Germany: Twenty Years After The Union

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Pete Mavrokordatos
Tarrant County College District

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Pete Mavrokordatos, Tarrant County College/U. of Phoenix/Intercollege Larnaca, Cyprus
Stan Stascinsky, Tarrant County College, USA
Andrew Michael, Intercollege Larnaca, Cyprus/Northcentral U., Arizona, USA

ABSTRACT

One of the most important events in the world after World War II was the reunification of Germany, during the late 1980s and early 1990s. The aim of this paper is to discuss the general economic conditions in Germany, before and after the reunification. This paper is divided into four parts. The introductory section provides a summative discussion of the economic conditions in East and West Germany from World War II until the time of reunification. The second section presents an evaluation of the German economy since the reunification. The third section presents macroeconomic data to illustrate the general impact of the unification on the German economy. The final section offers concluding remarks and recommendations.

I. INTRODUCTION

Germany was divided into East and West by the allies right after World War II. East Germany remained under Soviet control for a number of years, and then under Soviet influence until 1989, whereas West Germany was under western control and financial support until 1948, and since then under western influence. Numerous developments took place in both Germanies during those 40 years, but perhaps the most important one took place in 1961, when the East German government built a wall to separate East and West Berlin. In 1989, this wall opened as a result of a mass exodus of East Germans to the West, as well as many demonstrations in a number of East German cities. Finally, by October 1990, the two German States were reunited, and in June 1991, the German seat of government was moved to Berlin.

Due to the different political and economic influences in the two countries since the division their respective economies headed in different directions. This section of the paper discusses the economic performance of both East and West Germany from the end of World War II until 1989, the year of the unification. We first begin with West Germany.

West Germany

1948 - 1960 During this period the West German economy was very robust. It experienced very fast growth, low price inflation, declining unemployment and a good external trade balance. One of the most important factors driving this success was a strong improvement in labor productivity which was in turn due primarily to three conditions:

a. a rapid reconstruction of the capital stock
b. a powerful structural adjustment of employment
c. German wages were lower only than the US and the UK

As a result of these factors, wages rose by 15% between 1947 and 1950, while the consumer price index rose by 14.3%, and labor productivity rose by 17.7%. All these contributed to strong profit margins for firms. This success continued between 1950 and 1960, during which time the GDP doubled, worker productivity rose by 75%, and there was virtual price stability. This growth was accompanied by only one significant recession, which was in 1957-58.

What were the factors contributing to this unbelievable success? Demand for German goods was very strong pushing exports up by 17.5%. The strong demand for goods was fueled by a relatively loose monetary policy (made possible by the lack of inflation). On the fiscal side, policy during 1952-56 created a budget surplus of more than 3% of GNP. In short, during the years 1950-1955 the German economy performed amazingly.

In 1955 inflationary pressures began to develop. Specifically, inflation for that year was about 2%. While this seems mild relative to today's standards, it must be remembered that Germany was not far removed from a period of hyperinflation in the 1930s and was therefore extremely wary of any inflation. As a result, the monetary authorities altered their monetary stance. They tightened credit by raising the discount rate from 3% to 5%. This brought on a recession in 1957, and to remedy it they again reversed their monetary policy, lowering the discount rate to 2.75%. The economy responded by emerging from the recession in 1958.

1960-1973 This period is known as the transition years. During these years, there were very tight labor market conditions, due to labor shortages, with foreign workers being imported to fill the gaps. Unemployment was below 1%. These labor market conditions contributed to price inflation, and by 1960 the monetary authorities had to tighten credit by raising the discount rate to 5% and the minimum required reserves by 55%. As a result the external trade balance was aggravated and exports declined, and by November of the same year the monetary policy was reversed to improve the external trade balance. By 1963 exports picked up and growth was up to 6.7%, but by 1965 the West German government experienced its first budget deficit since 1951, 1.4% of GNP. During the next year wages rose faster than productivity, and this continued for the next two years, with the result that profits were squeezed, investment collapsed, interest rates rose, and the GDP shrank by 0.1%. As a result of this recession, the monetary authorities adopted expansionary measures, and by 1968 exports rose to 8.4%, leading the economy out of its only recession of the decade. West Germany's economic performance reached its peak during the period 1969-1973 a period known as the German economic miracle characterized by the following three conditions:

a. In 1970, the degree of capital stock utilization reached the highest level since 1956
b. Inflationary pressures started to appear, with consumer price inflation between 5 - 7%
c. Germany realized maximum capacity and growth

