# TEN YEARS AFTER GERMAN ECONOMIC UNIFICATION: ARE THERE ANY LESSONS FOR KOREAN UNIFICATION?

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Ten years ago, in 1990, Western and Eastern Germany became unified. After a short period of unrest in 1989, unification was finalized incredibly fast and came as a surprise to all, laymen and experts alike. In the following years, Western German political, economic and social institutions were transferred to the former German Democratic Republic (Eastern Germany). Together with this, considerable amounts of money and expert knowledge were transferred to create the 'flourishing landscapes,' which then-German chancellor Helmut Kohl had promised the Eastern Germans before unification. Considerable changes were achieved and Eastern Germans today enjoy a standard of living much higher than in all other transformation states in Central and Eastern Europe. However, still some urgent economic problems are remained unsolved and an economic convergence is far from being achieved. This article takes a retrospective look on ten years of German unification focusing on monetary unification, institutional changes, privatization and the labor market. Finally, it discusses comparisons with the Korean situation.

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## I. Introduction

Ten years ago, in 1990, Western and Eastern Germany reunited. After a short period of unrest in 1989, unification came about incredibly fast and was a surprise to all, laymen and experts alike. In the following years, Western German political, economic and social institutions were transferred to the former German Democratic Republic (East Germany).[1] Together with this, a considerable amount of money and expert knowledge was transferred to create a 'flourishing landscape,' which then German chancellor Helmut Kohl had promised the East Germans before unification. Considerable changes were achieved and East Germans today enjoy a standard of living much higher than that of other former communist states of Central and Eastern Europe. However, there are still some urgent economic problems that remain unsolved and a true economic convergence is far from being achieved.

This paper will take a retrospective look on the tens years of German unification and discusses comparisons with the Korean situation. In the second section economic co-operation in Germany before 1989 is discussed. Often the Korean situation of today is compared with the rapprochement policy of Germany since the 1970s. The long road from the rapprochement to unification in Germany might hold some lessons for today's situation in Korea. Unification in Germany meant an almost complete transfer of Western German institutions to the former GDR. The third section analyzes whether or not this transfer was facilitated or inhibited the transformation of the East German economy. The fourth section deals with monetary unification in Germany as a political and economic problem. Privatization and

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1 Before German unification, the term 'Eastern Germany' was used for the German territories now lost to Poland and the former GDR was called 'Central Germany' (Mitteldeutschland). However, after unification and the '2+4' - peace talks, it was called Eastern Germany. Synonymous is the term 'neue Bundeslander' (new federal states).

industrial restructuring are discussed in section five, followed by the concluding section that focuses on the lasting problem of unemployment in Eastern Germany.

## II. Economic Cooperation in Germany Before 1989

Economic relations between West Germany (the Federal Republic of Germany, FRG) and East Germany (the German Democratic Republic, GDR) always played a special role in the long road from German division to eventual unification. After the Second World War, the four occupying powers (the USA, United Kingdom, France and the Soviet Union) decided in Potsdam in 1945 that Germany was to be administered as a single economic entity.[2] While political division and the foundation of the Federal Republic of Germany and the German Democratic Republic in 1949 made this obsolete, economic relations still remained in existence. The special situation of West Berlin (an island surrounded by the GDR) made inter-zonal economic contacts necessary, and, after the failed boycott of Western Berlin in 1948, German inter-zonal trade played a prominent role in economics and politics.[3]

*Innerdeutscher Handel* (East-West trade) was not carried out in scarce foreign currencies, but in special *Verrechnungseinheiten VE* (units of account). In many respects, this gave the GDR an advantage over other socialist states, which could only carry out trade in hard currency, usually the dollar. Trade between Eastern and Western Germany was

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2 However, de facto the Potsdam conference showed already an impossibility to reconcile the American idea of rebuilding Germany as a sustainable country and the Soviet idea to press for the highest reparations possible. The Soviet gained the exclusive right to administer reparations in their zone, while the three other zones followed a much more moderate reparation policy; see Graml (1989), p. 42. For the dispute about reparations after the war see Kuklick (1972).

3 For an overview see Haendcke-Hoppe (1989), pp. 646-650.

strictly bilateral and was equilibrated annually by an interest-free credit. Even as West Germany became integrated into the European Community, trade between the two Germanys was exempted from any tariffs or quotas on goods. Only the politically imposed restriction of trade in technology (according to the so-called cocom list of sensitive goods) was applied to the GDR as it was part of the socialist bloc.

With the policy of rapprochement and peaceful coexistence in place since the late 1960s, economic relations took on a new dimension. Western Germany became the second-largest trading partner for the GDR accounting for almost 12 percent of its foreign trade, after the Soviet Union, which accounted for around one third of its foreign trade. With reductions on the VAT, trade was additionally promoted. For West Germany this had an important political dimension: Since the *Grundlagenvertrag of 1972* (the basic treaty regulating the relations of the FRG and the GDR) the GDR insisted on the existence of two independent German states, but even the leader of the GDR, Erich Honecker, had to admit that there were still special trading relations between the two nations.

