

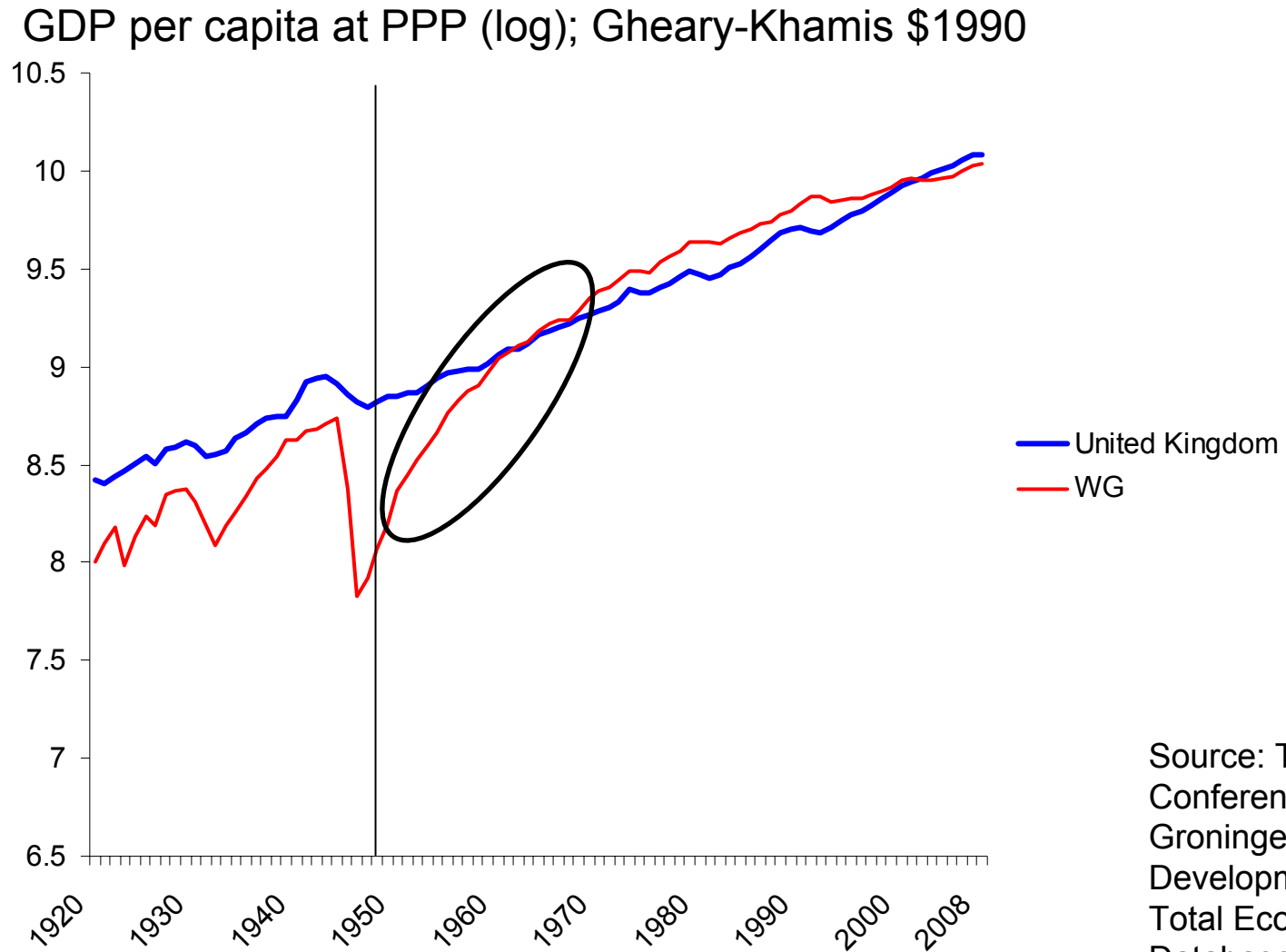
Good institutions are not enough – persistent problems of East German development

Wendy Carlin

UCL & CEPR

March 2010

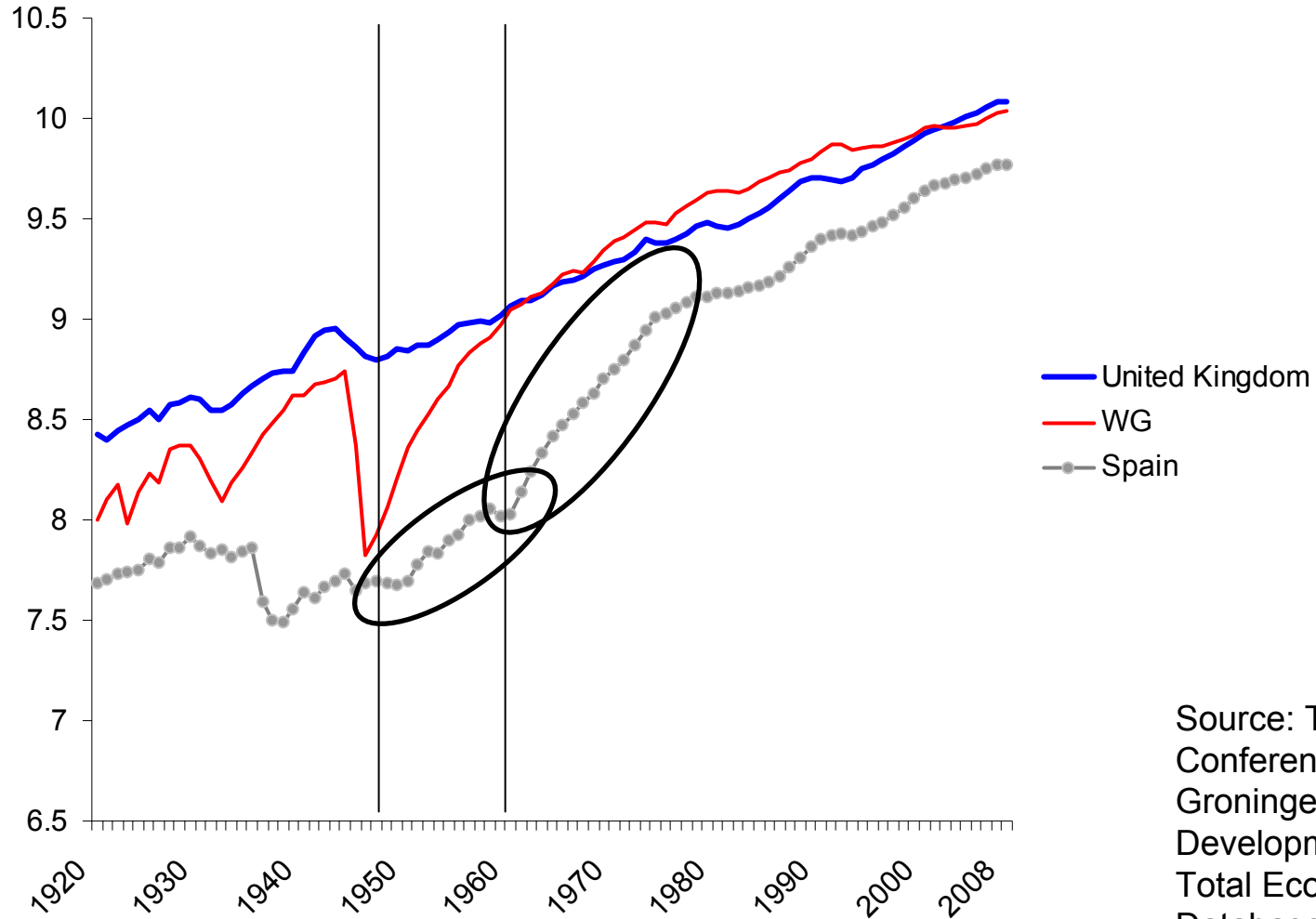
Expectations for post-reform growth #1



Source: The Conference Board and Groningen Growth and Development Centre, Total Economy Database