Another important development during the 1960-1973 period was the growth of the government sector. In 1960 government spending was 32.9% of the GNP, but by 1973 this rose to 42.1%.

Also, taxes and social security rose to 43.3% of GNP by 1973, a figure that was only 35.9% in 1960.

1973-1989 During the last period before the reunification the West German economy did not fare overall as well as during the previous years. In 1973, West Germany had the lowest GDP growth of the six most industrialized countries contributing to labor surpluses. There were two major recessions in this period, 1974-75 and 1981-82, with very slow recovery. Both of these recessions were world wide phenomena and both were preceded by a hefty raw material price shock. What were the factors within West Germany that contributed to these recessions? In 1973, the inflation rate rose to 7% so the authorities imposed a tight monetary policy, which by 1974 resulted in a discount rate of 7% and a prime rate of 10.2%. As a result, investment contracted by 10% and the economy sank into recession. The authorities responded to this with expansionary measures, and in 1976 exports grew by 10% and investment increased pulling the economy out of its slump. Despite this recovery, persistent unemployment continued through the 1970s.

East Germany

East Germany, more formally known as the German Democratic Republic (GDR), was created in 1949. It was formed from the German provinces which were part of Russia's zone of occupation at the end of World War II. As a result East Germany began its existence in a state of economic void. To fill this void the USSR began overlaying on East Germany its own Stalinist economic model. Industry and agriculture were nationalized, central planning bodies were formed, and generally all the important aspects of the Soviet system were put into place. Given that East Germany was under occupation by Soviet troops, it is not surprising that the whole imposition went fairly smoothly. Thus the GDR was poised to serve as a good test for economic development under a Soviet communist system.

The GDR from the outset possessed a well trained and efficient workforce and with this the economy began a respectable recovery. By 1961 the Soviet Communist system was fully functioning and had driven industrial production up an average of 8% for each of the preceding five years. These growth rates, however, were relatively lower than those of West Germany. It was inevitable that comparisons would be made with the West German economy, which had recovered even faster and more impressively after the war. This led to the construction of the Berlin Wall in 1961 in order to stem the rapid outflow of GDR citizens who were looking for a better standard of living in the west. This highlights a problem with the East German economy which continued until the collapse of socialism - that of comparison with the West. For despite the fact that the GDR, economically, was a model for the rest of the Soviet Satellites, East Germany always measured itself not against Hungary, not against Czechoslovakia, but against West Germany. In such comparisons the East Germans could, by virtue of physical proximity, language commonality, etc., easily see that their own standard of living was not equal to that of their former countrymen in the west.

This continued until the late 1980s, when economic stagnation in the Eastern bloc communist countries became prevalent. Soviet President Gorbachev had instituted liberal reforms in the Soviet Union in an effort to revive the failing economy and address the people's desire for more political freedom. Once these reforms were put into place, however, they challenged inertia and exploded out of Gorbachev's control as first one satellite, then another declared independence and the Soviet Union began disintegrating. In East Germany, it has been noted that the economy was at this time not in very bad shape at least not in comparison to its East European counterparts. For this reason the collapse of socialism in the GDR cannot really be attributed to the internal dynamics of East Germany, but was perhaps more of a domino effect from the communist regimes that were falling all around it. Regardless, though, the East Germans were clearly not satisfied with their status quo. Demonstrations and riots occurred on the streets during the celebration of the GDR's 40th anniversary in 1989, and in November of that year a mass exodus from East Germany to West occurred as the borders opened and the Berlin Wall came down. The socialist political-economic system that had defined the GDR collapsed. This led, as with the other former communist countries, to the question of what direction to take now that socialism had failed. East Germany had a unique solution to the question, namely, to reunite with its Western counterpart. Though the prospect of a reunited Germany created some measure of trepidation in a Europe mindful of the ravages of World War II, the idea caught on quickly and Germany reunited in the summer of 1990.

