

# AICGS Transatlantic Perspectives

October 2009

## What Happened to the Blooming Landscapes?

*By Jennifer Hunt*

What accounts for eastern Germany's stalled economic convergence with western Germany?

How have wage increases, privatization, and an overvalued currency impacted eastern Germany's growth?

*Durch eine gemeinsame Anstrengung wird es uns gelingen, Mecklenburg/Vorpommern und Sachsen-Anhalt, Brandenburg, Sachsen und Thüringen schon bald wieder in blühende Landschaften zu verwandeln, in denen es sich zu leben und zu arbeiten lohnt.*

Chancellor Helmut Kohl

Television address on the occasion of monetary union, 1 July 1990<sup>1</sup>

On the eve of monetary union, Chancellor Helmut Kohl and most citizens of eastern Germany were optimistic that after a painful but short transition period, eastern Germany's economy would rapidly converge with that of western Germany. Economists who based their expectations on historical convergence among regions in other countries, such as the United States, were much more pessimistic. Robert Barro predicted it would take seventy years to eliminate three quarters of the gap in GDP per capita. However, historically lagging regions have not benefited from the largesse eastern Germany has enjoyed: western Germany has transferred 4 percent of its GDP every year for twenty years to the east, a region with initially one quarter of the west's population. A reasonable benchmark for the economic progress of eastern Germany is the Czech Republic, whose pre-1990 economic history was similar to that of East Germany, but which has had no rich cousin to finance its transition. Measured against this benchmark, economic progress in eastern Germany is a disappointment. The puzzle is whether the stalled convergence with western Germany is related to initial policy mistakes, to shortcomings in current policies, or to emigration.

The recent evolution of real GDP in eastern Germany and the Czech Republic is shown in Figure 1.<sup>2</sup> While Czech GDP is now more than 40 percent higher than in 1990, eastern German GDP is less than 10 percent higher than when the Berlin Wall fell in 1989. Large-scale emigration from eastern Germany explains much of the sluggishness of eastern German GDP growth, yet a per capita comparison with the Czech Republic is also unflattering to eastern Germany. In 2008, GDP per capita in the Czech Republic was 92 percent of the eastern German level if Berlin is included in eastern Germany, and 95 percent if Berlin is excluded from eastern Germany.<sup>3</sup> The Czech Republic is thus close to overtaking eastern Germany: these ratios have increased from 80 percent and 86 percent respectively in 2000. The ratio of eastern German to western German GDP per capita meanwhile has stagnated at 78-79 percent since 2003, only slightly above the 72 percent ratio reached by 1995.

Optimistic students of the eastern German economy observe that there is considerable heterogeneity within the east, with some regions performing much better than others. Yet analysis of GDP per capita at the level of the federal state does not support this optimism. Figure 2 shows that Saxony, the richest eastern state other than Berlin, is still far behind the western state that is poorest over most of the post-transition period, Lower Saxony. The gap between the two is much larger than the gap between Saxony and the poorest eastern state, Mecklenburg-West Pomerania. Meanwhile, the unified Berlin economy has stagnated at approximately the level of Lower Saxony. In order to find eastern regions that perform better than the poorest western regions, it is necessary to go to a considerably finer level of geographic disaggregation.

Some economists view eastern Germany as a victim of policies imposed at the time of reunification. The politically motivated decision to unify the currency at a one-for-one exchange rate, for example, is widely viewed as having contributed to the initial collapse of the eastern economy by overvaluing the eastern currency. The huge wage increases imposed by labor unions surely also played a role in the leap in unemployment, the decline in output, and the difficulties experienced in privatizing firms. The *Treuhandanstalt*, responsible for privatizing eastern firms, quickly closed all firms non-viable in the long run. Furthermore, the Treuhand's policy of seeking to match the remaining firms with western expertise led to their becoming subsidiaries of western firms and therefore unlikely to engage in the highest skill tasks, including research and development.

