the principle of restitution
of property, were admitted in cases of “urgent” investment requirements - a halfhearted measure, because the revocation of the clause “restitution before compensation” would have been equivalent to admit a fundamental political mistake. In practice, however, these modifications cannot eliminate the uncertainty about the right of disposal, since they too require individual decisions case by case - i.e. about the “urgency” of an investment project. These decisions are contestable - the appeals resulting in lengthy legal proceedings - that is to say, any assignation of property can be blocked by an interim injunction (einstweilige Verfügung). In fact, these legislative corrections create new uncertainty for the potential investor about the outcome of legal proceedings.

**Compensation before Restitution - Green Light for Investment**

A truly clarifying act dispelling the uncertainty about property rights and clearing the way for investment would be the reversal of the legal principle into “compensation before restitution”. The transformation of a centrally administered economic system into a market economic order is a historically unique occurrence, only comparable to the aftermath of war. Therefore “Lastenausgleich”, that is the “distribution of the burden”, a system of financial compensation for losses suffered as practiced in West Germany after World War II, should be applied now in order to solve the property problem. The Federal Constitutional Court did judge the principle of financial compensation as constitutional solution in a very specific aspect in this context, basing its decision on the paramount public interest in the activation of the economy in East Germany. Thus the expropriations executed by the Soviet Military Administration between 1945 and 1948 are to be considered - and accepted - as consequences of Germany’s defeat in World War II.

Comparable to loss of property because of destruction in military action compensation is to be orientated at the financial capacity of the economy in an attempt to equalize the burden. Restitution should be possible in absence of public interest, but legal entitlement should be excluded; otherwise again law suits would block investment.

This would be an adequate and practical solution in the opinion of the Council of Economic Advisors to the Federal Ministry of Economic Affairs. Compensation should be financed out of a fund, which would be fed by the proceeds from the sale of property to investors.

The loss in revenue and the need for public transfer resulting from the paralysis of the economy due to the “restitution principle” is much more costly than the “compensation principle”.
The Factor “Wage” in Economic Integration

After monetary union in July 1990 the level of wages in East Germany was about one third of that prevailing in West Germany - Corresponding the difference in productivity of labor. One year later, by July 1991, the level of wages will have reached 60% of the level in West Germany.

The increase in wages was not left to the market. Labour unions established themselves as accepted partners in collective bargaining.

Compensation for the rise in the cost of living following monetary union had been the first goal labour unions pursued after economic unification. Already on July 1, 1990, a collective agreement in the financial services sector raised wages by 50%. On October 10, 1990, an increase in wages of 35% was agreed in the chemical industry.

The firms held by the Treuhand did not earn this increase in personnel cost; the wage increase was financed with liquidity credits granted by the Treuhand. The massive increase of the wage rate went hand in hand with massive reductions of the work force; for the Treuhand firms - anyhow for sale - wage is of minor importance in comparison to their vital market problem. The newly founded, independent small enterprises, however, are seriously affected by the wage increase.

In the metal industry (whose organizations include the electrical and electronic branches) the first objective of the labour union was to prevent uncontrolled massive dismissal of personnel - although the necessity of reduction of personnel in order to achieve the West German standard of productivity was recognized. A quick rise of wages in East Germany to the level of West Germany is the only way for labour unions to prevent the West German level from coming under downward pressure through East-West migration.

Wage differentiation, a two-tier wage structure, is politically untenable in a unified economic territory. The absurdity of this situation is particularly striking in the unified city of Berlin.

The wage rate policy of labour unions in East Germany was not productivity oriented; their goal in collective bargaining was to raise wages in several steps rapidly to the West German level. Despite contrary rhetoric the employer’s associations have accepted this. These employers’ associations, the labour unions’ negotiating partners, unite the administrators turned managers of the forms under the wings of the Treuhand, not the independent small and medium sized entrepreneurs; these businessmen accuse the Treuhand’s lieutenants of irresponsibility. For small and medium sized enterprises
the wage level is to be taken as given. Wage restraint is not the proper instrument for the promotion of this sector; however, tax concessions by the Government are. By April 1991, in the industrial sector the level of wages in East Germany had reached 50 to 55% of the level in West Germany; in the financial services sector already 70 to 85%.

