

International Summer Program

European Integration



Germany

From Cold War to the Breakdown of the Iron Curtain

Prof. Dr. Werner Smolny, Tuesday, July 4, 2006

Germany

– From Cold War to the Breakdown of the Iron Curtain

Prof. Dr. Werner Smolny, University of Ulm

Faculty of Mathematics and Economics

Ludwig Erhard Chair

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Germany – An Economist's View

- **Basic Facts**
- **Post World War II Reconstruction**
- **German Unification**
- **Germany Today**
- **Conclusions**

Map of Germany



Germany – Some Basic Facts

- **Founding member of the European Union**
- **Largest country in the EU
in terms of income and population**

- **World Champion in terms of exports**

*German exports are about 10 percent of total world trade
—> about the same figure as compared with the USA*

- **At the eastern border of the old EU (15)
and at the center of the new EU (25)**

Map of Europe



German History: A very short Overview

- **Two devastating World Wars in the first half of the 20th century**
 - *World War I, 1914-1918, World War II, 1939-1945*
- **In between the wars, first democracy, then fascist leadership, 1933-1945**
- **After World War II, democracy and fast recovery**
- **Since 1951, member of the European communities**
- **In 1990, German unification**

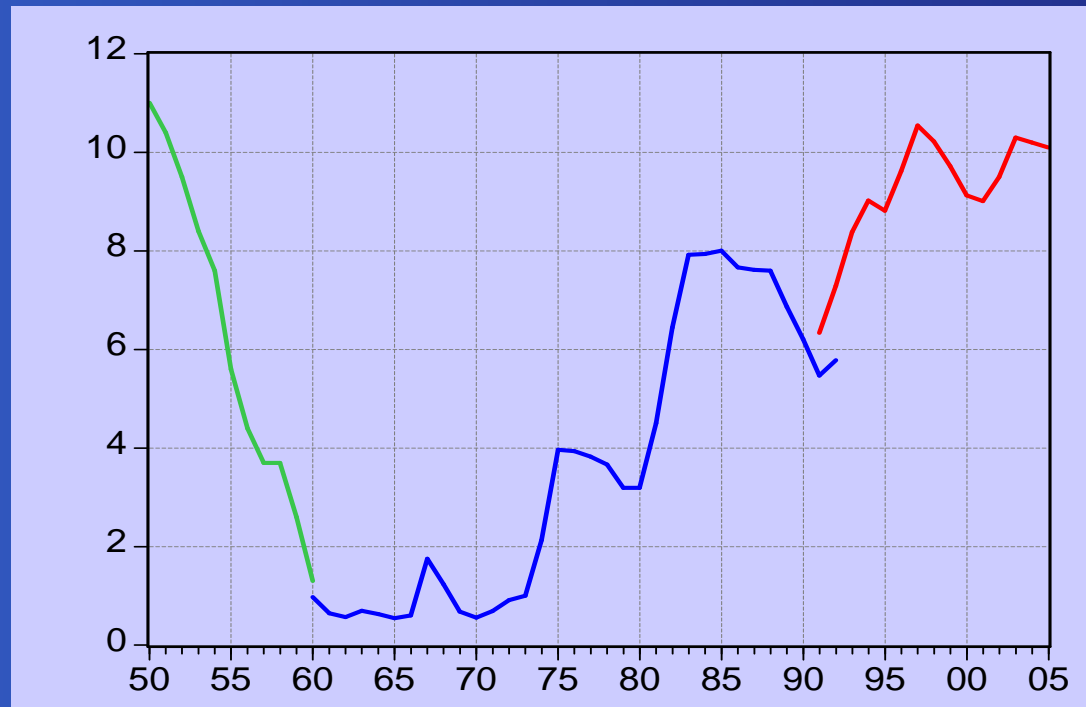
After World War II

West Germany: FRG	East Germany: GDR
<p><i>3 zones: US, UK, France</i> <i>democracy</i> <i>political parties</i> <i>CDU, FDP, SPD, Greens</i></p>	<p><i>Soviet zone</i> <i>“Socialism”</i> <i>one-party system</i> <i>SED</i></p>
<p><i>market economy</i> <i>fast reconstruction</i></p>	<p><i>central planning</i> <i>slow reconstruction</i></p>
<p><i>member of EU and Nato</i></p>	<p><i>member of CMEA and Warsaw Pact</i></p>
<p><i>important role in</i> <i>European integration</i></p>	<p><i>Moskau led</i> <i>member with highest income in CEE</i></p>

Post World War II Reconstruction

- **Doubling of GDP between 1946 and 1951**
- **Doubling of GDP in the fifties**
 - *average annual growth rate: 7%*
- **Full employment with unemployment rates below 1 percent in 1961**
- **Economic growth with 3-4% growth rates and full employment 1960-1973**

