Exit and Voice - The Political Economy of Wages and Unemployment in a Unified Country – The German Case –

by

Heiner Flassbeck

I The Failure of Socialism 2

II The Transition to a Market Economy - Shock versus Gradualism..............5

III East Germany Takes a Different Path..10

IV Economic Developments in East and West Germany after Monetary Union 12

V Germany`s Two Labour Markets 17

VI Exit and Voice - Migration and the Balance of Power on the Labour Market 18

VII Spurious Solutions...24

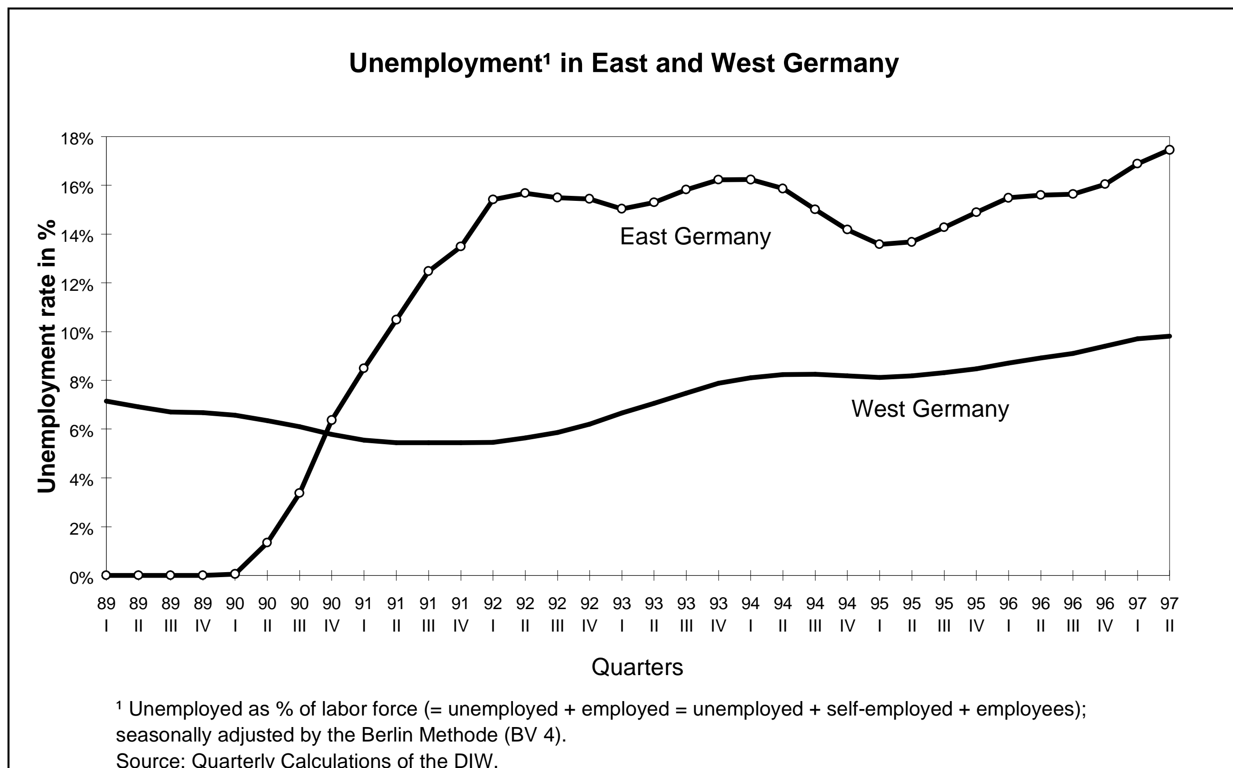
VIII The Conclusion for Germany..26

IX The Conclusion for Korea...27

References 29

Germany is unified since 1990 - politically. In economic terms, though, the Wall has been replaced by a deepening rift. Monetary, economic and social union has not yet brought East and West closer together by unleashing the unifying forces of the market. There has been no repeat of the "economic miracle" of post-war West Germany. It is only thanks to a massive transfer of resources by the German state that real incomes during the first years after unification have risen. The economic divide manifests itself most clearly on the labour market: in West Germany the demand for labour has been booming in the first years, in East Germany more than a third of the workforce have lost their jobs. Even today East Germany's unemployment rate with 20 % by far exceeds the one in the West (Graph 1).

Graph 1



¹ Unemployed as % of labor force (= unemployed + employed = unemployed + self-employed + employees); seasonally adjusted by the Berlin Methode (BV 4).
Source: Quarterly Calculations of the DIW.

I. The Failure of Socialism

The attempts made by post-war Eastern European countries, including the German Democratic Republic (GDR), to build a more human society and an economic system capable of competing with the market economy have failed. Many reasons can be put forward for this failure: an unbridled bureaucracy, the inflexibility of state-run firms, the inability of the ruling communist

parties to reform along democratic lines, all these are undoubtedly factors which can help to explain why socialist systems have been functioning so poorly.

At bottom, however, something else is responsible for the long run falling behind of the centrally controlled social and economic systems: these systems have simply failed in the economic sphere. They have proved incapable of using the post-war period to draw level with the market economies or, as was originally expected, to overtake them, and of offering their citizens a greater degree of "social peace" than Western countries.

The inability of these systems to motivate people was evident at all levels, but was particularly apparent in the sphere of production. They were unable to create a climate for innovations leading to new products and production processes which, in the market economy, are generated as a matter of course by firms. It has been a characteristic feature of planned economies that they not only failed to provide incentives in this direction, but that they systematically created barriers to innovation.

The rigid framework of five-year plans prevented firms from developing innovations in the period between two plans. Even the desperate attempt made in their last years to create incentive mechanisms at plant level has failed miserably: innovative firms were unable to translate their innovative activity into market success because both the bureaucracy - right up the planning commissions - and the firms supplying inputs to the innovative enterprise systematically blokked changes to the plans as they themselves did not benefit from rising profits generated by the innovation. It was only at great expense and then only in specific areas that the planned economies could reach the technological standard of the West: they were never able to do so systematically over the whole range of economic activity.

This is exactly the market systems comparative advantage: the willingness of individuals (Schumpeter's pioneers) to invest, to convince others of the value of their innovation and then to translate it into market success. As the innovation gains ground, additional "pioneer" rents accrue - for a time - to all those involved. Suppliers as well as clients of the pioneer stand to gain and therefore have an interest in promoting the innovation.

Thus the market economy is characterized by the willingness of all social actors constantly to revise their plans and to adapt to changing circumstances. In the final analysis it is less the efficiency of the individual enterprise than the efficiency resulting from this cooperation which makes the market economy so successful. Planned economies, on the other hand, do exactly the opposite. They fix a given production technology and a given supply structure for a considerable period during which it is impossible to change the system or successfully to test the conditions on which it is based.

The collapse of the socialist system had come at a time in which the economic boom in the Western world during the 1980s had made it abundantly clear that the socialist countries never had a chance to catch up with the West. Until the end of the 1970s East European countries could at least console themselves with the fact that Western countries were facing serious economic problems in the form of unemployment and inflation. But the economic crisis, which for a time seemed endemic to market economies, was largely overcome in the course of the 1980s and had been succeeded by a strong economic recovery. In the 1980s there was no longer a comfortable explanation for the relative backwardness of the planned economies.

It is also worth noting that the planned economies were no more successful than the West elsewhere in the social and political field. One of the most obvious examples here is the environment, where planned economies have done far more ecological damage than market economies and have proved incapable of meeting this, one of the new challenges of the industrial age

II. The Transition to the Market Economy: Shock versus Gradualism

Almost without exception the countries of Eastern Europe in the 1990s began to move away from the planned economy at a precipitous speed. But even after nearly a decade of transition it is far from clear whether the transition from a centrally planned to a market-based system, i.e. from centralised to decentralised control over economic activity, should happen in a gradualist manner or occur in form of a shock. With the exception of the GDR the countries of Eastern Europe had to take a definitive decision whether the transition to the market economy should take place at one full swoop (shock therapy) or as a succession of small steps (gradualism). While almost all the national governments have clearly moved towards a market economy of

the Western brand the "shock therapy versus gradualism" debate continues. The standard political view still seems to be that a policy based on gradualism is more easily realised, that a staged transition from one system to the other places less of a burden on the population and will minimize the adjustment problems.

