

Brenke, Karl

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## A critical retrospective: German monetary union

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# A Critical Retrospective: German Monetary Union

By Karl Brenke

Twenty-five years ago, East Germany adopted the deutschmark as its currency. In terms of East German economic development, monetary union proved to be a disaster. With virtually no warning, East Germany's few productive factories and businesses were exposed to free market competition; industrial production collapsed in a way unparalleled in history. Nevertheless, for political reasons, introducing monetary union at the start of the process of system transformation was almost unavoidable. Given the insecure foreign policy situation, the aim was to seize the chance of reunification and push through monetary union to create an irreversible *fait accompli*. Moreover, this move was intended to put a brake on the massive exodus of people from East Germany. Admittedly, it also buttressed the widespread illusion among the East German population that a strong currency would facilitate fast-track income parity on West German levels. This illusion, however, also encouraged excessive wage hikes which only served to intensify the shock of alignment in summer 1990, complicate economic renewal in eastern Germany, and increase the financial costs.

## Fall of East Germany and SED's Helplessness

Germany's monetary, economic, and social union came into force 25 years ago—and it was completely unexpected. The East German Socialist Unity Party (SED) and the state leadership had planned to dedicate 1989 to a series of festivities to mark the 40th anniversary of the German Democratic Republic (GDR). Not even in their wildest dreams could they have imagined that East Germany would no longer exist just one year later. Even in the West, it was inconceivable that the GDR could collapse like a house of cards—especially since a large percentage of the population supported the prevailing policies.<sup>1</sup>

The impetus for change came from abroad. The *perestroika* movement in the Soviet Union had a strong impact on the political climate in East Germany. The first expression of the ruling regime's loss of authority came in the shape of protests over the evident rigging of the local election results in May 1989. That summer, thousands of East Germans determined to leave the country occupied West Germany's embassies in Prague, Warsaw, and Budapest. In September, when Hungary opened its borders, people from East Germany could cross there to the West. Simultaneously, steadily growing crowds swelled the "Monday demonstrations" calling for political freedom and the freedom to travel. In mid-October, Erich Honecker, SED leader and East Germany's head of state, was forced to resign. The Berlin Wall fell on 9 November.

In the fall of 1989, East Germany's economic problems were becoming increasingly obvious. Previously, there was only a suspicion of such problems based on the

<sup>1</sup> The ruling Socialist Unity Party (SED) alone in East Germany had almost 2.3 million members, equal to one in six of the adult population. The figure for support is even higher taking into account members of the parties in political alliances with the SED. In addition, there were a variety of mass organizations, some with very large numbers of members—for example, the Free German Youth (FDJ) movement, the Young Pioneers Organizations, the Free German Trade Union Federation (FDGB), and Combat Groups of the Working Class (*Betriebskampfgruppen*).

growing obsolescence of the production plants. However, these problems were never openly discussed. Instead, the political leadership denied and repressed them.<sup>2</sup> In a nutshell, East Germany had lived far beyond its means.<sup>3</sup> A growing proportion of its economic resources was used for consumption, and no funds ploughed into the investments necessary for upgrading production facilities; it was a “social policy of capital erosion.”<sup>4</sup> Rather than export income and loans from abroad utilized for acquiring plant equipment as initially foreseen by the party line of the “unity of economic and social policy,” these were spent on purchasing consumer goods such as, for instance, foodstuffs.

In the debate in the fall of 1989, East Germany was presented internationally as hopelessly indebted.<sup>5</sup> By the end of 1989, external financial obligations, surging in the period after 1985 due to growing export deficits, had reached 49 billion *Valutamark*.<sup>6</sup> Moreover, the state had significant liabilities to its own banking system.<sup>7</sup> Although it may seem reasonable to doubt the theory of East Germany’s total overindebtedness,<sup>8</sup> the country would hardly have been in a position to act on its own to reduce its debt burden to a viable level. In view of the country’s poor economic performance, significant cuts in consumption would have been inevitable, placing an enormous pressure on the government to justify any go-it-alone policy.

**2** On October 7, 1989, in his ceremonial address to mark East Germany’s 40th anniversary, East German leader Erich Honecker noted that since the country had been founded, it had developed “an economy with a modern structure and great economic potential.” He added that it “is characterized by dynamism and growing efficiency.” The speech also contained the promise that thanks to the use of microelectronics, productivity in East Germany, already “among the ten most productive industrial nations in the world” was set to see a future increase even greater than before. See “Durch das Volk und für das Volk wurde Großes vollbracht,” Ceremonial address by Erich Honecker, General Secretary of the Central Committee of the SED and Chairman of the Council of State of the GDR, *Neues Deutschland*, October 9, 1989 (Translated by Allison Brown: [http://www.germanhistorydocs.ghi-dc.org/pdf/eng/Chapter14Doc\\_14.pdf](http://www.germanhistorydocs.ghi-dc.org/pdf/eng/Chapter14Doc_14.pdf)).

**3** For an overview of the debate, see K. Brenke, “Die Jahre 1989 und 1990: Das wirtschaftliche Desaster der DDR - schleichender Niedergang und Schocktherapie,” *Vierteljahrshefte des DIW*, no. 2 (2009).

**4** P. Hübner, “Industrielle Manager in der SBZ/DDR. Sozial- und mentalitätsgeschichtliche Aspekte,” *Geschichte und Gesellschaft*, no. 24 (1998).

