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August 22, 1991

To: Members of the Executive Board

From: The Secretary

Subject: The Economic Transformation of East Germany - Lessons for Eastern Europe

The attached paper on lessons for Eastern Europe from the economic transformation of East Germany provides background material for the 1991 Article IV consultation discussions with Germany, which is tentatively scheduled for discussion on Wednesday, September 11, 1991.

Mr. Wolf (ext. 7413), Mr. Boote (ext. 8801), or Mr. Bredenkamp (ext. 8881) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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The Economic Transformation of East Germany: Lessons for Eastern Europe

Prepared by a Staff Team 1/

Approved by the European Department

August 22, 1991

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1/ Messrs. Wolf, Boote, Bredenkamp and Mihaljek (all EUR).

I. Introduction

This paper examines the lessons from the economic transformation in east Germany in the year following German economic, monetary and social union (GEMSU), for the countries of central and eastern Europe. Successful transformation of these economies into market-based economies launched on a path of rapid and sustained growth requires not only radical systemic change, but also the enhancement of their human and physical capital, and appropriate macroeconomic policies. This paper focuses on the issues of systemic change and capital formation. 1/ Section II deals with the liberalization of markets, in the sense of the elimination of controls over prices and of quantitative restrictions. The third section examines the need to create a supportive institutional environment for the efficient functioning of markets as well as for avoiding abuses and alleviating the social costs of the transformation. The crucial importance of establishing effective ownership is explored in Section IV, and selected problems in enhancing human and physical capital are discussed in Section V. The final section draws some general lessons from the east German experience for Eastern Europe.

Obviously there are limits to the extent to which lessons can be drawn from the brief history of systemic and structural change in east Germany. The east German experience is unique in that the former GDR was unified with a highly developed market economy ready and able to assist in a massive way with its transformation. Unification has resulted in several key differences from Eastern Europe. These include: (i) immediate and virtually complete liberalization of product and capital markets; (ii) comprehensive and rapid adoption of west German institutions and legislation throughout the economy; (iii) a macroeconomic environment characterized by the extension of traditionally anti-inflationary policies to east Germany, a fixed exchange rate vis-à-vis the western part of Germany, and the removal of any east German current account constraint; and (iv) the widespread expectation of east German living standards rising to a level approximately equal to those in west Germany, in the medium term. These differences notwithstanding, the east German experience does offer some useful lessons for East Europe.

II. Liberalizing Markets

1. Product markets

GEMSU set forth the principle of free prices and free movement of goods, throughout east and west Germany from July 1, 1990. The lifting of restrictions on pricing and intra-German trade in goods and services was accompanied by the abolition of east Germany's complex system of price subsidies and turnover taxes. The latter were replaced by west German indirect taxes. The prices of a few goods and services which were regulated in west Germany (including household energy, postal and telephone charges,

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1/ The issue of appropriate macroeconomic policies is not generally discussed, because of the unique character--in the context of Eastern Europe--of the macroeconomic environment in east Germany following GEMSU (see below).

public transport tariffs and rents) continued to be administered in the new Länder. In January 1991, electricity prices were increased to western levels, and public transport subsidies reduced; in the spring, postal charges and coal and gas prices were increased. A special agreement was reached with the pharmaceutical companies, whereby western prices for medicines would be phased in gradually in east Germany, so as to soften the impact on the east German health insurance funds. Agricultural producers in east Germany became subject to the price-support and other mechanisms of the EC's Common Agricultural Policy, and restrictions on east German foreign trade in general were superseded by standard EC trading regulations. Temporary subsidies were, however, granted to east German firms to fulfill existing export contracts with former CMEA partners. These were followed in 1991 by the introduction of special terms on official export credit guarantees for exports to the Soviet Union.

One immediate consequence of the shift to free product markets was a change in relative prices. Data on price developments in east Germany are limited and difficult to interpret due to large changes in the pattern of demand, in the quality of goods available, and in the structure of taxes and subsidies. The available data suggest that industrial producer prices declined by around one-third following GEMSU due to the lower taxation of consumer goods and increased competition. While overall consumer prices were little changed, there was a sharp shift in relative prices. Food prices rose substantially due to the removal of food subsidies, though drink and tobacco prices declined by up to one half. Prices of consumer goods declined by around one-third--with a decline of over two-thirds for certain electronic goods such as televisions. Prices of services more than doubled and there were also large increases in some administered prices such as energy. A marked modification of price relativities is a phenomenon common to many planned economies in transformation, given the tendency in these countries to subsidize the consumption of food while imposing heavy taxes on consumer durables, though this is likely to occur over a longer time scale than in east Germany. When combined with trade liberalization, the general effect will be, as it was in east Germany, to shift demand toward imports (since this tends to be the primary source of desirable consumer durables), at the expense of domestic production. Reinforcing this shift in the east German case was a reported preference for "western" products of all types, including food, based largely on their superior quality, packaging and novelty value; by contrast, imports from the CMEA area dropped sharply in the second half of 1990.

