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Currency Union and Economic Reform in the GDR: a comprehensive one-step approach

CONTENTS

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by

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GERMAN UNIFICATION AND EUROPEAN UNITY

INTRODUCTION

In the agitated discussion of German unification, a great deal of attention has been focussed on the Two and the Four, and rather less on the Twelve. This is unfortunate. Firstly, because the EC has a very important role to play in the process. Secondly, because contrary to widespread belief, there are strong grounds for thinking that, far from being a danger to the EC, German unification will highlight its profile and status and strengthen its institutions.

The principal reasons in favour of this argument are not to be found simply or even mainly in the often repeated assertions of German political leaders that there must be a close connection between the two integration processes, or the obvious appeal to Germany's partners of a strong Germany safely locked into the EC. Rational arguments can after all be swept aside by emotional events. The grounds for believing that they will not lie elsewhere: in the increasing autonomy and robustness of the EC institutions and in the emergence over the last twelve months of a complex schedule of inter-related negotiations which seem highly likely to re-enforce this autonomy and robustness.

INSTITUTIONAL AUTONOMY AND ROBUSTNESS

The institutional point has both a formal and a dynamic aspect. Formally, the European Community has been from the beginning about the pooling of sovereignty. It is not therefore, like NATO or the United Nations, a voluntary association of sovereign states, but an independent political entity, with its own laws, which once adopted supercede the separate laws of the states, and its own institutions, which, within the areas defined by the Treaties, override the autonomy of member governments. Withdrawl from the integrated command structure of the Alliance is, as the French proved in 1967, relatively straightforward. Secession from the Community by an independent minded Germany would be exceedingly complex, if not impossible.

This legal position has an immediate bearing on the present day debate about Germany's Eastern frontier. The issue is of course, at one level, a matter for the Germans. It is also, however, a matter for the EC, since the frontiers of the new Germany will *ipso facto* be the frontiers of the EC. As it is utterly inconceivable that the Eleven would agree to any modification, whatever the pressure from the new Germany, they have in effect a veto. This should provide additional comfort to the Poles: it might also be useful to Dr. Kohl in his dealings with the German Right, since presumably only the lunatic fringe would contemplate a break with the EC.

Given the current drama surrounding the frontiers issue, this formal point is important. The dynamic aspect of the relationship between member states and the EC is, however, arguably even more important. The German question has come to the fore just as Single European Act Europe came into its own. Two features of this new Europe are particularly relevant in the present situation:

- The growing complexity of its political system, which renders simpliste notions of national sovereignty rather absurd.
- The increasingly high international profile of the European Community institutions.

The Single European Act, through its re-introduction of qualified majority voting and its extension of the powers of the European Parliament, transformed the political system of the European Community. Once the principle of majority voting was accepted in certain key areas of Community business, the practice spilled over into others. National interests are, it need hardly be said, still fiercely fought for, but with the virtual abandonment of the veto, there has been a marked tendency across the Community agenda as a whole to temper unilateral initiatives and ambitions to the prevailing wind. No one state dominates; no one state can block. It is difficult to see how a united Germany, augmented by the addition of sixteen million citizens, but without, almost certainly, any increased voting power in the Community institutions, can buck this trend. Leadership is one thing: dominance quite another.

The moderation of national ambitions in the more robust, majority-led Community has had a major influence on the emergence of another phenomenom: the increasing autonomy, not only of the Commission, but also of the Council. Over the past few years, and still more over the last few months, there has frequently been a striking contrast between what is said and decided at Community level and what is said, sometimes by the same ministers, back in their member states.

The phenomenom is probably best illustrated for present purposes by the Foreign Ministers, who meet at least once a month, and usually more, in the General Affairs Council and other special gatherings. Since the last quarter of 1989, there has by all accounts been a group dynamic, unaffected by the change from the presidency of a major EC state to the presidency of a small one, which has made the apparent choice between widening and deepening, so frequently discussed outside, seem academic and irrelevant. With the possible exception of the British Foreign Secretary and, on occasions his Dutch colleague, whose performance is variously described as curious or perverse, all those involved, including Mr. Genscher, seem to take it for granted that German unification, which is inevitable, not only must, but also will, be accompanied by a further strengthening of the European Community. Back in the national capitals, however, the tone has often been very different.

It might be tempting to dismiss this contrast between the consensus at Community level and the fragmented national debates as little more than of passing interest: a case of "hot air" at high level, which has little to do with the real world of everyday. This would almost certainly be the reaction of most of the serious political commentators around the Community, who precisely because they are based in national capitals, and as such are remote from the day to day operations of the Community, attach more credence to the actions of those whom they can see and hear rather than those who operate in a European stratosphere. Three years ago, they would probably still have been right. In the new situation, however, the autonomy of the Community institutions has far greater operational significance.

This change is partly a consequence of the general enlargement of the Community's powers that followed the Single European Act. It is also, however, a result of pressures in the international system. In Moscow and Washington, Stockholm and Tokyo, Europe's principal partners have shown a marked preference for dealing with the EC as such, rather thanwith its individual components. The transfer of sovereignty already sanctioned by the Treaties, has in other words been accelerated by growing international recognition, particularly since 1988. London, and more particularly Mrs. Thatcher, probably know more keenly than anybody else the practical consequences of altered attitudes by special relations.

THE EC'S NEGOTIATING AGENDA AND ITS DYNAMIC IMPLICATIONS

Just how significant and demanding the Community's external responsibilities now are can be ganged if we consider some (and by no means all) of the important negotiations which the EC as such will be involved in over the coming months;

Six sets of negotiations are particularly significant in the present context :

- The settlement of the German question itself. The immediate significance of the EC's formal stake in the definition of the new Germany's external frontier has already been remarked upon. It is, however, only one aspect of an extremely complex list of issues that will have to be discussed between the two Germanies and the Community institutions. Nobody seriously doubts that East Germany will be "absorbed" rather than "admitted" into the Community. There will, even so, be important questions, such as the implications for the Community budget, the extension of the Common Agricultural Policy to an area which was traditionally crucial to German agriculture and the arrangement of "transitional" regimes, affording East German industry a measure of temporary protection, which will endow the negotiations with many of the characteristics of a formal enlargement.

For that reason, it cannot be stressed too often that "initiative" does not only lie with the Germans themselves. On the contrary, the demands of the Eleven, mediated via the Community institutions, could be a factor of some importance in the adjustment process. So too, incidentally could a well timed and imaginative gesture of generosity by Germany's partners.

