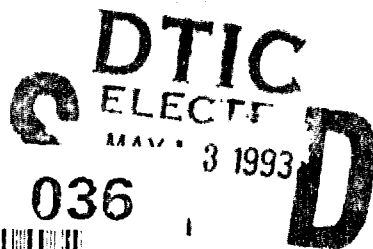
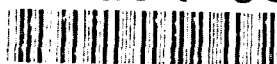


Reproduced From
Best Available Copy



(2)

AD-A264 036



The views expressed in this paper are those of the author and do not necessarily reflect the views of the Department of Defense or any of its agencies. This document may not be released for open publication until it has been cleared by the appropriate military service or government agency.

THE ECONOMIC STRATEGY FOR GERMAN UNIFICATION

BY

LIEUTENANT COLONEL ROY A. BROOKS
United States Army

DISTRIBUTION STATEMENT A:

Approved for public release.
Distribution is unlimited.

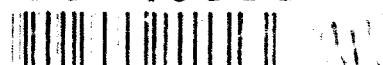
USAWC CLASS OF 1993



U.S. ARMY WAR COLLEGE, CARLISLE BARRACKS, PA 17013-5050

93 5 11 22 3

93-10556



REPORT DOCUMENTATION PAGE

Form Approved
OMB No. 0704-0188

1a. REPORT SECURITY CLASSIFICATION UNCLASSIFIED		1b. RESTRICTIVE MARKINGS	
2a. SECURITY CLASSIFICATION AUTHORITY		3. DISTRIBUTION / AVAILABILITY OF REPORT APPROVED FOR PUBLIC RELEASE; DISTRIBUTION IS UNLIMITED	
2b. DECLASSIFICATION / DOWNGRADING SCHEDULE			
4. PERFORMING ORGANIZATION REPORT NUMBER(S)		5. MONITORING ORGANIZATION REPORT NUMBER(S)	
6a. NAME OF PERFORMING ORGANIZATION US ARMY WAR COLLEGE	6b. OFFICE SYMBOL (If applicable)	7a. NAME OF MONITORING ORGANIZATION	
6c. ADDRESS (City, State, and ZIP Code) ROOT HALL, BUILDING 122 CARLISLE, PA 17013-5050		7b. ADDRESS (City, State, and ZIP Code)	
8a. NAME OF FUNDING / SPONSORING ORGANIZATION	8b. OFFICE SYMBOL (If applicable)	9. PROCUREMENT INSTRUMENT IDENTIFICATION NUMBER	
8c. ADDRESS (City, State, and ZIP Code)		10. SOURCE OF FUNDING NUMBERS	
		PROGRAM ELEMENT NO.	PROJECT NO.
		TASK NO.	WORK UNIT ACCESSION NO.
11. TITLE (Include Security Classification) THE ECONOMIC STRATEGY FOR GERMAN UNIFICATION			
12. PERSONAL AUTHOR(S) ROY A. BROOKS, LTC			
13a. TYPE OF REPORT STUDY PROJECT	13b. TIME COVERED FROM _____ TO _____	14. DATE OF REPORT (Year, Month, Day) 93 FEB 19	15. PAGE COUNT 36
16. SUPPLEMENTARY NOTATION			
17. COSATI CODES		18. SUBJECT TERMS (Continue on reverse if necessary and identify by block number)	
FIELD	GROUP		
19. ABSTRACT (Continue on reverse if necessary and identify by block number) SEE REVERSE PAGE			
20. DISTRIBUTION / AVAILABILITY OF ABSTRACT ☒ UNCLASSIFIED/UNLIMITED ☐ SAME AS RPT. ☐ DTIC USERS		21. ABSTRACT SECURITY CLASSIFICATION UNCLASSIFIED	
22a. NAME OF RESPONSIBLE INDIVIDUAL Dr. Leif Rosenberger		22b. TELEPHONE (Include Area Code) 245-3021	22c. OFFICE SYMBOL DNSS

ABSTRACT

AUTHOR: Roy A. Brooks, LTC, USA

TITLE: The Economic Strategy for German Unification

FORMAT: Individual Study Project

DATE: 19 February 1993 PAGES: 25 CLASSIFICATION: Unclassified

German unification occurred at midnight on 2 October 1990 with the hope for a fully integrated and developed social and economic union between the former East Germany and West Germany. The two countries developed with basic political ideological differences that profoundly impacted on each country's economic, social and cultural systems. The government coalition headed by the Christian Democratic Union party with Chancellor Kohl as Federal Chancellor was required to develop both a vision and a supporting strategy to facilitate the union. Political motivation and pressure, however, led Kohl to develop a short sighted but politically acceptable short term program that adversely impacted on the economic development in the east. As implemented, the plan produced high government debt, high interest rates, and a resultant prolonged recession within the united country. Secondly, investors disappeared and high unemployment plagued the east. More important to its European trading partners who are tied to Germany's currency through the European Exchange Rate Mechanism (ERM), a conservative German monetary policy exported recession throughout the European Community. Non European countries including the United States and Japan found they were also restricted in dealing with their own sluggish economies because of Germany's internal economic policies. This study examines Kohl's plan from a macro economic vantage point. It shows that today's world economies are interdependent and that unilateral government actions by one major power can adversely impact the entire world economic system. The paper recommends a course of action Germany must follow to benefit unification and economic integration, to support the basic goals of the Maastricht Treaty, and to support an interdependent world economy.

USAWC MILITARY STUDIES PROGRAM PAPER

The views expressed in this paper are those of the author and do not necessarily reflect the views of the Department of Defense or any of its agencies. This document may not be released for open publication until it has been cleared by the appropriate military service or government agency.

