25 YEARS OF GERMAN UNITY

Economic consequences of reunification – implications for Europe

Blossoming landscapes?

When the reunification of Germany became a reality in 1990, it was also time for the forecasters to take centre stage. How long would it take until the East German economy had shaken off the consequences of 40 years of communism? And how long would it take until living standards in eastern Germany matched those in western Germany? Views on such issues differed greatly. The optimists' camp was led by the German chancellor, Helmut Kohl, who held out the imminent prospect of "blossoming landscapes" in economic terms for the five new federal states. The "Aufbau Ost" development programme was expected to last around half a decade. It was not only politicians but also some economists who believed that it might be possible to catch up that fast.

At the same time, however, there were quite a number of economists predicting a very long-winded adaptation process for the reunited Germany. Researchers specialised in analysing economic catch-up and adaptation processes warned against excessive optimism, as experience suggested that it would take more like several decades than merely several years for East to converge with West.

Twenty-five years on, the progress made with the Aufbau Ost is impossible to deny. Measured against the ailing economy in the last days of communism, the promised blossoming landscapes in eastern Germany are today a reality, even if everything has taken longer than the optimists anticipated. The former president of the Treuhandanstalt privatisation agency, Birgit Breuel, described the introduction of free-market conditions in East Germany as "without precedent in the history of the world", despite all the difficulties encountered and mistakes made. Yet the process of economic adaptation is by no means over. In a recently published study, the Berlin Institute for Population and Development comes to the conclusion that, even 25 years after reunification, the old border is still visible in many areas such as economic output, population development, wealth and the size of agricultural enterprises.

Author:

Dr. Jörn Quitzau
Macro Research
Telefon +49 40 350 60-113
joern.quitzau@berenberg.de

www.berenberg.de

1990: when systems collide

Clash of totally different systems – politically, socially and economically

To decide whether the situation reached today can be classified as an economic-policy success story demands a look back to the year of reunification. Back then, it was not just two parts of a divided country that came together, there was a veritable collision of two systems that could hardly have been more disparate – politically, socially and economically. Public life in the former East Germany was shaped by the planned economy system under communism that only managed to more or less work for so long because the population was kept trapped in its own country by walls and border fences. Without the impenetrable border with the West, large parts of the East German population would have "voted with their feet" much earlier and turned their back on the communist economic and social model. Instead, they went through the motions of the communist experiment until its collapse could no longer be prevented.

Reunification revealed inefficiency of the East German economy

When the Berlin Wall fell in November 1989, it was a political godsend, yet there was no match-up whatsoever between East and West in economic terms. The reason for this is that the old West Germany had experienced an economic miracle in the post-war years and was now one of the leading economic powers in the world with its model of the social market economy. The West German economy was highly productive, competitive and export-driven, and had brought tremendous prosperity to its citizens with what were unimaginable consumer riches for the eastern population. The picture in East Germany was totally different. Although official statistics registered full employment as the state guaranteed work for all, hidden unemployment reached up to 30 percent according to estimates by the Ifo Institute. Productivity was low, with the per-capita income of East German population no more than 30 percent of the West German level. The enterprises were ailing, the whole system inefficient. Moreover, the East German economy was hardly integrated in the global economy at all. With the breakup of the Soviet Union and the Eastern Bloc, its only notable trading partners in the other communist countries of eastern Europe also disappeared.

Alongside the new currency, the former East Germany also had the entire German tax and welfare system foisted upon it. At the end of the 1980s, the welfare state was actually already too extensive for the old West Germany and needed to be pared back.

The political turnaround came as a massive shock to the East German economy. Practically overnight, a pitiful planned economy needed to be integrated into the western competitive world dominated by the markets. Alongside the new currency, the former East Germany also had the entire German tax and welfare system foisted upon it. At the end of the 1980s, the welfare state was actually already too extensive for the old West Germany and needed to be pared back. Now this excessively generous system of social welfare, unemployment benefits and pensions had to be extended to the new federal states, without the eastern German population being even remotely in a position to itself generate the income required to support this safety net. Worse still, the level of social welfare and unemployment benefits served to introduce a de facto minimum wage in eastern Germany. As a result, reunification triggered a very painful adjustment at first that had little to do with blossoming landscapes.