Whichever course is chosen, the EC will loom large in the consciousness of the Germans as they re-unite. It is for this reason fortunate that the Bonn-Brussels axis, which has arguably been even more important since early 1988 than the Bonn-Paris axis as a motor of European integration, is basically in such good shape. At a personal level Jacques Delors is the preferred confidant of both Dr. Kohl and Mr. Genscher. These personal relations are, however, backed up by an increasingly complex and effective system of contacts between the Commission and the Bonn administration. The Council Secretariat, COREPER and also the Parliament consolidate the link still further. The significance of this "special relationship" seems certain to increase rather than diminish over the coming months.

- <u>EC-US discussions of a "new relationship"</u>. The EC has taken the Bush administration's invitation to work out a "new relationship" rather seriously. The matter was discussed at some length in separate meetings in February between Chancellor Kohl, Mr. Haughey and the President. It may be too early to envisage a new Treaty, but the ministerial meetings between the two sides in April and the European Council meeting in June seem certain to register advances in terms of procedure and possibly even of substance.

  Once again, the long term implications are far reaching and profound. Presumably nobody will in the negotiations themselves speak of a re-negotiation of the North Atlantic Treaty. It is obvious, however, that if the EC and the US agree to enhance the political dimensions of their relationship, it must over time affect discussions about the future of NATO itself. Yet again the complexities of the "German problem" seem likely to act as a stimulus rather than a brake.

- <u>EC negotations with Eastern Europe and the Soviet Union</u>. The EC's role at the centre of the group of Twenty-Four and the growing complexity and depth of trade and cooperation agreements with the Eastern European states and the Soviet Union have projected the Community as such into a central role in East-West relations. The negotiating agenda over the coming months is still more hectic than hitherto. Its course will doubtless be influenced by what happens in the centre of Europe: its outcome, both directly in the redefinition of relations between the Community and the countries concerned, and indirectly through its impact on the EC's profile and status will profoundly affect the environment in which the new Germany operates.

- EC-EFTA relations. Formal negotiations between the EC and EFTA have already been agreed upon at the joint ministerial meeting in December 1989. The pre-negotiations in 1989 uncovered a whole host of difficult, institutional and legal problems that still have to be sorted out, and it may be that a final outcome to the negotiations will be arrived at later than public opinion in several of the EFTA countries believes or wants. There is little doubt, however, that there will be a conclusion, and that yet again the central focus of attention will be on the Community itself as the major political actor, in a volatile Europe.

- The CSCE process. The exact scope of the CSCE Summit later this year is still a matter of discussion, but it is already apparent from recent meetings of the EC Foreign Ministers, not to mention the practical planning of the Commission, that the EC leaders have every intention of exploiting the extra leverage that their collective power gives them. If, as we have suggested earlier, the Community's standing in the German issue has by then been unequivocally established, and progress continues along the other negotiating tracks, there seems little doubt that this new CSCE round will be even more notable in the "political integration" of the European Community than the first Helsinki process in the 1970s.

- Treaty Revision within the EC. The decision to establish an inter-governmental conference has already been taken: its agenda is still to be negotiated. It will certainly include Economic and Monetary Union, but it would be very surprising if it did not accumulate additional dimensions, including in particular an extension of majority voting, an enhancement of the political accountability of the executive, and a strengthening of the Community's capacity to act in the international system. This broadening of the agenda would probably have occured even if the Berlin Wall had not come down: the fact that it has, makes the extension likelier still.

All the negotiations referred to above are significant in their own right. They will not, however, develop in isolation. On the contrary, they will feed on each other, interact with one another and eventually merge in what is to all intents and purposes a redesigning of the European political architecture and a redefinition of the Community's role within it. It has always been difficult if not impossible to slow down one negotiating train when it has left the platform: to put the brakes on six will defy the ingenuity of even the most tenacious defenders of national sovereignty, whether in the UK, or France, or Germany or indeed anywhere else.

SEIZING THE INITIATIVE: SOME PRACTICAL CONSEQUENCES

The links between German unification and European integration analysed above constitute a solid base for optimism. It would, however, be foolish to be complacent.

The EC needs to seize the initiative while it has the chance. Four points merit particular attention :

- <u>The limited significance of "independent" national policies and politics</u>. The point is relevant to observers no less than actors. It would be rash to claim that what goes on in national capitals, and more particularly in the larger ones, is absolutely irrelevant, but it does seem clear that the autonomy of the Community institutions, including the Council, should be taken more seriously when trying to assess where the Community and Europe are going.

  The point has even more relevance of course to policy-makers themselves. Despite the emotional and bruising controversy within Bonn and between Bonn and some of its partners over the Polish frontiers, all the evidence suggests that the German government needs little lecturing on the main issue. Its leaders have preached the connection between the two integration processes: they have also practiced it, as the growing contacts between Bonn and Brussels in the past few months prove.

  Elsewhere, the picture is more confused, and no where more so than in Paris and London, where reminders of their former status as great powers through the revival of the Big Four machinery have further stirred up waters that were already rather muddy. In Paris, there have been more than a few hints, coming out of the Elysée itself, that a revival of the old special relationship between Paris and Moscow should be considered a serious option. There have also been calls for strong relations with the other "Western" capitals. Fortunately, however, the French still instinctively think in terms of the European Community as the appropriate framework within which to safeguard their national interests, and their actual behaviour within EC fora has therefore been much more European and realistic than the rhetoric at home might suggest.

  The same, unfortunately, has not always been true of Britain, whose government looks increasingly like the Archie Rice of the international community, aspiring to roles long since beyond its capacity, to the considerable embarrassment of its friends and the general impoverishment of the international scene. As one senior Community official observed last week: at precisely the moment when the European Community most needs the resources and experience of what is still one of the best diplomatic machines in the Western world, the diplomats involved are totally preoccupied with an uphill struggle to keep Britain in touch with the action.

Marginalisation is no longer simply a theoretical possibility: it is a daily reality.

- The need to enhance the Community's capacity to act externally. The whole drift of the argument so far has been that the opportunities for the EC acting collectively in the new situation are incomparably greater than those of any member state acting separately. This makes the need for urgent attention to the actual functioning of the Community's management of its external relations all the greater. Ambassador Froment-Meurice and I recently discussed this question in a report on **European Foreign Policy**. Of the proposals advanced in our report, three are worth emphasising:

  - The need for a major stengthening of the personnel resources of the Community institutions. As we stressed, this should be an occasion for greater rather than lesser cooperation between the Commission and national foreign ministries. Whatever solutions are adopted, however, the need becomes greater by the day.

