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## Eastern Germany's quality as a business location

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kind can offer some degree of creditor protection only if the central bank is made completely independent from political directives.<sup>24</sup> However, even central-bank independence does not in itself guarantee that monetary policy will be oriented towards stability; its mere existence does not automatically give economic agents a high degree of confidence in their own currency. For this reason, an independent Russian central bank that had to use the classical instruments of a fiat money system would first have to earn the trust of economic agents over a fairly long period by pursuing a stability-oriented monetary policy.

### **Conclusion**

The IMF reform proposals for the rouble do not offer much by way of credibility; in terms of transparency and creditor protection, the IMF plan is little better than a classical gold standard with a fixed gold parity. A modified gold standard along the lines proposed by Irving Fisher or a currency board system are both superior to the IMF

concept in this respect. Large question marks also remain over the concept's ability to meet the competence requirements. Basically, it stands and falls on the ability of the IMF to persuade the Russian Government to accept its ideas. It also presupposes that the traditional instruments of a fiat money system can be applied quickly, and that they will bite. However, it is doubtful whether these preconditions can be met quickly and effectively.

For these reasons it is important to consider alternative concepts as well. With a currency board system or a gold standard à la Fisher, credibility and confidence in the monetary and exchange rate policy of the rouble zone could be generated very quickly. Even if one acknowledges that the gain in credibility is bought at the cost of a possible loss of flexibility,<sup>25</sup> and that over the long term a fiat money system is superior from the economic point of view, this is by no means at odds with an interim solution for the extremely delicate phase of the transformation process in the former Soviet Union.

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Michael Krakowski, Dirk Lau, Andreas Lux\*

## **Eastern Germany's Quality as a Business Location**

*Private investment has a key role to play in the "economic take-off" in Eastern Germany. Can the region attract sufficient investment? What factors stand in the way of a rapid improvement in the quality of the new Länder as a location?*

**B**y their peaceful revolution of 1989/90, the people of Eastern Germany expressed their wish for a new economic order. Their elected representatives quickly reached fundamental decisions that established the social market economy but also contributed to a virtual collapse of production in that country. These fundamental decisions included the introduction of economic, monetary and social union (which led to a large real

reevaluation in Eastern Germany), integration into the Federal Republic of Germany and the decision to follow the principle of "restitution rather than compensation" with regard to confiscated property. This article will explore how the potential of Eastern Germany as a business location should be assessed in the new conditions.

The "location debate", which has flared up again with increasing vehemence, revolves primarily around the question of how the rising burden on the public finances due to transfer payments can be reduced or made more bearable, with attention focussing increasingly on the burden being placed on locations in Western Germany.<sup>1</sup> The debate has been triggered by the recognition that the

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"blossoming" of Eastern Germany will undoubtedly take longer than at least some people had been expecting as recently as last year. Part of the miscalculation may have been due to the fact that in many instances a sober analysis of the true locational potential in Eastern Germany was not carried out and dreams were spun all too readily.

In this article, the term "locational potential" will be used to describe the extent to which a country is able to attract investment and to achieve high incomes with highly productive jobs. Studies of locational potential generally look at changes in the factors affecting a country's attractiveness as a place for investment, that is to say the cost, volume and quality of the production factors of land, labour and capital, the cost of new investment, the efficiency of the allocation of production factors and the prices that can be obtained for the goods and services produced. These factors must be examined separately, as there is no yardstick for measuring their combined effect on the quality of a location. As the attractiveness of a location must always be measured in relation to that of others, changes in the relevant determinants in the country in question must also be analysed by comparison with those in other countries in order to establish whether there has been a relative improvement or deterioration in the location's position.

In the case of Eastern Germany such analysis is of only limited value. An examination of the changes in locational factors in the recent past produces a clear but trivial finding, namely that the switch to a market economy significantly increased the attractiveness of Eastern Germany for new investment. However, there seems little point in comparing Eastern Germany's locational quality before and after the change of system. Consequently, any estimation of Eastern Germany's locational potential must confine itself to sketching the present and foreseeable developments. Of necessity, plausibility must play a part in this.