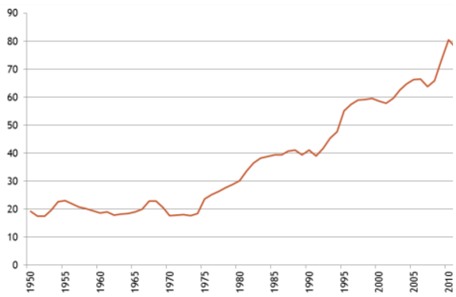
Industrial production contracted by around one-third while payroll costs exploded, which caused the unemployment rate in eastern Germany to top 15 percent. Given such massive setbacks, the Aufbau Ost (and the associated boom in demand) had to be financed by large-scale West-East transfers. During the period from 1991 to 1999, the eastern German federal states received net transfers of somewhere in the region of EUR 600 billion and the volume of West-East transfers totalled some EUR 80 billion in the years thereafter. All in all, the amounts transferred by now amount to a grand total of around EUR 2 trillion.

Financial West-East transfers amount to a grand total of around EUR 2 trillion.

The reunited Germany: unique path in Europe

The Aufbau Ost was the all-encompassing topic in Germany for many years after 1990. For years, the integration of the former East Germany into the economic order of the old Federal Republic absorbed considerable administrative and economic resources. Structural reforms that would have been urgently required in western Germany as well were shelved. While Germany was primarily concerned with sorting itself out, many other countries in Europe were getting themselves ready for the launch of the single European currency. The convergence criteria forced the potential euro adopters to consolidate their public finances. While these countries paid down their sovereign debt, Germany had to cope with reunification and did so to a large extent by taking on more debt.

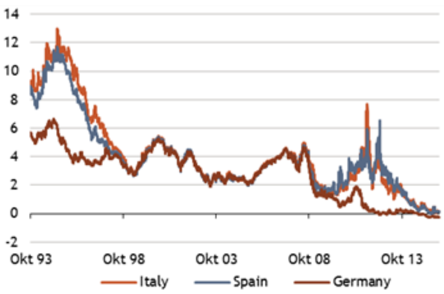
1. Germany: Public gross debt



In % of GDP. Source: Federal Ministry of Finance.

The advent of the euro ushered in a period of European interest rate convergence. The interest rates on government bonds that had previously been several percentage points higher than those on comparable German Bunds now fell to German levels. From then on – at least until the onset of the euro crisis – all euro adopters could finance themselves practically just as cheaply as had only been possible for Germany to that point. This provided a massive economic stimulus for the rest of the eurozone. At the same time, Germany was weighed down by the financial consequences of reunification and expansion stagnated. Minimal growth, rising unemployment, high public deficits, reform backlog – these were the symptoms that made Germany the “sick man of Europe”.

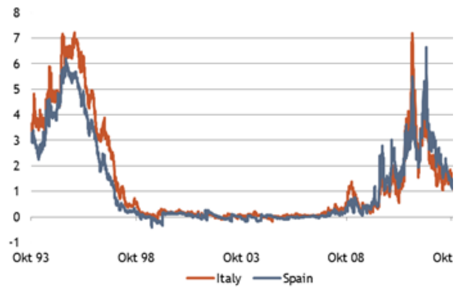
2. Government bond yields (two years)



In %. Source: Bloomberg.

The reform backlog was certainly in part a consequence of reunification, as the Aufbau Ost demanded the full attention of the politicians over several years. Whereas eastern Germany was not merely reformed but transformed from a planned economy to a market economy, the willingness or attention required to modernise decaying West German structures was missing. Consequently, at the start of the new millennium the reunited Germany had a regulatory framework that, although it represented a quantum leap for the former East Germany, no longer satisfied the requirements of global (location-based) competition. At the same time, the federal structure of the Federal Republic contributed to the lack of reform over many years. The central government requires the approval of the federal states for many important laws. The Kohl government repeatedly fell foul of the opposition majority in the Bundesrat for its planned reforms.