In east Germany, the surge in demand for imports was met through a substantial balance of payments deficit. For most East European countries, who do not share a common currency with a major western economy and whose balance of payments positions are for the most part tightly constrained, this is not an option. These countries would need to allow for likely shifts in the composition of demand when setting exchange rate, and possibly tariff, policy. They could also begin, at an early stage, to promote higher quality standards and more emphasis on marketing and packaging, in order to win back domestic customers for locally made (often cheaper) products. 1/2/

Agricultural producers in east Germany suffered not only from the shift in demand but also from a sharp drop in producer prices. Prior to GEMSU, they had received prices 2-3 times higher than their west German counterparts (at an exchange rate of 1:1). As food subsidies were eliminated, so too were these differentials. Despite compensation payments from the Federal Government, the still largely state-owned or cooperative farms reduced output substantially. A similar response may be expected in other East European countries in situations where agricultural output has been stimulated by subsidies and demand boosted by artificially low prices.

The immediate liberalization of product markets resulted in a massive decline in east German output with industrial production down by nearly two-thirds since GEMSU. The weak condition of much of east German industry at GEMSU was exposed by world market competition. This lack of competitiveness was exacerbated by rapid wage growth (see below). The supply response has been diminished by problems of institution building, establishing effective ownership and human and physical capital formation discussed in sections III to V below. On the demand side, the shift of consumer demand away from east German goods and the collapse of the CMEA market amplified the fall in east German production. 3/ Clearly, East European countries can expect--and indeed have already experienced--a decline in production in response to product market liberalization, world competition, and the collapse of CMEA markets. In part, this represents a necessary restructuring. They may, however, be able to temper the pace and size of this output decline, by tailoring macro-policies to maintain competitiveness and by a balanced set of economic reforms.

2. The labor market

With the advent of GEMSU, west German labor laws, which determine among other things the procedures that firms are obliged to follow in laying off workers, came into effect in the east. Some east German enterprises under financial pressure reportedly flouted these labor laws in their haste to

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1/ Some east German households reportedly have already begun to switch back to local products (particularly food) for these reasons.

2/ Since July 1990, the west German office for quality standards (DIN) has opened 23 offices in east Germany, and undertaken various steps to promote its norms such as promotional campaigns and technology transfer. Agreements on the use of DIN standards have been signed in other Eastern European countries; enterprises can pay for the right to use these standards in local currencies.

3/ For a more detailed discussion of the background behind the fall in east German output over the past year, see Chapter III of the forthcoming paper Germany, Economic Developments and Issues.

reduce workforces. Moreover, as the extent of the collapse in the east German economy became clear, the authorities resorted, temporarily, to nonmarket means to moderate the rise in unemployment. Subsidies were introduced for short-time working and a large number of east German public servants whose functions had disappeared were retained on the state's payroll (the so-called "holding pattern"); employers and unions agreed a ban on lay-offs in the metals and engineering sector.

The traditionally strict control over wages in the GDR had begun to break down even before GEMSU. Under these circumstances, the extension of the west German wage-bargaining system to east Germany represented perhaps not so much "liberalization" as the establishment of a new system of rules for setting wages in a market environment. In this system, basic wage increases for each industry are agreed between the regional employers' federation and the regional labor union representatives. They are binding on federation members, though only as minima--there can be, and typically is, significant wage drift. In the first rounds of post-GEMSU negotiations, very large increases were agreed for east German workers. As a result, wage rates in east German industry reportedly rose by more than 40 percent in the course of 1990. These increases can only have reduced still further the number of east German firms able to compete on world markets.

The essential problem appears to have been that neither party to the negotiations acted as they would have been expected to in a market economy. The west German labor unions brought in to represent the east German workers--who would normally be trading off wage objectives against unemployment--were committed, probably out of self interest to some extent, to the aim of a substantial reduction in the wage differential between east and west Germany. On the employers' side, enterprise managers were still not subject to the discipline that, in west Germany, the owners of the firm would impose, and so had little or no incentive to resist wage rises well in excess of what they could afford (see Section IV). The perceived reluctance of the authorities to allow large-scale unemployment is likely to have contributed to these attitudes.

While these circumstances are clearly peculiar to the case of German unification, the outcome has one clear implication for other reforming economies: whatever system of wage bargaining is chosen (with or without industry-wide agreements), the interests of the owners must be adequately represented. If they are not, and wages rise unduly fast, the result is likely to be higher unemployment. Other East European countries will be less able to afford this than Germany. To the extent that higher wages lead to returns to capital being unduly squeezed, output and investment (including vital foreign investment) will also suffer.