**5** See G. Schürer, G. Beil, A. Schalck, E. Höfner, and A. Donda, “Analyse der ökonomischen Lage der DDR mit Schlussbetrachtungen,” prepared for the Politburo of the SED’s Central Committee, October 27, 1989 (duplicated manuscript).

**6** See G. Schürer et al., p. 5. The *Valutamark* was primarily a statistical unit of account in East German foreign trade, though the basis for its calculation was kept secret. For 1989, one can assume that a *Valutamark* was worth approximately four East German marks. See U. Ludwig, R. Stäglin, and C. Stahmer with the assistance of K-H. Siehndel, “Verflechtungsanalysen für die Volkswirtschaft der DDR am Vorabend der deutschen Vereinigung,” *Beiträge zur Strukturforchung*, no. 163 (1996).

**7** Amounting to 123 billion East German marks in 1988. See G. Schürer et al., p. 4.

**8** See German *Bundesbank*, *Die Zahlungsbilanz der ehemaligen DDR 1973 bis 1989* (Frankfurt a. M.: 1999).

The GDR governments led by Krenz and then Modrow in the months following Honecker’s resignation hoped to preserve the country’s independence by reforming the economy. The drive toward greater economic efficiency was to comprise three main pillars: a shift away from rigid state planning, greater economic autonomy for production facilities, and more performance-related wages. In addition, growing numbers of private enterprises were also to be permitted. However, state ownership of property was to remain the central form of ownership.<sup>9</sup> According to its statutes, the renewed SED party sought to realize “socialism [...] beyond the profit economy, exploitation, and bureaucratic administrative socialism.” Nevertheless, virtually no reforms were initiated; the East German leadership seemed paralyzed.<sup>10</sup>

## High Migration Levels

With the general population continuing to have little faith in East Germany’s independent economic future, more demonstrations were held again. Now, though, there were new slogans calling for German reunification.

This lack of faith played its part in fueling a major wave of migration, although those leaving were also drawn by higher incomes in West Germany. In November 1989, the month when the Wall came down, 73,000 people left East Germany for the West, with another 59,000 leaving in December. In the first three months of 1990, almost 50,000 people emigrated every month (see Figure 1).<sup>11</sup> The size of this exodus was reminiscent of the period before the Wall went up, with large numbers leaving East Germany by August 1961 when the border to West Berlin was sealed (see Figure 2). Furthermore, after the Wall had fallen, a significant and growing proportion of East Germans also began commuting to jobs in West Germany and West Berlin, although there are no figures available on the precise number.

From the perspective of East German economists and social scientists, the key labor market problem of the *Wende* (the fall of the Wall and change in regime) was the loss of the labor force through the flood of migration and commuters to the West; their view of events did not include the possibility of a steep rise in unemployment

**9** See, for example, G. Gysi, “Wir kämpfen für die DDR, für soziale Sicherheit, für Stabilität und Frieden,” *Materialien zum außerordentlichen Parteitag der SED-PDS* (Berlin: December 1989).

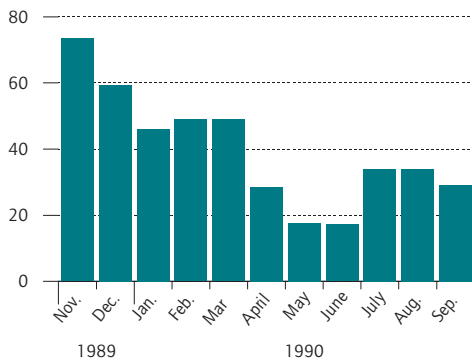
**10** Aside from a law on forming joint ventures between state-owned businesses and western investors.

**11** These were the figures given by the East German administrative bodies. The exodus may well have been larger since not everyone leaving East Germany informed the responsible authorities of their intentions.

Figure 1

**Emigration from the GDR to the Federal Republic of Germany 1989/90**

1,000 persons



Sources: Statistical office of the GDR; Gemeinsames Statistisches Amt der neuen Länder.

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The lack of faith in the economic future fuelled a major emigration wave.

during economic reconstruction.<sup>12</sup> The various suggestions on how to “safeguard the labor supply” included setting up “wage compensation funds” to finance the mandatory conversion of wages from deutschmarks to East German marks for those commuters working in the West. Such a move was intended to make this cross-border commuting less attractive. In addition, the proposal of generally limiting the free movement of workers was also discussed.<sup>13</sup> None of these measures were practically or legally viable, however.<sup>14</sup>

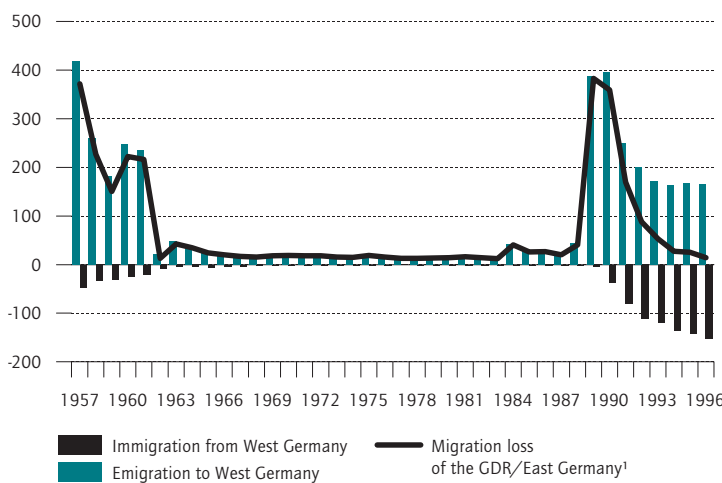
**Policy-Makers Opt for Monetary Union**