THE ECONOMIC STRATEGY FOR GERMAN UNIFICATION

AN INDIVIDUAL STUDY PROJECT

by

Lieutenant Colonel Roy A. Brooks
United States Army

Dr. Leif Rosenberger
Project Advisor

DISTRIBUTION STATEMENT A: Approved for public release; distribution is unlimited.

U.S. Army War College
Carlisle Barracks, Pennsylvania 17013
19 February 1993

RECEIVED 1

Accession For	
NTIS CRA&I	☒
DTIC TAB	☐
Unannounced	☐
Justification	
By	
Distribution /	
Availability Codes	
Dist	Avail and / or Special
A-1	

ABSTRACT

AUTHOR: Roy A. Brooks, LTC, USA

TITLE: The Economic Strategy for German Unification

FORMAT: Individual Study Project

DATE: 19 February 1993 PAGES: 25 CLASSIFICATION: Unclassified

German unification occurred at midnight on 2 October 1990 with the hope for a fully integrated and developed social and economic union between the former East Germany and West Germany. The two countries developed with basic political ideological differences that profoundly impacted on each country's economic, social and cultural systems. The government coalition headed by the Christian Democratic Union party with Chancellor Kohl as Federal Chancellor was required to develop both a vision and a supporting strategy to facilitate the union. Political motivation and pressure, however, led Kohl to develop a short sighted but politically acceptable short term program that adversely impacted on the economic development in the east. As implemented, the plan produced high government debt, high interest rates, and a resultant prolonged recession within the united country. Secondly, investors disappeared and high unemployment plagued the east. More important to its European trading partners who are tied to Germany's currency through the European Exchange Rate Mechanism (ERM), a conservative German monetary policy exported recession throughout the European Community. Non European countries including the United States and Japan found they were also restricted in dealing with their own sluggish economies because of Germany's internal economic policies. This study examines Kohl's plan from a macro economic vantage point. It shows that today's world economies are interdependent and that unilateral government actions by one major power can adversely impact the entire world economic system. The paper recommends a course of action Germany must follow to benefit unification and economic integration, to support the basic goals of the Maastricht Treaty, and to support an interdependent world economy.

LIST OF FIGURES

<u>Figure</u>		<u>Page</u>
Figure 1	Unemployment	8
Figure 2	Changes in GDP	10
Figure 3	The Bills Yet to Come	12

INTRODUCTION

At midnight on 2 October 1990 the European continent was transformed by the unification of the German Democratic Republic (GDR), East Germany, and the Federal Republic of Germany (FRG), West Germany. The Federal Republic's establishment ended almost 40 years of division between the two states that begun at the end of World War II and lasted through the end of the Cold War. The division between east and west was based on political and ideological differences that profoundly impacted on the development of each country's economic, social, and cultural systems. The West German coalition government, controlled by Chancellor Helmut Kohl's Christian Democratic Union (CDU) party, was required to look past the euphoria of sudden unification and develop both the vision and the strategy to facilitate economic, political, and social integration of the east's less developed and centrally planned economy with the west's more mature and powerful capitalistic economic system.

Chancellor Kohl's had a vision for a fully integrated and developed German economy. The vision was supported by a monetary and fiscal strategy aimed at ensuring Germany's position as a European and World economic power. The supporting strategy aim was to minimize the impact on the west's quality of life while it propelled the east into

unheard of economic prosperity.¹

While the goals of stability, development, and growth were enviable, the strategy's shortsightedness and political motivation became apparent during implementation. Policy implementation efforts were not in the best interests of Germany and its people. Further, Kohl ignored policy decision impacts on Germany's European neighbors, its non European trading partners, and the world's developing countries. In reality, the united Germany's new government ignored policy impacts on an interdependent world economy - one in which the monetary and fiscal policies of a world economic powerhouse like Germany impact on all the world's countries.

This paper examines the German government's economic strategy for rebuilding the east, the domestic difficulties encountered in strategy implementation, and economic policy decisions impacts Germany's and the world's economy. This macro-economic look at a major economic power underscores the complexities and pressures born by nation-states that unilaterally develop domestic policies without regard for the potential global results of narrowly conceived and implemented monetary and fiscal programs.

PROBLEMS IN THE EAST

As the German government moved from the euphoria of unification to the realities of building an economic union and

single economic state, the immediate challenge facing Kohl and his economic advisors was solving the "multifaceted economic inequities between the old and new Laender (states)."² While the old East Germany was considered "the economic jewel"³ of Communism and the Soviet Union, East Germany lagged behind West Germany in most economic indicators. Possibly more important to the new united German government was the degradation in the east's infrastructure and environment during the post World War II era.⁴

While no comparable modern historical cases are available to contrast the challenges facing Germany's government and no historic model exists to base a unification strategy, one could argue the United States' Marshall Plan faced the problems of a destroyed European infrastructure, a demoralized society and a bankrupt government. The major difference, however, is that the centrally planned and governed economy of the former East Germany and its poor management practices are ideologically opposed to western business theories. Unlike post World War II, no system of management was available in the east to rebuild the region's economy. More important, no pool of "capitalists" trained in western economics was available to rebuild the infrastructure, establish new laws, restructure Communist institutions and teach the people how to operate in a free market environment. The dismal situation was the result of two generations living and working under an unsound economic philosophy - one of centralized government

planning with no free enterprise and one possessed with disdain for individual initiative and creativity.