  - The importance of forging an ever closer link between the external policies of the European Community under the Treaties and European Political Cooperation, which is still inter-governmental in character. In practice, events are pushing the Community far further in this direction than we would have dared to hope when we wrote our report three months ago. There is, however, still a need to consolidate and formalise the linkage. Some measures can be pushed through short of Treaty Revision: the inter-governmental conference offers, however, an ideal opportunity to perform the task even more effectively.

  - The advisability of more frequent meetings of the European Council. Brussels insiders still profess some distaste for this proposal, which is also resented by Foreign Offices, who dominate the General Affairs Council. In a period such as the present, however, when so much is at stake, it is vitally important that those with the highest responsibilities in the member states should be more actively involved in the Community's decision-making process. It is important for at least two reasons. They can deliver. They can also learn. The view from the top, as European Council meetings of the past few years have repeatedly demonstrated, is significantly different from the one that Prime Ministers normally live with at home.

- The European Community's opportunity for constructive and imaginative statesmanship vis-à-vis the new Germany. Previous paragraphs have emphasised the leverage that the Community has in the German unification process. It exceeds that of any other group, including the Four

Powers, NATO and the Warsaw Pact. It should be exercised. It is, however, to be hoped that it will also be tempered by imaginative magnanimity. German unification will be costly. It will also, in the medium to long term, stimulate growth throughout the Community. The period of maximum costs offers the Community an opportunity for an imaginative gesture, which can only realise dividends in the subsequent period of greater prosperity.

- <u>The paramount importance of greater political accountability in the European Community</u>. This article has highlighted the relative weakness of national governments and the increasing strength of the Community institutions. It has, in other words, provided yet another demonstration of the inadequacy of democratic controls and political accountability in the Community. The solution cannot be found in futile efforts to claw back powers that have already been lost. It must be sought in the strengthening of control systems at Community level itself. Even if we are not yet mature enough for Federation, the inter-governmental conference must surely address issues such as the extension of majority voting, a parallel increase in the cooperation procedures with the European Parliament, and the political accountability of the European Commission to both the Parliament and Council.

To sum up. If, instead, of interpreting the future through backward looking lenses, both the EC and Germany seize the manifold opportunities provided by the EC framework, German unification should prove not a menace to the European order, but a catalyst of change for the better. The Four Powers have no more than a residual role, which they should have accomplished well before the end of this year. The Community, by contrast, has an obvious vocation as the cornerstone of the new Europe.

The special European Council meeting in April offers an ideal opportunity to demonstrate the EC's strength and relevance. The Council conclusions will almost certainly include lofty declarations on both German unity and European unity. If, in addition, the Council could agree on two practical measures, a major turning point would have been passed. The first would be a decision to extend the agenda of the inter-governmental conference to cover institutional issues and foreign policy. Speeding up of the process would also be welcome, but the substantive issue is the most important. The second practical step would involve a pledge from Germany's partners that they are ready to share a part of the cost of the unification process, both through the ordinary operation of Community policies in a poorer region, and by the setting aside of a significant, symbolic sum for special assistance.

Currency Union between East and West Germany: what should be the conversion rate?

by

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1. Introduction

A monetary union between West and East Germany now appears to be unavoidable. According to some economists, (Gros and Steinherr[1] for example), it is also desirable as a strategy to quickly integrate the GDR into a market economy and to raise the level of economic welfare in that country.

Many economists will dispute the view that instantaneous monetary union is a good strategy for economic integration of so widely different countries as the GDR and the Federal Republic[2].

The wisdom of a shock therapy using the currency as an instrument remains in doubt. Since the political decision to go ahead seems to have been made, the practical question that has to be solved concerns the conversion rate at which the DM will be introduced in the GDR.

A political momentum appears to have been built up in favor of a conversion rate of 1 : 1. (Some top officials from the Bundesbank are known to have come out for the the conversion rate of 1 : 1. See also, Gros and Steinherr who propose the same rate for current

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1. See Daniel Gros and Alfred Steinherr, "Currency union and economic reform in the GDR. A comprehensive one-step approach, mimeo, 1990
2. See Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, Zur Unterstützung der Wirtschaftsreform in der DDR : Voraussetzungen und Möglichkeiten, Sondergutachten vom 20. Januar 1990.

transactions[3]). These proposals seem to have been based on simple calculations of unit labor costs. Labor productivity in the GDR appears to be about half of labor productivity in the Federal Republic, whereas the average wage level in the industry of the GDR is only 40 % of the West German level. Thus at a conversion rate of 1 : 1 the unit labor cost of the GDR would still be below the West German level (about 20%).

This simple calculation is extremely misleading when comparing two economies that are structurally as different as the GDR and the Federal Republic. I want to concentrate on two issues here, that have to be analyzed before one can be confident that the simple calculations of the unit labor costs give a true picture of the competitive position of these two economies.

2. Differences in quality of goods.

The long lines of "Trabants" that have recently been seen on West-German roads have dramatized the substantial difference in the quality of goods produced in the two Germanies. The quality of such goods as cars, consumer durables, machinery (typically traded goods) produced by the GDR appears to be a fraction of the quality of West German products. This raises a serious problem with the

3. These authors also propose a different rate (1 : 2) for conversion of financial assets. The rate at which financial assets are converted raises special questions. Some of these questions are discussed in section 6.

productivity measures we use. These productivity comparisons tell us that when one East German worker produces one car (a Trabant) a West German worker produces two cars (say a VW Passat). Since the East German worker receives only 40 % of the West German wage, the Trabant would be cheaper (approximately 20 %) than the VW Passat at a conversion rate of 1 : 1. It seems clear however that given the low quality of the Trabant, the long delivery time, etc. few if any of these cars will be sold after M-day (the day of the introduction of the DM in the GDR).

This quality problem appears to be a very general one, especially in the traded goods sector. In order for unit labor costs calculations to make sense they should be corrected for quality differences. I am afraid that these corrections will make clear that vast portions of the tradable goods sector of the GDR will not be competitive at a conversion rate of 1 : 1. The result will be that on M-day these sectors will be wiped out almost at once if a conversion rate of 1 : 1 is used, producing a shock wave in the labor market. Since M-day is supposed to happen this year (1990), the investment plans by West German firms will certainly not be in a far enough phase of realization to absorb the unemployed.

A much lower rate for the Ostmark (for example 1 : 2 or 1 : 3) will in my opinion be necessary to give the East German products enough price competitivenes to offset the unfavorable quality difference. This will also give the East German economy some temporary "protection" against imports from West Germany, and soften the blow that is likely to occur on M-day.

