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Dieter Lösch*

The Post-war Transformation of West Germany's Economy: A Model for the GDR?

The unification of the two German states within a relatively short period of time now appears inevitable. Yet there is no historical precedent for a successful transformation from a socialist to a market economy. Doubts have been voiced by some as to whether such a transformation is possible. The following article compares the situation facing the GDR today with that facing the Federal Republic in 1948 and examines the conclusions to be drawn from this comparison.

The result of the general election on 18th March will show what proportion of the people in the GDR still dream of a better socialism, or of a "third way" between the played-out Stalinist form of socialism and so-called capitalism which is still despised. Whatever the result, however, it looks as if events have already assumed their own inexorable momentum towards a market economy. Now that the border is open – and no one would want, or indeed be able, to change that – no future government of the GDR, however it might be composed after the elections, will be in a position to freely choose its future economic system.

What may at first sight be a surprising line of argument is in fact the absolutely compelling conclusion of an economic analysis of the status quo between the two parts of Germany since 9th November 1989:

□ It has become plainly evident during the few weeks since the opening of the border between East and West Germany that, even after 40 years of partition and 28 years of largely one-sided isolation on the part of the GDR, the fact that the two German states share the same history, culture and language (and indeed, in West German eyes, the same citizenship), means that the *transaction costs* involved in trading goods and services or in the movement of labour and capital between them are in principle¹ lower than is normally the case between neighbouring sovereign states.

□ The opening of the internal German border has led to the development – albeit undesired – of an asymmetrically integrated, *pan-German labour market*.

□ Under the terms governing intra-German trade, the goods market is a unilaterally largely open one.

□ Nevertheless the continued existence of the socialist economic system in the GDR still constitutes a barrier to factor and goods mobility in the eastward direction.

Sooner or later, this one-sided partial integration which already exists between the economies of the two German states, and which cannot be reversed without erecting new artificial barriers to the population's mobility, will force the GDR's economy to adapt to that of the Federal Republic. The new government in the GDR can either face up to this situation and, as it were, make a virtue out of necessity by actively adapting its system to the West German one as quickly as humanly possible, thus allowing West German real capital to go and meet East German human capital instead of the other way round, or else it can attempt to put its own concepts of an economic system into practice. In the latter case, as long as the border remains open the loss of the best qualified sections of its labour force will mean that the GDR literally bleeds to death, ultimately forcing it to abandon its experimental reforms and seek accession to the Federal Republic. It is difficult to forecast how long such a process might last; there can hardly be any disputing, though, that it would be a very painful process which would also pose difficult problems for the Federal Republic. It may well be correct in principle to assume that the emigration from the GDR would eventually dry up of its own accord if the would-be employees arriving in West Germany were unable to find either work or accommodation, yet the economy in the GDR would

* Hamburg Institute for Economic Research (HWWA), Hamburg, West Germany. This article was written before the GDR elections of 18th March. The conclusions drawn by the author are, however, not affected by the election results.

¹ I.e. in principle rather than in reality, as there are still transactional barriers which cause high, or indeed prohibitive, costs in some of the areas named.

reach a point of collapse well before such point were reached. The problem for the GDR does not lie so much in the sheer number of people migrating to the Federal Republic – 57,000 did so in January 1990 – as in the fact that those who are turning their backs on the country tend especially to be the highly-trained, skilled personnel. Even if it proved possible to drastically reduce the number of people leaving, the GDR is hardly likely in the long run to be able to cope with the “brain drain” induced by the pay differentials between East and West unless it is able to compensate for it by bringing in know-how and capital from outside. However, this flow of real and human capital into the GDR will not get under way unless the GDR abolishes its socialist economic system instead of just reforming it.

If the future GDR government recognizes the needs of the moment and endeavours to convert its system very rapidly into a market economy, it may well be able to minimize the social costs inevitably associated with this, and to lay the foundations for a second German economic miracle.