Expectations for post-reform growth #2

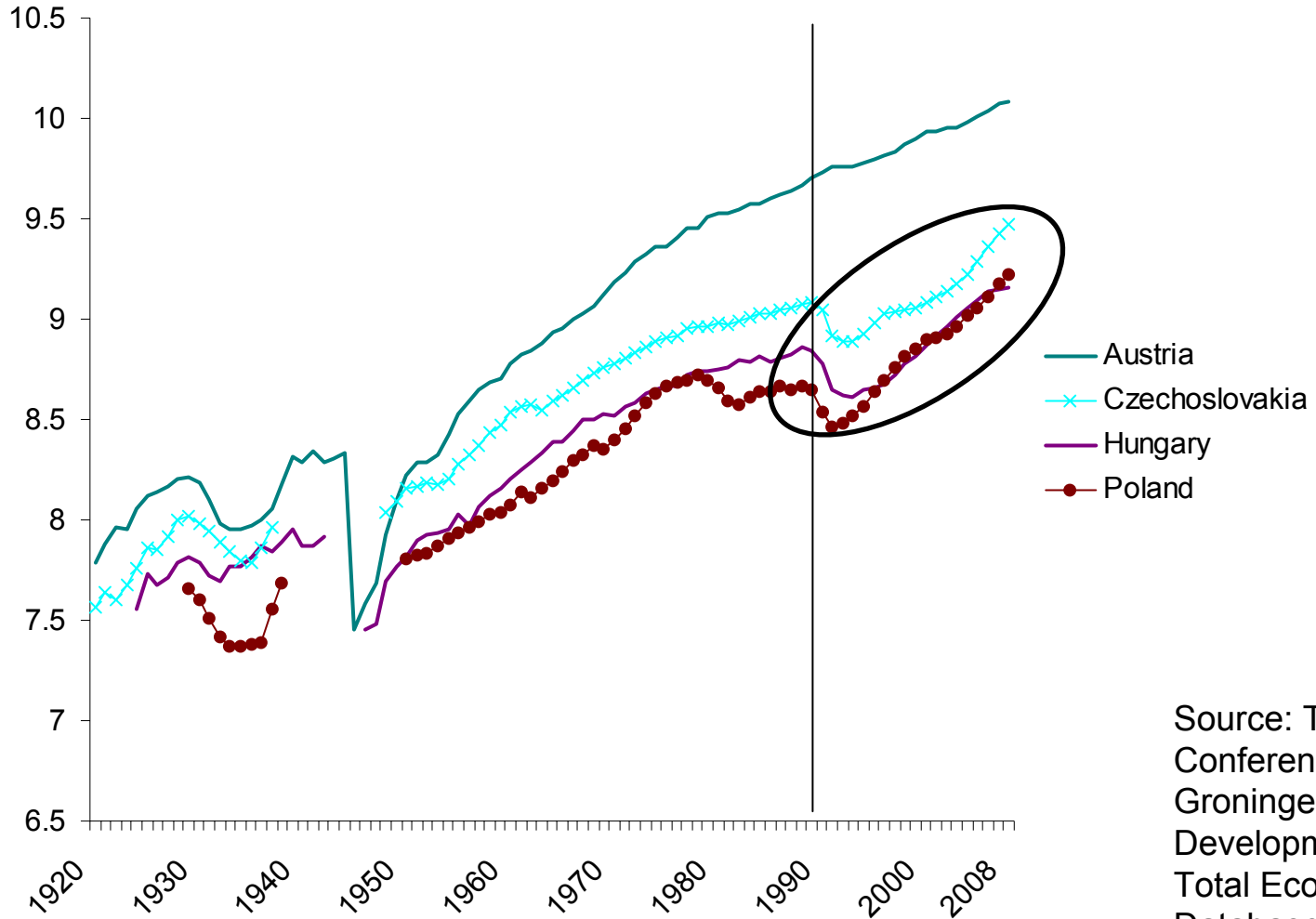
GDP per capita at PPP (log); Gheary-Khamis \$1990



Source: The Conference Board and Groningen Growth and Development Centre, Total Economy Database

Disappointing outcomes

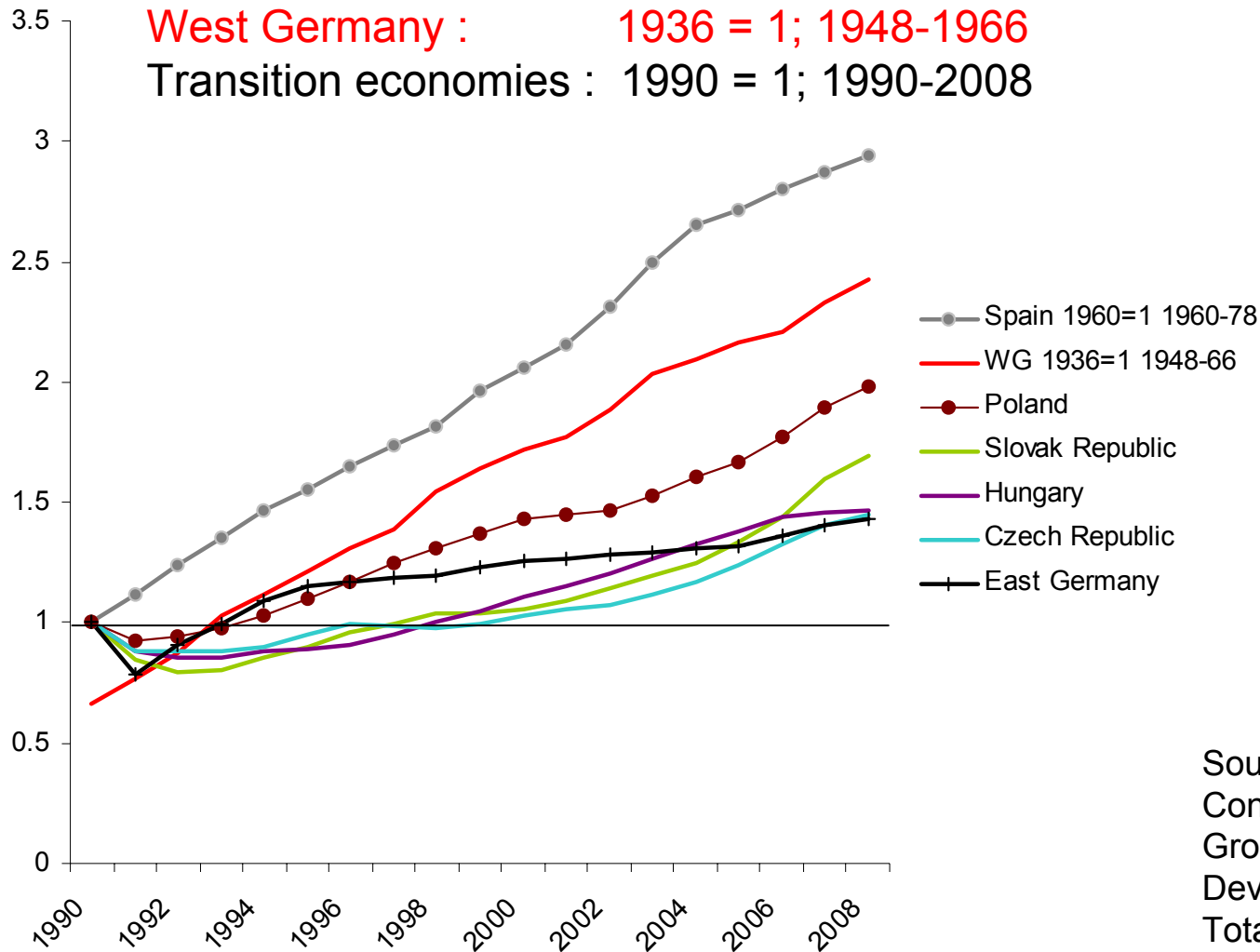
GDP per capita at PPP (log); Gheary-Khamis \$1990



