The Transformation Policy in East Germany – A Partial Success Story

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Introduction

"Mezzogiorno without the mafia". This is how Germany's former federal chancellor Helmut Schmidt called the state of the East German economy in 2005. Uwe Müller, a German journalist, spoke of the "Disaster of German Unity" (Supergau Deutsche Einheit).

These negative judgements about German unification are not justified. There are three main reasons that demand a more optimistic reading of the process and its outcome.[1]

1. The radical economic transformation of East Germany was unavoidable. The new-found freedom of East Germans led to a dramatic surge in the mobility of labour which had to be countered with drastic measures. There were no realistic alternatives to immediate monetary union, rapid privatisation, massive economic subsidies and public investments. The Germans chose the right path. They can be proud of it.

2. The outcome of the economic transformation is better than generally assumed yet worse than the expectations of the early 1990s. Hence German economic unification is a partial success, no less but also no more. That it is no more has nothing to do with political failures of unification. It is rather the consequence of the fundamental and widespread damage done to East Germany's economy by over forty years of socialist rule. In fact, a four decade long isolation from the world market caused severe and lasting repercussions for East Germany (and for Central Europe).

[1] The brevity of this article requires at times a somewhat apodictic presentation of facts. An extended version of my argument along with empirical data can be found in my book "*Die Bilanz. Eine wirtschaftliche Analyse der Deutschen Einheit*", Published by the Carl Hanser Verlag, Munich in September 2009.

3. The continued lack of innovative strength of East Germany's industry is one of the main reasons for the remaining productivity gap between the West and the East. At the same time, however, a large extent of flexibility on the plant level and comparatively low unit labour costs provides competitive advantages. These, however, can only be exploited if economic policy shifts its focus on strengthening the innovative power and capacity of eastern industry.

The Path: Reconstructing the East Instead of Enlarging the West

The fall of the Berlin Wall twenty years ago signified the victory of freedom and marked the beginning of a new-found mobility for East Germans. As East Germans won the right to free movement the possibility to leave the East for work and life in West Germany became a realistic alternative for many. The widespread repercussions of this development are rarely recognised in their true dimension.[2] In fact, it is these repercussions that ruled out the application of the same evolutionary transformation model chosen by many Central and East European countries. At the time, wage levels in the East amounted to less than 20 percent of West German rates and they remain at less than 30 percent today. East Germany would quickly have been emptied with millions of productive and capable workers deserting to the West. The mass exodus of workers would have made the successful reconstruction of the East German economy impossible and would have lead to a simple enlargement of West Germany at the cost of an abandoned East. Politically and morally this scenario has never been an option and was as such never seriously considered.

In fact, the decision to avoid any large-scale movement of labour out of East Germany quickly became a categorical *leitmotif* which limited the scope of political decision-making. In order to quickly achieve a significant rise in wages in the East, political decisions had to be taken swiftly and implemented irreversibly. With the political commitment to reconstruct the East German economy and to counteract a potential mass exodus of labour out

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[2] Among the few exceptions are Klaus von Dohnanyi's book "*Das Deutsche Wagnis. Über die wirtschaftlichen und sozialen Folgen der Einheit*", Munich 1990 and Walter Heering's article "Acht Jahre deutsche Währungsunion. Ein Beitrag wider die Legendenbildung im Vereinigungsprozess" in: *APuZ*, (1998) 24, pp. 20–34.

of East Germany, three fundamental decisions were made: swift economic and monetary union; rapid privatisation; and the massive support for economic development.

Owing to the Bundesbank's almost unrivalled international reputation as the guardian of price stability, the introduction of the Deutsche Mark in East Germany in the mid-1990s created widespread confidence in monetary stability. This in turn provided East Germany with the solid foundation necessary for economic progress.