The government's challenge to make long-term social changes in the east required Chancellor Kohl to address a number of important issues simultaneously that included: rising unemployment, privatizing government-owned businesses, wage reforms, agricultural privatization, environmental concerns, former East German debt, and relations with former East Bloc adversaries and the Soviet Union states. In devising a strategy to address the substantial problems facing unification, the political realities of unification were not ignored but often took precedence. The most important demands centered on a single premise - "equality between eastern citizens and the west was imperative."⁵ Eastern equality was politically translated to "take the necessary actions to raise the east's standard of living to the west's."⁶ Equality, however, was not defined in the traditional US concept of equal opportunity but more narrowly as comparable wages and lifestyles. Tremendous political pressure existed for the establishment of higher more comparable wage rates for Germany's eastern workers. Coupled with the east's appetite for western goods, Bonn developed a politically acceptable strategy for the short run but risked unacceptable long-term economic consequences.

A second and equally important issue that affected the strategy was purely economic - How would unification be

financed without totally crippling Germany's western economy?⁷ Kohl ran his 1990 political campaign with the claim that financing unification costs would not require tax hikes.⁸ His claim was challenged by many economists who predicted the likelihood of high government debt if wage equality and unrealistic conversion rates (1.8:1) were approved. Because no one could accurately predict the costs of unification, Kohl's strategy did not adequately plan for the nearly 140 million Deutsche Marks spent in 1990 nor the nearly 150 million Deutsche Marks it is now estimated to cost the Bonn government annually over the next 4 years.⁹

A year after unification, no one should have been surprised that public opinion shifted from euphoria to gloom, that tax hikes were eminent, or that the German economy would begin to slide into a recession with the increase in national debt, increase in eastern wages, growth of eastern unemployment, and the potential for destructive inflation.¹⁰ As a result, Germany became responsible for the European Community's persistent recession and a contributor to the slow recovery of a lingering world-wide recession.

A STRATEGY FOR UNIFICATION

Kohl's unification strategy, at least for the political reasons stated earlier, conforms to one theory prescribed for eastern European country's converting to free market systems -

the "shock treatment" approach. The approach calls for making immediate instead of gradual moves toward market based economies. The most well known application of the theory occurred in Poland and brought with it three painful years of high unemployment, slow economic growth and inflation. The Kohl government, however, believed the German version could be accomplished quickly and without the same painful side effects - high national debt, high unemployment, and low productivity.

The plan implemented was concerned first with the major political issues - the conversion of East German Marks to West German Marks, equality of wages, and unemployment. In July 1991, the government approved a 1.8:1 exchange rate between the two currencies (West German Marks and East German Marks).¹¹ This fulfilled a Kohl campaign promise intended to increase the Christian Democratic Union's (CDU) power in the eastern Laenders while providing eastern German's with a windfall that allowed them to purchase western goods. It also gave the impression of an immediate increase in the standard of living. More importantly, the currency restructuring it was argued, would increase consumer spending on goods produced in the east. Unfortunately, while the easterner's purchase levels increased, their expenditures were made on higher quality, more technically developed, and therefore more desirable western goods. Inferior eastern goods produced at higher costs because of increased labor rates went unsold. As a result, the policy restricted eastern manufacturer's

worldwide competitiveness, increased the number of eastern business closures, and retarded the eastern Laender's prospects for economic growth.

The other concerns, wages and employment demands, were also addressed. At unification, total German unemployment numbered approximately 1.4 million people with that number rising to nearly 3.0 million jobless by the close of 1992.¹² The continuing problem with high unemployment rates can be attributed to many factors including low worker productivity, high wages, and inefficient and poorly managed plants. Artificially high labor rates coupled with low productivity caused eastern companies to become uncompetitive even with Third World markets. Motivated by unification's political objectives, the government drove wage rates up nearly 30% in an attempt to bring about wage rate parity by 1994. With the western tradition of centralized bargaining established in the east, aggressive union demands that were approved resulted in progressively higher wage increases - up to 6.4% annually.¹³ As wages rose, prices for eastern German products continued to rise further reducing the competitiveness of eastern German companies in world markets and at home.

As eastern companies lost their competitiveness, the Bonn government was forced to increase subsidies to inefficient businesses to not only keep them competitive but more importantly to slow the growth in unemployment figures and to stem the flow of eastern German refugees to western Laenders.

The liberal wage packages and government subsidies did little to ease the German unemployment rate but instead were major contributors to the increased unemployment woes and contributed to the increased level of government debt. Businesses continued to close their doors. During 1992, the jobless rate in eastern Germany was about 15%.¹⁴



fig 1.

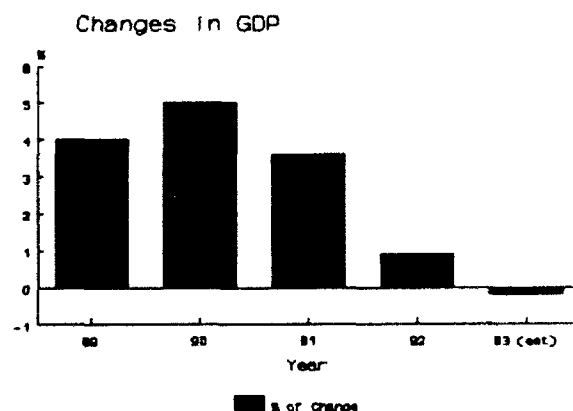
The third element of the plan was the development of a strategy for rebuilding the east's infrastructure and privatizing both industry and agriculture. The establishment of the Treuhandanstalt in Berlin in March 1990 provided a governmental structure charged with privatizing the economies of the new eastern states. As reported in The Economist, "Its aim was to ready enterprises for eventual purchase and then to match interested investors with appropriate business opportunities."¹⁵ With some 12,000 companies to privatize, the Treuhand acted more as a holding company. Often selling

companies below cost as an incentive to attract owners, prospective clients are offered various tax credits and incentives under the condition that the company retain its work force, cleans up environmental damage and remains in business.¹⁶ While some 1700 unprofitable companies have been liquidated and an additional 8700 privatized, the Treuhand is now left to dispose of the most unprofitable companies. Compounding Bonn's budget problems, the Treuhand will leave the German government with a "\$300 billion debt by the end of the decade."¹⁷ Despite the high number of companies privatized, their numbers did little to offset the pressures of unemployment because only 22% of those working in the east were employed in the privately owned companies.¹⁸