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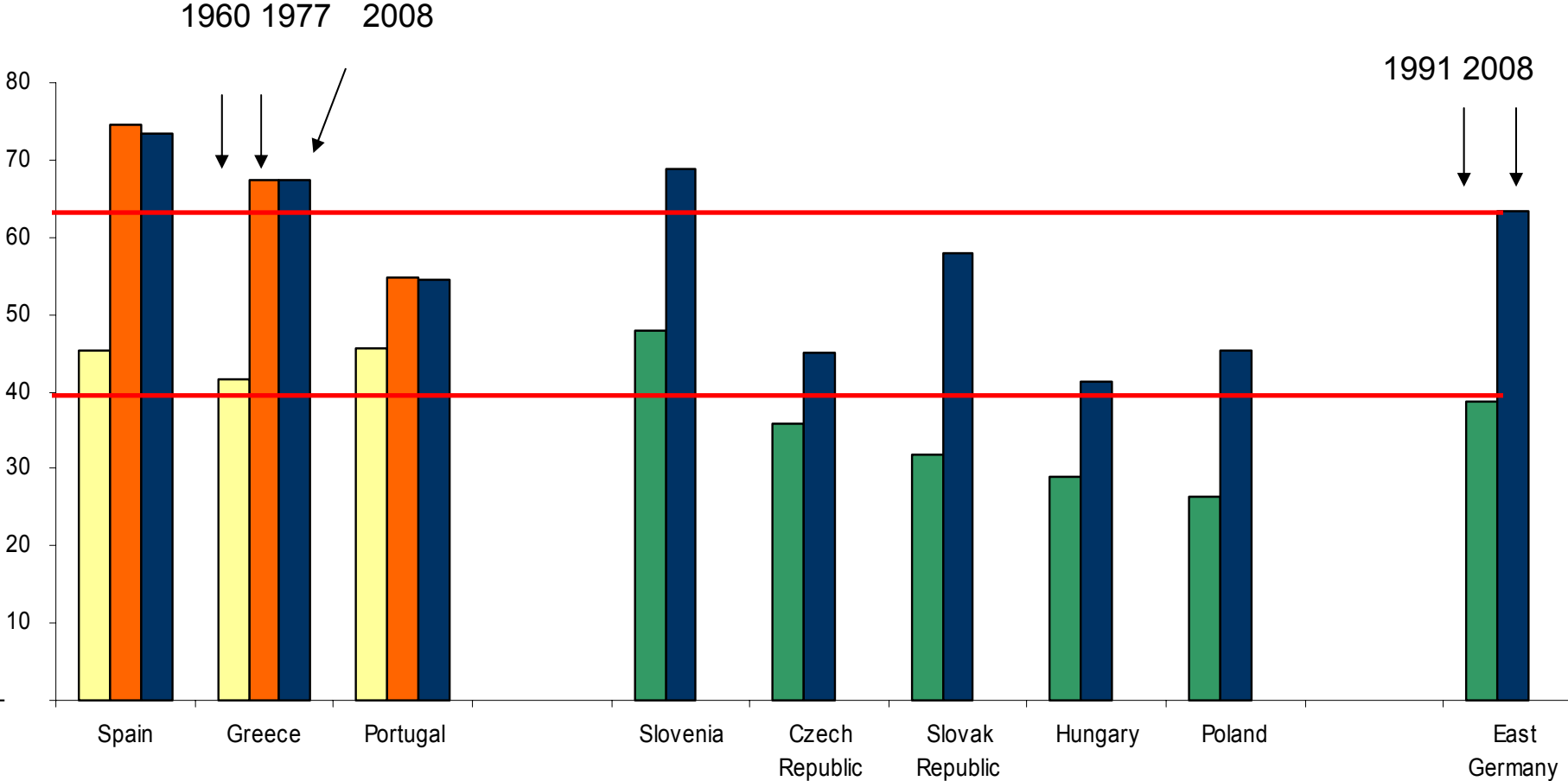
Post-reform GDP per capita growth: 18 years

Spain : 1960 = 1; 1960-1978
West Germany : 1936 = 1; 1948-1966
 Transition economies : 1990 = 1; 1990-2008

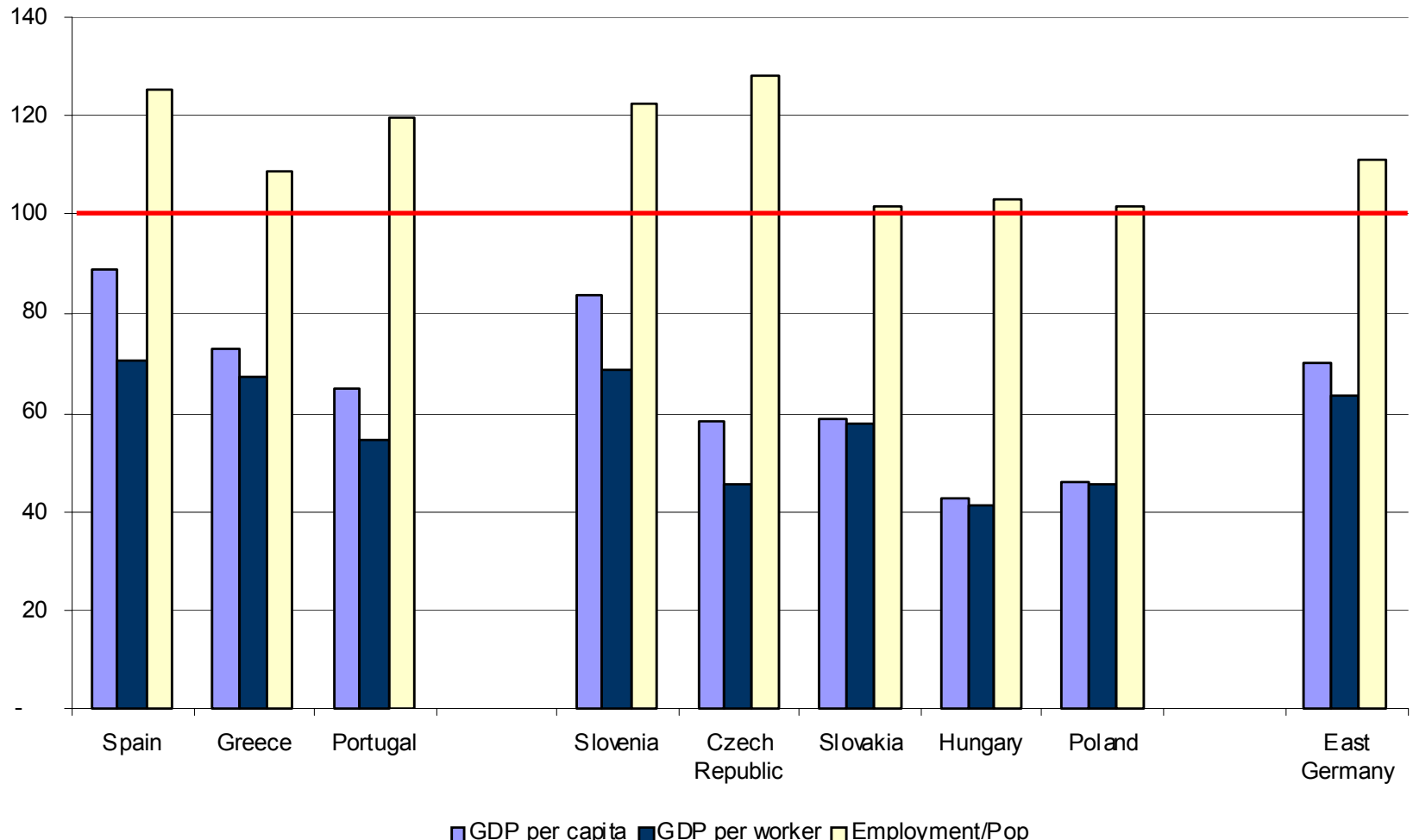


Source: The Conference Board and Groningen Growth and Development Centre, Total Economy Database

Comparing the southern with the transition catch-up: productivity (GDP per worker), France = 100



Comparing GDP per capita, productivity & employment rates in 2008: **France = 100**



Post-reform catch-up episodes

- Expectations for transition based on earlier European episodes – but conditions for catch-up very different
- Most transition countries began further behind relative to France than were the southern countries in 1960
- Southern productivity catch-up stopped after about 20 years
- East Germany's catch-up similar to Greece's from 1960; neither exceptionally good nor bad compared with other transition economies

What was the binding constraint on catch-up in transition?

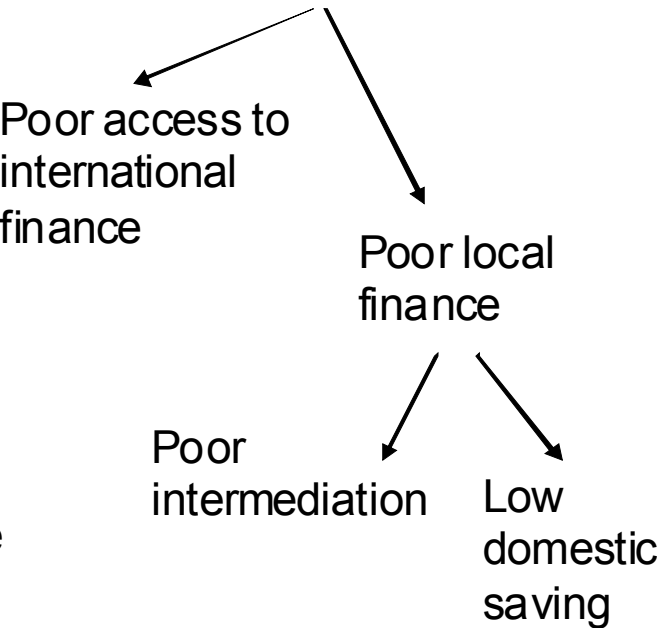
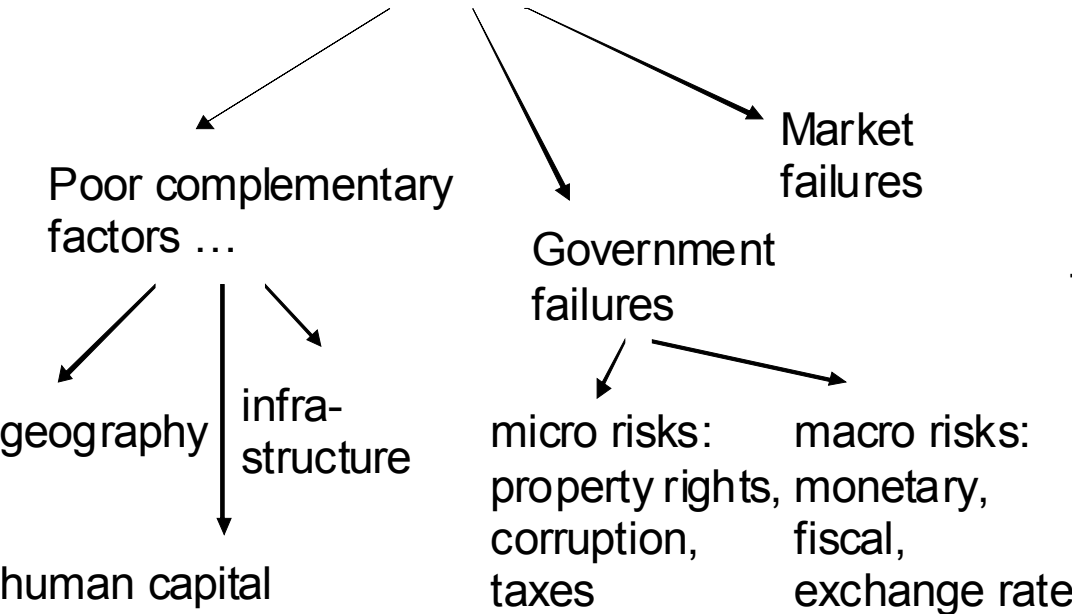
- A framework for analysis – “growth diagnostics” of Hausmann, Rodrik and Velasco
- Comparison between East Germany and other transition economies

