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German Economic Unification

The world is about to witness an unprecedented economic experiment to determine whether the two disparate economic systems of East Germany and West Germany can be rapidly merged into one without incurring unacceptably large social and economic costs. The merger will completely dismantle the East German centrally-planned economy and replace it with the West German market economy. The first step in this historic experiment will be monetary unification.

That economic unification of the two Germanys should begin with monetary unification is startling. Historically, nations that seek closer economic ties have started by removing trade barriers, and then proceeded to integrate or harmonize domestic economic policies. With national currency generally regarded as the epitome of national economic sovereignty, monetary unification has been viewed as appropriate only at the final stage of economic integration.

The difference in this case lies in the overwhelming desire of the people on both sides of the border between the two Germanys for immediate political and economic unification. Precisely because money symbolizes national economic sovereignty and permeates all national economic activities, both sides decided to start with monetary unification, thereby setting up irresistible market forces that would in one stroke propel the two economies toward rapid and complete economic integration.

This *Letter* discusses the provisions of monetary unification, and examines the implications of German economic integration for Germany and the rest of the world.

The two Germanys

The Second World War left Germany politically divided and economically devastated. Aided by massive economic assistance from the United States under the Marshall Plan, West Germany recovered rapidly after 1948. Its remarkably successful economic growth since then shows how well a free market economy can perform under sound monetary and fiscal management. With a population of 61 million, West Germany now ranks among the foremost industrially advanced nations in the world, and has one of the highest per capita incomes ($14,200), lowest annual inflation rates (3 percent), and largest trade surpluses ($55 billion, current account balance) in the world.

Its 16 million brothers and sisters on the other side of the border, in contrast, have not fared so well with their Soviet-type, centrally-planned economy. Since 1945, virtually all means of production have been owned and operated by the state, prices and wages have been rigidly controlled by the planning authorities, and capital markets have been nonexistent. Productive incentives have been lacking, and resources have been allocated through a bargaining process between enterprises and the planning authorities. As a result, investment in infrastructure and plant and equipment has been woefully inadequate. Environmental pollution is rampant, and shortages of consumer goods are common. Though significantly higher than those of the other East European countries (Bulgaria, Czechoslovakia, Hungary, Poland, and Romania), its per capita income is estimated to be only one- to two-thirds that of West Germany.

Monetary unification

It is against this background that monetary unification between the two Germanys will occur on July 2. From then on, the West German Deutsche mark (DM) will be legal tender on both sides of the border. All debts (including bank deposits) and payments (including pensions and wages) will be converted from the East German Ost mark (OM) to the DM at rates stipulated in an agreement signed by both governments on May 2.

The agreement provides for conversion at a one-to-one rate for all East German wages and salaries, pensions, rents, and personal savings up

to 4,000 Ost marks, and at a two-to-one rate (that is, two OM per DM) for all other monetary exchanges.

Many observers are concerned about these conversion rates. Both are considerably lower than the current official rate of 3-to-1 and the black market rate of between 5- and 6-to-1 in East Germany. These rates reflect West Germany's accession to the East Germans' strong desire to "preserve" the value of their savings; a low conversion rate gives East German consumers greater purchasing power over goods manufactured in West Germany and other countries. At the same time, however, a low conversion rate raises the DM price of East German products, and makes those products less competitive against West German goods and those of other countries.

Costs to West Germany

To the extent that the conversion rates overvalue the OM relative to its "true" purchasing power in DM, the agreement represents an immediate transfer of wealth from West German residents to East German residents. The magnitude of the transfer depends on the total amount of the OM-denominated assets converted and on the "true" value of the OM. For illustration, consider the conversion of East German personal savings. The total amount of East German currency and bank deposits held by individuals has been estimated to be about OM 170 billion. Assuming that the official one-to-one conversion rate applies to this entire amount, but that the true value of the OM is, say, 4-to-1, then the transfer of wealth arising from personal-savings conversion would be DM 127.5 billion (DM 170 billion less the true value of East Germans' personal savings of DM 42.5 billion). This is a relatively modest amount compared to the DM 2.2 trillion West German economy.

However, the cost of economic integration to West Germany is not limited to this one-time wealth transfer. The May 2 agreement also provides for raising the average East German pension from OM 420 per month to the average West German pension of DM 1,100 per month. Given the approximately 3 million retirees in East Germany, the increased pension payment will be about DM 25 billion per year. In addition, there are currently an estimated 1.4 million unemployed workers in East Germany. Raising their unemployment benefit to the West German level will cost an estimated DM 10 billion a year.