In the 1970s the competition between the economic systems of the East and West was intense. The goal of the leadership of the GDR under Ulbricht and Honecker was to overtake West Germany in production.[4] One reason was that East Germans had (in contrast to

4 The somewhat strange formula for that was called "Uberholen ohne Einzuholen" (overtaking without reaching), meaning that the GDR did not want merely to reach some standards set by a Western country, but to set itself new maximum standards in science and technology - a goal that became more and more illusionary; see Cornelsen (1989), p. 267. Honecker stressed especially the importance of microelectronics, CAD/CAM, modern computer technology, automated production systems and other new technologies; see Jeffries (1990), p. 120. However, given the framework of a socialist economy, serious innovation problems were inevitable and the technological gap to Western Europe was rising - a problem that North Korea also faces. The import of key innovative technologies without an appropriate environment (e.g. functioning markets, including labour markets) will not allow the North to catch up.

other socialist countries) easy access to West German TV and could directly compare their unfavorable living standards with those of their brethren in the West. In the effort to grant their citizens better living standards, consumer goods and technological goods were imported from Western countries and West Germany. This led to an accumulation of debt, which came to a sudden end in 1981, as Poland and Romania defaulted on their debts. At that time, the GDR had accumulated debts of around $11.67 billion (excluding transactions with West Germany) and could not raise any more money on Western financial markets.[5] However, the special relation East Germany enjoyed with West Germany helped overcome this crisis. In 1983 and 1984 two unconditional lines of credit worth one billion DM each were guaranteed by West Germany.

After the debt crisis, the GDR tried to increase its exports to improve its balance of payments situation. However, the poor quality of East German goods made trade with the West increasingly difficult. Therefore, more than 55 percent of all exports were raw materials and intermediate goods of low quality. Especially, mineral oil products were important, since the GDR enjoyed relatively cheap supplies from the Soviet Union. This later led to the bizarre result that the GDR suffered as much as oil exporting countries from the drop in the price of oil in the late 1980s. Besides trade, license productions of Western goods (the most famous were Salamander shoes) accounted only for a small part of economic co-operation. Until 1989, joint ventures were impossible, since the GDR feared extended contacts with the West for political reasons. The Hungarian reforms and reforms in other socialist states, were viewed by an increasingly phobic socialist leadership of Honecker with mistrust, as they were thought to be a deviation from socialist orthodoxy.

One of the main reasons for the superior performance of the GDR

5 Until 1985, the GDR could reduce the debts by 5 bn dollar, but in the following years it was raising again; see Haendcke-Hoppe (1989), p. 644.

compared to other socialist countries was the steady flow of Western German money. In addition to the annual credits mentioned above, which were estimated at around 2.5 billion DM. This includes an annual maintenance fee of 575 million DM for the transit route from the FRG to West Berlin (a motorway full of potholes), fees for special services (like postal services or visa fees), the revenues from so-called intershops (with Western goods, mainly for Western tourists and those with relatives in the West) and tourist hotels and the forced exchange of 25 DM (or 15 DM for retired persons) daily for visitors of the GDR at the fictitious rate of 1:1 (DM for Ostmark). Additionally, Western Germans sent parcels estimated to be worth approximately 750 million DM annually to East Germany.

What was the Western motivation for these transfers? First of all, the special situation of West Berlin was in question. While East Berlin was labeled 'the capital of the GDR,' West Berlin was seen by the GDR as a special territory, not part of the FRG. The isolation of West Berlin gave the East some leverage, but transfers and the transit route helped to foster relations between West Berlin and the FRG. Moreover, transfers also improved long term relations with the East. While direct conditionality was avoided, financial transfers were sometimes made openly, sometimes implicitly linked to the improvement in East-West relations. The concerns over the border regime, and the murders of those attempting to flee, were the most visible point of Western criticism. Another concern was the increased possibility of personal visits by people from both parts of Germany. In 1987, more than 3 million Eastern Germans could visit the Western part of Germany.[6] This not only was important for the families and their cross-border ties, but it also confirmed the status of Germany as one nation.

6 For 1988, according to the statistics published in the socialist party newspaper "Neues Deutschland," almost 7 million visits to non-socialist countries were granted to the GDR citizens and slightly more visits from non-socialist countries to the GDR took place; see Schwartau / Vortmann (1989), p. 303.

Can there be any lessons from German economic co-operation for Korea? Definitely. However, the situation is not comparable, since East Germany was firmly integrated politically with the socialist bloc, not isolated like North Korea, and therefore enjoyed much less sovereignty over its decisions. One lesson is that economic co-operation is a double-edged sword. Later accounts of East German politburo officials show that without Western financial aid the GDR might have collapsed even earlier than 1989. The last two socialist governments in late 1989 and 1990, led by Krenz and Modrow, tried desperately to get additional West German credit to stabilize their political situation. Critics note that West German financial flows might have unnecessarily prolonged the socialist regime of the GDR.