3. <u>The distorted structure of relative prices in the GDR.</u>

The previous problem of quality differences is aggravated by the distorted price structure in the GDR. A general pattern seems to be that tradable consumer goods (e.g. cars, refrigerators, TV-sets) are priced two or three times higher than the same goods in West Germany (using a rate of 1 : 1 to convert East German prices into West German ones). On the other hand basic necessities (basic food products) and services such as housing, public transportation, education are cheaper in the GDR than in the Federal Republic (see the statistical appendix to the Sondergutachten of the Sachverständigenrat, op. cit.). This suggests that the relative price of tradables versus non-tradables in the GDR is much higher than in the Federal Republic.

The implication of this distorted price structure is the following. First, monetary union will suddenly force the relative price of tradables to decline substantially in the GDR. This will increase the demand for tradables in the GDR. This increased demand is almost certainly to take the form of increased imports from West Germany. At the same time East German firms producing these tradables will be confronted by a substantial decline of the price of their products. The wage they pay their workers may become too high given this unfavorable price development.

To the extent that the high prices of tradables in the GDR observed today are the result of indirect taxes, however, producers will not suffer directly from the reduced prices of their products. In that case it is the East German government which will loose part of its revenues.

A conversion rate of say 1 : 2 may provide a shock absorber to allow the East German economy to weather the shock wave that will inevitably follow the introduction of the DM into the GDR.

There is a second implication of the distorted price structure in the GDR : It makes the comparison of the GDP statistics in the GDR and in the Federal Republic hazardous. These statistics show that today GDP per capita in the GDR is about half the GDP per capita in the Federal Republic. This is sometimes used as evidence that productivity in the GDR is half of the West German level. (see Gros and Steinherr, p. 7). If, however, one would evaluate the GDP in the GDR using the West German price structure (which one should do, because that is what the market will enforce on M-day), it is very likely that the East German GDP is significantly lower than the published one. It should be noted that this is also what one finds in developing countries that have very high levels of protection of domestic industries.

4. The conversion rate and the wage dynamics

The structural differences between the GDR and the Federal Republic make it very difficult the estimate the equilibrium rate at which the conversion should be performed. In the long run the choice of the conversion rate should be immaterial since wage and price changes will adjust automatically and will validate whatever choice has been made. Whatever we do, in the long run the real wages will have to reflect productivity levels. In the short run, however, different choices of the conversion rate are of great importance and may lead to drastically different dynamic developments.

In the previous paragraphs it was argued that a conversion rate of 1 : 1 is likely to be an overvalued rate (of the Ostmark). Such an overvalued rate will lead to deflationary pressures in the GDR which will manifest itself in a strong increase in unemployment and a downward pressure on the East German nominal wage level. This downward pressure on the East German wage level can then only be mitigated by generous unemployment benefits financed by the Federal Republic.

A different strategy consists in choosing a conversion rate that undervalues the Ostmark, for example, 1 : 2. This will change the nature of the wage and employment dynamics in the GDR. In this case there will be upward pressure on the East German nominal wage level, and the unemployment problem will not be as severe. Ultimately this strategy will lead, as in the previous case, to a situation where the real wage level in the GDR reflects the prevailing productivity levels (which today we find difficult to measure). The dynamics of the adjustment process, however, is likely to be more comfortable in this case than when we start with an overvalued rate.

In addition, the introduction of a monetary union with an undervalued rate is more likely to be successful in stopping the emigration from the GDR than when one starts with an overvalued rate. In the former case we introduce a dynamics with a low real wage at the start and increasing real wages thereafter. In the second case we start with a high initial real wage and a downward pressure thereafter. Since the emigration is most likely to be determined by future expected income and employment trends, the overvaluation strategy is likely to lead to a new wave of emigration when it becomes clear that the monetary integration process does not produce the intended miracles.

If we knew the equilibrium conversion rate we could pick it rightaway. Unfortunately there is extreme uncertainty about what that rate is. Whatever we choose we are likely to err. It is, however, desirable to choose an undervalued rate rather than an overvalued one if we are to err anyway.

5. The real wage level on M-day

It is important to stress that a conversion rate of 1 : 2 does not imply that the real wage level of East German workers will decline on M-day relative to its present level. In fact it is very likely that such a conversion rate will lead to an increase in the purchasing power of East German wages relative to what it is today.

The average East German industrial worker now earns 1,300 Ostmark a month[4]. After M-day he will be paid 650 DM a month with a conversion rate of 1 : 2. The prices of domestically produced goods, however, (e.g. basic necessities, rent, public transportation, heating) will also be quoted in DM at half their previous Ostmark price. Thus the purchasing power of the wage of the East German worker in terms of domestically produced goods will not be affected, at least not immediately.

After M-day the goods imported from West Germany will be priced at their West German level. With a conversion rate of 1 : 2 the East German worker will only be able to buy half of what he would get with the more favorable rate of 1 : 1. Compared to the present situation, however, the East German worker is likely to gain puchasing power even with a conversion rate of 1 : 2. This is so because at the present time West German goods are not available for most GDR residents except if these

4. See Sondergutachten of the Sachverständigenrat, op. cit., statistical appendix.

are willing and capable of paying the black market rate of the DM which stands close to 1 : 6. Thus with a conversion rate of 1 : 2 the East German worker will certainly be able to buy more West German goods than he can today.

The problem with the 1 : 2 conversion rate, therefore, is not that it would bring hardship to the East Germans. It would not. The problem is becoming a political one because by promising a conversion rate of 1 : 1 German politicians are raising unrealistic expectations of GDR residents about their real wages after M-day. Once these expectations are firmly held it will be difficult for the same politicians to backtrack, so that the conversion rate of 1 : 1 becomes inevitable.

6. The conversion rate and the monetary overhang

The stock of savings in the GDR is now estimated to be approximately 160 billion Ostmark. At a conversion rate of 1 : 1 this would add an equal amount of relatively liquid DM assets. It is now recognized by most observers that such a monetary overhang would increase inflationary pressures in the Federal Republic. One solution to this problem, which seems to be favored by German officials, is to stick to the 1 : 1 conversion rate but to restrict the amount any individual will be able to convert after M-day and to consolidate the rest into long term DM-assets.

