What Can Korea Learn from German Unification?

Chung Hoon Lee*

Introduction

Unification of the two Koreas, if and when it takes place, will be a costly event if the experience of German unification is any indication. As it is now widely recognized, unification of the two Germanys has cost the unified Germany dearly: Between 1989 and 1992 East Germany's manufacturing output decreased by one-third and its GDP and employment by one-half (Schmidt and Sander 1993, Siebert 1993).

A structural transformation of an economic system—whether it is from a centrally planned, socialist economy to a free-market economy or from a war-time economy to a peace-time economy, is a costly process. But there are reasons to believe that, in the case of German unification, the wrong policy choices made the cost of unification greater than it would have been otherwise. If this is true, then the lessons for Korea are more straightforward: Determine which policies were at fault and make certain that they are not replicated in Korea.[1]

How Korea should prepare itself for unification depends on how unification will actually take place. There are basically two alternative scenarios. The first is a gradual, evolutionary process such as the one outlined in "To Build a National Community through the Korean Commonwealth: A Blueprint for Korean Unification (National Unification Board, Seoul, 1989). It envisions

* Dr. Chung Hoon Lee is Director of the Center for Korean Studies, and Professor of Economics, University of Hawaii at Manoa.

[1] For an extensive discussion of German unification and its policy implications for Korea, see Deutsches Institut fur Wirtschaftsforschung (1995).

the adoption by the two Koreas of a National Community Charter by which both sides would recognize each other and seek co-existence, irrespective of political differences. This would then be followed by the creation of a Korean Commonwealth. This commonwealth would not be a union of states or a federal state but would be rather similar to the European Community where each country remains sovereign. The final stage will be reached when a Unified Democratic Republic is established based upon general elections. If this scenario is realized, unification will most likely be a matter of integrating two market economies because in this scenario North Korea is likely to evolve into a quasi market economy such as the one in China.

The second scenario is, as was the case in Germany, the absorption of North Korea by South Korea upon the collapse of the former. Unification will then require a rapid transformation of North Korea's socialist economy into a market economy while it is being integrated into the South Korean economy. The cost will be extremely high if the German experience is any indication.

This paper addresses some major economic issues concerning only the second scenario. There is no urgency with the first scenario since it is an evolutionary process and there will be ample time for South Korea to prepare itself because events will unfold gradually over time. The second scenario is, however, different because if it occurs, it will do so unexpectedly. It is, therefore, never too early for South Korea to prepare itself for that contingency.

Economic Issues of Unification

If Korean unification takes place as envisioned in the second scenario it will entail two separate but related economic problems: (1) transforming the centrally planned socialist economy of North Korea into a market economy—the so-called transition problem—and (2) integrating it with the market economy of the south. The German experience shows that three policy issues, inter alia, will play a critical role in determining the cost of economic transition and integration. These are (1) the method of privatizing state- and collectively-owned properties, (2) the choice of the conversion rate between the two currencies, and (3) the wage policy.

Privatization

The ultimate purpose of privatizing state- and collectively-owned enterprises (henceforth, state-owned) is to create private enterprises in North Korea and thus transform its economy into a market economy. Privatizing state-owned enterprises—the so-called top-down privatization—is in fact one of the two privatization processes that must take place in such a transformation. The other process is bottom-up privatization, i.e., an expansion of the private sector by creating new private enterprises in a former socialist economy.

(1) Bottom-Up Privatization:

Bottom-up privatization in North Korea may take place with investments from the south and the rest of the world, as well as with investments by some North Koreans. However, the latter will be in a handicapped position because, having lived in a socialist planned economy, they would lack the necessary know-how and perhaps even the inclination for entrepreneurial activities. They may also lack access to the necessary credit for investment. Thus, to encourage bottom-up privatization by North Koreans it would be necessary to establish specialized financial institutions that would provide subsidized credits to North Korean entrepreneurs for a specified period of time.

