Micro- and Macroeconomic Adjustment Processes in East Germany – Fourteenth Report

by the German Institute for Economic Research, Berlin (DIW) and the Institute for the World Economy at the University of Kiel (IfW) with the collaboration of the Institute for Economic Research Halle (IWH)

The German Institute for Economic Research, Berlin (DIW), the Institute for Economic Research, Halle, and the Institute for the World Economy, Kiel, have accompanied the economic reconstruction of east Germany from the outset in the form of a research project commissioned by the Federal Ministry of the Economy. This article provides a summary of the Fourteenth Report, which focuses on the reasons behind the slowdown in the pace of the adjustment processes and the contribution to be made by economic policy to overcoming the barriers to adjustment.[1]

The east German economy in the spring of 1996

The rate of economic growth in east Germany declined steadily during the course of last year. In the first quarter of this year there was no economic growth in real terms on the same period the previous year (cf. table 1). This was largely due to the cold winter, which led to an extraordinarily sharp contraction of construction work. It also significantly dampened manufacturing output, which, in east Germany, is oriented to a comparatively high degree towards the production of inputs for the construction sector. There was a sharp drop, for instance, in the output of the glass and ceramics industry and in quarrying and stone-working.

Yet irrespective of such short-term effects, it is evident that the "catching up process" in eastern Germany has slowed. There are a number of reasons for this:

– In east Germany, as elsewhere, the generally depressed state of economic activity is making its effects felt, damaging the sales prospects of east German firms on supra-regional markets and dampening investment.

– Economic developments are also being influenced by the fact that the major "wave" of investment in the new federal states has, for the time being, now passed its zenith. Many projects setting up new, or restructuring and modernising existing firms are now in their final stages or have already been completed. In some cases this has led to excess capacity (as in the case of office space in some areas). Significant progress has also been made in modernising the public infrastructure. These factors have slowed economic activity, particularly in the construction industry, over the last twelve months.

The trade, transport and private services sectors have not been as badly affected by the economic slowdown as manufacturing industry and construction. In recent months private consumption has provided a significant stimulus following the sharp rise in real incomes at the start of this year. Even so, the fact remains that, even in the tertiary sector, economic growth slowed last year.

The situation on the labour market remains correspondingly bleak. Employment expanded ever more hesitantly in the course of last year; in some sectors – manufacturing industry for example – there were even further net job losses. There has been a marked increase in registered unemployment, a trend that primarily reflects the cutback in labour market policy measures. Unemployment leapt up in the first quarter of this year as this trend was reinforced by significant job losses (cf. table 2). There are no grounds for the belief that this merely reflects seasonal factors.

A summary of typical barriers to growth: survey findings

The official statistics provide only very limited information on the precise course taken by the adjustment process at the micro level. In order to close this information gap the DIW began at an early stage to obtain corresponding evaluations and data from manufacturing firms. Four surveys have been conducted so far: in the summer of 1991, summer 1992, winter 1993/94 and in the spring of 1995.[2] In this report the results of all four surveys are set in relation to one another for the first

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[1] The full version of the report is available in German: Institut für Weltwirtschaft, *Kieler Diskussionsbeiträge,* No. 277/278 and the Forschungsreihe, No. 7, 1996 of the Institut für Wirtschaftsforschung Halle. The previous thirteen reports have also been published in the *Economic Bulletin*.

[2] Just under 1 700 industrial firms employing more than 1 million workers participated in the summer 1991 survey; almost 2 000 industrial firms with just under half a million employees responded in the summer of 1992, just under 2 500 firms with more than 200 000 employees in the winter of 1993/94 and 2 800 firms with 180 000 workers in the spring of 1995. The detailed results of the surveys were published in the third, fourth, sixth, seventh, tenth, eleventh and thirteenth reports, all of which have appeared in the *Economic Bulletin*.