This pressure for the GDR to reform its system on the one hand together with the low transaction costs between West and East Germany on the other – quite apart from the willingness of the Federal Republic, its Länder and its local authorities as well as a large part of its people to help the GDR – provide the country with a unique opportunity to carry through within a relatively short time with relatively little sacrifice something no other “real socialist” country has yet managed, namely to transform its soviet-type, socialist planned economy into a functioning, dynamic market economy.

The Unsolved Problem of Transformation

However, quite how the transformation from a real socialist economic order to a market economy can be achieved is still a completely open question. Some have even voiced fundamental doubts as to whether such an undertaking is even possible. There is no historical precedent for a successful transformation from a socialist to a market economy. Any previous attempts at reform in the Eastern bloc did not have a market economy as their objective, but sought either to “perfect” socialism or to introduce what was known as a “parametric system of control”, a hybrid type of system with evident planned-economy structures. In Hungary and Poland, too, the declared aim was long one of merely reforming socialism, not of abolishing it. It was not until about the middle of last year that the two countries expressed their desire to restructure their economic systems to create a market economy along Western European lines.

However, not only are there no precedents for any transformation of a soviet-socialist type of economy to a market economy, but there is also no theory as to how this might occur. It is hardly surprising that no such theory has ever been developed in the Eastern bloc countries, since the introduction of a market economy, which is now the declared aim in Hungary and Poland, and which is being demanded by virtually all political groupings to the right of the former SED in East Germany, was not even a subject for discussion as it entailed the “restoration of capitalism”. Even in Hungary, it was extremely hazardous to demand a market economy or to consider its introduction in public until well into the 1980s, even if it was lightly disguised under the additional label “socialist”. Thus even Janos Kornai, whom I believe to be the most astute critic and analyst of the functional deficiencies of the soviet-type economy, has not developed any concept as to how the problem of transformation should be solved. In an article published in December 1986, he still posed the question: “... can a reform process in a socialist country go much beyond what has been accomplished in Hungary? Or does contemporary Hungary exhibit more or less the ultimate limits of reform?”² His answer to this question suggests that Kornai is basically sceptical about the possibility of transformation, and that he can only conceive of efforts to transform the economic system being successful through the medium of reform, i.e. as the outcome of a relatively long, drawn out process.³

In a situation in which even such a clear-sighted analyst as Kornai is unable to say whether it is at all possible to transform “real socialism” beyond a certain point, it is no wonder that people cannot agree on how such a transformation should be brought about.

The main differences of opinion concern the question of whether the process should take place step by step over a longer period or whether, if it is to be possible at all, it has to be pushed through, as it were, at one fell swoop.

□ Advocates of the piecemeal concept maintain that it takes time for institutions to adapt, that people also need to be given time to accustom themselves to a new social environment, and that this offers the best way of avoiding social hardships. Indeed, the argument continues, a complete shake-out of an entire economic and social order is far too risky an affair and is highly likely to lead to chaos, or to a situation in which events

² Janos Kornai: The Hungarian Reform Process: Visions, Hopes, and Reality, in: *Journal of Economic Literature*, Vol. XXIV (December 1986), pp. 1687-1737, esp. p. 1734.

³ Cf. *ibid.*

assume a momentum of their own which makes them impossible to control and in fact just as likely to lead back to a system of Stalinist terror as towards a free market system.

□ The arguments against the piecemeal concept are no less plausible. These state that the market economy is an interdependent, self-regulating system which can only function properly if all the elements which are essential for the regulatory mechanism to work are in place and are serviceable. Just as it would be impossible to change from a system of driving on the left-hand side of the road to driving on the right by first requiring taxis and buses to change over while all other drivers remained as they had been, it is said to be out of the question to incorporate individual elements of a market economy into a planned-economy system without this system ultimately "crashing". Though the analogy is a little clumsy, it does put over an argument against step-by-step transformation which ought to be taken seriously, namely that if prices are freed, say, in a non-competitive environment in which enterprises are subject only to "soft budgetary constraints" this is highly unlikely to improve the provision of goods and services to the population and would tend more to have an inflationary effect. Similarly, "soft budgetary constraints" will do little to realize any intention of forcing enterprises to work profitably. In short, certain minimum legal and organizational preconditions need to be fulfilled if a market economy is really to function.

