

Economic Changes in Germany Since Reunification

Megan Karpac



Introduction

The economic changes and integration efforts that had to be made in order to bring about the recent reunification of the two Germanies were vast and complex. The economic systems of East and West Germany were so very different that it would have been impossible to come to a compromise had East Germany not accepted the system of the West. According to historian Mary Fulbrook, "The most important factor which led to the unification of the two Germanies was economic." (Fulbrook, p. 84) She takes this position because the economy of the German Democratic Republic (East Germany) was in such a terrible state that an economic crisis was in the making if it was to try to compete with the West. Also, the migration of people from East to West Germany after the dismantling of the wall was burdensome on the West because West Germany did not have jobs or living space for all those migrating. Unification and a make-over of the East seemed inevitable to insure the security and stability of both sides.

The economic unification of East and West Germany was a mammoth project that is still going on today. The integration of the two systems involved the privatization of many eastern enterprises, a union of the banking systems, special care to limit unemployment, a rearrangement of property rights, and a huge influx of money and capital from the West to the East. Another great economic concern was the change in monetary policy and the currency reform, both of which had the potential to cause major difficulties in both East and West Germany. The immense need for financing from West Germany was also a problem because the West Germans were not necessarily in the position to take on such a huge financial responsibility. Unification also affected the European Community and Germany's role in it, including the establishment of the new European currency and the continuation of trade. Lastly, the international community was affected with respect to trade, German foreign policy, NATO, German competitiveness, and the foreign debt.

In this essay I explain what happened to the economy in Germany as a result of reunification, and what effects this had on other parts of the world. Even though the differences between the East and West were vast and complex and the West had to take on a great burden to help the East, reunification seems to have been successful so far. The German people are working hard to make this work and that is the main requirement: a willingness of the people to change and adapt to help their nation succeed.

West and East Germany before Reunification

Before reunification the West German economy was a social market economy, as all of Germany is today. There is basically a free market with some state interference. Private ownership of the means of production and of industry is the accepted norm. A method of decision-making in business called co-

determination is used where the workers, or representatives of the workers, have a voice in decisions. (Fulbrook, p. 48) Industrial unions, with one union per industry, are in place to protect workers' rights; but employment is not guaranteed, and women are not a highly represented group in the work force. The major trading partners of West Germany were, and still are, the countries of the European Community. Compared to East Germany, West Germany enjoyed higher living standards and a higher GDP, but there was a more unequal distribution of income. The "economic miracle" that had happened after World War II to make West Germany competitive economically had worked wonders, and West Germany was still a great economic force in world affairs at the time of reunification when a successful and strong unified Germany took its place. In the East the economic situation was much different. The East German economy was a socialist system installed by the communists when they took control of East Germany after World War II. Public ownership of everything engendered collectivism and centralization. Because many enterprises were state-owned monopolies, they were less efficient than their Western counterparts. There was little incentive for people to work hard because the government took care of and controlled many facets of life. Even prices were set by the government, thus causing a "distorted price-system" - i.e., a price system not controlled by supply and demand. (Grosser, p. 109) Productivity was low because there was disguised unemployment, which meant that many of the people working were not needed to perform the work being done.

Little technological development, outdated capital stock, and a lack of competition were three major problems affecting East Germany. To a large degree these were caused by the lack of incentive on the part of Easterners to experiment with more productive techniques and to improve production. A single trade union existed in East Germany for all workers, but this was not really a workers' union. It was more a vehicle used by the SED (the Socialist Unity Party) to espouse its policies and maintain control over the people. (Fulbrook, p. 51) The SED was a party formed in April 1946 through a merger of the KPD (the East German Communist Party) and the SPD (the Social Democratic Party). Employment was guaranteed, but this would come to be a problem after unification when people who were used to being guaranteed a job were laid off. East German trade was mainly with the other socialist countries, particularly the Soviet Union. Even with this trade, the East tried to import as little as possible and produce everything on its own, even if this meant goods would cost more. Firms tried to produce all of their own inputs (Giersch, pp. 258-59), and conglomerates and monopolies did not specialize and therefore did not benefit from comparative advantage.

Some problems that resulted from the economic system in pre-unification East Germany were a low GDP per capita and hence a low standard of living for most citizens. The East German mark was not convertible into foreign currencies so East Germans had difficulty buying foreign goods. They could not buy West German goods unless they had the coveted West German deutsche mark. East German citizens had to endure this low standard of living and this difficult life because they were effectively under the control of the Soviet Union. There were many problems with the system that were disguised in the state-of-the-economy reports from the East German government, but no one really knew just how bad it was until after unification. It took the integration of the two Germanies to show the depth of the troubles that the East was experiencing.