Monetary union between the two Germanys was first posited in the political arena in mid-January 1990 as a means to slow the exodus to the West.<sup>15</sup> The West German government willingly adopted the suggestion as its own, presenting it publicly on February 6. Since the deutschmark was associated with economic prosperity and a higher standard of living, the idea of monetary union strongly resonated with the general population in East Germany. Such an association was evident in a popular slogan chanted at the demonstrations: “*Kommt die D-Mark, bleiben wir. Kommt sie nicht, gehen wir zu ihr*” (If we get the Deutschmark, we’ll stay here! If not, we’ll move over there!). The announcement of monetary union may well have also been a decisive factor in the mid-March East German elections for the unicameral *Volkskammer* which returned the Ost-CDU (Christian Democratic Union of East Germany) and its allies as the clear winners. In the polls prior to the election, the Ost-CDU was seen as trailing. Yet the party’s victory was also a vote for the deutschmark; an “independent East Germany” was no longer a real option. Immediately following the elections, the monthly figures of those leaving the country dropped by half.

Figure 2

**Emigration from the GDR/East Germany and Immigration to the GDR/East Germany**

1,000 persons



1 Incl. East Berlin.

Source: Federal Statistical Office.

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The size of the exodus was reminiscent of the period before the wall was constructed.

12 See L. Hummel, E. Sachse, and V. Thiel, “Vorschläge zur gemeinsamen Beratung mit dem DIW,” January 17, 1990 (duplicated manuscript). In winter 1989–1990, at the initiative of East German social scientists and scholars, a working group on the labor market was formed with DIW Berlin members.

13 Hummel et al, “Vorschläge.”

14 The proposals were incompatible with West Germany’s constitution. According to the Basic Law (*Grundgesetz*), every citizen of East Germany was already a citizen of the Federal German state; under these proposals, East German citizens would have been even worse off than citizens of other EU member states. As a result, there was no way of stopping the mass migration of the labor force from East to West Germany. At most, migration into the social system could be decreased. See K. Brenke, V. Meinhardt, F. Stille, J. Volz, H. Vortmann, and G. G. Wagner, “Auswirkungen der Öffnung der innerdeutschen Grenze auf den bundesrepublikanischen Arbeitsmarkt,” *DIW Discussion Papers*, no. 5 (1990).

15 It was proposed by the social democratic SPD politician Ingrid Matthäus-Meyer in a solo action which had not been agreed with the executive of her party. See I. Matthäus-Meyer, “Signal zum Bleiben,” *Die Zeit*, January 19, 1990.

## Economic Debate over Monetary Union

The announcement of monetary union came as a complete surprise. On the very same day the West German government first proposed monetary union, the *Bundesbank* issued a statement that any such move still lay in the distant future. The vast majority of economists and social scientists shared the *Bundesbank*'s view that monetary union could not take place ahead of a program of fundamental economic reforms in East Germany.

In February 1990, an open letter by the (then West Germany's) Council of Economic Experts attracted particular notice. In this, the Council laid out a road map which began with dismantling the planned economy price system with its subsidies and excessively weighted prices, resolving the problem of accumulated excesses in the money supply and purchasing power due to the scarcity of goods, creating a financial system capable of meeting the demands of a market economy, and introducing a series of other reforms—not least the sweeping privatization of state-owned companies.<sup>16</sup> Initially, there was to be a fixed exchange rate for the East German mark, with convertibility phased in gradually—and as quickly as possible.<sup>17</sup> The Council also reasoned that monetary union would clearly highlight the gap between East German incomes and those in the West. Since monetary union was tied to the illusion of quickly achieving parity with western living standards, this was expected to trigger a series of excessive pay increases.<sup>18</sup>

DIW Berlin similarly argued for East Germany's statehood and separate currencies. The exchange rate of the East German mark could be linked to the deutschmark, but with the rate set as low as possible—the proposed rate was five East German marks to one deutschmark.<sup>19</sup> Thus, the argument continued, export trade could successfully assert itself in competition, while the low exchange rate would attract the foreign investments so ur-

gently needed. The convertibility of the East German mark should only be established at the end of the reform process. Moreover, it was essential to ensure that pay increases were related to increases in productivity. Finally, on the political level, the DIW saw a confederation model as a possibility.<sup>20</sup>

There were also economists and experts advocating a swift move to monetary union, however. Economist Hans Willgeroth, for example, saw the monetary union treaty as itself already providing an adequate regulatory basis.<sup>21</sup> This, he argued, not only excluded government financing through the printing press, but would, above all, establish tolerably reliable price signals on a deutschmark basis; thus, investors would not be exposed to exchange rate and convertibility risks which, in turn, would have a favorable effect on the level of interest rates. In Willgeroth's view, whether the currency was convertible or not was immaterial, since prices and incomes would in any case have to be aligned with productivity. Alternatively, if a separate currency were maintained, this would lead—for instance, in cases of excessive pay increases—to massive depreciation. The associated increase in import prices would result in expanded inflation within the country, amounting to an indirect adjustment in real wages. In a monetary union, Willgeroth argued, increasing prices in the wake of excessive wage rises would produce a drain on purchasing power. The falling demand and growing unemployment would then force an adjustment in nominal wages.