II. GERMANY SINCE REUNIFICATION

After the above economic review of the two German States prior to the unification, this section aims to provide an evaluation of the Unified Germany from 1990 until 2003. As was discussed in the previous section, the two economies had become completely different since the split. While the West had linked its post war reform to a market economy, the East had transformed to a Soviet type command economy. The final outcome was that at the time of reunification the per capita GDP in East Germany was 40% less than the West, and labor productivity was 30% less. Economic unification came on July 1, 1990. While political unification followed on October 3, 1990.

A number of years have already passed since the unification, and the rebuilding of the Eastern economy has not been easy. Nevertheless, the Eastern economy has responded to the reunification plan, and the inequalities between the two have narrowed tremendously. One of the first things that the parliament of East Germany did right after the economic unification was to create a trustee agency. The job of this agency was to make both large and small firms competitive and to help transfer them to private hands by 1994, since all of them were owned by the state.

Switching from a socialist state to a capitalist state involved potential benefits as well as costs. Not everything would be successful and not everyone would benefit. In the former East Germany (which we'll now refer to as eastern Germany), unemployment rose sharply as a result of bankruptcies and the effort by business managers to slash payroll. Western Germany was, and still is, carrying almost the entire burden of the reunification helping eastern Germany recover. This is illustrated by the fact that during the first five years of unification it had spent more than $586.5 billion in eastern Germany for the improvement of infrastructure, such as transportation, housing and environmental protection. Another factor contributing to the eastern German development has been the increase of investment by foreign firms. All these efforts eventually began reaping benefits, and by 1994 the Eastern economy grew by 9.4%, and the per capita GDP stood at about 50% of that of western Germany. This figure was up from 30% at the end of 1990. However, unemployment still remained high at 14% of the labor force. By 1997, the economic production was less than 57% of that of the west, and the wage costs in connection with real net output were nearly 30% higher. Thus, the most important goal became to increase productivity in order to reduce the impact of the high labor costs, and this was sought by maintaining existing jobs and creating new ones, in cooperation with business management.

The business sector has contributed to the development of East Germany, and all the trade and industrial associations have pledged to implement measures to stabilize capital expenditure on equipment if the following three conditions were met:

a. the trade tax be abolished;
b. investment and equity assistance remain available to trade and industry; and
c. overall investment-friendly conditions exist.

The Federal government has done its share to contribute to the development of eastern Germany. Some of the measures it has taken include continuing to provide large-scale assistance (such as tax incentives) to commerce and industry, eliminating special depreciation allowances in return for a noticeable increase in investment allowances, providing assistance to the housing construction industry for the modernization of old buildings, and providing a six year plan with conditions for assistance.

Overall the developments since reunification indicate that both the German government and the German people working together are doing everything they can to make this unification work. This view is supported by the latest data available. Germany now is the fifth largest economy in the world, with a GDP of $2.863 trillion in 2008, and a per capita GDP of $34800, which also makes Germany the largest economy in Europe. Other data that show a tremendous improvement in Germany include unemployment of 7.9%, and inflation of 2.8%. In conclusion, the indications are that Germany has come a long way since the fall of the Berlin Wall, especially with the negative economic and political conditions of East Germany.