Table 1

Gross Value-added in the New Federal States at 1991 Prices

	1994				1995				1996
	1st quarter	2nd quarter	3rd quarter	4th quarter	1st quarter	2nd quarter	3rd quarter	4th quarter	1st quarter
					DM billion				
Agriculture and forestry	0.34	0.26	4.12	1.61	0.37	0.24	4.70	1.79	0.31
Producing sectors	23.36	25.85	26.53	27.39	25.59	27.65	27.80	28.10	24.12
Mining, energy and water	3.52	2.96	2.81	3.35	3.12	2.66	2.60	3.25	3.15
Manufacturing industry	10.16	11.66	12.05	13.35	11.42	12.76	12.84	14.06	11.57
Construction	9.68	11.23	11.67	10.69	11.05	12.23	12.37	10.78	9.40
Trade and transport	8.35	9.07	9.24	10.16	8.59	9.49	9.67	10.59	8.85
Trade	5.45	5.90	5.84	6.74	5.55	6.13	6.07	6.99	5.74
Transport, communication	2.90	3.17	3.40	3.42	3.04	3.36	3.60	3.60	3.11
Services	14.27	15.10	15.30	15.63	15.45	16.26	16.34	16.44	16.24
Government, private households, non-profit organisations	13.64	13.17	12.92	12.36	14.12	13.82	13.40	12.88	14.72
Government	11.93	11.40	11.04	10.43	12.20	11.81	11.39	10.86	12.67
Private households, non-profit organisations	1.71	1.77	1.88	1.93	1.92	2.01	2.01	2.02	2.05
Gross value-added, unadjusted	59.96	63.45	68.11	67.15	64.12	67.46	71.91	69.80	64.24
Gross domestic product	59.80	63.50	67.90	67.10	63.80	67.40	71.40	69.80	63.80
					Change on same quarter of previous year in %				
Agriculture and forestry	.	.	.	.	.	.	.	.	.
Producer sector	16.4	15.5	13.3	14.4	9.5	7.0	4.8	2.6	–5.7
Mining, energy and water	–2.7	–0.7	–2.1	–5.9	–11.1	–10.4	–7.5	–2.9	1.0
Manufacturing industry	15.6	13.5	10.7	15.1	12.4	9.5	6.5	5.4	1.3
Construction	26.3	23.0	20.9	21.7	14.1	9.0	6.0	0.8	–14.9
Trade and transport	8.0	7.6	7.6	6.7	2.9	4.6	4.7	4.2	3.0
Trade	6.8	6.2	4.7	6.1	1.7	4.0	3.9	3.8	3.6
Transport, communication	10.4	10.3	12.8	8.0	5.1	5.8	5.9	5.1	2.0
Services	8.9	8.2	8.2	10.0	8.3	7.7	6.8	5.2	5.1
Government, private households, non-profit organisations	–2.8	–5.0	3.4	2.4	3.5	4.9	3.7	4.2	4.2
Gross value-added, unadjusted	7.9	7.0	8.2	9.2	6.9	6.3	5.6	3.9	0.2
Gross domestic product	8.5	7.6	8.3	9.5	6.7	6.1	5.6	4.0	0.0

Source: Federal Statistical Office; DIW.

time. From this, information can be obtained on the development of individual firms over time.

Comparison of the four sets of annual results shows that firms initially perceived themselves to be facing massive problems, but that the pressure to adjust to these problems has since steadily declined. In the summer of 1991 more than four-fifths of the firms surveyed reported that they were experiencing great difficulties holding their own on the market; in the summer of 1992 the figure was more than two-thirds and by the spring of 1995 just over half (cf. table 2).