## The Question of the Right Conversion Rate

Admittedly, rather than puzzling over when monetary union should be introduced or whether it should be introduced at all, the public debate largely focused on the appropriate conversion rate for the East German mark to deutschmark. The general population in East Germany expected the rate to be one to one, and showed a marked lack of enthusiasm for any other option such as, for instance, the possible rates put forward by the *Bundesbank*.<sup>22</sup> The East German government indicated a similarly strong resistance to any rates deviating from conversion at par.

With regard to the conversion rate debate, two aspects were particularly significant. First, there was a concern over monetary stability, not least in the *Bundesbank*, worried that the additional money and build-up of con-

16 "Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Brief des Sachverständigenrates vom 9. Februar 1990 an den Bundeskanzler," (letter from the German Council of Economic Experts to the German Chancellor), in *Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Auf dem Wege zur wirtschaftlichen Einheit Deutschlands. Jahresgutachten 1990/91*, (Stuttgart: 1990), 307.

17 "Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Zur Unterstützung der Wirtschaftsreformen in der DDR: Voraussetzungen und Möglichkeiten. Sondergutachten vom 20. Januar 1990," (special report by the German Council of Economic Experts on support for economic reforms in the GDR: prerequisites and opportunities), in *Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Auf dem Wege zur wirtschaftlichen Einheit Deutschlands. Jahresgutachten 1990/91*, (Stuttgart: 1990), 289.

18 "Brief des Sachverständigenrates": 308.

19 DIW Berlin, "Reform der Wirtschaftsordnung in der DDR und die Aufgaben der Bundesrepublik. Stellungnahme einer deutsch-deutschen Arbeitsgruppe," *DIW Wochenbericht*, no. 6 (1990): 68ff.

20 See L. Hoffmann, *Warten auf den Aufschwung* (Regensburg: 1993).

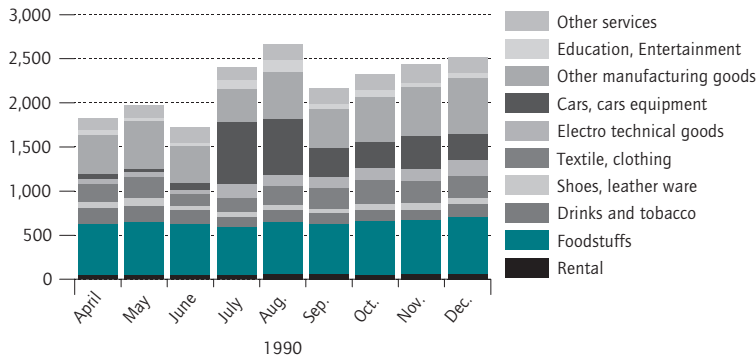
21 H. Willgeroth, "Probleme der deutsch-deutschen Währungsunion," *Zeitschrift für Wirtschaftspolitik*, no. 3 (1990).

22 For bank deposits and loans, the *Bundesbank* favored a conversion rate of two East German marks to one deutschmark.

Figure 3

**Monthly Expenditures of Employees Households with Two Children<sup>1</sup> in the GDR resp. East Germany**

DDR-Mark resp. D-Mark



<sup>1</sup> Without households of unemployed main income earners.

Sources: Statistical Office of the GDR; Gemeinsames Statistisches Amt der neuen Länder; DIW calculations.

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After German monetary union in East Germany the sales of cars and electrical products increased.

sumer needs among East German citizens could trigger a spending spree and fuel inflation. Second, if the conversion rate were set too high, the fear was that this could lead to a *de facto* appreciation, leaving East German companies unable to withstand competition. This, however, raised the question of East Germany's economic productivity, but it was a question without any sufficiently reliable answer. West German government estimates put productivity in East Germany at approximately one third of their level.<sup>23</sup>

In the treaty on establishing the monetary, economic, and social union, it was agreed that flow variables (wages, current state social provisions such as retirement benefits, etc.) were to be converted at par. This rate was justified since, for example, wages were also approximately only around one third of the West German levels.<sup>24</sup> Although, in principle, stock variables (bank balances, debts, etc.) would be subject to a conversion rate of two East German marks to one deutschmark, under a system of age-related tiered amounts, certain percentages of the bank balances were also to be exchanged at par.<sup>25</sup> In practice, the conversion ratio for stock variables was 1.6

<sup>23</sup> J. Ludewig, *Unternehmen Wiedervereinigung. Von Planern, Machern, Visionären* (Hamburg: 2015), 44.

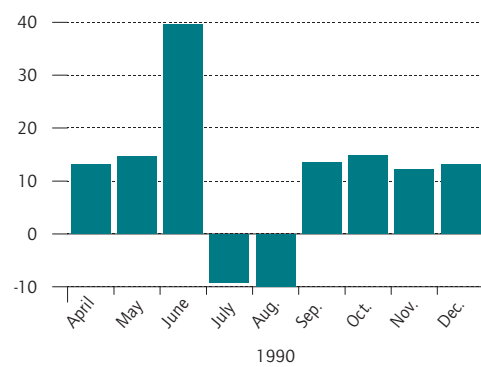
<sup>24</sup> Ludewig, *Unternehmen Wiedervereinigung*.