III. Statistical Analysis

Table 1
Real GDP for East and West Germany and United Germany in Bil. Of 1999 $ US
1989 - 2003

Year	E. Germ.	W. Germ.	Germany
1980	201.9	1251.6	
1981	206	1252.8	
1982	205.3	1241.1	
1983	209.2	1263	
1984	215.2	1298.4	
1985	221.9	1325	
1986	225	1356	
1987	228.9	1376	
1988	231.3	1427	
1989	234	1479	
1990			1762.5
1991			1808
1992			1848
1993			1828
1994			1871
1995			1903.2
1996			1918
1997			1945
1998			1983
1999			2023.1
2000			2081
2001			2099
2002			2102.3
2003			2100.2

Sources: Total Economy Database: Real Gross Domestic Product, OECD, 2004 August
Total Economy Database: Real Gross Domestic Product, Eastern Europe and Central Asia 2004 August

Table 1 shows the GDP for East Germany and West Germany between 1980 and 1989 and the combined GDP until 2003. Since the unification there has been a steady increase in GDP. This is also shown in Figure 1 which shows how the two Germanies compared before uniting, as well as the growth trend of the united Germany.

Figure 1

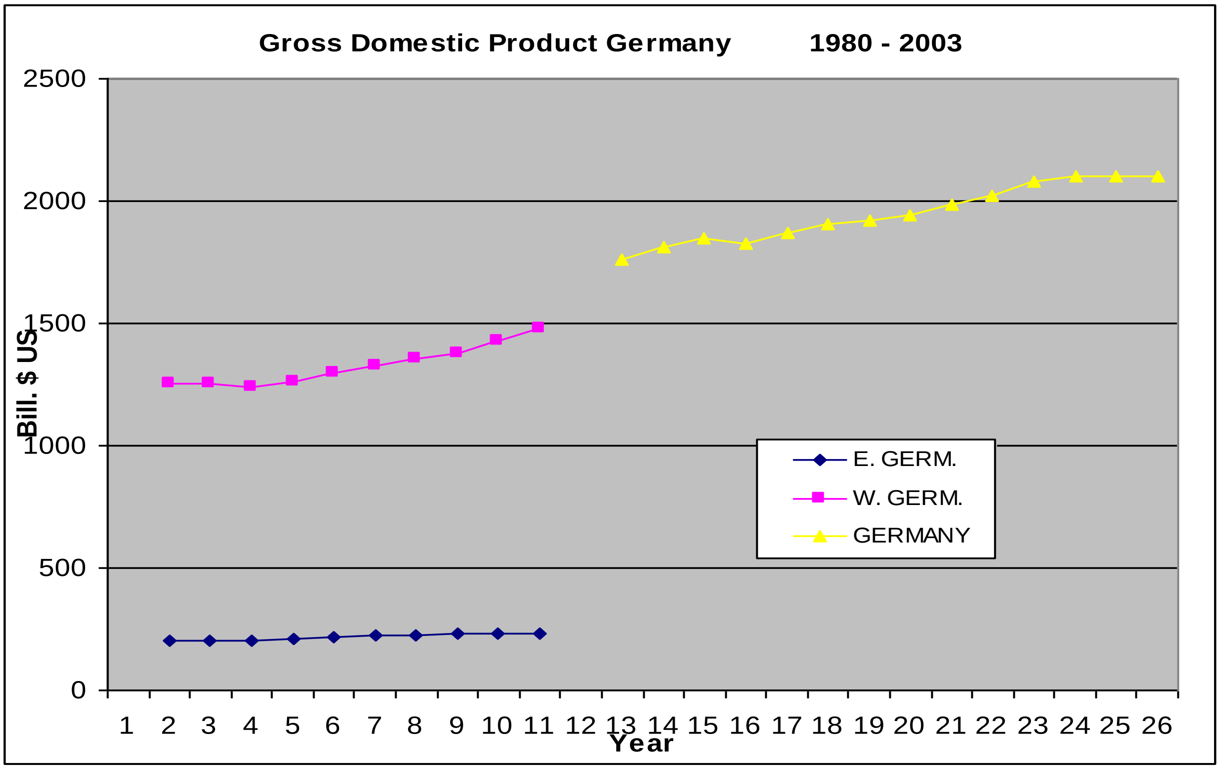

Table 2 and Figure 2 show the growth rates for the two Germanies before 1990, and the combined rate after 1990. The growth rates suggest a mixed performance. It was expected that the immediate years after the reunification (e.g. up to 1996) would be difficult due to the different economic conditions in the two economies prior to reunification. Although from 1997 to 2000 the German economy experienced increasing growth rates, from 2001 to 2003 its growth rates became anemic. However, during this period, lower growth rates were not unique to Germany as other western economies also experienced recessions.