The academic debate nevertheless has come to the conclusion that gradualism contains a central conceptual error. The staged transition from a planned to a market economy is bound to fail because it does not take account of the complexity and interdependence of the factors in a dynamic market context. Metaphorically speaking, gradualism implies that in a complex piece of machinery one cog begins to turn while all the others remain still. Shock therapy, on the other hand, is the attempt to start all of the cogs turning at one go. Liberalising the prices of some goods, for example, is not helpful and will fail to make the system more efficient if other prices, such as those for inputs and complementary goods, remain frozen. Under these conditions the price mechanism, the interplay of different prices, cannot work properly. The monetary reform implemented in the Federal Republic of Germany in 1948 is proof that shock therapy can be successful if the overall economic framework is adequate. Then virtually all prices - with the exception of rents and the prices of some food items - were liberalised at a stroke, enabling the system to make the best of its flexibility straight away. Production increased rapidly. Almost all the East European countries - and China - have tried to learn lessons from this example, but none of these countries has actually opted for such a radical shock therapy as was implemented in the Federal Republic in 1948.

A classic case of the failure of gradualism seems to be the on-going situation in the Russian Republic. For many years now Russian policy makers have been trying to modify the system in a series of marginal reforms. Even now that the transition to the market economy is the declared aim of the government the authorities are not able to go the whole way quickly. The failure of this experiment compared with successfull countries is now apparent. Western observers blame the lack of political willingness to implement reforms quickly for this failure. But things may not be so simple. Why is it, it should be asked, that the economic situation in countries - such as Hungary, or Czechoslovakia - which have been much bolder in implementing market-oriented reforms is still precarious. And why are countries, which have been successful for a very long

time like the Asian developing countries are suddenly shaken by economic crisis and depression.

To answer these questions it may be helpful to consider a hypothetical case in which a country opts for a radical shock therapy. Or, to look at it in another way, was "1948" in the Federal Republic of Germany just an historical accident, or what were the concrete macroeconomic conditions under which this unique experiment - the overnight transition from one system to another - could be successful? Is the "economic miracle" of the Federal Republic merely a mirage shimmering before the eyes of other countries but which they can never reach.

What happens on the first days of a radical shock therapy? In purely theoretical terms, the shock transition from the planned to the market economy has - given suitable macroeconomic conditions - only one effect: a rise in the price of a number of goods. One of the fundamental insights gained by liberal economists from their observations of the war economy of the German Third Reich was that centrally planned and administered economies can only function if they allow inflation to occur or actually use it as an instrument of economic policy[1]. This may seem paradoxical given the fact that in economic systems of this type the price level is usually almost constant, as the authorities lay great stress on the fact that nominal wage increases are not devalued by price rises. But this only means that "open inflation" has not occurred. It does not preclude the phenomenon known as "suppressed inflation". In such economies inflation does not manifest itself in rising prices but still in the fact that there is too much money chasing too few goods. Planned economies can only sell their products if there is a permanent overhang of purchasing power. This excessive money supply can only occur if wages and other forms of income in monetary terms do not correspond to the supply of goods which households would also demand if they were free to choose. As the economy is closed, consumers do not have the freedom to choose. Labour productivity, as measured, is thus necessarily false because it includes goods which in the quality and quantity offered would not be demanded by consumers if they had a choice.

---

[1]Cf.. for example, W. Eucken: "Deutschland vor und nach der Währungsreform" (Germany before and after Monetary Refom), and F. A. Hayek, "Vollbeschäftigung, Planwirtschaft und Inflation" (Full-employment, the Planned Economy and Inflation) in, A. Hunold (Ed.),. *Vollbeschäftigung, Inflation und Planwirtschaft, Erlenbach-Zürich,* 1951

As the planned economy is unable to respond to the preferences of customers with sufficient sensitivity or, alternatively, to generate preferences as firms in the market economy do, it is only able to sell its qualitatively poor and quantitatively insufficient - products by the phenomenon of “too much money chasing too few goods“. This is achieved by paying excessively high wages, i.e. wages which exceed not measured productivity, but potential (real) productivity of the economy. Relatively high wages create the impression of a relatively high real income level, a level which, however, does not exist in reality as a glance at the supermarket shelves suffices to show. This is the specific form of money illusion generated by planned economies and one which manifests itself in long queues and the hamster-like mentality of consumers. It is only under conditions of total isolation from the outside world and an excessive money supply that this extreme form of a seller's market can possibly function.

This money illusion bears a high price. The fact that the relatively high real wage level comes about not only as a result of high nominal wages but also due to the massive subsidisation of the prices of certain goods (the so-called “second wage-packet") leads to allocative distortions on a huge scale. This results in resources - such as water, energy and food - being wasted and is also reflected in the endless queues common in such economies. Even more important, the economy can only support such "living above one's means" by cutting back net investment. The standard of living is only as high as it is because the devalorisation of buildings, the depreciation of the capital stock and the environmental costs of production are not reflected in the prices of consumer goods. It is only when market forces are introduced and subsidies are reduced that the obsolescence of the machine park and the real standard of living are revealed.

Thus, returning to our hypothetical model, the price rises which accompany the transition period to the market economy are not themselves inflation. They merely indicate the extent to which the planned economy has suppressed inflation in the past. The price rises accurately reflect supply and demand conditions on the markets. In other words, what used to be expressed in queues now shows up in rising prices.

Decisive for the success or failure of the transition process is how workers react to this new development. Obviously the rise in prices following the introduction of the new system is to be interpreted as a cut in living standards. This is the most common central error in the interpreta-

tion of the whole process of transition. This error then gives rise to the central problem facing macroeconomic policy. What has actually happened in the transition from the planned to the market economy is not a reduction in living standards, but a revelation of the existing standard of living, and its expression in market prices. In real terms, i.e. in terms of the volume of goods, a change of the system alters nothing. Stocks of goods, the factors of production, everything is as it was. At t_{+1} the economy has exactly the same amount of goods and services at its disposal as at t_{-1}. All that the market economy reveals is that the old system had considered itself richer than it was because it had not taken account of the fact how poor the quality of its products are compared to those on the world market.

The abrupt transition to the market economy is a precondition for flexibility and entrepreneurship. But the new system can make its positive effects felt - e.g. by reducing costs - only in the longer term. Cost reductions will ultimately lead to lower prices, to higher real incomes and so to an increase in disposable purchasing power in the hands of economic actors. The positive supply-side shock does not make its effects felt on day $t_{+}1$. Nevertheless, as the "economic miracle" in West Germany has shown, given a suitable macroeconomic framework it can help to overcome economic stagnation within months after the transition.

To create a suitable macroeconomic framework, however, is a difficult task. If the price rises which succeed the transition to the market economy are interpreted not as a one-off phenomenon but as inflation and as a cut in living standards, this will create a strong pressure in the aftermath of the transition to adjust wage levels to compensate for this apparent “drop in the standard of living“. The resulting increase in wages means either that corporate profits, and with them the level of investment, fall dramatically, or that the rise in wages is passed on to prices, leading to inflationary pressure in the course of the unavoidable and necessary changes in relative prices. In this way the one-off effect of the initial price rises is perpetuated in an inflationary process. Normally, under such circumstances the external value of the currency cannot be maintained: the economy enters a vicious circle of inflation, wage increases and currency devaluation which can only be broken with the blunt instrument of a restrictive monetary policy. This has been the pattern of adjustment in almost all the smaller East European countries in the 1990s. None of them have succeeded in convincing economic actors, and in particular the

trade unions, that the initial price increases would be a one-off phenomenon and that price stability could be expected in the short run as soon as the supply of goods would begin to rise.

If this vicious circle is broken with the help of restrictive monetary policy, living standards begin to sink substantially and - for the first time in this scenario - unemployment rises dramatically. Even in the market economy there is no immediate cure for high interest rates resulting from a restrictive monetary policy. There is neither a government programme nor a retreat on the reform-policy front that could prevent real incomes from falling and unemployment rising in this case. This chain of events is usually interpreted as a necessary by-product of the transition to the market economy. What is misunderstood, is that the secondary shock of the restrictive monetary policy is not the natural concomitant of the transition from one system to the other. It is a perfectly normal, negative demand shock such as that experienced by Western economies following the negative supply effects of the oil-price shocks in the mid and in the late 1970s.

lt was all but impossible for the East European countries to escape from the spiral of inflation, wage rises and currency depreciation particularly as a great many additional problems of the transition period had to be solved at the same time. The thorniest problem at the microeconomic level was undoubtedly the transformation of the formerly state-run enterprises into private companies. So far not a single country with the exemption of East Germany has succeeded in privatizing the bulk of its formerly state-run enterprises. They lack the capital to privatize the industries quickly and, for political reasons, they are seeking to avoid a total "sell-out" of their capital stock to the West that characterized the East German privatization process.