What is the binding constraint on growth where private investment and entrepreneurship are low?

Growth depends on (rate of return – real interest rate)

If low rate of return, then is it because of ...

If high cost of finance then is it ...



Growth diagnostics for transition economies

Was low investment & weak entrepreneurship due to

A lack of finance?

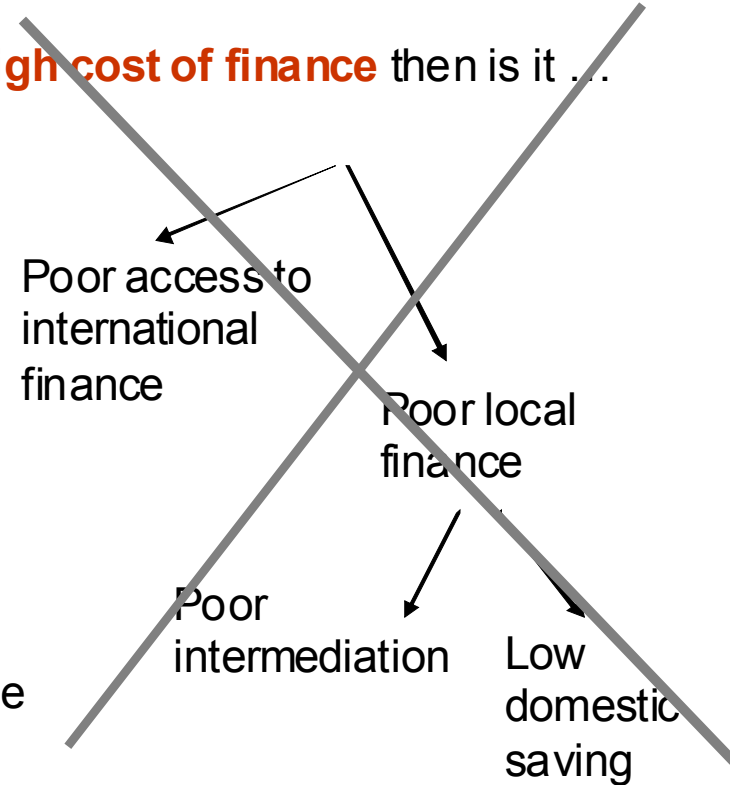
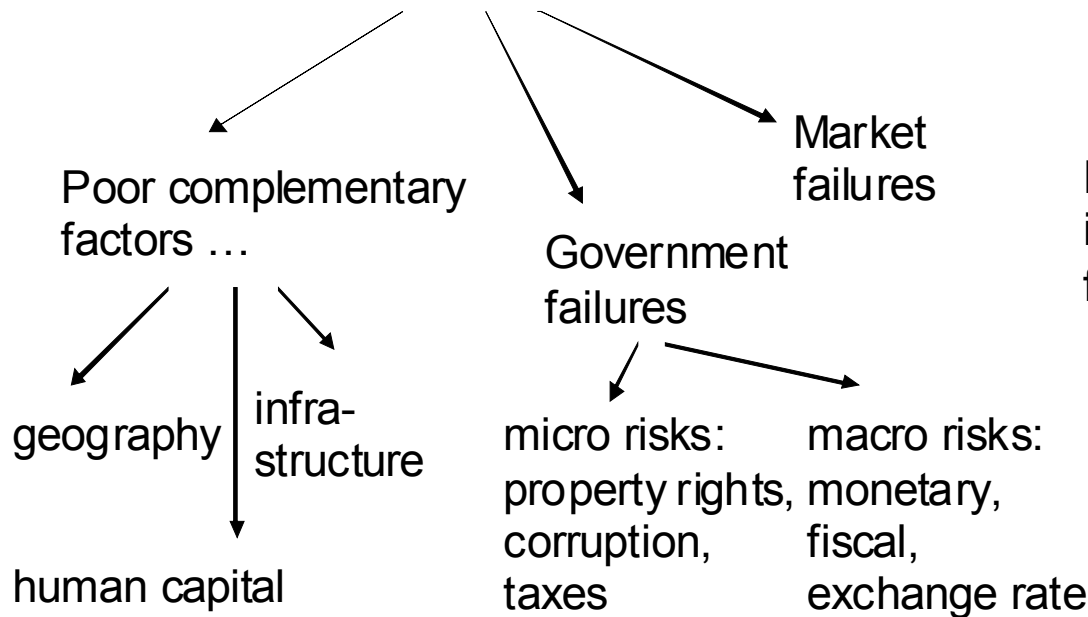
- Not international finance: CEECs did not suffer from Lucas paradox: capital flowed in; no repeated balance of payments crises
- Not domestic finance: international banks took over banking networks

If not the cost of finance, then the rate of return ...

Growth depends on (rate of return – real interest rate)

If low rate of return, then is it because of ...

If high cost of finance then is it ...



Why a low rate of return?

- Poor complementary factors? No – good geography; legacy of communism in infra and human capital was good
- Government failure? Yes – institutional weakness
 - Stabilization, liberalization & privatization did not create functioning market economy institutions (legal system, anti-corruption, tax & customs administration, etc.)
 - Large state owned enterprises needed *effective* owners / corporate governance institutions ... not just *private* owners

What about East Germany?

Institutional weakness was a less plausible constraint

Institutional transfer from the Federal Republic

Two caveats:

1. Institutions are norms – not just rules on the books
 - Legacy of communism persisted; evidence in attitudes
2. Mismatch of WG institutions with EG needs
 - Union wage-setting + THA + social security entitlements → EG left with cost burden but without micro-institutional benefits of WG ‘model’
 - Why? WG export-oriented core was not replicated in the East
 - However, there has been substantial institutional adaptation in wage-setting