The decision to enter into an inter-German monetary union was brave. It was taken against the advice of renowned economists – in particular the German Council of Economic Experts. Opponents of a monetary union between East and West Germany put forward the following two arguments. Firstly, it was feared that once both currencies merged irrevocably, the possibility to boost the international competitiveness of German industry by means of changing the external value of the *D-Mark* would be lost forever. Secondly, critics argued that the one to one exchange rate would result in rising labour costs followed by a sharp fall in production of East German industry. Even today, these arguments continue to be put forward by critics who hold inter-German monetary union as one of the original sins of German unity.[3]

However, this criticism fails to acknowledge that when the decision for monetary union was taken, it was already impossible to control labour cost through exchange rate manipulation. The key reason for this stemmed from the massive rise in labour mobility from East to West following the fall of the Berlin Wall. The exchange rate of one Mark (East) to one Deutsche Mark meant that wage levels in East Germany stood at one third of West German rates.[4] Nonetheless, even at one third of West German rates, the East was still not attractive enough to halt the exodus of highly productive workers. Hence, wage adjustments had to be made quickly. An exchange rate of two Mark (East) to one Deutsche Mark would have lowered East German wages even further to only one sixth of West German standards. It is highly unlikely that this state of affairs could have been stabilized even in the short run.

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[3] Most prominently, Helmut Schmidt's work "*Auf dem Weg zur deutschen Einheit*", Reinbek 2005, p. 114.

[4] Incidentally, this ratio was also named in some – albeit only partially accurate – comparative studies on labour productivity in East and West Germany.

The fact is that, soon after the wall had come down, East Germans irreversibly started to make all their economic calculations in Deutsche Mark. They were already living according to what economists would label a 'Deutsche Mark Standard'. With access to West German products, it was the value of their wage in terms of the West German currency that counted for East German workers, and nothing else. If necessary, they were willing to move to the West to earn higher wages and, crucially, they were also free to do so. Only the restriction of movement, combined with a non-convertible *Mark* (East), could have forced them to continue producing and consuming East German products. This, however, would have meant the unthinkable, namely erecting a new wall.

Hence, inter-German monetary union emerged as the only viable solution. Not only was it morally and politically the only correct choice. It was also an economically sound decision.[5] What followed in terms of the fall of production was not due to the specifics of the currency union, but the consequence of the newly gained freedom. That freedom suddenly unveiled the disastrous competitive state of East German industry.

What followed from 1990 onwards was in fact a drastic decline of East German industrial production. An all time low was reached in 1992. At the same time, a German trustee agency called *Treuhandanstalt* was given the authority to take over all former East German production and service facilities. Its guiding principle was to privatize as fast as possible, and this has been achieved. As a holding company of all previous GDR nationally-owned enterprises, it managed to sell these assets in record time. Indeed, until the *Treuhandanstalt* closed its doors at the end of 1994, the bulk of the 14,000 businesses had been privatized. However, the financial nd economic fallout from this was dramatic as it led to a deficit of over 200 billion *Deutsche Mark* and the elimination of about 2.5 million industrial jobs. Furthermore, the radical course taken by the *Treuhandanstalt* was perceived by many East Germans as a form of colonialism by West Germany and the systematic destruction of four decades worth of East German achievements. Understandably, this created widespread negative sentiments amongst the East German population.

[5] For a very convincing argument see: Walter Heering "Acht Jahre deutsche Währungsunion. Ein Beitrag wider die Legendenbildung im Vereinigungsprozess" in: *APuZ*, (1998) 24, pp. 20–34.

However, the economic assessment of the agency's work has to be significantly more positive. Most importantly, the *Treuhandanstalt* succeeded in creating a viable industrial core with competitive companies attuned to the free market. Buyers' investment and employment commitments were largely met and, at times, even exceeded. In the vast majority of cases the business models proved viable. A considerable number of East German industrial companies that are profitable today were previously owned by the German trustee agency. Furthermore, the *Treuhandanstalt* fulfilled a second important role that is often overlooked: it successfully withstood political pressure to keep ailing industries afloat through heavy subsidies. Precisely this would have been the greatest risk of privatization at a slower pace as some prominent economists[6] had proposed at the time and continue to argue for today.[7]