Unemployment: Germany since the 50th

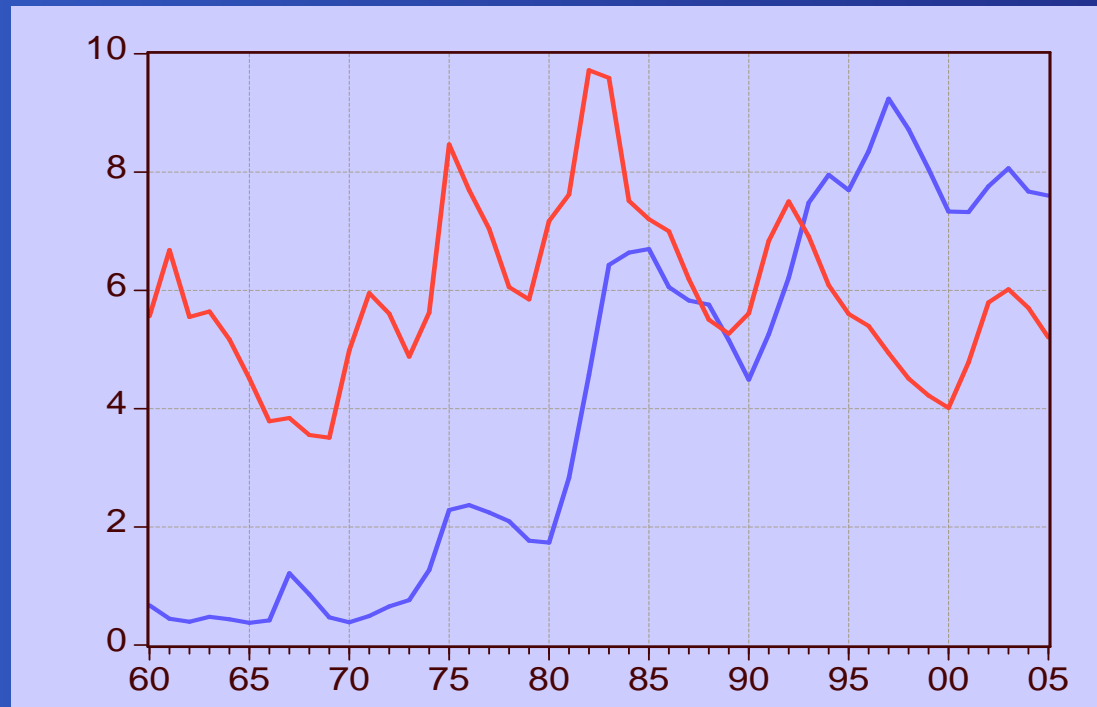


unemployment rate

– *impressive labor market success
in the fifties and in the sixties*

national definitions

A Comparison with the USA



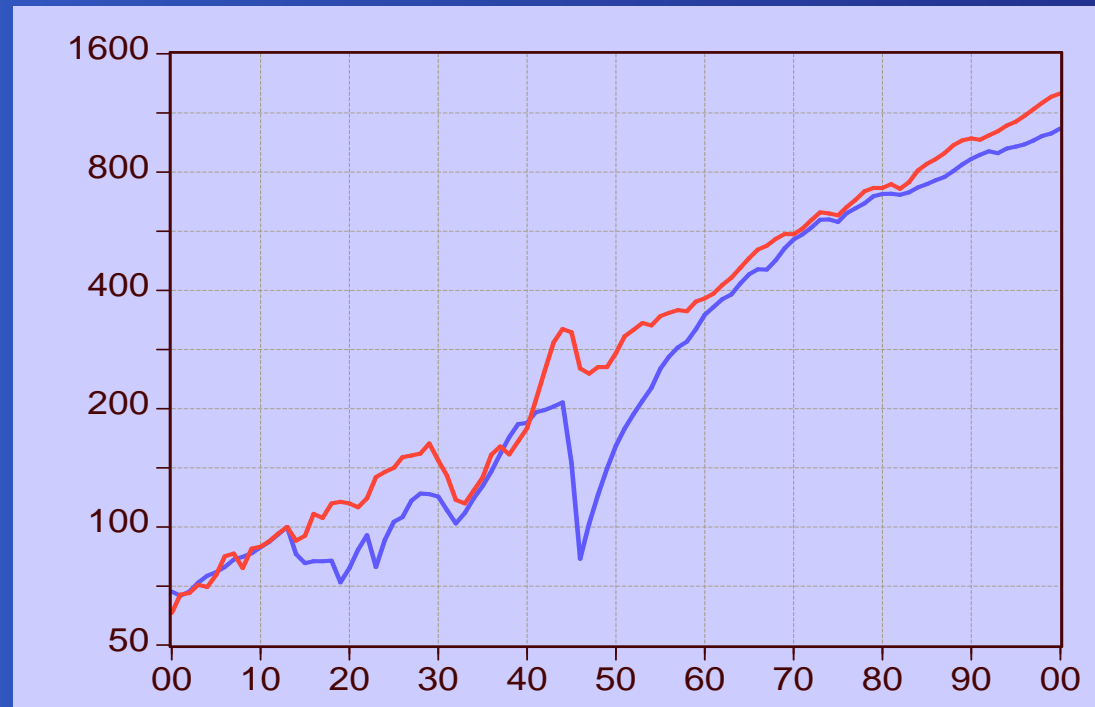
unemployment rate

– Germany

– USA

Source: OECD

GDP Growth: A Comparison with the USA



– Germany

– USA

index of real GDP, index₁₉₁₃=100, log scale

A Comparison with the USA

- **Similar growth trend in the 20th century**
 - *3 percent annual growth 1900 – 2000*
- **Higher growth rates after World War II until the eighties** → *catching-up*
- **Slower growth since the eighties**
 - *widening of the gap*
- **Reasons: working time, labor market problems**
 - *income gap: about 1/3*
 - *working time gap: about 20 percent*
 - *employment gap: about 10 percentage points*