Even the question of the appropriate reference countries is difficult to resolve. On the face of it, the level of development of this region suggests that its competitors would be developing or newly industrialised countries, but the prospect that Eastern Germany will become a high-wage country within the foreseeable future militates

against this. Given high wages, a supply structure typical of developing or newly industrialised countries would not be competitive in international markets. One of Eastern Germany's main competitors is likely to be Western Germany. The Eastern Länder must therefore also be able to hold their own against the industrial locations with which Western Germany itself competes.

### Obstacles due to Legacy from the Past

One of the consequences of the fundamental decisions taken in Eastern Germany was a chronic shortage of land owing to institutional factors. The East German administration was overwhelmed by the flood of applications for the return of property, so that potential investors were not always able to site their projects in their chosen location. It will be years before legal certainty can be guaranteed in this area. Potential investors are further restricted in their choice of location by previous ecological damage, which is commonplace but the extent of which is not always known. Both factors have a serious adverse effect on Eastern Germany's desirability as a location; both will decline in importance, but they will continue to be relevant over the medium term.

The possibility that the Federal Government will meet ecological costs indirectly via the Treuhandanstalt does not provide sufficient reassurance. The arrangements will have to be negotiated case by case, often at great length. The cost of such negotiations cannot be quantified, but they cause not inconsiderable delay in the implementation of investment plans. The same applies to outstanding financial debt, which will be handled in a similar way.

With the ending of product-related subsidies, the changeover to the use of convertible currencies for trade settlements between Eastern and Western Germany, the removal of price controls and the start of free trade with other regions, it became clear that the capital stock available in Eastern Germany was largely unusable for production in a market economy. The situation was exacerbated by the large real currency appreciation in Eastern Germany associated with monetary union. For years the GDR had lived beyond its means in the sense that obsolete plant was kept in operation and investment on its replacement was neglected. The country was living off its capital.

In 1990 the Treuhandanstalt took over almost the entire stock of productive capital. It continues to manage this part of the assets of the people of the former German Democratic Republic. Its initial balance sheet, in which it values these assets shows a deficit of DM 209.3 billion. The expectation is that when the Treuhandanstalt is dissolved its deficit will be even higher, placing a heavy burden on the public finances.<sup>2</sup> The rapidity of privatisation

<sup>1</sup> This was discussed in M. Krakowski, D. Lau, A. Lux: Auswirkungen der Wiedervereinigung auf die Standortqualität Westdeutschlands, in: Wirtschaftsdienst, Vol. 72 (1992), No. 9, pp. 464 ff.

<sup>2</sup> The Federal Minister for Economic Affairs estimates that the Treuhandanstalt's deficit will increase to DM 250 billion by 1995; cf. Bundesminister für Wirtschaft: Strategie für den Standort Deutschland: Wirtschaftspolitik für die neunziger Jahre, Bonn, 15th September 1992, p. 7.

in Eastern Germany may have contributed to a fall in the prices for East German enterprises, but this effect is not estimated to have been great. It should also be borne in mind that the Treuhandanstalt has taken on responsibilities not directly associated with privatisation and, partly for political reasons, is pursuing strategies that do not always maximise the selling price of enterprises. Nevertheless, the negative net worth of the Treuhandanstalt's assets is due mainly to the fact that the capital stock inherited from the GDR is largely unsuitable for efficient production in the market conditions prevailing since the borders were opened.

An outdated capital stock is also an obstacle to new investment. There are few positive spillover effects between enterprises, which depend on advances among competitors, suppliers and client firms. As a result, the local environment makes no positive impact on new investment projects. As well as the capital stock being outdated, deficiencies in local services are an important factor for investors. For example, business services were virtually non-existent in the former GDR. It is true that much new investment has taken place in this field, but serious bottlenecks are still apparent. The supply of distribution, transport and other services is still far lower in the East than in the West (cf. Table 1). The essential local web of service companies, suppliers and consuming companies still has to be built up.

The remarks about the capital stock in the closing days of the GDR also apply largely to infrastructure, which in wide areas of the economy is outdated and in need of replacement. The problems of adjustment to a new structure of prices and demand are evident here too, although in a less acute form. For example, it is expected that there will be a further shift of traffic from the railways to the roads and that natural gas, oil and probably even hard coal will be given preference over brown coal. The sewage disposal system is also in great need of modernisation.