□ The follow-up argument against the piecemeal concept is that even if partial reforms are successfully carried out, their positive effects will most probably work through considerably more slowly than their negative ones; the latter generally make themselves felt within a very short time for certain social strata or groups, or indeed for the entire population, whereas the positive effects of reform measures – assuming such effects are generated at all – take longer to make themselves felt. This leads to the danger for any piecemeal transformation that once the first steps towards introducing elements of a market economy have been taken, resistance will develop against any further steps and these will be prevented. As in the case of earlier attempts at reform in Eastern Europe, this could then lead to the reform process coming to an abrupt end. Thus the argument runs that a "point of no return" should be passed in a determined manner, making the process irreversible by introducing the market economy in a single step. Only then would it be possible to solve the acceptance problems facing the new system which would become acute as a result of the inevitable adjustment processes; that is, only then would it be

possible to hold out against the resistance of the people until such time as the positive effects of the transformation worked through so as to be noticeable to the majority of the population.

Since there are plausible arguments both for and against this piecemeal concept it would seem appropriate to examine more closely the question of whether an abrupt or a step-by-step transformation is the more practicable of the two. The reference system which suggests itself here is the only case available in economic history in which a system which at least had similarities to the soviet-type economy was successfully transformed into a market economy, and we might expect this to provide some indications of how the transformation problem could be solved.

Erhard's Reforms as a Reference System

The return to the market economy in the three Western occupied zones which were to become the Federal Republic of Germany in 1949 actually began on 1st March 1948 when the *Bank deutscher Länder* was founded; this initially functioned as the central bank for the British and American "bi-zone", and the provincial banks (*Landeszentralbanken*) in the French zone joined the system in June.⁴

□ The establishment of the *Bank deutscher Länder* and the *Landeszentralbanken* meant that the "tri-zone" already had a central bank system which was capable of functioning and to all intents and purposes independent before the currency reform of June 1948. This created the right preconditions for a monetary policy oriented towards stability.

□ The second stage of the reforms was the currency reform which took place on 21st June 1948. It was prepared and carried out by the Allies. The aim of this move was to eliminate the monetary overhang which was estimated at approximately 300 billion Reichsmarks, and to reactivate credit transactions by rehabilitating the several thousand banks and financial institutions which were still in existence. A point to note for our current purposes is that upon closer examination, this measure – though it had been prepared in secret and was abruptly carried out – turns out not to have been confined to that third weekend in June 1948. At the beginning of October, of the 50% of all current account balances, time deposits and savings which had been devalued by a 1:10 ratio and credited to

⁴ Cf. H. Müller: Die westdeutsche Währungsreform von 1948, in: Deutsche Bundesbank (publ.): Währung und Wirtschaft in Deutschland 1876-1975, Frankfurt 1976, pp. 433 ff.

blocked accounts on the June date, 70% were now completely annulled in order to bring about a further substantial fall in the money supply on the basis of experience up to that time. Another significant aspect is that issues of income or wealth distribution did not receive any special consideration during the currency reform; the only concessions in this direction were that social insurance rights were converted on a 1:1 basis, and savings deposits of up to 5,000 Reichsmarks were converted in full at the rate of 1:10.

□ The third element of the reform was instituted simultaneously with the currency reform: prices were largely deregulated and the majority of the control provisions were repealed. Fixed prices, and in some cases rationing, remained in force for staple foods, oil and petrol, fertilizer and iron and steel products; rents and lease payments also remained fixed. The wage freeze was not lifted until November 1948; now that collective bargaining had again been permitted, a new law on collective bargaining (the *Tarifvertragsgesetz*) came into force on 9th April 1949.