Various initiatives for the promotion of economic development complemented the work of the *Treuhandanstalt*. These included the comprehensive expansion and reconstruction of infrastructure as well as the support for the set-up and expansion of new industries. Initiatives for the promotion of economic development took place at all levels, beginning with the East German *Länder* (federal states) and local authorities up to the German federal government and the European Union. The success of these initiatives was felt quickly and initially began with a boom in the construction industry. While this meant the speedy reconstruction and renovation of the largely neglected East German towns, it also resulted in a high percentage of empty and unused business and office spaces. Later economic development efforts focused ever more exclusively on the support of manufacturing industries.

Gradually, East Germany experienced a significant increase in industrial production and has even seen a rise in employment figures[8] in recent years. While East Germany's contribution to the country's overall industrial production output stood at 3.4 percent in 1992, by 2008 it had risen to almost 10 percent. While the

[6] See: Gerlinde Sinn and Hans-Werner Sinn "*Kaltstart. Volkswirtschaftliche Aspekte der deutschen Vereinigung*", Munich 1993, Chapter IV.

[7] See: Helmut Schmidt "*Auf dem Weg zur deutschen Einheit*", Reinbek 2005, p. 114 ff.

[8] Economic experts are divided in opinion upon whether this manner of initiating economic development has led to excessive capital intensity of East Germany's manufacturing industry. While the theoretical argument is convincing, empirical evidence suggests otherwise. See: Karl-Heinz Paqué "*Die Bilanz. Eine wirtschaftliche Analyse der Deutschen Einheit*", Carl Hanser Verlag, Munich 2009.

construction industry has been shrinking since the mid 1990s, the manufacturing industry has regained a prominent position.

It is difficult to present a realistic alternative to the measures that were actually taken. This is all the more so if one takes into consideration the specific context of the times. The most crucial challenge that had to be dealt with concerned the overwhelming willingness of the East German workforce to abandon their home for a life in the West. The threat of a mass exodus made it impossible to safeguard that part of industry whose products constituted only an insignificant percentage of West German productivity in the international market. Other than in Central and Eastern Europe, given the specific conditions in East Germany at the time, this part of industry had to be abolished. Moreover, this meant an enormously fast structural change with very high unemployment.

The Outcome: Industries without Trade Unions

What is the situation in East Germany today? It is evident that, with regard to the industrial sector, the common perception that the East is not catching up is simply not true. Until very recently, the gross value-added per employee in East Germany has gone up continuously. It rose from just below one quarter of West German standards in 1991 to roughly two thirds in 2000 and reached 78.3 percent in 2008.[9]

Only if one looks at the economy as a whole (and not just industry), one might come to the conclusion that East Germany's catching up as massively slowed down. However, this is mainly due to some trends that must be regarded as a normalization of the East German economy: the massive shrinkage of the construction industry, a stagnating private service sector and a shrinking public sector. It is apparent that these trends are unavoidable if the current dependency on government subsidies is to be overcome. Both the construction industry and the service sector with their focus on the domestic market have to be replaced by an internationally competitive and export-oriented manufacturing

[9] In 2008 labour productivity in East Germany's manufacturing industry per working hour stood at 71.0 percent of West German standards as daily working hours in the East were on average 10 percent longer.

industry. As economic growth has to be firmly based on a self sustaining and highly productive industry, the economic transition process is moving in the right direction.[10]

Remarkably, the rising labour productivity in the East's manufacturing industry has not been matched by corresponding wage increases. Since the late 1990s, compensation in East Germany stood at a constant 67 to 68 percent of West German standards, with no upward trend despite the continued progress of productivity. Correspondingly, unit labour costs, defined as the ratio of total labour costs to real output (or wage to labour productivity), have continuously fallen reaching 86 percent of West German standards in 2008. Despite lower productivity, East Germany has a competitive advantage over West Germany with a view to unit labour costs. And note that West Germany itself has massively lowered its unit labour costs by international standards since the mid 1990s as it experienced only moderate wage growth over a longer period of time. Hence, by all national and international standards, East Germany is now a highly competitive industrial location.