**Table 1**  
**The Supply of Services in Eastern Germany**

	in DM bn		in %		Old Länder = 100 <sup>1</sup>	
	1990 2nd half	1991	1990 2nd half	1991	1990 2nd half	1991
Gross value added <sup>2</sup>	91.0	176.5	100.0	100.0	30.9	29.5
of which:						
Distribution & transport	19.8	34.1	21.8	19.3	43.2	36.7
Service companies	15.9	45.5	17.5	25.8	17.3	23.0

<sup>1</sup> Gross value added per inhabitant in Eastern Germany in relation to gross value added per inhabitant in the old Länder. <sup>2</sup> Adjusted.

Source: Statistisches Bundesamt: Vierteljahresergebnisse der Sozialproduktsberechnung, 2. Vierteljahr 1992; own calculations.

Telecommunications bottlenecks have been eased, but not eliminated.

It is not only in relation to Western Germany that Eastern Germany is at a disadvantage in terms of infrastructure; it is also one of the worse provided regions within the EC. An indicator developed for the Federal Ministry for Regional Planning, Building and Urban Development to measure production-related infrastructure shows that before unification the new Länder (with the exception of the Eastern sector of Berlin) were on a par with Spain.<sup>3</sup> The infrastructure will probably reach West German standards over the long term, but this will take time, so that this disadvantage will remain over the medium term.

Despite the locational disadvantages mentioned here, rapid investment in Eastern Germany has taken place on a substantial scale in some fields. Demand factors probably played a decisive part in some of these "early" investment decisions, for the incorporation of Eastern Germany into the Federal Republic meant creating a single budget, which made transfer payments to Eastern Germany possible on a scale that would have been completely unrealistic for other "reform regions" in Central and Eastern Europe. These massive transfers prevented a decline in total demand, despite the dramatic fall in East German production and hence in the region's GDP; indeed, the final domestic consumption of goods actually increased. Thanks to the unification of the two states, Eastern Germany's overall demand is therefore in a sense "underwritten".

In the light of these demand conditions, all enterprises producing primarily to meet local demand therefore soon had a strong incentive to invest. Since the number of potential suppliers in such markets is also limited, firms also had an incentive to establish a position quickly. Examples of this are service sectors such as regional daily newspapers, distribution, banking and insurance, but also public utilities.<sup>4</sup> The danger of a future collapse in demand in Eastern Germany remains small, especially as regards demand from the personal and state sectors. This will therefore have a positive impact on the region's quality as a location.

Some West German manufacturing firms producing internationally traded goods decided on substantial investment at a very early stage. However, investment planning cannot have been carried out with the usual care

<sup>3</sup> Cf. Bundesminister für Raumordnung, Bauwesen und Städtebau: Raumordnungsbericht 1991, pp. 66 ff.

<sup>4</sup> Cf. M. Krakowski et al.: Die deutsche Wirtschaft im Anpassungsschock – Strukturbericht 1991, Hamburg 1992, pp. 171 ff.

in such a short space of time, so that factors other than strictly economic ones undoubtedly played a decisive part. These early investment decisions cannot be interpreted as a positive economic assessment of Eastern Germany as a location, as they were probably partly motivated by political considerations, traditional ties and the prospect of state subsidies. Nevertheless, they created nuclei – in the car industry, for example – around which other projects by suppliers and consuming firms have now developed.

## Advantages from Capital Subsidies?

The disadvantages described above are partly offset by the fact that capital costs in Eastern Germany are far lower than in the Western Länder. With market interest rates the same, high direct and indirect capital subsidies are paid in Eastern Germany or taxes are levied at a lower level; the scale of such assistance is no longer clearly quantifiable. Subsidies can add up to 35% of the investment costs. On top of this come special write-offs and low-cost loans.<sup>5</sup> This cost advantage has to be seen in context, however, as substantial incentives are also available for investment projects in a number of other underdeveloped or "old industrial" regions of the European Community.