□ The fourth transformational step towards the market economy was the liberalization of foreign trade. This was not taken abruptly, but spread over a number of stages. The first moves towards liberalization were taken, under powerful pressure from the United States, before the currency reform and hence long before West Germany had achieved sovereignty. As early as 1948, the "United Economic Area" was forced to allow most-favoured-nation treatment to 13 countries; in August 1949, the Federal Republic was forced to give such treatment to imports from all other countries, regardless of whether this was reciprocated by the exporting nations concerned; by the end of 1949, quotas were lifted from at least 50% of the total private-sector imports into West Germany.⁵ In 1950/51, a new schedule of West German customs duties was drawn up which led "...with persistent American intervention in favour of lower tariffs ... to a break with the protectionist tradition".⁶ The Federal Republic of Germany became party to the GATT on 1st October 1951.

□ During the course of this fourth step towards the market economy, Erhard was forced to slow down the pace of reform and to temporarily rescind some of the liberalization measures already taken. The rapid relaxation of impediments to foreign trade had led immediately to a balance-of-payments deficit for West

Germany in 1949 and 1950. For those two years, it was still possible to balance the current account thanks to the inflow of foreign exchange under the Marshall Plan. What precipitated the crisis, however, was the pronounced rise in raw material prices on the world markets at the end of 1950 in the wake of the Korean War. This sent West Germany's current account into the red. Even after it had taken up the \$320 million quota it was allowed by the European Payments Union and taken out an additional special loan of \$180 million, there was still not enough foreign exchange available to balance the books. The result was that the liberalization achieved up to that time was drastically cut back in 1951: some import quotas were reintroduced, as also was the requirement to place 50% of the equivalent value in D-marks of foreign exchange required for import on cash deposit; finally, a complete stop was put to the issuance of import licences for a time. It was not possible to continue with the liberalization process until the Federal Republic's exports had risen strongly in the second half of 1951.

□ Apart from the period of setback mentioned above, the liberalization of foreign trade was accompanied by a relaxation of exchange controls. Starting in 1952, the D-mark was convertible for practical purposes at a uniform fixed exchange rate for the payment for goods and services. However, capital convertibility was not introduced until much later.

With the help of these five reform measures, the West German economy was turned into a functioning, dynamic market economy within about four years. They were later followed by supplementary, supportive measures such as the Industrial Constitution Law, the Law Against Restraints on Competition, and increases in benefits and reforms in the field of social policy. Similarly, particular areas of the economy were not deregulated until much later, or indeed have yet to be deregulated (e.g. the housing market and transport). Even so, the essential task, namely the introduction of the market economy, had been dealt with long before the mid-1950s.

The Dangers for Economic Equilibrium

In reality, the transformation did not occur nearly as simply and smoothly as the above brief summary implies. On the contrary: Ludwig Erhard, to whom the historical credit is indisputably due for having pushed through and persisted with the transformation policy in the face of the fiercest resistance, had to ride out severe political storms and was exposed to intense hostility. In spite of his great personal courage and his almost messianic faith in the achievement potential of the

⁵ W. Abelshauser: *Wirtschaftsgeschichte der Bundesrepublik Deutschland 1945-1980*, Frankfurt am Main 1983, pp. 151 ff.

⁶ *Ibid.*, p. 153.

market economy, he would nevertheless presumably have failed if it had been necessary to obtain legitimization by plebiscite at each stage of the process, and also if he had not succeeded within a relatively short period in mastering the disturbances in macroeconomic equilibrium which occurred in the course of the transformation process. In this latter respect, he was also aided by a whole series of fortunate circumstances.⁷

□ During the West German transformation process, any telling *disturbance in price stability* was only short-lived. As a result of the well-devised cut in the currency and of the consumer goods which had been hoarded and were rushed onto the market as soon as the new money had been distributed, the release of price controls after the currency reform left the new D-mark prices not far from the Reichsmark prices which had been frozen in 1936. Although the large backlog of demand led to a 16% rise in the cost-of-living index within a short time, this simultaneously acted as a signal to businesses that they should expand their production as quickly as possible. With the support of a restrictive monetary policy, it proved possible to get inflation under control by 1950. After a short phase during which the retail price index actually fell slightly, price stability had to all intents and purposes been attained in the early

1950s, with annual inflation rates below 3%. At the same time, there was a steady improvement in the supply of goods, and wage levels began to grow faster than prices.