The sectoral labour union Commerce, Banking, Insurance (Handel, Banken und Versicherungen/HBV), organizing employees in commerce and finance, was in a particularly advantageous negotiating position. The two service sectors had remained especially underdeveloped in the former system, and new employment was created after monetary union. In the newly established branch offices of West German banks in East Germany West German productivity standards were immediately introduced.

The wage level in East Germany’s metal industry stood at 42% of that of West Germany by March 1991. A pioneering contract covering a period of 3 years, that was concluded in the negotiating area of Mecklenburg in April 1991, stipulates the increase of wages up to the West German level in 3 steps by 1994. The importance of this agreement is the long term planning security it creates.

Equalization of wage levels will be particularly rapid in Berlin. Thus in the construction business wages will be equal in East and West Berlin by April 1, 1992.

West Germany’s wage structure was adopted for East Germany on April 1, 1991 both in the metal as well as in the chemical industries - and will be on July 1 for public service. As a concrete example gross remuneration in the chemical industry in East Germany varies now between 1,350 DM per month on level I to 3,100 DM per month on the highest level, level X III, which corresponds to 55 to 60% of the level in the chemical industry in West Germany. Thus wage is not a comparative advantage of industry in East Germany. Competitiveness must be achieved through capital investment and transfer of modern technology.

Wage Subsidy

“ABM”, Employment Creation Measures, are essentially a social policy instrument; an alternative policy instrument, which would make more economic sense are wage subsidies.

Ernst Moritz Lipp, chief economist of the Dresdner Bank proposes the following modalities:

The difference between the politically agreed - that is the collectively negotiated - wage increase and productivity increase should be paid by the Federal Labour Office. Such a measure would maintain a certain employment and make more sense than
pasting unemployment benefits for idleness.

**Labour Relations**

Unification of the two German states was followed - in some cases preceded - by the unification of the corresponding institutions and organizations - political parties, churches, industrial associations etc.

The former East German labour unions were totally discredited as “transmission” organizations of the Communist Party within firms. After democratization in the GDR the East German labour unions attempted to regain their original function as representatives of the interests of the dependently employed work force. From April 1990 until unification in October 1990 around 670 collectively bargained contracts were concluded in the GDR - among them a rationalization protection agreement in the metal industry, which was canceled by a provision in the “Unification Treaty”.

The policy of West German labour unions towards unification with their East German counterparts varied. The most important one, the Metal Worker’s Union (IG Metall) did not unify with the Metal Worker’s Union of the GDR, but forced it to dissolve and expanded itself into East Germany.

Whereas the labour unions acted reasonably in East Germany their policy in West Germany was irresponsible. Instead of restrain in solidarity with East Germany's labour force they all opened negotiation rounds with double digit demands - the highest In 15 years!

**The State of Infrastructure: Physical Obstruction of Investment**

The infrastructure in East Germany is a physical obstacle to investment. Transport and particularly communication are underdeveloped; the infrastructure, most of which was inherited from the times before World War II has fallen into decay. Residential and commercial infrastructure, buildings and the supply grid for public utilities are in despair.

The reconstruction of the decayed infrastructure requires the lifetime of a generation. In Germany planning periods for express highways with the related legal expropriation and environmental protection procedures may last up to 20 years. The new Federal Minister of Transport, an East German, will face constitutional objections in his attempt to cut planning periods only into half. Until now work on the reconstruction of roads and railroads, and on their necessary expansion, has not even begun - one year after
economic unification.

With respect to tele-communications, the nervous system of the economy, East Germany belongs to the group of least developed countries. Until July 1991 it was practically impossible to telephone between East and West Germany - with the exception of Leipzig where matters improved in April. The German Telecom promises to install in East Germany the most modern telecommunications system in Europe - by the year 2000!