Despite high capital subsidies and the incentives for firms to acquire a position quickly in individual sectors, total investment in Eastern Germany has remained low so far. According to provisional estimates by the Federal Statistical Office, gross fixed investment totalled DM 85.7 billion in 1991.<sup>6</sup> On a per capita basis, this was only about 60% of the West German level; the disparity in capital endowment per head of population therefore widened further in 1991. The long lead times usually associated with investment projects probably account for the low level of investment so far. Investment has risen significantly in 1992 (the council of economic advisers estimates it at DM 109 billion),<sup>7</sup> but the capital endowment gap in relation to Western Germany has widened further. In Eastern Germany the per capita capital stock must be built up to a level that more or less matches that in the Western Länder in volume and quality.

## Qualified Labour?

The high level of qualification of the labour force is often cited as a positive aspect in Eastern Germany's favour. The formal qualification structure in Eastern Germany is good both in comparison with Western Germany and by international standards. According to the latest labour market survey for the new Länder, in 1990 only 10.2% of employed persons had no certificate of education or had received only partial skills training. The corresponding percentage in Western Germany was 21.1% in 1989. The

proportion of university graduates (including technical college graduates) in Eastern Germany was 10.7%, only slightly lower than the 11.6% recorded in Western Germany.<sup>8</sup>

The data on formal qualifications should not mislead one into overestimating the quality of the labour force in the East, however. For one thing, it is questionable whether training was up to West German standards in every case, and for another it is often pointed out that workers were often overqualified for the tasks they were performing and were therefore unable to maintain their level of qualification. The areas in which highly qualified workers were concentrated were also different than in the Federal Republic; for example, in 1988 4.1% of workers in the GDR were employed in R&D, compared with 5.4% in the Federal Republic. Moreover, 18.9% of university graduates were employed in R&D in the Federal Republic, compared with only 12.0% in the GDR. The bulk of workers with university degrees in the former GDR were employed in administration (51.2% of the total); in industry alone, the proportion engaged in office and administrative activities was even higher.<sup>9</sup>

Furthermore, professional expertise was generally acquired on a capital stock that was obsolete by West German standards. After the opening-up of markets and the removal of most price controls, many jobs and activities proved to be uncompetitive. This reduces the value of a further part of the experience and expertise of the labour force.

As the change in Eastern Germany has also created a considerable need for adjustment in the qualifications of the labour force, the flexibility with which human capital adapts to the new conditions is important for the attractiveness of the region as a business location. The great willingness to attend further education or retraining courses is a positive factor in this regard. In a survey carried out for the Federal Labour Office in November 1990, 78% of the workers interviewed said they

<sup>5</sup> Cf. Bundesminister für Wirtschaft (ed.): *Wirtschaftliche Förderung in den neuen Bundesländern*, Bonn 1991, pp. 15 f.

<sup>6</sup> Cf. Statistisches Bundesamt: *Zur wirtschaftlichen und sozialen Lage in den neuen Bundesländern*, No. 11, 1992.

<sup>7</sup> Cf. Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: *Jahresgutachten 1992/93*, p. 93.

<sup>8</sup> Cf. H. Bielenski et al.: *Arbeitsmarkt-Monitor für die neuen Bundesländer. Eine Arbeitsmarktumfrage der Bundesanstalt für Arbeit: Zwischenbilanz und ausgewählte Ergebnisse*, in: *Mitteilungen aus der Arbeitsmarkt- und Berufsforschung*, No. 2, 1992, pp. 147 ff.

<sup>9</sup> Cf. B. Görzig, M. Gornig: *Produktivität und Wettbewerbsfähigkeit der DDR*, DIW-Beiträge zur Strukturforchung, No. 121, Berlin 1991, p. 42.

<sup>10</sup> Cf. H. Bielenski, B. von Rosenbladt: *Arbeitsmarkt-Monitor für die neuen Bundesländer, Beiträge zur Arbeitsmarkt- und Berufsforschung*, 148.1, Nuremberg 1991, p. 40.