3. Real estate and financial markets

Rents are currently unchanged from the levels in the former GDR: they are to be increased to cover maintenance costs from October 1, 1991. 1/ Further increases are envisaged to cover capital costs by end 1993. From then, private sector rents in east Germany will be subject to the same controls as in west Germany, with rents increased as new tenancies are established and rents on existing tenancies fall below the regional average. Low state rents and inertia in private rents have significantly stunted the growth of an east German market in residential real estate. Trading in real estate also requires that title to property can be clearly established. This is currently not the case in east Germany, because of inadequate land records as the upkeep of a land registry was of little or no interest to the former regime. The problems this caused--in terms of discouraging buyers from entering the market--were amplified by the restitution of property to former owners (see Section IV).

East German (and intra-German) capital markets were liberalized on July 1, 1990. Sales of east German assets (fixed or financial) were open to all comers, both west German and foreign. West German banks quickly established footholds in the east--in some cases by absorbing the former branches of the *Staatsbank*, in other cases by setting up new branch networks (see Section III). They began competing with the east German savings banks for deposits and extending short-term liquidity loans to east German enterprises (although mostly with *Treuhand* guarantees). The early emergence of effective competition in the banking sector primarily reflected the goal of west German banks of establishing German-wide networks. It is likely to be much more difficult to establish an effective, competitive banking system in other East European countries. Despite comprehensive liberalization, the experience of west German banks in attempting to lure east German depositors away from the old savings bank network has been mixed. Depositors have appeared reluctant to switch allegiance from the east German savings banks--perhaps reflecting their greater convenience--despite being offered somewhat higher interest rates elsewhere. At the same time, private capital flows from the west have been inhibited by a host of factors, including problems in establishing title, bottlenecks in local administration, and inadequate infrastructure (see Sections III-V).

III. Institution Building

1. Legal, statistical and accounting systems

The coming into effect of the Unity Treaty on October 3, 1990 marked the formal adoption by east Germany of an entire legal and regulatory framework for a market economy, though much of this framework had been

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1/ Rents for new residential construction are untied and rent increases are permitted for modernized property.

established earlier under GEMSU. Although the speed and perhaps the scale of changes in this framework need not be as great in Eastern Europe, the east German experience is revealing. In many areas of the law, such as administrative law and that regulating private property, contract law, arbitration law and bankruptcy, more or less complete retraining of lawyers and establishment of a truly independent judiciary will be necessary. The east German experience also highlights the importance of making new laws supportive of market activities as simple and transparent as possible. It was decided to retain--for a transition period--the east German bankruptcy law because it was shorter and much simpler than that prevailing in west Germany. Likewise, as planned infrastructural projects in east Germany became bogged down in the complex and lengthy planning procedures in force in west Germany, there was a growing realization that such procedures needed to be relaxed and simplified in the east.

Considerable progress has already been achieved in reforming the statistical system of east Germany and integrating it with that of the western part of the country. This experience has shown, however, that considerable retraining will be necessary in new methodologies and techniques, including the wider use of survey methods rather than data gathering on the basis of complete enumeration as under central planning. Nevertheless, the old and new statistical systems need to be effectively bridged, and various statistical time series revised. This means that the inherited statistical structure should not be abandoned overnight, and that the knowledge of its practitioners needs to be tapped. New techniques should be quickly developed to measure adequately the growth of private sector activities, so as not to exaggerate the transitional decline in output as restructuring takes place.

With respect to enterprise accounting, special difficulties will exist in arriving at "opening balances", given the initial lack of a basis for the valuation of fixed assets (including land) and the high uncertainty of all asset values in the early stages of restructuring. This may have important implications for the speed at which enterprises can effectively be privatized. Lack of expertise would also appear to be a constraint and technical assistance could play a critical role in supporting training programs in bookkeeping, accounting and auditing in Eastern Europe.

2. <u>The fiscal system, local administration and social safety net</u>

Transformation of the east German fiscal system has involved tax reform, the setting up of a new tax administration, the introduction of the federal fiscal structure and the adoption of the west German system for public expenditures and budgeting procedures. The biggest problem has been with tax administration. In east Germany, as in many East European countries, there existed no tax administration in the usual sense, because the main taxpayers--the state enterprises--remitted automatically to the budget a planned share of profits. The tax administration that did exist--which had its origins in the pre-World War II period--applied only to small entities where taxation was usually intended to be repressive. The scale of the problem--officials estimated that the size of the east German tax administration needed to be increased five-fold, and existing tax collectors required extensive retraining--is indicative of the practical tasks facing the East European countries as they reform their fiscal systems.