But it would be a mistake, in my opinion, to place too much emphasis on these microeconomic barriers. Capital and entrepreneurial motivation can only be mobilized if the macroeconomic conditions are favorable. Not one of the macroeconomic factors, which restrict the economies of Eastern Europe today, was given in the case of the Federal Republic of Germany in 1948. Microeconomic structures were favorable too in 1948: West Germany's entrepreneurial tradition was still alive, there was private ownership of the means of production, a market-economic tradition which had been only briefly interrupted and the State bureaucracy was far less firmly ingrained in people's minds than after forty years of socialism. Much more important were the

macroeconomic conditions. They were fundamentally different from those prevailing in transition countries today.

- Wage increases were moderate. Unions accepted the initial price rises and did not allow them to feed into additional wage increases. The D-Mark was pegged against the US-Dollar at a very low rate so that - in real terms- the D-Mark was undervalued throughout the first 20 years of recovery. Even the sharp rise in profits in the 50s was accepted by the trade unions as a normal phenomenon consistent with the very steep trajectory of the upturn;
- Throughout the 1950s interest rates in West Germany were extremely low. Given the very high elasticity of supply on the goods markets and stable prices, monetary policy was very generous, and indeed it had no reason to pursue a more restrictive course.

The macroeconomic framework was of vital importance for the success of the West German reform process in the 1950s. It is to misunderstand the nature of the so-called "economic miracle" if the extremely favourable conditions at the macro-level - in terms of both monetary and incomes policies - are not taken into account properly. These conditions will not be repeated in the East European countries in the foreseeable future and they were not repeated by East Germany.

Thus one of the reasons why the situation of many countries of Eastern Europe is so intractable is that - in contrast to West Germany after 1948 - they are facing a dilemma of convertibility: Many opted for a undervalued exchange rate in the first round, giving their firms a good chance to compete on the world market. But the consequent sharp rise in import prices exacerbated the problem of domestic inflation. More and more countries switched to a system of pegged exchange rates to avoid that result. But with a creeping overvaluation companies are exposed to fierce competition on both domestic and foreign markets, current account deficits emerg and unemployment rises.

From a purely economic perspective, the option of an undervalued currency represents the only viable path, as it gives enterprises a chance to adjust gradually to conditions on the world market and reduces the danger of a severe adjustment shock resulting from a loss of competitiveness. But given that inflation is a major problem during the transition period and that interna-

tional capital is needed, most countries have opted for a currency peg in an effort to import stability and capital at the same time.

III. East Germany Takes a Different Path

The economic solutions available for East Germany were different. East Germany had a „big brother“. Thus, it could choose a completely different path from the very beginning. The political situation and the high mobility of labour within Germany as a whole meant that the GDR was forced to go a different way. Very early on it became clear that the GDR could only convince its population to remain within the country if a radical transition to a marktet system was made. What was far from clear at the beginning was that the GDR would also choose an extremely high exchange rate in order to keep the inflationary shock low and to push real incomes. But it was very soon after the Wall came down that the conviction gained ground in the GDR that monetary union between the GDR and the Federal Republic could be a way of stemming the migration of qualified labour out of the country and catching up quickly with the Federal Republic. This conviction and its quick implementation had dramatic consequences.

As already mentioned, all the countries of Eastern Europe were confronted with a trade-off between higher incomes via lower import prices on the one hand and the danger of rising unemployment on the other. Faced with this dilemma the GDR rapidly and unequivocally opted for an extremely high exchange rate, and thus for high real incomes and against full employment. The high exchange rate resulted from the fact that monetary union effectively meant that all current transactions were converted at a rate of 1 GDR Mark = 1 D-Mark. This despite the fact that at the end of 1989 the previous regime had decided that the internal conversion rate was 4 GDR Mark = 1 D-Mark. In other words, the transition process to the market economy in the GDR was overlayed by other, secondary shocks, namely the switch to a (very) hard currency.

The positive supply-side shock of the transition from the planned to the market economy was thus countered by an appreciation shock whose dimensions were historically unprecedented. Appreciation shocks have two prime consequences: firstly, they cheapen imports so that the real incomes of economic actors in the country in question are higher than they would be at a more "realistic" exchange rate; secondly, given open borders and full currency convertibility, the appreciation means that domestic products cannot be sold at home or abroad in sufficient quantities to maintain full employment. Here again a glance back at the situation in West Germany in 1948 is very instructive. If the Federal Republic had not opted for a low exchange rate - the rate was then four D-Mark to the dollar - but had opted for monetary union with the USA or an exchange rate of 1:1, the "economic miracle" in the Federal Republic would certainly never have occurred.

Similarly, in East Germany it was not the transition to the market economy which caused unemployment to rise sharply; it was the fact that the negative demand shock caused by currency appreciation more than offset the positive supply-side shock resulting from the transition to the market economy. The conceptual mistake made by many politicians was all too glibly to project the experiences of the currency and economic reforms of 1948 in the Federal Republic onto conditions in East Germany. Many observers believed that it would be enough merely to introduce a market-economic framework - irrespective of the actual form it should take - and an economic dynamic comparable to that of 1948 would be released.

The motor behind West Germany's economic growth during the 1950s was the export sector, the expansion of which was facilitated by the undervaluation of the D-Mark, which was the result of a currency peg and a very moderate increase of unit labour costs over a long period. During the same period, large parts of the economy were protected by trade barriers. Moreover, in the aftermath of the war the other European countries were at about the same stage of development and real income levels as Germany. The Federal Republic did not lag too far behind its most important trading partners in terms of productivity and the standard of living.

The new economic order, it was thought, would also permit the East German economy to shift over to a steeper growth trajectory and so to reach a real income level comparable with that in the West in the medium term. Private entrepreneurship, freed from the straitjackets of the plan-

ned economy, a non-punitive tax system and the financial strength of West Germany to provide the necessary infrastructure were to furnish the basis for the economic upturn. It was expected that productivity could be substantially raised in the very short term merely by removing supply constraints in the production process and by making more efficient use of raw materials. These measures created the impression that a quick increase in productivity and a reduction in costs were possible in the short run. In theoretical terms, using a traditional diagram showing macroeconomic supply and demand curves, the introduction of the market economy should shift the supply curve for the economy as a whole to the right (positive supply shock). This would lead to a fall in prices with a simultaneous increase in the volume of transactions.

This - naive - view has proved to be completely false. The comparison between the situation in the GDR at the beginning of the 90s and that prevailing in the early years of the Federal Republic failed to take account of the central difference in initial conditions facing the two economies.The introduction of the D-Mark in the GDR in July 1990 represented an currency appreciation for East Germany as an economic region of more than 300%. After this appreciation shock East Germany was swamped by goods from the West as industry there was able to supply the East German market without suffering from significant capacity constraints. On top of that, corporate competitiveness in East Germany deteriorated further due to rapid (two-digit) wage and salary increases which were in no way matched by the rates of productivity growth: costs were reduced as inputs became cheaper, corporate taxation was reduced and manning levels cut. But this was either insufficient - or had little practical effect due to the extent of the fall in output levels - to reduce unit costs to any significant degree. Indeed, the opposite occurred: productivity per employee fell substantially during the second half of 1990, while costs were rising quickly. Moreover, irrespective of cost considerations the clear preference of East German consumers for Westem products inevitably exacerbated the problems of dwindling demand facing East German firms.

Many commentators, observers and policy makers definitely believed that monetary, economic and social union, introduced July, 1, 1990, i.e. the conversion of all current transaction, including wages, at a rate of 1 DM:1 GDR-Mark either made economic sense or was backed by West German "solidarity" - i.e. the willingness to transfer resources to East Germany. Policy makers were just counting on the introduction of the market economy to release entrepreneurial spirits

which were thought to be lying dormant in East Germany. Here the decisive inconsistency in political decision-making can be found: The path chosen by fully liberalising market forces would have been a plausible strategy if the level of wages and costs in East Germany in D-Mark had been much lower or - given higher wages - if sufficient "solidarity" (i.e. financial aid) had been forthcoming from the West. In actual fact policy-makers opted for relatively high wages in the new federal states without securing a sufficiently high level of solidarity in the West. In other words, the way in which monetary, economic and social union was implemented in practice entailed the implicit decision to push through with the process of economic unification even at the cost of a huge split in labour markets. As a result the adjustment costs were largely born - not for the first time - by the unemployed, while German society as a whole sought to escape with only a marginal reduction in its living standards.