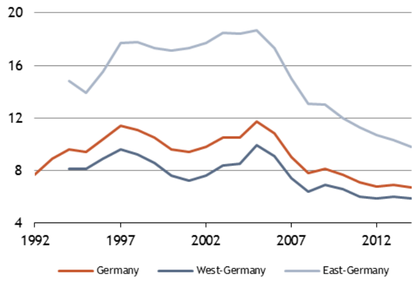
3. Bond spreads versus two-year Bunds



In %. Source: Bloomberg.

After the red-green coalition came to power in 1998, the reform backlog continued to exist at first. Not until the second red-green legislative period did things start to change. In March 2003, chancellor Schröder set out his Agenda 2010, a series of reforms aimed at modernising the German welfare state and in particular the German labour market. It took until 2006 for the first successes of the supply-side reforms to become evident. Yet Agenda 2010 brought Germany back to the path of growth and its effects are still being felt. In this way, not only the integration of the new federal states but also the fundamental economic-policy reorientation of the reunited Germany has been a success over the past 25 years.

4. Unemployment rate



Unemployment rate in % of the civilian labour force.
Source: The Federal Employment Agency.

Lessons for Europe

Reunification: a role model for Europe?

It makes sense to try and derive lessons for ever-closer union in Europe from the reunification of Germany. In fact, a number of conclusions can be drawn for the further integration of Europe.

Economic convergence takes a very long time and cannot be imposed "in a hurry".

1. Reunification provides more evidence that economic convergence takes a very long time and cannot be imposed "in a hurry". In other words, plenty of patience will be needed for the further integration of Europe. One of the reasons for this is that huge financial transfers to accelerate the convergence of living standards, as flowed from western to eastern Germany, are not a realistic option for European integration.

Political leadership is essential.

2. Without a clear political commitment to the goal of integration, it will be hard for ever-closer union to succeed. The path is so rocky that the convergence process can quickly falter. In such situations, political leadership is essential.

A great willingness to change is crucial.

3. The population needs to demonstrate a great willingness to change. Almost everything changed for the citizens in eastern Germany – not just politically and economically, but also in their daily lives. If varyingly strong economies, diverse mentalities and different work-

ing and living habits are to be integrated, everyone involved needs to be willing to accept the inevitable changes this entails.

4. Market reforms can also work in places where people had been indoctrinated in a completely different economic system. Given a good framework, economic growth is theoretically possible anywhere.

Given a good framework, economic growth is theoretically possible anywhere.

5. Structural reforms are more important than financial transfers in this context. Reforms generate growth, transfers foster financial dependencies.

Transfers foster financial dependencies.

Even if these points do contain valuable insights for the further integration process, it is important not to try comparing apples with pears. Reunification was too much of a special happening, too much of a unique event, for the lessons that can be learnt from it to be directly transferrable. In Germany, an artificial division between East and West was ended; in Europe, on the other hand, the goal is to bring together sovereign nation-states with in many cases very different histories, different languages and different mentalities.

Reunification was too much of a special happening, too much of a unique event, for the lessons that can be learnt from it to be directly transferrable.

Further dissimilarities should also be noted. German reunification brought fundamental rights to the citizens of the former East Germany practically overnight, notably including political freedom. Compared with the last days of East Germany, the financial and material situation of the population improved very quickly, and the range of products offered to consumers in eastern Germany veritably exploded. For the vast majority of the citizens, reunification was consequently a step into a new, better life. This holds true irrespective of the fact that the reunited Germany could of course not meet all the hopes and expectations of every single individual.

For the vast majority of the citizens, reunification was consequently a step into a new, better life.