Local authorities in east Germany have sought to take on the responsibility of enterprise ownership, even in activities (such as cinemas and various retail shops and services) which in a market economy would normally be under private ownership. There is an evident need, which may well apply to Eastern Europe, for local governments to adopt a realistic view with respect to their appropriate role (e.g., the provision of various public goods) in a market economy. The carrying out of this role is also likely to require extensive staff retraining.

The need for institution building in the area of social security is particularly strong during the transition to a market economy. The added urgency, in the east German case, has resulted from the speed of the transformation. Reforms were needed in four major areas: (i) unemployment insurance; (ii) social welfare programs on a means-tested basis (in the former GDR, benefits for children were large, apartments were cheap, and the minimum pension was widely available); (iii) health insurance; and (iv) the pension system. In east Germany, delays were caused by the need for new procedures; new accounting, information, payment, and tax systems; and much expanded requirements for staff training. For example, the staff of unemployment offices in east Germany--initially set up in spring 1990--had by mid-1991 expanded to some 20,000, who were expected to handle as many as 800,000 unemployed. They were largely recruited from the former civil service, and were given crash courses of only one to two weeks in duration, compared to the three years of training usually provided in west Germany. Initial steps had been taken to build up social welfare offices. These were unlikely to be fully effective until 1993: until then; social allowances are being added to pensions rather than provided (as in west Germany) on a means-tested basis.

Given the considerable uncertainties in the early stages of the transition about the future structure of production, the agencies entrusted with training in east Germany faced uncertainty about the areas in which specific job skills should be taught and whether such training should wait until individuals had actually obtained new employment. Public works jobs were being created to help clean up the environment and provide a range of social services. Moreover, governmentally-supported enterprises for public works established in mid-1991 (the so-called Beschäftgungsgesellschaften) were criticized for not being subject to market discipline and as such likely to be inefficient and for being, in effect, subsidized and therefore able to undercut nascent private activity. 1/

1/ For further details see Chapter IV of the paper, Germany, Economic Developments and Issues.

3. The banking system

The task of creating a modern banking system was approached in a unique way in east Germany. Initially, the two largest west German banks operated the branches of the former Staatsbank through joint ventures, and also opened their own branches in the new Länder. Currently, wholly-owned operations have been established or are in the process of being established. (Other commercial banks relied on their own branches from the beginning.) The approach taken by the larger banks had both advantages and disadvantages: through joint ventures they obtained the Staatsbank's most valuable assets--permanent office space and personnel with knowledge of east German operations; on the other hand, they had to provide considerable training for employees who had no experience in commercial banking in a market economy. 1/ Despite all the technical assistance (which included the computerization of banking operations), some problems have only recently been overcome by the commercial banks (modernization of the settlements system, antiquated bookkeeping), while others appear to be far less tractable (lack of managers skilled in credit evaluation, risk assessment, modern banking instruments and international banking; of clerical staff without adequate computer and customer service skills; and a lack of adequate office space). The scale of these problems varies, of course, across Eastern Europe, but the east German experience indicates that they are unlikely to be quickly overcome.

Transformation has been slower with the savings banks and cooperative banks, although they benefitted from support from the west German associations of savings banks and of cooperative banks, respectively, primarily through the "pairing" system (west German institutions provided technical assistance and managerial talent to east German counterparts), partly financed by the establishment of a solidarity fund by west German savings banks. Managerial problems have been more acute in these two sectors; as a result, it took much longer to establish a functioning payments system; and they were far behind the commercial banks in terms of services and financial assets offered to customers.

The problem for the banking system of inherited bad loans has been solved by government assuming responsibility for these loans. In the case of industrial enterprises, pre-GEMSU loans are assets of the state-owned Deutsche Kreditbank which does not lend to enterprises. In the case of the cooperative banks (which had lent to agricultural operations and small craftsman), like the Deutsche Kreditbank, their pre-July 1990 loans are guaranteed by government either through the Treuhand or via the mechanism of Ausgleichsforderungen (equalization claims). 2/ These claims will be settled in 1995, based on the December 31, 1994 bank balance sheets. This

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1/ Most branch managers were brought in from the banks' west German operations.

2/ For details see German Unification--Economic Issues, Occasional Paper, No. 75 (December 1990), Chapter X.

approach has the advantage of the banking system being able to start operations with a clean balance sheet, unsaddled with the problem of old loans. Since enterprises prior to 1995 remain liable for the full value of their old loans (unless assumed by the Treuhand in privatization), lending to such enterprises may be discouraged. 1/ The main difficulty of this approach of the government guaranteeing all pre-July 1990 loans is its potential cost, which is currently unknown.

