CHAPTER –II

CHANGING CONFIGURATION OF
UNIFIED GERMANY’S ECONOMY

Three sets of cataclysmic changes in Europe in the recent years have generated world-wide interest and influenced thinking on economic and political issues in the developed as well as the developing countries. First and foremost, is the European Union based on the Single European Act, 1987, establishing a barrier free European Community by the end of December 1992; the Mastricht Treaty, 1991, envisaging a European Monetary Union with a single currency, a European Central Bank; and a common monetary policy by 1996. It is believed that these changes have had favourable impact on the economic management in Europe and have led to significant improvement in factor productivity and external competitiveness of the community which had shown sluggish trends in the last decades.

Another major change has been the pace of German unification and the problems faced thereafter. Infact, the 1989 social and economic upheavals in Eastern Europe, spelling the capitulation of the totalitarian socialist regimes, have entered our consciousness as truly historical events. The Gorbachev era or Perestroika facilitated the people’s revolution against the grave economic and social failures of these regimes. The former German Democratic Republic (GDR) was one of the last countries to free itself from the communist yoke.
The merger of the erstwhile GDR with the Federal Republic of Germany began with the crumbling down of the Berlin Wall on 9th November, 1989. German unification was accomplished through the application of Article 23, which meant accession of East Germany to West Germany, without affecting in any way the Basic Law. Then of course, unification process carried due approval of the four allied powers (US, Soviet Union, UK and France) and also of its eastern neighbour, Poland in as much as it affected the latter’s interest.¹

Political unification was consummated by the all German election on 2nd December 1990, in which for the first time, the electorate of the five new Bundesländer (federal states), established in the former GDR was also entitled to vote. From these all German elections, the Christian Democrats (CDU/ Christian Social Union (CSU) emerged as the strongest party, thus enabling Chancellor Helmut Kohl (CDU) to continue his coalition government with Free Democratic Party (Liberals), to which the then Foreign Minister Genscher belongs.

At the same time as the internal legal and administrative framework for the German unification had to be tackled, the so-called ‘external aspect’s of the reunification of Germany also had to be negotiated and resolved. In an unprecedented effort of international co-operation, the chief diplomats and government officials of the four allied powers together with their counterparts from the two German states, succeeded in resolving most of the

highly complex and intricate problems comprising the international dimensions of the reunification of Germany.

**The Structure and Main Issues of The International Negotiations:**

The entire matter usually referred to as the 'external aspects' of the unification of Germany embodies in reality a bulk of highly complicated political issues. Among them are on the one hand the whole international framework and the external preconditions that shaped the negotiations regarding the emergence of a reunited sovereign German state. On the other hand, the so called 'external aspects' point also to a number of important questions with respect to the future status and role a United Germany may have in relation to its neighbours, and in world politics at large.

To begin with, at least five points deserve special attention if one tries to delineate briefly the scope of the international negotiations, which eventually paved the way for a swift reunification of the two Germanies and the specific agreements for coping with the related security problems. First, the negotiations needed to address the basic questions concerning the termination of the rights and responsibilities with respect to Germany and Berlin as a whole hitherto reserved by the Four Powers, thus restoring to a united Germany full sovereignty. Second, its was necessary to confirm the definitive borders of the United Germany, especially the Polish –German border, understandably a crucial point for Poland. Third, agreement had to be reached on the delicate subject of the temporary stationing of Soviet troops in Germany and their ultimate withdrawal and the no less sensitive
question regarding the right of the united Germany to belong to alliances, both of which apparently called for substantial concessions on the part of the Soviet Union. Fourth, provisions to tackle the size of German armed forces and other limitations regarding the military power status of the united Germany also had to be worked out. Finally, in the fifth point, the German negotiators had to meet some wishes and expectations advanced mainly by the Soviet Union and Poland for financial and economic support to overcome at least some of the most urgent needs associated with the new situation.²

In the overall negotiation process which brought about the international settlement of the reunification of Germany, several bargaining levels, bilateral as well as multilateral, had to be distinguished. With regard to the multilateral negotiations, the single most important forum was what became known as the “Two plus Four” negotiations in which the Foreign Ministers of the two Germanies and the Four Powers participated. The talks and deliberations of the Bonn Government with its foreign partners, in the European Community (EC) and in the North Atlantic Treaty Organization (NATO) greatly facilitated and supported the negotiations regarding the unification of Germany. Due to the fact that from its very beginning the achievement of the political unification of Germany was considered a subject of utmost importance to all other European States, agreement was reached to the extent that the Conference on Security and Co-operation in

Europe (CSCE) should also in some way be brought in to finally approve the results arrived at.

The continuous and close contacts between the Bonn government and the Bush administration were extremely helpful during the negotiations. Without the determined backing of the Bush administration, the unification of Germany could hardly have been achieved so smoothly and so rapidly. Moreover, the talks between Chancellor Kohl and President Gorbachev were indeed extremely important. Last but not the least, the discussions between Bonn and the Polish government formed a substantial part of the overall deliberations because the definitive settlement of the border question and the evolution of the still sensitive relationship between Germany and Poland necessarily had to be regarded as part and parcel of any stable solution for German unification.

For the whole international negotiation process, it proved very helpful that already on 13th February 1990, as a result of the agreement to the Two plus Four platform, the stage was set for settlement of the “open skies”. This basic agreement was later reached so as to deal with the external aspects of German unification only within the small circle of the two post-war German states and the former four victorious powers.3

On 12th September, 1990, the Treaty on the Final Settlement with Respect to Germany was signed in Moscow. From a German point of view, an essential feature of the treaty is the provision that the Four Powers

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3 Ibid.
terminate their rights and responsibilities relating to Germany. Accordingly, all corresponding related quadripartite agreements and practices were also terminated and all Four-Power institutions were dissolved. Thus, United Germany has full sovereignty over its internal and external affairs (Article 7). This also includes the right to belong to alliances with all the rights and responsibilities arising there-from (Article 6).

To be precise, the bilateral and multilateral negotiations put an end to the sorrowful period of the Cold War, and all the distresses and pains of a divided country in the Centre of a similarly divided continent, where the so-called German Question could not find any satisfying answer for more than four decades of bitter East-West confrontation. The outcome of the negotiations with respect to Germany, which eventually united the people and the territory of the Federal Republic of Germany to GDR and the whole of Berlin into one single German state, created of course, a bigger Germany in a completely changed international environment.

German unification did not occur only by lucky chance at a unique historical moment in post-World War II European history. Rather, it was made possible by the concurrence of a variety of factors, the most influential of which were the lasting consequences of the previous détente policies, in particular the long-term pay-offs of Bonn’s Ostpolitik dating back to the early 1970s, the changes being promoted by the CSCE process, the new rapprochement in the US-Soviet relations and the changing nature of the Soviet American duopoly and above all Gorbachev’s decision to encourage
reform at home and abroad and to reduce Soviet power in Central and
Eastern Europe.

In retrospect, it is worth recalling that the definition of the security
status of United Germany and particularly the question of Germany's
continued membership in NATO was the most difficult problem to be
resolved. For some time, the Soviet Union strongly opposed the proposal of
the West and the wish of the Germans to maintain its membership of the
Western Alliance. Only after intensive bilateral talks and agreements
between Kohl and Gorbachev in Moscow and in the Caucasus on 16 July,
1990, was an overall agreement reached that included Gorbachev's
willingness to accept NATO membership for United Germany.

The underlying prerequisite for this unexpected concession on the
Soviet side was on the one hand the London declaration of the NATO
summit on 6 July 1990, in which the heads of the western allies offered to
the Soviet Union and to the other members of the then still existing Warsaw
Pact not to treat them as adversaries any longer and to exchange with them
renunciation - of- force agreements thus demonstrating the new attitude of
East-West relations.\(^4\) On the other hand, apart from the arrangements to limit
the size of the armed forces and the military potential of a united Germany,
Chancellor Kohl in his meeting with Gorbachev was prepared to promote
closer Soviet-German co-operation and above all to meet requests for
considerable financial and economic support in return for Moscow's

concessions to allow Germany to unify basically on Western terms. Thus, it could be argued that Bonn was prepared to draw on its rich economic resources to buttress the international agreements to bring about Germany’s unification.

As mentioned earlier, political unification was consummated by the all German election on 2\textsuperscript{nd} December 1990. Earlier Germany had been undergoing an economic, monetary and social union since 1\textsuperscript{st} July 1990. The idea of a monetary union was formulated by the former Social Democratic Party (SPD) Mayor of Hamburg, Klaus von Dohnani on 21\textsuperscript{st} December 1989 and reiterated by the financial expert of the SPD, Ingrid Matthaeus-Maier on 19\textsuperscript{th} January 1990. both called for an exchange rate of 1:1 Ostmark to D-Marks replacing the earlier conversion rate of 5:1 Measures were also taken to contain the influx of East German migrants.\footnote{Rolf Hasse, “German unification and European Upheavals”, Aussenpolitik II, (Tuebingen),1992.}

After the breaching of the Berlin Wall on 9\textsuperscript{th} November 1989, the legal allowance for GDR travelers was DM 15 per year. To give these citizens more freedom to travel and consume and thus to persuade them to remain living in East Germany, the FRG government offered immediately ‘welcome money’ (Begrüßungsgeld) of DM 100 per person per year. Several municipalities added grants of different amounts to visitors to their townships. Already by 5\textsuperscript{th} December, 1989, the two German governments had agreed to establish a travel–currency fund (Reisedevisenfonds) which would replace the Begrüßungsgeld on 1\textsuperscript{st} January 1990. Parts of this
agreement were: the mandatory exchange of DM 25 for German visitors to the GDR was lifted as well as the obligatory visa. All citizens of the GDR could obtain DM 200 by exchanging their currency as follows:

DM 100 (children upto 14 years DM 50) at a rate of 1:1, the second DM 100 (children upto 14 years DM50) at a rate of 1:5. The average exchange rate for this procedure was 1:3, an exchange rate which then determined the exchange market during the first months of 1990. The Reisedevisenfonds was abolished with the full introduction of the deutschmark on 1st July 1990. The fund was used only during the first two months (DM 2.17 billion) and vanished when the option of a monetary union and a more favorable conversion rate began taking shape.