IV. Economic Developments in East and West Germany after Monetary Union

The consequence of monetary, economic and social union for East Germany was a dramatic fall in the volume of domestic output. Real gross domestic product (the sum of gross value added in the various branches of the economy) fell between the second half of 1989 and the same period in 1990 (on six-month averages) by a quarter. Within a few months after monetary union net industrial production had fallen by almost half on the previous year's figures. Output also fell drastically in mining and, initially, in the construction sector, for which many had foreseen a major boom immediately following monetary union, due to the poor state of infrastructure and the housing stock in the GDR. This initial decline in construction happened because the uncertainties surrounding future economic trends, the persistent disputes about ownership rights, and the inadequate provision of local government in East Germany with financial resources and qualified staff caused the majority of existing construction projects to be frozen and planned investment could not be implemented quickly. Moreover, the contraction of economic activity was not confined to the industrial sector: in retail and wholesale trade and the transport sector output also fell by more than 20% on the previous year. The decline was equally severe in agriculture and forestry which, in the period immediately following monetary union, had trouble finding buyers for their products at any price. Only in the service sector gross value added in

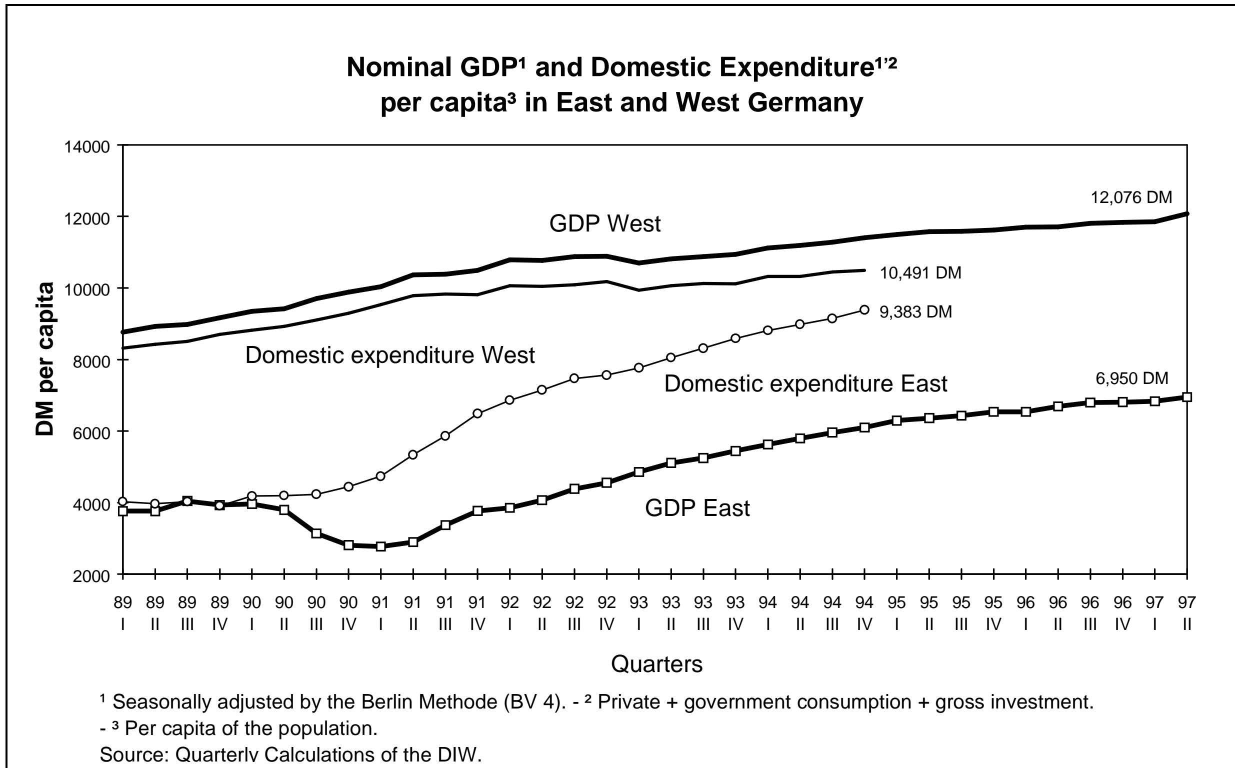
1990 exceeded the previous year's levels. These branches were, however, too small to prevent the dramatic fall in overall GDP.

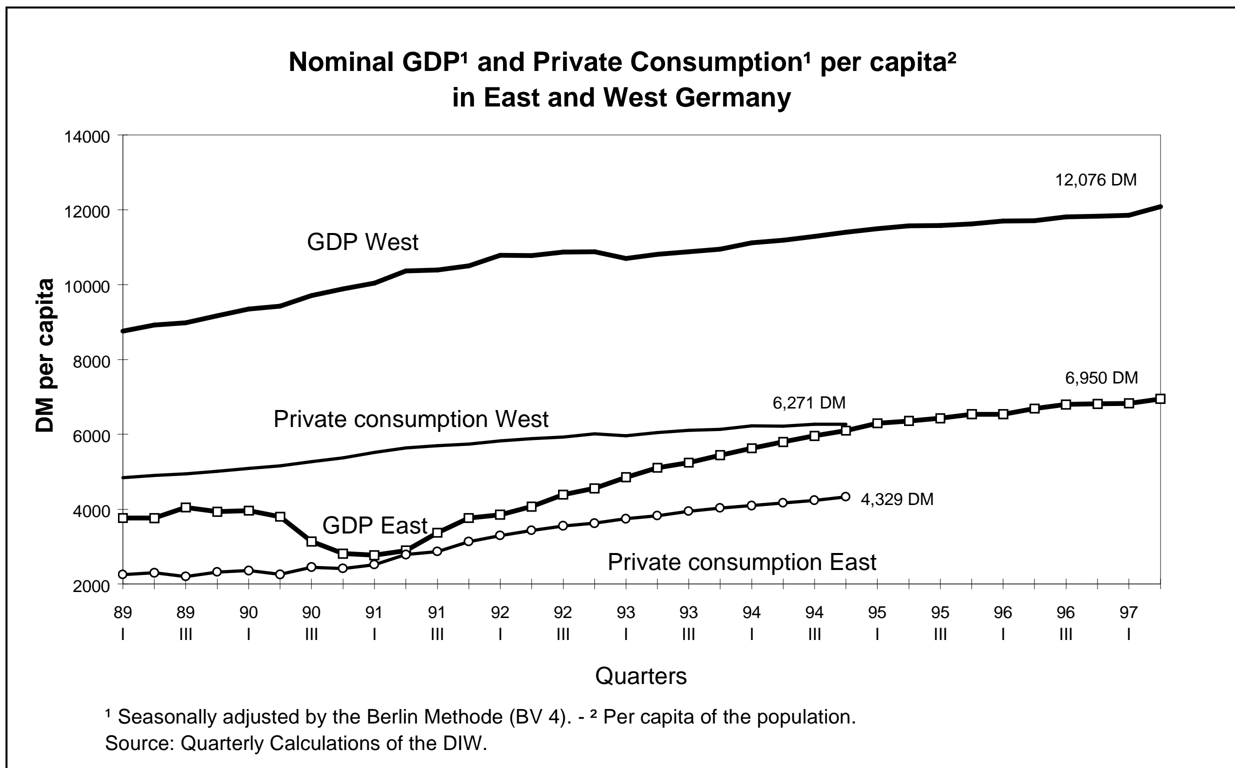
The collapse in output during the second half of 1990 was largely a result of losses on the domestic market. The level of exports was held stable during 1990 by massive export subsidies for trade with the former CMEA countries. When the measures implemented to support trade with Eastern Europe expired (mostly at the end of 1990) large shares of East Germany's foreign markets were also lost. In the first quarter of 1991 the value of goods exports to the CMEA countries was 50% down on the same period of the previous year. Overall goods exports during the first half of 1991 were one third lower than for the same period in 1990. This loss of export markets led to a further collapse in industrial production at the turn of the year (1990/91) by more than 30% within two months (Graph 2).