It is clear that the conversion of the stock of savings at a rate of 1 : 1 implies a huge and unexpected windfall profit for GDR-residents. The size of this unexpected capital gain can be estimated as follows. The black market rate of the DM/Ostmark prior to the downfall of the communist regime in the GDR was 1 : 6. This was the price GDR residents were willing to pay for one DM in order to buy West German goods and services. This black market rate was generally known in the GDR. Therefore, it is reasonable to assume that this rate was close to what GDR-savers expected the purchasing power of their savings to be in terms of West German goods. Now all of a sudden East German residents face the prospect that this purchasing power will be multiplied by six. This unexpected windfall profit represents a mind-boggling 50 % of the East German gross national product[5].

It is easy to understand the political economy aspect of such a conversion. The benefits for the East-German residents can clearly be measured and identified. The costs, however, although not less real, cannot be measured and identified with the same precision. This has opened the door to German politicians to promise large benefits to GDR residents, while keeping the costs in the dark. It is likely, however, that the very favorable conversion rate of 1 : 1 will turn out to be a poisoned

5. At a conversion rate of 1 : 1 the savings account of GDR residents are worth 160 billion DM; at the black market rate they are worth 27 billion DM. The difference between DM 160 billion and DM 27 billion (DM 133 billion) is a measure of the unexpected windfall profit. The GDP of the GDR amounts to approximately 270 billion Ostmark.

gift for East German residents. The rate that adds a vast amount of purchasing power to their savings is the same rate that will make it very difficult for them to be competitive and to sell their goods and services in the West.

A more realistic rate of 1 : 2 would still provide GDR residents with a large (and unexpected) windfall profit. In addition, it would reduce the need to consolidate a large amount of East German savings into long term assets. With this more realistic rate GDR-residents would be able to immediately enjoy purchasing Western goods instead of having to wait for an uncertain future.

7. Implications for the EMS

The monetary unification of the GDR with the Federal Republic is of utmost importance not only for Germany but also for the other EMS-members. It clearly raises the spectre of future turmoil in the system. The danger does not come in the first place from the monetary overhang created by converting East German financial assets at a rate that is too favorable. The inflationary consequences of this conversion can be contained relatively easily by consolidating part of these savings into long term assets.

The danger for the future stability of the EMS comes from the fact that at a conversion rate of 1 : 1 the Federal Republic is likely to create its own Mezzogiorno.

As we argued earlier, at that conversion rate the real wage level in the GDR will be stuck at too high a level compared to its productivity level. This is likely to lead to a "regional problem" very much like the one that exists between the North and the South of Italy, with well-known ingredients, i.e. regional unemployment, large budgetary transfers and continuing emigration.

Such a situation will put a lot of pressure on the macroeconomic policies of Germany. These pressures will spill over into the process of monetary policy making. When one large region in Germany will be facing substantial structural adjustment problems, the pressure on the Bundesbank to facilitate this adjustment by following looser monetary policies will be mounting. Presumably, representatives of these regions will also sit on the board of directors of the Bundesbank and may add to these pressures. It remains to be seen whether the Bundesbank will be able to resist them. In any case, it becomes less certain that the German monetary authorities will maintain their (hard fought for) reputation of a bastion of monetary stability in Europe.

8. Conclusion

There is some merit in the view that monetary integration can be used as a shock therapy to force change in the GDR. This strategy, however, is a high-risk one. As economists, we have to admit that the chances of success of such a shock therapy are very uncertain. It is therefore important to maximize the chances of its success by choosing the right conversion rate. The introduction of the DM into the GDR at a conversion rate of 1 : 1 would, in my opinion, maximize the probability of failure, because it would make this shock therapy unbearable. It could wipe out large sections of the East German industrial sector almost overnight. The pressure to stop this with other means (e.g. import tariffs, administrative controls) would be overwhelming, and would halt the momentum towards economic integration. The implications for the unemployment level are difficult to forecast but are likely to be severe.

All this could be avoided if the large investment flows from West Germany would materialize quickly enough. However, since political decisions imply that monetary integration should be implemented in 1990 these investments will not have led to sufficient production to solve the problem.

Therefore, it seems to be of paramount importance to introduce the DM into East Germany at a significantly lower conversion rate of the Ostmark than 1 : 1. The fact that this is politically difficult, should not prevent economists to stress the dangers of starting an experiment with an exchange rate of the East German currency that appears to be vastly overvalued.

Currency Union and Economic Reform in the GDR:
a comprehensive one-step approach

by

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Introduction and Summary

Political acceptability and the need for economic reforms in the GDR are already beyond any doubt. How to proceed is however subject of considerable debate. The current desperate state of the GDR economy, nearly 100 000 Übersiedler since the beginning of the year and widespread uncertainties underline the urgency of a concrete and convincing action programme. Plans that produce results only along an uncertain schedule and in the more distant future are not cutting ice anymore. Therefore step-wise reforms will not do.

This contribution suggests an immediately implementable and coherent package that is irreversible, provides a maximum of reliable market information, and a sound prospect for long-term growth. To minimise budgetary transfers with the aim of reducing migration to the west, simple and incentive-rich privatisation of collective property is proposed that guarantees widespread participation of GDR citizens in any future boom and increase the returns from staying home.

Experience in many countries suggests that partial reforms are problematic, slow and produce disappointing results. The propelling force of a market economy cannot be unleashed with partial steps producing new contradictions: Prometheus partially bound is not Prometheus unbound. Therefore the following conditions need to be assured simultaneously:

(i) a price system free of controls and subsidies;

(ii) a stable currency and an efficient capital market;

(iii) private property for all resources;

(iv) a legal framework that clearly defines property and contractual rights inclusive of those of the public sector.

That such a complete reform can be brought about rapidly was demonstrated by the FRG in 1948. Many were those that considered Erhardt's plan as sheer folly. Few would dispute the immediate and long-term success of his reforms.

The situation of the GDR today is serious but infinitely easier, and not only for the financial transfers from the FRG. More important is the potential of private investments by foreign firms once a clear framework is in place. Much can be copied directly from the FRG. Plans for reunification suggest for instance that the legal approach to economic reform is most usefully modelled on the existing framework of the FRG. Moreover, free trade with the FRG and hence with the EEC will not encounter the convertibility problem of the FRG which in the years after 1948 did not have the necessary foreign exchange reserves. A sustained flow of capital investments will finance current account deficits of the GDR, although it is hard to estimate their precise size.

The two pillars of our reform package are currency union and distribution of state property among the people of the GDR.

Currency union will eliminate any balance of payments constraint. Currency union will also establish, virtually overnight, the price system of the FRG and access to the capital market of the FRG (and hence of the world). No separate and difficult price reform will be needed. This is then the basis providing a reliable long-term framework which will stimulate domestic and foreign investment as well as domestic savings. The Bundesbank's track record for providing a stable anchor for the price level should not be disturbed as it can take into consideration the evolution of money demand in both parts of Germany for the control of the entire money supply.