A successful case of bottom-up privatization was found in China where some of the most dynamic enterprises since 1984 have been non-state-owned small industrial firms located mostly in rural areas (McMillan and Naughton 1992, Perkins 1992). Rapid expansion of these enterprises has diminished the share of state-owned enterprises in China's GDP and has also had the effect of forcing state-owned enterprises to become more efficient. In fact, this Chinese experience has led McMillan and Naughton to conclude that "[r]apid privatization need not be the centerpiece of a reform policy." The Chinese experience is not, however, applicable to Korea.

As McMillan and Naughton recognized, the high profitability of private enterprises was due more to their capturing a part of the monopoly rent created by the artificial state pricing policy than to their having superior efficiency. That is, in China the demand for manufactured goods was diverted at lucrative prices from state-owned to newly established private enterprises. However, this diversion of demand to private enterprises was made possible only because their domestic markets were protected from import competition from the rest of the world.

In East Germany, the story is different, because upon unification the state pricing policy was abolished and the East German markets became vulnerable to competition from the rest of the world. The demand was diverted from state-owned enterprises to imports from West Germany and the rest of the world, and not to budding new East German private enterprises. Furthermore, without artificially maintained high prices there was no monopoly rent to be captured by these firms and thus no indirect subsidy for them.

The situation that will prevail in a unified Korea will be similar to that of Germany and not to that of China since it will be impossible to maintain artificially high prices for the products manufactured by North Korean state-owned enterprises and have them, at the same time, compete with goods imported from South Korea and the rest of the world at a free-market price. In other words, in a unified Korea state-owned enterprises cannot be maintained as a way of providing indirect subsidies to new private North Korean enterprises. If subsidies are warranted for these enterprises it is better to subsidize them directly rather than indirectly by maintaining state-owned enterprises which themselves will be able to survive only with heavy subsidies from the government.

(2) State-Owned Enterprises:

As the above argument indicates, one of the first things that needs to be done in North Korea upon unification is the privatization of most, if not all, of the state-owned enterprises. Privatization experiences in East Germany and Poland point out that although privatizing small-scale enterprises, especially in the service sector, is relatively easy there are several obstacles to privatizing large state-owned industrial enterprises.[2]

Privatizing large state-owned industrial enterprises in North Korea will run into similar obstacles. Experiences in other former socialist countries point out that many state-owned enterprises are overstaffed and have poor performance. Furthermore, claims of dispossessed previous owners and the lack of capital market institutions have hindered rapid privatization (Schmieding 1992a).

Uncertainty regarding property rights (ownership) has been identified as a main cause for lack of investment and, worse, for the depletion of the existing assets in former East Germany (Sinn 1992). The establishment of a clear ownership title can be, however, a costly process because, for example, there may be difficulties in distinguishing between the ownership of a firm and the ownership of land, incomplete and neglected records, administrative bottlenecks in processing claims applications (note that there have been 1.2 million applications in the case of Germany), and multiple ownership claims when a firm has added pieces of land and buildings over time (Siebert 1991).

In Germany, until March 1991 attempts at privatization by the Treuhandanstalt were frozen whenever claims by previous owners were announced.[3] A decision on 23 April 1991 by the German Constitution Court has reduced, but not eliminated, the scope of restitution by ruling that restitution does not have to be the only solution for expropriation that took place after 1949. The decision has thus separated in principle the issue of the claims of dispossessed previous owners from the issue of compensation.

In North Korea, disputes over ownership may not be a serious obstacle as most of the private enterprises that were socialized in

[2] Privatization of small commercial and industrial firms was rapidly carried out in Poland. Financing these firms has proven to be a major problem since the banking system has difficulties in appraising small firms headed by new entrepreneurs (Fischer 1992). This is another reason for establishing special development banks in North Korea.