Currency Conversion

Economic union was seen as an important beginning point in the unification process because many economists and politicians thought that it could be used as an impetus to full political and social union. According to historian Dieter Grosser, "As soon as the monetary and economic union was implemented, the GDR's monetary, fiscal, and economic policy would be controlled by Bonn, making full and formal reunification the inevitable next step." (Grosser, p. 27)

The steps in German monetary unification began in 1990. In January of that year, a German-German Economic Commission was set up to deal with economic and financial matters concerning the East and West. Then on February 7 a cabinet committee on German unity was established to deal with the economic challenges and problems. Finally, on May 18 the German-German Treaty on Economic, Monetary, and Social Union (GEMSU) was signed in Bonn. It was ratified by both German parliaments by June 21 and took effect on July 1, 1990. At this point the East German government gave up all control of its financial and monetary policy matters to the Bonn government. The West German deutsche mark became the legal tender of the East, and the Bundesbank in Frankfurt became the only central bank. East Germany was forced to convert from its socialist system to a social market economy with much financial aid and other forms of assistance from the Federal Republic of Germany (FRG).

The currency conversion was done at different rates. Financial assets and liabilities were converted at a rate of two East German marks to one West German deutsche mark. A rate of one-to-one was given for up to two thousand deutsche marks for anyone under fourteen years old, four thousand deutsche marks for anyone fourteen through fifty-eight, and six thousand deutsche marks for anyone older than fifty-eight.

Along with the currency conversion came another problem - inflation. Easterners spending their new deutsche marks on Western goods that they could not purchase before caused an increase in demand for products, which led to an increase in prices - inflation. This inflation in turn caused a decrease in investment in Germany and made growth difficult. There was a devaluation of the deutsche mark which decreased the value of DM-denominated assets. Inflation was rapid until 1992, but in 1993 and 1994 it dropped to 3.9 percent and 2.4 percent per year respectively. (Weisfeld) The sudden currency conversion, though necessary to bring about speedy reunification, turned out to be a drain on the economy of the East as prices rose and jobs were lost because of decreased investment and low productivity. This was an inevitable consequence of monetary union and may have happened even with a different plan than the one put into place.

Integration of the Two Systems

One of the most important difficulties associated with unification was the integration of the vastly different East German economic system into that of the West. This would not be an easy task after 45 years of separate rule. Changes needed to be made in the areas of business, employment, living standards, and the banking system.

After reunification, economists around the world discovered the horrible conditions actually present in the former GDR. Realizing that the businesses and industries, with low wages and productivity and little capital stock, were not on a par with those in the West, they concluded that something had to be done or the East would crumble. The solution seemed to be to privatize East German firms in order to bring them into the capitalist system and try to make them competitive with the rest of the world. In order to achieve this industrial equality, Jrolf suggested that "the unprivatized firms ... require[d] a three-stage transformation process that consisted of stabilization, adaptation, and a radical new product or production development to establish a competitive position in the new market economy." (Jrolf, p. 27)

Workers in the East were one of the groups most affected by reunification. They had a choice between migration to the West, early retirement, or retraining by the government. Many workers chose migration because wages in the East were only one-third to one-half the level of wages in the West, and employment was difficult to find as many East German firms closed down.(Andersen, p. 125) The problem was that many of those who left the East were young, skilled workers who would be the best hope for building the new economy. In all, between the autumn of 1989 and the autumn of 1990,

approximately 600,000 people migrated from East to West. (Hall and Ludwig, p. 31)

Instead of migrating to the West, some unemployed workers chose early retirement. This was also not very healthy for the Eastern economy because it meant that there were even more people depending on the government for care. Lastly, the government offered occupational retraining programs to employees who were laid off. These programs were a good idea in theory as long as the programs were well-run and well-thought-out and the workers were trained in the right areas - areas where employment was available and workers were needed. Unfortunately, most of these programs were not training people in skills that were needed for the job openings available, and consequently many people coming out of them could not find jobs. According to Professor Dennis Snower, an economist at the University of London, "Government training programs are standardized, whereas companies need specialized, idiosyncratic skills. Thus many workers who go through job-training schemes still don't get hired." (Ingrassia, p. A14)