□ A more serious threat to the transformation policy than that of inflation was that of burgeoning *unemployment*. Erhard was under no illusion that structural reform would inevitably have to follow currency reform and the relaxation of price controls, nor that this would be associated with the loss of numerous jobs. Yet he was confident that, in the wake of that structural change, those members of the labour force who had been released would find fresh employment, and that the growing economy and properly functioning labour market would eventually also bring full employment. The unanswered question, however, was whether these adjustment processes would occur quickly enough for the policy-makers to persist with the reforms. Following a rise in unemployment from 760,000 in mid-1948 to 1.56 million in December 1949 (i.e. after the numbers had almost doubled) the situation looked exceedingly ominous. In fact, though, the number of persons employed during that period did not fall by any

⁷ On this and the following, cf. Ludwig Erhard: *Wohlstand für alle*, Düsseldorf and Vienna 1957.

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In time for the direct elections to the European Parliament the Hamburg Institute for Economic Research (HWWA) published this book containing a series of lectures held at Hamburg University in the winter semester 1988/89. It presents a wide range of views and opinions on central questions which dominate the current discussion on Europe.

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more than 150,000 in absolute terms; the main reason for the rise in unemployment was the increase in the potential labour force caused by the influx of refugees. From 1950 onwards, there was then a more or less continuous rise in the number of people in employment. Up to 1958, when full employment was attained, there were 6.5 million newly created jobs while approximately 50% of those that existed in 1948 were "rationalized out" during the same period as a result of growth-induced structural change.

□ As already suggested, Erhard's reform policy was also placed under strong pressure by the country's *foreign trade* position. Although the associated anti-inflationary effect of the increased imports did mean support was given to the objective of price stability, by 1951 the serious balance-of-payments crisis mentioned earlier had come to a head. However, with the aid of tight foreign trade controls and a restrictive monetary policy it was possible to get the situation back under control. From a short-term point of view, vital contributions were made to this by the Marshall Plan and what was referred to as the Korea boom. In the long run though, it was only because the West German economy had proved internationally competitive from the outset that it achieved a persistently positive balance of payments which also allowed the newly formed republic to fulfil its obligations as agreed at the London Conference. Given the years of detachment from foreign countries resulting from the Nazi regime's ideology of autarchy and from the disruption to relations caused by the war itself, this international competitiveness was by no means assured from the beginning.

The above provides a summary of the currency and economic reforms in West Germany. The question is, was this a transformation according to the "*big bang*" model or was it a case of *piecemeal social engineering*?⁸

Phases of System Transformation

By its nature, the transformation was a process and not an event taking place at one fixed point in time. Even so, it did take place within a relatively brief period. A closer examination shows that this process consisted of three phases which may be conceptually distinguished:

□ *Phase I.* The establishment of a two-tier banking system during this phase created the right preconditions

for a stability-oriented monetary policy. Its other essential element – the currency reform – reduced the money supply with the aim of adapting it to the supply of goods, thus rendering improbable from the beginning that major movements in price levels would occur once prices were deregulated for this might have undermined confidence in the new currency.

At this stage, there was no immediate need for Erhard to take any further major legislative or organizational measures to develop micro- and macro-structures appropriate to the market economy; the legal system was still in place, a micro-structure which could permit or encourage competition was still intact (and had in fact been improved by the Allies' deglomeration measures), and the founding of the Federal Republic also increased the scope for taking sole responsibility for economic policy and improving the instruments available.

