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A tale of two Germanies. Any lessons for Central Europe? A note

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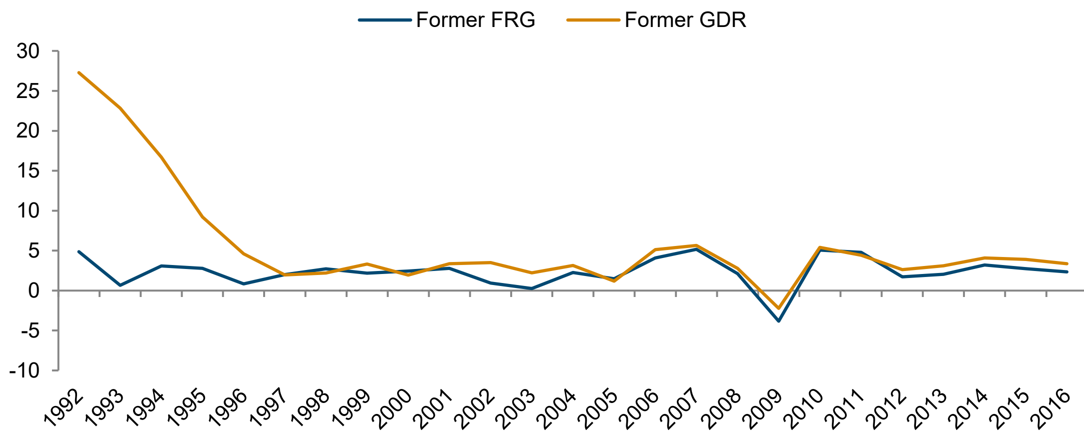
The income gaps separating the Central European (CE) countries from Western Europe have narrowed substantially since the early 1990s. The catch-up is quite impressive, especially for the generally less-affluent CE countries admitted to the European Union (e.g. Romania or Poland). Economic growth in the new EU Member States is believed to have been supported not only by significant financial transfers 'from Brussels', but also by the institutional harmonisation involved and by economic integration. This is despite the possibility that there may be issues involved regarding the form and rate of integration based on free trade, free capital and labour movement within the enlarged EU. These developments *seem* to bode well for the future of CE countries, justifying the expectation of relatively rapid convergence with Western European income levels. However, some experts invoke the propensity of middle-income countries generally to get stuck in a 'middle-income trap'. Obviously, these writers are less optimistic.

The controversy over the future of CE countries' catch-up with the West is unlikely to be resolved anytime soon. There are many issues to consider. At the same time, it may be instructive to reflect on what has happened to income convergence between the former East Germany (the German Democratic Republic or GDR) and the former West Germany (the Federal Republic of Germany or FRG). The German unification of 1991 was followed by the former GDR's speedy integration into the FRG. Since this was a political unification it followed a default economic position of complete liberalisation of trade, capital and labour movement, as well as monetary unification. These economic transitions were accompanied by the abrupt imposition of FRG institutional and economic policy frameworks on the 'new' *Länder* (federal states). Unification was also accompanied by huge financial transfers. The consensus view is that the 'new' *Länder* received the equivalent of about EUR 1,600 billion in (net) financial transfers between 1991 and 2013. That corresponds to about 57% of 2013 German GDP.

Given this set of circumstances, one would expect rapid convergence between the two parts of Germany. However, the facts do not support that expectation and it is this that may provide some limited insight into the CE cases. For convergence to occur then for some metrics the GDR should outperform the FRG. It turns out that, although there was a period of rapid convergence, it was relatively short.