However, any negative effects of monetary union and union wages should have been reversed by price and wage adjustments in the intervening twenty years. A monetary union which overvalued the eastern currency should have been followed by a fall in prices in the east to return the real exchange rate to its correct level. The fact that prices rose in the east casts some doubt on whether the nominal exchange rate was an important factor. In reaction to the initial unrealistic wage demands of the labor unions, the collective bargaining system collapsed, and the share of eastern workers covered by a union contract had fallen to 34 percent by 2000 and has kept falling since. This should have freed wages to fall to the market level even if nominal wage cuts were socially unpalatable, through gradual erosion by inflation. In fact, labor costs per hour worked have been rising gradually since 2000 (to 75.6 percent in 2008). Either eastern wages are not in fact too high, or there is some impediment to adjustment through inflation. Western-level social welfare benefits serve as a floor to wages, but cannot prevent downward wage adjustment in more skilled jobs. If this wage floor were the only impediment, labor costs should fall due to a reduction in skilled wages, thereby reducing wage inequality. Instead, hourly labor costs are rising (apparently due to rising productivity; see below) and inequality has converged to the higher western level. On balance, it seems unlikely that the current stagnation in convergence is a relic of bad policies at reunification, although the long-term effects of the method of privatization are hard to assess.

The analysis of eastern convergence as a problem of regional integration, rather than transition from communism, begins with a decomposition of GDP growth into growth in inputs (capital and labor) and growth in productivity. The slow-down in convergence can be traced to a slow-down in eastern productivity growth. Productivity has not ceased converging entirely: Eastern value-added per hour worked has risen from 70.1 percent of the western level in 2000 to 75.6 percent in 2008. However, this has not been sufficient for eastern Germany to keep pace with the Czech Republic in terms of growth in GDP per capita.

Many possible explanations for the slow productivity growth have been examined by economists and discarded as wanting. Eastern firms initially had to contend with poor infrastructure, difficulties obtaining credit, and a lack of workers with managerial, entrepreneurial, and marketing skills. However, the quality of eastern infrastructure is now equal to that of the west, and twenty years should have been sufficient to attract talent from the west, to train eastern managers, and to establish creditworthiness. Furthermore, these problems would have beset the Czech Republic in equal measure. Eastern firms are smaller than western firms and are less likely to be company headquarters, but this seems merely symptomatic of an underlying problem.

The small size of eastern Germany's manufacturing sector compared to that of western Germany and the Czech Republic may indicate that resources are misallocated across sectors. The government-subsidized construction boom and possibly the labor union influence on wages initially prevented the allocation of workers to the sectors that would be optimal in the long run. The misallocation is likely to have been perpetuated by the long-running government subsidies to capital at the expense of labor, favoring structures (such as housing) over equipment. These subsidies may have led to less investment in equipment than would have been the case without subsidies.

Another set of explanations for slow productivity growth involves the depopulation of eastern Germany. The population decline of 13.7 percent from 1988 to 2008 has been caused in part by reduced fertility, but especially by the emigration of young adults, particularly the educated. This must act as a brake on productivity, particularly if the emigrants are also among the most able workers along

unobservable dimensions. Some economists have further proposed that the depopulation reduces eastern productivity by reducing agglomeration effects: the benefits to firms of having other firms located in close spatial proximity. The Czech Republic's population, by contrast, has remained steady throughout transition.

Sustained economic growth in eastern Germany has proved elusive despite transfers of €1 trillion from western Germany. Slow growth does not appear to be the result of policy mistakes at the time of reunification. However, the passage of time has served to narrow the set of plausible alternative explanations. The loss of productive young people to the west is one remaining hypothesis. From the perspective of the welfare of Germany as a whole, it is not desirable to intervene to stop this emigration, even if it is harming the east. A misallocation of resources across sectors due to distorting subsidies is another remaining hypothesis. The appropriate response may be to reduce as much as possible subsidies to the east that do not flow automatically through the social welfare system: since it is unclear what the market failures are that should be corrected, it may be better at this stage in transition to have faith in the market.