The (Hi-)story of Post War Reconstruction

■ The Starting Point

USA: productivity leader, large free integrated market

Germany: productivity backwardness, destroyed, small markets, hardly international trade

■ Reconstruction and Economic Integration

- democracy and market economy*
- opening of the borders, productivity catching-up*

Theoretical Arguments

■ Catching-up with respect to the past

Germany had a strong industrial base already before the war, and exhibited high investment rates during the war

■ Catching-up with respect to the leader

*Economic integration and increases of world trade
—> Germany's role in world trade increased as well*

■ Strong investment in Germany

—> domestic firms and foreign direct investment

Prerequisites for Growth and Catching-up

- **Political stability:**

- *Democracy and European Integration*

- **Economic stability:**

- *Fixed exchange rates within the Bretton Woods system*

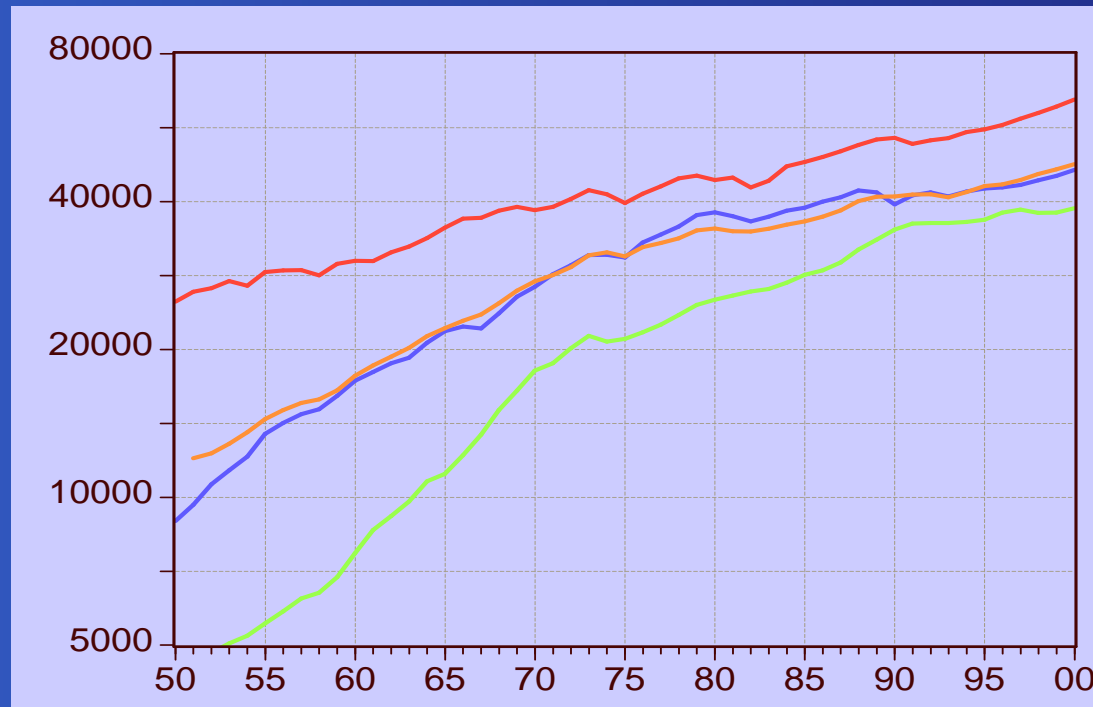
- **Economic integration:**

- *Fast increases of world trade and European Integration*

- **Foreign aid: *The Marshall-Plan***

- **Consequence: *Fast catching-up***

Productivity Convergence



– Germany – USA – Japan – EU-15

GDP per worker, Purchasing Power Parities 1996

Post World War II Reconstruction

- In terms of economics,
Germany was together with Japan
one of the most successful countries
during the period after the war until the eighties
- Low unemployment until the eighties
- Higher productivity growth in Germany
as compared with the USA

The Development since the 70th

- **Since 1974 Germany exhibited the same economic problems as most industrial countries**
 - *breakdown of Bretton Woods exchange rate system*
 - *OPEC Oil price shocks*
 - *increase of inflation*
 - *reduction of world trade growth*
 - *reduction of economic growth rates*
 - *increase of unemployment*

- **In 1989, the Berlin Wall was opened ...**

Time Table of German Unification, Part I

May 1989	Removal of border controls in Hungary
Aug. 1989	Mass migration of GDR-citizens via Hungary
Sep. 1989	“Monday demonstrations” in Leipzig
Nov. 1989	<i>Opening of the German border</i>
Jan. 1990	Privat ownership of production facilities and joint ventures with foreigners permitted
May 1990	Begin of 2+4 negotiations

Time Table of German Unification, Part II

May 1990	Signing of the treaty about formation of an economic, monetary and social union
July 1990	The treaty came into force
Aug. 1990	Signing of the unification treaty
Sep. 1990	Closing of the 2+4 treaty
Oct. 1990	<i>German unification</i>
Oct. 1990	Elections of East German state parliaments
Dec. 1990	Elections of the Federal Government