Table 2
Growth Rates for W. Germany, East Germany and United Germany
1989 - 2003

Year	E. Germ.	W. Germ.	Germany
1980	2.1	1.1	
1981	2	0.09	
1982	-0.3	-0.9	
1983	1.9	1.7	
1984	2.8	2.8	
1985	3.1	2	
1986	1.4	2.3	
1987	1.7	1.5	
1988	1.1	3.7	
1989	1.2	3.6	
1990			3.4
1991			2.6
1992			2.2
1993			-1
1994			2.3
1995			1.7
1996			0.8
1997			1.4
1998			2
1999			2.1
2000			2.9
2001			0.8
2002			0.2
2003			-0.1

Sources: Total Economy Database: Groningen Growth and Development Center (GGDC) February 2004.

Figure 2

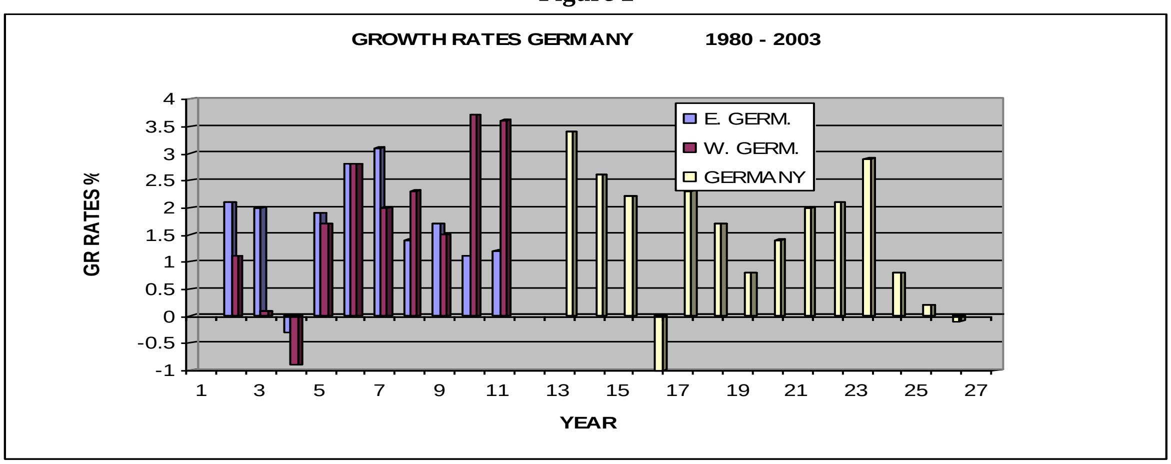

Table 3 shows total trade between the U.S. and W. Germany for the years 1980 – 1989, as well as the United Germany since 1989. Both Table 3 and Figure 3 clearly show that Germany has always had a trade surplus with the U.S. Germany's strong export performance has positively affected the German economy and the state of the reunified economy.