To a considerable extent the positive demand effects emanating from high real incomes in East Germany, stabilized at a relatively high level by govemment transfers from West to East, benefited the West rather than the East German economy. The end of the 1980s had already seen an economic boom in West Germany as in most industrialised countries and rapid employment growth: during the first half of 1991 the West German employment level was almost 2 million or nearly 10 percent higher than three years before.

Thus, the driving force behind the boom in the "old" Federal Republic was the sharp increase in demand from abroad and, subsequently, from East Germany. As the result of separate national accounting statistics for East and West Germany till 1994, West German goods sold in East Germany were counted as exports. Total exports so defined rose by one third between 1988 and 1991. The only other component of total output to achieve growth rates of this magnitude was investment in equipment, but this is largely to be seen as a reflection of the increase in foreign demand. Private consumption, on the other hand, did not make a substantial contribution to economic growth until 1991 in the wake of a substantial programme of tax cuts. The consumer-oriented sectors of the West German economy were the prime beneficiaries of the boom. The food, drink and tobacco industries, the consumer-good industries and

Graph 2





retail and wholesale trade profited greatly from the boost to demand coming from East Germany. In the winter months of 1990/91 the food, drink and tobacco industry increased its output by almost 20% on the same period 12 months earlier. Consumer-good producers increased their

level of output by more than 8%. The investment-good sector, on the other end, recorded growth of only 4.5% because of the sharp fall in foreign demand from mid-1991 on. Due to the high levels of capacity utilisation in West German industry and the marked slowdown in the rest of the world economy, overseas firms increasingly penetrated the German market. During the winter months of 1990/91 the volume of imports rose by about 15%. Stagnating export growth and the boom in imports brought about a dramatic change in Germany's trade balances. At the beginning of 1991 the pan-German current account went into deficit for the first time since 1981; in spring even the balance of visible trade was negative for the first time after the second world war.

Of course these changes have been reflected in shifts in the capital balance: Germany became a net importer of capital. The fact that the trade balances deficit was not to be taken unduly dramatically. The swing from surplus to deficit in the current account was, just as text books predict, the direct consequence of the growth differential between West Germany and the other industrialized countries, on the one hand, and the structural competitive weakness of the East German economy on the other. Given the inadequate level of capital formation in East Germany the problem of East Germany's lack of competitiveness could be solved by importing capital. It was clear that, during the reconstruction phase at least, the new federal states would be a net importer of capital.

In such a constellation the only way to avoid the swing in the current account for Germany as a whole would have been to accept a marked slowdown in West German economic growth. A restrictive monetary policy or the rapid consolidation of the fiscal deficits could have been implemented to cut domestic absorption. But this would have weakened the vigour of the West German economy, and West German economic strength was a necessary condition for financing the reconstruction of East Germany. The current account deficit did not indicate a loss of international competitiveness on the part of the West German economy. The public debate in Germany, periodically rekindled and oscillating around phrases such as "fundamental competitive weakness", "technological deficiency", "excessive tax burden" and "living below our means" did not even approximate the true picture as far as West Germany's competitive position was concerned. Additionally, during the years prior to German unification the Federal Republic had been "living below its means“ to an incredible extent. Even if the unification had not occurred,

a reduction in West Germany's trade surpluses would have been necessary in order to reduce the disequilibria on world goods and capital markets. The revolutionary changes in Germany and the reactions of policy makers had made net capital imports all but inevitable. In addition, it must be recognised that it was only thanks to the enormous increase in imports that the inflationary threat posed for West Germany by the boost in demand from East Germany could be largely averted. The potential conflict between an increase in employment and a rise in inflation was largely avoided till 1992 by increasing imports and running down the surplus on current account.

The economic unification of the two Germanies had provided the West German economy with an unexpected demand boost at a very favourable point in time, while it had pushed the East German economy, which in any case was in a precarious position, deep into crisis. In the short term this displacement of demand from East to West (not just to West Germany) was a zero-sum game in which one side gave with one hand what it took with the other. Within both "regions" of Germany, though, major changes in income distribution did occurr and there had been - irrespective of the economic collapse in the new federal states - a massive redistribution of resources from West to East.

I expected from the beginning that only in the medium term the transition from an inefficient to an efficient economic system in East Germany could provide new and, on balance, positive impulses for the Germany economy as a whole. The East German economy had plunged so deeply into crisis that it would take a long time before it could catch up with the economic dynamics in Western Europe without outside help. Given this, it was a grave mistake of many observers[2] to believe that East German would begin to catch up if the pace of growth in West Germany would slow down. Only if the West German economy operated at full steam capital - both public and private - could be mobilised for the reconstruction in the new federal states. A growth slowdown in West Germany, as it happened after 1992, would lead to the suspension of planned investment projects in East Germany and thus slow the "stopping train East" still further. Moreover, "pure“ redistribution from West to East, i.e. an actual reduction in living standards in

[2] The Prime Minister of the state of Saxony, Kurt Biedenkopf, for instance, replying to the question how the "'stopping train East" and the "intercity West" could be brought closer together, was reported as saying: "then the intercity will have to travel more slowly!".

absolute terms in the West in order to raise in the East is, economically, a rather naive idea as it ignores the logic of the "transfer problem" that characterized the German situation.

A „Transfer Problem“, following the discussion about German reparation payments after the first world war and the Treaty of Versailles, describes the question whether a country can pay a certain amount of money to another country without suffering a decline in its standard of living. According to the „solution“ of this problem, offered by J. M. Keynes, which I regard as the only tenable one, the country with an obligation to pay has to run current account surpluses. These surpluses can be the result of an improved competitiveness of the paying country or a slowdown of its economic activity. Both, improved competitiveness by falling wages and prices and a slowdown of economic activity will lead to a reduction of the standard of living in the paying country. It is questionable whether under such conditions the „budget problem“ can be solved, namely whether the population of the paying country can be convinced to sacrifice a part of their gross income to help the „poor on the other side“. The German „solution“ with East Germans loosing competitiveness by increasing their wages too quick and thus offering West Germany a huge increase in market shares is a much more plausible outcome as West Germans had to solve only the budget problem but not an additional current account problem.[3] Nevertheless, the only way to avoid big transfers and the political turmoil which they induce is to preserve the international competitiveness of both sides.

V. Germany’s Two Labour Markets

The divergent economic trends in East and West Germany were particularly evident on the labour market. Political and economic unification had, far from leading to a harmonisation, actually widened the gap between the two economic regions. The former GDR, where full employment had been one of the state's major policy aims for 40 years, experienced almost overnight the all but total collapse of its labour market, while the old Federal Republic was chalking up the best labour market statistics for decades.

[3] See far an analysis of the German Unification as a Transfer-Problem and the relevant literature: Heiner Flassbeck: Die Deutsche Vereinigung - ein Transferproblem, in: Vierteljahrshefte zur Wirtschaftsentwicklung, Heft 3, 64. Jg., 1995, pp. 404-413.

The dimensions of this breach in the labour market can be easily illustrated. Whereas in the second half of 1990 the level of employment in West Germany rose by 800 000 (3.1%) on the previous year's figure, the number employed in East Germany fell by 1.3 million or 14%: in manufacturing industry, which used to employ some 40% of the workforce, employment fell by almost 20%. Job losses of such an order of magnitude in sectors and branches which were no longer competitive, and which were not compensated by job creation in other sectors to any great extent, led to a dramatic increase in unemployment. One year after monetary union, registered unemployment in East Germany had reached about 840 000, an unemployment rate of 9.5%.

The scale of the collapse of the labour market was, however, understated by the unemployment figures. A comprehensive labour market analysis for East Germany had to take into account the widespread use of short-time working and the specific way in which the German Labour Promotion Law had been applied in the former GDR. The provisions of the Unification Treaty concerning short-time working provided that state benefits were available even if the lack of orders in a certain company was not of a temporary but of a long-term nature. Short-time working, considered as an instrument of labour market policy under this provisions, was an instrument to hide open unemployment. By the end of June 1991 the two million employees on short-time working were performing on average only 44% of regular working hours. In September 1990 the figure had been 56%. Converting the short-time figures into "full-time unemployment", the unemployment figures would have been more than 1 million above official unemployment levels. Taking this "full-time equivalent" into account, the corrected figure for the unemployment rate (April to June 1991) rose to about 22%.