German Unification: Political Success

1985	Gorbachev became leader of the soviet union –> “perestroika” (restructuring)
May 1989	Removal of border controls in Hungary
Nov. 1989	<i>Opening of the German border</i>
July 1990	Economic, Monetary and Social Union
Oct. 1990	<i>German unification</i>
Dec. 1991	Dissolution of the Soviet Union
May 2004	8 CEECs joined the European Union

● **It took less than one year ...**

German Unification: Economic Problems

■ The Starting Point

The currency conversion rate of 1:1 (Ost-Mark/DM) implied a wage level of about 30 % of the West level

Aggregate productivity roughly corresponds, but productivity in manufacturing was only about 1/10

- outdated East German technology*
- workers not familiar with modern technology*
- management not familiar with market economy*

Consequences

■ Breakdown of Demand

- *eastern consumers switched to western products*
- *eastern investors were not interested in outdated technology*
- *former East European trade partners would not pay hard currency for East German products*
- *east-west trade was low already before unification*

East Germany was member of the CMEA (Council of Mutual Economic Assistance), the “EU” of the Eastern bloc countries

Breakdown of Output and Employment



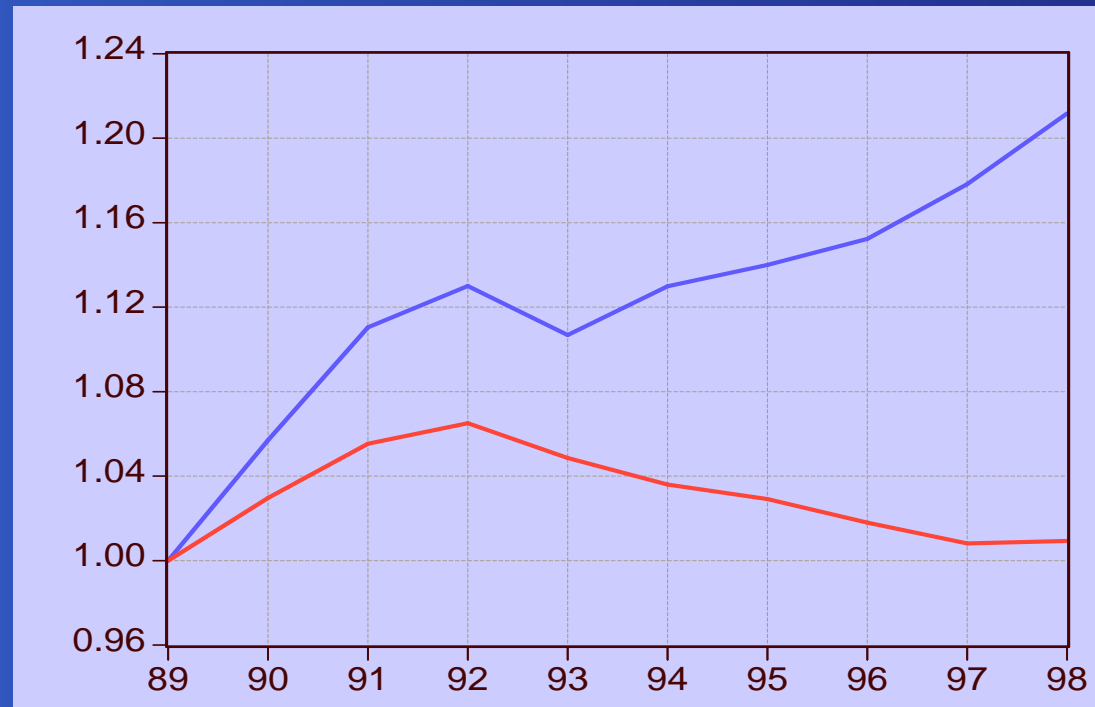
– index of GDP – index of employment

East Germany

Unification Shock

- Output broke down by about 1/3
- Employment adjusted slowly afterwards due to several measures of active labour market policy
- Productivity decreased
- West Germany, in contrast, experienced an “Unification Boom”