The goal of the Treuhand, the state agency in charge of privatizing business and industry, was to stabilize the economy and bring capitalism to the East. This would not be an easy task. As of the end of 1995, the Treuhand had helped to privatize 14,000 state-owned East German companies. (Steinmetz, p. A6) Also, about 870,000 new private business have been established in the East since reunification. (Menke- Glijckert, p. 39) Many of the firms being privatized are being bought by foreigners or West Germans. However, investment in the East has been relatively slow because investors are cautious about taking the risk. Some factors that have inhibited private investment so far are:

- * a poor infrastructure;
- * the difficulty of finding land and buildings in East Germany because of legal problems with former owners trying to claim their land;
- * red tape (when trying to obtain permits, etc.);
- * financial problems that Eastern companies which have been taken over may have had previously and not addressed (especially environmental problems);
- * rapid wage increases;
- * uncertainties in regard to Eastern Europe. (Andersen, pp. 126-27)

The government is trying to spur further investment by giving tax incentives and other subsidies, but other investment stimuli need to be found in order to attract more investors. Unfortunately, Germany has been investing more money outside of its borders than foreign countries have been investing in Germany. In 1994, for example, German companies invested 18 billion marks (\$12.5 billion) abroad while foreign companies invested only 5 billion marks in Germany. (Ingrassia, p. A14) In the first nine months of 1995, German companies invested 26 billion marks abroad. (Templeman, p. 46) Many German companies have been investing abroad rather than within Germany because of overregulation of business and rigid union work rules. As more companies have expanded abroad and shut down operations in Germany, unemployment of German workers has increased. With German unemployment so high and the standard of living in East Germany so low, Germans must realize that to improve their country they need to put money into it.

Even with substantial economic assistance from the West, the East still has many hurdles to overcome. West German capital stock is somewhat outdated, but the capital stock in the East is in far worse shape. Also, productivity in the East is only about one-third that in the West. (Reier, p. 43) Easterners and Westerners alike would much rather buy superior Western goods than over-priced Eastern ones. Because of this, the East faces difficulties expanding its industrial base.

Transportation and environmental problems have also plagued East Germany. First, the roads of the East were not built to handle the kind of traffic that would be coming from the West. New roads will have to

be built, and old ones will have to be upgraded and widened. (Cole, p. 3) Also, the railroads either need to be revamped or closed to the excessive traffic that has come into the East since reunification. Secondly, before unification the East had very low environmental standards. Many of the industries have to "clean up their acts," which is going to be very costly. Lignite, a very dirty fossil fuel, was used in the former GDR for 70 percent of domestic heating and electricity. (Cole, p. 4) Also, the East wasted considerable energy because of its antiquated industrial and private facilities used for electricity and heating, low efficiency, badly insulated homes, and subsidized low power rates making it not worth saving energy because the price was so low (Schurig, Greenpeace). Other environmental problems in the East are highly polluted soil and water. All told, it is estimated that it will cost 100 billion U.S. dollars to clean up East Germany. (Cole, p. 4)

Still, the process of unification has brought with it many bright spots also. According to John Hall, a professor of Economics and International Studies at Portland State University, and Udo Ludwig, a Senior Research Fellow at the Institute for Economic Research in Halle, Germany, "East German families are benefiting from rising family incomes and enjoying substantial increases in their bundle of consumer goods with greater choice." (Hall and Ludwig, p. 26) There is also "greater stability" in the economy and politics in the East because it is now under the economic and political system of the West. Moreover, East German citizens can rest easy knowing that the social welfare system of West Germany is always ready to help them if they should experience economic difficulties. (Hall and Ludwig, p. 26) Hall and Ludwig also find the future to be promising. Labor productivity in East Germany increased 20 percent from the time of reunification to 1994, and output in East Germany is also increasing. (Hall and Ludwig, p. 26) Unfortunately, however, the growth rate of the unified German economy is still low. In 1994, the growth rate of the economy was only 2.9 percent, in 1995 1.9 percent, and German economics minister Ginter Rexrodt predicts growth of less than 2 percent for 1996. (Reuters, p. D2) Rexrodt blames the slowdown of the economy on an overvalued mark, wage hikes, and rising taxes. (Templeman, P. 46)

Financing From the West

Another major problem with unification was that it was enormously costly. Because the East was poor and run down, the only obvious source of financing was West Germany. It was estimated in 1989 that about 100 billion DM per year would be needed to eventually bring the East up to the level of the West. In 1990, the government deficit rose by 74 billion DM compared to a rise of only eight billion DM in 1989. (Andersen, p. 129) This difference in the yearly deficits means that about 66 billion of the 1990 deficit can be attributed to transfers to the East or other financial costs of reunification. According to the Economist, the West sent DM 170 billion to the East in 1991. ("Germany," p. Survey 5) All told, transfer payments since reunification have averaged about 150 billion DM per year from 1990 until 1994. (Menke-Glilckert, p. 39) These transfer payments have gone to upgrade infrastructure in the East, to act as investment to stimulate growth, and to pay for other programs such as unemployment insurance, pensions, health care, and welfare. It has been estimated that it will take ten to fifteen years to raise Eastern living standards to those of the West.

