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Paul J. J. Welfens\*

## German Unification in Perspective

*When German unification took place in 1990, the government was optimistic that the process of closing the economic gap between the two Germanies would be a brief one. However, economic unification has turned out to be more costly and much more complex than anticipated. But on the other hand it is equally true that some problems have been tackled with remarkable success, especially privatization. For the reforming of eastern Europe there are several interesting aspects in these developments.*

When Germany was facing unification in 1990, the Bonn government expected the problems with respect to integrating the former GDR into West Germany's politico-economic framework to be limited. Monetary unification on July 1, 1990 replaced the nonconvertible East German currency with the Deutsche Mark, and this was perceived as the basis for economic recovery in East Germany. Incomes and pensions were exchanged at a rate of 1:1, as were most savings, while the black market exchange rate had been about 7:1 and the internal exchange rate for export industries 4:1; assets and liabilities were exchanged at 2:1, but liabilities implied a much higher debt burden, namely high West German interest rates (8-9%) instead of the previous 3% in the GDR. With the West German currency coming to East Germany, there was hope that the westward migration of East Germans could be stopped, economic confidence restored and the economy stabilized. Actually the East German economy continued its collapse and in the autumn German unification took place. The inward-oriented East German economy with its 16.5 m. inhabitants (20% of the all-German figure) was integrated into the much bigger West German economy, where per capita incomes were about four times as high as in the former GDR, where export/GNP ratios were almost twice as high and where thriving two-way foreign direct investment reinforced integration into the world economy.

At the date of political unification, October 3, 1990 it was widely expected that closing the East-West income gap in Germany would take less than a decade. In July 1990 the financial resource transfer to eastern Germany was estimated by the government at about DM 35 bn. annually (\$ 20 bn. or 1.4% of West Germany's GNP). Moreover, few changes were expected with respect to Germany's pro-integration policy stance in the EC. Financial transfers have in fact been much higher – by a factor of 4 in 1991, or

5% of West Germany's GNP – and the expected time-frame for closing the intra-German income gap is now two decades rather than one.

Unification problems could change Germany's traditional international economic role and affect its industry in many ways. Traditionally, the FRG was an advocate of free trade policy and – at least in the 1980s – was a considerable net exporter of capital (equivalent to a current account surplus); there was a clear pro-EC integration policy stance and a well-established joint EC leadership along the Bonn-Paris axis, and in a broader sense also an intra-EC balance of power among Germany, France, Italy and the UK, whose GNPs and population figures were similar. The FRG was a strong supporter of transatlantic cooperation and played an important role in Eastern Europe, namely in the context of detente policies following Brandt's Ostpolitik, which tried to use West Germany's highly exposed position in central Europe as a starting point for East-West cooperation. The West German economy enjoyed internal politico-economic stability, prosperity and low inflation rates in the period 1960-1989.

Unification raises new problems for a new Germany. Taxes were increased already in early 1991 – a few months after the first all-German election – and actual and anticipated transfers to eastern Germany increased sharply: DM 140 bn. in 1991 and an estimated DM 180 bn. in 1992. Almost three-quarters of all transfers are for public consumption or social expenditure, so that transfers only marginally create economic benefits and higher future taxes.

While east Germany has a population of 26% of that of west Germany, output was only 8% of that of west Germany in 1991, but due to west German resource transfers wage rates have already reached 60% of those in west Germany. In 1989 productivity in eastern Germany was between one quarter and one third of that in western Germany and at the aggregate level productivity has only

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slightly increased since unification. Only with high east German per capita investment and continuous retraining of the labour force can the intra-German productivity gap be closed. Eastern German unemployment rates have increased from 1.6% in mid-1990 (when monetary unification took place) to 17% in the first quarter of 1992; moreover, including those on short-term work and in retraining schemes, the effective unemployment rate is close to 25%, which is not surprising in view of the sudden exposure of the east German economy to world market competition (without domestic wage restraint).