VIII. Prospects for the Completion of Economic Integration

An economy divided

For the first year after economic unification, that is from July 1990 to July 1991, economic development in East and West Germany is contrary. While production and employment in West Germany are on the rise both are falling in East Germany; unemployment decreases in West and increases in East Germany.

Short term prospects for 1991: further deterioration

The majority of economists—and by now the Federal Government, too - are expecting a further aggravation of the economic situation in East Germany for the current year 1991.

According to the German Institute of Economic Research (DIW) and the Kiel Institute of World Economics production in East Germany will drop to one third of its level in 1989.

The drop in production will have dramatic consequences on the labour market. Estimates about employment vary between a fall to 5 Mio persons (McKinsey) and 6 Mio persons (DIW and Kiel) from 9,35 Mio in 1989; that is, unemployment will reach 3 to 4 Mio persons, that is between 40 and 50% of the labour force.

The DIW estimates that during the first half of 1991 employment will fall by 37% in industry and 28% in agriculture - and even in commerce and transport by 22%.

An increasingly nagging question, which begins to worry West German economic and political leaders is whether or not the Federal Republic as a whole, whether the West German economy will be drawn into the downward whirl spiral of the East German economy. The authors of a study commissioned to McKinsey by the Federal Government clearly see this danger.
Growth Potential

In order to catch up with the West German economy - which will not stand still in the meantime - two digit growth rates are required for over a decade.

For 1991 the Federal Government forecasts a growth rate of 2.5% to 3% for the West German economy. The Ifo Institute predicts a growth rate between 2 and 2.5% - including an assumed effect of the tax increase in July 1991. Anyhow, not much more growth is to be expected for West Germany’s ripe economy in the long run.

The starting situation for the East German economy is a shortage of industrial capital combined with an abundance of qualified labour. Regarding East Germany’s obsolete capital as equivalent to the capital destroyed through war on West German soil, these conditions are similar to those which resulted in West Germany’s high growth rates after the war.

It was hoped— and still is despite the chilling winds from the World Market, which left the first East German market forces that surfaced after monetary union frost bitten—that the transformation from a centrally controlled economy to a market economy will unleash productive forces the same way Prof. Ludwig Erhard’s shift from a war economy to a market economy did. However, the two situations are not alike; with the exception of the USA, defeated Germany’s victorious European competitors were likewise destroyed then. Now, the East German economy finds itself alone in a “post-war position” with respect to the “West,” and sees itself directly confronted with one of the most advanced industrial economies; it is more likely that this condition stifles rather than releases market forces in East Germany. It is clear that the West German economy will have to pull the East German economy out of the slump. It is only to be hoped that it will not drag its feet in this haul and learn running by itself soon.

The longer term perspective: structural change

The fundamental orientation for change is evident: Industrial sectors which have lost competitiveness in all advanced industrialized countries, such as steel, ship building, textile, must shrink also in East Germany.

The service sector - both production and consumption orientated - is underdeveloped in East Germany and must expand. East Germany’s industry in general is highly energy intensive and industrial pollution is extremely high. Adjustment to world energy prices and to the European Community’s ecological standards is indispensable.
In face of the dilapidated condition of residential infrastructure and of transportation infrastructure there is an enormous need for reconstruction and modernization. The construction industry will be the principal supporting sector for the East German economy in the next decade.

**De-industrialization**

If the present tendency continues East Germany will be de-industrialized; it will be a consumption region, a market for products of the industry located in West Germany.

At best, East Germany will be an “extended work bench” of West German industry. In competition for investment with West Germany and with other countries of the European Community, yes even with East European countries like Czechoslovakia location factors are negative. As a matter of fact East Germany has no comparative advantage with respect to West Germany, since wages will be equalized by the time newly constructed production facilities will go into operation.