A comprehensive process of transformation had to be initiated within an extremely short time. All proposals for a slower pace of integration, the retention of the exchange rate as an instrument of adjustment, and the adoption of a common currency only after the GDR had achieved a thorough reform of its price and wage systems, a certain amount of restructuring and an increase in its level of productivity were reasonable from an economic point of view. But they ignored the tide of emigration which could only be stemmed by a faster move towards economic and political unification.

Economic and Monetary Union:

The treaty between the Federal Republic of Germany and the German Democratic Republic establishing a Monetary, Economic and Social Union was negotiated in six weeks time. This became effective on 1st July 1990. In
six chapters and thirty eight articles, the document which included a joint protocol on guidelines as well as nine appendices containing detailed legal procedures, spelled out the specifics of how the economic unification process was to be accomplished. The complete integration or legal unification was brought about by the Unification Treaty signed on 31st August 1990 and was approved later on 20 September 1990 by both parliaments.

This treaty settled not only the question of the conversion rate, but it is also a blueprint about the ways and means of achieving the intended economic integration and the transformation of the East German economy. Moreover, it is also a manifesto of the German economic system referred to as the ‘social market economy’. The main points of the treaty are:

1. with great emphasis it is expressed in article 1 that the economic system in Germany will be a social-market economy. All elements of this concept are put into a legal frame which is clearer and better than all references to this concept in the other laws of the FRG. That is why the treaty includes the social union, too; but it is necessary to keep in mind that ‘social’ means more than welfare policy.

2. as the basis of the monetary union, the deutschmark will be the only currency and the Deutsche Bundesbank the only central bank (article 1 sect 2). The responsibility of the Deutsche Bundesbank for monetary

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policy, day-to-day exchange policy, price stability, and its independence is confirmed. (article 10)

3. all civil, commercial and public laws of the FRG were operative in the erstwhile GDR.

4. with some exemptions, the fixed prices of the GDR were abolished.

5. a ‘Trust Fund’ (Treuhandanstalt) was established to help privatize the state-owned enterprises: to privatize them, to break them up, to sell them and to support them temporarily if they have a chance of surviving.  

6. the most intricate task was the choice of the conversion rates, which were a mixture of economic rationality, distributional aspects and political promises.

7. for real assets, conversion assets had been selected which fluctuate between 1:1 and 3:1. The calculatory average rate of conversion is 1:8:1 and is thus more generous than the rate of 1:9:1 proposed by the Deutsche Bundesbank at the end of March 1990. The government particularly improved conversion conditions for small savers.  

The structural changes occasioned by the monetary union led to the people in East Germany having to face enormous problems of adjustment. A price had to be paid for the rapid introduction of market economy and the process of privatization. The process of adjustment has to be seen as a historic achievement even though the costs for the same have to be borne by all German citizens.

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8 Rolf Hasse, “German Unification and European Upheavals”, Aussenpolitik II/92,p.123.
Today certain tangible results are evident. The new laender are considered to be the region with the highest growth in Europe. The East German industry is on the move after a production slump in the early nineties with a growth rate of 14 percent. In fact, the economic slowdown which began in 1995 in Germany and in nearly all the other industrial countries had been overcome by 1996.

At the end of the 1980s East Germany's economic structure resembled that of West Germany twenty years ago. Almost half of the labour force was employed in the mining, energy, manufacturing and construction sectors. 11 percent still worked in agriculture. On the other hand, the service industries were relatively under-represented especially with respect to modern services. The structure of the industrial sector was very similar to that of west Germany. It was dominated by mechanical engineering, chemicals, electrical engineering, precision tools and optics. The various manufacturing and processing stages were integrated in large industrial units. East Germany lacked the small and medium sized firms which are the mainstay of West German industry.

Unification did have favourable impact on West Germany initially. The massive transfer of funds to East created demand for the products of the firms in western part of Germany. It is estimated that unification added 1.5 percent points to GDP growth in 1990 and a further one percentage point in 1991. For the eastern part, however, the initial economic impact was extremely painful. Thus in the first six months of the EMU, unemployment
rose six to seven times, unit labour costs, by 50 to 60 percent and the general level of activity fell by 20 percent.

As the trends suggest, for the German economy as a whole as well, the process of unification has proved difficult. This has been partly because the exceptional advantages favouring unification have been accompanied by disadvantages such as the existence of relatively weak incentives in the eastern part to adjust to the new environment on account of the provision of a social safety net meant for a highly developed country; the adoption of Western Germany's regulatory framework, which introduced rigidities and cumbersome procedures impeding the growth process; and above all the widening of the gap between production costs in Eastern Germany and world prices resulting in increasing lack of competitiveness.

The lack of competitiveness of an economy usually necessitates a real devaluation in the short run. Real wages fall, and external balance is established at a sustainable level of capital inflow. Subsequently, the restructuring process is supposed to lead to an increase in competitive exports. Such an increase has to be sustained by productivity growth, and together both, export growth and productivity growth, facilitate the maintenance of external balance, the achievement of internal balance and an improvement in the average standard of living. In East Germany, unification entailed a revaluation of the currency and an increase in real wages. With an unofficial exchange rate of about 4.4 East Marks for 1 DM at the time, the adoption of a 1:1 conversion rate was equivalent to a real appreciation of
more than 300%. As the productivity level in the East was roughly a third of that in the West, the East German wages and salaries were at about 50 percent of the West German level, the 1:1 conversion rate eliminated the possibility of using the exchange rate to compensate for lower average productivity. Also in conjunction with the problems of an underdeveloped communication and transportation infrastructure and widespread environmental degradation, the significantly higher unit labour costs made the East German economy non-competitive overnight.

The speed of East German integration into the world economy coupled with much higher unit labour costs led to a larger decline in output than in any other transition economy and also to a much larger drop of the manufacturing sector's share in output. During 1989-91, East German GDP shrunk by 35 percent and the share of manufacturing output in GDP was nearly halved. During the same period, employment dropped by 2.2 million, the equivalent of 25 percent of the 1991 level. With 1989 as the base year, the index of industrial production had fallen to 40 in East Germany in 1994.

The dramatic drop in East German manufacturing output is also the result of a decline in external demand and a shift in internal demand. The disintegration of the Soviet Union and the fundamental restructuring process in the other COMECON economies led to a drastic decrease in the demand for East German imports. The impact of the East German economy was all the more severe, as export dependence on COMECON members was particularly high. (The COMECON was dissolved formally in June 1991.)
East German exports to Central and Eastern Europe fell from DM 28.9 million in 1989 to DM 11.0 million in 1991.

Domestic consumption in East Germany did not decline after 1989. Consumption levels in East Germany could be maintained due to the wage policy and more importantly, transfers from West Germany of a magnitude that dwarfs the Marshall Plan. Transfers from West to East Germany amounted to around 75 percent of East German GDP in 1991 and roughly 6 percent of West German GDP. The Marshall Plan, in contrast, amounted to only around 3 percent of West German GDP in 1950. While the huge transfer payments maintained East German levels of consumption, demand for tradable goods was aimed primarily at West German goods. The increased demand for West German products was the result of lower prices in some cases, better quality in others, ready availability, and the cumulative effect of 40 years of demonstration effect via West German television.

In addition to the massive transfers, the adoption of the West German institutional structure was a crucial aspect of unification. With the economic and social union came the extension of West German laws and institutional arrangements to all areas of East German life, including the extensive welfare provisions, which accounted of course, for a substantial part of the transfer payments.

While a considerable part of East German demand was indeed met with output increase in the West, investment in East Germany started increasing in 1991 as a result of massive government incentives. In 1992, the
East German economy began to grow again at quite impressive rates although starting from a low base in 1991. In 1996, East German GDP was nearly 40 percent higher than in 1991, but still about 10 percent below the level of 1989. Construction was the leading structure in the boom, but all sectors grew considerably after 1991. Nevertheless, growth has slowed down since 1995, and in 1996 GDP growth in the East was only 2 percent compared to 1.3 percent in the West.\(^9\)

An analysis of export performance gives an imperfect picture, but the overall results seem to suggest a greater ability to compete, especially after 1994. Exports as a share of sales declined from 15 percent in 1991 to 12.8 percent in 1994. The respective shares in West Germany are 23.2 percent and 24.7 percent. Branches with large export shares in the 1980s, especially chemical and structural metal products, had manufactured products that had been “competitive” in the COMECON countries, but that could no longer compete in the context of international prices and the disadvantageous initial conditions after unification.