Finally, the government plan addressed a series of problems including environmental issues, the removal of Soviet troops and settlement of pre-existing East German debts. The German Unity Fund and the Debt Settlement Fund were established to provide nearly \$60 billion in funds for infrastructure rebuilding and debt repayment while over \$30 billion was set aside for Soviet troop withdrawals, export credits to the former Soviet Union and other economic aid.¹⁹ Together, the four parts to the Kohl plan provided an ambitious agenda. While the plan was comprehensive, by underestimating associated costs and implementing politically motivated policies, Kohl's economic strategy could not be supported nor sustained by the powerful German economy.

In the short run, the Kohl plan instituted in late 1989 and carried into 1990 did have some immediate positive effects on the entire German economy. The country's economy was not initially crippled as some predicted. In fact, most economic indicators were very positive. As examples, the western portion of the German economy grew by 4.5% in 1990 while Germany reduced its trade surplus by nearly 20% and increased imports by approximately 6% to feed shortages in the eastern Laenders. More disquieting, however, were export figures that showed a minimal rise of only 2% for the year. The small rise can be attributed to a world-wide recession that reduced the demand for expensive German goods, increases in world wide unemployment rates, and the threat of inflation.²⁰

After the artificial east German consumer demand ran out of steam in 1991, the economic picture turned gloomy. The GDP for the last 3 months of 1991 decreased by 1.9% while for 1992 the GDP rose only 0.9% - well below the 2.5% growth rate many



Source: The Economist, 8 January 1993, p. 17

fig 2.

economist believe is necessary to create jobs and expand a sluggish economy.²¹ A poll of leading businessmen and economists conducted by The Economist magazine in January 1993 was not optimistic. Those polled believed the economy would

remain sluggish throughout 1993. The overall German GDP was expected to fall by 0.2% during the year even with a projected 12% gain for the eastern Laenders. These projections are a reversal from late 1992 estimates of a 0.3% increase in real GDP.²²

During 1992, inflation rose to nearly 4.0% - an extremely high rate by German standards. The fears of inflation resulted in corresponding increases in the interest rates. Throughout 1991 and 1992, the Deutsche Bundesbank, the German equivalent to the U.S. Federal Reserve Bank, incrementally raised interest rates. By mid-1993, interest rates on short-term money reached 9.5% compared to 6% in the United States.²³ "Tight money" caused by the Bundesbank's refusal to reduce interest rates further compounded the government's difficulty in dealing with high wages, government subsidies and a resulting high government debt.

WHAT WENT WRONG WITH THE KOHL PLAN?

What were some of causes for the economic turndown of Europe's strongest economy and one of the world's "big three" (along with the United States and Japan)? Throughout the preceding section that outlined the Kohl plan, high wages, a liberal exchange rate, and heavy government subsidies were discussed. In short, the government was attempting to use government debt as a mechanism to fuel the east's recovery.

As the mounting costs of unification placed Germany in an over-borrowed condition, the government hoped to convince the Bundesbank to lower interest rates as a means of stimulating growth. Unfortunately, the reluctance of the Bundesbank to lower rates coupled with continued borrowing compounded the problem.

The government's poor fiscal policy created a government debt level that hampered its attempts to stimulate an economy in recession nor finance the troubled eastern businesses. Total German borrowing in 1991 by various parts of the government amounted to nearly 200 billion Deutsche Marks (just under \$100 billion). The number is equivalent to approximately 8% of the GDP.²⁴ Approximately, 4-5% can be directly attributed to unification costs. Many German economists believed that without some restrictions on spending, the government must be "prepared to start a public-debt snowball that could grow to American proportions."²⁵ The budget deficit woes are not short-term problems but as the following chart indicates are projected to top 100 billion Deutsche Marks through at least 1996.²⁶

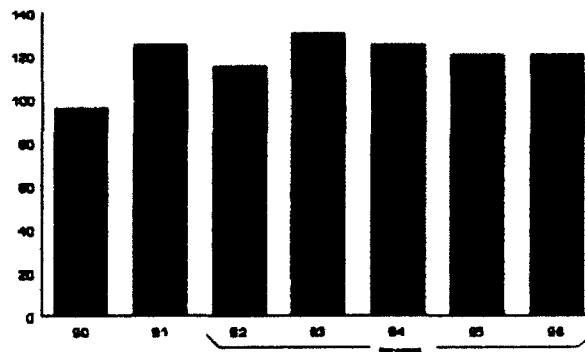
During the same period the situation could easily worsen as the federal government assumes an additional debt of 400 billion Deutsche Marks in 1995 when the Treuhand debts and the former East Germany's debt are transferred to the federal government.²⁷

The skyrocketing debt certainly limits the German government's ability to use fiscal policy to stimulate its slack economy. Keynesian theorists would expect the government to boost spending and cut taxes to stimulate investment and increase

aggregate demand. The high German debt, however, increases inflationary pressures and reduces the possibility of utilizing fiscal policy to stimulate growth.