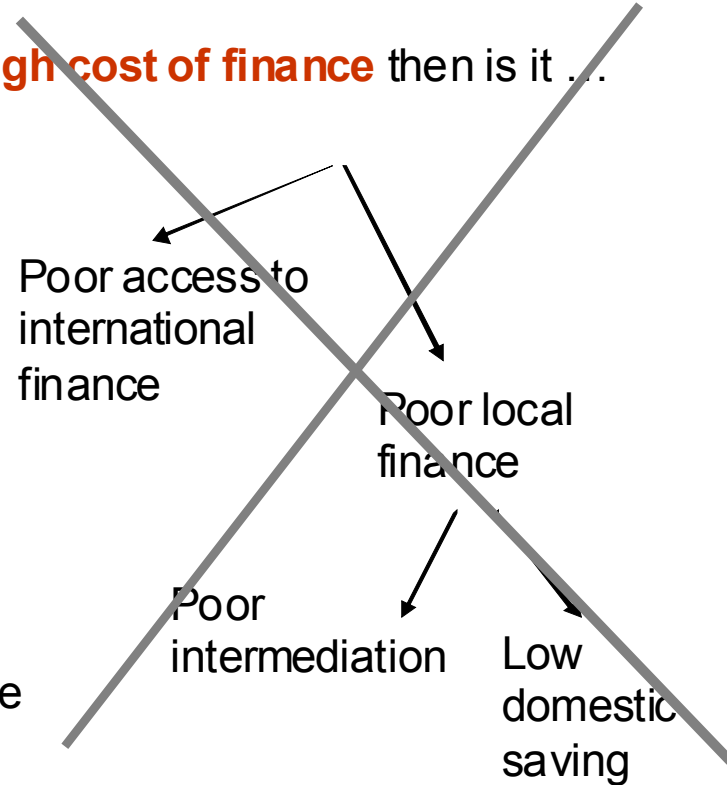
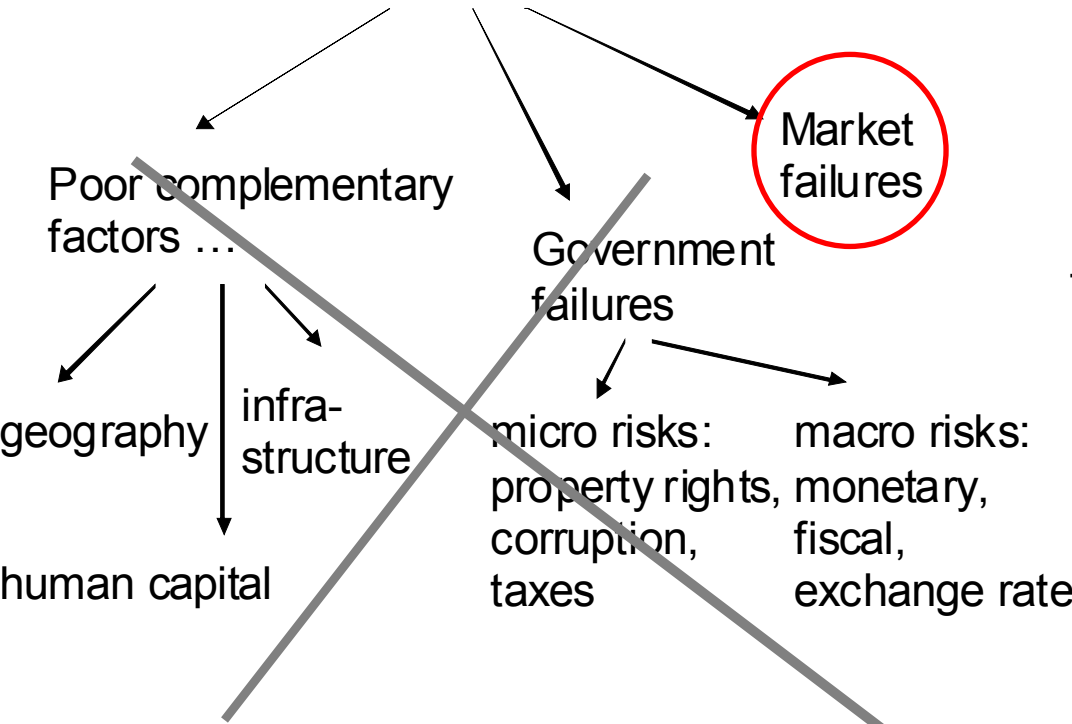
Bottom line: high quality, credible institutions; some mismatch but subsequent adaptation

The binding constraint in East Germany was not institutional quality ... but market failures

Growth depends on (rate of return – real interest rate)

If low rate of return, then is it because of ...

If high cost of finance then is it ...



What is ‘market failure’ as a binding constraint?

- Hausmann, Rodrik & Velasco: *“the development process is largely about structural change: it can be characterized as one in which an economy finds out – self discovers – what it can be good at, out of the many products and processes that already exist”*
- EG’s problem of self-discovery: floor to real wages imposed by the *political settlement* of unification → needed to ‘self discover’ closer to the technology frontier than a typical developing or transition country

How to find a niche in the international division of labour after 40 years of absence?

- New ideas to replace old activities
- Openness to trade & capital flows does not automatically generate knowledge of niches
- Discovery inhibited by learning & coordination externalities
- In core of WG economy, complex institutional matrix promotes spillover of technological & marketing information; coordination of lumpy upstream & downstream investments – not replicated in the East

Market failures of coordination and information externalities

Examples from research on EG

- Uhlig's multiple equilibria model → low productivity & outmigration from non-networked to networked regions
- Rosenfeld et al.'s empirical characterization of spatially concentrated industries – clusters with network & innovation characteristics relatively rare in EG

Methods of discovery

- Discovery based on historical roots – e.g. Zeiss/Jena (Kogut & Zander)
- Traditional industrial policy – e.g. solving forward & backward linkages by massive state intervention in chemical complex Infraleuna (Paqué)

Policy makers should pay most attention to the binding constraint

East Germany – inadequate supply of good projects

- Not lack of savings or access to finance, or inefficient or corrupt institutions, or weakness of complementary factors
- Initial overvaluation of EG's real exchange rate was outcome of political constraints set by unification
- Solution required dealing with market failures inhibiting development on a sufficient scale of globally competitive activities

Shortage of 'export-base' jobs

Jobs directly or indirectly producing goods & services sold beyond the region

Regional weakness = lacks sufficient export base jobs; dependence on transfers to support living standards (e.g. via national benefit & government pay scales)

Two ways to eliminate regional weakness

1. Potential workers move to the other region (WG)
2. New jobs are created in EG

If not 1 and 2, then

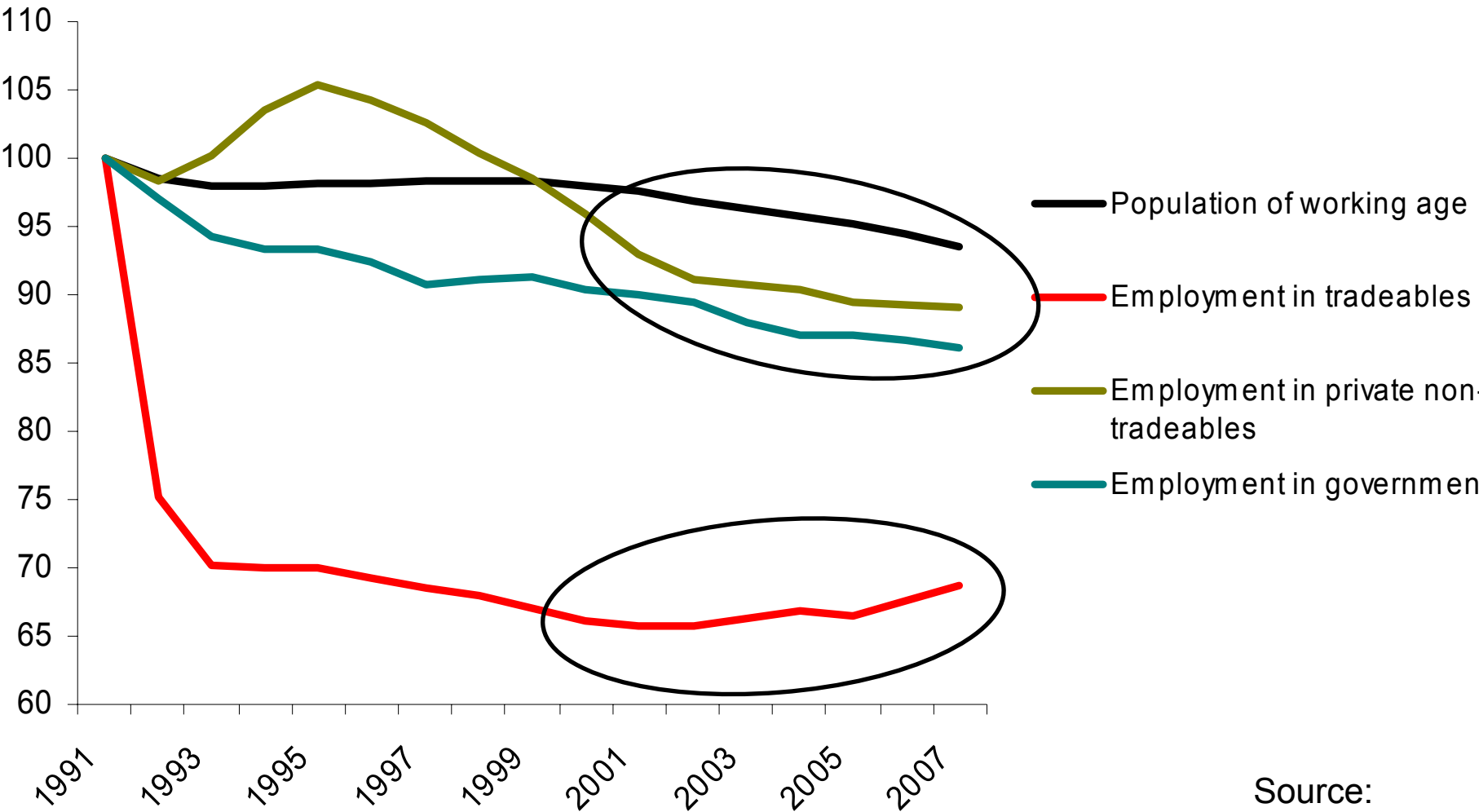
3. Mezzogiorno scenario → excess population remains in lagging region but local economic development too weak to absorb it