[3] The Treaty on German Economic, Monetary and Social Union of July 1, 1990, which formalized the economic union of the Federal Republic of Germany and the German Democratic Republic, established the Treuhandanstalt ("trust fund") to help privatize the state-owned enterprises while restructuring and supporting them temporarily.

1946 had belonged to the Japanese and would, in all likelihood, not be claimed by their former owners. Many of the enterprises that were established after 1946 were created by the state or local authorities, and it is unlikely that there would be any private claims for restitution or compensation against them. But even in these cases potential disputes could arise over the ownership of the land on which state-owned enterprises were established. To prevent such disputes from stalling the privatization process, Korea should from the beginning establish compensation, not restitution, as a general rule for settling ownership disputes. If this is done, enterprises can be rapidly privatized with compensation being made by the state at a later date when ownership disputes are actually settled.

Once compensation, not restitution, is adopted as the method of settling ownership disputes, privatization becomes a matter of choosing between the sales and give-away approach. The German Treuhand approach is basically a sales approach, whereas the voucher scheme used in former Czechoslovakia is a give-away approach.

In deciding which approach to privatization to use, Korea may consider the three criteria proposed by Blanchard and Layard (1992)—speed, fairness, and efficient control.

Clearly, the speed at which privatization can be carried out is an important factor. As pointed out by Blanchard and Layard, speed is advantageous because it prevents possible reversal, it removes uncertainty, it protects the government budget from being siphoned off to support inefficient firms, and it may help promote fairness by minimizing the danger of underhanded privatization by those inside the system. Given the well-publicized slowness of privatization by the Treuhandanstalt, one can easily conclude that for speedy privatization give-away is superior to the sales approach.

To achieve fairness in privatization, i.e., a fair distribution of the assets of state-owned enterprises, Blanchard and Layard advocate giving them away via a distribution of shares or vouchers to citizens, preferably in equal amounts to everyone, including children.

An additional argument in favor of give-away is that sales would favor the former nomenklatura since they are the ones with liquid assets and can thus purchase the usually undervalued assets in the transition economy. However, in the case of Korea it is likely that a majority of North Korean assets will be purchased by South Korean residents and businesses and not by the North Korean nomenklatura. Furthermore, with the inflow of money and businesses from the south it is unlikely that assets in North Korea will remain undervalued for long once privatization begins. Fairness can then be achieved through the distribution of equal amounts of privatization proceeds among the North Koreans.

In considering fairness in the Korean context we need to pay special attention to the question of regional balance between north and south. If most of the North Korean assets are purchased by South Koreans and the sales revenues are distributed to the North Koreans, the social structure pattern that will emerge in the north will be a dualistic one consisting of southern "capitalists" and northern workers. In a society where for more than fifty years capitalists have been depicted as exploiters of the working class, economically prosperous southern "capitalists" would be an object of envy and hatred, especially if unification results in widespread unemployment in the north as severe as that in former East Germany. Given the fractious regionalism that has plagued its long history, Korea cannot afford to ignore the possibility of such a regional imbalance and conflict emerging from privatization.

For achieving a regional balance the give-away approach is a preferred method of privatization. A free distribution of shares or vouchers would give the North Koreans clear title to properties in the north, and with the appropriate education it can provide them with a sense of being capitalists themselves. Certainly, there will be some people who would like to sell their shares or vouchers to increase their current consumption. Trading in shares or vouchers for cash can be, however, justifiably prevented for a year or so until North Koreans become better informed of the nature of vouchers and shares and of the workings of the capitalist market economy, especially the workings of the stock market. Lack of such knowledge clearly constitutes a case of market imperfection especially in an economy where markets have been newly introduced. In such a situation the banning of trading in vouchers or shares for a year or so, except in the manner discussed below, seems fully warranted on the basis of equity as well as economic efficiency.

The third criterion for privatization is efficient control of assets. With this criterion the sales approach is superior to a free distribution of shares or vouchers since it is administratively simple and leads to good corporate governance. The voucher system has some serious drawbacks in efficiency due to the share ownership being widely diffused among a large number of people. Consequently, the interest of owners cannot be adequately protected.