The gravity of the competitiveness problem varies between different enterprise categories. It is particularly acute for firms owned by the Treuhandanstalt or its successor institutions. The relative share accounted for by these "problem firms" has declined sharply over the

Table 2

Manufacturing Firms in East Germany Facing Problems on the Market, 1991 to 1995

as a % of firms surveyed

	Summer 1991	Summer 1992	Winter 1993/94	Spring 1995
Form of ownership				
Private firms	62	57	55	52
of which:				
privatised Treuhand firms	X 1)	62 2)	60	55
reprivatised Treuhand firms	X 1)	.	64	65
firms privately owned before 1990	X 1)	58	51	48
firms founded after 1989	X 1)	41	45	46
of which:				
independent firms	73	59	55	55
firms owned by west German or foreign companies	56	52	56	45
Firms owned by the Treuhandanstalt or its successor organisations	88	84	82	53
Enterprise size category				
Firms with ... employees				
1 to 19	75	61	51	52
20 to 49	81	63	55	54
50 to 99	78	67	63	54
100 to 199	84	65	65	47
200 to 499	85	73	63	48
500 or more	92	78	77	58
Selected Industries				
Quarrying	72	39	40	37
Iron, non-ferrous metals, foundries	87	74	59	67
Chemicals	87	70	63	56
Metalworking, surface alloys	87	65	59	50
Steel and light-metal construction	72	58	62	62
Engineering	84	77	65	58
Automobiles	79	51	75	48
Electrical engineering	87	71	58	44
Sheet metal goods	82	65	49	54
Wood processing	80	61	54	50
Paper and paper processing	91	67	62	50
Printing	77	53	40	57
Plastics	82	62	48	48
Textiles, clothing	90	74	62	61
Food, drink and tobacco	83	63	59	54
All firms	84	66	57	52

1) Figure not significant due to small number of cases. — 2) Incl. reprivatised firms.
Sources: DIW surveys conducted in summer 1991, summer 1992, winter 1993/94 and spring 1995.

past five years as Treuhand firms have been privatised or closed down. Yet among privatised or reprivatised firms, too, the proportion of companies facing major problems was considerable. According to the survey findings, new businesses are experiencing fewer difficulties in withstanding competitive pressure. On the other hand, unlike in the other enterprise categories, there has been no decline here in the proportion of firms facing competitiveness problems. As far as ownership forms are concerned, it is evident that independent firms are more likely to face problems than those owned by west German and foreign companies.

Table 3

Selected Problems Perceived by Manufacturing Firms in East Germany 1991 to 1995

	... % of firms saw ... as a problem			
	Summer 1991	Summer 1992	Winter 1993/94	Spring 1995
Delays in recouping debts	–	–	–	59
Inadequate equity capital	–	–	–	52
Increasing competitive pressure	–	–	–	50
Liquidity constraint	–	–	–	49
Wage and salary growth too rapid	31	44	41	43
Lack of finance for investment	53	49	39	43
Difficulty in obtaining skilled labour	6	17	20	27
Suppliers of comparable products cheaper	–	22	26	26
Local administration clumsy	–	28	25	26
Plant/buildings outdated	38	38	28	23
Sales/distribution inadequate	46	39	18	22
Local infrastructure inadequate	15	28	18	17
Shortage of commercial sites and premises	–	13	14	16
Skill level of workforce inadequate	14	13	10	9
After sales service inadequate	–	13	10	6
Product quality inadequate	7	7	4	2
Plant/equipment too large	16	16	10	–
Key staff have left the firm	6	7	3	–

Source: DIW surveys conducted in summer 1991, summer 1992, winter 1993/94 and spring 1995.

Two problems have proved particularly thorny throughout the entire period: financing problems on the one hand and rapid wage growth on the other (cf. table 3). It seems that it is becoming increasingly difficult to find skilled labour. The proportion of firms operating with outdated plant and those reporting problems on the sales/distribution side, on the other hand, has declined. Overall these trends suggest that the problems of adjusting to the market economy have largely been overcome, whereas those typical of the consolidation and market penetration phase are becoming more relevant.