□ *Phase II.* The above phase of setting up the legislative and institutional framework was followed by a phase of liberalization. This included the relaxation of price controls, the liberalization of foreign trade and the introduction of D-mark convertibility. The latter two steps, in particular, were carried through on a gradual basis and, as already mentioned, there were also short-term setbacks. If these had been longer-lasting, the entire reform project might have been placed in jeopardy. Thanks to Erhard's courage and determination, he did not allow these setbacks to prevent him from continuing to push ahead rapidly with the liberalization policy in the face of all the opposition generated and notwithstanding the risks which undoubtedly were present.

□ *Phase III.* This adjustment phase occurred partly parallel to the second one. It was a relatively long process during which the structure of prices, employment and production adapted to the overall conditions created by an open market economy. It can be assumed that these adjustment processes were completed at the latest once full employment and complete D-mark convertibility had been achieved.⁹

The above breakdown shows clearly that a "big bang" system transformation in its purest form is simply not possible. An economic system cannot be reshaped overnight, as it were. Phase I needs to be given time. Institutions have to be legislatively prepared and then practically put into place. The Phase II liberalization measures, on the other hand, can actually be carried

⁸ The concept of piecemeal social engineering was developed by Sir Karl Popper, who intended it as a counter-concept to the Marxist "utopian technique of all-embracing planning"; Popper advocates openness in the shaping of society, pleading that it is impossible to realize an ideal state on the basis of a design for the social order as an indivisible whole.

⁹ The adjustment processes were succeeded immediately by fluctuations in the business cycle due to causes other than the newly created conditions for the system transformation.

through at one particular point in time, even if this is not quite what happened during Erhard's reforms. Phase II, in that sense, is not really a phase at all but one solitary act. It is also the crucial step in a system transformation. If concentrating on this act in particular, then, the big bang model really is the correct one to apply to the system transformation. Give or take a few details, this is indeed what happened in 1948. "The transition to the new economic system, as far as the first crucial steps were concerned, literally took place overnight."¹⁰

Nevertheless, the Phase II big bang did not by any means imply that a point of no return in favour of the market economy had been passed. It would still have been quite possible for Erhard's reform to fail during Phase III, had those responsible not managed to get to grips with the tendencies towards disequilibrium in the goods and labour markets and in foreign trade within a relatively short time through the application of economic policy.

This phase pattern should not, of course, be interpreted too rigidly. There is a great deal of overlap between the individual phases. In order to keep Phase I as short as possible, for example, it is best to create only the absolutely essential legal and institutional bases for liberalization; nor do all areas need to be liberalized at

once in Phase II, although it might be a good thing given that experience shows later partial liberalization measures to be generally very difficult to enforce. The corollary is that there will still be some reforms in the legal and economic policy framework (deregulation and liberalization measures) which need to be carried out during Phase III.

Conditions for Success

Erhard's transformation policy provides a good backdrop against which to highlight the conditions which will need to be fulfilled if any economic system, of whatever kind, is to be transferred into a market economy:

□ It is essential to have a clear concept of what objective to strive for, that is, of what is needed to make the market economy function. Eucken outlined these preconditions in terms of his seven constitutive and four regulatory principles. To put it in more concrete terms, the market economy must have competitive structures, that is autonomous, rival enterprises subject to hard budgetary restrictions, the free choice of occupation,

¹⁰ Christian Watrin: Das Unternehmertalent in der DDR ist nicht verschüttet, in: Frankfurter Allgemeine Zeitung, No. 278, 30th November 1989, p. 19 (our translation).

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Hans-Hagen Härtel u.a.

ENTWICKLUNGSLINIEN IM INTERNATIONALEN STRUKTURWANDEL

Spezialuntersuchung im Rahmen der
HWWA-Strukturberichterstattung 1991

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In what direction and with what speed does structural change take place in a highly developed economy which is strongly integrated into the international division of labour such as that of the Federal Republic of Germany? What is the pattern of structural change in other industrial countries? What evidence is there to back up the opinion that "structural" causes are mainly responsible for misdevelopments such as high unemployment and the slowing-down of productivity growth? Answers are given to these questions in the latest special analysis produced by the HWWA-Institute within the framework of its "Structural Report" to the Federal Ministry of Economics, Bonn. (Only available in German.)