Given the huge pent-up demand in eastern Germany, most observers expected that German unity would benefit both western and eastern European countries in their role as suppliers of consumer and investment goods as well as intermediate goods. Indeed, German imports did rapidly increase in 1991 while exports stayed almost level, so that the all-German economy recorded a current account deficit: west Germany's high current account surplus, which had hovered between 3 and 5% of GNP in the period 1982-89 suddenly switched to a negative position that could aggravate during 1992 if EC partners' economies do not rebound. Moreover, with (west)Germany's inflation rate switching from below EC average to EC average (or above), one can no longer count on the silent real depreciation that used to stimulate the FRG's net exports to the EC. Germany is no longer a net exporter of capital, but increasingly uses foreign savings and could indeed in the mid-1990s join the USA with its twin budget and current account deficit.

With wage increases way ahead of productivity growth in eastern Germany, the Bonn government has to subsidize industrial investment heavily in the former German Democratic Republic. There is a subsidy rate of about one third for each DM invested by private investors in eastern Germany. As opinion polls showed in 1991, investment planned by west German firms often could not be realized in eastern Germany because administrative bottlenecks and legal problems with the acquisition of firms caused delays.

The EC Commission, which is partly in charge of competition policy and can block competition-distorting subsidies in EC member countries, is closely watching the enormous subsidization of investment in eastern Germany. Certain EC member states like Portugal, Spain and Greece are afraid that high German investment subsidies for eastern Germany will lure away foreign direct

investment that otherwise would help the southern EC member countries to catch up with average EC per capita incomes. When the Maastricht summit introduced an additional EC fund for regional policy (ECU 2.6 bn. annually), which would primarily benefit Portugal, Spain, Greece and Ireland, but also part of eastern Germany, the Bonn government had no serious arguments against it.

If high investment expenditure by east German firms in east Germany reinforces the rising amount of west German investments in the former GDR, one may hope for a small economic miracle in east Germany. However, for the all-German economy an east German economic miracle would be of only partial relevance because the strength of the west German economy – nine times as large as that of eastern Germany – is decisive for economic growth and prosperity in the economy as a whole. Strong economic growth in Germany would help other EC members and it would support political stability in Germany where an intensified struggle for income is expected if the economic cake does not grow fast enough. The deceleration of west German economic growth in 1991/92 is alarming: from 4.5% in 1990 it fell to 3.2% in 1991 and is expected to reach about 1-2% in 1992; taking into account the fact that the west German labour force has increased by about 1.3% between 1988 and 1992, per capita growth indeed looks moderate. East Germany's GDP is expected to grow at 10% annually over several years, but for the all-German performance, growth in western Germany is decisive.

### **Inflation Problems**

Monetary stability in the sense of low inflation rates and internal social consensus built upon economic prosperity, full employment and a modern welfare state were the trade mark of West Germany in the 1970s and 1980s. For historical reasons, namely because of the hyperinflation of 1923 and because of the post World War II currency reform which effectively wiped out the bulk of citizens' savings, Germans have developed a high sensitivity for inflation. However, the short-term problem for most east Germans is unemployment, where the number of short-time workers – often benefitting from transitory wage subsidies – was reduced by 500,000 in late 1991 when the short-term workers joined the already unemployed as job-saving programmes were phased out. By April 1991 net output in the producing sector had reached the bottom line, namely an index of 59.4 (1989 3rd quarter = 100) so that the reduction of industrial output by more than one third within one and a half years explains the surge in the east German unemployment rate. However, with 17% in January 1992 the peak level seems to have been reached. Product assortments as well as technologies require radical improvement in the new competitive environment.<sup>1</sup>

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<sup>1</sup> This time-consuming adjustment could make a case for transitory wage subsidization; cf. G. A. Akerlof et al.: East Germany in From the Cold: the Economic Aftermath of Currency Union, Brookings Papers on Economic Activity, 1991.

German unification is characterized by some rapidly successful developments as well as a host of problems. German monetary union was well organized and quickly accomplished, namely on July 1, 1990 when the West German currency, Deutsche Mark, became legal tender in the GDR, too. The Bundesbank faced some technical problems and indeed overlooked part of the East German money stock, so that instead of a planned increase of the all-German monetary stock of 10% a rise of almost 15% occurred. Given the fact that East German GNP was estimated to be about 10% of the West German GNP, a minor inflationary impulse could have resulted from currency unification, but one should take into account that unification certainly raised permanent (long-term expected) incomes in the former GDR; since permanent, not momentary, real incomes determine the demand for money it seems unlikely that monetary unification strongly contributed to inflationary pressures in Germany. However, monetary policy has become more difficult to tighten since the Bundesbank directly controls only the monetary base and can affect the loan market only indirectly; credit demand has shown a sustaining increase despite higher real interest rates.