For East European countries, the advantage of an east German approach is that it establishes a commercial banking system free from inherited old debts. Banks are thus able to concentrate on new, profitable lending operations without the need to raise margins to build provisions to cover old debts. The temptation for banks to "throw good money after bad" to maintain the value of their existing loan portfolios is thereby avoided. The main disadvantage of guaranteeing or assuming all old debts is the large potential cost to the budget. If the banks remain responsible for handling these old debts, but they are guaranteed by government, the incentive to collect will be greatly diminished. If a separate agency is established for collecting old debts, this may be susceptible to political influence. For East European countries that have already established commercial banking systems some years ago, such as Hungary and Poland, another disadvantage is the moral hazard of a retrospective bail out of commercial banks. These banks were established with a mandate to act commercially and manage these inherited assets (old debts); if these debts are subsequently taken over by government, this could have a deleterious effect on future bank behavior.

The west German system of prudential supervision has been adopted in east Germany. Little is to be learned, however, from the east German experience so far with respect to prudential standards and bank supervision. This is because up to now all old loans--and most new loans--in east Germany have been effectively guaranteed by government. East German banks are therefore carrying little risk.

IV. Establishing Effective Ownership

Enterprise reform is widely recognized as crucial to economic transformation. A key requirement of enterprise reform is the establishment of effective ownership, so as to ensure that enterprises operate subject to a hard budget constraint and that their capital is not squandered through the over-rewarding of workers and managers. The experience of the former GDR and the countries of Eastern Europe has demonstrated that the state tends to be an ineffective owner of enterprises. In consequence, privatization is seen as the key to establishing effective ownership. This same experience shows, however, that effective privatization is unlikely to be accomplished overnight. The objective should therefore be to accompany the process of privatization with measures to strengthen the exercise of ownership rights

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1/ This applies particularly to some agricultural borrowers.

over the enterprises that remain--at least for the time being--under state ownership. This involves both enterprise restructuring and the liquidation of non-viable enterprises.

1. The Treuhandanstalt 1/

The approach to the reform of state-owned enterprises in east Germany has been to assign the functions described above to a single agency. The Treuhand was established by the former GDR in December 1989 to transform state-owned enterprises into limited liability companies. In June 1990, after GEMSU, title to the bulk of east German industry was transferred to the Treuhand. Consideration was given by the German government to the establishment of four holding companies to carry out the functions of the Treuhand, but this proposal was rejected on the grounds that it would be slower and more cumbersome and it would be difficult to allocate enterprises across holding companies. There had also been objections to giving away the shares of such companies to the population. 2/

Under the Trust Authority Law, the mandate of the Treuhand was broadened to embrace privatization, structural adjustment, asset management, maximizing receipts and minimizing budgetary costs. Within this mandate, the Treuhand has also embraced the goals of maximizing employment and investment. The central office of the Treuhand--in Berlin--is responsible for the larger state enterprises (those with more than 1,500 employees), accounting for around one-third of the enterprises owned by the Treuhand. The remaining two-thirds of enterprises are supervised by the 15 Treuhand branches. The Treuhand also has specialist agencies responsible for the privatization of retail trading companies and real estate. Decisions on larger enterprises are subject to a supervisory board including representatives of management, labor, and state governments and the Ministry of Finance.

In the early months of its existence, both before and after unification, enterprises owned by the Treuhand were left somewhat to their own devices. Many of them survived by reducing employment, spinning off peripheral activities and selling assets. Inevitably, this process involved abuses. Increasingly, within the framework of German ownership laws, the Treuhand has exercised a closer supervision over the activities of enterprises under its control. The Treuhand is currently in the process of requiring, from all enterprises, business plans based on fully audited balance sheets. These plans will provide the basis for decisions on the future of the enterprise concerned, including the possibility for more active restructuring involving rearrangements of assets, further employment

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1/ For a more detailed discussion of the operations of the Treuhand, see Chapter VI of the paper, Germany, Economic Developments and Issues.

2/ For details of possible alternative approaches to privatization, see Borensztein and Kumar "Proposals for Privatization in Eastern Europe", WP/91/36, April 1991.

reductions and new investment. The scope for a more active Treuhand role in restructuring, however, is limited by the availability of staff. The Treuhand has a strong preference for the closure of clearly non-viable enterprises by liquidation--under its control--rather than through court-controlled bankruptcy procedures.

Privatization has been achieved by various means such as direct negotiations, auctions and sales through investment banks. The Treuhand seeks employment and investment guarantees from buyers, for which it offers price concessions. Negotiations cover the costs of environmental damage and servicing old company debts; the Treuhand typically provides a cap to the purchaser on the risk from environmental damage. It also seeks to promote entrepreneurship in east Germany; around one fifth of sales have been in the form of management buyouts. The Treuhand remains in close contact with the Länder on employment considerations and the Bundeskartellamt on competition issues. Except for nontradables or tradables with a typically regional focus--such as cement or dairy products--the reference market for competition policy has been that of united Germany. The Treuhand has recently begun more actively to market its enterprises to potential buyers, both in Germany and abroad.

