

Interview with Dr. Horst Siebert:

## What to Learn From the German Reunification

*The following is a written interview between Dr. Horst Siebert, the President of the Kiel Institute of World Economics, and Dr. Soon-Won Chung, the Senior Director of Research at HRI.*



*Dr. Siebert*

**Dr. Chung:** What do you think were the major factors responsible for the collapse of East European countries including East Germany in the late eighties?

**Dr. Siebert:** The major factor was what we call the transformation shock. A new price vector became valid, and prices changed for outputs as well for very important inputs. This meant that the existing capital stock was largely obsolete under the new conditions. Using a macroeconomic production function, a decline in output was the necessary consequence.

Whereas Eastern European countries had the exchange rate as an additional policy instrument to regain competitiveness, East Germany experienced a 400 percent appreciation of its old currency. This was an additional shock for the East German industry. But in the German case, dual currencies, one for West Germany and one for East Germany, would not have been a possible solution.

An extreme difficulty in the German case was the quick wage adjustment to the West German level. This destroyed the viability of old firms and prevented the birth of new firms. Investment became less attractive. In contrast, some of the

Eastern European countries have experienced strong real wage reductions, for instance, by 31 percent in Poland (1990) and by 35 percent in the Czech Republic (1991).

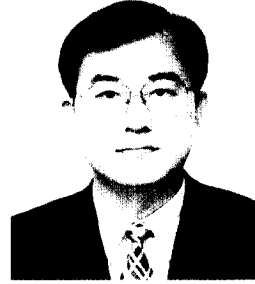
**Dr. Chung:** How would you evaluate the German reunification in 1990 overall? Did you think that there existed any other alternatives at that time?

**Dr. Siebert:** At the end of 1989 the idea was discussed whether one could have two states in an integration process over several years. In January of 1990, we had discussions on whether one could have two currencies for the interim period, possibly both being controlled by the Bundesbank. But with the completely free movement of people which was guaranteed by the German constitution, these options were not feasible. In the German case with a very small political time window, there was no option other than the big bang with an instantaneous extension of the West German constitution to East Germany.

**Dr. Chung:** In terms of the economic integration of East and West Germany, would you consider the past six years' efforts a success or a failure? Among various policy measures (such as currency, wages, public transfer, and privatization) which have been successful and which have failed? If you had another chance, how would you correct those that have failed?

**Dr. Siebert:** A definite failure was wage policy. Wages increased much more than productivity, and even today (1995 data) unit labor costs in East Germany are 30 percent higher than in West Germany. This indicates that the region is not competitive. Wage increases should have been kept in line with productivity increases.

Many economists have proposed wage subsidies in order to keep firms competitive and allow higher income to workers. I am afraid that such an approach would have established a moral hazard problem for trade unions. It would not have restrained wage increases. The philosophy of German economic policy was to speed up capital accumulation taking into account that a completely new capital stock has to be created in East Germany.



*Dr. Chung*

Consequently strong capital subsidies were used. I think that there was no alternative to such a policy of capital subsidization.

For privatization, we did not apply the voucher system but capital ownership was quickly established. This approach was basically correct because it allowed us to pull capital as well as management techniques into Eastern Germany and establish market access very quickly.

It was proposed that ownership should have been given to the East German people, but taking into account that the Treuhandanstalt basically lost roughly 300 billion DM in privatizing the enterprise sector there was really not much to be given to the East German population, except a negative capital value. Moreover, such an ownership structure would have prevented private capital owners from going into East Germany.

As is known by now, previous owners of firms, land and houses were not reinstated if they were expropriated by the Russian military government of 1945-1949 (this was the bulk of the East German industry); otherwise they were reinstated. Of course, the respect of property rights delayed investment, and only 60 percent of all reinstatement cases of private losses (houses and land) have been solved (spring 1996). Possibly, neglecting property rights would have speeded up economic development, but the respect of property rights must be looked upon as an "investment" in the certainty of rights for the future. With this historical experience of respecting property rights under unusual conditions, it will be very difficult to disregard property rights in the future.

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**Dr. Chung:** What is the major problem at the moment?

**Dr. Siebert:** Public transfers to East Germany amount to 4 percent of German GDP and, of course, represent a heavy burden on the German economy. The share of government spending to GDP has risen to 50 percent. Taxes were increased considerably, and public debt doubled from 900 billion DM (1989) to 2 trillion DM. The difficult task of German fiscal policy is to change this fiscal policy stance and to reduce

transfers to East Germany over time.

The major problem at the moment is whether a competitive export base has been established. Also the catching-up process seems to be stalling. The answer to this question will only be known in some years from now.

**Dr. Chung:** Six years after the reunification, Prime Minister Kohl's promise of "blossoming landscapes" has yet to be realized. How do East Germans feel about this promise remaining unfulfilled. On the other hand, what have been the major sources of complaints from West Germans regarding the reunification process?

**Dr. Siebert:** Since 1990, the East German GDP per capita has increased from roughly 30 percent of the West German level to 55 percent (in 1995). From a historical perspective, this is quite an achievement. However, 55 percent also signals how far East Germany still has to go. It is a long road. It is my impression that the majority of East Germans are satisfied with the change; however, a large section of the population is disappointed. In these times of tremendous change and upheaval, groups of the population including the previous stakeholders have lost. Unemployment including hidden unemployment still runs at 25 percent. In West Germany, people feel the burden of transfers through higher taxes.

**Dr. Chung:** Many Koreans were amazed by the speed and ease of the German reunification process in political terms. In particular, the lack of military resistance on the part of the East German political elite was difficult to fathom, as most experts expect (and thus are worried about) strong resistance from top North Korean leaders at the time of Korean reunification. What do you think made such a peaceful (that is, bloodless) concession of political power possible?

**Dr. Siebert:** The peaceful change of political power was only possible because there was an unsurmountably strong wish of the population for political change and for political freedom.

**Dr. Chung:** What is your view on the prospect of Korean

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reunification? In what form is it most likely to happen? More pertinently, will it take a different form from the German unification?

**Dr. Siebert:** In contrast to the German case, with East Germany accounting for only one fourth of the West German population, a larger population would have to be integrated into the South Korean economy. In addition, with the large geographical size of North Korea, investment in infrastructure like roads would also be relatively more intensive than in the German case. Consequently, the burden of unification and the transition problems would be more severe in the Korean case if Korea mimics the German procedure. One question therefore could be from an economic point of view, whether a slower integration process would be possible with two different economies coexisting for some time. Some essentials like basic legal rules would apply to the two systems immediately, and both regions would have to agree on guiding principles which would have to be laid down in the unification treaty. Possibly, two currencies might be an option for the interim period, so that the northern region has its own exchange rate for adjustment. Considerably, the complete freedom of people to settle wherever they like might have to be restricted for an interim period.

**Dr. Chung:** What should we Koreans learn from the German experiences? Are there any specific suggestions (both economic and political) that you would like to make for Korean policy-makers?

**Dr. Siebert:** German unification only came about because East Germans wanted to change their political system and because they wanted to be unified. One major reason why this strong wish was there is that East Germans could watch West German television. That was what economists call a demonstration effect. Unification of Korea is sure to come about when North Koreans will be able to watch South Korean televisions. The Korean engineer who finds the inexpensive plug that makes this possible will be an important driving force for unification. SKP

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