Given the nature of unification, the German government had to offer massive support, if it wanted to prevent the total collapse of the East German manufacturing sector. Therefore, the government provided direct and indirect support for private investment. The indirect support consisted of massive public investment to improve the infrastructure in transportation and telecommunications and to address the worst of the environmental

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disasters. Such investment was a necessary condition for making large private investment feasible. Given the cost differences, it was, however, not sufficient. Direct subsidies were needed as well to entice autonomous private investment.

It is important to remember that west Germany has had an extensive investment support structure in place for many years, primarily to foster convergence among different economic regions. This investment support structure, which existed in West Germany at the federal state, and local level, was extended to cover all of East Germany. In addition, a number of special programmes were set up just for East Germany, and investors also had access to various support funds of the European Community. The most important sources of investment subsidies were investment allowances (Investitionszuschüsse) with an initial maximum subsidy rate of 23 percent of investment costs, investment grants (Investitionszulagen) which initially provided a maximum subsidy of 8 percent, special depreciation provisions which allowed a 50 percent depreciation on the investment cost for income tax purposes in the first five years, and the various subsidized loan, funds from the Reconstruction Loan Corporation (kreditanstalt fuer wiederaufbau, kfw), the German Compensation Bank (Deutsche Ausgleichsbank), and the European Recovery Programme (ERP).

The amount of support from these different programmes was substantial. Over 1991-95, total investment support to East German Corporations (investment grants, investment allowances, and accelerated
depreciation) amounted to DM 22.1 billion. Subsidized credits from the major loan funds to the manufacturing sector totaled DM 76.6 billion. Over 1991-94 the sum of investment allowances was equivalent to 40.3 percent of nominal fixed investment in East German manufacturing. ERP credits were granted for 13.3 of total investment and KfW credits for 35.8 percent.

While there was an amalgam of different support programmes, the government did not pursue an industrial policy targeting particular sectors. That is also evident in the Treuhandanstalt’s approach to privatization. Even though there were attempts to preserve key industries in certain areas because of their economic importance to those regions, government policies generally refrained from promoting particular industries or products. Instead, they provided support for specific activities regardless of sector, e.g. investment, R &D expenditure, export credits etc.

All previous estimates of the costs of unification have proved incorrect, because they are grossly underestimated. This is so because of enhanced social spending caused by sluggish East German receipts, the surge in unemployment, heavy outlays needed for infrastructure, industry and social security. German payments in the context of the Gulf War has also put additional burden on the German treasury.10

During the Gulf War, Germany did not join in the coalitions military effort, but it paid well to help cover the costs incurred by the United States and those countries which did join in the coalitions military effort. It also

worked efficiently and co-operatively in the logistical area, making certain that equipment and troops from United States bases in the Federal Republic moved swiftly into the Saudi desert for operation "Desert Shield" and "Desert Storm".

It is obvious that this international crisis came too soon for United Germany. They were shocked by the rapidity of unification and fixated on the problems it had brought. This was a classic overload situation. The delay and hesitation prior to an official German government reaction of any kind was a clear indicator of this overload.

Costs of unification, which were initially estimated at DM 500 billion, were in 1991 put at four times this figure. It included DM 127 billion in transport, DM 60 billion in telecommunications and between DM 800 billion and DM 1000 billion in housing, modernization and construction.

Finances of the East German Lander were collapsing. By March 1991, they had already consumed 40 percent of the entire DM 35 billion unification cost budget set aside for 1991. The Eastern Laender were sliding towards a budget deficit of DM 50 billion in 1991 and many towns were nearly bankrupt. Western Laender, after considerable pressure from the Federal Government, had reluctantly agreed to chip in an extra DM 15 billion over the next four years.

Basically, there was great optimism because it was believed that the situation in Germany was comparable to the situation in 1945. They started from nothing at that time, and a few years later they had a
Wirtschaftswunder, (economic miracle) and it was believed that the same would happen this time. However, this proved to be wrong. In 1945, the German were united in poverty, now Germany has rich Germans and poor Germans. In 1945 there was a gradual progression from poor to less poor and later to well-to-do. Now the transformation from poor to rich had to be done in a hurry.

Further, there was a basic misunderstanding between the rich West Germans and the poor East Germans. The opinion of the East Germans was that they lost the war along with the West Germans but East Germans suffered forty-five years longer. Therefore, they felt that they had to be compensated. But the West Germans opined that nothing was given to them free after 1945. They had to work hard for everything. They also felt that it was high time that the East Germans learned to work. In short, the transformation of a society based on feelings of jealousy into an achievement created society.

TREUHANDANSTALT:

The instrument that is meant to accomplish the speedy transformation is the Treuhandanstalt (Trust Institution). Treuhandanstalt was initially created by the Modrow government to take control of the economy away from the ministries but still to keep hold of the reins in a central body. It was thus manned by communist apparachiks. It was not transformed into a more western style organisation until two weeks before the monetary union of 18 June 1990.
The Structure of Treuhandanstalt:

The structure of the Treuhandanstalt is very interesting. There is a Supervisory Board and a Management Board. The Supervisory Board is really a Verwaltungsrat, und counsel d' administration powers; it is in other words a supervisory board with extended powers. It has twenty-three members. These are the five Prime Ministers from the five new Bundeslaender; two high-level civil servants, the Secretaries of State from the finance and the economics ministers in Bonn; one representative from the Bundesbank; one Chartered Accountant; one East German Kombinatsleiter (head of a combine); seven West German entrepreneurs, among them the Chairman, two foreign entrepreneurs, and finally, four high-level representatives of the Union, among the Chief Unionist, the chief of the DGB in Germany.11

Composition of Treuhandanstalt:

It is a very well-balanced composition with interesting inputs from all sides, and it is a kind of mini parliament. It works on a consensual basis.

There is another group within this Supervisory Board; a Chairman's Committee composed of five members. They are: the Chairman who is an entrepreneur; a foreign entrepreneur, a Chartered Accountant, a high-level civil servant; and a union representative. Their task is to set the agenda, to discuss strategy and to prepare the meetings.

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The Board of Management is responsible for the actual daily affairs. It consists of nine-persons-seven individuals from the West and two individuals from the East. They all have functional tasks".12

**Task of Treuhandanstalt:**

The task of the Treuhandanstalt was to privatize as soon as possible; to restructure what had to be restructured so that it could be privatized or shut down depending on the outcome; and to immediately shut down what had to be shut down.

In the first phase, the property of 8,000 enterprises with 6.9 million employees was transferred. The asset value according to East German standards was 620 billion marks. In the second phase, much later in September 1991, there was an additional property transfer of about 10 million acres of land, which was 40 percent of the size of the GDR territory and was about 30 percent larger than the size of Belgium. The entire Stasi (state police) property, union property and party property were transferred to the Treuhand.

Altogether they had property rights to 8,000 firms, 30,000 commercial outlets, 2000 pharmacies, 700 bookshops and 900 movie theatres. Furthermore, there were owners of union holiday centres with more than 40,000 beds. It was one of the biggest hotel chains in the world. In one Verein, the Sport and Technikverein, they found 250 properties (real estate),

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650 planes and 40,000 rifles. I am mentioning this to give you an idea of the scope of the Treuhand.

Privatization was not an easy task. The East Germans were used to another system and were educated according to a different standard. They were not used to the West German way of thinking. They lived in a sterilized atmosphere for forty-five years, and suddenly they were exposed to a higher grade of technology which they had earlier not been exposed to.

The Treuhandanstalt has more than once been compared to the Bundesbank. Opposing testimony argues that its position to withstand political interference was in fact weak and that it usually had to give into large sales subsidies once the liquidation option became politically obsolete. Liquidation constraints played an important role in the privatization process and is crucial for understanding the distribution of privatization outcomes. We find in particular that large firms and firms in industries with high sectoral unemployment profited disproportionately from liquidation constraints and could only be sold with large sales subsidies. This subsidy bias towards large state owned enterprises (SOEs) increased over time and suggests a sequential erosion of the Treuhandanstalt’s decision autonomy. Normally, a privatization agency facing an erosion of its decision autonomy will try to accelerate the liquidation process in order to preempt high sales subsidies in a later stage of the privatization when liquidation is no longer politically feasible.
The Treuhandanstalt adopted a wholesale method for privatization. Potential buyers submitted their entire entrepreneurial plan for firm development and a bid was approved based on the entire business plan rather than on the basis of maximum sales proceeds alone. The sales contracts typically specified investment and employment pledges of the investor. In most cases contractual penalties were specified for violation of the pledges.

Table 1 presents summary statistics for the German privatization programme. The privatization process gained momentum after the German unification in October 1990 and proceeded at full speed.\(^\text{13}\)

\begin{table}[h]
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\begin{tabular}{|c|c|c|c|}
\hline
Quarter & Privatizations & Restitutions & Liquidations \\
\hline
1990:4 & 30 & 77 & \\
1991:1 & 1670 & 491 & 160 \\
1991:2 & 252 & 173 \\
1991:3 & 931 & 140 & 222 \\
1991:4 & 696 & 239 & 281 \\
1992:1 & 715 & 152 & 351 \\
1992:2 & 591 & 170 & 331 \\
1992:3 & 614 & 212 & 209 \\
1992:4 & 311 & 136 & 5 \\
1993:1 & 240 & 92 & 3 \\
1993:2 & 133 & 157 & 0 \\
1993:3 & 178 & 98 & 0 \\
1993:4 & 166 & 33 & 0 \\
Total & 6245 & 1804 & 1920 \\
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\end{tabular}
\end{table}


Upto January 1994, a total of 6245 SOEs had been sold, and 3219 had been liquidated. Many liquidations included those of holding companies

after their major assets had been sold (Restliquidationen). Excluding the liquidation of holdings reduced the number of liquidation decisions to 1812. In 1920 cases the SOEs had been returned to previous owners or to local government. A portfolio of 951 SOEs was left for sale at the end of January 1994. Actually we can compare the liquidation decisions to successful sales. The quarterly sales of SOEs decreased from 931 privatizations in the third quarter of 1991 to 166 privatizations in the fourth quarter of 1993. The number of liquidations peaked with 351 cases in the first quarter of 1992 with few liquidation decisions after third quarter of 1992. Most liquidation decisions were made in an early phase of the privatization programme.