<sup>25</sup> See *Deutsche Bundesbank*, "Modalitäten der Währungsumstellung in der Deutschen Demokratischen Republik zum 1. Juli 1990," *Monatsbericht der Deutschen Bundesbank*, no. 6 (1990).

Figure 4

**Savings Rate of Employees Households with Two Children<sup>1</sup>**

In Percent of Household Income



<sup>1</sup> Without households of unemployed main income earners.

Sources: Statistical Office of the GDR; Gemeinsames Statistisches Amt der neuen Länder; DIW calculations.

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In September 1990 the savings rate rose again.

to 1.<sup>26</sup> As measured by the production potential—which could only be roughly estimated—the additional money supply for East Germany was approximately 50 percent too high; for the entire currency area, this was 4.5 percent, which was viable under the stability policy.<sup>27</sup>

**Shock after Currency Change-Over**

Introducing the deutschmark into the territory of East Germany on July 1, 1990 did in fact give a strong impetus to consumer spending—particularly since households there had refrained from making purchases over the previous few weeks while they waited for the much-anticipated deutschmark (see Figure 3). Above all, the sales of cars and electrical products increased, yet this could hardly be called a sustained out-and-out shopping binge since consumer demand fell in September and the saving rate rose again (see Figure 4).

This was a reaction to the economic development. The parts of the East German economy exposed to international competition were proving to be hopelessly inferior to competition from the West. Now within just a few

<sup>26</sup> P. Bofinger, "Geld- und Kreditpolitik nach der Bildung der deutschen Währungsunion," in *Wirtschaftspolitische Probleme der Integration der ehemaligen DDR in die Bundesrepublik*, eds. H. Gröner, E. Kantzenbach, O. G. Mayer (Berlin: 1991), 152.

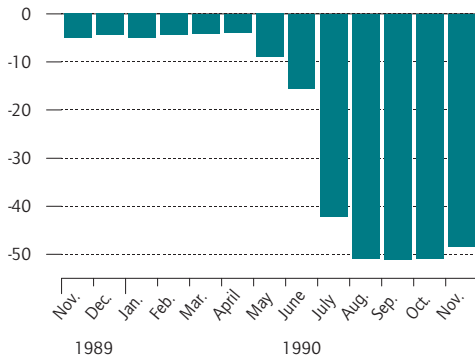
<sup>27</sup> Bofinger, "Geld- und Kreditpolitik": 163.



Figure 5

### Production in Industry in the GDR resp. East Germany

Change Versus Previous Year in Percent



Sources: Statistical Office of the GDR; Gemeinsames Statistisches Amt der neuen Länder; DIW calculations.

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Within just a few weeks industrial production fell by nearly 50 percent.

weeks, industrial production, which had already shown signs of faltering before, fell by almost 50 percent (see Figure 5)—a scenario that is historically unique.<sup>28</sup> Underemployment rose by leaps and bounds. Not only did the number of registered unemployed increase sharply, but so did the number of short-time workers; frequently, short-time workers had no hours to work at all, since there was nothing to do.

Major job creation programs were also launched and, from late 1990, many employees were shifted into qualification schemes which had been quickly set up.<sup>29</sup> Numerous people were given early retirement. The wave of redundancies first hit retired people who were still working and some foreign employees, and neither of these groups ever appeared again in any official labor market statistic. By late 1990, approximately three million people of the previous labor force potential of 9.8 million were either unemployed, placed in labor market policy measures, or pensioned off. The situation on the labor market became even worse the following year. Given the dramatically deteriorating situation on the labor market,

<sup>28</sup> Germany experienced a similarly dramatic collapse in industrial production in the early 1930s. The collapse lasted two years—from early 1930 to early 1932. R. Wagenführ, "Die Entwicklung der Produktion," in *Das Wirtschaftsjahr 1932/33. Tatsachen, Entwicklungsbedingungen und Aussichten der deutschen Volkswirtschaft*, ed. F. Raab (Leipzig: 1933), 17.

<sup>29</sup> Wagenführ, "Die Entwicklung."

the prospects for the future were uncertain, which also explains why there was no sustained consumer binge as had sometimes been expected.<sup>30</sup>

### Causes for Collapse

Although converting from a planned to a market economy was expected to lead to the closure of large numbers of production facilities and high levels of personnel adjustment, no-one anticipated the full extent of the collapse after monetary union. The causes for this collapse could have been on the demand side; after all, rather than East Germany undergoing such radical political and economic changes alone, the entire Eastern Bloc was affected—including countries which were traditionally the leading foreign customers for East German products. However, this cannot be the cause of the rapid and dramatic decline in industrial production, particularly in the weeks directly after monetary union. On the contrary, the German federal government provided a massive support program of favorable conditions for those factories and businesses trading with Eastern Bloc partners.<sup>31</sup> Without this support, then, industrial production would have collapsed even more dramatically.

With the availability of the deutschmark, the preferences of the East German population changed, often happier to buy goods from the West instead of those produced locally. Since western goods genuinely offered better quality in terms of production, functionality, or design, such a purchase decision may well have been taken on rational grounds. On the other hand, the decision may also have involved irrational grounds, with East German goods merely suffering from their association with a poor image. Be that as it may, ultimately the decisive factor is the consumer's wishes and the price. Productivity is low where the goods produced cannot be sold or are only sold in the low-price segment.