VI. Exit and Voice: Migration and the Balance of Power on the Labour Market

Although both the demand and supply sides of the labour markets in East and West Germany continue to develop along diverging trajectories, this does not mean that they can be explained independently of one another. The hinge linking the two labour markets was the migration of labour from East to West Germany. This movement - consisting both of actual migration and those merely "commuting" across the former border - meant that it would be all but impossible

to devise strategies for one labour market without having to consider the reaction of economic variables affecting the other.

The existence of a large number of potential migrants - in the following both actual migrants and "commuters" will be subsumed under the one term - had a significant effect on wage and salary trends in East Germany. The "propensity to migrate" within Germany was in view of the lack of language problems, the relatively high social acceptance of migrants in West Germany, and the extremely low costs involved - very high. This fact must then be set against the background of the extremely unfavourable economic situation in the new federal states.

Average monthly incomes in East Germany (average for the second half of 1990) were just under DM 1400; in West Germany about DM 4 000 (Graph 3). Average incomes in the new federal states were thus only about 40% of those in the West. Add to this the considerably less favorable labour market perspectives and it is hardly surprising that substantial numbers of East Germans opted to migrate to the West. Unfortunately, it was extremely difficult to ascertain the precise extent of migration as East German citizens moving to West Germany have not been registered since the borders were officially opened. Provisional estimates for 1990 suggest about 150 000 persons of working age may have switched domicile from East to West. To this must be added about 200 000 "commuters" (year's end 1990). By the middle of the first year the number of "commuters" working (but not living) in West Germany had climbed to 350 000.

In the longer term it could be important to distinguish between the two forms of labour migration as they could have different effects on investment in East Germany. The permanent migration of labour could prove to be a crippling millstone around the neck of the East German economy if the lack of skilled labour were to prove an obstacle to investment. Even in case of a significant improvement in the economic situation in East Germany, it would have been unlikely that workers who had shifted their life-focus and perspectives to West Germany would return.

Graph 3

[1] Seasonally adjusted by the Berlin Methode (BV 4).
Source: Quarterly Calculations of the DIW.

This risk was less acute in the case of "short-term migration", i.e. commuting between a home in the East and the work place in West Germany, as ties remained to the place of domicile. Moreover, commuting of this type could be conceived simply as a reduction in the supply of labour in East Germany and thus an easing of the pressure on the labour market there. Employment in West Germany went some way to reduce the loss of "human capital" which in the case of unemployment the East would have occured. Increasingly employees from East Germany were receiving training from West German employers in the use of modern technology. This amounted to a transfer of technical know-how from West to East Germany, at least if workers subsequently gained employment in their home area. For these reasons such temporary migration had a positive effect.

The substantial rise in East German incomes immediately after the unification had frequently been justified with reference to the threat of migration of "human capital", i.e., a mass exit from East Germany. This argument, together with the frequent citation of the "law of one price" for homogeneous goods in a single market, led to the political justification of wage and salary increases of 30% within the first year. Wages increased even more rapidly during 1991, namely by more than 40%.

The central question facing economic policy makers at this time was, whether the wage hike in the East German labour markets had to be interpreted as the result of market forces and, as such, should be accepted or rejected in the public discussion. In other words, was the critical question seemed to be whether the extent of labour mobility was sufficient to explain the margin by which the rate of wage increases exceeded the rate of productivity growth.

The wage hike, however, was hardly the product of market forces but rather an expression of the fact that the trade unions had been able to exploit the power vacuum, the lack of voice, on the employer side and that the general state of public opinion was to push through excessive pay demands. Economic policy makers were prepared to accept additonal support and subsidies for the East German economy while knowing that this would merely encourage the unions - without them having to worry about voice from the employers side or additional sanctions from the labour market - to seek an even more rapid upwards adjustment of wages to West German levels. Thus, the state would have been well advised to suspend such aid, to subvert the unions' wage-adjustment strategy through labour market sanctions, and to end the "moral hazard" constellation for the unions. The politically conditions, however, for such a brave move were not given.

Nevertheless, a closer look at labour market developments reveals that the interpretation of the rapid upwards adjustment of East German wages to West German levels as a result of market forces is not tenable. Instead, it was definitely the lack of power and voice on the side of capital which can explain the wage hike. A pure market model works something like this: if the borders between two countries with different capital resources, labour productivity and wage levels are opened at an exchange rate which serves just to stabilise the level of output in both countries (i.e. one which has no effect on competitiveness) then, to the extent that labour is mobile, labour will migrate from the low-wage to the high-wage country. This migration causes a shortage of labour in the low-wage country and a labour surplus in the high-wage country. This will tend to bring wage levels into equilibrium, exerting upward pressure in the low-wage, downward in the high-wage country, which forces marginal firms in the low-wage country out of business and leads to the creation of new productive capacity in the high-wage country.

Important for the evaluation of this constellation are the supply and demand trends on the labour market. Clearly, the mobility of labour ensures that persistent unemployment occurs in neither the high nor in the low-wage country. The low-wage country is characterized by a labour shortage. The fact that the wage growth is temporarily decoupled from productivity growth is a reflection of a shortage of labour there. Exit cannot - under market conditions - go hand in hand with rising unemployment.

This leaves us with the only one possible conclusion regarding the labour market situation after the unification in Germany. The introduction of the monetary union, i.e. an exchange rate of 1:1 for all current transactions, effectively set a wage level in East Germany which incorrectly evaluated the willingness of those living in the new federal states to migrate. The leap in unemployment in East Germany indicates that the wage level so fixed was unnecessarily high given the actual extent of potential labour mobility. An exchange rate and thus a wage level appropriate to the actual "propensity to migrate" would have led to a labour shortage in East Germany.

Even if it is the case that the initial exchange rate error was unavoidable in 1990 for various reasons, the mobility argument cannot offer an explanation for the persistent divergence of labour market trajectories in East and West. A fall in unemployment in West Germany, despite immigration, and rising unemployment in East Germany, despite mass exit, requires according to the rules of the market - rising wages in West and falling wages in East Germany, in order to bring competition on goods markets, and, as a consequence, the labour market perspectives of both regions more closely in line. Of course this mechanism is no way to prevent migration because markets do not bring quantity adjustments to a standstill but rather they tend to lead to similar demand and supply conditions on all markets. By the same token it is simply incorrect to say that a rapid upward adjustment of wages would put a stop to migration when it is clear that the low-wage country is uncompetitive on the goods markets compared with the high-wage country and that this was the main cause of unemployment in the former.

A much more plausible explanation for the rapid wage increase in East Germany than the mobility argument is the view that an effective labour market simply did not exist in East Germany immediately before and after monetary union and that the trade unions have been successful in

their attempts - in a highly centralised bargaining processes - to exploit the power vacuum on the employer side. It can scarcely be maintained that a power vacuum, such a lack of voice, did not exist. The entire process of unification, and in particular monetary union, would have taken a quite different way if there had been an effective body representing employer interests in East Germany. If it is recalled how much resistance West German employers mobilised in the 1960s and 1970s against currency appreciation of just a few percentage points, then it is clear that monetary union, with its effective appreciation of over 300% would have been a non-starter if a private corporate sector had existed. In many ways this is a paradoxical constellation: The rapid transition of the GDR economy to a market economy with a hard, convertible currency and open borders and thus the rapid process of political unification in Germany was only possible because private **firms,** one of the essential prerequisites for a market economy to function, did not exist.

Monetary, economic and social union had laid bare the competitive weakness of the economy of the former GDR. Over the decades the autarky and misallocation characteristic of the planned economy in the GDR meant that neither from inside nor outside the country there was sufficient pressure on the economy to ensure steady investment at a high level, to extend and modernize the capital stock. Compared with Western industrialized countries the East German machine park was antiquated and unproductive. It was only possible to continue production with this capital stock because the GDR did not have to compete on the world market.