On the other hand, East-West economic co-operation might have played a decisive role in peaceful unification. Western aid and trade could not overcome the economic difficulties of a centrally planned economy. But it could alleviate the poor living conditions in the GDR while simultaneously improving official relations. The leadership of the GDR was always aware of the long term destabilizing impact of these relations on their regime. This is the reason why they tried to avoid co-operation in the form of joint ventures in the late 1980s that other socialist countries tried out. Even if the Western financial flows might have extended the survival of the socialist regime, it is questionable, if an earlier collapse in the early or mid-1980s in the differing international environment of that time would also have led to a peaceful reunification process.

If, with the help of economic co-operation, inter-Korean relations can improve as inter-German relations improved in the 1970s and 1980s, it should be seen as a chance for possible peaceful reunification. Short-term expectations to overcome the desolate economic situation of North Korea or to realize profitable opportunities for South Korean firms should best be avoided. In the long run, economic relations might be a helpful steppingstone leading to unification, which may also slowly change the attitudes of Northern Koreans used to fifty years of socialist misallocation and mismanagement. German experience shows that this is one of the most challenging tasks of economic transformation. Especially, the importance of increased contacts for a comparison of the socialist system in North Korea and the capitalist system in South Korea are important - in Germany the citizens of the former GDR enjoyed relatively free access to Western TV, in North Korea the seclusion is much more complete.[7]

## III. German Unification as Institutional Transfer–Blessing or Burden?

The speed of unification was probably the most amazing feature of the German unification process. Unification experts and laymen alike were twice fooled: First, they did not expect unification to come at all until late 1989. Then, after the opening of the border in October of 1989, they did not expect it to come so soon and so completely, leading to the absorption of the GDR by Western Germany in October of 1990. As in October of 1989 the borders were open, soon afterwards the new Prime Minister of the GDR, Hans Modrow, a reform communist, proposed a partnership treaty with Western Germany. This was immediately answered by the 10 Point Plan of West German Chancellor Helmut Kohl, who first opened the way to unification.[8]

While these plans still envisioned the possibility of unification as being rather distant, in February of 1990, as Helmut Kohl was campaigning in East Germany for the first free parliament (*Volkskam-*

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7 The importance of the access to TV can be seen in the name, the GDR citizens gave the region around the Saxonian town Dresden, where due to the geographical situation Western TV could not be watched: It was called “valley of the uninformed” (*Tal der Ahnungslosen*).

8 For the text see Kohl (1991).

*mer*), he offered a single currency plan to the GDR. This proposal was immediately greeted with enthusiasm by the East German people, and was the beginning of a massive program of institutional transfer that considerably speeded up the unification process. After the landslide victory of the conservative, pro-unification 'Alliance for Germany' in East Germany, in May of 1990, West Germany established a German unity fund of 115 billion Deutschmarks (around $80 billion, then). While today the sum seems to be inadequate, at that time most economic experts expected that the revenues from privatization would make unification largely self-financing. On May 18, 1990 Helmut Kohl and the new East German Prime Minister Lothar de Maziere signed a state treaty establishing an economic, monetary and social union. In July, five new states (Saxony, Saxony-Anhalt, Mecklenburg - West Pomerania, Brandenburg and Thuringia) were established in East Germany according to the West German model of federalism. At the end of August the unification treaty was signed, which signaled an almost complete transfer of West German institutions to East Germany by the date of unification, October 3, 1990.

The East German economy at the time of unification faced an overwhelming number of problems: Immediately visible to every visitor, the whole state was gray; industry was in decline; the environment devastated. The centrally planned economy distorted incentives for workers and managers alike. Wages and prices did not reflect shortages, economic planning was weak, i.e. distorted by incorrect information and production outside the plan. Despite the import of Western technology, the technological gap with the West was widening in crucial fields such as technology. Some necessary goods such as foodstuffs were heavily subsidized. Firms with deficits were subsidized as well, and bankruptcy was unknown (so-called "weak budget constraint" of firms). Therefore, every firm, regardless of its inefficiency, could survive in the GDR.[9]

In this situation it was clear that economic institutions like laws, legal norms or organizations had to be changed.[10] But the obvious question is in what direction? First, the leaders of the citizens movement thought of something like a third way, new institutions such as the short-lived idea of round tables—where citizens and state met to discuss changes.[11] However, the socialists resented such changes and the inexperienced leaders of the citizens' movement made these meetings often ineffective. Soon, it became clear that the great majority of East Germans wanted an immediate introduction to Western institutions.

The institutional transfer that followed meant that East Germans had to accept West German laws, legal norms and organizations as a whole, with all their problems: Red tape, over-regulation, historically-high standards of social and environmental regulation, without an immediate convergence of income.[12] Despite these problems, institutional transfer can be seen as the most valuable asset in East German transformation compared to transformation in Central and Eastern Europe.[13] East Germany immediately enjoyed the certainty about its

9 For an extended discussion of economic problems of socialism see Gregory / Stuart (1998).

10 Speaking about institutions in an economic sense, one can distinguish 'formal' (external) institutions, which are laid down clearly like laws, and 'informal' (internal) institutions like customs and private dispute settlement.