On this basis, then, the causes for the massive slump in production must logically lie on the supply side. Obviously, the conversion rate did not reflect productivity. Numerous publications before and after monetary union were dedicated to the productivity gap between West and East Germany; their estimates vary widely, with pro-

<sup>30</sup> Even before monetary union, responses from the vast majority of households taking part in surveys indicated that their spending behavior was not going to change fundamentally after the introduction of the deutschmark. See Institut für angewandte Wirtschaftsforschung, *Kaufrausch nach der Währungsunion*.

<sup>31</sup> See DIW Berlin, Institute for the World Economy, "Macroeconomic and Microeconomic Adjustment Processes in East Germany—Third Report," *DIW Economic Bulletin*, no. 39–40 (1991), as well as DIW Berlin, Institute for the World Economy, "Macroeconomic and Microeconomic Adjustment Processes in East Germany—Fifth Report," *DIW Economic Bulletin*, no. 12–13 (1991).

Table 1

**Monthly Gross Wages<sup>1</sup> in the GDR by Selected Industries**

	Mark			Change in Percent	
	1st halfyear 1989	1st quarter 1990	2nd quarter 1990	1st Qu. 1990 versus 1st halfyear 1989	2nd Qu. 1990 versus 1st Qu. 1990
Manufacture of chemicals, pharmaceuticals	1,101	1,115	1,283	1.3	15.1
Manufacture of basic metals, metal products	1,119	1,132	1,335	1.2	17.9
Manufacture of construction materials	1,027	1,081	1,230	5.3	13.8
Machinery, cars, transport equipment	1,088	1,124	1,229	3.3	9.3
Elektrical, elektronical goods, computers	1,055	1,091	1,195	3.4	9.5
Light manufacturing	962	994	1,062	3.3	6.8
Manufacture of textiles	967	994	1,048	2.8	5.4
Manufacture of food products	974	1,032	1,142	6.0	10.7
Electricity and coal mining	1,227	1,228	1,385	0.1	12.8
Water supply, waste	1,013	1,051	1,228	3.8	16.8
Transportation	1,162	1,277	1,334	9.9	4.5
Postal services, telecommunication	968	1,016	1,282	5.0	26.2
Education		1,088	1,174		7.9
Health services		1,250	1,531		22.5
Residential care, social worker activities		944	1,101		16.6
Scientific research and development		1,320	1,484		12.4
Creative and arts activities		1,084	1,225		13.0
<b>Total</b>		<b>1,116</b>	<b>1,242</b>	<b>4.1<sup>2</sup></b>	<b>11.3</b>

<sup>1</sup> Full-time equivalent.

<sup>2</sup> Only industries with complete data.

Sources: Statistical office of the GDR; DIW calculations.

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Already before the German monetary union the wages increased.

ductivity in East Germany rated as only 50 percent or even 25 percent of that in West Germany.<sup>32</sup>

Although the productivity lag to West Germany no doubt varied in different sectors, with the gap possibly narrower in services than in the manufacturing sector, only one standard conversion rate could be set. To do justice to the realities across all sectors of the economy, the value of the East German mark ought to have been far lower than the deutschmark. For example, if the rate of 4.3 to 1 is taken as the benchmark, the internal clearing rate used by East German factories and businesses for exports to a non-socialist economic area (*nicht-sozialistisches Wirtschaftsgebiet*, NSW), then monetary union brought a considerable *de facto* appreciation of the manufacturing sector—and this even though the factories and plants active in the NSW export business were certainly not inefficient.<sup>33</sup>

<sup>32</sup> For an overview see, for example, G. Heske, *Volkswirtschaftliche Gesamtrechnung DDR 1950–1989* (Cologne: 2009); Ludwig, Stäglin, and Stahmer, "Verflechtungsanalysen."

<sup>33</sup> Sinn and Sinn point out that the conversion rate would have been appropriate in terms of purchasing power. A variety of goods are included in calculating purchasing power: non-tradable manufactured goods, usually labor intensive, where the productivity differences between West and East Germany

## Failed Wages Policy

Moreover, the granting of substantial wage increases even in the run-up to monetary union was overlooked. In the second quarter of 1990, wages in East Germany were 11 percent higher than in the first quarter, and they had also increased prior to that time (see Table 1).

Growth in wages was justified by reference to massive consumer price hikes. In fact, consumer prices fell between June 1989 and June 1990 (see Table 2), possibly as the result of factories and businesses reducing their stock on hand. A selective perception may have fueled this assumption of a general price rise: when there were individual price rises for certain goods, this was generalized to conclude that there was sweeping price inflation. However, prices only rose generally with monetary union, due in part to stronger consumer demand and also to partially abandoning a policy of price distortion.

were most likely relatively slight, as well as tradable goods where the productivity differences were most likely larger. The problem would have been that the productivity lag for tradable goods produced in East Germany would have been below purchasing power parity. G. Sinn and H. W. Sinn, *Kaltstart. Volkswirtschaftliche Aspekte der deutschen Vereinigung* (Tübingen: 1993), 44–5.