With the country in a recession and fiscal policy options limited, the government hoped to use a more liberal monetary policy to stimulate investment. Unfortunately, the Bundesbank is not inclined to reduce interest rates to encourage borrowing, spending, and investment. Quite simply, the Bundesbank's primary charter is to keep prices stable by dampening the effects of inflation. As such, the short-term interest rates in the country have remained high solely to reduce the impact of higher wages, low productivity, and high government spending on the nation's inflation rate. While inflation drifted to near 4.0% during 1993, the Bundesbank as steadfastly held to its policy of high interest rates. The policy has in effect discouraged private investment thus making monetary policy a contributor to the prolonged nature

The bills yet to come
Public-sector budget deficits, DM bn



Source: Federal Ministry of Finance; Bundesbank; DE Research estimates
The Economist, 11 November 1995, p. 27.

fig. 3

of the current recession and not an option for stimulating the economy.

WHAT IS THE GLOBAL IMPACT?

Germany's persistent recession resulting from its unification strategy of heavy borrowing has negatively impacted on the global economy. While seemingly in the best interests of a united Germany when developed in 1989, the Kohl plan for the quick integration of east and west Germany had both short and long term effects on the global economy. First, Germany has exported slow economic growth along with its attendant difficulties to the European Community's member countries. Additionally, by using a rather cavalier approach, German economic policy has jeopardized the future structure of the European Community. Finally, a prolonged German recession can potentially slow the economic recovery of its trading partners to include the United States and Japan.

European Economic Growth Retarded

The economic conditions throughout Europe are similar to Germany's. Inflation, high unemployment, and low investments have led to a deep recession. Most European government's are also over-borrowed and therefore unable to utilize sound fiscal policy to stimulate growth. Because each country is part of the European Exchange Rate Mechanism (ERM) and tied to

the DM, they are restricted from using monetary policy (lowering interest rates) as an economic stimuli by Germany's high interest rates. The large wage increases, high unemployment, and large government deficits that add to German inflationary pressures were directly transferred to other members of the EC through the ERM by requiring members to pursue Germany's high interest rate policy.

While in theory European Community currencies are only loosely tied together under the ERM, in reality the currencies are at the mercy of Germany's central bank, the Bundesbank. The aim of the Bundesbank is to utilize strict monetary policy to curb inflationary pressures. With their currencies tied to the ERM, each EC country must either raise internal interest rates to stay within the guidelines of the ERM (currency fluctuations must stay within approximately 2.5% of the German DM) or opt out of the mechanism and reduce interest rates unilaterally.

To opt out of the ERM and unilaterally reduce interest rates, member countries risk reducing the possibility of European integration. As long term goals, the reduction of tariffs, the move toward a single currency, and the desire for European free trade that integration promises is good for each country and the region. However, during periods of recessionary pressure, the welfare of the individual state is paramount. The consequences of pursuing the long term good versus the short term political necessities continue to

confront EC leaders and particularly the Bundesbank.

By not maintaining high interest rates and remaining within the guidelines of the ERM mechanism, the member nations also risk currency devaluations as their low-value currencies are sold in the market place. Mass currency sell-offs further retard economic growth as costs of imports rise. Increased costs in basic needs such as food or energy sources can be catastrophic to businesses and individual citizens required to pay higher costs for essential goods. The Bundesbank's conservative policy of maintaining high interest rates then directly impacts each EC government's ability to take appropriate actions to stimulate their respective economies. As a result, European businessmen remain reluctant to borrow at the high interest rates further dampening efforts to stimulate economic growth.

Politically, the governments of the EC countries have been under political pressure to encourage investment and reduce unemployment yet are restricted while their currencies are tied to the ERM. The signals sent by the Bundesbank during early 1993 remain conservative. Helmut Schlesinger, president of the Bundesbank, speaking in Oslo indicated the current interest rate of 8.25% would remain constant over the foreseeable future particularly if wage rates rise.²⁸ Only recently, 7 January 1993, did the Bundesbank make some concessions by reducing its short-term interest rates from 9.5% to 9.0%. Though the move may restore some confidence

throughout Europe in Germany's good faith, little short-term impact is expected on either the German or EC member economies.²⁹

Along with high interest rates, the decline of German productivity and the high cost of German goods has reduced trading opportunities. German imports declined by nearly 6% during 1992 because of the recession.³⁰ The slow down in imports further dampens the ability of Germany's trading partners to stimulate economic growth through their respective export markets. The reverse is also true. The high cost of German goods caused by high labor rates and government business regulations have reduced German exports dampening the outlook for a quick end to the current recession.

The backlash to German economic policies occurred on 16 September 1992 in what has come to be known as "Black Wednesday." Massive sales of both Britain's Pound Sterling and Italy's Lira caused tremendous devaluation pressures that forced both to reconsider their positions on the European Exchange Rate Mechanism. In both cases, to remain in a monetary "basket of currencies" tied to the Deutsche Mark was not in either country's best interest - both countries pulled out of the ERM. Recessionary pressures at home that were reenforced through political realities required the Italian and British governments to abandon the ERM and take the necessary steps to reduce the impact of the recession on their countries. The impact will certainly be felt by those

supporting European economic union as pressures mount on the governments of all EC countries.