**Table 2**  
**Eastern Germany's Imports and Exports, by Region**  
(share and change over previous year, in percent)

	Imports				Exports			
	1991		1992 <sup>a</sup>		1991		1992 <sup>a</sup>	
	Share	Change	Share	Change	Share	Change	Share	Change
Western industrial countries	36.2	-30.5	47.4	12.6	25.5	-12.7	33.2	4.1
of which:								
EC	21.5	-12.7	26.3	2.6	17.1	1.6	22.4	6.6
Other European industrial countries	11.9	-48.7	15.7	16.0	7.3	-33.5	9.0	-3.8
Non-European industrial countries	2.7	-35.2	5.3	86.7	1.2	-23.5	1.6	12.8
Developing countries	6.3	-45.9	4.5	-40.2	7.4	-38.7	18.0	92.7
State-trading countries	57.4	-59.5	48.1	-35.1	66.5	-62.0	56.2	-29.3
of which:								
European state-trading countries	56.3	-58.8	47.5	-34.5	65.5	-61.7	55.4	-29.1

<sup>a</sup> Jan.-Sept.

Sources: E. Wohlers: Außenhandelseffekte der deutschen Vereinigung, in: Hamburger Jahrbuch für Wirtschafts- und Gesellschaftspolitik, Vol. 37, 1992; Statistisches Bundesamt; own calculations.

were interested in taking part in training or courses to obtain a professional qualification.<sup>10</sup>

The Federal Labour Office responded to demand by introducing training courses for East German workers at the end of 1990. In November 1992 494,600 persons were attending professional further education, retraining and induction courses provided by the Office.<sup>11</sup> In addition to this are the workers inducted into new jobs by their employers without subsidies from the Office or who are undergoing in-house training. East German commuters working in Western Germany are also acquiring additional professional skills. In many cases they are learning the use of modern technology on the job. These are all signs that shortcomings in the quality of labour should be reduced relatively quickly.

High labour mobility could also pose a danger for the attractiveness of the East as a business location, however. Worker migration could hinder the development of the East German economy if it led to a shortage of skilled labour. Nevertheless, there is no evidence so far that better qualified East German workers have been significantly overrepresented among migrants.<sup>12</sup>

Basic wages in Eastern Germany were increased substantially even before economic, monetary and social union, and this trend has continued thereafter. In 1990 the mean gross monthly earnings of fully employed workers and clerical employees in East German industry (including construction and civil engineering) amounted on an annual average basis to 35% of the corresponding West German figure, setting the GDR Mark and the Deutsche Mark at parity up to the time of monetary union. By 1991 the ratio had already risen to an average of 47.1%.<sup>13</sup> In that year average East German basic wages,

by contrast, were already 60% of the Western level. Contractual working hours were also cut; at present the contractual standard is a 40-hour week, compared with 38 hours in Western Germany.<sup>14</sup>

By the end of 1991 wage agreements had been signed in 30 industries providing for contractual monthly earnings to be gradually raised to parity with those in Western Germany. In most cases equality should be achieved in 1994.<sup>15</sup> The working week would still be longer than in the West and paid holidays and the other benefits provided by firms would also be lower. It is not expected that actual earnings will have adjusted completely to West German levels by 1994, but it can be foreseen that by that time Eastern Germany will be among the regions with the highest labour costs in the world. Potential investors are already taking account of this wage trend when deciding where to locate investments. Hence, they cannot count on low labour costs to offset other locational disadvantages which are likely to persist over the medium term.

In the course of the transformation of the economic system in Eastern Germany very few jobs proved to be competitive. Even at the wage levels prevailing before the change, it would have been unavoidable for enterprises to shed labour in order to compete. The subsequent sharp increases in wages exacerbated this problem. At the end of November 1992 1,086,464 persons were registered with labour exchanges as unemployed and the unemployment

<sup>11</sup> Cf. Bundesanstalt für Arbeit: Arbeitsmarkt in Zahlen. Aktuelle Daten für das Bundesgebiet Ost, Nürnberg November 1992.

<sup>12</sup> Cf. DIW-Wochenbericht, No. 5-6/1992, p. 60.

<sup>13</sup> Cf. Statistisches Bundesamt: Zur wirtschaftlichen und sozialen Lage in den neuen Bundesländern, No. 4, 1992.

