Do not perpetuate the Dutch Disease in Europe: Lessons from German reunification for a European Fiscal Union

Gerlinde Sinn, Hans-Werner Sinn 01 November 2015

With a European transfer union on the cards, we can learn a lot from Germany's reunification – a transfer union of sorts. This column takes us through various lessons, concluding that transfers would cement southern Europe's lack of competitiveness and drive Europe into permanent stagnation.

This is an abridged translation of an article that first appeared in German in Frankfurter Allgemeine Zeitung (see Sinn and Sinn 2015).

Europe is debating further moves towards a transfer union, following the implicit and explicit transfers in the form of fiscal rescue programmes and monetary bail-out operations by the ECB. French President François Hollande and his young Minister of Economy Emmanuel Macron are now proposing a fiscal union complete with a common budget, a pooling of old debts, a common deposit insurance, a common unemployment insurance, a common finance minister and a common parliament (Hollande 2015 and Macron 2015).

As their proposal happens to coincide with the twenty-fifth anniversary of German reunification, which has led to the establishment of an intra-German transfer union, it might be useful to review the German experience in detail before further, and irrevocable, steps are taken to transform the Eurozone. In fact, it turns out that the German example should actually serve a warning for those who want to move ahead as quickly as possible, since it has been far less successful than outsiders seem to assume. While East German cities have all been beautifully renovated and reunification succeeded politically, East German productivity has seen very little progress in the last twenty years. Indeed, the convergence between East and West Germany petered out as early as 1995, with East German GDP not only ceasing to grow faster than West Germany's, but actually falling behind. While GDP rose by 30% between 1995 and 2015 in the West German federal states, it did so only by 23% in the eastern states.

The fact that nominal per capita GDP in the eastern states relative to the western states nevertheless grew from 67% in 1995 to 71% in 2013, as the chart below shows, is attributable in its entirety to the unequal population dynamics. Over the 19 years from early 1995 to late 2013, a net number of 770,000 East Germans emigrated to the western portion of the country, on top of the 870,000 who had done so in the years before.

If GDP is calculated not with reference to the population as a whole but in terms of people in gainful employment, the convergence looks somewhat better. This is, however, not a particularly relevant measure, because the labour productivity measured in this way can be raised to any level by wage rises and the associated elimination of less productive jobs.

Figure 1. East-West Germany convergence

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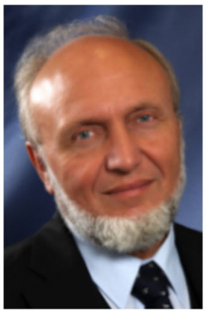

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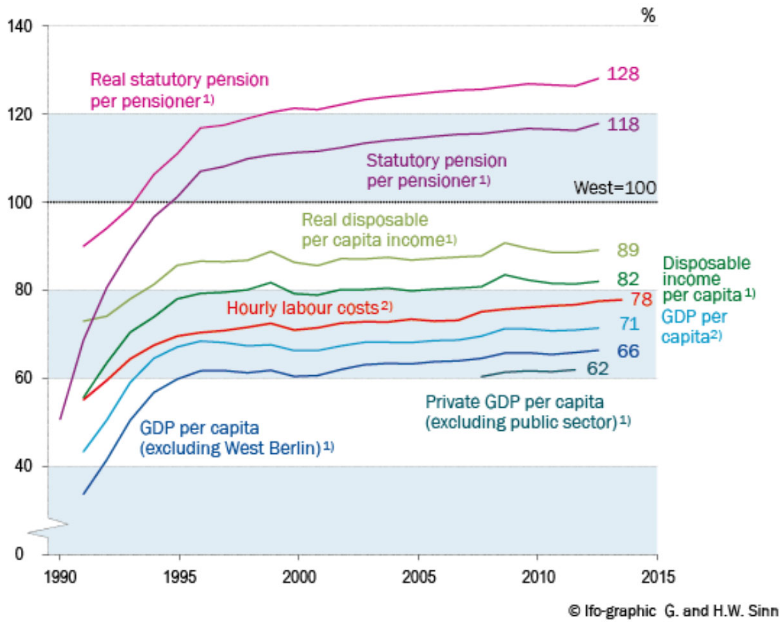

Notes: 1. Former East German territory relative to West German territory including West Berlin. 2. East German federal states (including all of Berlin) relative to the West German federal states (excluding West Berlin).
Sources: Statistische Ämter der Länder, Volkswirtschaftliche Gesamtrechnungen der Länder.