A Future European Union is Jeopardized

Germany's importance in the European Community (EC) is critical to furthering the goals of the Maastricht Treaty. The German Deutsche Mark has traditionally been the strongest currency of the member nations. Over the past ten years, the German economy has been considered a global economic powerhouse along with the United States and Japan. In general, Germany's powerful economy has shaped the economic stability of the European continent. Without stable German fiscal and monetary policies, the governments of the EC are restricted in their ability to manage or influence their respective economies unless they pull out of the exchange mechanism.

The abandonment of the ERM by Britain and Italy has dealt a blow to those proponents of a fully integrated Europe. In the long run a fully integrated European Community with a single currency is in each member country's best interest. The need to reduce trade barriers and government subsidies that reduce productivity and prevent the free movement of goods and services throughout the trading community is clearly warranted. The first step is still the establishment of a single European Currency, regardless of name - one that is freely accepted without conversion costs. While the British

and Italian move away from the ERM was a setback, the impact should only delay efforts to move toward a single currency.

Global Economies Suffer

German fiscal and monetary policies have a significant impact on the world's other economies. While most countries, particularly the two largest - Japan and the United States, struggle to stimulate their respective economies, Germany's persistent recession limits trading opportunities.

What's in the best interest of the United States and Japan? For two countries struggling with slow economic recovery, both would like to see German and European imports on the rise. For this to happen, the European Community must grow. For European economies to grow unemployment must be reduced, production and investment must increase, and interest rates must be lowered. As in the United States, the key to economic growth is the reduction of government debt, particularly government debt interest payments. In short, the European recession must be ended to enable the economies to possess the capability to increase imports.

With a European recession in full swing, EC members are not in a position to finance foreign purchases. As a result, U.S. exports to EC countries are off. This is despite a strong German DM that makes U.S. and Japanese products look more desirable. Without a market for their goods, The United States and Japan will experience slower growth in their export

markets which in turn directly effects rates of production, investment, and economic growth throughout the world.

As important, non EC countries including the United States and Japan, do not view Europe as a good location for investments in established businesses, new ventures, nor in the purchase of existing companies. The lack of private and corporate investment from outside the EC because of the high labor costs, environmental costs and governmental regulations has reduced for foreign investment.

THE GOVERNMENT PLAN FAILED

The problem of ballooning debt, high interest rates, costs of unification, and high wages have all led Germany down an economic path where choices were politically motivated. The question is whether the program followed after unification in 1989 was successful. Clearly, wage parity by 1994 unsupported by productivity increases cost the eastern Laender more in the long run than it provided the citizenry in the period immediately following unification. Fragile industries that were barely competitive, even in the third world market place, became totally uncompetitive even in within eastern Germany. Unproductive businesses closed and the subsequent increases in unemployment drove many to the west in search of jobs already in short supply thus overburdening the government's social system and the western Laender. A 15%

unemployment rate in the east has led to the revitalization of "right wing radical" groups that further disrupt efforts to stabilize the east. While government subsidies for faltering businesses have slowed the unemployment rate, when coupled with high wages, the two have in reality retarded economic development and growth in the eastern states, driven up government debt and deepened the recession.

The inward looking plan impacted the European and world economies. High interest rates required European governments to maintain high interest rates to remain part of the ERM. Because European economies were also over borrowed, monetary policy as an option was not available to the European Community. Additionally, export markets throughout Europe dried up as prices rose further aggravating economic recovery. Non-European countries, including the U.S. suffered from the lack of markets as spending levels throughout Europe declined. Finally, by pursuing a short-sighted economic strategy the possibility for economic union in the short run looks more and more unlikely.

THE NEW PLAN - A SOLIDARITY PACT?

With the government in debt and the nation still in a deep recession, the solutions available to generate growth in the German economy are very limited. Classical Keynesian theory calls for increases in government spending and tax cuts

as the best strategy to increase aggregate spending which in turn stimulates the economy. The German government, however, finds itself in a similar situation to that faced by then President Bush in 1992 - high government debt! The government's heavy debt load and more importantly the high cost of maintaining the debt (interest payments) and continued high government spending levels removes the use of fiscal policy as a viable option. The second strategy available to Kohl is to encourage private and corporate investment. To implement monetary policy, the current level of short-term interest rates must be brought down by the Bundesbank. Throughout 1992 the Bundesbank's reluctance to reduce interest rates was driven by the fear of higher inflation. The Kohl government is clearly in a predicament that requires federal debt reduction, wage and price stability, and government spending cuts.

Recognizing the dilemma, the government began a "general savings offensive" in late 1992.³¹ Sounding like President Bill Clinton, Richard Goehner, Chairman of the CDU's Basic Program Commission, called for the German people to sacrifice when he stated: "The western German's should stop expecting a further increase in the living standards and be ready to work more than they have done in the past."³² To summarize, Chancellor Kohl asked for what's become known as a "solidarity pact" between politicians, unions, and business."³³ As originally proposed the pact limited or cut many social

benefits including reductions to unemployment payments, changes to housing allowances, public school user fees and reduction to government subsidies for farms, coal mines, and shipyards but more important reduced government subsidies in the east. The December, 1992 plan restricted government spending increases at the federal, state and local levels to a maximum of 3%; the unions were asked to hold wage increase demands to a maximum of 4% during 1993 negotiations while dropping demands for wage parity in 1994; and the parliament would increase income taxes on the rich.³⁴ The major spending cuts and attempts to hold the line on wage increases, social programs and subsidies were designed to address the forecasted 1993 deficit of 44 billion Deutsche Mark. In late 1992, economists forecasted a 20% increase in the overall debt (from \$111 billion to \$125 billion).³⁵ By making major reductions in the country's debt, Kohl hopes to allay the Bundesbank's fears of a spiraling inflation rate and obtain a corresponding reduction in interest rates.