As a way of getting around these drawbacks Blanchard and Lanyard propose mutual funds or holding companies which will own a controlling share in a certain number of enterprises. Citizens will then be given shares in each of these mutual funds or holding companies.

There are, however, problems in trying to impose efficient control over assets through mutual funds. To prevent possible fraud, the mutual funds will need to be supervised by the government. But privatization may then turn out to be in namesake only as it is still the government that will be managing the enterprises through the mutual funds (Schmieding 1992a). A more basic question, however, is whether the mutual funds are the best instrument through which enterprises can be efficiently managed.

Given that in the Korean case the influx of money and businesses from the south will minimize the possibility of undervaluing the North Korean assets, a combination of sales and give-away may be the best alternative for privatization.

I propose the following combined approach which takes into account some of the lessons from the German privatization experience (Schatz 1992):

- The government establishes an independent institution, a trust fund, to which all the properties to be privatized are transferred. A controlling share in each of these enterprises is then sold to the investor (an individual or a firm) who offers the highest price. The investor will be then be in control of the enterprise and thus in charge of necessary restructuring.

- Vouchers, which are claims against the trust fund, are equally distributed to all North Koreans. These claims will be exchanged for shares in a special account to be established in every mutual fund operated in South Korea. These special accounts are only for the North Koreans and their assets consist solely of the shares in the former North Korean state-owned enterprises.
- The vouchers that mutual funds obtain in exchange for their shares will be used by them to bid for the remaining shares in the privatized enterprises yet held by the trust fund.

Through this process of privatization, three competitive markets will emerge: (1) a market for a controlling block of shares in the enterprises being privatized by the trust fund, (2) a market for the vouchers held by the North Koreans in exchange for shares in the mutual funds, and (3) a market for the remaining shares held by the trust fund in exchange for the vouchers now held by the mutual funds.

As a result of privatization, each North Korean will typically have cash from the trust fund and some shares in a mutual fund. Given the great uncertainty regarding the viability of many of the newly privatized enterprises, as evidenced in the case of East Germany, it may be rational to require that North Koreans do not convert their mutual fund shares for cash for a year or two. This period of time may be needed for necessary restructuring for privatized firms and for the corresponding portfolio adjustment by the mutual funds. A management-fee schedule directly proportional to the price of the share will give the mutual fund a strong incentive to maximize the value of its portfolio for the time when trading in shares is allowed.

The process of privatization outlined above will be rapid since the trust fund functions solely as a privatizing agency and not as an agency in charge of restructuring state-owned enterprises before privatization. It has the advantage of putting the privatized enterprise under the direct control of a single individual or firm. It also has the advantage of turning the North Koreans into "capitalists" (for some this may be only for a short period of time until they sell their mutual fund shares). It also transfers the task of evaluating privatized enterprises from North Korean individuals to the mutual funds. This will help the North Koreans because it will be far easier for them to pick one of several well-established mutual funds than to pick on their own a mix of shares in the recently privatized enterprises. The trust will be dissolved once the shares held by it are exchanged by a specified future date for vouchers offered by the mutual funds.

(3) Land and Collective Farms:

In privatizing the collective farms in North Korea, land will have to be classified into four types based on previous ownership. The first is the land that belonged to the Japanese colonialists until 1945; the second is the land that was expropriated from "rich" or absentee Korean landowners under North Korea's 1946 Law of Land Reform; the third is the land that was distributed to cultivators under the same law and held by them until 1958 when collectivization was completed; and the fourth is the land that was held by small cultivators until 1958. How land will be privatized will vary from case to case.