This development requires explanation as it was not anticipated in the 1990s. Its root cause lies in the erosion of the nation-wide collective agreements in manufacturing industries (in German: the so-called *Flächentarifvertrag*). Due to the high unemployment rates in East Germany, neither employer associations nor trade unions managed to rally large scale support. As a matter of fact, the percentage of industrial companies bound by collective wage agreements is extremely low. It appears that flexible ad hoc solutions that make room for competitively low labour costs have been adopted instead.

What remains to be explained is the persistent labour productivity gap between West and East Germany of about twenty to thirty percent, depending of how industrial productivity is measured (per employee or per hour). Statistical observations and empirical studies show that this gap can no longer be explained by the unavailability of technology or capital or by possible deficits in the education and qualification of employees. Roughly 300,000

[10] For a detailed analysis see: K.-H. Paqué (Footnote 1) Chapter 4 and Harald Simons "*Transfers und Wirtschaftswachstum. Theorie und Empirie am Beispiel Ostdeutschland*", Marburg 2009.

East Germans commute to West Germany for work each day and have no trouble meeting the productivity levels of their West German colleagues. Hence, it appears most likely that the reason for East Germany's comparatively low productivity lies with the kind of products that are being produced in the East.

A main indicator supporting this hypothesis is the remaining deficit in export orientation and research activity of East Germany companies. Industrial Research and Development (R&D) activity remains much larger in West German than in East German businesses. In 2006, only 0.43 percent of all employees in East Germany were employed in the R&D sector whereas the figure for West Germany stood at 0.88 percent in the same year. This ratio has remained almost constant since the mid 1990s. It appears evident that the reindustrialisation of East Germany has proceeded without fostering enhanced research activity and orientation. In addition, industrial export figures for East Germany remain lower than those of the West. In 2008, the share of exports in West Germany reached almost 46 percent whereas East German figures hovered around a much lower 33 percent. On a positive note, however, these figures have increased quite dramatically rising from 12 percent in the mid 1990s to roughly 20 percent in 2000 until reaching 33 percent in 2008.

The two remaining structural weaknesses of East Germany's industry are closely intertwined. To some extent a common cause lies in the specifics of ownership structure and company size of the manufacturing industry in East Germany. In 2005, more than four-fifths of all companies in the East were owned by East Germans. With only 12 employees on average, the small size of these businesses hinders ambitions to increase export quotas and to intensify industrial research activity. While 48 percent of workers are employed by these (relatively small) East German owned businesses, 47 percent of the workforce is employed by (usually bigger) West German and foreign owned companies. Anecdotal evidence suggests that while the latter uses the latest technology in the production process, their research departments have largely remained in the West with only standardised production taking place in the East German section of the business. As such, East Germany's industry continues to function as the 'extended work bench' of West Germany. As such, its situation is typical for industry in structurally weak areas. While it is competitive at the wage levels typical for its domestic market, structural weaknesses cause it to fall short of reaching the same levels of added value that are common in the main areas of industrial activity in West Germany.

All in all, the result of economic transformation in East Germany has to be described as a partial success. While a new industrial core has been created as the basis of economic growth, it does not yet meet West German standards either in terms of productivity or in terms of innovation. However, it has to be added that the West German standard is particularly demanding. It is important to remember that until 1989, East Germany was governed along socialist economic principles and had largely been sealed off from the world market. Forty years of socialist rule had led to an enormous waste of resources as well as the continuous loss of innovative strength. After 1990 even highly educated engineers were unable to develop new products and to position them on the world market. Almost all industrial branches required a complete reorganisation, which had to be done swiftly otherwise, the exodus of qualified workers would have become unstoppable.