<sup>14</sup> Cf. WSI-Mitteilungen 3/1992, p. 131.

<sup>15</sup> Cf. *ibid.*, p. 127.

rate stood at 13.4%.<sup>16</sup> It would have been much higher still, but for the massive use of labour market instruments such as work creation programmes, early retirement schemes, short-time working schemes and training measures.

The high unemployment in Eastern Germany is partly the consequence of the adjustment process, but it could itself become a locational disadvantage. There is a danger of the so-called hysteresis phenomenon, in other words the persistence of unemployment at a high level. Long-term unemployment leads to a loss of qualification. Furthermore, the unemployed may lose their motivation, reducing their chances in the labour market. Both of these factors could mean that when demand for labour rises enterprises will regard the unemployed as unsuitable candidates, so that a labour shortage develops despite high unemployment.

### Opportunities in Trade with Eastern Europe?

Eastern Germany's proximity to the reforming countries in Central and Eastern Europe, its established relations with the region and its knowledge of the market are often emphasised as an export advantage. The collapse in trade with these countries after the changeover to settlement in convertible currency (cf. Table 2) does not necessarily refute this proposition. In part, the collapse can be explained by the overall decline in demand in the reform countries as a result of their problems in the conversion of their foreign trade and production. It can be hoped that Eastern Germany will benefit disproportionately from a recovery in demand, even though it is likely to be slow and moderate. However, Eastern Germany's problems do not stem only from a general decline in demand from Eastern Europe: a larger proportion of demand from these countries was for products from Western Germany and other Western industrial countries, as many East German products were no longer competitive at the new exchange rates. If Eastern Germany is to benefit from its established market relations, it must offer an appropriate product range that can compete in both breadth and price with goods from Western Germany and other regions.

However, the longer it takes to build up production to offer such a product range, and the slower the recovery in demand from the reform countries and the more far-reaching the changes in these countries, the more Eastern Germany's established relationships within the region will wane in importance. Some investors will undoubtedly benefit, but relatively little importance should be attached to good contacts with the East as a general positive factor

in Eastern Germany's favour. The importance of Eastern Germany's membership of the European Community should be assessed in the same light. Here too, it is true that some investors seeking a base from which to benefit from access to the markets of the European Community will choose Eastern Germany—perhaps to take advantage of capital subsidies. EC membership and high subsidies are also available in other regions, however.

### Ultramodern Economy in the Future?

The rather uninspiring picture presented here of the attractiveness of Eastern Germany as a business location is occasionally compared with the vision of a region that will soon have one of the most modern capital stocks in the world and a very modern infrastructure. Highly productive firms would then pay very high wages and be able to market their products in East and West at good prices. It is very probable that the technological standard of Eastern Germany's new capital stock will be very high, for three reasons. First, modern capital goods are now available, thanks to the opening-up of markets. Secondly, with high wages, only highly productive capital is viable, and thirdly, capital inputs are massively subsidised by the economic promotion programmes in the new *Länder*. The vision of a highly productive, modern economy should not be dismissed out of hand. Nevertheless, two points deserve to be made with regard to the chances of its being realised.

First, a location is to be judged negatively, not positively, if its available infrastructure and productive capital do not meet modern standards. Admittedly, this means that what will exist in a few years' time will have been newly created and hence be modern, but it in no way answers the question whether, in view of the adverse factors described above, investment will have been on a large enough scale to provide sufficient work for the labour force in Eastern Germany. It is also questionable whether a dense network of supplier and consumer industries can develop rapidly enough for the area to be attractive to new investors even, and increasingly, without subsidies.

Secondly, the construction of modern industries can probably only succeed if high capital subsidies continue to be paid, infrastructure investment is financed largely out of tax revenue from Western Germany and local demand is also sustained by transfer payments from the West. That this is necessary is an indication of low locational quality. By itself, the region is not able to attract sufficient investment. However, with very high transfers from another region or country to finance investment, infrastructure and demand, many regions are in a position to develop modern industries, provided the labour supply is of a high standard. And this is the case in Eastern Germany.

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<sup>16</sup> Cf. Bundesanstalt für Arbeit, op. cit.