Reactions to the new plan while initially favorable have met with positive and negative results. First, Kohl's plan attempted to restrict pay increases to under 4% or lower for the new year. Mr. Rudolf Seiters, the Bonn government's chief negotiator and interior minister, hoped to stabilize pay increases at 2.5%. As reported in the 25 January 1993 Financial Times, he said "inflation could rise above 4 per cent unless wage rises were kept to the 2.5% mark." During

early January negotiations, however, the trade union representing the public sector, OeTV, continued its demands for a 5% wage increase. The union head, Ms. Monika Wulf-Mathies, stated the "government's unwillingness to compromise ... could lead to conflict." Primary concern to the union has been the Bundesbank's reluctance to lower interest rates. However, Seiters pointed out that higher wage concessions are inflationary and could "delay moves by the Bundesbank to lower interest rates."³⁶ When the union finally agreed to only a 3% increase in February, the Bundesbank seemed to reward the parties by lowering its rates 0.5%.³⁷ Lower interest rates are a key element to the "solidarity plan."

Wage increases in the east may be held to a minimum with the latest settlement with the OeTV. The belief of some western economists is that creating jobs will be more important than wage parity. As reported by The Financial Times, the Opel car manufacturer has "not joined the federal employees' association." This allows the company to negotiate wage contracts separately.³⁸ "With labour costs 80 per cent higher in east Germany than west Germany, when productivity and wage levels are taken into account, enterprises will want to try and attract both foreign and west German investment through lower wages," The Times quoted one economist.³⁹ This last attitude will only benefit eastern German recovery and should be a first step towards moving the country out of recession.

The bright spot for the German economy occurred on 5 February 1993 with the Bundesbank's decision to lower interest rates on short-term money. The 0.5% drop was unexpected because of the uncertainty of wage negotiations and the results of government cost cutting actions. While a small victory for Kohl's new plan, the move should have little effect on moving the country out of recession. For the European Community and the ERM, EC countries received little reprieve from high interest rates. The Danish central bank in fact raised its interest rates by 2% just prior to the Bundesbank's announcement. Robin Marshall, chief economist for the Chase Manhattan Bank in London, was quoted by the Wall Street Journal as follows: "Instead of cuts of one-quarter point and one-half point, the Bundesbank needs to come down rapidly by two or three full points to ease the pressure."⁴⁰ Despite the small gains made with its monetary policy and smaller unproven gains using fiscal conservation, the German economy remains mired in deep recession with little short-term prospects for improvement. For the EC, so closely tied to the German economy, the outlook is equally grim with little chance for economic union, particularly monetary union to occur in the near future. Jacques Delors, president of the EC Commission quoted from a speech given on 4 February 1993 said, "We are in a crisis. If there is no growth between now and 1997, there will be no EMU."⁴¹

THE BETTER WAY?

Was there a better economic and political path for Germany to follow in 1989? Can the solidarity plan of 1993 stimulate an economy steeped in recession to grow while it supports unification objectives? The answer to both questions is yes. The original unification plan was driven by political motivation rather than what was best for Germany, its people, the European Community, and the world. The goal to capture votes and to build a political consensus overpowered the need set reasonable and logical goals. Specifically, wage parity without corresponding productivity increases, while good intentioned, drove a fiscal policy that relied on high government debt. The attempt to bring eastern living standards to that of the west failed miserably because high wages drove manufacturing costs and prices to a level that made eastern companies unprofitable and uncompetitive. The subsequent use of government subsidies to offset poor productivity further aggravated government debt levels. Clearly, German economic policy would have been best served using conservative fiscal policy.

A gradual approach to unification that emphasized modernization, job creation, and competitiveness would have allowed the government to reduce substantially the high levels of government debt. In the long run, the slow move to integration would have produced a steadily growing economy

built on a steady foundation of investment and government spending instead of the short term appearance of growth - a growth resulting from the windfall of a liberal exchange rate.

By following a conservative policy, the Kohl government would have left itself with an array of fiscal options to deal with the country's economic slowdown rather than relying on action not forthcoming from the Bundesbank.

In retrospect, Chancellor Kohl took a politically expedient route toward unification. He was clearly an opportunist whose best shot undermined his own economy, has left Europe in a recession, and removed the EC as an effective trading partner for the rest of the world.

The newly unveiled but untested "solidarity pact" has the potential to solve German recessionary problems. Tough fiscal restraint, particularly cutting government expenditures is the strategy to follow. Second, wage increase restrictions in the east should allow for more investment that will generate a slow recovery. Finally, interest rate reductions could only help the German economy despite the risk of inflation and would be beneficial to the rest of the European Community and the world.

Unfortunately the plan's success requires the cooperation of the people who have suffered the most in the mismanaged unification effort - the middle class, the poor, and the unemployed from the east. Its success is fully dependent on populations's willingness to accept minimal wage rate

increases and reduced government services. More important is the government's ability to control its own spending. The short run outlook is bleak for German recovery, but as costs are controlled and spending reduced the economy should begin to grow with full recovery most probable in two to three years.

ENDNOTES

¹ David B. Walker, "Germany: Confronting the Aftermath of Reunification," Current History: a World Affairs Journal, no 568 (November, 1992): 359.

² Ibid.

³ Ibid.

⁴ Edwin P. Gossen, LTC, U.S. Army. German Economic and Monetary Union. (Carlisle, PA: U.S. Army War College. 1991): 32-34.