Table 3
U.S. Exports And Imports To/From W. Germany 1980 - 1989
And United Germany 1990 - 2003

Year		**Exports**		**Imports**		**Net Exp.**
1980		10960		11693		-733
1981		10277		11379		-1102
1982		9291		11975		-2684
1983		8737		12695		-3958
1984		9084		16996		-7912
1985		9050.2		20239.2		-11189
1986		10560.6		25123.8		-14563.2
1987		11747.7		27069.4		-15321.7
1988		14347.5		26362		-12014.5
1989		16862.3		24832.3		-7970
1990		18759.9		28162		-9402.1
1991		21302.5		26136.4		-4833.9
1992		21248.5		28820.4		-7571.9
1993		18932.3		28562		-9629.7
1994		19229.1		31744.3		-12515.2
1995		22394.3		36843.9		-14449.6
1996		23494.9		38944.9		-15450
1997		24458.3		43121.4		-18663.1
1998		26657.2		49841.9		-23184.7
1999		26800.3		55228.3		-28428
2000		29448.4		58512.9		-29064.5
2001		29995.4		59076.6		-29081.2
2002		26629.6		62505.7		-35876.1
2003		28831.9		68112.7		-39280.8

Sources: United States, Bureau of the Census, Statistical Abstract of the United States: 1987, 107th edition, Washington, DC, 1986.
United States, Bureau of the Census, Trade (Imports, Exports and Trade Balance) with Federal Republic of Germany, 14 Oct. 2004.

Figure 3

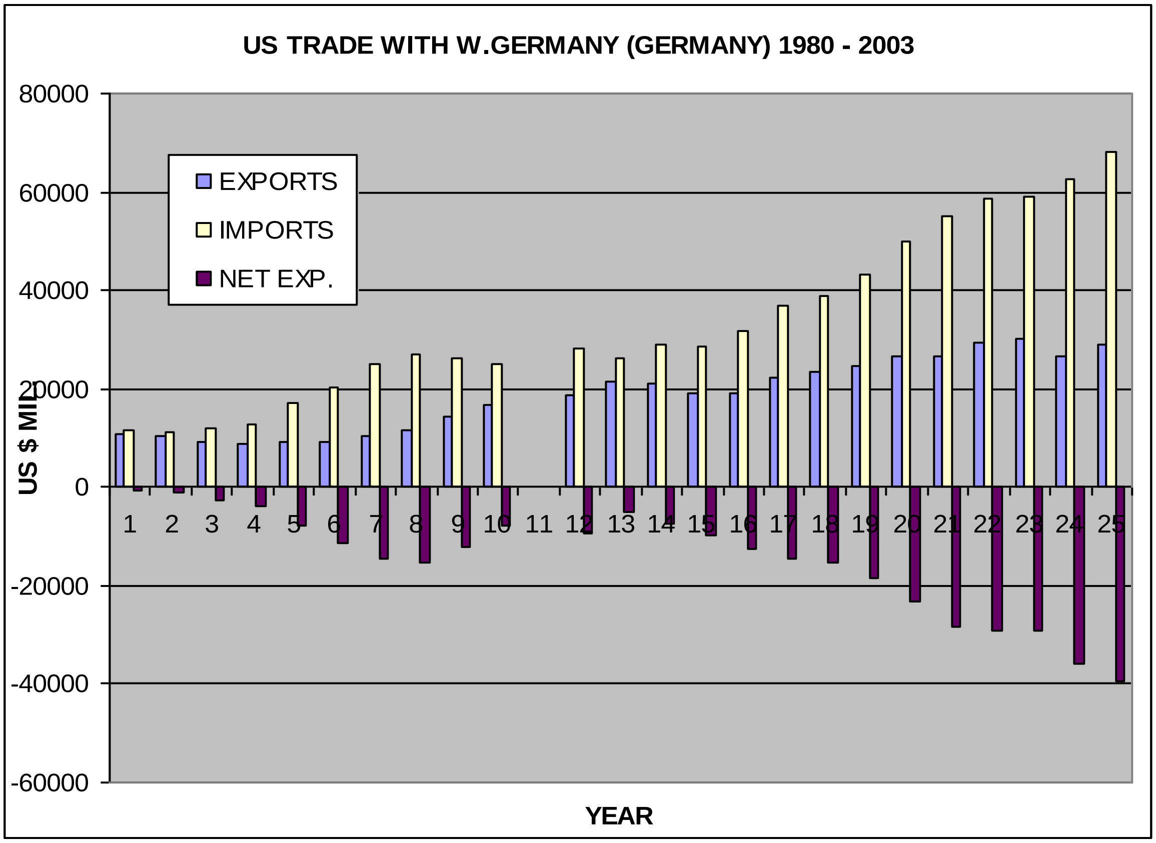

Table 4 shows the Gross Domestic Product of a select number of countries. Germany's GDP is only less than Japan's, the European Union's as a whole, and the United States. This is another indication that the reunification of the West and the East has been successful positively influencing Germany's economic performance.