The fact that some of the difficulties mentioned have declined in importance while others have become more pressing is partly a reflection of the enormous changes that have occurred in the stock of firms: many firms have not survived on the market, while on the other hand a large number of new firms have been set up. There have also been substantial changes over time in ownership structures: in 1991 92% of those employed by the firms surveyed worked for firms owned by the Treuhandanstalt, whereas there are now just a handful of former industrial combines that are still administered by one of the institutions which took over the tasks of the Treuhandanstalt closed down at the end of 1994. Privatised firms now account for three-quarters of the workforce, newly founded businesses a fifth. Three-quarters of the firms surveyed can be considered as industrial "Mittelstand", i.e. independent small- and medium-sized firms. On the other hand west German and foreign-owned subsidiaries account for half of the industrial jobs.

In order to determine whether firms have been able to solve their problems, or whether they now face new difficulties, it is not sufficient merely to compare a number of unrelated cross-sectional analyses. What is required is a longitudinal analysis of individual firms. To this end the 1 200 firms that participated in both the last two DIW surveys were selected. These firms account for around half of the firms surveyed in winter 1993/94 and two-fifths of those participating in the spring 1995 survey.

The results of this longitudinal evaluation of the data confirm the picture already given: just under half of the firms believe that they can withstand competitive pressure without great difficulty, while the remainder are clearly facing major problems. Overall this distribution has remained virtually unchanged in both surveys. More detailed analysis reveals more highly differentiated trends, however.

- Only a third of the firms experiencing significant competitiveness problems in the winter of 1993/94 have since managed to overcome these initial difficulties. To put it another way, two-thirds of the firms experiencing problems then have not made decisive progress since.
- For as many as 40% of the firms that, by and large, were operating without serious problems in 1993, the situation has changed: they are now suffering serious competitiveness problems.

The adjustment process has been particularly sluggish among reprivatised firms and companies that were privately owned prior to unification. Many of the firms privatised by the Treuhandanstalt, on the other hand, have mastered their problems. At the same time, the proportion of privatised firms whose problems have worsened in the recent years is also disproportionately high. Relatively few newly founded businesses, on the other hand, report a deterioration in their situation.

The situation facing many independent firms has clearly grown more acute in recent years. Far fewer of them have proved able to overcome the initial problems, and the proportion of such firms reporting a deterioration in their situation is relatively high. Firms owned by west German or foreign companies have, it seems, been better able to cope with the adjustment process.

The longitudinal analysis confirms that there are two major problem-areas facing east German firms: difficulties in obtaining finance and wage trends (cf. table 4). Only around one-third of the firms surveyed has mastered these problems. Two further problematic areas have increased in relevance: the majority of firms now face stiff competitive pressure and many companies are still having difficulties in obtaining skilled labour.

Conclusions for economic policy

The fundamental economic problem in east Germany is the inadequate competitiveness of many of its firms. The most evident symptoms are declining output, sales difficulties and financial problems. The causes behind this are to be seen both in the unsatisfactory overall economic context and in regionally specific competitive weaknesses, such as the state of transport infrastructure, enterprise-size deficiencies and market imperfections. In many cases, though, the difficulties reflect managerial errors; small- and medium-sized firms, in particular, frequently still lack adequate knowledge and experience of the market economy. Economic reconstruction in east Germany is increasingly proving a Herculean task requiring enormous strength and stamina.

Should government support be abandoned or expanded?

So far the underlying approach taken by economic policy makers has been to improve the attractiveness of eastern Germany as a production location and, for a transitional period, to offer investors compensation for the disadvantages they face there. Investors committing themselves in east Germany should be offered at least as favourable locational conditions as investors in west Germany. This implies that the support is to be provided for as long as the differences in locational competitiveness remain or, conversely, that it can and must be reduced to the extent that these differences narrow. The DIW, the IfW and the IWH consider this approach appropriate to the situation in east Germany.

Yet increasingly voices are being raised calling for a change of course in government support policy, although the views on what precisely should be done differ greatly. It has been argued that government support for east Germany should be:

- reduced or even terminated completely – but also that it should be increased further;
- streamlined and focused on a small number of programmes – but also that it should be differentiated further to take account of the specific problems faced by individual groups;
- concentrated on certain branches and regions – but also that it should be spread as widely as possible.