Pessimists visualize East Germany as a chronically depressed area - similar to the south of Italy, that it will become Germany’s “Mezzogiorno.”

East Germany’s industrial work force consists of 3,4 Mio persons. A reduction by 20%, that is around 700,000, which took place in the 2nd half of 1990 (against the same period in 1989) must not be considered “de-industrialization”; it is rather a shift to a modern structure of economic sectors - in the opinion of the Federal Minister of Finance, Theo Waigel.

In the meantime, in the first half of 1991, industrial employment will drop by 37% vis-à-vis the 1st half of 1990. and, at present at least, the persons dismissed from the industrial sector do not find employment in the service sector, which itself - although it is underdeveloped - is still reducing personnel.

The question arises when does modernization of sectoral structure stop and destruction of industry begin? East Germany’s industrial employment of 3,4 Mio persons represents 38% of total employment. West Germany’s industrial employment constitutes 34% of total employment. Thus the reduction of only 400,000 persons would suffice to equalize East and West Germany in this respect. Hope is set against those pessimistic prophecies by politicians. The Federal Minister of Foreign Affairs, Hans-Dietrich Genscher, foresees in East Germany “the most modern industrial region in Europe.” It is to hoped that his prophecy will be self-fulfilling.

**IX. Complete economic integration**
The turning point

The complete economic integration of East Germany will be - for the foreseeable future - the central national policy goal. Considerations concerning the prospects for the achievement of this goal can be reduced to the question: when, more precisely, in which year, will the regional GDP per capita of the East German economy, that is, East German productivity of labour, have reached the level of West Germany?

The process of economic integration started on July 1, 1990, with the GDR’s GDP per capita at a level that was one third of that of West Germany. The process began with a steep drop. The question of immediate concern is, when will the East German economy’s downward movement come to an end, when will be the turning point from where it will turn upward?

Political statements about an imminent upward turn are but incantations uttered to conjure up the economic boom. At present there are no objective data indicating a change in direction. All economists agree, that the economic situation in East Germany will still deteriorate in 1991; politicians who had “promised” the “upswing” for 1991 have therefore postponed the turn of the tide to the year 1992.

Capital Requirements

There is agreement among economists that the amount of capital required to raise the level of productivity in East Germany to the level of West Germany will be 100 Bio DM per annum until the year 2000 as a minimum.

Prof. Siebert, Kiel, calculates the capital requirement adjusting the West German capital stock by the East German population, which is one fourth of that of West Germany. The capital stock of all firms in West Germany amounts to 4,400 Bio DM in 1989, of which one fourth is 1,100 Bio DM.

Under the assumption - which is not at all unrealistic - that all of East Germany’s firms’ capital stock is obsolete, its replacement would require 1,100 Bio DM. Aiming at the year 2000 capital investment in the amount of 110 Bio DM per year would be required to achieve the same level of productivity in East Germany as the one in West Germany. In comparison: Private investment of all firm in West Germany was 290 Bio DM in 1989.

The IMF calculates the investment requirements at 1,800 Bio DM, that is 180 Bio DM p.a. for 10 years, including the investment in infrastructure, if the productivity of
the economy in East Germany is to reach the level of the West German economy by the year 2000. One third of this amount, around 60 Bio p.a., will have to be public investment into infrastructure, two thirds, 120 Bio DM p.a., will have to be invested by the private sector.

The ear 2000: Economy still divided

Investment in the magnitude of 100 to 120 Bio DM p.a. in the private sector and 50 to 60 Bio DM p.a. in the public sector is simply impossible - financially and physically. In consequence economic integration will not be completed by the year 2000. The regional GDP per capita, the productivity of the economy in East Germany will not have reached the level of West Germany - and West Germany will still be subsidizing the equalized personal income of the East German population by 2000. Even if financial capital for investment were abundant, the physical time required to produce production equipment in this magnitude is not instant.

The East German population is only one fourth of that of West Germany. At best half the amount can physically be invested as the IMF argues. This implies the duplication of the time East Germany needs to catch up with West Germany - leaving open the question where even this amount - reduced in half - will come from.