11 For an overview over different utopias in the citizens' movements see Engelhardt (1991), pp. 142-143, Artzt (1997), pp. 24-29. Soon, those reformers which did not accept the transfer of institutions (mainly gathered in the 'Neues Forum') were marginalized in elections.

12 In the discussion about institutional transfer, it is often said that Western Germany's model of 'Social market economy' was transferred to the former GDR. This is, however, misleading if the ideal type 'social market economy' is meant. Western Germany itself saw a long decline of its model of social market economy, leading to the discussion of 'reform traffic jam' and 'German disease' in the early 1990s. See, for example, Streit (1997), pp. 6-9. The decline of the German model (and, ultimately, growth) can be explained with Olson's theory of the rise and decline of nations due to increasing special interest legislation in stable democracies; see Olson (1982).

13 See Seliger (2000a).

new legal system. Disputes over law, the uncertainties about future investment, and the weak enforcement of law, all these problems were largely absent.

The problem of enforcement is especially important. While it is easy to transfer laws, an enforcement requires specific knowledge and skills. After 1990, thousands of civil servants, managers and academics helped implement the new institutions in Eastern Germany in a smooth way. While they were often resented as '*Besser-Wessi*' (literally a Know-it-all Westerner), their role should not be underestimated. Managerial skills, judicial skills for the new law, and academic skills under the conditions of freedom of research instead of Marxist-Leninist indoctrination were largely absent in Eastern Germany. The social sciences departments of universities, the schools, the courts, all could profit from this transfer of experience. Today, for example, East Germany offers a very well renowned university landscape. Universities like Humboldt University in Berlin or Jena University, with its ancient tradition, attract students with their modern research facilities, scholars and students from all around the world. Without an institutional transfer, this would not have been possible.

An institutional change does not only mean a change of laws and organizations, but also a change of social norms and values. This process is much more difficult, since these norms are often deeply rooted inside human beings. The change from the 'homo sovieticus' (soviet man) to 'homo oeconomicus' (the capitalist man) is a challenging task.[14] Values that were long seen as detrimental, like entrepreneurship, suddenly became central to the new economy. The socialist production process, with its frequent interruptions due to shortages and with labor hoarding inside firms, led to a totally different work

14 For an idealized classification of attitudes in market economies and socialist economies see Brinkmann (1995), p. 110. However, this does not mean that entrepreneurship was completely absent in the GDR and other socialist countries; see Seliger (2000b).

ethic. Marketing was not necessary under central planning. To change these 'internal institutions' is not easy and will require at least a generation.[15] Even today, East German firms are weak in international markets. Their export orientation is much lower than that of West German firms. A lack of marketing skills is an important explanation for this. However, a new generation of entrepreneurs in high technology is also developing, especially in Saxony and Thuringia.

For Korea, the German institutional change offers two lessons: First, "One state - two systems" is illusory. Even waiting for the "spontaneous" development of appropriate external institutions is illusory. A transfer of institutions will offer the smoothest way of unification. It can prevent the chaos and unpredictability typical of states in transformation. But this does not mean that the transfer of South Korean institutions completes unification. The change of internal institutions will require an unpredictably long period of time. Also, while an institutional transfer is superior to any other possible way (e.g. the development of specific new North Korean institutions in the process of unification), it nevertheless means that institutions will have to be adjusted to North Korean circumstances. This is the more true for those institutions affecting the competitiveness of the North Korean economy. Germany's monetary unification and labor market unification are good examples of this, and they will be subsequently discussed.

## IV. Germany's Monetary Unification and Its Aftermath– A Political Success Story and Economic Disaster

After the opening of the border with the German Democratic Republic in October of 1989, the uncertainty over the future led to a mass migration from East Germany to West Germany. In March of

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15 On the role of informal institutions in transformation see Mummert (1995 and 1998).

1990, only half a year after reunification, almost 600,000 people, mostly younger and more flexible, left East Germany. East Germany's economy was on the brink of collapse, and West Germany wanted to put a brake on migration. In this situation, the introduction of a common currency was seen as a major step to prevent migration. In East Germany, demonstrators shouted 'If the Deutschmark does not come to us, we will go to it."[16] Money in Germany had a symbolic value, since the currency reform of 1948 ended post-war inflation, and created a stable currency that is accepted worldwide and is linked in the mind of German citizens to the post-world war German 'economic miracle.'[17]

In this situation Helmut Kohl in early February of 1990, as he was electioneering for the first free parliament of the GDR, the Volkskammer, proposed an early currency union. He was not only concerned with migration and the favorable effect on the conservative 'alliance for Germany,' which he supported, but also hoped that a currency union would irrevocably cement unification. While the Gorbachev government in the Soviet Union was sympathetic to unification, his regime was shaky and endangered by a reversal. The failed coup d'etat of 1991 proved Helmut Kohl's suspicions.