Given the political need for economic restructuring in eastern Germany and the very important role of government expenditure in both western and eastern Germany – and those outlays are hardly interest-rate elastic – a given increase in the monetary base leads to a stronger expansion of broad monetary aggregates than before: M3, the target monetary aggregate of the Bundesbank is comprised of cash and bank deposits, savings at statutory notice and time deposits, and certainly a rising share of credit-financed expenditures will contribute to a rise in bank deposits.

Sustained westward migration and a wave of asylum seekers as well as immigrating ethnic Germans from eastern Europe have led to housing shortages in Germany, higher rents and stronger claims for nominal wage increases. With 25% of incomes in western Germany spent on housing, rising rents are crucial and certainly add to the new conflicts over income distribution and burden-sharing. In 1989 the German inflation rate was 2.7%, but in early 1992 4.5% was exceeded and wage negotiations faced a stalemate. West Germans have always been very sensitive to inflation rates higher than 2%, and this explains deep concerns about monetary stability – in west Germany, while east Germany's priority is lower unemployment rates. Facing an inflation rate of 4-5% in 1992, nominal and real interest rates increased in Germany and – via the EMS system – in the whole of Europe. With the need to finance record deficits, the Minister of Finance – as all his EC colleagues – would

prefer to see lower interest rates, whereas the Bundesbank (promising a declining inflation rate in 1992) is keen to maintain interest rates at a high level in order to curb inflation. The traditional consensus between Bonn and Frankfurt has become fragile in the aftermath of German unification. Compared to 1990 the amount invested by foreigners in German government bonds in 1991 has tripled, and this could imply a greater role of exchange speculation in capital flows to Germany, which would then face higher interest rate volatility. With short-term interest rates in 1992 much higher than long-term rates a German recession seems to be unavoidable. A recession could compound the problems of Germany's fiscal deficit and public debt, the dynamics of which are determined more by expenditure at the level of the Länder and in the municipalities than by the federal government.

The Deutsche Bundesbank declared that it was adopting a restrictive policy course in 1991 when it became clear that accelerated wage increases, the demand boost for western firms after unification and ample liquidity had created the potential for a surge in the west German inflation rate. M3 was to expand by 3.5 to 5.5% between the last quarter of 1991 and the fourth quarter of 1992, but monetary growth seems to be way above target. The west German inflation rate reached 3.5% in 1991 and is expected to reach 3-5% in 1992-94: as of 1993 higher value-added tax rates will raise the recorded inflation rate by half a percentage point and, in the long term, by almost a full percentage point.

Average savings rates of west German households increased by almost a full percentage point after German unification: from 13% of disposable income to some 14%. Deficit/GNP ratios are high not only in Germany, but also in Italy (10% of GNP) and, most recently, in the UK where for 1992/1993 an increased deficit ratio of 4-5% is expected. Since the US deficit/GNP ratio remains high at 3% (5% for general government) the OECD country group is facing sustained public credit demand that reduces the potential for lowering interest rates even in a period of slow growth. With a depressed Tokyo stock market and new financial problems for firms and banks in Japan, capital outflows from this country will decline and in any case will be available only at higher real interest rates.

### Successful Privatization

The switch from a socialist economy with its huge state-owned industry to a market economy requires comprehensive privatization. Socialist economies in Eastern Europe were characterized by oversized plants and firms (with a strong emphasis on static economies of scale/advantages of mass production), but also by a bias

in favour of heavy industry and the neglect of modern service industries. In 1989 the output structure of East German industry was similar to that in Western Germany in 1965, and this points to an enormous need for structural change on the one hand. On the other hand there is a need for privatization along with a reduction in the size of firms: in Western Germany employment in firms with less than 500 employees represented two thirds of all jobs, while two thirds of employment in the GDR was in firms with more than 500 employees. For that latter group of firms the Treuhandanstalt (THA) – as the institution in charge of privatization in east Germany – has set up supervisory boards. Most members on these boards are from west German firms or banks; more than 3,600 people from the west serve on supervisory boards and about 2,600 western business men are on the management boards of THA firms.