The untold truth is that economic convergence has been even worse than the 71% mentioned above suggests, since the GDP of the East German federal states includes the GDP of West Berlin. If account is taken of this effect, by comparing the ex-communist territory with that of former West Germany including West Berlin, eastern per capita GDP for 2013 comes barely to 66% of the western level.

A further point is the artificial inflation of eastern GDP resulting from salary harmonisation in the public sector. When only eastern private-sector per capita GDP is considered, the convergence figure is merely 62%.

The lack of productivity convergence contrasts sharply with the convergence in living standards, which has indeed evolved satisfactorily. The evolution of disposable per capita income, which reached 82% of the western level in 2013, is evidence of this. If one considers that prices in the east are around 8% lower than in the west (see Meister and Nierhaus 2001) n real terms the convergence of living standards comes to 89% of the western level. This is in part the effect of a progressive tax system, which automatically redistributes from west to east, but also of the transfers via the federal budget, the Solidarity Pact II and the pension system.

The effect exerted by the national pension system can be seen in the upper two curves of the chart. In nominal terms, pensions per pensioner in eastern Germany are currently 118% of the western German level – in real terms they are even higher, at 128%. These figures result from the generosity with which the pension-relevant years of East Germans were incorporated into the western pension system, recognising their long and uninterrupted occupational histories under communism.

All of this has been extremely costly for West Germany. Currently, the net transfers through public budgets amount to 70 billion euros per year, totalling some 1.75 trillion euros since reunification. Replicating this strategy on a European level to prop up the five southern European crisis countries would be astronomically expensive, given that their population accounts for 40% of the Eurozone total (against only 20% which the Germans living in East Germany represented in the German total).

What lies behind the stall in economic convergence? In our opinion, it is the overhasty adjustment of wages. The adjustment occurred because West German employers' associations and labour unions alike set up branch offices in the east which, even before the firms entrusted to the Treuhandanstalt (the agency charged with restructuring and selling of East German state-owned companies) were privatised, conducted long-term wage bargaining on behalf of their East Germans peers. The employers' associations, receiving their clues from the West, demanded an equalisation of wages in order to protect their own jobs in the west by preventing international investors from acquiring East German companies and competing against West German companies with new p[…]cesses and products at lower wages. 'If the Japanese want to come', the sotto-voce argument […] 'let them at least pay West German wages'. As the chart shows, the effect of this wage bargaining-by-proxy was that hourly wages rose significantly faster than overall productivity in terms of GPD per capita This was expected and observed early on (see Sinn and Sinn 1991, 2003).

The one-to-one currency conversion adopted upon reunification had made the relative hourly wages jump from 7% to 30% of the western level, because the exchange rate at which East Germany had been able to trade successfully with the west was 4.3 to one. Contrary to the often-voiced assertion that this was the reason for East Germany's problems, the one-to-one currency conversion was unavoidable, given that relative prices for food and other consumer goods were much lower than in the west, implying that the purchasing value of an East German mark was about the same as that of the deutschmark. Anything below the one-to-one currency conversion would have reduced the real income of East German citizens and would have provoked a revolt. At a wage of 30% of the west's, the East German economy would surely have been able to attract much business investment from all over the world, given that east Germans were very well trained in technical professions and now shared the same legal system and offered the same security as West Germany.

However, the proxy wage negotiations made wages increase to much higher levels. As the chart shows, wages always grew faster than aggregate productivity in the private sector, eventually reaching 78% of the western level, while productivity stalled at 62%. It is no surprise that international investors, who were champing at the bit, revised their investment plans in view of this reality, deciding eventually not to come. Sony, for one, chose to vacate its planned European headquarters at Potsdamer Platz in Berlin.

That's just the way it is. Investments fuel wage rises, because they increase the demand for labour, but wages cannot run ahead of investment, since investors will then fail to come. It is like revolving doors at the airport: you can only cross them at a moderate pace – if you rush, they will stop.

The German government tried to avert the disaster by instituting massive tax relief to counter the devastating effects of the wage rush. The tax subsidies often exceeded 100% of the capital costs set by the market, thus pushing the effective capital costs into negative territory (see Sinn 1995, 2002). This spurred investment in capital-intensive companies and property, but created only a few jobs.