Diverse arguments have been put forward for each of these positions – arguments that not infrequently conceal purely self-interested motives.

One demand, albeit an extreme one, is that the special support measures for eastern Germany should be abolished: support should be reduced to the level provided in west Germany. In justification of this position it is argued that the aim of the support – to compensate for locational disadvantages – has been largely achieved, that the continued provision of support would privilege investors in east Germany and thus lead to regional competitive distortions.

An equally extreme view amounts, in principle, to the call for the volume of support to be increased fur-

Table 4

Selected Problems for Manufacturing Firms in East Germany, 1993 and 1995

as a % of all firms

	Firms experiencing the problem in 1993				Firms not experiencing the problem in 1993				Memo item: firms that had the problem in 1995 as a % of all firms
	Total	of which: firms that in 1995 ...		Memo item: firms as a % of all firms	Total	of which: firms that in 1995 ...		Memo item: firms as a % of all firms	
		still had the problem	no longer had the problem			still did not have the problem	had the problem		
Wage and salary growth too rapid	100	65	35	43	100	64	36	57	48
Lack of finance for investment	100	67	33	36	100	69	31	64	44
Plant/buildings outdated	100	54	46	28	100	85	15	72	24
Sales/distribution inadequate	100	44	56	27	100	86	14	73	22
Suppliers of comparable products cheaper	100	48	52	26	100	79	21	74	28
Local administration clumsy	100	44	56	23	100	83	17	73	24
Difficulty in obtaining skilled labour	100	57	43	18	100	83	17	82	25
Local infrastructure inadequate	100	38	62	17	100	88	12	83	16
Shortage of commercial sites and premises	100	50	50	13	100	93	7	87	13
After sales service inadequate	100	16	84	9	100	95	5	91	6
Skill level of workforce inadequate	100	25	75	9	100	95	5	91	7
Product quality inadequate	100	7	93	4	100	98	2	96	2

1) Firms that took part in both surveys.
Source: DIW surveys conducted in winter 1993/94 and spring 1995.

ther. This view is justified with respect to the existential difficulties faced by many east German firms. It is also argued in this context that substantial sums have already been invested and that these would be lost were the firms to fail.

The three institutes are of the opinion that neither of these demands is convincing. With the best will in the world it cannot be claimed that the competitive deficits in east Germany, whose roots lie in the division of the country, have already been overcome and that therefore additional support is unnecessary. On the other hand it is necessary to warn against the dangers of placing firms facing existential difficulties under virtual government protection, and in the final analysis this is what the demands for new support programmes and greater resource allocations amount to.

Concentrating government support

Nevertheless, economic policy makers need not – and must not – stand aside and watch as events take their course. If, as is now evident, the catching up process in east Germany is now only making sluggish progress, they must concentrate all their efforts on rendering government support more efficient. Regional economic research offers the following guidelines to this end. Regional growth process, steered by market forces, frequently proceed unevenly. Generally the concentration of economic activities generates greater welfare gains – thanks to positive externalities – than an even spatial distribution of economic activity.

Regional networks consisting of supply and sales relations are particularly successful if they extend to supra-regional markets. The growth potential of a region is determined decisively by its export basis.

Frequently, technological and organisational knowledge exhibits the characteristics of a local public good, i.e. research and development make their impact felt through local spill-over effects. An economic region seeking to catch up rapidly with highly developed areas should therefore produce its own know-how.

With regard to a restructuring of government support measures, the following conclusions can be drawn from the above:

(1) The emphasis of government support policy should be shifted away from support for individual firms in favour of general support for regional competitiveness. Two elements should be given priority: improving the institutional framework and improving transport infrastructure.