It is premature, less than one year after unification, to assess the operations of the Treuhand. The results are difficult to interpret. As of June 1991, around 2,600 industrial enterprises had been privatized with proceeds of DM 10 billion. Commitments to over 500,000 jobs and DM 60 billion new investment had been secured through privatization. The pace of privatization has accelerated in 1991 with company sales currently running at around 300 a month. Around 450 companies had been closed, 350 through liquidation and 100 through bankruptcy procedures. In total, these enterprises had employed 90,000 workers. In the year to June 1991, due to the splitting up of many large enterprises, the number of Treuhand enterprises actually rose from 8,000 to 10,000; total employment, however, declined from 3 1/2 million to 2 3/4 million.

There are some clear, positive lessons to be learned from the German approach to enterprise reform. The breaking up of the old Kombinate--typically enormous agglomerations of enterprises--has probably fostered privatization. Peripheral activities have frequently been spun off, and are often good candidates for management buyouts. The privatization of retail and hotel enterprises carried out by the Gesellschaft für Privatizierung des Handels mbh (GPH) appears to be another success. The GPH managed to privatize most retail and hotel enterprises by June 1991. The speed of this process--with the sale of 17,000 shops and restaurants in little over six months--reflected the simple guidelines established by the GPH. Retail operations were sold excluding the premises, 1/ which avoided the restitution problem. Inventories were valued at wholesale prices, bids had to meet a minimum offer price, and the purchaser had to agree to maintain

1/ Hotels, however, were sold including land and buildings.

the nature of the business for two years and employment for one year. Decisions on bids were made by local branch committees of the Treuhand, including representatives of local governments and chambers of commerce. The speed of the process also reflects the relative tractability of the problems of the retail sector. This is a model which East European countries could probably emulate. It is particularly apposite given the striking impact of retail sector privatization on the likely availability of goods and therefore the perceived success of the transformation process. Equally, given the fast pace of change in the retail sector, existing stores, if not privatized, will quickly lose their value as new retail operations are set up elsewhere.

The Treuhand has benefitted from a major infusion of both financial resources and expertise from west Germany. Nevertheless, despite the recent acceleration in the pace of privatizations, the process of creating effective enterprise ownership through privatization appears likely to be lengthy. The Treuhand's emphasis on job preservation is likely to have increased pressures for rapid wage increases in east Germany and discouraged productivity increases. Its reluctance to close down unviable enterprises has slowed down the transfer of resources to more productive uses. The Treuhand's role in restructuring has been difficult to define.

There are other considerations, as well, that should be taken into account in considering whether the Treuhand-type model would be the most appropriate for other countries. First, there is a danger of undue political influence on the privatization process. The broad objectives of a single agency--including employment and investment--render accountability difficult. Second, transparency of decision-making is not ensured, with important trade-offs--such as between employment, investment and privatization receipts--decided within the organization. Third, it is questionable whether the multitude of objectives of a single agency provides appropriate incentives for speedy privatization. Fourth, it is also arguable whether wide-scale restructuring is an appropriate public sector function, particularly in countries with limited financial resources and know-how. Finally, the establishment of an organization with such wide-ranging responsibilities and powers could lead to corruption and insider dealing.

2. Obstacles to privatization

Privatization and the process of creating effective ownership face many obstacles. The east German experience underlines the importance of seeking to tackle these obstacles at an early stage. Many difficulties will unavoidably persist. An example is the difficulty of valuing assets in the context of rapid systemic change and general uncertainty. This has been reflected in east Germany in the difficulty experienced by a large number of Treuhand enterprises in drawing up audited balance sheets.

The Treuhand, not surprisingly, has found wide-ranging shortcomings in the management of enterprises under its control. Lack of familiarity with western-style accounts has made it difficult for many firms to prepare meaningful business plans. Financial planning and control tends to be deficient: enterprise managers have been slow to take advantage of bulk discounts on purchases, and there is little monitoring of receivables. Personnel management is weak; administrative costs in east German enterprises are generally twice the level of west Germany despite lower salaries. Enterprise managers also tend to have little concept of innovation and product development, or marketing. The Treuhand has tackled these problems by encouraging existing managers to hire western consultants and by changing managers. In the first year after unification around one-half of enterprise top managers were replaced, one-fifth by managers from west Germany. Clearly, the direct import of managerial talent on this scale is not an option for Eastern Europe. In part, however, the exposure of domestic managers to western techniques can be achieved by foreign direct investment. The need to promote human capital development is discussed further in Section V.