The privatization of whole industries and, actually, a whole economy implies a considerable strain for the capital market; and, of course, privatization on the envisaged scale requires enormous efforts on the part of the privatization agency. Starting with about 8,000 state-owned firms the German THA (which is under the supervision of the German Ministry of Finance) aimed to unbundle assets, to sell companies and to organize the spin-off of more easily digestible firms, especially firms from the huge industrial combines that had been set up in the GDR. The number of firms increased thereby to some 11,000 in early 1992; about 600 firms were closed. The closing down of non-profitable firms could be accelerated if job creation by newly established enterprises were supported more strongly by the federal government, regional governments and the banking community. There have been more than 500,000 new businesses established within 2 years after unification; however, the failure rate will be high – in western Germany only 50 out of 100 newly created firms survive the first five years and then the average number of persons employed is 5.5. This means that the creation of a significant number of new jobs in the medium term can only be achieved if the setting-up of new businesses is begun early and takes place on a considerable scale.

Successful privatization required the considerable slashing of the payroll, so that the number of employed in the initial THA firms fell from 4 m. in mid-1990 to about 2 m. in 1992. Low prices were accepted by the THA in many cases in exchange for guarantees for future employment and investment, with contracts providing for penalties to be paid to the THA if promises concerning employment and investment are not kept. Hence the THA organized privatization with many strings attached. The fact that the index of producer prices of industrial products (domestic

sales)<sup>2</sup> fell from 100 in 1989 to 62.1 at end-1990 and stayed at 63 in 1991 indicates that firms came under strong pressure to rationalize and thereby reduce costs, but also to upgrade and diversify the product assortment. This holds all the more as east German labour productivity increased only slowly from one quarter of the west German level in 1989 to about one third in 1992.

The THA has succeeded in completing within 2 years the whole subset of so-called small privatization in trade and in the service industry; furthermore, by mid-1992 more than 50% of the 12,000 east German industrial firms have been privatized; mostly within a framework that is compatible with theoretical considerations concerning privatization and competition, focusing on the privatization of whole branches of industry. This successful approach to rapid privatization is in marked contrast to the very slow pace of privatization in other ex-CMEA countries, most notably Poland.

With half the firms privatized in eastern Germany the more difficult other half is left for restructuring, liquidation or rapid privatization. The latter will become more and more difficult, while liquidation will face political problems stemming from the fact that unemployment rates in eastern Germany have mounted to 16% by the first quarter of 1992. One may well live with a 15-20% unemployment rate if one is used to a structural unemployment problem and if the shadow economy offers considerable opportunities for jobs and income – as used to be the case in Spain or Portugal. However, in east Germany, as in the other former CMEA countries, people are not used to unemployment.

In the former GDR prices – previously fixed at arbitrary levels – have increased by about 20% in the period 1989 to end-1991; however, nominal wages rose by almost 60%, so that hourly real wages increased strongly. But with declining participation ratios, reduced working hours and women often having lost their former jobs, real family incomes are often lower than before (while aspiration levels continue to increase as people become more “westernized” in their attitudes). East German households which used to spend about 3% of their income on housing all face the prospect of much higher rents; the government provides increasing housing allowances which in turn add to budget problems.

With the rapid privatization of so many assets in eastern Germany the net revenue from sales proceeds is limited. Since west German investors absolutely dominate the acquisitions and greenfield investments in eastern Germany, it is clear that mainly west German savings are

<sup>2</sup> Figures are taken from Deutsche Bundesbank (1992), Monthly Reports, Tab. VIII. 10, current issues.

the financial basis for the demand for assets in east Germany. West Germany's net savings rate is about 10% and has increased only slightly since unification. Asset prices in eastern Germany have been depressed by legal uncertainties and the need for restructuring on the one hand, and on the other hand increased real interest rates in the all-German economy have reduced the value of all real assets. With credit-rationing, an acceleration of privatization would indeed further depress asset values.<sup>3</sup> The net worth of the THA firms is put at no more than DM 30 bn. in a recent brochure by the German Ministry of Finance, and the possibility – probably quite realistic – is mentioned that ultimately liabilities might turn out to be greater than the value of assets.<sup>4</sup>

### Budget Problems

The merging of two economies as distinct as the Federal German market economy and the former GDR's planned economy raises many problems for both Germany itself and the whole of Europe. With the German monetary union of July 1, 1990 east German industry became almost fully and immediately exposed to international competition. By world market standards many products and technologies were outdated, so that unification implied an enormous need for rebuilding the capital stock, upgrading the infrastructure and building a social network comparable to the established standards in western Germany. High public spending is crowding out private investment and adding to inflation.