⁵ Ibid.

⁶ Ibid.

⁷ Walker. 359-360.

⁸ Ibid. 359.

⁹ "Helmut Kohl's Hour of Need," The Economist, 31 october 1992, 47.

¹⁰ Walker., 360.

¹¹ Roland Schoenfeld, "Germany II: Privatizing the East," The World Today, no. 8 & 9, (August/September 1992): 152-155.

¹² Walker., 360.

¹³ Walker.

¹⁴ The Economist, no 7790. (19 December 1992): 99.

¹⁵ Robert B. Hodess, "The Treuhandanstalt," The Economist, (November 1992): 14.

¹⁶ Ibid., 14.

¹⁷ Ibid., 14.

¹⁸ Ibid., 15.

¹⁹ Walker, 360-361.

- ²⁰ Ibid., 361.
- ²¹ The Economist. no 7790 (19 December 1992): 99.
- ²² The Economist. no 7793 (9 January 1993): 97.
- ²³ Walker, 361.
- ²⁴ Walker.
- ²⁵ The Economist. no. 6 (31 October 1993): 47.
- ²⁶ The Economist. no. 7788 (11 November 1992): 57.
- ²⁷ Ibid., 57.
- ²⁸ Daily Report. (8 January 1993): 12.
- ²⁹ "Germany: Paying the Bills," The Economist, (5 December 1992): 57.
- ³⁰ "CDU Drafts Social, Economic Policy Program," The Daily Report, (11 July 1993): 16-17.
- ³¹ The Economist. no 7791, (5 December 1992): 63.
- ³² Ibid., 57.
- ³³ Ibid., 63.
- ³⁴ Ibid.
- ³⁵ Ibid.
- ³⁶ Judy Dempsey, "German Public Sector Pay Talks Break Down," The Financial Times. (25 January 1993): 1.
- ³⁷ Terence Roth and Bob Hagerty, "German Bundesbank Lowers Key Rates," The Wall Street Journal, 5 February 1993: B1.
- ³⁸ Ibid.
- ³⁹ Ibid.
- ⁴⁰ Ibid
- ⁴¹ Ibid.

BIBLIOGRAPHY

- Bluth, Christopher. "Germany: Towards a New Security Format." The World Today. no. 11 (November, 1992): 197.
- Dempsey, Judy. The Financial Times. (25 January): 1.
- Goosen, Edwin P. LTC, U.S. Army. German Economic and Monetary Union. Carlisle, PA: U.S. Army War College, 1991.
- Heilbroner, Robert L. and Thurow, Lester C. Economics Explained. New York: Simon and Schuster, 1987.
- Hodess, Robin. "The Treuhandanstalt." The Economist. no. XX (November 1992): 14-15.
- Mazza, Jacqueline. "Trade and the Global Economy: Projecting U.S. Interests." Great Decisions. Hanover, NH: Foreign Policy Association, 1993: 47-51.
- Ross, George. "After Maastricht." World Policy Journal. no. 3 (Summer 1992): 487-513.
- Schares, Gail E. "Kohl Prods the Giant." Business Week. no 3302 (January, 1993): 52-54.
- Schoenfeld, Roland. "Germany II: Privatizing the East." The World Today. no. 8-9 (August/September 1992): 152-155.
- Schwenninger, Sherle R. "Reinvigorating the Global Economy." World Policy Journal. no. 3 (Summer 1992): 429-448.
- Thies, Jochen. "Germany I: Into Turbulent Waters." The World Today. no. 8-9, (August/September 1992): 148-151.
- Walker, David B. "Germany: Confronting the Aftermath of Unification." Current History: A World Affairs Journal, no. 568, (1992): 359-363.
- Wells, Rob. "Japan, Germany Cut Interest Rates," The Philadelphia Inquirer. (5 February 1993): A1 & A10.
- U.S. Central Intelligence Agency, Economic and Energy Indicators. (Washington: Directorate of Intelligence, 20 November 1992), 1-5.

Articles published in The Daily Report without author's names:

"Bundesbank Does Not Cut Interest Rates," 8 January 1993, 12.

"CDU Drafts Social, Economic Policy," 11 January 1993, 16-17.

Articles published in The Economist without author's names:

"An Idea that is Sinking Fast," 26 September 1992, 47-48.

"German Economy: Towards Zero," 21 November 1992, 76.

"Germany: Paying the bills," 5 November 1992, 57.

"Germany: Sour Politics," 11 July 1992, 50-52.

"Germany: The Vision Grows Foggy," 26 September 1992, 50.

"Helmut Kohl's Hour of Need," 31 October 1992, 47-48.

"Hope Bundesbank Cuts Interest Rates," , 63.

"The Glumness Behind Germany's Power," 3 October 1992, 49-50.

" , " 5 December 1992, 57-63.

"Output, Demand and Jobs," no. 7790, 19 December 1992, 99.

"The Bills Yet to Come," no. 7788, 11 November 1992, 57.

"The Economist Poll of Forecasters, January Averages," no. 7793,
January 1993, 97.

"Economic and Financial Indicators," no. 7790,
19 December 1992, 99.

Articles published in The Financial Times without author's names:

"International Economic Indicators: National Accounts,"
25 January 1993, 4.

"The gilt rubs off," 14 November 1992, 5.

Articles published in The Great Decisions without author's names:

"Germany's Role: In Europe? In the Atlantic Alliance?," 1993,
25-33.

"Is the World Dividing into Trading Blocs?," 1993, 51-53.

"What Direction for U.S. Trade Policy?," 1993, 53-55.