These advantages of currency union cannot be obtained as completely and quickly by a fixed exchange rate between the two marks or by a floating exchange rate as we show below.

A conditio sine qua non for the success of the German monetary union is, of course, that wages in the GDR remain below the FRG level until the productivity gap is closed. A "concerted action" might be useful to achieve this. Resistance from the (recently reformed) trade unions should not be too strong if wages are converted at 1:1 as this would already mean a significant real income gain. The appropriate rate of conversion is evaluated below.

Currency union would therefore improve the outlook for the GDR economy dramatically. The need to **reform property rights** should, however, be seized as an additional opportunity to commit citizens of the GDR to the development of their own country.

We therefore believe that our approach would have a significant impact on migration for two reasons: the wealth transformation and the improved future perspectives.

We propose that:

i) Ownership of housing is transferred to current occupants against payment of rent for 10 years, ownership is lost upon emigration.

ii) Small enterprises (less than 10 employees) are turned over to their managers/workers who will pay rent to acquire the buildings.

iii) Kombinate are transormed into holdings owned by the people. Kombinate own 50 % of the shares of VEB (which will become joint stock companies) the other 50 % is given to the workers, who can thus immediatley elect a non-political management. Workers' shares are lost upon emigration.

These irrevocable property rights would constitute a powerful incentive to stay.

I. Advantages of a full monetary union

The classic options regarding the monetary regime are all still open to the GDR: A free float, a fixed-but-adjustable peg and a common currency with the FRG. For obvious political reasons the last option has been chosen with little support by economists. We argue that, on the contrary, introducing the DM in the GDR would yield important economic advantages and that such a solution would be preferable to maintaining two currencies.

We argue that:

i) a step-by-step gradual approach provides far more flexibility but entails much more risk and will require more time for producing results;

ii) currency union provides the assurance about the real value of monetary assets that is needed in an economy that is to be restructured extensively and that has to grow rapidly;

iii) a currency union also fixes immediately a price system so that price reform is no more a political decision but rather a virtually instantaneous market reaction from which there is no escape.

Currency union vs a step-by-step approach

The academic discussion about German monetary unification often maintains that the GDR had the choice between a 'quasi' monetary union by just fixing the exchange rate between the two marks and a full monetary union with the DM as the common currency. This fails to recognize the essential point that a fixed exchange rate between the two marks does not represent a monetary union. A monetary union is defined as irrevocably fixed exchange rates plus full capital mobility. In the case of fixed exchange rates with the GDR neither condition would be satisfied because:

i) the exchange rate would definitely not be irrevocably fixed since the most common argument for keeping two separate currencies is that the exchange rate might be a necessary adjustment instrument in this difficult transition phase; and,

ii) limited convertibility and capital controls would be necessary to maintain this exchange rate fixed. Otherwise capital outflows would constantly raise doubts about the sustainability of the exchange rate and the Bundesbank would no longer be able to guarantee a strictly anti-inflationary monetary policy.

The fact that the exchange rate would probably not be fixed for a long time and that capital controls would be necessary are the main arguments against the intermediate solution of a fixed-but-adjustable peg. Both would make it difficult to achieve the high growth in trade and investment that is necessary for rapid growth in the GDR.

i) Trade: Exports (and imports) per capita of the FRG are about 28 times higher than those of the GDR. In order to come close to the level of the FRG, exports of the GDR would have to grow for the next 10 years by over 40 % in real terms each year. This would be much higher than the 15% growth achieved by the FRG in the 1950's, but on account of totally free access to the markets of the EC it would be much easier.

ii) Investment: To catch up in ten years with the FRG growth rates in the GDR would have to be about 7 % higher, or close to 10%. Using a capital output ratio of two and a depreciation rate of 12 % (as in the FRG) this implies that the ratio of investment to GDP in the GDR should be about 30 % for the next ten years, similar to those of fast growing Asian economies.

The very high growth rates of trade and investment that are necessary for the GDR to catch up with the FRG can only be achieved if the domestic capital market is well developed enough to provide the financing to existing and new enterprises and if the financing of exports and imports is not hampered by controls. Foreign financing of investments will be particularly sensitive to a stable monetary framework.

The introduction of the DM in the GDR would be sufficient to fulfil these conditions. On the external side, no capital controls would be needed and the financing of trade would be no problem. Without the DM as the basis the banking system in the GDR would not only have to cope with a system of capital controls, but it would also first have to learn how to operate in international financial markets which would certainly slow down the process of trade integration.

On the internal side, enterprises in the GDR, many of which will be new and small, would immediately have access to the banking system of the FRG. Introducing the DM is equivalent to creating immediately an efficient capital market, which would otherwise take some time to develop.

With the DM as the common currency the large current account deficits the GDR would have to run would be invisible (like those of, say, Bararia in the FRG) and could be financed by private capital without any difficulty. With two currencies the current account deficits would be highly visible, probably always a cause of concern for policy makers and therefore a source of expectations of exchange rate changes.

The only alterative that would allow the GDR authorities to abolish capital controls immediately would be flexible exchange rates. This solution would have the advantage that the real exchange rate would be established in the market and could therefore react to shocks even if nominal wages are rigid. But given the great uncertainty surrounding the success of the transition to a market economy and the eventual monetary unification this rate might fluctuate a lot and overshoot in the transition, as the monetary policy of the GDR Staatsbank would be the only anchor for prices and inflationary expectations in the GDR.

Flexible exchange rates therefore do not appear to be superior to the adoption of the DM as the common currency.

Currency union makes a price reform superfluous

Introducing the DM in the GDR would be equivalent to a price reform. Prices need to be freed anyway, but without the price system of the FRG prices might take a while to find their equilibrium level. It will take some time to privatise the existing state owned factories and since they are in most cases monopolists they might use their monopoly power when setting new prices. With the DM as the common currency and open borders that would not be possible.

It is often argued that the elimination of subsidies would raise the price level, according to some estimates by as much as 30 %, and that this implies a cut in real wages. However, the elimination of subsidies does not necessarily have to lead to a fall in real wages since the savings can be used to lower taxes and increase direct income transfers. Price reform and the elimination of subsidies should therefore lead to a redistribution of income, but should have little effect on the average level of real incomes.