A small, open economy - and East Germany since monetary union is a classic small, open economy - can only be competitive on world markets if wage costs per unit of output are not higher than those of the trading partners.[4] An economy with a small or rotten capital stock and thus low labour productivity can only sell its products on the world market if its wage costs are correspondingly low (Graph 4). The political debate in Germany after and before unification was focussed on what was perceived to be a dilemma. On the on hand, a high wage level seemed to

---

[4] Such a statement tends to surprise the public as there are after all other, seemingly much more important components of total costs - the costs of inputs, capital and imports. Yet it remains the fact that in an international comparison, it is only wages which count. At the level of the national economy, namely, inputs and f'ixed capital are clearly also the result solely of human labour, albeit in a different unit of output, or in an earlier period of time. Imports, finally, raw materials and financial capital, cost the same all over the world - given open markets - and thus do not affect the prices of goods between countries. What remains then is the cost of the immobile factor of production, labour, and the efficiency with which it is used in production, i.e. labour productivity. Given flxed exchange rates, then, competitiveness is determined by wage costs per unit of production or unit labour costs.

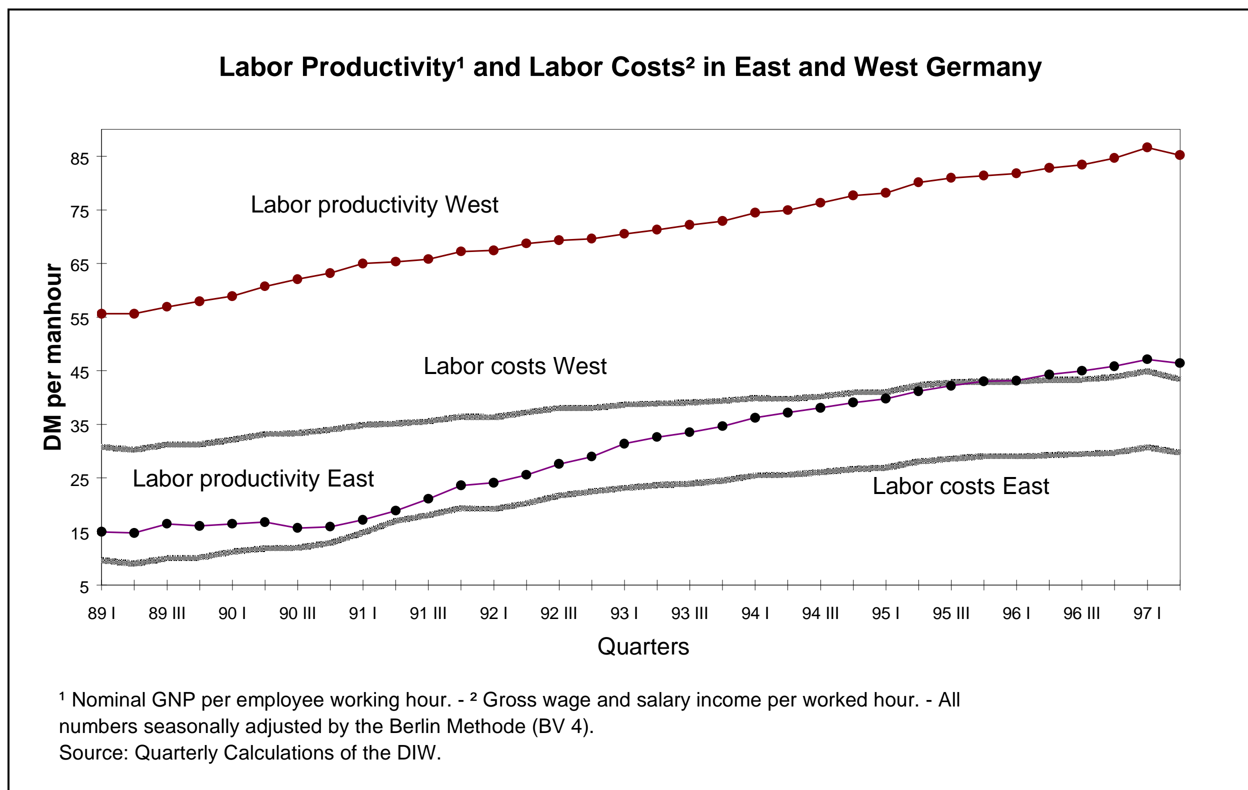
be necessary in order to prevent migration and the associated loss of "human capital". Equally, lower wages seemed to be required to enable East German firms to regain competitiveness and to set in motion a process of self-sustained growth.

In reality there was no dilemma. A low wage level and low labour migration are fully compatible. The decision to migrate is not merely a function of the difference in wage and salary incomes between low and high wage region. What is decisive for the decision to migrate is the expected level of incomes in the future. This means that the probability of obtaining a given income in a particular job is of prime significance. In other words, even in the context of a high overall wage level, expected income can be low if the chance of gaining a job is low, i.e. unemployment is high.

The fundamental misappraisal of the motives behind labour migration in the German case lies in the fact that low wages alone were perceived as the trigger for the decision to migrate. But this is to ignore the effect of the drastic wage rises on the level of unemployment. Rapid pay rises have stabilised incomes in absolute terms but they have also weakened the competitive position of East German firms by sharply raising unit labour costs. Only during the second half of 1990 unit labour wage costs rose 20% faster than those in West Germany. The competitive position of East German industry was weakened further during the course of 1991 (Graph 5). Thus, the effect of wage increases on expected incomes - i.e. wages multiplied by the probability of employment - cannot be determined a priori. Whether expected incomes rise or fall following a rise in wages depends on the extent to which the demand for labour reacts to the same wage rise. Given the state of the East German economy it was rather clear that the demand for labour was very sensitive to changes in wage rates. In other words, the rising wages can have caused the demand for labour to fall to such an extent that the decline in the probability to find a job more than offset the rise in wages, so that expected incomes actually had fallen and the incentive to migrate had risen. Thus, high wage increases could not stop the migration of labour from East Germany. They reduced the income disparity between East and West, but only at the price of reducing the demand for labour in East Germany. The resulting unemployment reduced expected incomes, the decisive parameter for the decision to migrate.

At the same time, it would be an exaggeration to place the entire blame for unemployment in East Germany at the door of the trade unions and their pay policies. Even at a lower wage level a large number of firms would not have been producing competitive products. Still, lower wages would have enabled some firms to survive, giving them the chance and the time to adjust to changing circumstances. Moreover, obstacles to investment such as the lack of an effective infrastructure cannot be overcome overnight: they must be taken as given by firms in their cost calculations for some time at least. In the short term the only variable which can be altered to compensate for unfavorable production conditions is the level of wages. However, given the political and social environment immediately before and after monetary union, this instrument remained unused. The consensus of opinion which emphasised the importance of a uniform wage level in East and West Germany was so strong that those - like me and many other economists - who warned against a superficial analysis of the problems went unheard.

Graph 5



Labor Productivity[1] and Labor Costs[2] in East and West Germany

[1] Nominal GNP per employee working hour. - [2] Gross wage and salary income per worked hour. - All numbers seasonally adjusted by the Berlin Methode (BV 4).
Source: Quarterly Calculations of the DIW.

VII. Spurious Solutions

Faced with the dramatic economic problems in East Germany a whole range of suggestions have been put forward to resolve the dilemma between outward migration due to income differentials and that due to rising unemployment. One is wage restraint in West Germany with the aim of stabilising the labour market. This line of argument is, however, based on a theoretical model in which, due to the mobility of labour, the prices for labour tend to equalise. This would imply slower wage growth or even wage cuts in West Germany. Such models are not able to explain wage movements and labour migration due to the different capital endowments of the two regions (a difference the models fail to take into account) and the resultant, seemingly paradox situation that a high-wage area possesses a significant competitive advantage over the low-wage region. For these reasons it would be impossible to achieve lower rates of wage growth or wage reductions in West Germany in the long run. They would, on the one hand, initially reduce the existing wage differential, while, on the other, leading to a reduction in unit wage costs; and the resultant scope for price cuts would exacerbate the competitiveness differential, the competitive advantage of the high-wage over the low-wage region. This would have the effect of reinforcing the diverging trajectories of labour market developments. A reduction in migration - which, as we have seen, is not only a function of wage differentials - would therefore be an extremely unlikely result of such a strategy.

This having said, it cannot be concluded from wage trends in Germany as a whole that the principle of centralised, free collective bargaining (*Tarifautonomie*) has failed. It is simply that immediately before and after the introduction of monetary union the essential preconditions for collective bargaining to work effectively - autonomous negotiating partners with equal rights and of equal strength - were not given. In view of the power vacuum on the employer side, the state, as the owner of most of the firms (in the guise of the *Treuhandanstalt*), ought to have taken on an active role on the employer side. This would not have represented state intervention in free collective bargaining, but rather the appropriate response in view of the nature of property relations at the time. In Germany the principle of free collective bargaining has been an extraordinary success story. The stability of the D-Mark and the competitiveness of the West

German economy on international markets are primarily a consequence of the negotiating process between employers' associations and trade unions, in which the negotiating parties have consistently shown a high degree of responsibility with respect to the overall state of the economy. In no way can the principle of *Tarifautonomie* in the Federal Republic be seen as "an encumbrance on the market economy", as some observers still believe.