While the people of the GDR enthusiastically greeted Kohl's announcement, all economic advisors were *unisono* in arguing against an early currency union. Especially the Bundesbank, the German Central Bank, feared that monetary unification would not be able to achieve its three economic goals: To guarantee liquidity to all of Germany, to allow East German industry, to maintain its competitiveness and to supply scarce capital for the building up of a new, modern capital stock in the former GDR.

Money in the GDR had a different function than in Western capital-

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16 "*Kommt die DM, bleiben wir, kommt sie nicht, gehn wir zu ihr.*"

17 In fact, the German national identity after the Second World War largely centered on the 'economic miracle' and the Deutschmark; see Spaulding (1997).

ist states. Prices did not reflect supplies, but were rather arbitrarily fixed. Instead of price hikes, the rationing of goods with fixed prices was applied, which led to the notoriously long queues for scarce goods in the GDR. For example, rents were for almost fifty years held at the niveau of 1937. Citizens accumulated money in their savings accounts, which they could not spend on the rationed goods, creating a so-called monetary overhang. The Bundesbank set conditions for monetary unification, which came into force in mid-1990. It was granted control over the currency union's monetary policy, and the West German banking system and West German financial and economic regulations were transferred to the East.

However, the most sensitive issue was the question of the conversion rate of Ostmark (currency of the GDR) to Deutschmark. The official exchange rate for this currency, which was not traded freely, had been 1 Ostmark to 1 Deutschmark before 1990. However, the black market rate was 1:5 to 1:10. The Deutschmark was a means to buy otherwise scarce goods, e.g. in the system of Intershops of the GDR. In terms of purchasing power, the exchange rate should have been more favorable; some economists argue even that the purchasing power of the Ostmark was higher than that of the Deutschmark.[18] But this argument ignores the differences in quality between goods made in the East and those made in the West, as well as the different rationing mechanisms in capitalist and socialist countries. In terms of foreign trade, the GDR applied an exchange rate of 1:2.5 to 1:5 or sometimes even 1:8 Deutschmark to the Ostmark. Export prices were fixed independently from costs, the main goal was to fulfill the ever-growing thirst for hard currency.

So, while old comparisons were useless in determining the conversion rate, the problem was complicated by a pre-election pledge made by Chancellor Helmut Kohl to switch currencies at a 1:1 rate. Later

18 See Sinn / Sinn (1994), p. 54, for an overview over different estimations, which range from 100 Ostmark / 128 DM to 100 Ostmark / 88 DM.

discussion of this issue led to a strong pressure on politicians not to take a different conversion rate.[19] The formula actually taken was slightly more complicated: Wages, prices and pensions were converted at a 1:1 rate, the first 4000 Marks of savings also (somewhat less for children, somewhat more for the elderly), the remainder of savings and financial claims (firm debts and housing loans) was converted at a 1:2 rate and so-called speculative money acquired shortly before unification was converted at a rate of 1:3.

Despite this conversion rate, the Consumer Price Index could be held remarkably stable, at an inflation rate of around 2.8 percent in 1990 and slightly above four percent in 1991 and 1992. But the costs for this were high and called by then Bundesbank President Karl Otto Pohl a 'disaster.'[20] Suddenly, East German firms had to compete with Western firms at the same level of prices, wages and costs, despite much lower productivity. Industrial output dropped in one month, July 1990, by 35 percent, and in the next month by another 15 percent. Unemployment soared and migration continued unabated. The hope of politicians to have one monetary area with two wage rates did not come true: In 1990 alone, wages rose by around 40 percent, putting additional strain on East German companies. Unemployment and falling tax revenues led to mounting budget deficits.

The Bundesbank fought against rising wages and budget deficits and a deteriorating current account position with interest rate hikes, which peaked in 1992 and were one factor in the crises of the European Monetary System (EMS) in autumn of 1992 and July of 1993.[21] The alternative, to revalue the Deutschmark, was not accepted by

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19 See Tietmeyer (2000). Hans Tietmeyer, a close aide of the German chancellor Helmut Kohl at the time of unification and later Bundesbank president, calls his article of review of 10 years of German unification characteristically 'German unification: learning from our mistakes.'

20 See also a recent interview with Pohl in Suddeutsche Zeitung (29.6.2000).

21 See Eichengreen / Wyplosz (1993). For the impact of monetary union on Germany's neighbors see also Deutsche Bundesbank (1992).

Germany's Western European partners in the EMS. In retrospect, giving the uncertainty about the external situation and domestic development in East Germany, monetary unification seems to have been inevitable in 1990. However, at the decided rate it undoubtedly also was a major reason for de-industrialization and unemployment in East Germany. It seemed impossible to maintain low wage levels in a currency union. Wages in East Germany rose, and continue to rise, much faster than productivity. The political aim of unification and the economic goal of competitiveness could not be reconciled. As long as the productivity level of the two countries is quite different, a monetary union will inevitably end up with this problem: fast wage increases with a destruction of competitiveness or mass migration in the case of persistent dramatic wage differences. Germany still suffers from this after 10 years.