There are three ways of raising money to finance the East's recovery. The German government can increase its debt, cut expenditures in the West, or increase taxes. The first method tried was deficit spending, which caused inflation and decreased investment. Finding this method unsatisfactory, the Kohl-Genscher coalition government decided that it had to raise taxes. In March 1991 an "Eastern Recovery Program" was designed in order to help the East solve the major problems that came to light with unification - inflation, high labor costs, low production, unemployment, and the inequality of living standards between the East and the West. An income tax surcharge of 7.5 percent was put into place; but despite the higher taxes, public borrowing made the deficit even worse. Many Germans complain about the high level of income taxes ("Germany," p. Survey 10), a complaint which has some merit since 47

percent of the average worker's paycheck goes toward taxes. (Weinberger, p. 35)

The continuing costs in Germany, stemming from efforts to raise the standard of living, building and transportation construction, welfare support, and unemployment payments combined with a high government deficit, make tax cuts almost impossible. Germany's public debt has been growing rapidly since reunification. In 1989, the debt was 43.2 percent of GDP, and by 1994 debt had grown to 53.2 percent of GDP. (Weisfeld) Jarausch explains that FRG citizens do not like supporting the East. He states that "prosperous FRG citizens resented paying the costs or showed patronizing sympathy." (Jarausch, p. 204)

Many Easterners, on the other hand, were expecting to immediately have living standards on a par with those of West Germany as a result of reunification. Westerners did not feel this was fair given that it took them four decades of hard work following the Second World War to reach the level at which they were living. It did not seem fair that the East should immediately benefit from the achievements of the West. Still, according to the Basic Law, the constitution of Western Germany enacted after WWII, all Germans should be treated equally. This made it necessary for the West to transfer money to the East. (Jarausch, p. 205) Also, the fact that so much Western money had to go East meant that less was left for government spending on Western problems and loans for Western industries. This fact also angered many Westerners.

High taxes and increased deficit spending both work to decrease investment in Germany, which in turn makes growth difficult. Included among recent government and industry recommendations to assist the unified German economy are a decrease in both deficit spending and taxes. These actions should decrease inflation and interest rates and spur investment and growth.

Effects on the European Community

The unification of the two Germanies caught the European community by surprise as much as it did everyone else. A united Germany, it seemed, would be even more powerful than West Germany alone. But West Germany was already a powerful part of the European Community and losing it would be a disaster for the EC. Therefore, the acceptance of a unified Germany into the European Community as soon as possible was very important so that Germany did not ignore the EC or try to "go it alone." This might have caused the European Community to crumble.

According to Robert Livingston, membership in the European Community is very important to Germany, second only to reunification. The most important buyer of German exports is the EC. In fact, the European Community bought almost 47.9 percent of German exports in 1993 while the United States bought only 7.7 percent. Germany also imports a great deal from the European Community. Of all Germany's imports, 46.4 percent in 1993 were from the EC compared to 7.3 percent from the United States. (National Trade Data Bank) Also, Germany sees the European Community "as an instrument to lend the German voice greater force," because a unified Germany would have many more people than any of the other important EC countries. (Livingston, pp. 168-69) East Germany, unlike the other countries of the Eastern bloc, was lucky in that it had West Germany and the European Community to fall back on in its time of economic and political reorganization. After the collapse of Comecon, a trading arrangement between the Soviet Union and the countries of the Eastern European bloc, there was a disappearance of the markets for East German goods. With its integration into West Germany and the European Community, East Germany now had a new set of markets. Unfortunately for the other countries of Eastern Europe, a new set of trading partners was not available. A big question for the European Community, therefore, was whether it would be strong enough to allow the poorer countries of Eastern Europe to join. Offering membership to these countries would mean that the Western

members of the Community would be left to support these countries, just as West Germany had to support East Germany.

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