In Contrast: West Germany



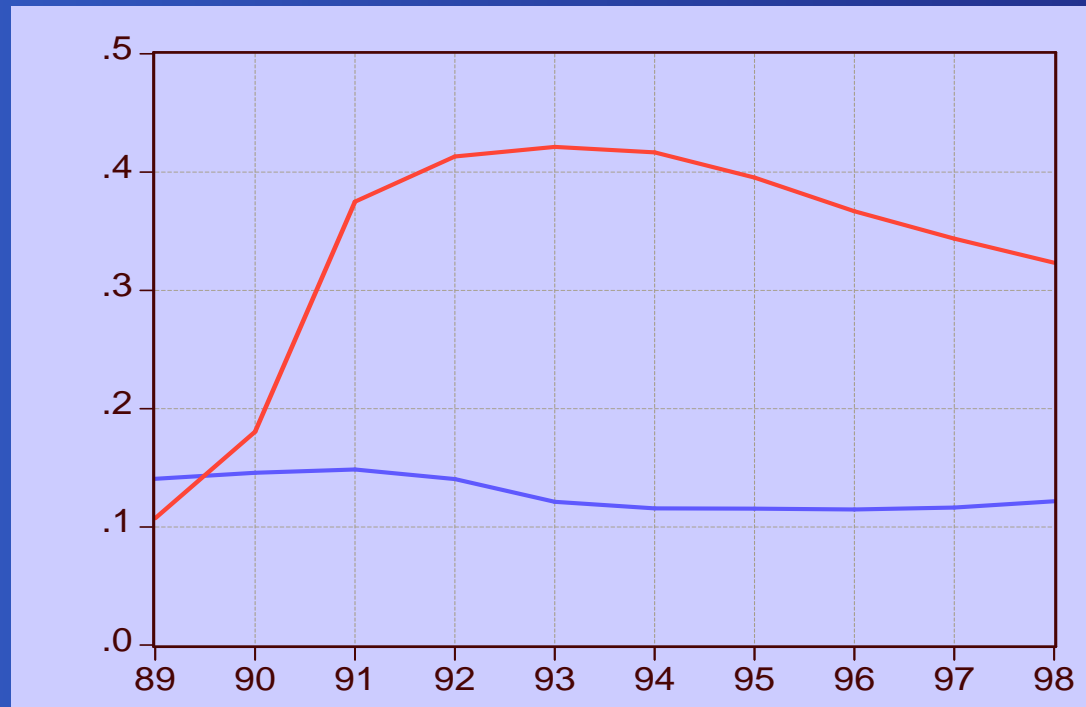
– index of GDP – index of employment

“Unification boom”

Recovery

- Afterwards, from 1992 onwards, a fast recovery process began
 - *increase of utilization*
 - *strong investment due to massive investment subsidies*
 - *increase of the capital per worker*
 - *inflow of modern technology*
 - *technology catching-up*
- Doubling of productivity within a few years