Liquidating a SOE in an early stage of the privatization process implies that the chance of finding a buyer are severely reduced since buyer search and matching requires time. Prolonged search on the other hand implies two countervailing risks. In the absence of a buyer, who can restructure the firm, its profitability is likely to deteriorate. The accumulating losses have to be absorbed by the privatization agency. A second risk may result from imperfect political insulation of the privatization agency. In a prolonged buyer search a SOE is more likely to find external political support against its liquidation and the privatization agency is likely to lose its liquidation option. In other words, one can say that political interference affects the policy of the privatization agency.

The Treuhandanstalt was led by Mrs. Birgit Breuel till the end of December 1994. When the office of Treuhand wound up on the last day of
1994, one of the most powerful institutions of Germany’s economic history made its exit from the political stage.\textsuperscript{14} It had only one task to fulfill, namely to convert the 40 year old economic systems of the erstwhile GDR into a social market economy within the shortest possible time. Founded in 1990, the Treuhand was at one time the largest holding company in the world, employing four million people in more than 8,000 firms (later 14,000 as some large firms were separated).

To sum up, let us concentrate on three facts of the German economic transition. First, the Treuhand focused on rapid privatization rather than state led restructuring despite the financial ability to purchase investment equipment and hire new management. Second, the Treuhand relied on sales rather than giveaways or vouchers despite the knowledge that sales would reduce the likelihood of significant ownership by eastern Germans. Third, eastern firms were purchased predominantly by established western firms, rather than by eastern Germans, or capital funds.

Sales of sick firms for a nominal price of one mark caused a stir. To some it was obvious that the profit went to opportunists and real estate crooks\textsuperscript{15}. Besides the conditions of the companies were unknown as a result, it became a burden rather than useful assets. Meanwhile, to improve the privatization process under Treuhandanstalt a Fact Finding Committee of the German Bundestadt was set up. It looked into such aspects as improved balance sheets, insufficient inquiry into the reputation of buyers; vast sums

\textsuperscript{14} Claus Hoecker, “Treuhand has written history”, \textit{German News} (German Embassy, New Delhi), February 1995,p.9.
\textsuperscript{15} Ibid.
of honorarium paid to middlemen and advisors, the lose supervision by the Finance Ministry in Bonn as well as the bonus system for quick sales.

The Fact Finding Committee report revealed that while coping with such a gigantic task, some mistakes were committed, as the Truehand itself has admitted. Losses to the tune of 300 million DM caused by criminally inclined investors and Treuhand managers were felt comparatively negligible. Nevertheless the committee observed that on balance, Treuhand achieved promises of investments worth more than 200 million DM, promises of employment for 1.5 million people and more than 65 billion DM of sales proceeds. With debts of some 270 billion DM, the tax-payers had to cope with.\(^\text{16}\)

To sum up, till date the work of Treuhand is reviewed in slogans: "Work achieved in Germany", is the praising by coalition of political parties in Bonn; "Privatization at any cost" was the commentary of the Social Democrats; "Vast destruction of the industrial climate in the eastern part" were the observations of Alliance 90/ the Greens. Critics however, perceive it differently. In the short term, most existing, eastern managers were not capable of envisaging and implementing the required restructuring. Through no fault of their own, eastern managers simply lacked experience with a market economy and basic management principles."\(^\text{17}\)


Eastern firms not transferred to the Treuhand included postal and telecommunication services, the railway, water supply and local public transport. These were retained under central control or transferred to local governments.

The sales process involved direct negotiations between Treuhand officials and potential buyers. In addition to selling price, the Treuhand considered a buyer’s willingness to provide employment and investment guarantees, the buyer’s business plan, and the negotiating team’s perception of the prospective buyer’s ability to implement its proposed business plan. In case of competing offers for a firm, the Treuhand negotiating team recommended a specific buyer to the Treuhand board. Overtime, the negotiating teams placed increased weight on a prospective buyer’s employment and investment guarantees. Table 2 provides data for employment provided by Treuhandanstalt.

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of firms and parts of firms sold</th>
<th>No. of liquidations in process</th>
<th>No. of firms remaining</th>
<th>No. of jobs guaranteed</th>
<th>Investment guarantees (in billions)</th>
<th>Net treuhand (DM billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990-91</td>
<td>2,672</td>
<td>789</td>
<td>6,212</td>
<td>930</td>
<td>114</td>
<td>21.5</td>
</tr>
<tr>
<td>1992</td>
<td>8,024</td>
<td>1,460</td>
<td>2,575</td>
<td>470</td>
<td>55</td>
<td>27.1</td>
</tr>
<tr>
<td>1993</td>
<td>2,600</td>
<td>947</td>
<td>950</td>
<td>87</td>
<td>17</td>
<td>36.8</td>
</tr>
<tr>
<td>8-1-994</td>
<td>1,092</td>
<td>-</td>
<td>147</td>
<td>13</td>
<td>21</td>
<td>31.6</td>
</tr>
<tr>
<td>Total</td>
<td>14,388</td>
<td>3,196</td>
<td>-</td>
<td>1,500</td>
<td>207</td>
<td>117.0</td>
</tr>
</tbody>
</table>

Panel A: Time Series of Privatization Activity
Panel B: Distribution of Neutrality of Buyers of East German Firms

<table>
<thead>
<tr>
<th></th>
<th>East German buyers (%)</th>
<th>West German buyers (%)</th>
<th>Foreign buyers (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of privatization</td>
<td>20.0</td>
<td>74.1</td>
<td>5.9</td>
</tr>
<tr>
<td>transactions (sales of</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>firms and parts of</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>firms)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total value of</td>
<td>2.9</td>
<td>87.1</td>
<td>10.0</td>
</tr>
<tr>
<td>investment guarantees</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total employment</td>
<td>9.2</td>
<td>8.6</td>
<td>10.2</td>
</tr>
<tr>
<td>guarantees</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note:
- figures not available.

a- Net treuhand cost is total funding provided by the Treuhand (the sum of investment subsidies, finds to cover losses and supply working capital, redundancy payments, and other costs/less cash proceeds from privatization.

b- Number of firms sold through a management buyout or buy in are used as a proxy for Eastern German ownership.

c- Countries with the highest number of sales are Switzerland, UK, Austria and the Netherlands.

d- Countries with the highest investments are France, US, UK and Canada

e- Countries with the highest employment commitments are France, Switzerland, Canada and the UK.

Despite the employment guarantees of the Treuhandanstalt, Germany continues to face unemployment problem. Rising unemployment and stagnant economic growth in the third quarter of 1995 in Germany was worrying policy makers. In a bid to fuel growth Bundesbank, cut interest rates by half a percent in December, taking it down to a seven year low. But analysts were not too sure that this would actually lead to a significant increase in growth rates.

The move by the Bundesbank came close on the heels of the revelation that unemployment rose to 3.71 million in the third quarter of 1995, taking up the unemployed percentage to 9.7 percent of the labour force. Orders to the German manufacturing units fell by 3.4 percent in October from September and 6.2 percent from a year before.
The Bundesbank had been under pressure from the two major political parties and major trade unions and trade associations to cut interest rates to encourage investments. By the German Central Bank move, the floor on short term lending rates had dropped to 3 percent and the Lombard rate- the emergency rate for overnight loans to banks- was cut to 5 percent. Interest rates were reduced due to weak money supply growth, slow inflation and effects of a stronger DM.

The strong DM was causing problems for German companies making its products uncompetitive in other countries. Some economists had predicted a fall in GDP in the fourth quarter of 1995 and continued weakness through 1996. Therefore, it was perceived by economists that this may not be the last time that interest rates would be reduced. That the future would not be too bright was also apparent from the agreement between industry and unions to go ahead with discussion on a union proposal for wage restraint in 1996 in return for job creation. Mr. Klaus Zurkel, leader of the IG Metall Engineering Union who had proposed the plan said that industry generate, 110,000 jobs in return for the wage freeze.\(^{18}\)

As would be expected, the unemployment position in eastern Germany remained worse than in the western part. Unemployment in the eastern part rose from 13 percent of the labour force in November 1994 to 14 percent in December 1995. Probably low wages in eastern Germany

compared to the higher wages in western Germany led East German units to register a 9.2 percent growth in order books in October 1995.