Korea will eventually face the same problem. If unification due to political circumstances (the change of regime in North Korea) happens without the economic situation in North Korea considerably improving, opening the border will pose a problem. The country must retain two currencies and differences in income and wage levels must persist. This situation from an economic point of view is desirable; since it allows for the gradual improvement of North Korean competitiveness, e.g. through foreign and Southern direct investment in an attractive low-wage location. However, this inevitably means that there will be a problem of mass migration towards the South, since cultural obstacles to migration are practically non-existent (common language and culture). Or South and North Korea form a currency union according to the German model, with an overvalued Northern currency. From the point of view of political economy, this seems more probable, as the German example showed. Even if such a union is manageable by monetary authorities (as in Germany), it means the loss of competitiveness of North Korean firms and resulting mass unemployment.

## V. Privatization and Restructuring in East German Transformation

One of the main tasks of transformation of the Eastern German economy was privatization.[22] In the German Democratic Republic (GDR), according to socialist creed, there was virtually no private ownership of the means of production. From 1945 to 1949, the Soviet occupation forces in East Germany nationalized important parts of industry and collectivized most of the land owned by the former aristocracy (the '*Junkers*'). Later, the GDR followed this path. With the forced nationalization of small enterprises in 1972, almost 100 percent of productive capital became state owned. Firms were organized as state-owned enterprises (*Volkseigener Betrieb VEB*) or as combines (*Kombinate*), large conglomerates that were characterized by vertical and horizontal integration.

In 1990, there was a consensus that the form of property had to be changed. Long before, the economists of the property rights school maintained that the form of property rights in socialist countries: state owned enterprises, were a major factor explaining the inefficiency of centrally planned economies.[23] Therefore, privatization seemed inevitable. But the way toward privatization was less clear: Western experiences with privatization since the 1980s were limited to a few, maybe a hundred (such as Chile) public companies, which underwent a long restructuring period before they were sold in the capital markets. This was not possible in the case of the former GDR, where these preconditions were not given. Another problem was the claim of former owners to forcibly nationalized property. Unified Germany wanted to provide a legal way for such people to recover their property. The other alternative, namely, the compensation of former owners, was feared for its detrimental fiscal impact. But in fact, restitu-

22 For an overview of privatization in Eastern Germany see Sinn / Sinn (1994), pp. 81-139.

23 For an application to transformation, see Riker / Weimer (1995).

tion claims were a major obstacle to the privatization of firms. Around 90 percent of restitutions were contested, often resulting in lengthy delays in investment. Therefore, in 1991, the German parliament passed an ‘obstacle removal law,’ which gave priority to investment over restitution.

The last socialist government of the GDR passed on March 1, 1990, the first Treuhand Act (Trusteeship law). With the passage of the law, a holding company for state-owned enterprises was formed and called the Treuhand. Through this institution, the socialists hoped to preserve this property as state property and also allowed members of the *nomenklatura*, the party and managerial class, to strip the companies of their assets. In July of 1990, the first (and last) freely elected East German parliament changed the Trusteeship law. From then on, the Treuhand was responsible for the competitive restructuring and privatization of its assets. In fact, the Treuhand became the largest company in the world: 8000 firms, 120 of them combines, with at least 40,000 plants, all under the trusteeship of the Treuhand. In July of 1990, those firms were transformed into incorporated companies. The Treuhand resumed their credit payments and guaranteed their survival for some time. Additionally, around 4 million hectares of land, half of its farmland and half of its forest, had to be privatized by the Treuhand.

The so-called ‘small’ privatization of retail businesses, movie theatres, restaurants, hotels and craft and services businesses was comparatively easy. The Treuhand either allowed for a Management-Buy-Out (i.e. the management became the owner, often leveraged by state-aided credit) or auctioned these firms off. But the privatization of the industrial property of the former GDR was much more complicated. Companies with sound business prospects (like gas stations) were quickly sold. But most companies were using degraded capital stock, ancient technology, were highly overstaffed, had lost their markets in Eastern Europe due to the break-up of the Soviet-led economic system and were in a price-cost-squeeze due to monetary unification.

Therefore, the original expectation that the Treuhand could generate huge amounts of revenue soon proved wrong.[24] Also, attempts by the state to restructure thousands of companies and make them competitive before selling them did not work. Instead of choosing the investor with the highest bid for a company, the Treuhand tried to sell companies to experienced investors with a track record, which committed themselves to the highest guaranteed level of investment and employment. In the five years that the Treuhand was in existence, from 1990 to 1994, around 20,000 private firms were created, with around 210 billion Deutschmarks of guaranteed investment and around 1.5 million guaranteed working places. With large state subsidies that were sometimes judged to not be in conformity with EU competition rules, industrial cores in steel production; shipyards and the chemical industry could survive. Other firms, which could not be sold, were liquidated.