The Export Base

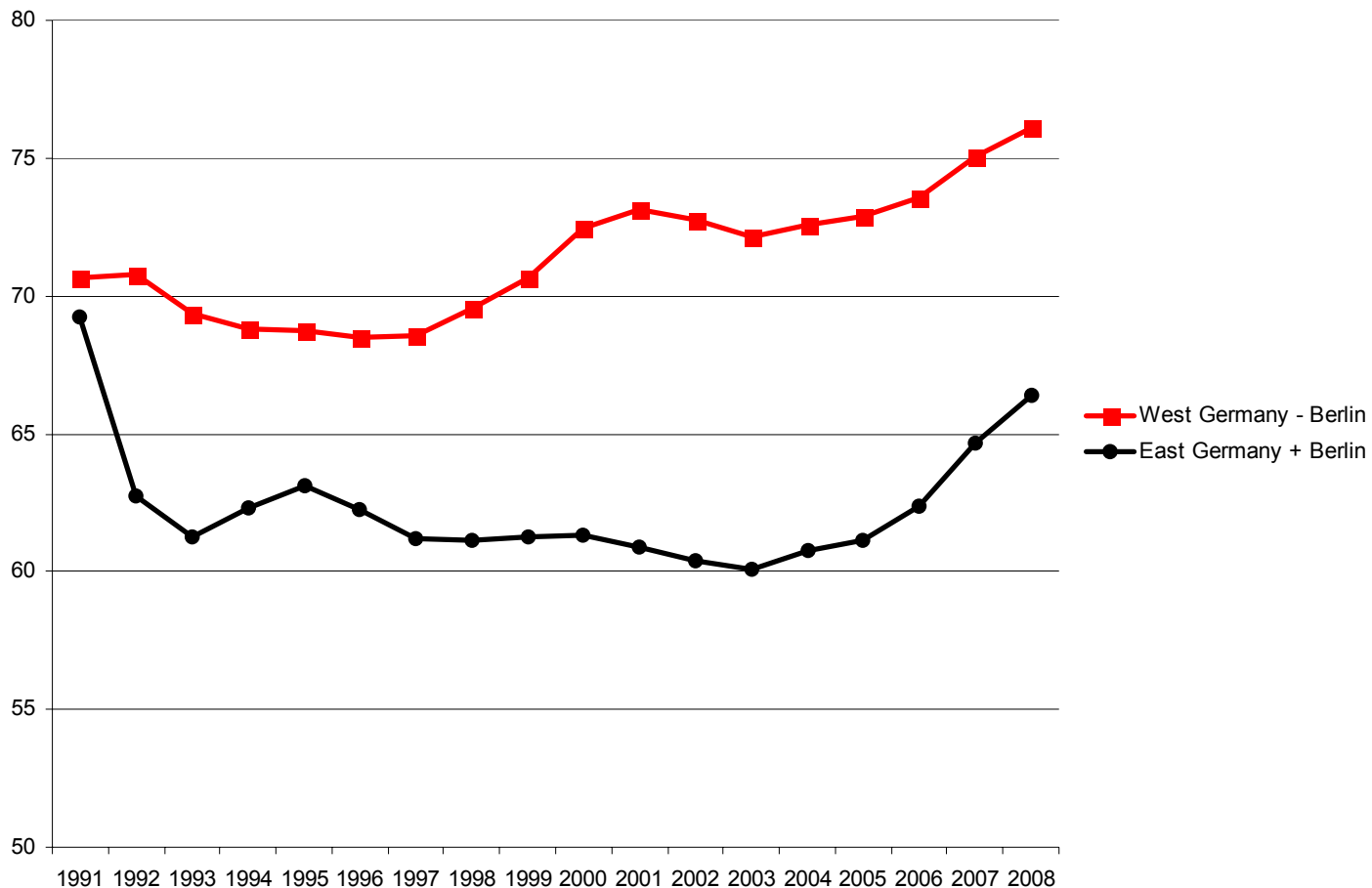
- Crude calculation of employment in tradeables, private non-tradeables & government
- Export base = manufacturing + agriculture + mining + 'excess employment' in finance & business services
- Calculate 'excess' using lowest ratio of employment to population in finance & business services across regions each year to fix 'minimum' needed for local needs; rest is 'excess' & allocated to tradeables

Adjustment processes in East Germany

Ratios to Germany as a whole: 1991=100

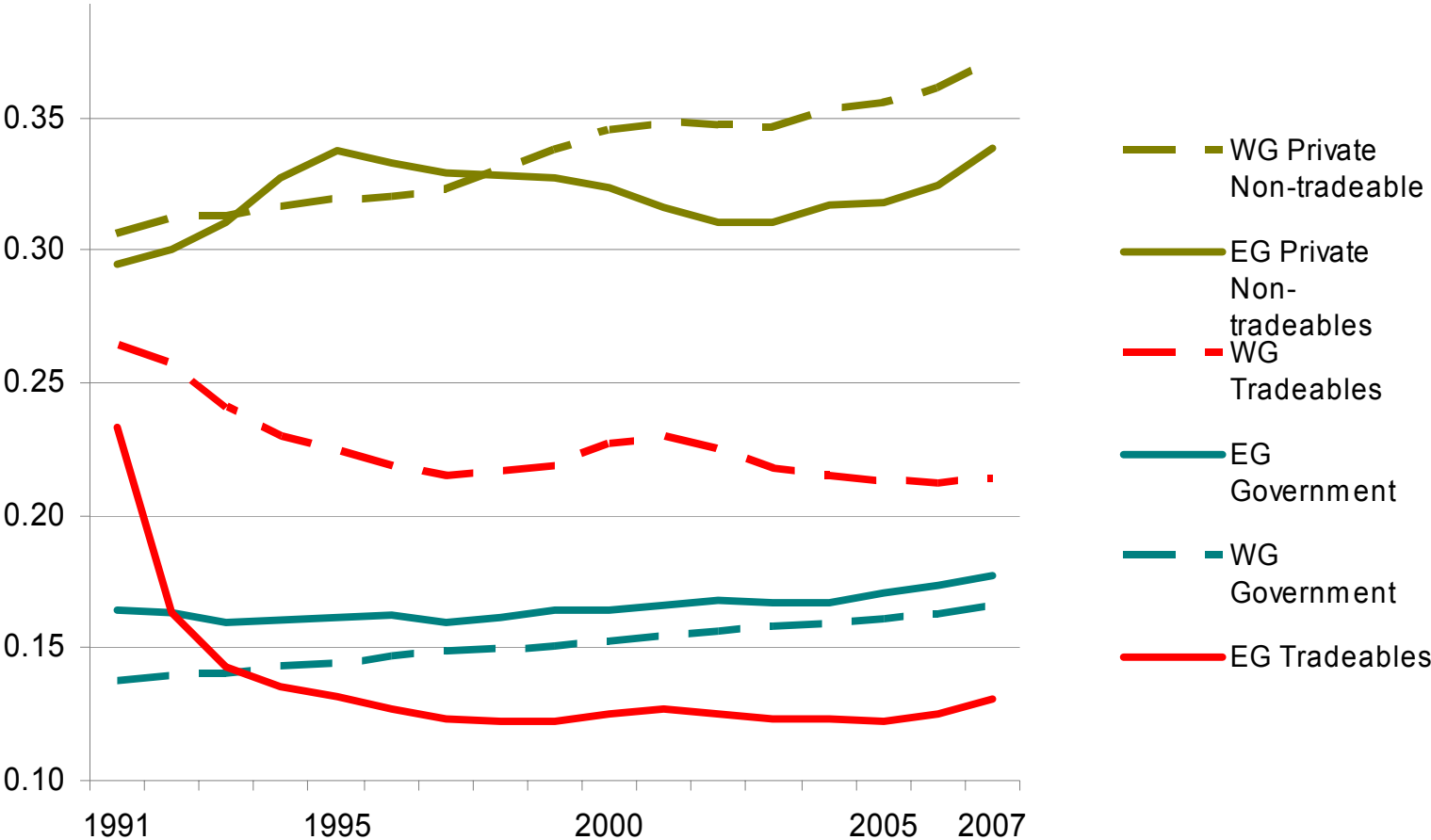


Trends in economy-wide employment rates (% working age population) East and West Germany



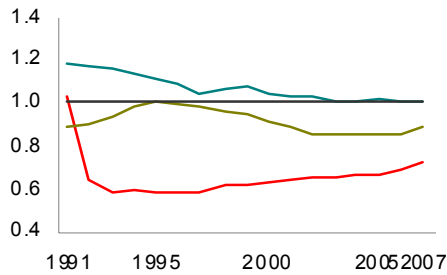
Trends in employment rates in East & West Germany, 1991-2007

Employment per head of working age population

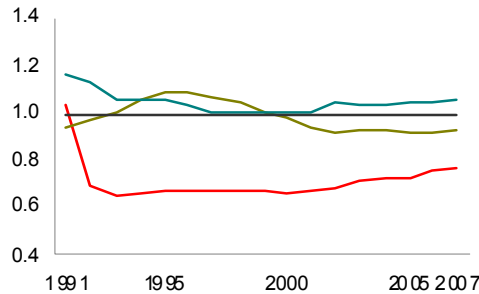


Evolution of the export base within East Germany: ratios of employment rates to WG