In the first case, neither compensation nor restitution to the former Japanese landowners will be necessary since they lost their property rights in Korea when they were expelled in 1945. In the second case, restitution to previous owners would be unnecessary since similar land reforms redistributing land from absentee landowners to cultivators was also carried out in South Korea and the basic philosophy behind land reforms seem to have been the same in both North and South Korea. But even in this case some compensation will have to be made, at least for the purpose of reaffirming the principle of private property in the unified Korea. Since these so-called "rich" or absentee landowners are probably no longer alive, compensation will have to be made to their descendants who may now reside in the south.

In the third case—the ownership of land given to cultivators in 1946 were later turned into collective farms—restitution may be a preferred solution as the North Korean land reform of 1946 was probably not that different from the land reforms carried out in the south, except for the matter of compensation. In the fourth case, the matter is straightforward, the land should be returned to the previous owners. (For the sake of equity, the farmers who receive land should be disqualified from receiving cash and vouchers from the trust fund.)

Choice of the Conversion Rate

How unification will affect the enterprises in North Korea will depend, inter alia, on the conversion rate between the North Korean won and the South Korean won. At a conversion rate favorable to the former—an overvaluation of the North Korean currency—the wage rate for North Korean labor will be higher in terms of the South Korean won than at a less favorable rate. Given the generally low productivity levels caused by "overstaffing" and obsolete technology that is typical of enterprises in a socialist economy, a favorable conversion rate for the North Korean won will have an adverse effect on the competitiveness of North Korean enterprises and will thus bring about a contraction in their output and employment.[4]

Furthermore, whatever the conversion rate may be, unification will put North Korean enterprises at a competitive disadvantage vis-a-vis South Korean firms since the latter would most likely have better products to compete with.[5] Consequently, North Korean enterprises will suffer a contraction in demand for their products, and a conversion rate favorable to the North Koreans will simply aggravate matters for them.

In Germany, the Treaty on German Economic, Monetary and Social Union of July 1, 1990 established the Deutsche Mark as the

[4] If wages were completely flexible, the choice of the conversion rate would not matter as wages will adjust to their equilibrium level after the economic union. This seems to be, however, an unlikely scenario.

[5] After the currency union East Germans almost completely stopped buying East German goods: since 1991 East Germany's imports have exceeded private consumption (Bofinger and Cernohorsky 1992).

only currency and the Deutsche Bundesbank as the only central bank in the unified Germany. It also transferred all the civil, commercial and public laws of West Germany to East Germany and set a conversion rate averaging 1.81 ostmark for one Deutsche mark.[6] All contracts concerning the current income were converted, however, at a rate of 1:1, a rate that many experts considered an overvaluation of the East German mark. This immediately had an adverse impact on the profitability of the former East German enterprises.

If the conversion rate was significantly less favorable to the East Germans it might have proved more profitable, but real wages in East Germany would then have been less than one third of those in West Germany (Schmidt and Sander 1993). With such a difference in wages, there could very likely have been a mass exodus from East to West Germany. Although, according to a survey of East Germans it is the lack of work for a sufficiently long period, not wage differentials, that has induced former East Germans to migrate to West Germany (Akerlof, et al. 1991).

In the final analysis, however, one is led to the conclusion that what determined the conversion rate was not economic rationality but the political imperatives of unification (Hasse 1993). In other words, the conversion rate was a means of transferring income and wealth from West to East Germany and thus for inducing enough East Germans to vote for unification. Furthermore, it would have been symbolically unacceptable to have maintained two different currencies for the newly unified Germany. Given these political realities, Korea may also not have many alternatives.

[6] The main conversion rates agreed upon in the Treaty on the Creation of a Monetary, Economic and Social Union between the Federal Republic of Germany and the German Democratic Republic (approved by both parliaments 20 September 1990) are:

a. Salaries, retiring pensions and housing rents 1:1

b. Credits of enterprises and individuals 2:1

c. Liabilities of enterprises and individuals 2:1

d. Savings of citizens of the GDR up to certain amounts depending on their ages 1:1

e. All savings above these ceilings and cash 2:1

f. Claims of individuals living outside the GDR 3:1.