The main economic argument against the introduction of the DM in the GDR is that it would make it difficult to change the real exchange rate if it is to high because wages cannot be reduced in nominal terms. However, the danger of overvaluation cannot be avoided anyway since the newly reformed trade unions are likely to 'see through' the effects of a devaluation of the mark and adjust their wage demands accordingly.

Loss of monetary souvereignty is not specific to currency union. The same loss would occur with a fixed exchange rate as the experience of the EMS demonstrates. The five Länder to be created in the territory of the GDR would anyway have the right to create Landeszentralbanken, which would be represented on the Bundesbankrat.

Conversion into DM at what rate?

Technically currency unification is not difficult, but a decision would have to be taken on the rate at which to convert. The conversion rate is important for competitivity, income distribution and financial obligations of the GDR and FRG. Given the uncertainty about productivity, the size and allocation of investment flows, and the labour cost structure only tentative quantitative assessments are possible. The following computations should be taken as reasonable orders of magnitude, useful for consistency checks, but not as definite proposals.

A conversion rate of 1:1 would revalue monetary assets and impose a high burden on debtors. A conversion closer to black market rates would alleviate debtors and provide to savers full convertibility at values not artificially inflated. Competitivity of the productive sector is claimed to benefit from a stronger devaluation. We are not at all convinced of this argument as a devaluation only improves competitivity if it can lower real wages. Hence, the absence of money illusion would render devaluation ill-suited for lowering current costs and would only generate social turmoil. Other means are required for that purpose.

In view of this double objective an obvious solution would be to apply a different rate to the **stock** of monetary assets and liabilities than to the **flow** of current payments, such as wages and rents.

Conversion rate for current transactions

For political reasons and concern about stable transition a rate of 1 : 1 for current payments seems unavoidable. However, this rate might not be far from the equilibrium exchange rate. GDP per capita is about one half of the level in the FRG whereas wage costs are only one-third on account of highly subsidised activities (housing, food, health, education). Hence, conversion at 1 : 1 might still give the GDR significant competitive advantage with unit labour costs two-thirds of the FRG.

The main point of this calculation is not to show that 1 : 1 represents the ideal rate, but only that conversion at this rate is not totally inconsistent with economic reality and, that lower conversion rates would only generate aggressive and possibly destabilising wage demands.

It is obvious that private capital would not flow into the GDR if wages were to rise immediately to the FRG level because the infrastructure is much less developed and the work force not familiar with modern technology. A rapid economic recovery therefore requires that the wage differential corresponds to the productivity differential. It is difficult to judge a priori to what extend the newly reformed trade unions in the GDR realize this.

The need for a social "concerted action"

To forestall the danger of an equalization of wages on a broad scale it might be useful to organize a **'concerted action'** under which governments, trade unions and representatives of industry negotiate a package that would consist of an agreement on the wage differentials, direct income transfers and subsidies in the form of lower tax rates and social security contributions. (See below how this might be financed.) Such a package should make the initial shock coming from the restructuring of the GDR economy acceptable to all parties involved and could be phased out once the economy is on a sustained growth path. Since conversion at 1 : 1 would already raise the purchasing power of wages in the GDR considerably trade unions would have little reason to object to such a package.

Conversion rate for financial stocks

The conversion rate for the stock of monetary assets and liabilities (including cash) could, and should be different from one.

One solution would be to convert at a rate between 1 and the black market rate. This would allow the government of the FRG to avoid paying for the substantial capital gains holders of savings accounts in the GDR would otherwise make. Using the estimate of about 160 billion mark in savings accounts in the GDR this would represent a capital levy of about 134 billion DM if a conversion rate of 1 : 6 is used instead of 1 : 1. Such a capital levy is an ideal tax on economic grounds and the amount involved is not negligible, even for the FRG.

However, with conversion close to the black market rate current account holders would lose in terms of goods they can now buy in the GDR. An intermediate solution might be to convert at about 2 to 3 to one. This would still yield very sizeable lump sum tax revenue (at 2 : 1 about 80 billion, at 3 : 1 about 100 billion DM) and would keep the average purchasing power of bank accounts and cash approximately constant.

If wages are converted 1 : 1, market interest rates applied to DM debt of enterprises and subsidies to enterprises phased out, will survival of any but the best not be at risk? This risk would indeed be very high if the debt of enterprises were converted 1 : 1. With a conversion rate closer to the black market rate financial costs would be very substantially lowered. Highly indebted firms will however need fresh capital injections or loans which should be made much easier by devaluation of old debt and access to the world market provided by currency union. Firms that are not viable in the long run even at those favourable financial conditions and with the freedom to eliminate excess employment need at any rate to be restructured, taken over or closed.

The opposition against the idea of converting bank accounts at less than 1 : 1 comes from the fact that conversion at 1 : 1 would imply a huge capital gain for the current asset holders. If social justice is the only criterium it would be necessary to convert bank accounts at a rate that keeps the purchasing power of these accounts constant.

For practical and political reasons it would be necessary to hand out an initial endowment ('Erstaustattung'). 500 DM per capita (a total of about 8 billion) would be sufficient since it would mean about one months' wages for an average family of four with two wage earners. The 'revenue' from the 'devaluation' of bank accounts minus the 'Erstaustattung' could be used to finance tax breaks on labor and social security contributions in particular an unemployment compensation fund.

Public sector finance and debt

It is often felt that government finances in the GDR represent a major source of risk and eventual liability for the Bundesbank and the government in Bonn after formation of a currency union.

Whilst no detailed data is available it is easy to establish upper bounds. Because public debt is not securitized it is necessarily financed out of cash and savings deposits. With their total close to 190 bn and a substantial amount of debt of enterprises and households we put the upper bound on domestic government debt at 120 bn. Conversion at, say 3:1 transforms this debt into DM 40 bn or DM 2500 per capita. This is about one month of GDP per capita and thus rather small.

As to current expenditures and receipts there would be major changes under the proposed reform package. Public debt would have to be remunerated at rates close to those in the FRG. The cost of debt service will increase and savers will receive the counterpart. The public debt being small overall interest expenditures would however not represent much.

Another major item of increased expenditures is unemployment compensation. At say, 10 % unemployment, about 1 million workers would be entitled to unemployment benefits. Such a high level of unemployment would however only last for a few years. With an average income of DM 1200 per month or DM 14 400 per year and a 50 % compensation, total annual payments would rise to about DM 8 bn. This is large but only temporary and not a net cost as there is at present at least that much hidden unemployment. Hidden unemployment lowers profitability of firms and thus the net contribution to government which for most firms is in fact negative (subsidies are larger than taxes). Hence, unemployment compensation can be financed largely out of reduced subsidies.