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stable money, free price formation, and the free exchange of goods, services and capital with other countries under convertible currency arrangements. If necessary, in a large country with good domestic competitive structures a market economy may be able to exist in the short or medium term without the opening up of external economic relations.

□ Apart from this clear concept, a further essential condition of success is the determined political will to push through the transformation. The less any government wanting to make the transformation can be assured of the acceptance of its ideas among broad sections of the populace, the greater that political will must be.

□ The abrupt introduction of the market economy by way of the single act of liberalization described above must be thoroughly prepared by creating the institutions which are indispensable to the market economy, that is by the phase of legislative and institutional (re)construction. No liberalization can take place unless these legal and institutional preconditions are essentially met. This phase, which may also be described as the preparatory phase for the transition to the market economy, may in theory take a relatively long period of time. In practice, though, it needs to be pushed through all the more quickly the deeper the crisis faced by the system concerned.

□ The liberalization of prices and wages and of foreign trade, including the introduction of currency convertibility, ought if possible to be executed in a single step at a single point in time. Some exceptions, partial protection and certain limits to convertibility can be retained in exceptional cases provided that the liberalization as a whole is sufficiently far-reaching for the process of competitive allocation to dominate.

□ During the adjustment phase, economic policy must effectively prevent any glaring shortfalls on the goals of the magic rectangle. To do this, it must apply measures which conform to the system, even though interest groups will make repeated demands for interventions which are in breach of this principle. A government must be determined enough to also persist with such policies despite stubborn resistance in the form, say of strikes or demonstrations.

The Chances of Success in the GDR

How does the current situation in East Germany measure up against these five conditions for success?

□ It will become clear after the elections on 18th March whether a government will be formed in the GDR which

clearly recognizes the necessity of introducing a market system and will have the determination to get the transformation process under way. Of course, there is no Ludwig Erhard on the horizon in the GDR, for there is a lack of outstanding market-oriented figures both in the political sphere and in the field of economics. On the other hand, the new East German government would be in a position to make use of large amounts of West German expertise free of charge. Such a GDR government would also have the inestimable advantage of being able to take over the greater part of the West German model. However, it would have to be prepared to weather the inevitable disputes and struggles itself.

□ One unknown quantity is the degree of acceptance of the market economy, the "restoration of capitalism", among the people of the GDR. Even if those parties which clearly state their allegiance to it are given a clear majority, it would be wrong to assume that there is a very broad understanding within the GDR of the conditions under which the market economy functions. The citizens of East Germany have been subjected for too long to rigorous anti-market-economy propaganda, and there is too great a fear of the necessary liberalization measures and too much anxiety about the inevitable sacrifices which will need to be made during the transition phase. Nevertheless, acceptance of the market-economy solution could be improved by effective public information. This would need to make it clear to the citizens of the GDR that the social market economy bears little resemblance to the distorted image of West German "capitalism" which has been painted by GDR propaganda over the course of 40 years, and also that the supposedly "socialist" values and objectives underlying social policy, which were so often spoken of after the dramatic events of last autumn, are in truth not so very different from those of our own social market economy.¹¹

□ The phase of institutional restructuring has already begun in the GDR. However, the changes in the legal structures are not nearly rapid or far-reaching enough, and certain quite crucial institutional preconditions for the transition to the market economy are missing altogether.