The average conversion rate calculated by the Deutsche Bundesbank is 1:1.81 (Hasse 1993).

Wage Policy

What aggravated the contraction in output and employment in East Germany was a wage cost explosion which far exceeded the market-clearing level (Akerlof, et al.).[7] Starting even before the currency union, wages began to rise in anticipation of the favorable terms of the currency conversion. In fact, between the fourth quarter of 1989 and the second quarter of 1990 wages rose by 20 percent (Schmidt and Sander 1993).

The workforce in the old socialist firms, which West German trade unions had actively helped organize, pressed for higher wage contracts. The old socialist management, not the owners, did not resist the pressure for higher wages. Moreover, they had every incentive to agree to the demands of the workforce in hopes of gaining its goodwill (Schatz and Schmidt 1992). In other words, during the transition from a centrally planned to a market economy, the owners' interest (i.e., the state) was not adequately represented at the wage bargaining table. There was not even a soft budget constraint on the demands by the management and labor since the government completely abstained itself from wage negotiations.

The opportunistic behavior of the workforce and management of the old socialist enterprises was further abetted by the self-interest of both West German trade unions and employers associations. From their perspective, low East German wages would have put downward pressure on West German wages and would have given new or restructured enterprises in East Germany a competitive edge over the established firms in West Germany. Thus, from the very beginning West German unions and employers associations supported their East German counterparts in the determination of wages (Bofinger and Cernohorsky 1992).

As a way of preserving existing jobs and rapidly creating new jobs Akerlof, et al. proposed a program of "self-eliminating flexible

[7] A secondary reason is a sharp drop in demand for East German goods as West German goods became available to East Germans and as exports to CMEA (Council for Mutual Economic Assistance) countries declined drastically.

employment bonuses." This would presumably have eliminated the gap between the high private cost of labor caused by high East German wages and the low marginal product of its labor. As pointed out, however, by Schmidt and Naujoks (1993), such a scheme would have discriminated against viable East German enterprises, would not have given adequate incentives for adjustment, and could have easily degenerated into a self-perpetuating mechanism for subsidies.

Clearly, given that the absence of the owners' interest at the wage bargaining table was a major cause for the wage cost explosion in East Germany, rapid privatization and thus the establishment of clear ownership rights would have moderated wage increases. The lesson for Korea is clear: it should carry out privatization as quickly as possible, and in those cases where that is not possible the government should not forfeit its responsibility as the owner of state-owned enterprises and act accordingly in its interest. It might even consider adopting some form of income policy during the transition period.

Conclusion

A conversion rate economically more rational than 1:1, and modest wage increases would have eased the cost of structural change for the East German economy. However, it would not have avoided the cost entirely since the demand for its inferior products would have decreased once western goods became available to the East Germans. This cost of temporary de-industrialization of the East German economy was a cost that could not be avoided in the process of its transformation into an open free-market economy. Getting the prices right, i.e., a correct conversion rate and correct wage rates, would not have been sufficient in preventing the high cost of such a radical structural change.

In preparing itself for possible unification, Korea needs to devise a method for rapid and efficient privatization and set the right conversion rate and wage policy. But these policies will not be sufficient since the two economies on the Korean peninsula are too disparate for costless integration to take place. Thus, there must also be a comprehensive regional development plan which will make the privatized enterprises viable, creating and nurturing new private enterprises, which in turn will generate employment. Such a plan must include means for transferring various market institutions from the south and developing human resources capable of effectively functioning in these institutions.

The experiences of Central and Eastern European countries prove beyond a doubt that introducing such market institutions in a former socialist economy is a costly and time-consuming process and is not something that can be left entirely to the market (Winiecki 1992). Thus, ironic as it may be, Korean unification will require the South Korean government to play a more active and extensive role than is normally expected of a government in a free-market economy.

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