With a 4.27 million unemployed, the unemployment in Germany had reached to 11.1 percent of the active population. The employer's body indicated that high labour costs were responsible for unemployment and lack of competitiveness. In Germany, the costs of pension were shared by employers, employees and the state. For every DM 100 on an employee's wage bill the employer must pay an additional DM 80.20 in non-labour costs. These costs are divided into two categories. The first is legally binding social insurance, which includes pension, health, unemployment and a new insurance introduced in 1995 to pay for nursing care in sickness or old age. These account for DM 26.50. Employees must match the costs, which are deducted from gross salary. Then comes the cost of paying for bank holidays (DM 4.20), maternity leave (an average of DM 0.40 per employee), and accident insurance (about DM 2, to which the employee does not contribute).

The second category of non-labour costs related to the Tarifvertrag-such contracts are agreed between employers and unions in each business sector. In Germany, every branch of the economy has a different range of perks and privileges. At some quarters, it is felt that reducing overtime could add 80,000 to 90,000 new jobs in 1995 without burdening employers with extra costs. Germany's biggest carmaker, Volkswagen AG, was at the forefront of the nation's attempts to sharpen competitive edge and save jobs
through economic flexibility. Volkswagen’s work model-providing for a pay cut and shorter working hours in return for job security- is a sign of the new business climate rapidly taking hold in Germany, which in turn has placed pressure on employees to lower their expectations on an ever-rising standard of living.\textsuperscript{19}

The luxury carmaker, Porsche, became the prominent company to introduce more flexible working hours. Negotiations were also underway at Volkswagen to extend the number of Saturdays worked consequently threatening the previously sacrosanct German weekend. Volkswagen’s work force has already been trimmed by 20 percent over the last ten years.

However, it would be unwise to underestimate the Federal Chancellor’s ability to respond to the challenges in managing the critical issues, that have been passed over in legacy to the new government. These critical issues are unemployment, taxation reform, new direction to be given to the nuclear power, and also it has to ensure its lead role in the processes of European integration. Euro had been introduced in eleven member states of the EU since January 1999: this is also the date when Germany assumed presidency of the EU for six months with focus on Agenda 2000. Under the Agenda 2000 project, the German presidency of the EU has to address the issues relating to the EU institutional reforms, its eastward expansion, as well as readying the financial framework for the next seven years (2000 to

\textsuperscript{19} Bureau Report, "VW hold the key to German miracle", \textit{The Economic Times}, (New Delhi), 11.2..1996.
2006) with a view to facilitating the accession of the reform countries of Central-Eastern Europe.

The toughest problem that the new government faces relates to unemployment. For the last nearly two decades, this has been haunting the German statesmen, as well as policy-makers in the other EU member states. Indeed, this chronic problem has been a ‘cause celebre’ for the down fall of the preceding governments in Britain, France and Germany. Within the EU, this has been one of the root causes of Eurosclerosis, and in 1994, the European Commission had prepared a white paper on “Growth, Competitiveness and Employment”, and the European Council adopted several measures, which included inter-alia the high speed train that linked major cities in several member states. In 1997, the Amsterdam Treaty on European Union, obligates the member states and the EU to work towards adoption of a coordinated strategy for employment and for promoting a skilled, trained and adoptable work force.\(^\text{20}\)

Within Germany as of 1999, there were four million people unemployed. In the new federal government, Walter Ruster, former Deputy Chairman of the IG Metall, a German Engineering Works Union, had been assigned the specific task under the rubric “Alliance for Jobs”. On short term basis, it aims at providing 100,000 young people with employment. Over the long run, the prime objective is that none of the young people remain unemployed for more than six months.

Many of the constructive programmes get stuck either at the negotiations stage, or they may be stalled at implementation level where the state functionaries have a key role. Here, for our reference on the magnitude of the problem, the German statistics seem to be revealing. There were 4,823,000 unemployed in both Western and Eastern Germany in January 1998. This figure moved down to 4,455,200 a year later: this means that new jobs found in one year were no more than 367,800. If one looks at vacancies for various jobs, they increased in one year from 250,500 to 300,100. That means new jobs in one year were no more than 49,000. Here one must not forget that Germany has more than four million unemployed. Chancellor Kohl acknowledges the criticality of the problem in his statement: “We will be judged by the way we deal with this issue”. The labour Minister, Riester shows consciousness about long-term effects of this chronic problem that may be accentuated owing to the demographic change and or poverty trap that many people may fall into it on reaching the retirement age due to their prolonged unemployment. As such, it is felt that the pension system may have to be made poverty-proof.

German Unification and the European Community: Trade aspects

Immediately after the first free election in the former GDR and the decision of the people to be reunited with the FRG, the European Council in its meeting of April 1990 in Dublin welcomed German unification under the ceiling of Europe. It should be noted that the European Commission took direct part in the process of negotiation and formation of the Einheitsvertrag
or the unity treaty. Such participation enabled all three parties (the FRG, the GDR or the five new states and the EC) to formulate regulations that should not contradict the laws and regulations of the Community. At the same time, the application of the laws and regulations of the EC was made clearer for the Federal Republic. Accordingly, the provisions of transitional regulations of the unity treaty was also accepted by the EC.

Since the Unification Treaty encompasses a wide range of very different matters that also relate to the EC, the internal and external trade aspects of German unification would be discussed. This aspect is very important because some main elements of external trade of the EC member countries are transferred to the European Commission. With the unification of Germany the former GDR is also integrated into the EC from which some consequences will result to the external trade of the EC as well as to united Germany.

The internal and external trade aspects of the unification of Germany have some special characteristics which are also important for the European Community and its relations to third countries. These special characteristics are discussed as follows:

1. Intra-German trade between the former GDR and the FRG has been considered in the Federal Republic as a trade relation of a special kind. It resulted from the unsolved political situation of Germany. The FRG did not accept the GDR as a foreign country, therefore, trade between the two German states was considered as intra-German and not as foreign trade. On
the other hand, the GDR always considered its trade with the FRG as foreign trade. According to the intergovernmental agreements both countries established clearing accounts at their central banks (the Deutsche Bundesbank for FRG and the Staatsbank for GDR) respectively. Payment transaction for imports were to be exclusively transacted from these accounts. A ‘swing’ (a credit without interest charges) was arranged in order to cover balances. This special relationship of both German states was accepted by the European Community. The intra-German trade protocol provided further that:

a) the FRG should avoid damage which might be caused by the intra-German trade protocols to the other states of the European Community.

b) these states are allowed to take protective measures in case of damages that might be incurred by them due to intra-German trade.

The idea of these provisions (items 2 and 3 of the supplements to the Treaties of Rome) was to avoid imports from ‘third countries’ via GDR and accordingly via the FRG into the European market. The FRG therefore introduced a regulation demanding certificates of origin for imports of goods from the GDR. It must be mentioned further that the agricultural products of the GDR were excluded from the European market regulation for agricultural products. Although intra-German trade was accepted by the EC, the provisions of Article 2 and especially Article 3 of the protocol protected the other EC member countries from being flooded by exports from the GDR or possibly by exports from the Eastern-Bloc countries with whom the
GDR had special ties. But it should be emphasized that due to the barter-trade character of the intra-German trade and due to strict currency regulations of the GDR, there was no substantial trade from the GDR to EC member countries and hardly any re-exports of its goods through the FRG into Western Europe. The same was true for GDR’s imports from the FRG because the export proceeds of the FRG could only be used in West Germany and for barter purchases from the GDR. In fact, the Western European countries had a preferences for exporting to the former GDR because their exports were not taxed by the GDR government, while exports from the FRG to the GDR were subject to taxation. Western European countries could, therefore, supply their products—especially agricultural products—to the GDR at more competitive prices. This was the main reason for the fact that the items 2 and 3 of the intra-German protocol could not be put into force during the whole period previous to German unification. With unification neither the provisions of Article 2 and 3 of the protocol nor the regulations about the certificates of origin have survived, while the obligations of the former GDR towards third countries still exist.

The centrally planned economy of the former GDR was integrated into the economy of the Comecon countries. These were supplemented by annual protocols. Furthermore, trade agreements with a large number of countries were either multilateral or bilateral agreements. Considering the trade ties of the Eastern Bloc, some 65 percent of the whole volume of trade of the GDR (in 1989 it amounted to $58.7 billion) was with the Comecon
countries, from which 55.4 percent was trade with the Soviet Union. (Germany's eastern trade policy will be discussed in detail in the latter part of this chapter). The remaining 35 percent consisted of trade between the GDR and the rest of the world. Here again 30 to 50 percent of GDR trade volume was trade with the FRG. These figures show the relatively higher degree of integration of the former GDR within the Eastern Bloc, especially with the Soviet Union. While the GDR exported primarily manufactured products to the Soviet Union, it imported from the Soviet Union raw material and energy. For example, 100 percent of its demand for oil, natural gas, lead, wood and phosphate was supplied by the Soviet Union. Compared to any other Western European country the amount of its trade with the rest of the world was very low (only percent of world trade, while the share of the Federal Republic amounted to some 12 percent). Forty years of ties with Eastern Bloc countries and a socialist economy turned the production and export structure of the former GDR into a 'compensatory function' of Comecon. The GDR was not able to compete with any other world-market-oriented countries of Western Europe.