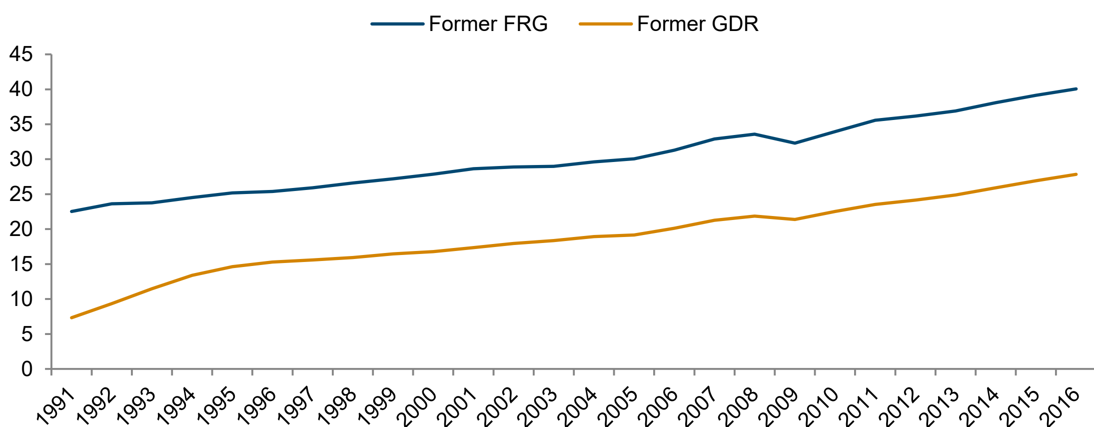
Figure 1 Growth rates of per capita nominal GDP, %, former FRG and former GDR, 1992–2016



Source: Own calculations based on data from the German Statistical Office and Eurostat.

As can be seen from Figure 1, faster relative growth in the former GDR's nominal per capita GDP ended in 1996. Moreover, part of the initially rapid growth in the former GDR may reflect an upward adjustment in prices (artificially suppressed pre-1991), rather than in real output. Since 1997, the growth rates for both parts of Germany have been close to one another (average growth was about 0.7 percentage points higher in the former GDR than in the former FRG over the period). It needs to be added that per capita GDP growth in the former GDR came at the same time as a falling population – so segments of the population were responding to their relative situation and to opportunity by moving. In the former FRG, both output and population rose over the period in question.

Figure 2 Per capita nominal GDP (EUR 000s), former FRG and former GDR, 1991-2016



Source: Own calculations based on data from the German Statistical Office and Eurostat.

Most significantly, German unification has *so far* left absolute per capita income differentials roughly unchanged (Figure 2). Of course, in relative terms there has been convergence (thanks to the already noted growth rate differential of about 0.7 percentage points per annum

in the former GDR's favour). However, if per capita income in the former GDR continues to rise at about 3.05% per year, against the 2.32% for the former FRG (the average rates between 1997 and 2016), it will take over 50 years for complete catch-up.

Clearly, there are differences between the situation of the GDR and that of CE countries. However, it can still be meaningful to ask, what lessons for CESEE can be drawn from the German experience? First, it appears that huge transfers from the West – even if coupled with complete unification (institutional, as well as 'real') – are not necessarily a guarantee of rapid convergence. The period of rapid convergence can come to a halt or the rate decline (in the former GDR this occurred 1997). Second, one wonders whether it was not the *complete* unification that was ultimately responsible for the failure of the German experiment. Arguably, a less radical real integration (a better managed approach to free trade, capital and labour flows, and monetary and economic policy unification) may have produced better end results. For example, though the transition in the GDR was not a free-for-all, giving GDR firms adequate protection for some time could have helped those firms to adapt to market conditions, restructure and develop 'organically', rather than end up as pieces of scrap. If more of the GDR's production capacities had been saved from liquidation, then more of the local labour force may have stayed in the East – instead of swelling the army of the permanently unemployed, or being induced to migrate to the West.

CE countries have been steadily integrating into the EU's institutional, monetary, fiscal and 'real' frameworks (the latter through large-scale trade and high foreign direct investment penetration by the West). In addition, most CE countries have drawn significant (in relation to their GDP) funds 'from Brussels' – and stand ready to receive further cash flows in the future. Do these facts justify the expectation that CE countries will continue their accelerated economic convergence in the future? In the light of the GDR experience, such an expectation may be frustrated. For CE countries – as for any middle-income country – successful catch-up seems to require far more consideration of the political economy and institutional management than seems to be the case at present where there is more of a passive integration into the existing economic order[1].

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[1] After only 11 years of separation, Saarland (under French administration after World War II) was returned to the FRG. Its initial reintegration took almost three years (1956–1959), during which time the Deutschmark was *not* the legal tender there, a customs border with the FRG was maintained and the freedom of foreigners (i.e. 'Federal Germans') to settle and acquire assets was restricted. By contrast, the GDR was annexed overnight and the GDR economy was subject to immediate takeover by the 'West Germans'.