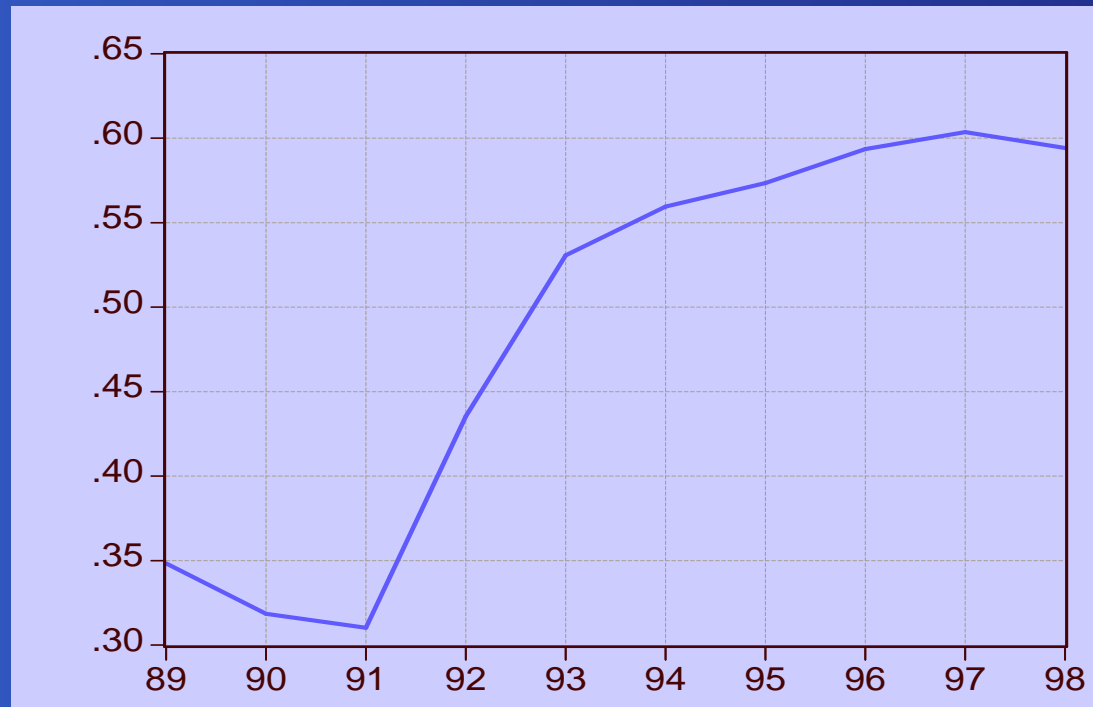
Investment



– West Germany – East Germany

share of investment in GDP

Relative Labor Productivity

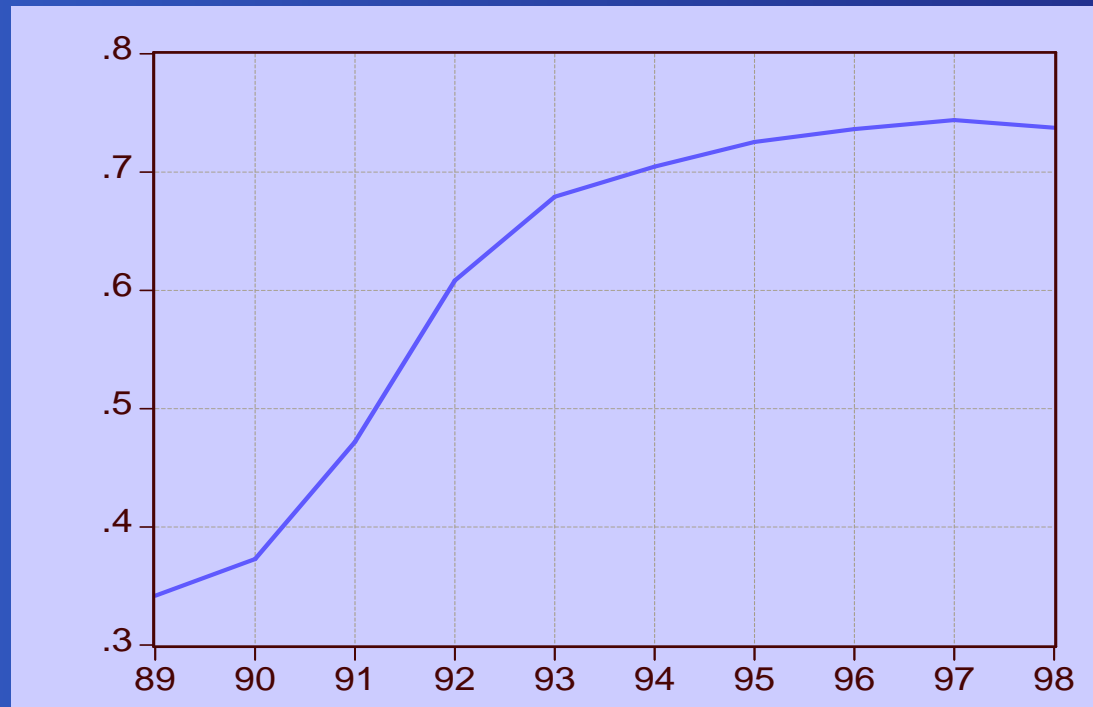


– relative productivity, East vs. West Germany

However, ...

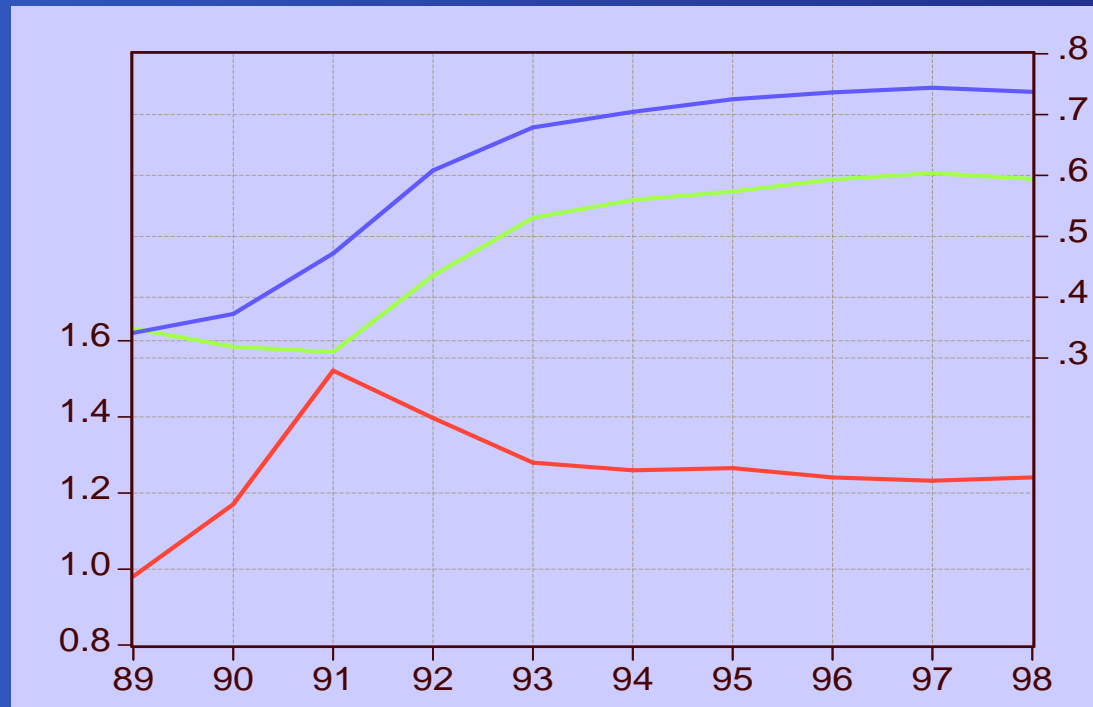
- **Wages increases faster and more as compared with productivity**
 - *workers demanded “convergence of living standards”*
 - *generous welfare system, large unemployment benefits*
- **Competitiveness deteriorated**
 - *real unit labor costs increased*
 - *employment remained low*
- **Unemployment increased to nearly 20 %**
- **Fading-out of the adjustment process after 5 years**