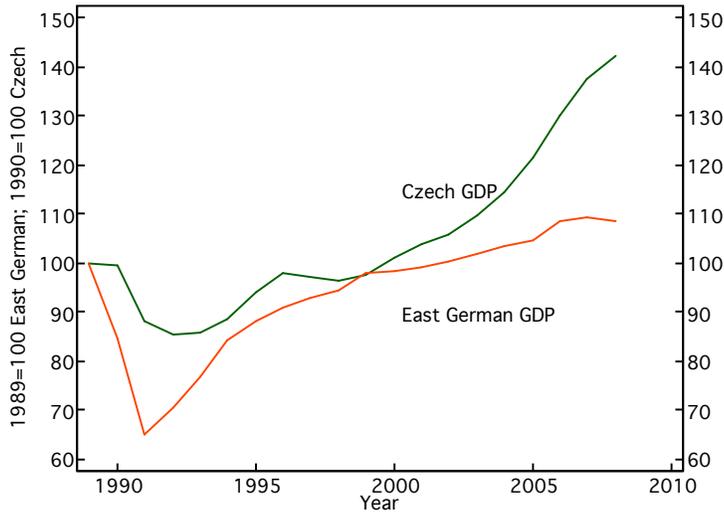
#### NOTES

1 Through a common endeavor, we will soon succeed in restoring Mecklenburg-West Pomerania, Saxony-Anhalt, Brandenburg, Saxony, and Thuringia to blooming landscapes in which it is worthwhile living and working.

2 Data before 1998 are for East Germany including East Berlin. Data from 1998 are based on East Germany excluding Berlin, which yields faster growth than would be the case if Berlin were included. From 1998 no separate statistics for East and West Berlin are available.

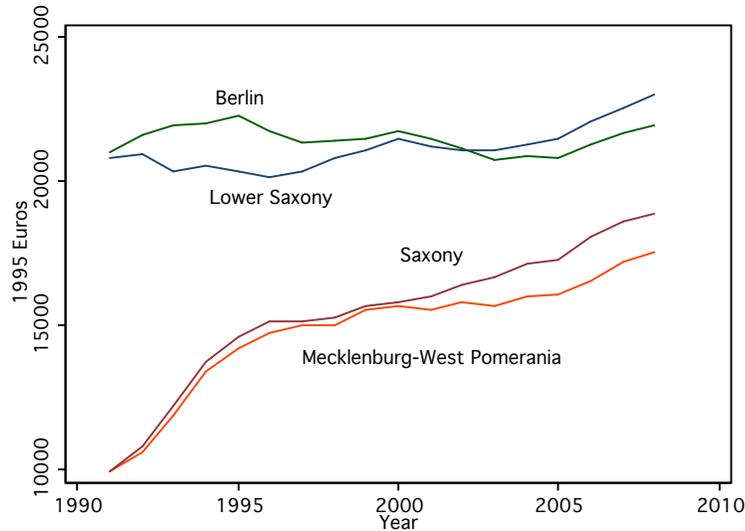
3 The calculations use purchasing power parity exchange rates.

Figure 1: Index of Real East German and Czech GDP 1989-2008



Sources: Czech Statistical Office and Statistische Ämter des Bundes und der Länder.

Figure 2: Real GDP per Capita in Selected States 1991-2008



Sources: Statistische Ämter des Bundes und der Länder.

The American Institute for Contemporary German Studies (AICGS) strengthens the German-American relationship in an evolving Europe and changing world. Affiliated with the Johns Hopkins University, the Institute produces objective and original analyses of developments and trends in Germany, Europe, and the United States; creates new transatlantic networks; and facilitates dialogue among the business, political, and academic communities to manage differences and define and promote common interests.

Through its three program areas (Business & Economics; Foreign & Domestic Policy; and Society, Culture, & Politics), AICGS provides a comprehensive program of public forums, policy studies, research, and study groups designed to enrich the political, corporate, and scholarly constituencies it serves.

AICGS  
1755 Massachusetts Ave. NW  
Suite 700  
Washington, DC 20036  
www.aicgs.org

The views expressed in this essay are those of the author alone. They do not necessarily reflect the views of the American Institute for Contemporary German Studies.

Dr. Jennifer Hunt is Professor of Economics at McGill University and a Research Associate at the National Bureau of Economic Research.

**AICGS is grateful to the Transatlantik-Programm der Bundesregierung der Bundesrepublik Deutschland aus Mitteln des European Recovery Program (ERP) des Bundesministeriums für Wirtschaft und Technologie (BMWi) and the Draeger Foundation for their generous support of this Essay.**