Officials on both sides of the border have estimated that unrestricted trade between the two Germanys at the stated currency conversion rates will make many East German businesses uncompetitive, causing at least a third of them to go bankrupt and adding another one million workers to the unemployed. In order to reduce the severity of the social dislocation, it has been proposed that the West German government help to reduce East German firms' costs by extending a DM 300 monthly wage subsidy per worker to them. Given the 9 million workers in East Germany, the proposal would add another DM 32 billion a year to the cost of unification.

All this does not include an estimated DM 150 billion to rebuild East Germany's road and railway systems and an estimated DM 100 billion for cleaning up East Germany's badly polluted environment in the next two years.

Estimating the total cost of German unification to West Germany is a hazardous undertaking. Estimates range from DM 250 billion ($147 billion) to DM 1 trillion ($586 billion) over several years. However, most of these estimates are no more than lists of what East Germany *needs* to improve its infrastructure, reduce pollution, and renovate outmoded and worn out plant and equipment. Whether such an extraordinary volume of capital actually would flow into East Germany depends both on the West German taxpayers' willingness to pay for East German reconstruction and on the expected returns to private investment in East German projects. In both cases, a large capital infusion into East Germany cannot be taken for granted. Rather than focusing on needs, then, it is more useful to examine how much capital is likely to be forthcoming for the rebuilding of East Germany.

Supply of funds

Taxpayers' willingness to bear the cost of East Germany's rehabilitation will determine the supply of public capital available to East Germany. Already, Chancellor Helmut Kohl's Christian Democratic Party lost in two recent state elections, allegedly because of voters' unwillingness to support the high cost of unification.

Moreover, on May 16, when a DM 115 billion ($70 billion) "German unity fund" was announced to finance the expected East German budget deficit over the five years from 1990 to 1994, the West German finance minister made

a point of declaring that the funding would be partly from government budgetary savings and partly from borrowing in the capital market—not from tax increases nor from central bank monetary expansion. This public funding averages only DM 23 billion ($13 billion) a year, considerably less than the total value of the desired subsidies from the West German government.

It is much more difficult to gauge private businesses' responses to investment opportunities in East Germany. Not surprisingly, as soon as the barriers were lifted, the perceived needs of a market of 16 million people starved for new capital and new technology brought forth a stampede of West German firms in various industries, including autos, electric equipment, metals, machinery, banking, insurance, and hotels—all eager to set up joint ventures in East Germany. A casual tally of these announced investment plans gives the impression that tens of billions of dollars will be poured into East Germany for rebuilding its economy.

In fact, however, the initial announcement is no more than a declaration of intention. On-site exploration must follow before concrete plans for investment are made, if such plans are made at all. Given the obstacles to business investment in East Germany, which include inadequate infrastructure, a legal and political framework that is in flux, and expectations of widespread economic dislocation arising from an overvalued cost structure, it would not be surprising to see some of the ambitious investment plans reduced in size, stretched out in time, or eventually abandoned.

In short, the "stampede" may be nothing more than an onrush of enthusiasm that will be followed by much reduced actual business investment on the basis of more realistic appraisals. To interpret this as a torrential inflow of capital and technology may be a bit farfetched.

Inflation and interest rates

Although the euphoria over growth prospects in East Germany is likely to fade as businesses and the West German public begin to make more realistic assessments of investment prospects in East Germany, in the meantime, two concerns have arisen concerning the strains that rebuilding the East German economy will place on West Germany and the rest of the world. The first is that increased demand for West German goods and capital due to the opening of East Germany will fuel inflation in West Germany. Indeed, inflation has been rising in West Germany in recent years, largely because the West German economy has been operating at a level that strains capacity.

In and of itself, however, increased spending in East Germany need not fuel inflation in West Germany. The one-time wealth transfer to East Germans when OM-denominated assets are converted to DM can be offset through open-market operations by the West German central bank (the Bundesbank). Likewise, increased borrowing by West German firms to fund investments in East Germany should not put upward pressure on goods prices, but, instead, on interest rates. Also, an increase in the West German budget deficit arising from aiding East Germany should not be inflationary as long as it is not financed by money creation by the central bank.

Given the Bundesbank's staunch anti-inflationary policy stance and past track record, it is doubtful that the German central bank would allow rapid monetary expansion to finance East German reconstruction. The more likely course would be for the increase in demand to drive up German interest rates and the exchange value of the Deutsche mark, reducing business investment in West Germany and the nation's trade surplus, thereby freeing up resources for East German reconstruction.

The second concern is that West Germany's increased demand for capital will raise world interest rates and make credit less available to borrowers in the rest of the world. Although the direction of the effects is perhaps correct, a sense of proportion is essential for proper assessment. The analysis in this *Letter* suggests that the amount of German borrowing is not likely to be as large as often alleged. Thus, there appears to be little basis for expecting a "world credit crunch" or a significant rise in world interest rates to result from German economic unification.

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