Even under the most favorable conditions for growth the economy in East Germany will remain behind West Germany for at least two decades - that is for another generation. The standard of living - measured exclusively in terms of personal income, not in quality conditions - will be equalized within 3 to 4 years; but it will not be produced in East Germany but transferred to East Germany from West Germany.

Investment Plans

For the current year 1991 Prof. Hans Karl Schneider, President of the Council of Economic Experts, estimates private investment in the industrial sector at 30 Bio DM and public investment in infrastructure at Bio DM. The Ifo Institute only expects private investment in the amount of 10 Bio DM for 1991.

After a decade of continuous expansion of the Western market economies a phase of cyclical contraction is predicted by economic analysts - even though this opinion is not unanimous. A decline in economic activity of Germany’s trading partners will reduce the country’s exports. Under this condition West German firms will not be prompted to expand their production capacity in East Germany.
**Institutional Obstruction persists**

Although there is no longer any lack of financial incentives for investment, institutional barriers to investment still persist. Property rights remain unclarified. Restitution still ranges over compensation. The provisions for preferential treatment of investors, which were enacted in March, were only half-hearted corrections to a fundamental mistake. The legal situation remains complicated.

The regional and local administration continue to be a procedural obstacle to investment. It will take many years before public administration will function properly in East Germany.

**Financing integration**

During the unification and election year 1990 the Federal Government pretended that it could pay the “cost of unification” out of its pocket and that it would cost the West German population nothing. Taxes would not be increased; that was the election pledge which lasted only to the moment the last vote had been cast. In fact, the newly formed coalition government - using Germany’s financial Golf War obligations as a convenient pretext - decided in January 1991 to impose temporarily a general surcharge of 7.5% on income tax from July 1991 to July 1992.

In order to finance the extensive Employment Creation Measures in East Germany, an increase of 2% of the contribution to unemployment insurance, which affects only the dependently employed persons up to the contribution assessment ceiling of 6,500 DM per month, was imposed.

According to the Ifo Institute the tax increase will slow down growth of the West German economy by 0.25 to 0.5%, which in turn will result in a loss of tax to the amount of 3 Bio DM. According to Germany’s Central Bank (Deutsche Bundesbank) the tax increase will raise prices by around 1%. This price effect, however, is to the DBB preferable to an increase in public debt. The cyclical effect is considered negligible by the DBB; it will be compensated by East German demand for West German products. There remains, however, a certain risk, that higher taxes by way of higher prices lead to higher wages, and that the DBB will stop this spiral with higher rates of interest.

The burden on the public budget will be unbearable unless radical cuts are made in other expenditures. The new Federal Minister of Economic Affairs appears to be
determined to cut deeply into the hard core of subsidies. In the past, however, all his predecessors, who proclaimed to do that, had their teeth broken.

The West German population will have to share part of its prosperity with their East German compatriots. However, solidarity in general, and national solidarity in particular, is underdeveloped among West Germans.

X. External Effects of Economic Unification

European Community

EC member states are already benefiting from the expanded German market for consumption products. They are negatively affected by the upward pressure on interest rates, which results in Germany from the enormous amount of capital required for investment in East Germany.

Traditionally depressed areas in the European Community will lose part of their share in the EC’s regional promotion program.

Eastern Europe

In a more long-term perspective East German’s economic recovery will spread to the neighboring countries in Eastern Europe and facilitate their integration into the European Community. In international comparison United Germany will fall behind the level West Germany held.

Japanese Economic Colonization of Europe

The capital required for investment in constant technological advancement of Germany’s industry will not be available. Already now the Federal Minister of Research and Technology is cutting subsidies for Research and Development. West Germany, the dynamic pole of Europe, will be preoccupied with the modernization of East Germany, which implies to look backwards technologically. These factors will give Japan the chance to extend its dominating position in key technologies and embark on the economic colonization of Europe.