In the first case the prime aim should be to overcome market imperfections in the form of public monopolies and market regulations. These serve to increase transaction costs and render the region less attractive to investors. Greater competition on the market for electricity, for instance, would bring about lower electricity prices. Surveys have shown that many firms consider the high cost of energy in east Germany as a serious locational disadvantage.

In the second case the aim is, in particular, to accelerate transport flows by extending the road and rail network. The inadequacies of the transport network impose heavy costs on east German firms that reduce their competitiveness. The transport projects under the "German Unity" Programme should be realised as quickly as possible and not, as is increasingly occurring, be postponed because of financing problems; other urgent projects that are planned for a later date should be brought forward.

(2) Support for investment should remain the central support instrument at the micro level. Given that the first wave of restructuring and modernisation investment is now clearly ebbing, a second wave of (replacement and expansion-linked) investment must now be initiated. Investment support should not merely assist existing firms, but also – and in particular – help investors to set up new businesses.

(3) For many reasons it seems appropriate to concentrate support on specific regions, namely the "growth nodes": areas which, by virtue of the comparatively favourable infrastructural endowment and their high concentration of economic activities, are most likely to be in a position to catch up in terms of productivity with west Germany. This would then be likely to exert a positive impact on other regions. The aim of regional equality favoured by current support policy should initially be deferred until satisfactory growth has been achieved in the large urban centres.

(4) The very narrow export base in east Germany suggests that, in principle, it would be advisable to concentrate support on firms operating on supra-regional markets. Besides firms in many branches of manufacturing industry, these include those in some areas of producer-related services and tourism. Accordingly the DIW and the IWH are in favour of prioritising firms in the "export sector" with regard to the provision of government support, as is already the case to some extent. The IfW, on the other hand, has reservations about such a sectoral differentiation because it believes that it is virtually impossible to formulate operational criteria on the basis of which the firms constituting the export basis of a region can be accurately identified. In an earlier report (cf. Thirteenth Report) the institutes also took opposing positions on this issue.

(5) As a matter of urgency the financial basis of firms already experiencing a growth process and in need of additional capital should be broadened. The best way of bringing this about is to extend the markets for venture capital and facilitating firms' access to them. New programmes should not be launched, however. This also implies that the process of selection to the detriment of uncompetitive firms should not be postponed.

(6) It would not be advisable to differentiate support by branch, location, type or size of company, calls for which have been raised in view of the increasingly diverse nature of the east German business sector. Caution is also required with special programmes designed to address specific weaknesses at the micro level (e.g. to provide managerial skills or promote sales). Deficiencies in these areas are best solved by means of learning processes on the market. Otherwise there is the danger of merely doctoring the symptoms.

The recommended strategy – for a concentration and against a differentiation of support funds – requires an enormous effort of political will, because initially it serves to intensify the process of selection and thus exacerbates the difficulties of the task of reducing unemployment. The calls for support for specific groups will grow louder. There are already voices calling for failed companies to be returned to the shelter of a successor to the Treuhandanstalt. Yet the fact remains that all firms, and that means those in east Germany, too, must at the end of the day hold their own on the market.

By providing massive support for the transformation process the government has sought to buy time – even for firms whose chances of successful restructuring were initially uncertain or slim. Yet much time has now passed and a substantial proportion of firms is still a long way from the profitability threshold. Continuing to offer support to such firms would merely postpone the problem further, incurring heavy costs, without really solving it.

Whatever steps economic policy makers consider taking, in one respect, and perhaps the most important one, their scope for action is tightly circumscribed: it is not in their power to exert an influence on wage cost trends (with the exception of indirect wage costs). The fundamental problem facing the east German economy is that the wage level remains far too high. Average unit labour costs are around one-third higher than in west Germany, and so far all the attempts to force them down have been confounded. Although the mistakes made in the past can no longer be rectified, one should avoid making the same mistakes again. Spreading out the process of wage adjustment to west German levels would be the best way of promoting economic development in east Germany. It is only then that the efforts being made by government to support east German firms can be successful.