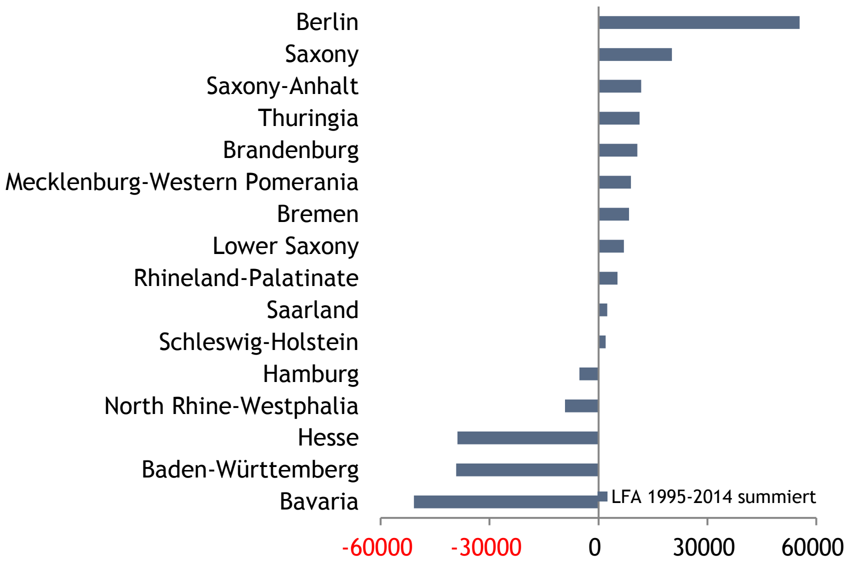
Set against all this, the benefits of the European Union are only relatively moderate. What is the end of border controls within the EU (and hence the end of time wasted waiting to cross frontiers) compared with the opportunity for the citizens of the former East Germany to be allowed to leave their own country for the West for the first time ever? At the material level, moreover, the benefits of Europe are harder to identify and have only appeared gradually. Although the abolition of trade barriers has raised prosperity levels for the citizens of Europe, not many of them equate their growing incomes directly with the single European market. Perceptions of the common European currency are also ambivalent: many countries have profited from falling interest rates in the single currency area over many years. Yet in light of high unemployment rates, large portions of the population in southern Europe view themselves as losers of the European integration process in the wake of the euro crisis.

What is the end of border controls within the EU (and hence the end of time wasted waiting to cross frontiers) compared with the opportunity for the citizens of the former East Germany to be allowed to leave their own country for the West for the first time ever?

Finally, there remains the question of how the catch-up process can be accelerated for the economically weaker regions of Europe. The German experience teaches that transfer payments can accompany structural changes and offset financial differences. However, fiscal equalisation schemes also create dependencies that in turn hinder the necessary structural change. The "uniformity of living standards" demanded by the German Basic Law (constitution) and employed to legitimise the wide-ranging fiscal equalisation system has not yet been achieved anyway, despite West-East transfers totalling somewhere around EUR 2 trillion. The federal states in eastern Germany continue without exception to be net recipients in the fiscal equalisation between federal states. That countries like Spain and Portugal implemented far-reaching structural reforms very quickly during the course of the euro crisis can no doubt be explained in part by the fact that no fiscal equalisation mechanism exists in Europe to automatically smooth out the economic differences between the countries. This is something that the proponents of a European fiscal equalisation system, who are currently expressing their views more avidly again, should take into account in their arguments.

The German experience teaches that transfer payments can accompany structural changes and offset financial differences. However, fiscal equalisation schemes also create dependencies that in turn hinder the necessary structural change.

5. Fiscal equalisation between federal states



In millions. Negative numbers indicate a contribution to the fiscal equilisation mechanism. Source: Federal Ministry of Finance.

BERENBERG

PARTNERSHIP SINCE 1590

Joh. Berenberg, Gossler & Co. KG
Neuer Jungfernstieg 20
20354 Hamburg
Germany
Phone +49 40 350 60-0
Fax +49 40 350 60-900
www.berenberg.com
info@berenberg.com