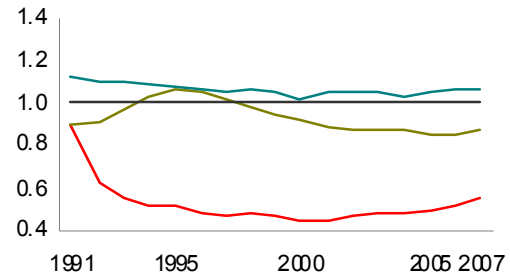
Thuringen



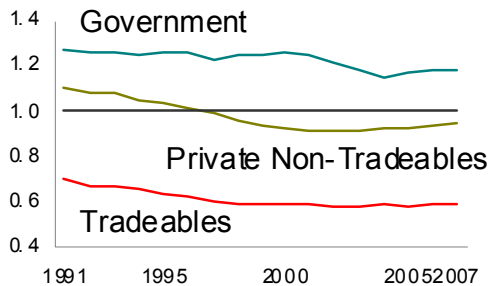
Sachsen



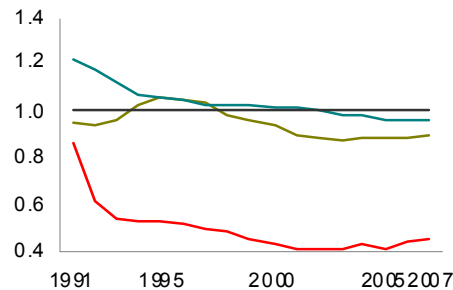
Sachsen-Anhalt



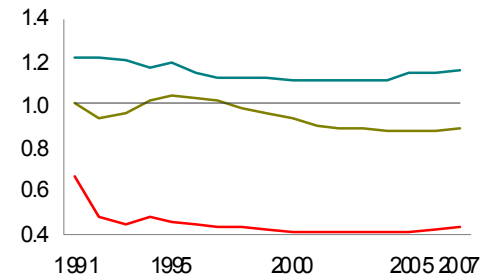
Berlin



Brandenburg



Mecklenburg-Vorpommern



EG's export base remains much too small – but tangible improvement has occurred

In addition to direct measures to ease the binding constraint, real depreciation versus West Germany was beneficial

