Study by the European Parliament on the impact of German unification on the European Community (May 1990)

Caption: In May 1990, the European Parliament's Directorate-General for Research draws up a working document which analyses the impact of German reunification on the European Community.

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The impact of German unification on the European Community (May 1990)

German Economic and Monetary Union (GEMU) and its consequences for the Community

I. Immigration pressure

1. The rapidly deteriorating economic situation of East Germany makes the task of creating favourable conditions for the economic development of the GDR urgent. This is the only way to stop the massive outflow of East Germans into the Federal Republic: more than 115,000 so far in 1990 and growing at the rate of 2,000 a day.

2. The immigration flood brings the East German economy closer to collapse as many immigrants have high professional qualifications. It also puts a serious strain on West German housing and financial resources, as the Federal Republic has received in recent months over 600,000 immigrants from the GDR and 350,000 German immigrants from other COMECON states.

3. The major objective of this paper is to offer a tentative analysis of the consequences of the German Economic and Monetary Union (GEMU) for both parts of Germany as well as for the Community. It is assumed that GEMU will be characterized by a complete internal market of both Germanies and the introduction of the DM in the GDR.

II. The GDR economy

4. The most acute problem of the GDR economy is that decades of isolation from world competition has permitted the conservation of an obsolete capital stock in industry as well as in infrastructure. This is the main reason why, although the East German labour force is relatively well trained, its productivity, however, is estimated to be less than half of that of West Germany. The modernisation of the country's capital stock, the establishment of incentives and the re-employment of the surplus labour force in productive activities are the basic prerequisites for a productivity increase, which is at the very base of any economic improvement.

5. For the transformation of the East German economy into a competitive market one, huge capital imports are necessary since the GDR does not produce modern investment goods, necessary for the restructuring of the country's capital stock. For this, the necessary institutional framework should first be established. The ownership of private property, the privatization of public enterprises, the liberalization of external trade, the necessary guarantees concerning the repatriation of profits, a reform of the money, credit and tax systems and a comprehensive reform of the price system, which is heavily distorted by subsidies, should be among the priorities of the East German Government to be elected on 18.3.1990.

6. However, to attract vital capital imports, the GDR also needs to offer investors production inputs at prices that permit a comparatively high profitability. In fact, labour is currently relatively cheap in the GDR since net earnings average less than half of those of the FRG labour force and other production inputs, such as raw materials, electricity or transport could be bought at a low price by investors, if a realistic DM/Ostmark conversion rate could be established.

III. The unification process

7. Though East Germany is roughly one-eighth of the economic size of the Federal Republic, the pace of the unification process will be of decisive importance. As a group of FRG and GDR economic experts warn: 'A too early union of both German states could render the catching-up process extremely difficult and make it possible only under the condition of very high adjustment costs for the East as well as for the West German economy.'

8. The introduction of a common currency would boost confidence in the GDR but it will eliminate the possibility of it to devalue its currency and give in this way a competitive advantage to its industry. In a monetary union, a region with lower productivity can no longer use the exchange rate adjustment

mechanism, but is forced to 'pay' for its competitive disadvantage with the closing down of inefficient industries and/or the lowering of its labour costs. Therefore, monetary union could not by itself weaken the motivation for immigration, as it would not remove the productivity difference. The immigration motivation for employment reasons will cease to exist only when real wages in both parts of Germany approach the same level, which will be the case when productivity in East and West Germany converge.

9. The question of the DM/Ostmark conversion rate is of decisive importance for the success of the unification process. In general, there are two possibilities: (a) the establishment of a 1:1 rate (more politically motivated) and (b) the establishment of a less than 1:1 rate (more oriented towards the productivity differential between FRG and GDR).

10. A 1:1 conversion rate would mean that the purchasing power of the GDR population would rapidly increase and that less direct transfers to households would be required. However, it would have negative effects on the GDR industry, as imports of Western consumer goods would sharply rise. Special attention should be taken to keep the inflationary impact from the conversion of the East German savings in DM under control (e.g. through gradual conversion). A less than 1:1 conversion rate (for example, 1:2, 1:3, etc.) would come closer to the productivity ratio between FRG and GDR. This ratio would permit East German enterprises to be more competitive, open unemployment would be lower and labour costs would be attractive for foreign investors. However, households would need more transfers.