A further proposal - the use of wage subsidies - aims to drive a wedge between net wages and wage costs: firms unit wage costs would be lower, income expectations higher, reducing the pressure to migrate. However, closer analysis shows that this seemingly attractive solution entails serious drawbacks. The proposal would be truly attractive if it meant that workers in East Germany would begin earning the same wages as in West Germany while at the same time firms - in terms of present wage levels - were relieved of a significant proportion of their cost burden. A few simple calculations suffice to show that this would have represented an extremely costly solution, placing an immense strain on the willingness of the West to cushion adjustment in the new federal states and tying up enormous reserves of capital which would then no longer have been available for investment. Moreover, solutions based on wage subsidies do not resolve the moral hazard problem of the trade unions mentioned above and thus run the risk of inducing additional, even higher wage increases.

All the same, any one of the various wage-subsidy models under discussion would have been preferable to the policy pursued in the first years by the *Treuhandanstalt* of granting so-called liquidity guarantees. In principle this means that firms still owned by the *Treuhandanstalt* were effectively receiving wage subsidies but without firms actually benefiting from a direct reduction in their costs. The *Treuhandanstalt* merely guaranteed loans: the firms were then able to take out loans with which they payed the full level of current wages. lf the firms failed they could resort to the state guarantee to pay back the loan. To this extent the costs of these "wage subsidies" arose later without any immediate positive effects except that some firms were enabled to stay afloat.

The conclusion to be drawn from the above is clear. The strategy of rapid wage adjustment was too heavy a burden for the Federal Republic as a whole to bear. lt is inconceivable that the state could provide transfers to the extent required over such a long period without going beyond its

financial limits in one form or another. As all the various actors involved did not accept the need to rethink policy in this matter the experiment called "Monetary, Economic and Social Union in Germany" may have to be considered a failure.

VIII. The Conclusion for Germany

This outcome begs the question whether there was ever an alternative to this kind of "unification experiment". This is not only a very difficult question, in many ways it is of purely academic interest. It is no longer important to determine in retrospect whether - and if so under which external conditions - the GDR could have taken its own path to community with the Federal Republic, but rather whether - and if so how - the citizens of the GDR could have made the adjustments necessary to travel down such a path. Any experiment of this type would inevitably have failed had the population not been prepared patiently to accept that it would take a not inconsiderable period of time in order to overcome the relative backwardness of the East German economy. The fact that many would not be sufficiently patient under any circumstances is a fact that none can change. The decisive political mistake which was made was the belief that the realisation of monetary, economic and social union alone would put a stop to the pressure to migrate. By forgetting that the "impatient ones" would not wait whatever the circumstances, false expectations were raised among the "patient ones". Instead of making efforts to explain the nature of economic processes, politicians indulged in wishful thinking. Where warnings against setting expectations too high would have been in order, East German citizens were promised "gifts". Emotions were stirred where what was needed were cool heads.

Monetary union and the rapid political unification of the two German states may have been inevitable and, in the final analysis, the right option. The way it was implemented in practice, however, was plagued by false analysis and inconsistency. Little attempt was made in both East and West Germany to explain to people the economic implication of such a step in such a way that they themselves could have foreseen the consequence of their own actions. This was particularly necessary where, after 40 years of economic confusion, scarcely anyone was in a position to comprehend what opting for the D-Mark as the common German currency really meant. Of course the majority of East Germans thought that this was the fastest way of achieving West German standards of living. Unfortunately the fact that a mere exchange of currencies will not

bring this about - and indeed in some ways can even make it more difficult - is not something that was mentioned at the demonstrations or during the election campaign.

From the point of view of democratic legitimation, too, the results of the process of German unification are ambivalent. Although during the course of 1990 East German citizens were able to vote in free and fair, democratic elections, they did not have a real choice. They were never presented with clear, comprehensible programmes, the consequences of which they were able to evaluate themselves. Democracy means more than setting out procedural rules. It is a necessary condition of democratic elections that voters have some idea of the options before them. In the normal run of gradual political and economic change this may be taken as given without specific efforts on the part of the body politic. It is not, however, the case in times of fundamental socio-economic change.

IX. The Conclusion for Korea

The two Koreas face unification under completely different circumstances than Germany. West Germany, at the time of unification, was one of the strongest and richest economies of the world with falling unemployment and a huge current account surplus. Germany at that time could shoulder even a transformation process incorporating huge losses in real income for the average citizen and the government.

South Korea today is in a different shape. Hit by a severe recession in the aftermath of the Asian crisis not even a much smoother unification process could be born without the risk of an economic depression. But even under normal circumstances, e.g. those prevailing a couple of years ago, would the „German way“ be feasible for Korea. The DIW (German Institute for Economic Research in Berlin) has calculated the economic burden of two different scenarios for economic integration of Korea. The result is straightforward: A German like shock scenario with a quick adjustment of wages in the North to the South would lead to a collapse of Korea as a whole.[5]

---

[5] German Unification - An Example for Korea? Edited by Heiner Flassbeck and Gustav A. Horn., Dartmouth, Aldershot, 1996.

Moreover, the two scenarios have shown that, from an economic point of view, the gradual integration of North Korea, i.e.a. smooth adjustment of wages, is clearly superior to shock therapy. At the same time, shock therapy is unavoidable with regard to the transformation of Noth Korea's economic institutions if capital and know-how is to be attracted to North Korea. It is a fundamental lesson of the German experience, and of the transformation in Eastern Europe, that different speeds should be chosen for transformation and integration in this sense respectively. This approach has so far not been tried in any transformation country. While shock therapy was adopted for both processes in Germany, Eastern Europeans chose either a gradual approach for both or gradualism in transformation but shock as integration is concerned..

The negative consequences of shock-like integration in East Germany have been described. In many countries in Eastern Europe, namely in Russia, reform seems to be bogged down halfway through the process with a real danger of a renewed recession in the region as the effects of shock integration are felt. From this, the conclusion would be to choose shock therapy as the transformation to market institutions is concerned and to avoid, at the same time, any kind of macroeconomic shock, coming from wages, the exchange rate or from the side of interest rates. The question is only whether different speeds for transformation and integration are politically feasible at all. There can be no doubt that the swift, shockwise integration into world markets also speeds up institutional transformation - at the cost, however, of a severe adjustment crisis. Slower integration, on the other hand, would give some protection to existing institutions too as the need for adjustment would appear less urgent at the first glance. This creates the danger that transformation without macroeconomic shocks will be incomplete and turn into a creeping structural crisis. To avoid these dangers it might be advisable to irrevocably fix the time frame for the complete integration of North Korea in advance. The need to transform North Korea institutionally would then be present form the very start, but without the strains of macro-shocks weighing down on the country right away. In this way, the rapid transformation of institutions could be effected, while integration could proceed at a slower pace. As a prerequisite for such a strategy, a broad-based political consensus would have to be established concerning the desirability of unification and the willingness to share the burden that even this approach would still place on the shoulders of the Korean people.

References

Eucken, W.: "Deutschland vor und nach der Währungsreform" (Germany before and after Monetary Refom). In: A. Hunold (Ed.), Vollbeschäftigung, Inflation und Planwirtschaft, Erlenbach-Zürich, 1951.

Flassbeck, Heiner: „Die Deutsche Vereinigung - ein Transferproblem. In: Vierteljahrshefte zur Wirtschaftsentwicklung, Heft 3, 64. Jg., 1995, pp. 404-413.

Hayek, F. A. "Vollbeschäftigung, Planwirtschaft und Inflation" (Full-employment, the Planned Economy and Inflation). In: , A. Hunold (Ed.),. Vollbeschäftigung, Inflation und Planwirtschaft, Erlenbach-Zürich, 1951.

Horn, G.A.; Flassbeck,H. and R. Zwiener „German Unification - An Example for Korea?" Edited by Heiner Flassbeck and Gustav A. Horn., Dartmouth, Aldershot, 1996.