It is highly informative to compare East Germany with the Czech Republic, a highly industrialized country, which traditionally had structural conditions that were very close in nature to those in East Germany. Today, productivity levels of the Czech industry stand at 30 percent and wages at only 20 percent of West German levels. Clearly, this is much less then was the case in the interwar period a much less than East Germany today. As the Czech Republic was not able to rely on a comprehensive aid programme and direct investments in the way that East Germany received support from West Germany it may be understandable that the country has fallen behind. Nonetheless, it also reveals that the task of catching up with the West following forty years of socialist mismanagement is much harder than it was anticipated in the early 1990s.

The Challenge: Improving Innovative Strength

The primary objective of German reunification was to reconstruct East Germany's economy to a degree that it could finance regional consumption through its own production and would not be reliant on transfer payments. In the terms of international economics, the

East has to balance its current accounts to ensure it does not spend above its means. In this context, a region's current account refers to the difference between production and consumption whereby consumption is composed of private and public consumption as well as investment.[11]

Almost unnoticed by the public, East Germany has made tremendous progress in balancing its current account. While the mid 1990s saw consumption exceed production by more than 100 billion Euros, in 2006, the deficit had shrunk to only 30 Billion Euro and it is likely to have shrunk even further since then. It is primarily due to the recovery of its manufacturing industry that East Germany's economy has managed to overcome the total dependency on transfer payments that kept it afloat in the 1990s. A deficit of 10 percent of production value remains today yet the figures are distorted by the impact of commuters – that is East Germans who contribute to West Germany's economic productivity – and transfers payments that arise from the legal obligations of unified Germany's pension and social security system. The current situation is more than respectable when the high employment rates of the former German Democratic Republic (GDR)[12] that is making these transfer payments necessary is considered.

Undoubtedly, while there is still plenty of room for improvement, significant progress has been made. Crucial follow-up measures need to see the reduction of government purchases and investments at latest by 2019 when the Solidarity Pact II comes to an end. A consolidation strategy is already under way, in particular with a view to the still overstaffed civil service.

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[11] In strict foreign economic terms, the concept of a region's current account also includes transfer balance. We have deliberately chosen to alter this traditional definition as we are interested in East Germany's continuing need for transfer payments.

[12] In illustration of this point see: Gerhard Ritter "*Der Preis der deutschen Einheit. Die Wiedervereinigung und die Krise des Sozialstaats*", Munich 2006. K.-H. Paqué (Footnote 1) offers a rough estimate of the volume of annual transfer payments with regard to pension and socials security obligations which have to be seen as a long-term effect of the GDR's socialist regime. The volume of annual transfer payments for pension payments stands at 21 billion Euros while 35 billion Euros are needed for social security payments. The total sum of 56 billion euros contributed to the annual production deficit in 2006 whereas commuters contributed an additional 8 billion euros to the total figure.

However, even more important are measures that aim to further boost industrial productivity. This goal has to be a guiding principle for political decision-making. It requires the reallocation of resources away from the current focus on infrastructure and job-creating measures towards initiatives that help boost the innovative strength of East Germany's industry. Successful collaboration between private research centres and public institutions of education and research has the potential to create future hotspots of industrial activity.

To achieve this goal requires the cooperation of all political levels within Germany's federal structure:

1. The federal government has to ensure that national programmes aimed at enhancing scientific excellence do not impact negatively on regional developments. In particular, East Germany's difficult starting position must not prevent it from participating fully in national strategies for closer collaboration between private and public research institutions. At the same time, the federal government has to ensure that key characteristics of East Germany's industry, including high levels of flexibility, remain intact as competitive advantages. As such, any form of regulating the labour market, for example by introducing a nationwide minimum wage is harmful.

2. Political decisions at state and community level have to focus on creating favourable structural conditions that attract industries and that are open to new developments. Decision-makers at the local level require competencies and resources that allow them to successfully compete with West German and foreign towns and communities in the recruitment of foreign investors. This is even more important for those regions that are not directly located within close proximity to major population and industry centres.

To be sure, even all these measures will have their inherent limits of effectiveness. It would be naive to expect too much from them. At any rate, they will take time to be effective. The task of overcoming the widespread economic damage that has been caused by forty years of socialist mismanagement remains a major national goal.

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