11. It should be pointed out that not only the rate, but also the modalities of the conversion are of critical importance. For example, the change of only a certain amount of DM per person could be permitted at a 1:1 rate, while any amount above this would be exchanged at a lower rate or against West German government bonds redeemable some years hence. Or, as is suggested in a first evaluation of German unification by the Commission of the European Communities, a part of the savings stock could be absorbed by privatizing state-owned companies and dwellings at prices that offer the perspective of capital gains and therefore have an incentive effect for East German citizens to stay in the GDR. The conversion of monetary assets could then be spread over several years and some savings could be converted into Federal DM-Bonds.

12. As the political trend tends towards a 1:1 rate, the establishment of certain modalities in the conversion procedure seems to be imperative, so that inflationary pressures can be avoided. According to Prof. Siebert's estimates, a 1:2 conversion rate would lead to a 33% increase in the quantity of money, while the inclusion of the GDR in the unified economic and monetary space would mean only a 6% increase in the supply of goods.

13. An exact assessment of the consequences of the unification process is impossible at this stage as neither the institutional nor the financial and monetary conditions have been settled. However, there are certain implications for the FRG, for the GDR and the Community which can be forecasted.

IV. Likely implications for the FRG

14. Depending on the rate and the modalities (e.g. establishment of a transitional period etc), the conversion of Ostmarks into DM will most probably have an inflationary impact. Estimates raise the inflation rate to 4% annually (from the current 2.6%) due to growing consumer demand and the growth in the money supply.

15. Strong increases in exports of investment and consumer goods to the GDR will lead to a higher GDP growth trend. It should be noted that the productive capacity of the FRG is currently 90% utilized.

16. Transfers to reduce the FRG/GDR income gap (especially concerning pensions and unemployment benefits) and to improve the GDR infrastructure and environmental protection could reach the order of 4–5% of GDP. This would lead to higher budget deficits and possibly to tax increases. However, tax receipts would rise endogenously in response to higher growth.

17. As the demand for money increases, interest rates will probably rise. Interest rates on government bonds recently rose to 9%, up from 7.3% at the beginning of the year, and a further increase cannot be excluded.

18. Through the unification of the German states, the FRG will save the ‘costs of the division’, namely the financial help to West Berlin, the transfer payments to the GDR, the regional aid to the frontier areas etc. These costs are estimated to be about DM 40 billion annually.

V. Likely implications for the GDR

19. Unemployment will rise as ageing industries are modernized. The extent of the labour force unemployed depends on a series of economic factors and mainly on whether a realistic DM/Ostmark conversion rate will be established. It also depends on how fast foreign investment into industry and infrastructure will be realized.

20. National savings estimated at about Ostmark 160 billion could drop in value after the price reform.

21. Prices for goods and services will rise as state subsidies are stripped away.

22. If export goods are priced in hard DM currency, East Germany’s exports to COMECON Members could be jeopardized. 65% of GDR’s foreign trade is currently with its financially strapped Eastern partners, who will find it difficult to pay in DM for the East German goods.

VI. Likely implications for the Community

23. Medium-term GDP growth perspectives in the Member States will improve due to increased exports to the FRG and GDR, because of a higher demand due to the modernization of the East German economy.

24. Resources from the Community budget and/or the Member States’ budgets will be used for the economic reconstruction of Eastern Germany. If the GDR remains for a transitional period an independent state, it will then profit from a new Eastern Europe Fund, while, as part of an existing Community country, it will qualify for support through the Structural Funds and the Community’s Financial Instruments.

25. In the case of immediate German unification, Community legislation will be applied to GDR territory after a negotiated transitional period. According to first estimates of the Commission of the European Communities, a unified Germany would receive a sum of ECU 1.5 to 2.0 billion per annum.

26. The full exploitation of the relatively efficient agricultural production of the GDR could increase the Community’s surplus production and create an additional burden to the Community Budget.

27. Should there be a drastic appreciation of the DM, due for example to a rapid increase of interest rates, then tensions will arise in the Exchange Rate Mechanism of the EMS, in the critical, preparatory phase of the European Monetary Union.

28. It should be noted that Monetary Union between the FRG and the GDR will be radically different than that foreseen for the European Community. In the first case East Berlin will immediately transfer its competences in monetary policy to the Bundesbank. In contrast, in the first phase of EMU, as described in the Delors Report, monetary authorities in the Member States will continue being responsible for national monetary policies and it is only in the later phases of EMU that a gradual transfer of competences to a European Central Bank will take place.

29. It is evident that at the current stage of discussion no reliable conclusion can be drawn regarding the impact of GEMU on the time schedule of the European Monetary Union. However it seems necessary to coordinate the timing of both procedures.