Relative Wages



– relative wages, East vs. West Germany

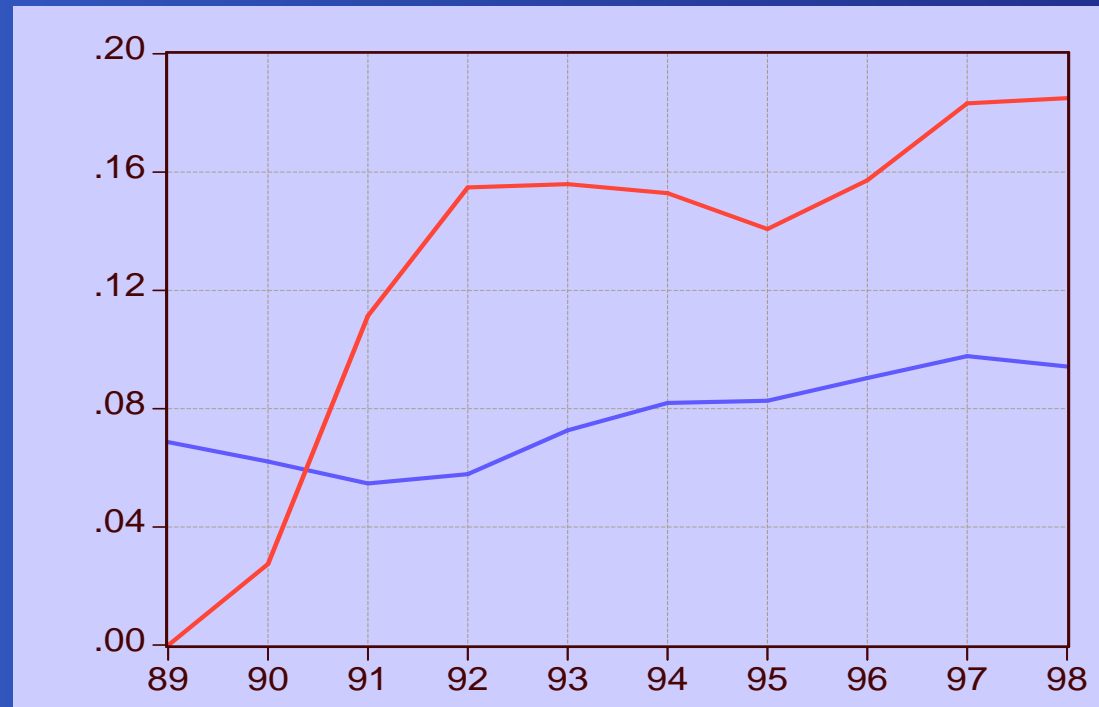
Competitiveness



– relative wages – relative productivity right hand scale

left hand scale – relative real unit labor costs

Unemployment



– West Germany – East Germany

16 Years after Unification

■ East Germany

- *wage gap of about 25 percent*
- *productivity gap of about 30 percent*
- *competitiveness slowly adjusting*
- *labor market situation desasterous*

■ West Germany

- *increase of unemployment*
- *problems with financing the welfare system*

■ Differences within East and West Germany as well

German Unification: Summary

■ Political success

transformation of centrally ruled command economy to democratic market economy within less than one year

■ Economic success

– fast catching up of productivity and wages

■ Economic problems

– breakdown of output and employment

– fading-out of the adjustment process within 5 years

– high unemployment, large fiscal deficits

Germany Today: Key Economic Data

- **Annual economic growth:** *about 2 percent*
- **Unemployment:** *about 10 percent*
West Germany: 8 percent, East Germany 18 percent
- **Inflation:** *less than 2 percent*
- **Trade balance:** *surplus above 4 percent of GDP*
- **Fiscal budget:** *deficit about 3 percent of GDP*
- **Public debt:** *about 2/3 of GDP*