The resource transfer to eastern Germany amounted to almost DM 150 bn. in 1991, which was about 70% of national income in the former GDR. For western Germany, the other side of the coin is a high budget deficit. There was a jump from an almost balanced budget in 1989 to a deficit/GNP ratio of 3.1 in 1990 and to 4.5 in 1991. The figures for 1991/92 are still below the record 1975 figure of 6.5% (after the OPEC shock); however, for the world economy it is a new situation that both the USA and Germany are running high budget deficits, while Japan's current account surplus could decline, especially if sustained US pressure and a domestic recovery reduced export growth and stimulated import growth in the 1990s. Moreover, real interest rates in Germany stood at 5% in 1990 and are expected to remain high. With highly integrated international financial markets and increasing mobility of real capital the high public demand for credit raises real interest rates in the whole of Europe and can contribute in the 1990s to higher interest rates worldwide.<sup>5</sup>

Higher interest rates mean considerably lower asset values, and some wealth losses in the EC as a whole should not only widen the gap between per capita wealth and personal wealth targets, but indirectly stimulate higher

savings. High real interest rates make the modernization of the outdated capital stock not only more expensive in eastern Germany, but in those east European economies which are opening up too. With capacity for matching high capital costs with a high rate of innovation (a high real return on investment) limited, the prospects for high and sustained private investment are moderate.

### Bottlenecks and Economic Divergences

The desperate state of public administration in eastern Germany was quickly improved by west German Länder dispatching junior and senior civil servants to the former GDR. Administrative bottlenecks were thereby reduced relatively quickly. The non-existence of language barriers was also helpful in organizing training and retraining in facilities of both west Germany's administration and industry. Finally, the crucial management factor, which is at a premium in all transforming ex-CMEA countries, did not become a long-term bottleneck since younger managers could be motivated to go east and many retired managers from the west were reactivated. Moreover, with almost exclusively west German firms buying into east German industry, firms in the former GDR became part of a functional network of west German firms. Nevertheless, the restructuring and modernization of east German industry is progressing only gradually as the 54% ratio of imports to final demand in the former GDR (more than double the west German figure) in 1991 showed – in contrast to a ratio of just 18% in 1989; while east Germany's output had fallen by a third in the period 1989-1991, final demand for capital goods and consumption increased by 27%. Almost 60% of east German incomes were financed by west German income transfers in 1991 and similar figures can be expected for several years to come. Public investment plays a very decisive role in the former GDR: the ratio of public investment to private investment is about 4:1 in eastern Germany, whereas in west Germany the ratio is 1:4. After a decade of rebuilding and upgrading the east German infrastructure, the ratio of eastern Germany should come down to that of west Germany.

On the productivity side it will take at least a decade to close the intra-German gap. Moreover, the gap is even bigger in terms of per capita wealth. Overall monetary

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<sup>3</sup> Cf. on this problem G. Sinn and H.-W. Sinn: Kaltstart. Volkswirtschaftliche Aspekte der deutschen Vereinigung, Tübingen 1991.

<sup>4</sup> German Ministry of Finance: Treuhandanstalt, Bonn 1992.

<sup>5</sup> Figures refer to Deutsche Bundesbank: Monatsberichte der Deutschen Bundesbank, July 1991. Real interest rates are calculated as nominal yield on domestic bonds outstanding minus the inflation rate (change in the cost of living index for all households) of the previous year.

wealth in western Germany amounted to some DM 2,700 bn. in 1990, while private households in the GDR had DM 130 bn.<sup>6</sup> While the east German population represents 20% of the all-German population, the output of the former GDR reached only 8-9% of west Germany's production in 1990, but even more striking was that monetary wealth was just 4.8% of that in west Germany. It will take at least a generation, if not much longer, to close the intra-German wealth gap, which indeed might be higher – evaluated at market prices – than suggested by the official statistics.