Table 4
Gross Domestic Product
Billion US dollars, current prices and PPPs, 2006 or latest available year

Iceland	10.9
Luxembourg	36.9
Slovak Republic	94.8
New Zealand	107.3
Finland	172.4
Ireland	173.2
Hungary	182.8
Denmark	191.5
Portugal	220.6
Czech Republic	226
Norway	242.6
Switzerland	285.3
Austria	295.6
Greece	303.6
Sweden	316.7
Belgium	353.5
Poland	558.3
Netherlands	597.2
Turkey	639.7
Australia	735.3
Korea	1112.7
Canada	1201
Mexico	1267.9
Spain	1294.8
Italy	1699.2
France	1962.1
United Kingdom	1997
Germany	2631.6
Japan	4077.8
EU15 total	12245.8
United States	13132.9

Source: OECD Factbook 2008: Economic, Environmental and Social Statistics - ISBN 92-64-04054-4- OECD 2008

Finally, Table 5 shows that in 2005, Germany ranked 13th in both outward and inward Foreign Direct Investment (FDI) as a percentage of GDP compared to 34 other high- and low-income countries. Although Germany has higher levels of inward FDI compared to Japan, Italy, and the United States, it attracts less FDI than other western EU countries such as Luxembourg, Ireland, the Netherlands, Denmark and the United Kingdom.

Table 5-FDI Stocks
As a percentage of GDP, 2005 or latest available year

	Outward FDI	Inward FDI
Japan	8.5	2.2
India	1.6	6.5
Greece	4.8	10.3
Italy	16.6	12.7
Korea	4.9	13.3
United States	19.8	15.1
Turkey	2.3	17.8
Austria	22.3	20.5
OECD total	25.7	21.0
China	2.9	21.0
Brazil	9.0	22.2
Russian Federation	19.2	23.6
Germany	28.7	23.7
Mexico	3.7	27.3
Finland	41.6	27.8
Australia	24.2	28.0
Iceland	62.2	29.0
France	41.3	29.4
Norway	34.8	29.4
Poland	2.1	29.5
Canada	34.9	30.9
South Africa	15.2	32.0
Spain	33.0	32.9
Slovak Republic	1.3	33.3
Portugal	23.8	35.4
United Kingdom	54.7	37.1
Denmark	49.1	44.6
New Zealand	11.4	45.3
Switzerland	114.5	45.4
Sweden	58.4	48.1
Czech Republic	2.9	48.6
Hungary	7.2	56.0
Netherlands	99.5	70.6
Ireland	51.3	82.9
Luxembourg	89.5	117.1

Source: OECD Factbook 2008: Economic, Environmental and Social Statistics - ISBN 92-64-04054-4- OECD 2008

IV. CONCLUSION

In concluding, it can be said that both Germanies as independent States experienced macroeconomic instability with that of East Germany being more severe than the West for the reasons discussed in this paper. Having overcome the initial difficulties associated with the transition from a command to mixed economic system, Germany's economic future appears to be bright. One set of data that is very encouraging for the Germans, is the trade data with the U.S. Germany has had a trade surplus with the U.S., indicating that Germany's products and services are in high demand. Germany needs to remain internationally competitive and should concentrate on increasing its exports to other countries as well. This will benefit their trade balance, as well as employment and productivity. There is a need to investigate the reasons for Germany's relatively lower levels of inward FDI. Possible reasons might be that the new EU countries from central and Eastern Europe are relatively more attractive to investors due to lower land and labor costs.

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