This is where a very important distinction shows up between the initial position in the GDR on the one hand and West Germany at the end of the 1940s on the other. In the Western zones in the post-war years, a

¹¹ It should be borne in mind that "state ownership of the means of production" and "planning" are not in the strict sense goals of socialism, but were conceived originally as the means to achieve more fundamental objectives.

microeconomic structure appropriate to competition was still completely intact: it consisted of tens of thousands of independent enterprises of all sizes, headed by proprietors and managers who generally had a sound knowledge of business economics, were characterized by an entrepreneurial way of thinking, were prepared to take risks and eager to make profits. In the GDR today there are approximately 220 state combines, which mainly have monopolies over their respective areas; they are under state ownership and have therefore been accustomed for several decades to soft budgetary restrictions; their management is largely uninformed and inexperienced in matters of corporate finance, marketing, business accounting, exporting and importing, etc.

Another missing element is that of a two-tier banking system; the GDR's national bank is not autonomous, nor is it able to exercise flexible control over the money supply; nor again is it likely that the commercial banking system will be able to take on all the functions a banking system needs to fulfil in a market economy. If, as is proposed, the D-mark replaces the Mark as the currency of the GDR and Federal German banks are permitted to trade there, this problem will solve itself. Even so, the currency conversion still needs to be properly organized, and this too takes time.

A cut in the currency will not be necessary in the GDR. Nevertheless, there is still no genuine unemployment insurance there, pensions are far too low and other elements of the modern welfare state are also absent. During the preparatory phase for the transition to the market economy, the GDR will therefore have to switch from its system of price subsidies to one of individual support, adapting pensions and wages accordingly and expanding the welfare safety-net.

The problem here is that the GDR has very little time available during which it can carry out the preparatory phase before the big bang. However, a determined GDR government would be able to make a virtue out of necessity and, as far as possible,¹² simply take over West German commercial law, which would simultaneously establish the harmonized commercial law necessary to prepare the way for an all-German economic union.

¹² That is, of course, in a partly simplified and/or improved form! There would be little point, for example, in the GDR copying our complex regulations on income tax in all their detail.

¹³ A fuller account of our concept of system transformation in the GDR is provided in the HWWA-Report No. 82 which appeared in mid-February; cf. Dieter Löscher and Peter Plötz: *Soziale Marktwirtschaft – Jetzt, ein Konzept für die Systemtransformation in der DDR*, HWWA-Report No. 82, Hamburg, February 1990.

The transformation of the state combines into autonomous enterprises subject to hard budgetary restrictions, which will be indispensable, will undoubtedly also take time – all the more so as a valuation would first have to be conducted and at the same time deglomeration would have to be begun.

The release of price and wage controls could be prepared gradually during Phase I by a reduction in price subsidies and rapid corrections to the distorted price structure. The same applies to the liberalization of "external" trade with West Germany.

□ All in all, it would not seem so impossible that the GDR could work through the preparatory phase for a big bang within a relatively short time. Following that, with the one-off action of completely freeing prices, liberalizing foreign trade and establishing currency convertibility on a target day not too far from now (perhaps on 1st January 1991), the market economy would be able to function in the GDR.

□ The transformation process, though, would still not be complete by a long way. Admittedly, once the deadline day for the introduction of the market economy had passed there would most probably be an immediate, strong inflow of West German and foreign capital into the GDR. This would go hand-in-hand with the transfer of technical and management know-how and would doubtless also at least reduce the westward migration of human capital and indeed counteract it by eastward migratory movements.

But on the other hand, there could be an immediate, strong upward trend of prices, and it would not take long before large-scale redundancies took place, which would inevitably also mean unemployment.

All this would confront the GDR's economic policy with very severe problems. It is extremely doubtful whether it would be able to solve these on its own. However, because it can be sure of the Federal Republic's assistance during this phase by giving material support to structural adjustment in the infrastructural sphere and providing back-up of a social nature, it appears by no means impossible that the ship of the GDR economy could be steered into calmer waters after a few transitional years.

To sum up this comparison as a whole, then, one must always remember that the same situation, whether in history or in economic history, never repeats itself exactly. Yet if the right lessons are learned from Ludwig Erhard's historic act and these are applied appropriately to the current situation, it is quite possible that we may witness a second German economic miracle.¹³