As regards German unification one should distinguish between some short-term problems that will be solved over time quasi-automatically and the more stubborn medium-term and long-term problems that will face the German politico-economic system for a decade or more. Major policy pitfalls are among the medium-term challenges, because they are difficult to reverse. The three impediments to a rapid and "cheap" east German reconstruction which emerged in the early stage of the unification process can now hardly be removed:

□ As regards the extent of reconstruction required in eastern Germany and the amounts needed to finance the closing of the economic gap, the German government and many experts significantly underestimated the problems early on, with the result that much too optimistic expectations were nurtured in the early stage of unification in 1990/91. The later disappointment was all the greater and the reduction in political credibility meant that more drastic measures had to be adopted. Moreover, increased uncertainty reduced the amount of profitable investment in the whole of Germany. Disappointment may have compounded psychological adjustment problems in the east German population, where many feel they are on the losing side in the process of political unification.

□ Money wages are increasing faster than productivity in eastern Germany, and this is mainly due to the lack of a private business sector, which would have resisted unions' aggressive wage demands with much more resolve than that actually shown by the representatives of west German employer organizations in charge of negotiating wages in 1991/92. Unions were naturally aggressive in east Germany and eager to prevent too high an east-west wage gap that would undermine their position in future wage negotiations in west Germany. Representatives from west German employer organizations had no active interest in resisting excessive wage claims and might even have considered high wage increases in east Germany as a good strategy for checking the potential of future market

entrants and newcomers from the former GDR. Only if the "concerted action" (a formerly popular tripartite institution comprising labour, employers and government) had been revived in the early phase of unification would there probably have been a chance of avoiding excessive wage growth in the first critical years of economic reconstruction.

□ Applying the principle that restitution goes before compensation (as set out in the Unification Treaty) might have its merits in terms of justice and ideology, but from an economic point of view it is the most costly west German input to unification. With about 1.2 million claims faced by east Germany there are abundant and complex legal uncertainties with respect to industrial ownership rights and property rights of real estate. It will take more than a decade to sort out these problems and determine the ultimate owners of 2 m. contested properties.

### Medium-term Problems

Unclear property titles constitute legal uncertainties which will impair investment over many years. Moreover, these uncertainties will also raise the risk premium on investments in eastern Germany. Legal uncertainties sharply reduce the amount of profitable investment and thereby slow down both the modernization of east Germany and the prospects for an endogenous process of catching-up economically. Hence much more public investment and much higher subsidies for private investors are needed to generate the required amount of capital investment in the former GDR – the side-effect being increased fiscal deficits and therefore higher real interest rates, which in turn reduce investment in capital equipment as well as in the housing sector. Housing shortages contribute to rising rents and *a fortiori* to higher wage claims which in turn could feed into higher inflation rates, or, with the Bundesbank adopting monetary restraint policies, into a recession (already triggered by declining investment growth in west Germany).

The three policy pitfalls mentioned above were compounded by the disintegration of the former Council of Mutual Economic Assistance and the USSR. While systemic transformations to a market economy are welcomed by Germany on political grounds, the negative economic fall-out from the economic crisis and disintegration of eastern Europe creates economic problems and uncertainties for the new Germany.

The consistently negative current account balance in every month of the first half of 1991 indicates the considerable swing in Germany's net export position after unification. Germany accounts for roughly 10% of world trade and changes in German trading patterns therefore

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<sup>6</sup> Deutsches Institut für Wirtschaftsforschung: Die Vermögens-einkommen der privaten Haushalte in der Bundesrepublik Deutschland 1990, DIW Wochenbericht, Vol. 58, 31/1991.

have considerable international effects. The main winners on the import side were the EC partners (EC: + 10.8%), in particular Belgium/Luxembourg, Denmark, France, Portugal, Spain and Italy. At the same time eastern European exporters recorded high growth rates since west German imports from this region increased by 17.8% over 1989 levels. The USA recorded lower exports to western Germany, but one may assume that US firms mainly benefitted via increased deliveries by EC subsidiaries to Germany. US sales in the EC are six times as high as US exports to the EC.<sup>7</sup>

Germany's foreign direct investment has increased, while inflows have decreased after unification – the latter development pointing to reduced locational advantages of the new Germany. In the long term, German investment abroad could increase if unification, and thus a bigger domestic market, allows German firms to develop more quickly firm-specific advantages, which are the basis for producing abroad despite the natural advantage of indigenous producers.