In retrospect, the sale to individual investors as opposed to the mass privatization by vouchers in some Central and Eastern European countries was successful.[25] No other country completed privatization as quickly. Only experienced investors could guarantee the flow of capital and the management know-how necessary for the survival of firms. West German firms were favored by this process because their direct investment was not restricted by the cultural, linguistic or legal

24 The last socialist Prime Minister, Modrow, in early 1990, estimated the Eastern German collective property (volkseigenes Vermogen) at around 1.6 trill. Ostmark. The Treuhand, however, amassed debts of 205 bn. Deutschmark until the mid-1990s. While the estimation of the collective property's value is not independent from the chosen approach to privatization and the monetary developments discussed above, this shows the unrealistic expectations and the lack of knowledge about the economic conditions in the former GDR.

25 The main advantage of selling assets rather than mass privatization is the problem of dispersed ownership and subsequently the lack of control of corporate governance in the latter case. Countries in CEE like Poland and the Czech Republic, which followed the way of mass privatization, today experience these problems, while those following the 'German approach,' like Estonia and Hungary, have had less problems with the task of privatization.

barriers typical of foreign direct investment.

However, this was also a danger, since the oligopolistic structure of West Germany's industries (like the banking sector) was transferred to the former GDR. Another problem was the subsidization of capital costs. Rightly, Germany's government refused to subsidize labor costs, since this would lead to a distortion of the labor market and delayed structural adjustment. But the subsidization of capital costs (in the form of special subsidies, government guarantees or tax breaks) was also problematic: While on one hand it facilitated the massive capital injection needed in the former GDR, on the other hand it led to investment in high-tech plants with few highly skilled and paid work places. The former GDR did not specialize according to its comparative advantage, namely, an abundant, well-educated and cheap work force.

So the verdict on Germany's post-unification privatization policy is mixed: There are some modern and competitive firms, but there is still a lack of employment opportunities in East Germany. Policies to create jobs in the service sector, and a larger wage-spread are urgently needed. Unemployment remains the single most important problem in East Germany.

## VI. Conclusion: After Ten Years of Unification–Progress and Change and Five Lessons for Korea

After ten years of unification, Eastern Germany shows in many respects an impressive performance and most economic indicators show growing convergence with the West. However, this convergence takes much longer than originally thought and is mainly financed by massive financial transfers, which today amount to more than 1.8 trillion Deutschmark.

Especially disappointing is the situation of the labor market.[26] In East Germany, the average unemployment rate in May of 2000 was

16.9 percent, more than twice the Western German rate of 7.5 percent. In some regions, especially the weak Northeast, unemployment is well above 20 percent. Before the Second World War, the Central German regions of Saxony, Thuringia and around Berlin were the industrial core of Germany. In the former GDR, the prominent role of heavy industry and the neglect of light and consumer industries fostered this role.

After unification, these industries suddenly had to compete internationally. However, given their old capital stock, the new demand conditions and the loss of traditional trade links, and monetary unification with its revaluation effects for Eastern Germany, their productivity was not sufficient to compete. To increase productivity, firms tried to get rid of the less productive workers. In central planning, firms were interested in receiving as many resources and workers as possible for plan fulfillment. After unification, this ‘labor hoarding’ was useless and many firms retained only 30 percent or in some cases just 10 percent of their former employees. Newly created firms could not absorb the dismissed workers fast enough to head off massive unemployment.

From 1989 to 1993, the number of employed in East Germany decreased from 9.9 million to only 6.2 million. Since this figure included newly created employment, it can be said that around half of the workers in the former GDR lost their jobs. The state tried to upgrade the qualifications of East Germans through an active labor market policy, but the state often lacked knowledge about the qualifications needed in the private labor market. Especially for older unemployed persons, the possibility of finding a job was small. Migration to West Germany, especially in border regions, played an important role in alleviating the problem of unemployment.

In this situation, the role of wage policy was disastrous: The trade unions demanded a fast wage convergence according to their slogan of

26 See Siebert (1995), pp. 105-122.

Table 1. The Eastern German Convergence Process

(Western Germany=100 percent)

| | 1991 | 1995 | 1999 |
|---|---|---|---|
| GDP / per capita | 31 | 55 | 56 |
| Net income / employee | 55 | 82 | 86 |
| Hourly Labor cost | 49 | 67 | 69 |
| Productivity | 33 | 53 | 56 |
| Per unit labor cost | 151 | 135 | 123 |
| Export quota | 52 | 40 | 53 |
| Investment / capita | 63 | 148 | 135 |
| Unemployment | 207 | 198 | 225 |

Source: Institut der Deutschen Wirtschaft, Cologne

'same payment for the same kind of work.' Given, that the productivity levels in East and West were different and that the relative scarcity of labor and capital was different, this slogan missed the point. More important, in the bipartite negotiation system transferred from West Germany trade unions had no equal partner. In the first years after unification, managers of firms not yet privatized were mostly appointed for a transition period by the state and not interested in conflicts with the labor force. The employers' associations were staffed by West German managers, who had no interest in low cost competitors in East Germany or at least did not resist the wage demands from trade unions.[27] Resulting from this asymmetry was a dramatic increase in wages: In 1992, Eastern German wages rose by more than 35 percent, in 1993 by an additional 15 percent and in the two following years by more than five percent each. While the productivity also increased during that time, the productivity wage gap was not closed and still today

27 Later, employer's associations in Eastern Germany saw this as a grave mistake, but by then, it was too late to reverse a wage policy and subsequently many employers left the employer's association to have the possibility to pay lower wages than the official ones; see Winkler (1998).

production per unit is on average 20 percent more expensive in East Germany than in West Germany.