The unification of Germany and its integration into the European Community have undoubtedly changed the whole production and export structure of the five new states of the now considerably larger Federal Republic. The introduction of the deutschmark as the new currency in July 1990 and of the market economy initiated shifts in the production and trade of the five new German states, diverting the international trade of the former
GDR towards Europe and the West, although the years 1990-91 showed, for example, considerable decreases of the intra Comecon trade of the former GDR, based on the fact that the economy of GDR was in a phase of complete reorientation or could say reorganization. Because of experiences of the former GDR with Eastern Bloc countries and in view of the reform policies in Eastern Europe, the potential for trade of a United Germany with Eastern Europe might substantially increase, giving the enlarged Federal Republic vast opportunities for trade and investment in Eastern Europe.

With the unification of Germany and the economic integration of the five new states as part of the European Community, the provisions of the joint custom tariff of the EC toward third countries came into force. This meant, first, that the regulations and legal norms and standards of the EC as well as those of the General Agreement on Tariffs and Trade (GATT) have been extended to the area of the former GDR. Second, the five new states can no longer enjoy the zero tariff for their exports to the Comecon states as they did before as a member of the Eastern Bloc.

The goal of realizing the European internal-market forced the EC and its member countries to follow a uniform external trade policy. The aim of such a policy was formulated in the Cecchini report. It was proposed here that the trade policy of the EC countries should be such that third countries should not enjoy gains from the creation of a larger European market without themselves making concessions to the EC. However, it must be

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mentioned here that the real trade policy of the EC is mainly formed by the ideas, interests and practice of the national EC members and their institutions.

Apart from the agricultural market regulation (Europaeische Agrarmarktordnung) of the EC, which was undoubtedly a very strong protective character, in the early nineties the protective-trade policy decrees of the EC led to strong criticism of European trade policy at home as well as in trading-partner countries. The philosophy of German trade policy is 'more free trade'; free intra-European trade as well as free world trade.

As of today, united Germany has increasingly become central to Europe's economy, geography, politics as well as security. Unification has raised both hopes and fears about how the largest and richest democracy in Europe will behave and function in regard to European Unification.

Since the 1950s, the Federal Republic of Germany has been one of the strongest supporters of economic and political integration of Europe. Economically the EC offered the prospect of economic recovery and prosperity by the opening up of new markets in the West for the exports of a revived, expanding German economy by promoting cross border trade and stimulating economies of scale. Politically, memberships of economic organisations enabled Germany to regain national sovereignty, and facilitated Germany's political and moral rehabilitation. Integration provided a kind of 'ersatz' (substitute) identity to united Germany. The EC served as a framework for problem solving and as an overall frame for value
reference. The Federal Republic also profited from belonging to a greater unit since it provided opportunities to hide itself behind the others. For the west, economic integration also had a political purpose; the containment of Germany. The German problem worked as a 'federator' for Western Europe, some West European countries reinforced their efforts to West European integration in order to incorporate the enlarged Germany.

The European Community has become the most important market for Germany’s industrial products, with substantial trade benefits, and securing employment in industry and commerce. In 1957, when the Treaties of Rome were concluded, Germany exported goods worth DM 14 billion to twelve member states of the European Community. In 1992, this rose to DM 365 billion. In no region of the world have German exports risen so sharply as those to the EC countries.\textsuperscript{22} By 1990 over 50 percent of all West German exports were absorbed by the EC. Almost three-quarters of the FRG's total surplus in trade is generated by intra-EC economic transactions. The creation of the Community with a tariff-free Customs Union and a market of 322 million people was a crucial factor in Germany's spectacular rise on to the world's most powerful economic actors.

German unification has disturbed the internal balance of power, around which the European Community had cohered. From being at the heart of Western Europe, France apprehended that it would be marginalized both economically and politically as a result of Germany’s increased

significance. German unification, in fact, acted as a catalyst to accelerate the pace, enlarge the scope, and deepen the process of European integration. France was keen to bind United Germany to the European Community so that its political weight on the continent would be somewhat diluted and be manageable.

There has been mounting resentment in Germany at the inequitable distribution of financial burdens. German payments to the EU budget rose from Dm 18.4 billion in 1985 (receiving only DM 10.1 billion in return) to DM 41 billion in 1995 (leaving it as a net payer to the extent of DM 25.9 billion). Germany has been reluctant to undertake additional contributions or to accept the growth in the EC budget favored by the European Commission and the southern members states. As Germany continues to bear an enormous burden of inner-German financial transfers and the need to contain the growth in new public debt in order to remain within the convergence criteria of the European Monetary Union, it wants more out of the EU and is no longer willing to be a net paymaster. Chancellor Helmut Kohl said, "Germany is not a goose that lays golden eggs all the time". He sought a revision of burden-sharing in the EU whereby other members with per capita incomes similar to Germany should assume more of the financial responsibility than hitherto under the Union's future financial regime.

The Maastricht Treaty failed to resolve the conflicts between sovereignty-conscious countries such as the UK which hanker for a looser Union based on intergovernmental cooperation and federalists like
Germany, Belgium and the Netherlands which want faster integration and streamlined decision-making. It also failed to deal with the problem of eastward enlargement and the institutional challenges it had raised.23

Domestic criticism of the Maastricht agreements from a broad cross-section of German society was further fuelled by the Bundesbank’s criticism that the signatories failed to reach agreement on the future structure of the proposed political union which must be pursued simultaneously with currency union. There was growing feeling that Germany should not surrender control over its finances, without an adequate ‘quid pro quo’ viz, enhanced political privileges in future policy-making processes. After a long and difficult process of ratification (which lasted over two years), the Maastricht Treaty went into effect on November 1, 1993.

Some European countries (especially France) were concerned about the potential emergence of a “Teutonic bloc” comprised of German links to Croatia, Hungary, the Baltics and selected other republics. The northward enlargement of the EU and the inclusion of Austria and further enlargement could lead to shifting the weight and strength of the European Union further to Germany. [Current 15 members of the EU are Austria, Belgium, Denmark, Finland, France. Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the UK. The 10 new members that were included in 2004 are Estonia, Latvia, Lithuania, Poland, Czech Republic, Hungary, Slovakia, Slovenia, Malta and Cyprus. (By the year

23 Ibid.
2007, the proposed membership for enlargement of EU recommended includes 2 more states, i.e., Bulgaria and Romania].

Germany has been the main spokesman, supporter and initiator of the speedy integration of Central and East European States into the European Community. CEES integration in the European Union will only strengthen the overall German position in the Union. Moreover, as an immediate neighbour, it has the highest stake amongst member states of the European Union in stabilizing the volatile East Europe undergoing a difficult transition process and plagued by ethnic strife in order to offset adverse domestic consequences for itself. Germany also feels that, like previous enlargements, eastward enlargement would play an important role in shaping political values and expectations of key elite groups on liberal-democratic lines. Economically, it seeks to consolidate its privileged access to East European markets, having already emerged as the leading trade partner and major investor in most of its eastern neighbours. The European Community, as Lily Gardner Feldman points out, serves “a triple function for Germany with respect to East Central Europe: it multilateralizes the political and economic cost of influence, spreads the burden and responsibility for failure, and reduces the potential for unilateralism”.

Considerable tensions about the arrival of the euro and misgivings on the minds of the skeptical electorates have marked the European Monetary Union. There have been fears about giving up economic sovereignty in
exchange for uncertain calculations as to how the new monetary and associated institutions could limit or decrease their power as nations.

The single market and monetary union, the Germans argue are “a protective reform” of the welfare system, save German tourists about DM 2 billion in money-changing costs every year, and avoid economic losses as a result of exchange rate fluctuations (which cost an estimated several hundred thousand jobs in recent years). The Germans realize that the EU’s financial integration, if successful, could result in the largest, the most open, and the most liquid financial market in the world, surpassing those of the United States and Japan.

The belt tightening by European countries to meet the Maastricht criteria led to the implementation of unpopular and tough measures would be conducive in restoring control over wild public finances, both for its own sake and because Europe’s ageing populations are destined to impose growing financial burdens over the next few decades.

The SPD Chancellor-candidate, Gerhard Schroeder, has repeatedly warned of the “social consequences” of the decision for Europe. He argued that as long as there was no harmonizing of taxes and social standards, unemployment would escalate. He termed the European Monetary Union as a hasty process, with a sickness-prone premature birth. In fact, the inflation-phobic German electorate remains unconvinced by arguments of experts that the euro will lower prices for consumers, make European travel easier, increase pressure to lower taxes, attract more competition. The Germans are
apprehensive that the 290 million Euroland could lead to wide-scale
dislocation, higher unemployment, and resounding public discontent.

In the 1998 German federal elections, it had become very difficult to
convince an already sceptical German electorate that they should agree to
abandon the stable Deutschmark to an uncertain euro. The ruling coalition
has been arguing that there is a two-fold guarantee of stability- an
independent European Central Bank-even more independent than the
Bundesbank; and a stability pact to ensure continued compliance with the
stability criteria after the euro has been introduced. Experts suggest that this
would compel fiscal discipline since it would no longer be possible for a
country to run up budgetary deficits to avoid recession. A successful
completion of the European Monetary Union will, considerably increase
Europe’s competitiveness and would constitute the single most important
employment programme the Union can ever think of.