The inflow of foreign direct investment into Germany could remain low, but investment in EC partner countries could become increasingly important for German firms facing sharper global competition while labour costs are increasing quickly at home and the social consensus is weakened. German investors in eastern Europe will certainly try to exploit opportunities for labour-intensive production in a region where wages are expected to remain relatively low while productivity could be raised considerably.

### East European Transition

With the military and political threat from the USSR no longer existing, Germany's economic and foreign policy will enjoy a higher degree of freedom in Europe. If nationalistic tendencies gain influence in Germany in the 1990s the EC will become less attractive as a supranational institution for framing Germany's policies. Industrial rivalries between Germany, France and the UK could also lead to conflict (e. g. Renault versus Volkswagen in the Skoda deal in the CSFR): foreign direct investment and trade in a gradually prospering eastern Europe could become fields of fierce competition. However, a smaller role by state enterprises – due to privatization schemes – in all major EC countries will

reduce the danger that state-owned or state-dominated firms from major EC countries will be the main players in commercial rivalry in eastern Europe and thereby translate business rivalry into political conflict. Moreover, the emergence of "Euronationals", which is a relatively new phenomenon much related to the formation of the single EC market, could entail new opportunities to jointly exploit investment and trade options in eastern Europe.<sup>8</sup>

Germany has so far contributed almost ECU 36 bn. of a total of 63 bn. in international financial support for the CIS. According to the EC Commission, Germany thus accounted for more than 50% of all financial support (not all funds were already disbursed). In the period September 1990-January 1992 other EC countries gave ECU 12 bn., while the USA gave 4.1, Korea 2.2 and Japan 2.0 bn. for the CIS.<sup>9</sup>

Strong support for the CIS gives Germany an overproportional influence in eastern Europe but the very uneven burden-sharing in the EC also indicates the diverging commercial and political interests of the leading EC countries. Here, eastern European developments and dynamics could lead to increasing intra-EC conflict and to declining EC coherence.

The united Germany is naturally involved in the east European transition. First, this transition means modernization of the capital stock and west Germany is Europe's major producer and exporter of capital equipment. Second, this transition involved the break-up of the CMEA which lost its most western member country, the GDR, to the united Germany. Since the GDR's foreign trade had been dominantly oriented towards CMEA countries, German unification implied that part of these trade relations would be inherited by the new Germany. With the German currency union of July 1990 the labour intensive industries in the former GDR were no longer competitive in eastern Europe, where the switch to hard currency settlements generally encouraged a reorientation of imports in favour of new supply sources. The west German government and the THA subsidized part of the traditional east European exports of east German firms in order to save jobs and buy time for the restructuring process. East Germany's share in total German exports is only 3%, but it could increase in the 1990s. Because of its geographical proximity, east German industry will benefit greatly from a sustained transformation and modernization in eastern Europe. However, it is very unlikely that Russia will again become one of Germany's top four trading partners, as it was the last time the whole of Europe was a market economy: in 1913. Table 1 gives some historical figures; Germany's trade with the USSR reached not more than 2% of total German exports and

<sup>7</sup> On USA-EC economic relations see G. Hufbauer (ed.): *Europe 1992. An American Perspective*, Washington D. C. 1990; M. Klein and P. J. J. Welfens (eds.): *Multinationals in the New Europe and Global Trade*, Heidelberg and New York 1992.

<sup>8</sup> Cf. M. Klein and P. J. J. Welfens (eds.), *op. cit.*

<sup>9</sup> IWD (1992), *Deutschland gibt am meisten*, IWD Mitteilungen No. 10, March 5, 1992, Cologne.



imports, which suggests some potential for a future increase, but only in the long term and possibly after a temporarily declining share.

### Return to Historical Trading Patterns?

The last time the whole of Europe was a market economy, in 1913, Germany's regional trading pattern was quite different from that prevailing in western Germany on the eve of unification. In 1913 Russia – then comprising part of what today is Poland – accounted for 13.2% of German imports; on the German export side it was 8.7%. Both figures are in marked contrast to the figures of 1989 when the Soviet shares in German exports and imports amounted to 1.7% and 1.8% respectively. Adding to these shares the figures for Poland, namely 0.7% for both the export and the import side, does not change the impression from Table 1 that eastern Europe's position with regard to Germany was much stronger before World War I than it was in the late 1980s.