Pervasive uncertainty is inimical to both rapid privatization and new investment. Although uncertainty is an unavoidable result of the rapid pace of change, policy-induced uncertainties should be avoided where possible. An obvious example in the east German case is restitution. The legislative creation of wide-scale restitution rights has imposed uncertainty on property ownership which has delayed privatization and new investment. This problem has been alleviated--but not, according to some, removed--by the subsequent legislation establishing priority for investment (with compensation) over restitution. It is not obvious that restitution or compensation of confiscated property is essential to establish credible property rights in Eastern Europe. The strong political imperative, however, is reflected in action on previously compensated property by most East European governments. The east German experience suggests that restitution should, if possible, be avoided as it delays economic transformation. If deemed politically necessary, compensation does not need to be at full market value; indeed, tight budgetary constraints in East European countries imply the need to limit compensation.

There are inevitably also many social constraints on the privatization and restructuring processes. Political pressures to moderate the rise in unemployment are unavoidable. In part, these can be reduced by the establishment of an appropriate social safety net (Section III). A key question is whether these pressures are best channelled through the privatization agency--at the risk of slowing down the privatization process--or belong more appropriately to government. Inadequate infrastructure--discussed in Section V below--also slows down privatization.

A constraint in many East European countries is the widespread existence of monopolies. In east Germany, the problem of monopolies has been largely removed by unification, and the Bundeskartellamt has prevented dominant enterprises in west Germany from purchasing their counterparts in east Germany. This is likely, however, to be a more difficult issue to resolve in Eastern Europe. It may be preferable to break up monopolies prior to privatization, but there is obviously a danger that this could slow down the process. Alternatively, monopolies could be privatized and subject to regulation. The incidence of effective monopolies will of course be reduced by import liberalization.

V. Human and Physical Capital Formation

In planned economies, the accumulation of plant and machinery (generally of poor quality and with outdated technology) tended to take precedence over the upgrading of the existing capital stock and investment in basic infrastructure--transportation, storage and communications in particular. The basic problem for human resources was one of accumulated skills that were inappropriate to the needs of a market economy. The east German experience confirms that deficiencies in human and physical capital can significantly slow the process of institution building and hamper economic growth.

1. Human capital

The blue-collar industrial worker in east Germany is generally regarded as being well-educated and highly skilled. West German manufacturing firms investing in east Germany have reportedly found it relatively easy, with a brief retraining period, to update these skills for modern techniques and machinery. Nevertheless, as the economy is restructured and new activities emerge (in the services sector in particular), it is clear that an enormous training effort will be needed. Given the externalities involved in training, especially in a climate of radical economic change, much of this burden will rest with the government.

Of more immediate concern in the German case, however, has been the almost total lack of qualified white-collar staff and, above all, managers with knowledge and experience in accounting, auditing, marketing and cost management. This is a problem which other East European countries are very likely to share, and it extends beyond the enterprise sector into many areas of public administration. There is no easy solution, since--however much is spent on education and training--the accumulation of these skills takes time (years, in many cases).

Germany has relied heavily on seconding managers and other professionals from the west to key positions in east German industry and government. In so doing, east Germany has had a number of advantages that East European countries could not expect: a common language, currency and legal system, as well as public-spirited western agencies and companies willing to give up, temporarily, valuable staff. Despite the relatively favorable circumstances, however, this has not proved to be a panacea even in Germany. The scale of the problem is too great--even two or three western managers in each _Treuhand_-owned firm would require 20-30,000 secondments--and there is a limit to the number of westerners willing to accept what they perceive to be inferior housing, schooling and cultural facilities in the east. The implication is that while full use should be made of western management, to the extent possible, governments must also look for assistance in developing domestic managerial talent at an early stage. This might include setting up local business schools, arranging internships with western corporations and sending students on foreign management courses.

2. Infrastructural investment

The low capacity and poor quality of the road, railways, inland waterways and telephone system in east Germany have been among the most commonly cited obstacles to private investment. Placing calls to and from east Germany was initially almost impossible at certain times of the day. The west German telephone company instituted a rapid investment program, making use of satellite technology to raise capacity. Although the bulk of the investment is still to come, the level of service is already said to be acceptable, at least for business users. Deficiencies in the transportation networks will, by their nature, call for large investments over a long period. Early progress in this area has been hampered in east Germany by the adoption of west Germany's complex and fairly demanding planning procedures. Other countries should avoid this problem by a more gradual change of planning procedures and by eschewing unduly cumbersome regulations. In the short run, it may be possible to make more efficient use of the existing road and rail systems, at relatively low cost, through improved traffic control techniques. Firms might also, as in east Germany, attempt to compensate for insufficient freight capacity by establishing smaller and less centralized distribution centers.

Environmental considerations may also generate significant infrastructure investment needs. An example in Germany has been the decision to limit the use of environmentally damaging brown coal, substituting natural gas in its place. Interestingly, in this case, two private companies had been competing to build parallel pipelines for the import of gas from Norway and the Netherlands, and the first of these pipelines was completed in only three months. In addition to the environmental gains, this introduced a valuable element of competition in the supply of energy to east Germany.