In the end, three-fourths of the industrial jobs in the former East Germany were lost. While 4.08 million people were employed in manufacturing in East Germany at the time of its demise, only 920,000 are employed there today. It is true that many jobs were created in construction and services, but these are areas safe from international competition. Despite mass emigration and early retirement, the unemployment rate in the new federal states (including Berlin) today is 9.0%, against 5.8% in West Germany.

The Social Union agreed in the summer of 1990 between West and East Germany, and later anchored in the Reunification Treaty, cushioned the consequences of massive unemployment through social transfers. However, the social transfers themselves created further unemployment, since their nature as replacement income in effect set a floor for the wages below which, understandably, East Germans were not willing to work. The artificially inflated wages that originally had resulted from the bargaining-by-proxy became thus permanent. Seen in this way, the social transfers managed to create a stagnating equilibrium that still today fails to exploit the potential inherent in a well-functioning market economy.

East Germany squandered thus the head start it had over the other ex-Comecon countries upon joining the EU. Since the other countries joined the EU only in 2005, East Germany could have taken advantage of joining a 300-million-consumer market 15 years ahead of the rest. With a low-wage strategy coupled with property rights to the assets of the formerly communist state, as we called for at the time in our book "Kaltstart" (see Sinn and Sinn 1991). An economic miracle similar to Ireland's could have come about, with new products and new companies conquering the markets. Fresh investment would have flowed to East Germany, spurring labour demand. In this way, the labour unions could eventually have pushed through permanently higher wages without reducing competitiveness – probably even higher wages than prevail today.

The argument that the wage strategy chosen was the best one to forestall mass emigration to the western part of the country was not convincing. It would have been better to let the new federal citizens work in the West than financing their forced unemployment in the East. In view of the recent announcement by German Chancellor Angela Merkel that Germany is in a position to integrate more than a million migrants from less-developed countries into the labour market, with hindsight the old argument appears outlandish. It is also worth bearing in mind that, as mentioned previously, a net total of 1.64 million East Germans did move to the western part of the country anyway. Had wages not been made to converge artificially, many more jobs would probably have been created in East Germany, and migration would have perhaps been lower (see Akerlof et al. 1991).

To correct the devastating effect the social replacement incomes had on wages, the Agenda 2010 reforms introduced by former Chancellor Gerhard Schröder in 2003 eliminated Germany's second-tier unemployment benefit system, replacing it with a basic social assistance coupled with wage subsidies, the so-called Unemployment Benefit II. This induced a turnaround in the German labour market at large by allowing for the emergence of low-wage jobs. However, as effective as the Agenda 2010 turned out to be for the overall German labour market, it came too late for east Germany and could not prevent many national and international investors from skipping the eastern German states and going straight to Poland, Hungary, the Czech Republic or Slovakia to set up new productions sites.

The rapid wage increases, supported by generous welfare benefits, had the effect of inflicting the so-called Dutch disease onto East Germany. When the Netherlands found gas deposits in the 1960s, the income from gas exports pushed up wages in the public sector and the energy industry, stimulating the domestic sector and causing imports to rise, but also undermining the competitiveness of the Dutch export industries, because competition in the labour markets forced these industries to also pay higher wages. It was not until the Wassenaar Agreement of 1982, coupled with a subsequent fall in world energy prices, that wages became more moderate and the economy started to gradually improve.[1] While the eastern German states have exported no gas, the financial transfers from the West played—and still play—the same role, making possible wage growth beyond productivity growth and thus reducing competitiveness.

The Dutch Disease is also in evidence throughout Southern Europe today, with the low-interest loans made possible by the public rescue funds and the ECB guarantees taking the role of Dutch gas or inter-German transfers. Whether an economy receives money from abroad in the form of transfers or proceeds from gas exports or loans makes no difference. In each case the foreign funds make it possible to uphold non-competitive wage structures – in other words, to maintain a living standard that exceeds the level compatible with local productivity. The result is excessive prices and a loss of competitiveness.

The fiscal union demanded by Hollande now is an understandable attempt to compensate for the lack of competitiveness of the southern EU countries by resorting to international transfers, but these transfers would cement their lack of competitiveness and drive Europe into permanent stagnation. The travails of German reunification should be a warning against pursuing this course.

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Endnotes

1 The notion stems from an article in The Economist (1977). For a first attempt to model the phenomenon theoretically see: Corden and Neary (1982).