Table 2

**Development of the Consumer Prices in the GDR resp. East Germany**

	All Private Households		Households of Employees <sup>1</sup>		
	June 1990	July 1990	July 1990	January 1991	November 1991
	Index; June 1989 = 100		Index; 1989 = 100		
Foodstuff, drinks, tobacco	96.2	114.0	115.4	119.3	126.4
Clothing, shoes	51.7	57.5	57.5	69.9	72.4
Rental costs, energy	100.0	100.0	100.0	158.6	375.8
Furniture, home appliances	84.8	74.5	74.8	82.4	85.0
Health and body care products	88.5	119.4	119.4	137.7	147.7
Transportation, telecommunication	93.4	85.2	85.2	97.8	111.8
Education, entertainment, cultural activities	88.3	88.5	88.5	117.7	129.0
Others	92.6	99.0	99.0	134.4	135.2
<b>Total</b>	<b>87.9</b>	<b>94.5</b>		<b>108.9</b>	<b>127.6</b>

<sup>1</sup> Since January 1991 without East Berlin.

Source: Statistical office of the GDR; Landesamt für Datenverarbeitung und Statistik Brandenburg; Gemeinsames Statistisches Amt der neuen Länder; DIW Calculations.

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In contrast to the people's assumptions consumer prices fell before the monetary union.

Consequently, prices for previously heavily subsidized foods increased sharply in July 1990. In 1991, the rents for apartments in particular rose dramatically.

The wage increases before monetary union, though, were just the prelude to a strong and rapid wage drift. In some cases, wage rises had already been agreed for the months after monetary union.<sup>34</sup> This was the case, for example, in the key metal and electrical industry where pay levels rose in two steps by a good 40 percent by early October. This also no doubt gave a further impetus to the decline in industrial production. In fall 1990, the collective bargaining policy passed to the national German unions and employers' associations—which were, however, largely influenced by West German players. In spring 1991, the metal and electrical industry reached an agreement on wages gradually rising to achieve full parity with western German levels by April 1994. But with the employers' associations then put under pressure, this actually came to nothing. As a result, however, some member companies left, but it was far more serious that, due to this wage policy, many of the privatized and newly founded companies did not even join the associations in the first place.<sup>35</sup> The pay agreements did not

apply to these businesses; moreover, in 1993, the metal industry employers revoked the planned incremental wage increases to meet levels in western Germany.

The wage drift steadily weakened across the economy as a whole, yet nonetheless consumer prices did not rise as fast as wages until 1995 (see Figure 6). Up until 1992, there was even the absurd situation in industry that wages outstripped economic output.<sup>36</sup> In other words, average factories and plants, many not privatized at that time, made massive losses which, ultimately, were shouldered by the state.

## Conclusion

In contrast to European monetary union, an idea first raised in the late 1950s<sup>37</sup> and discussed more or less intensely over the subsequent decades, the monetary union of East and West Germany suddenly and unexpectedly appeared on the political agenda. Furthermore, unlike European monetary union, the objective was not to utilize a common currency to mutually link regions with similar economic systems, but to transform a command economy into a market economy. Yet there was no historical model providing the experience of how to cope with

<sup>34</sup> The IG Metall (Industrial Union of Metalworkers) pushed through a flat-rate increase for the metal and electrical industry of DM 250 from July 1 and DM 300 as of October 1, 1990 for each person employed in the industrial sector. See K. Ohl, "Die Ost-West-Tarifangleichung in der Metall- und Elektroindustrie," *WSI-Mitteilungen*, no. 11 (2009): 628.

<sup>35</sup> Ohl, "Die Ost-West-Tarifangleichung," as well as DIW Berlin, Institute for the World Economy, "Macroeconomic and Microeconomic Adjustment Processes in

East Germany - Thirteenth Report," *DIW Economic Bulletin*, no. 27-28 (1995).

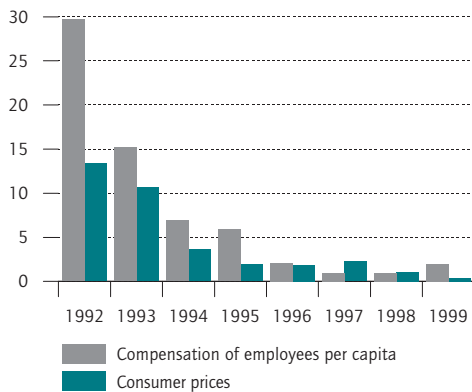
<sup>36</sup> K. Brenke, "Eastern Germany Still Playing Economic Catch-up," *DIW Economic Bulletin*, no. 11 (2014).

<sup>37</sup> W. Abelshäuser, "Die Erblast des Euro - eine kurze Geschichte der Europäischen Währungsunion," *Aus Politik und Zeitgeschichte*, no. 43 (2010): 40.

Figure 6

### Development of Wages and Consumer Prices in East Germany

Change Versus Previous Year in Percent



Sources: Arbeitskreis Volkswirtschaftliche Gesamtrechnung der Länder; Federal Statistical Office; DIW calculations.

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Until 1995 wages increased faster than the consumer prices.

the simultaneous transformation of monetary union and the economic system. Here then, rather than seeking to create regional equalization in the course of conventional or desirable economic development,<sup>38</sup> the aim was the economic reconstruction of a run-down region.

In addition, the political sphere was under pressure to slow labor force migration. The large-scale loss of human capital across the territory of the former East Germany would have left economic reconstruction with no viable chance of success; moreover, in western Germany, this flow of inward migration was considered a barely manageable burden.