For East Germans, the resulting convergence in incomes is impressive. Today, the net income of employees is more than 85 percent of the Western average. Also, pensions rose by 165 percent since 1990, while in West Germany they rose only by 23 percent. But the costs of this strategy were high, not only in increasing debt levels and huge transfers but also in inflexibility of the economy and unemployment. In a dynamic and growing economy, for additional employment to be created, wages have to rise less than productivity. In East Germany, the opposite was the case. As a result, the upswing in the East was not self-sustaining, but largely financed by the West. It should be noted that de-industrialization and mass unemployment also mean social problems and regional problems: Not all regions are similarly affected, some regions in Northeast Germany are now de-populating.

The state tried to alleviate these problems with more than 150 different programs of regional, economic and technological aid. However, after ten years of unification and as a consequence of these policies, it can be said that the state largely failed in this task. Instead of intervening in the economic process, the state should try to create a framework for competition between regions. The rigidity of the German labor market is one of the hindrances to forming such a competitive framework. An overwhelming number of employees are covered by wage contracts negotiated at an industrial level, not leaving a room for the needs and problems of individual firms.

In this respect, East Germany, with its specific transformation problems, might become a role model for reform of the West German labor market. Due to the rigidity of bilateral negotiations, many East German employers left the employers' association and negotiated wages on the firm level. With this strategy, they could preserve competitive wage levels, which had also an impact on West Germany, where more and more opening clauses in wage contracts allow for flexibility in the difficult economic environment for firms.

Ten years after German unification, the success of economic policies is mixed. Today East Germans enjoy a much higher living standard than ten years ago and higher than all other Central and Eastern European countries. But for a successful economic catching up process, reforms throughout Germany are needed. The 'economic miracle' of West Germany after 1948 could not be repeated by East Germany. In the meantime, Germany accumulated more and more rigidities in their goods and factor markets. Given the unwillingness of the population to tackle cumbersome reforms in these areas, political leaders have so far avoided addressing the issue. To overcome this 'reform traffic jam' is the main challenge after ten years of unification.[28]

Indeed, the current German situation offers some lessons for Korea: A strong and healthy economic partner can alleviate many of the problems, which an inevitable transformation of the economy will bring. So, a precondition for successfully mastering unification is the economic health of South Korea's economy. While the 'four plus one' reform policy (reform of the public sector, the private sector, the financial industry and the labor market) was a good beginning for regaining economic health, the prospects of Korean rapprochement awakened a euphoria in South Korea, which often neglected that fact that the South Korean economy is still far from achieving its own reform goals.[29] Second, while the rapprochement can change the perception of North Koreans of their own economic system (due to the possibility of comparison), it is not a substitute for economic transformation. As long as the main economic mechanisms in North Korea are based on planning, South Korean or international investment will not lead to the necessary modernization of North Korean industry. This is an important difference to the gradualist reform in China, where there is a development of a private sector disconnected from the state planning

28 See Mummert / Wohlgemuth (1998).

29 For a discussion, see Seliger (2000c).

mechanism.[30] Third, the most successful method of economic transformation seems to be the quick and complete transfer of the basic institutions of a market economy, notably legal, but without transferring additional social and economic regulations, which are not appropriate for the level of economic development of North Korea. However, from a political economic point of view, such a transfer is highly unlikely, since it means the acceptance of a split development even in a unified country and increases the problem of mass migration. Fourth, transfers of money can help alleviate the social problems of transformation. However, they tend to persist and then create the danger of preventing structural adjustment and of artificially nurturing a non-viable economy. Therefore, the digressive nature of adjustment transfers with a pre-determined phase out would be economically desirable.

Fifth, most important, every transformation process offers some dilemmas, i.e. situations without an 'optimal' solution. Even the most well prepared unification and transformation (and Korea is in the unique situation to learn from the experiences of the last ten years) cannot escape from that dilemma. One already mentioned is the problem of mass migration; another dilemma is the inappropriateness of transferred institutions, which are nevertheless preferable to the uncertainty. Ultimately, transformation and unification will be costly and lengthy - while a good preparation can help decrease the costs and speed up the time, a 'fast track' towards unification is not possible.

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30 In the case of North Korea, Young (1999), p. 88, speaks of a 'system defending opening,' i.e. an opening of the economy in a way possibly not endangering the economic system. While ultimately, such an attempt to preserve the systems seems to be highly unlikely to succeed (given the experiences of CEE), it nevertheless means that today's Southern and foreign investment in North Korea has a rather limited impact.