Any dangers for price stability in the FRG?

It is sometimes feared that by converting GDR savings accounts into DM the German money supply would increase and this would be inflationary. However, money demand obviously also increases since the economy of the GDR also needs money. The decisive question is therefore wether the increase in the demand or the supply of DM is stronger.

The amount of DM created depends on the conversion rate used for monetary assets and liabilities as discussed above.

Simple estimate of money demand in the GDR suggest that with a conversion of 1 : 1 there might be a 'monetary overhang' of between 60 and 110 billion DM. However, because there are no alternative financial assets in the GDR a much larger part of savings deposits has a non-monetary function and would be shifted into non-monetary financial assets, once accessible. It is therefore likely that the monetary overhang is overestimated. As long as savings deposits are converted at less than 2 : 1 there should therefore be no danger of uncontrollable inflationary pressures (at least from the creation of the German monetary union per se).

II. The potential impact on emigration from the GDR

For many the decisive criterium is whether any reform is likely to reduce the stream of Übersiedler. It would continue even if direct subsidies or adoption of the DM raises the purchasing power of present wages considerably. The stream will only diminish if prospective Übersiedler can expect that the present value of their future earnings while remaining in the territory of the GDR is not far from what they would get in the territory of the FRG.

Growth perspectives

The introduction of the DM in the GDR could have a substantial impact on the stream of Übersiedler if it raises the rate of growth of income in the GDR. Even assuming that currency union would have no direct impact on the level of income, a one percentage point increase in the rate of growth of income would reduce the time needed for the GDR to catch up with the FRG by one to two years.

Even retaining the optimistic scenario that the GDR will grow by 6 to 7 % more than the FRG, and therefore catch up in 10 to 12 years, a one percentage point increase in the growth rate would still raise the prospective income for a person that stays in the GDR by about 10% on a discounted present value basis. A one percentage point increase in the rate of growth might therefore have the same impact on emigration as a transfer of about 30 billion DM.

What makes people stay?

It is often argued that a currency union will immediately align prices and wages in the GDR to levels in the FRG. This is certainly true for prices when all obstacles to trade are eliminated. It would only be true for wages if labour were perfectly mobile. Low labour mobility in the FRG, despite differences in income and employment perspectives suggests that under normal circumstances - which would be re-established by prospects of stable growth within a currency union - labour mobility is restricted by family ties, habits, risk aversion and, above all, the cost of migration. ? we propose to create non-movable property rights by distributing state owned property to the people further reduce migration.

This is obviously also the time to eliminate, now that movers are not anymore escaping a totalitarian regime, subsidies for accommodating Übersiedler in the FRG. Although justifiable in the past, such subsidies are now a misdirected incentive.

A proposal for privatising collective property

Instead of subsidising migration it would be more conform with the objective of minimising East-West migration to make it attractive to stay. This can be achieved by a programme of spreading private ownership of collectivity-owned houses and productive assets as described below.

Privatisation is often considered as a very complicated and lengthy process requiring years. There are several reason for this:

i) the value of collective assets cannot be determined without a meaningful price system;

ii) most citizens do not have the resources to purchase;

iii) there are no markets yet for trading; and, finally,

iv) it would take years to negotiate politically acceptable schemes, to evaluate and process transactions.

Our scheme avoids these difficulties and it should also shorten the political negotiation delay because it is conform with social justice and therefore from the onset gains widespread support. Citizens of the GDR were led to believe that they were the owners of all social goods in proportions never specified, but assumed to be uniform. Because this was the implicit social contract it needs to be respected even if one does not share the underlying ideas.

If social goods were sold who would buy them? One needs to respect concerns about an Ausverkauf to western buyers. Equal concern is warranted if those able to accumulate wealth in association with the old regime could now acquire large shares of the stock of wealth to be privatised. Any privatisation scheme should also contribute to the creation of markets and to a better management and allocation of assets.

For all these reasons we propose the following measures:

i) Transfer of ownership of housing to present occupants. Rents would continued to be paid for, say, 10 years and they would be considered as instalments for the acquisition price. Rents could be indexed to average wage rates and therefore rise only in line with purchasing power. Houses can be traded but ownership rights would be lost after emigration.

ii) The same system can be applied to agricultural sector, cooperatives (Genossenschaften) are free to split up or to stay together.

iii) Individual and small enterprises are turned over to the present managers/workers who will continue to pay taxes and rents to acquire the buildings.

iv) The about 300 Kombinate will be turned into joint stock companies (Aktiengesellschaften). Each Kombinat issues a number of shares equal to the number of citizens with voting rights. Each such citizen will receive one share in each Kombinat and thus a highly-diversified portfolio of the economy of the GDR. The value of these shares cannot be known a priori and need not be known: they are distributed freely. At least at the end of the socialist experience collective ownership would acquire a concrete sense. Such shares are tradable. Their current book-value may not amount to much but after a currency union present value of future earnings could be a multiple for at least some of them. Therefore there is an incentive to holding on to them.

The Kombinate would own 50 % of the VEBs in the Kombinat. The remainder is given to the workers in the VEB. These shares would not be tradable for, say, two years and would be lost on emigration. To provide incentives to stay in the GDR. Workers would thereby also take greater interest in the performance and management of their firm. Kombinate would be closer to a holding company as they are already to a large measure today. VEBs are legally independent entities, frequently with an independent finance plan. Kombinate could provide management or financial expertise or they could sell their shares to a western firm. VEBs would also be free to opt out of a Kombinat which would then be reduced to the role of large shareholder.

One implication of this proposal is that government employees would only receive shares in the Kombinate but not in VEBs. Therefore they would receive fewer shares than workers or members of Genossenschaften. This differentiation can be seen as a premium for the job security they have.

With such widespread share ownership all citizens of the GDR would become overnight "capitalists", an objective actively pursued in the FRG without complete success however. Creation of a stock market would be greatly stimulated and long-term gains are likely to be important judging by the experience of the FRG. Few people invested in stocks in the late 1940s but those that did have never regretted. Nor would they have regretted staying in the FRG.

Concrete Steps

The newly-elected government could announce shortly after 18 March a programme along the lines proposed. It is important to consider it as a package and to announce it as such, even if all components cannot be implemented the same day.

The currency union, establishment of free trade and elimination of all price controls can be implemented right away. Reform of property right, as proposed here, would also be operative almost immediately since it requires only the appropriate laws to be passed. Once the legal framework is in place market forces would be operating right away throughout the economy.

It is therefore perfectly feasible to have all the reforms implemented before the end of the summer of 1990.