- Nominal wage growth slower
- Productivity growth higher

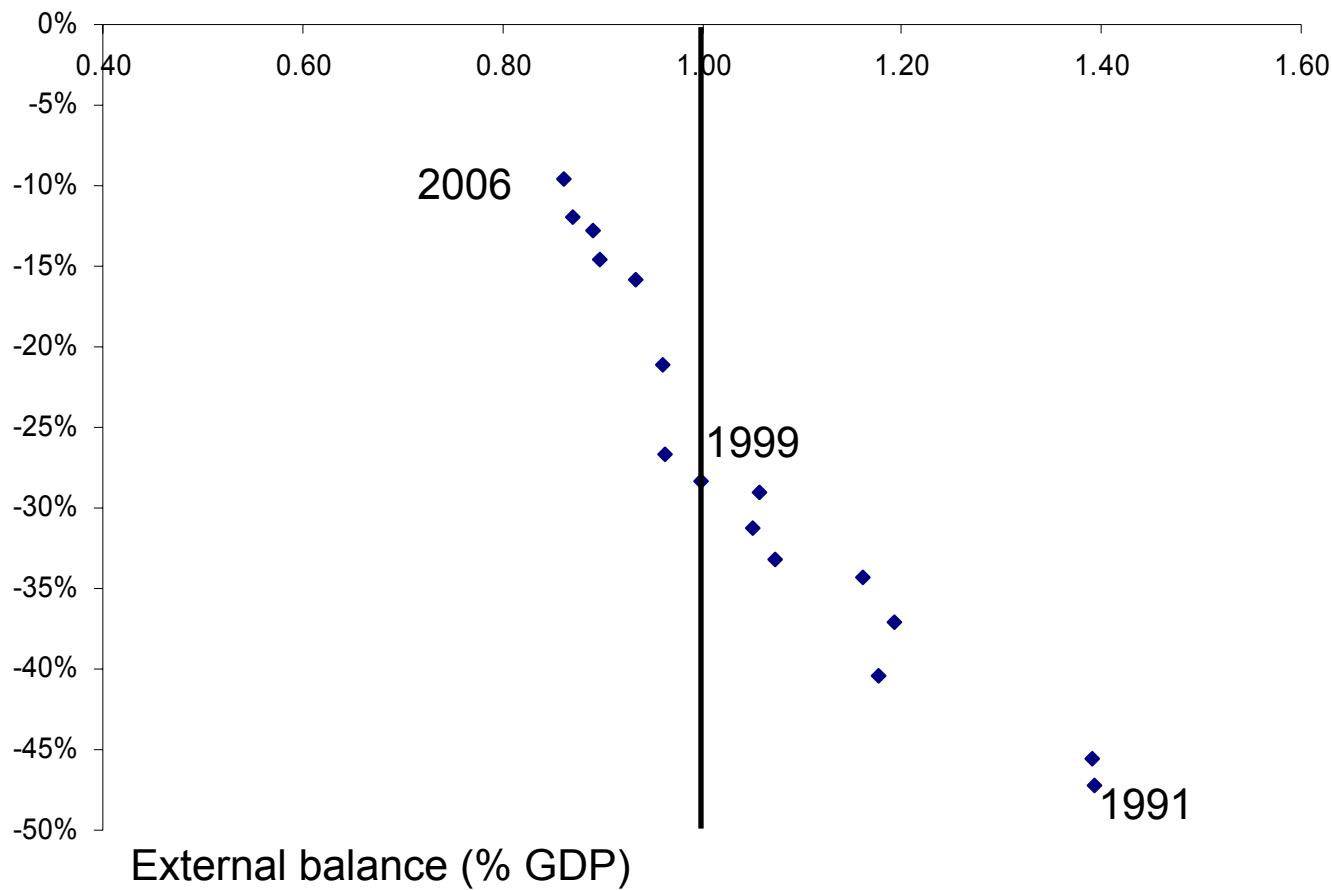
Reflected in

- Falling external deficit
- Stabilization of hours worked in tradeables

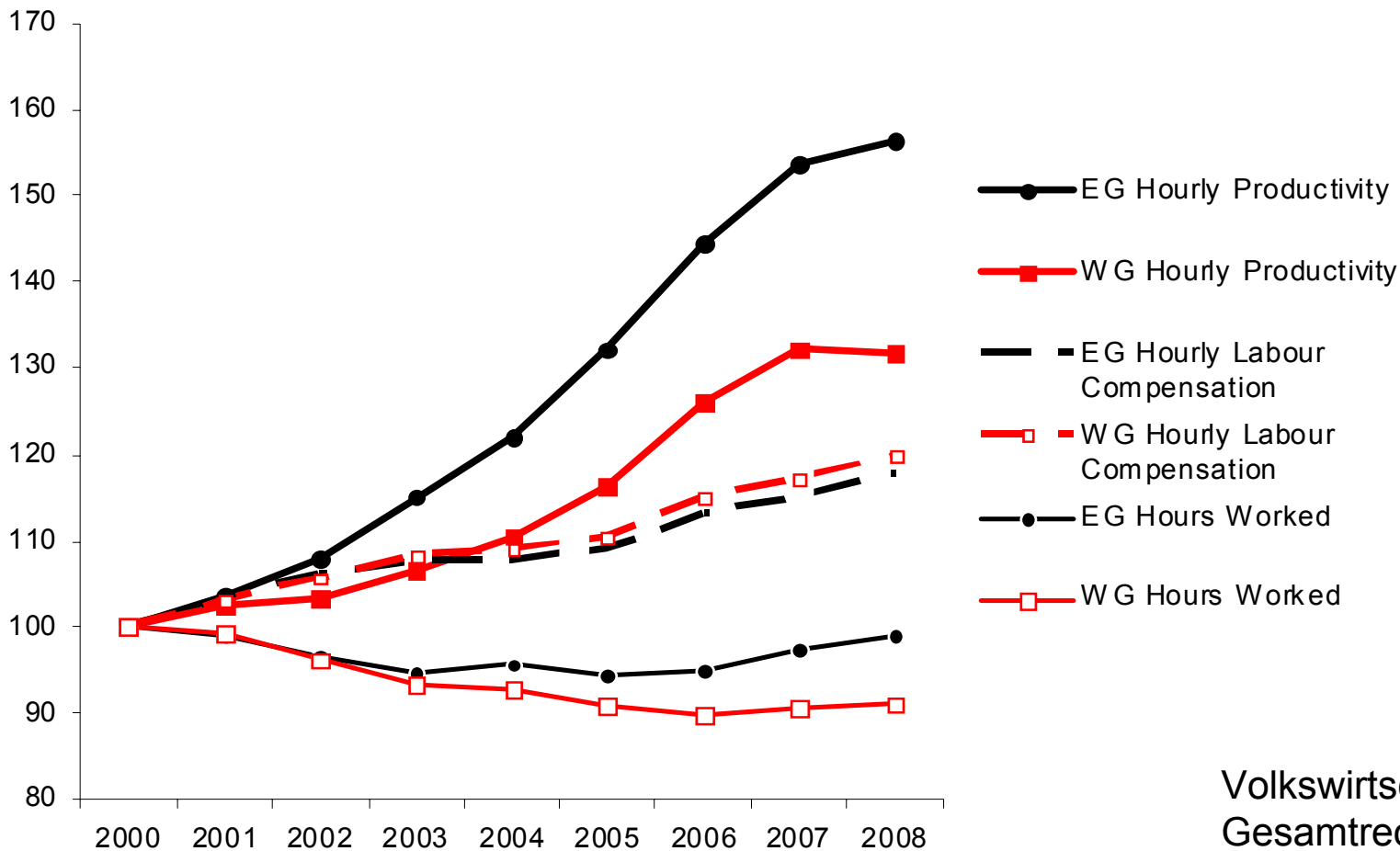
East Germany: improvement in

- relative unit labour costs in manufacturing
- in external balance

Relative unit labour costs EG/WG

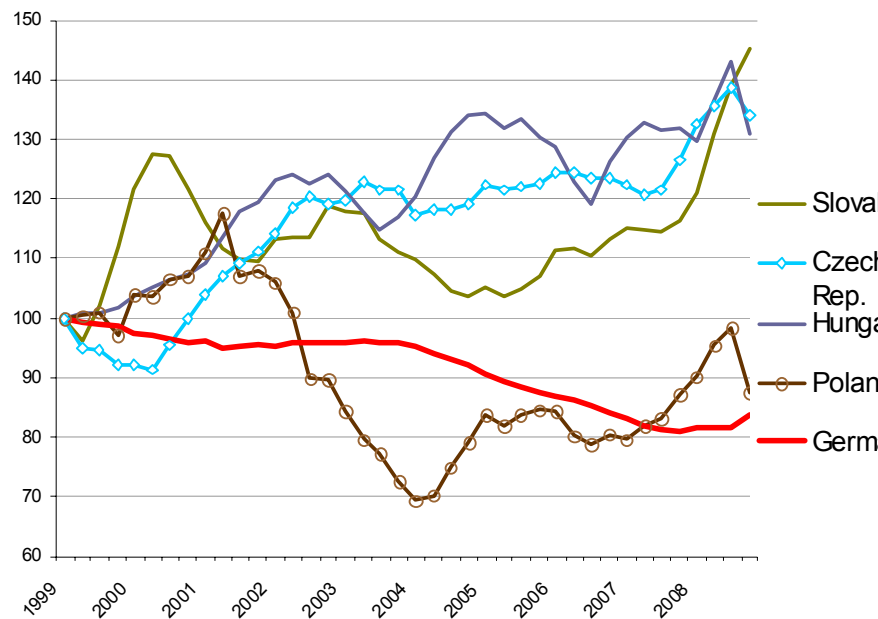
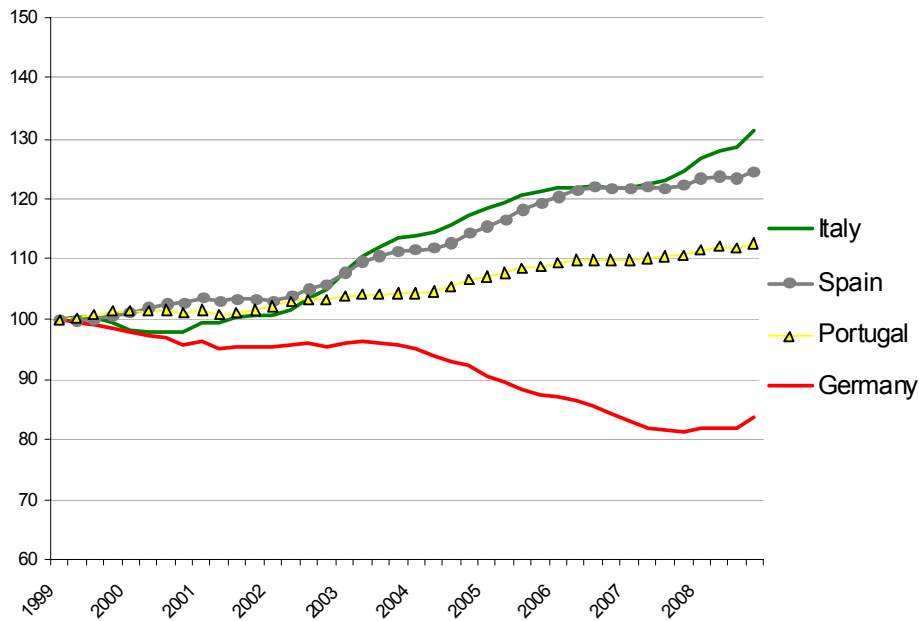


East and West German Productivity, Labour Compensation and Hours worked in Manufacturing, 2000-2008 (2000=100)



The broader context – real exchange rate changes: Germany versus southern and transition countries

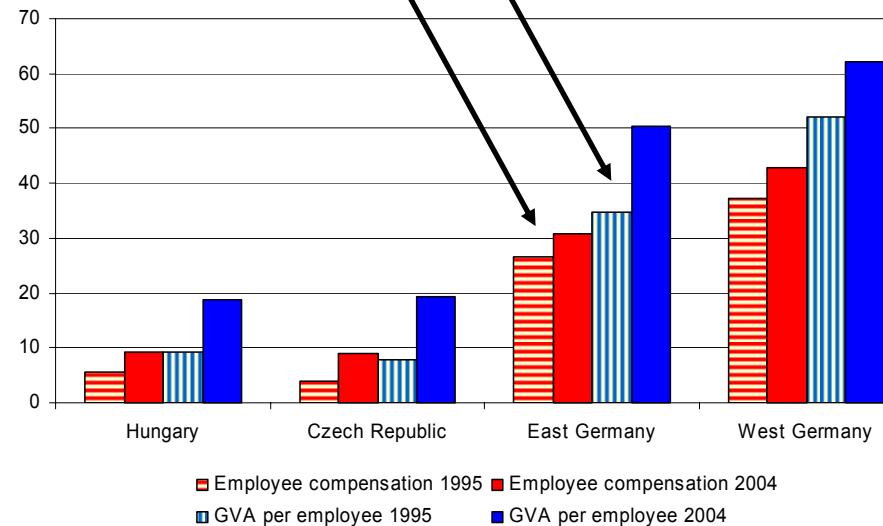
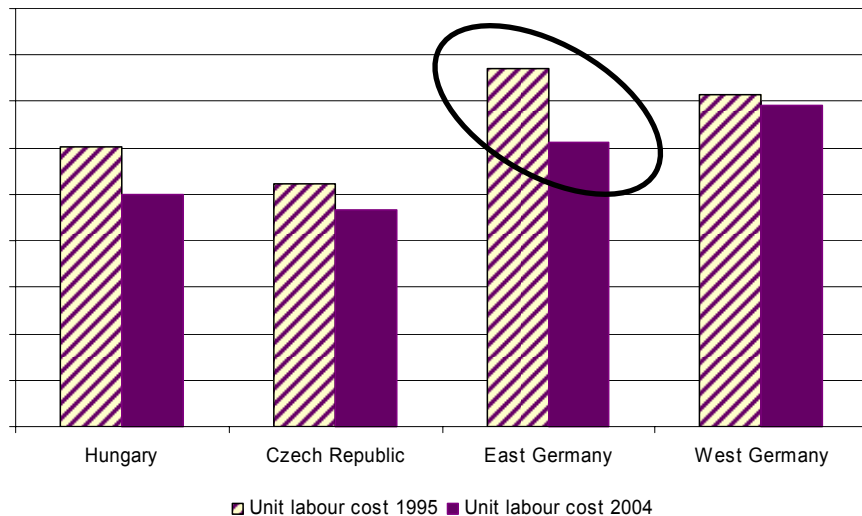
Intra-EU27 Relative unit labour costs in manufacturing 1999=100



Direct comparison of levels of unit labour costs in euros 1995 and 2004; industry Czech Republic, Hungary, East & West Germany

Biggest rise in productivity

Smallest rise in employee compensation



Summing up

- As shown elsewhere in transition, 40 (or more) years outside the global market economy left a substantial legacy
- East Germany's performance since unification should be judged as satisfactory – no clear evidence of a Mezzogiorno scenario
- No room for complacency – catch-up is very slow; poles of tradeables success are much too small
- Well-designed industrial policy should target the market failures

Finally

- More balanced growth in West Germany with less reliance on exports would reduce tensions in eurozone that depress growth in Germany's largest market (40% of German exports go to eurozone; 9% to US; 3% to China)
- Given East Germany's greater labour market flexibility, a West German growth locomotive for Europe would also promote East German catch-up

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