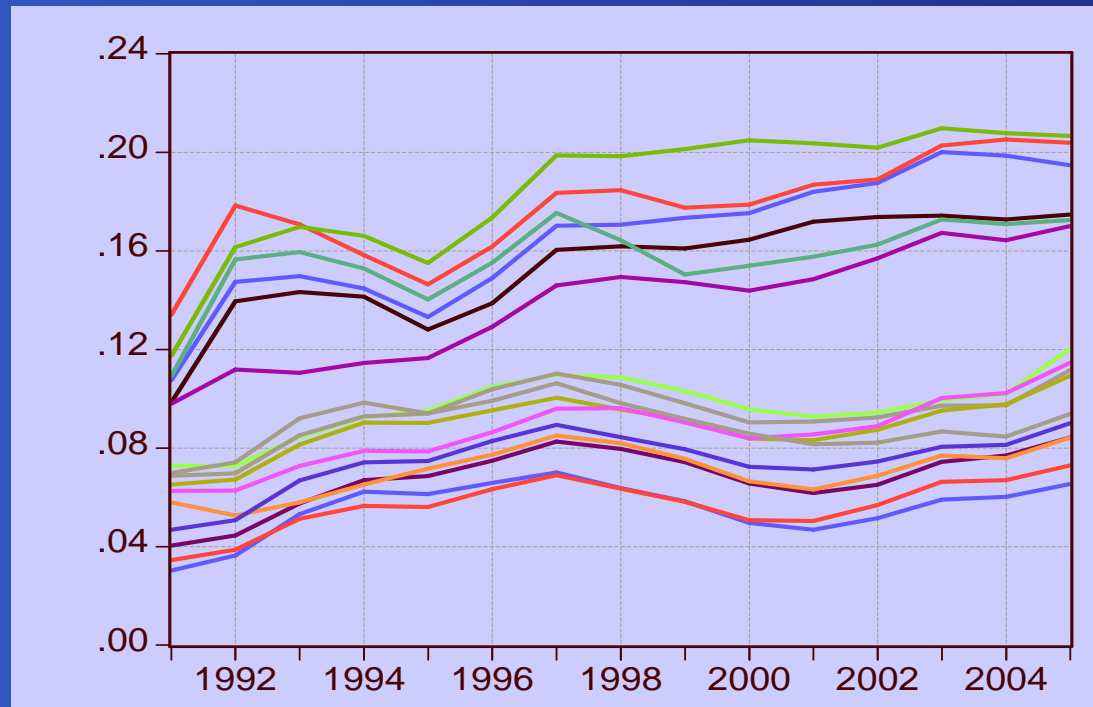
averages since 2001

Unemployment: International Comparison

<p>Germany, France, Italy, Belgium, Greece, Europe</p>	<p>8-10 percent</p>
<p>USA, UK, Ireland, Austria Switzerland, The Netherlands</p>	<p>4-5 percent</p>
<p>Spain, Slovakia East Germany, Poland</p>	<p>above 10 percent nearly 20 percent</p>

– Unemployment is a problem not only in Germany but some countries are better off

Differences in Germany as well



unemployment rate

16 states

– *considerable regional differences*

Regional Differences

West Germany	8 percent
North Rhine Westfalia	10 percent
Baden Württemberg, Bavaria	6 percent
East Germany	18 percent
Saxony-Anhalt	20 percent
Thuringia	16 percent

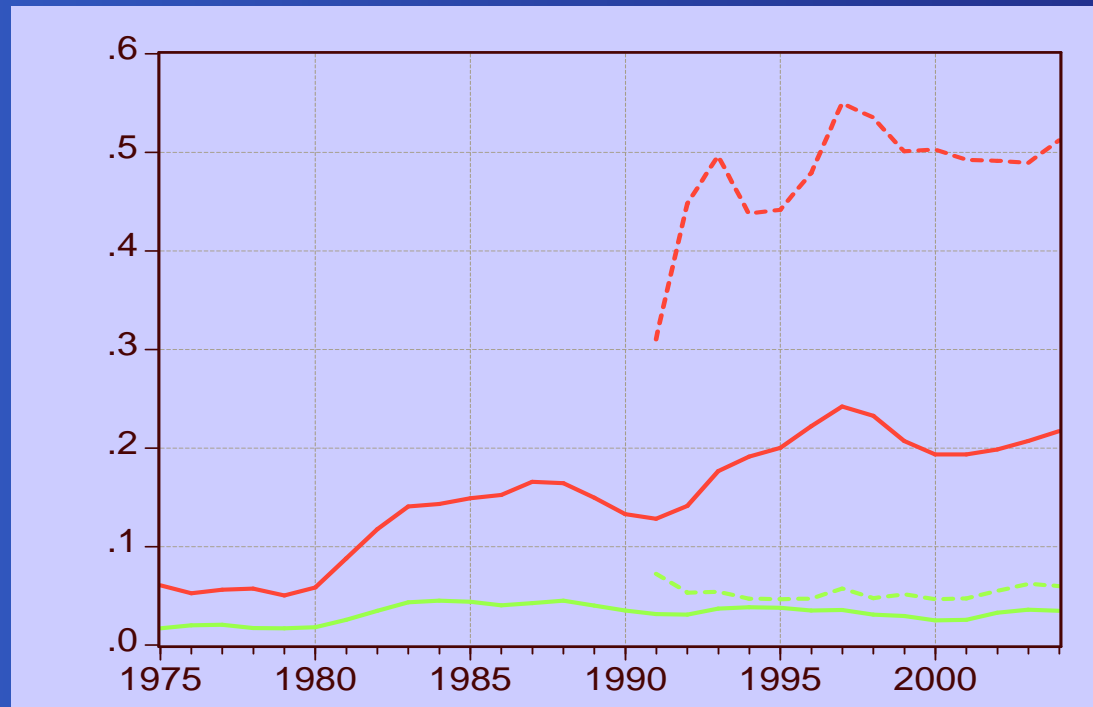
– *differences between East and West Germany
and between north and south Germany*

Unemployment: Differences by Qualification

Qualification of employees	West	East
university degree	3 %	5 %
skilled workers	6 %	18 %
unskilled	20 %	50 %
average	8%	18 %

- *considerable differences by qualification*
- *considerable differences, East and West Germany*

Unemployment Rate by Qualification



Unemployment rate
 — West --- East

unskilled
 university degree

- **unskilled**: more than twice as high
- **university degree**: near full employment

Germany today: Perspectives

- **Economic growth:** *slowly increasing*
- **Unemployment:** *slowly decreasing*
 - *problem of unskilled workers and of East Germany*
- **Fiscal deficits:** *3 percent Maastricht rate*
- **Financing the welfare system**
 - *pensions, health care, unemployment benefits*
- **Slow reform process**
 - *but optimism is increasing*

Germany: Comparative Advantages

- **Stable and strong political system**
- **Key role in the European Union**
- **Germany is still one of the rich countries in Europe and in the world**
- **World champion in terms of exports**
- **Strong industrial basis**
- **Highly qualified work force**

Summary

■ Central Role in European Integration

- *at the eastern border of the old Europe
and at the center of the new Europe*

■ Post World War II Reconstruction

- *democracy and fast reconstruction*
- *productivity catching-up and full employment*

■ German Unification

- *political success and economic problems*

■ Slow reform process

- *but optimism is increasing*