From the economic point of view, it would have made most sense to tackle the transformation of the system first—which was the approach taken in eastern European EU member states. But in the case of East Germany, this was not an option. In the elections for the *Volkskammer* in March 1990, East Germany's population had voted for a swift move to monetary union. If this had then been postponed, East Germany would have found itself treading on very thin ice, both politically and economically, if not facing total chaos. Although it may

<sup>38</sup> As is assumed in older theories of optimum monetary union. According to Mundell, given the high mobility of the factors of production of labor and capital, currency union occurs where, within one currency area, labor and capital flow to an emergent region. See R. A. Mundell, "A Theory of Optimum Currency Areas," *American Economic Review*, no. 4 (1961).

seem from this perspective as if the West German government was driven by developments in East Germany, this is not the case. Instead, it was not only forcing the pace of monetary union but also promising that, in the case of German reunification, the former East Germany would soon catch up and thrive, transformed into "*blühende Landschaften*" (blossoming landscapes). The main objective was to seize the chance of reunification as fast as possible on the assumption that, given the unstable situation in the Soviet Union in particular, this window of opportunity would soon close.<sup>39</sup> By quickly establishing monetary union, an irreversible process would be started.

With monetary union, the system underwent transformation through shock therapy. Overnight, East Germany's economy was exposed to competitive forces which, to a large extent, it was quite unable to cope with. The conversion rate of the East German mark to deutschmark was fixed at the wrong level, failing to reflect the economic performance of factories producing goods for transregional trade. To align incomes to output and lay the foundation for a self-generated catch-up process,<sup>40</sup> it would have been necessary to reduce costs and, in particular, cut wages. Although wage cuts might have triggered an increase in labor force migration, the figures for those leaving eastern Germany rose anyway. After monetary union, the outflow from eastern Germany increased again, probably due to growing underemployment, and remained high over the subsequent years as well. However, outward migration no longer reached the levels in the period directly before monetary union.

In wage development, though, the trend was markedly away from wage cuts. Instead, wages rose sharply, with union representatives finding it more than easy to push up pay levels. Before monetary union, their counterparts in negotiations were the heads of state combines who, due to their involvement in the old political system, had to have the interests of their workforces at heart; moreover, they were themselves employees and so also interested in higher wages. Later on, the representatives of the employers' associations influenced by the West then had no interest in lower wages, let alone wage cuts, since efficient production in eastern Germany could have competed with businesses in western Germany. The political sphere was also unable to act against this type of wage policy since the right to free wage determination by employers and employees is anchored in the German constitution. As a result, there

<sup>39</sup> See Ludewig, *Unternehmen Wiedervereinigung*.

<sup>40</sup> See G. A. Horn, U. Fritsche, and W. Scheremet, "Die doppelte Währungsunion: Deutschland und Europa im wirtschaftlichen Integrationsprozess. Ein Rückblick und Vergleich," *DIW Berlin Quarterly Journal of Economic Research*, no. 2 (2000): 166ff.

could only have been, at most, voluntary wage restraint agreements. But given the widespread illusion among the general population in East Germany that their incomes would quickly attain parity with West Germany, this was an impossibility.

After monetary union, extensive financial resources were deployed to cushion the social impact of growing underemployment and support factories and businesses earmarked for privatization. Purchasing power drained to western Germany, boosting the economy there and fueling inflation. The *Bundesbank*, with its remit of ensuring monetary stability, saw itself facing a “stabilization crisis”<sup>41</sup> and reacted by robustly raising the base interest rates. As a result, the economy in western Germany weakened significantly, placing an additional strain on the *Aufbau Ost* reconstruction program since, for example, with underutilized capacities in western Germany, it was more difficult to find investors. Moreover, the higher interest rates created tensions in the European monetary system.

If it was vital to seize the opportunity for swift political unification and if the aim was to put a brake on the

wave of migration from East Germany, monetary union needed to be implemented at the start of the economic restructuring process. In political terms, then, monetary union was absolutely essential, although it proved to be a disaster economically. Fundamentally, the problem was the expectation linked to the adoption of a strong currency that this alone—as it were, automatically—would create economic efficiency and higher incomes. Such an expectation blanked out the fact that incomes have to be earned through the requisite productivity. Moreover, rather like the sorcerer’s apprentice, policymakers had further fueled the illusion of East Germany quickly achieving income parity with West Germany.

Since monetary union was embedded in an economic and social union, economic reconstruction in eastern Germany was less driven by the adjustment processes there than, first and foremost, massive transfers from western Germany.<sup>42</sup> This policy has produced considerable achievements—in particular, the re-industrialization of eastern Germany.<sup>43</sup> Nevertheless, eastern Germany is still dependent on transfers, and per capita economic output is now only just slightly over 70 percent of the value in western Germany.

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**41** M. Neumann, “Transformationsproblem in der ostdeutschen Wirtschaft: Unvermeidliche Anpassungskrise oder wirtschaftspolitische Fehler?,” in *Die zweifache Integration: Deutschland und Europa. Workshop zur Strukturberichterstattung*, ed. H. Siebert (Tübingen: 1993), 92.

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**42** Their own estimates put the cumulative amount at approximately 1.3 to 1.6 billion euros since 1990.

**43** See Brenke “Eastern Germany.”

Karl Brenke is researcher in the department of Forecasting and Economic Policy of the DIW Berlin | kbrenke@diw.de

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DIW Berlin – Deutsches Institut  
für Wirtschaftsforschung e.V.  
Mohrenstraße 58, 10117 Berlin  
T +49 30 897 89 -0  
F +49 30 897 89 -200

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Renate Bogdanovic  
Tel. +49-30-89789-249  
presse@diw.de

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