Even if eastern Europe transforms into market economies, a return to the pre-World War I trade pattern is not to be expected. The emergence of Japan as a leading trading partner and the significant role of the NICs cannot be overlooked. This, of course, does not rule out that east European exports to Germany and the whole OECD area could strongly increase during the 1990s.

In 1991 the united Germany was the most important

trading partner of Russia, Poland and Hungary, and the CSFR could follow as soon as trade with the ex-USSR further decreases. The east European economies will reorient the focus of their infrastructure – looking much more westward, namely towards Berlin and Brussels, rather than looking towards Moscow. Except for Hungary, where US firms are leading the list of foreign investors, Germany is the most important source of foreign direct investment in eastern Europe.

German economic policy is likely to actively promote the export of the German market economy model. The Deutsche Bundesbank already serves as an institutional model for setting up new central banks within two-tier banking systems in eastern Europe. With some of the Treuhandanstalt's 15 regional offices closing after small and medium firms have been privatized, the successful management could try to use their experiences and acquired know-how for setting up consulting firms in eastern Europe or the German government could actively encourage Treuhandanstalt teams to go east, especially to the Commonwealth of Independent States. Germany could, via active support for privatization in the former USSR, exert a strong influence that would ultimately benefit German industry and give German foreign economic policy a much stronger influence than ever in the past 45 years. Germany could then indeed become a dominating power in central Europe – a development that other EC countries could prevent only by actively supporting their industry to take a greater role as investors in eastern Europe. Eastern Europe's modernization and structural adjustment is impaired by high European real interest rates; moreover, this will make capital flow liberalization in the former CMEA countries quite difficult. High productivity gains in eastern Germany without very high investments show Eastern Europe how crucial the management factor for the reorganization of industry is. Indeed, the dismemberment of firms in the course of privatization would make limited sense if national and international programmes did not help to reduce the management bottleneck first. Foreign investors can play only a limited role in the whole restructuring process and few countries – possibly Hungary and the CSFR – could expect that more than 10% of gross capital formation would be accounted for by FDI.<sup>10</sup> East Germany also shows the importance of a functional institutional system for which not only west Germany but the EC could give some orientation for eastern Europe. Very much needed is a convertible and strong currency since this – together with competition – is the institutional basis for efficient market allocation.

Table 1

### The Direction of German Trade, 1913 and 1989<sup>1</sup>

(shares of merchandise trade with selected countries in percent)

	Country Share in German Imports		Country Share in German Exports	
	1913	1989	1913	1989
USA	15.9	7.6	7.1	7.3
Russia <sup>2</sup> (Poland)	13.2	1.7	8.7	1.8
Great Britain	8.1	6.8	14.2	9.3
Austria- Hungary <sup>3</sup> (CSFR)	7.7	(A) 4.1 (H) 0.5	10.9	(A) 5.5 (H) 0.6
France	5.4	11.9	7.8	13.2
Italy	3.0	8.9	3.9	9.3
China <sup>4</sup> (Taiwan)	0.7	1.1	1.2	0.7
Rumania	0.7	0.3	1.4	0.1
Serbia <sup>5</sup>	0.1	1.3	0.5	1.1
Japan	0.4	6.3	1.2	2.4
Bulgaria	<0.1	0.1	0.3	0.2

<sup>1</sup> figures for 1989 are for west Germany.

<sup>2</sup> figures for 1989 refer to the Soviet Union.

<sup>3</sup> figures for 1989 are comprised of the country shares of Austria, Hungary and the CSFR.

<sup>4</sup> figures for 1989 refer to the People's Republic of China.

<sup>5</sup> figures for 1989 are for Yugoslavia.

Sources: Statistisches Handbuch für das Deutsche Reich, Vol. II, Statistisches Bundesamt and Deutsche Bundesbank, own calculations; adapted from: P. J. J. Welfens (ed.): Economic Aspects of German Unification, New York 1992.

<sup>10</sup> Cf. P. J. J. Welfens: Market-based Systemic Transformations in Eastern Europe, New York (forthcoming).