Several aspects of German behaviour in the 1990s have led many to
fear that Germany might seek to translate its economic prominence into
political dominance. Proponents of this view argue that Germany’s capacity
to determine monetary and therefore economic decisions in the Community
justifies the resentment of its neighbours and gives rise to worried questions
as to the ultimate motives of Germany. For the Europeans, a constant source
of anxiety is whether the self-interested policies of Germany are also good
for them.
Have characteristics of German economic strength - over one fourth of EC’s GDP (1986), one fourth of EC’s external and internal trade, Deutschmark as the most important currency within the EC, leading net contributions to the EC budgets- translated into growing political influence or hegemony? Is Germany in a position to recast the EU according to its own national preferences and priorities? Or should Germany be seen as a gentle giant, in which a United Germany and a United Europe are two sides of the same coin? Some point to how Germany has been flexing its diplomatic muscles and asserting itself. The unilateral German recognition of the breakaway Yugoslav Republics in December 1991 and the forcing up of interest rates by the Bundesbank in 1992 was perceived as a “mockery” of the proclaimed eagerness of the most federally-minded EC member to subordinate national self-interest to Community interest. Obviously domestic needs of the German economy received top priority at the expense of wider European considerations.

Historically, western integration and its institutional mechanisms have been instruments to contain German revival within a broader institutional framework based on mutual trust and interdependence. It is doubtful whether the growing German influence will culminate in dominance. The political, economic, military and cultural integration of the Federal Republic with the rest of Europe and growing interdependence preclude the imposition of German interests while ignoring those of other countries on the continent. The fears of a German Alleingang (going it
alone) or *Sonderweg* (special way) are unlikely because the intermeshing of the ECs economies would spell ruin for the Germans. Similarly, the abolition of the German mark, which is now questioned by a substantial majority of German citizens, would end German hegemony in monetary policies. Additionally, the establishment of a European Monetary Union and the European Central Bank will weaken the influence of the Bundesbank.

Frequent consultations and joint positions between the Franco-German couple have helped the Germans to avoid offending European sensitivities, and push the EC along to meet French and German demands and needs. As during the Cold War days, united Germany in the post-Cold War era will tend to view partnerships with France in order to sustain the European Union as the foundation of both its foreign and domestic policy. France is Germany’s first partner, and the quality of Germany’s relationship with France defines Germany’s successes in the European Union as a whole. In the past there was progress in integration only when they were the motor of integration. Though this motor does not yet display signs of spluttering, it remains uncertain whether Germany would be willing or able to placate France at all costs.

As the union gets bigger, the centre of gravity will drift north and the Mediterranean countries will find it increasingly difficult to grab the lion’s share of the Union’s regional aid. Distributional conflicts are likely to be accentuated because the Germans are determined to create a European financial system governed by the principles of solidarity and fair burden-
sharing as well as ensure strict budgetary discipline and to improve return flows to Germany.

It is difficult for Europeans to change their mindset and mental reservations about Germany which belong to another age. Germany powerful though it may have become, has for over four and a half decades behaved as a genuine democracy. Germany also has the highest stake in European integration. Because of its Mittelage, Germany has nine neighbours, more than any other European nation. From its very inception upto the present the European Community/European Union has been of inestimable economic and political value to Germany. It is, therefore, hardly surprising that European integration is, by and large, seen as vital to German interests. German prosperity clearly lies in Europe and its future in an integrated, united Europe.

Germany's Eastern Trade Policy

Since 1989, Germany has experienced dramatic changes in its domestic and international environments. Unification entailed the rapid, total dissolution of the GDR and generated new problems, interests and structures in the enlarged Federal Republic. The collapse of the Berlin Wall was also bound up intimately with the end of the East-West divide, which altered the international context within which West Germany had conducted its foreign policy for four decades.

Prior to 1989, West German trade policy towards the Soviet Union and its eastern satellites served larger foreign policy aims. It formed an
integral part of Ostpolitik, which sought to foster a sturdy regional détente capable of advancing the cause of unification. Although the export share of West German gross national product reached 30 percent by the end of the 1980s, the livelihood of neither the nation nor individual firms depended on trade with the East. Indeed, between 1984 and 1989, the USSR-by far the largest eastern trading partner of the Federal Republic of Germany-absorbed an average of only 1.8 percent of total German exports.

Unification did little to change Germany's national trade profile. In 1991, the share of total exports absorbed by the former eastern bloc rose to 2.7 percent - a respectable increase, but hardly enough to alter Germany's entire trade policy after 1990. So our expectations of change are confined to eastern trade policy and arise from a confluence of factors, both domestic and international. First, the ex-GDR literally was designed for trade with the eastern bloc, which meant that the economic fate of the region was inextricably linked to the fate of the eastern trade. Second, the end of the Cold War removed the security constraints on German policies towards its "natural" trading partner, Russia while elevating support for Russian political and economic reform via international trade into a primary German objective, one that would contribute to European security and stability. Finally, the relatively modest volume of eastern German trade with Eastern Europe and the Soviet Union, coupled with its highly idiosyncratic character, meant that Bonn policy makers could entertain interventionist trade responses without necessarily provoking political opposition from
exporters in western German or other European Community member countries, because assistance to eastern firms would not directly harm their economic interests.24

Germany’s heightened stake in eastern trade translated into a growing likelihood of greater trade interventionism towards the region. Yet, in the face of an unexpected and steep decline in the volume of trade with the former Soviet Union and Eastern Europe, the unified German government rejected calls to intensify its efforts to assist export firms in the former GDR. This decision, announced in the fall of 1992, underscored that a mere 2 years after the merging of the two Germanys, eastern trade policy would eschew interventionism.

Unification altered the prevailing constellation of trade interests as well as parliamentary - electoral institutions in Germany, which combined should have generated powerful demands for an interventionist trade policy after 1990. However, we must also document that the events of 1989 to 1990 left untouched the dominant ideas that governed the West German political economy, as well as the institutions – some lodged within the federal bureaucracy and others at the international level-linked to those ideas.

The collapse of the Berlin Wall and its tumultuous aftermath ushered in many dramatic changes, particularly in the realm of interests and institutions, but left a key ideational –institutional nexus largely untouched. The preferences of domestic actors vary systematically with the degree to

\[\text{Ibid.}\]
which they benefit from the international economy, and their preferences influence politics and policy outcomes predictably. Internationalization affects domestic actors through changes in transaction costs and relative prices. For East German enterprises confronting the shift to a market economy, unification entailed the introduction of the Deutsch Mark, foreign trade with eastern Europe in hard currency, and exposure as well as access to West German and global markets.

For firms in the former GDR able to produce internationally competitive products, transaction costs would be lower after 1990. Such firms could be expected to prosper in an economic environment free of the complex bureaucracy and rigid exchange rate mechanisms of the communist era trade system and consequently would place few demands for assistance on the government. Lower transaction costs do not necessarily accrue to all economic actors, however. For most eastern German firms, the new economic parameters brought many outright disadvantages. Firms that exported primarily to markets in the Soviet Union would suffer from hard currency and floating exchange rate transactions because their customers did not have easy access to such payment options.

The impact of changes in relative prices on the interests of eastern German manufacturing industries turned on two factors. The first is the structural dependence of eastern German export industry on Soviet markets, which ranged between 70 percent and 90 percent for the typical firm. East German foreign trade, the bulk of it conducted with its Council for Mutual
Economic Assistance (CMEA) partners, contributed 28.9 percent of gross domestic product in 1989. East Germany exported 76 percent of its fishing vessels, 68 percent of its passenger rail cars, and 84 percent of its cranes to the USSR. Although these and other goods made in the GDR could be sold in western Germany or on world markets after 1989, most were below world standards and, because of substantial subsidization by Soviet purchasers, priced well above their actual value in those markets.

The second factor is the level of asset specificity among eastern German firms. The capacity of economic units, whether enterprises or individuals to respond to shifts in relative prices depends on whether their assets can be shifted into other economic activities. The challenges generated by asset specificity will vary from the impossible (e.g., coal mines are useful to coal production alone) to the costly or difficult (a highly specialized labour force can be retrained) to virtually costless (financial capital can be easily reallocated). Normally, it is expected that units resist responding to market forces and relative price changes the more specific their assets are, because the costs of reallocation are likely to be greater than the costs of political action.

In eastern Germany, asset specificity for many enterprises was high. Socialist production there revolved around enormous, highly integrated and specialized industrial conglomerates (kombinate) that were ill-equipped to respond flexibly to market signals. Decades of under investment left eastern Germany with aging and technologically backward production facilities that
would require massive infusions of capital to bring the region up to world standards. Finally, long-standing trade dependence on Soviet markets caused eastern German firms to adopt production methods tailored specifically to the oftentimes unique demands of Soviet purchasers. As such, kombinate management, their employees, trade unions, and regional governments in the former GDR could reasonably be expected to develop a strong common interest in trade policies designed to address these manifold economic vulnerabilities.

The Bonn government had a clear, strong foreign policy interest in sustaining the export capacity of the eastern Laender, because this would ease the difficult economic and political transition in the eastern bloc, above all in the former USSR. The GDR was the Soviet Union’s foremost trading partner, especially in capital goods. The interest was reciprocal; by maintaining eastern German-Soviet trade ties after 1990, Moscow hoped to create a basis for expanded trade with the most powerful and influential country in Europe and to acquire access to international markets despite its as-yet nonconvertible ruble.

Bonn also had a domestic stake in supporting East German export industries, in light of the numerous promises made during the 1990 election campaign about the largely costless, painless and brief adjustment period awaiting citizens in the eastern region. These commitments were sealed by the federal election held on December 1990, in which Kohl’s governing coalition polled 56.8 percent of the vote in the former GDR, as compared to
54.7 percent in the old FRG. The coalition parties posted a majority of 134 in the lower house, with the eastern region contributing 92 seats. With this result, the new Laender established themselves as a new and important electoral market for the ruling party as they sought to maintain their grip on national power into the next century.

Germany's trade policy towards the former Soviet bloc (Osthandelspolitik) sought to promote liberalization in eastern Europe and the USSR. Bonn concluded separate treaties with the principal countries in the region to create the basis for future cooperation in the areas of cultural exchange, the environment and trade. In marked contrast to the preunification period, however, general foreign policy goals now shared the stage with domestic economic concerns in driving German trade policy towards the East. To shore up bilateral Soviet trade with the GDR, the federal government responded on several fronts. For example, it agreed to maintain CMEA's "transfer ruble" mechanism in 1990 and deferred claims for payment on the pre-1990 transfer ruble account balance of DM 1.7 billion owed to the GDR by the Soviet Union. Furthermore, at Bonn's request, the EC approved derogations to the common external tariff for existing export contracts from the CMEA countries to the former GDR. Bonn also provided DM 2 billion to eastern German firms in 1990, much of it prior to formal unification, to enable them to meet preexisting contractual obligations with CMEA purchasers.
Post unification, the federal government opted to rely on an existing instrument to support trade between the USSR and the new Laender: Hermes, the federal export credit insurance programme created in 1949 to assist West German firms in securing a foothold in world markets. Hermes is administered by a state-backed agency, Hermes kreditversicherungs-AG, which reimburses commercial loans for exports in the event of a purchaser default. It was designed not to serve as a general export subsidy; coverage is legally proscribed if there is a high probability of default. In comparison to other state-run programmes in Europe, Hermes operated "more on the principles of laisser-faire and subsidiarity".25

The decision to apply an old instrument to new challenges was preceded by ministerial debates between late 1990 and early 1991. Those in favour of Hermes stressed three arguments. First, Hermes had an established, proven track record. Second, it could function as a mechanism for maintaining trade with the USSR during the transition period, because the USSR did not yet have the requisite hard currency reserves to finance unassisted trade. Finally, it would stabilize export-dependent jobs in the new Laender and provide firms located there with a stable source of revenue that could be used to support their eventual and essential shift into western markets— all without adding to government budget outlays.

Opponents of Hermes argued that the risk of Soviet default was increasing and that the approach would lock in pre-1990 trade linkages.

between the former GDR and the CMEA region, thereby retarding structural economic transformation both at home and abroad. These officials floated several options, including a package of tied export credits that was rejected because of projected costs and the need for EC and OECD permission, which was considered highly unlikely.

Confronted with Hermes as the only available trade option, opponents countered that it would be better to abandon export credit guarantees and pump resources directly into eastern German firms, the vast majority of which remained under Treuhandanstalt control. This sectoral approach also met with widespread opposition in ministerial circles, because this would have required the government to reverse its commitment to rapid, market-oriented privatization.

Hermes was subsequently modified to suit the needs of eastern German firms and their potential customers in the USSR. After formal negotiations with the OECD and informal consultations with the EC Commission, Bonn secured permission to implement a set of special conditions, for which only applications submitted by eastern German firms seeking export contracts with Soviet purchasers during the 1991 calendar year were eligible. The conditions consisted of generally easier insurance terms, including a waiver of the deposit requirements for Soviet purchasers and longer amortization deadlines. Bonn expressly declined to ask for a geographical extension of the special conditions to cover the whole of Eastern Europe, for fear of undermining the prevailing OECD regime.
governing export subsidies. In fact, the Bonn government was quite content with the outcome, as it appeared both to rescue eastern firms and to establish a long-term basis for trade with Russia.

From 1991 to 1992, the total value of exports to Eastern Europe and the USSR /Commonwealth of Independent States (CIS) guaranteed by Hermes rose by more than 160 percent to DM 11.2 billion, or 29.6 percent of total Hermes coverage in 1991. DM 5.9 billion in exports came from eastern German firms, the bulk of which was destined for Russia. Some of the DM 20 billion in special Hermes guarantees was not disbursed in 1991, and the money was carried over into the next year. At the same time, however, unanticipated shortcomings in the Hermes approach began to appear. First export markets in the former eastern bloc deteriorated rapidly, especially in the Soviet Union, leaving many eastern German firms floundering. Between 1990 and 1991, total exports from eastern Germany to the USSR fell by 49 percent; in some product categories, the decline approached total collapse. Second given their new access to world markets, Russians often chose not to use precious hard currency to buy east German goods.²⁶

Hermes offered no subsidies or grants to Russian importers, which translated into weak incentives for them to rely on established trade relations with the former GDR. Although the Russian government may not have wanted ex-GDR “junk”, it remained very interested in maintaining trade ties with Germany, both for economic and foreign policy reasons. By early 1991,

²⁶ Ibid.
eastern German industrial production had fallen to one third of its 1989 level and continued to decline over the course of the calendar year. In December 1991, the unemployment rate in the new Laender reached 12 percent, and a further 12 percent of the labour force was on some kind of part-time work.

In the midst of these changing parameters, Bonn ministries considered suspending Hermes assistance for CIS trade but rejected this option in January 1992. Instead, the government decided to place a DM 5 billion cap on export guarantees in 1992, with each individual credit guarantee limited to DM 100 million. Eligibility was restricted to former Soviet Republics that pledged to assume responsibility for the international debts of the USSR, a condition that excluded Azerbaijan, Ukraine, Uzbekistan and Georgia. At the same time, the government strengthened the domestic rationale for the overall policy approach, 95 percent of the credits were reserved for eastern firms. Only those eastern firm with solid, long-term economic prospects were to be considered, any western German firms applying for assistance had to document that their supplier firms hailed predominantly from the eastern provinces.

In contrast to the situation in 1990 to 1991, the economics ministry could point to a solid coalition of support for Hermes among public and private actors in the eastern Laender, comprised of the management and trade unions in key export firms, the treuhandanstalt, and local and state governments. This coalition stressed the dire consequences of a complete breakdown in German -CIS trade, which was estimated to support upto
700,000 jobs directly in the new Länder. At this juncture, the Treuhandanstalt had in its possession more than 5,000 firms, many of them large employers almost wholly dependent on CIS contracts. For example, Sket, a machine tool manufacturer announced it would lay off 80 percent of its 5,100 employees if contracts from the CIS were not forthcoming.

In response to the precipitous decline in exports to the former Soviet republics, economic dislocation in the eastern Länder, the federal government announced in 1992 midyear that it would undertake a thorough review of trade policy towards the East. The need for action was all the more pressing as eastern German firms, despite the blockage of Hermes guarantees, continued to produce goods on the assumption that trade with the CIS would eventually resume. Inventories by early September had reached a level equivalent to half a year's production. The review proposals included the following:

a) debt-equity swaps, in which the CIS countries would mortgage raw materials against immediate deliveries of manufactured goods from eastern German firms,

b) liquidity assistance from the Treuhandanstalt to cover exports to the CIS for which payment was promised but not received,

c) a ruble fund, into which CIS purchasers would deposit payments for eastern German exports- Bonn would then use this fund to finance German direct investment or joint ventures in these countries and compensate eastern German firms in DM via indirect federal payments,
d) state supported "clearing houses" which would purchase inventory stocks from eastern firms and sell them on eastern markets for what they could bring, and
e) the classification of some or all of the CIS as developing countries, which would enable Bonn to access budgetary sources heretofore off-limits.

Hermes was also on the review agenda, in the form of proposals to reintroduce the 1991 special conditions, to extend coverage to include eastern German exports to western markets, as well as to introduce greater flexibility by making barter exchange and other types of transactions eligible for export credit guarantees.

Given the crushing political pressures for a governmental response to the mounting crisis in the former GDR, Chancellor Kohl had declared the issue of Osthandelspolitik or eastern trade to be a matter of utmost priority for the government in light of the economic crisis in the new Laender. He announced that the government would employ the Treuhandanstalt to maintain the industrial core of the former GDR's economy, even if this meant that unprivatized firms might spend several years under public or para-public tutelage as they were prepared for eventual sale.

With respect to trade instruments, Bonn announced that there would be no increase in the Hermes budget at that time, because of DM 1.8 billion of the original DM 5 billion had not been used up. Existing Hermes guidelines were modified to include barter exchange, and certain guarantee
deadlines for the CIS countries were extended into 1993. The government also encouraged private trading or clearing houses to get involved in moving the growing inventories of eastern firms. An industry-supported clearing house was set up in 1994 to facilitate barter exchange between German firms and producers in the former Soviet Union. The main impetus was perceived inadequacies in the Hermes programme.

After 1992, the share of the annual Hermes budget for the CIS declined steadily. The government budgeted DM 4 billion in 1993 and DM 3.5 billion in 1994 (DM 2.5 billion for Russia and DM 1 billion for the rest of the CIS). By 1996, the annual budget had dropped to DM 2.3 billion. The government also adopted a more cautious approach to applications for Hermes assistance from eastern German firms in light of the mounting default by CIS purchasers and the overall level of federal liability for insured contracts with this region, both of which reached levels unprecedented in the 40 year history of the programme.

By opting for a sectoral solution, the government chose an approach that was in the end at least as expensive and probably more so, than a continuation of pre 1992 eastern trade policy. Western firms contributed to the eventual policy outcome by vigorously opposing any change in German policy that might threaten the international trade order and its liberal norms.