3. Encouraging private investment

Governments have an important role to play in fostering private investment, including by foreign firms. Their main contribution should be in minimizing the legal and institutional obstacles involved. This is doubly important in reforming planned economies, since the barriers to private investment are, in many cases, also barriers to privatization (see Section IV).

The German authorities have introduced a range of grants and tax concessions to encourage investment in the eastern Länder. Such investment subsidies can be justified as a temporary measure to compensate for the human, infrastructural and other problems facing investment in east Germany compared to west Germany. However, country-wide investment subsidies should be viewed with great caution by East European countries, not least because of their budgetary cost. These costs could be exacerbated by competition between countries for foreign investment. A preferable approach for these countries is to promote a favorable climate for investment through appropriate macro-policies and institutional arrangements (such as full convertibility of foreign investors' funds) rather than specific measures of investment promotion. Some targeted schemes may, however, be warranted to offset the particular distortions faced by small businesses. In the credit market, for example, informational problems and administrative costs may prejudice lenders against small firms. For these reasons, governments may be justified in granting limited subsidies for loans to small enterprises, as Germany does through the Kreditanstalt für Wiederaufbau. Similarly, there may be a case for providing government assistance in management training for small firms (whose size might otherwise preclude the release of managers for training purposes).

VI. Conclusions

Despite the peculiarities of the east German experience noted in Section I--including a unique macroeconomic environment and the opportunity to import a range of ready-made institutions from west Germany--this experience is rich enough to yield, in addition to the number of specific insights noted in earlier sections, several general conclusions of relevance to Eastern Europe.

First, despite the import of already established monetary credibility via the deutsche mark and liberal access to west German budgetary resources, there has been a dramatic fall in production in east Germany. Eastern Europe currently faces a similar phenomenon, on a more limited scale. In part this is a response to a common set of factors--discussed further below--namely an inappropriate product mix for which demand is falling, uncertainty, slowness in the building of key institutions, the lack of effective ownership and the collapse of the CMEA market. These common factors have been amplified in east Germany by a growing lack of competitiveness. It is unclear how much of the east German output fall is due to the factors common to Eastern Europe--and therefore potentially to be repeated in other countries albeit over a longer time scale--and how much is a reflection of the unique German economic environment.

Second, the east German experience shows that despite quick and comprehensive liberalization of the product and capital markets, less rapid progress in institution building can slow the inflow of private capital, impede the elimination of key infrastructural bottlenecks, and retard the process of restructuring more generally. To the extent that significant uncertainties remain about the legal and other institutional environment--including the threat of property restitution--economic activity in the early stages of the transformation may be biased towards trading activities at the expense of investment in production, hence delaying the fundamental restructuring necessary to achieve rapid and sustained output growth. All this argues for policies that foster the establishment of a new and favorable institutional framework as quickly as possible.

Third, the process of institution building in east Germany has benefitted greatly from the widespread adoption of the west German legal framework and institutions, and from massive technical and financial assistance. Even the importation of ready-made institutions has been shown to take time, however, in the sense that despite a well-educated labor force being in place, its training in many areas--the law, accounting, customer service, product innovation, management, marketing and banking--is at the outset simply inadequate to breathe effective life into the new institutional framework. The situation is not fundamentally different in Eastern Europe; hence large-scale technical assistance will be necessary in those countries over an extended period.

Although these needs exist, they should not be exaggerated. Market-oriented institution building in some East European countries was already well ahead of developments in east Germany prior to GEMSU. Moreover, the East European countries are not operating in a political context in which, in the short- and medium-run, they would need to function with such a sophisticated set of institutions as those found in Western Europe. A fourth conclusion would be, therefore, that the urgency and character of external technical assistance needs will differ significantly across countries, depending upon their starting position and the degree of sophistication of institutions aimed for in the medium-term.

A fifth general lesson relates to the differing speed of effective liberalization in different markets, including the establishment of effective ownership control. Arguably the greater this difference, the slower will be the speed of transformation of the economy and the larger the associated budgetary costs. Two examples from the east German experience come to mind.

One is the relatively comprehensive overnight liberation of the product markets (including foreign trade) accompanied by the absence of effective ownership of enterprises remaining in the state sector and by labor market rigidities of an institutional nature. This has contributed to an extra-ordinarily steep decline in output, a surge in wages and a rise in effective unemployment (i.e., including short-term work, and "holding pattern" arrangements for public servants) with large budgetary costs in the form of unemployment insurance and employment subsidies.

A second example involves the rapid and comprehensive liberalization of the capital market. This has not been accompanied, until now, by massive inflows of private capital into east Germany. One of the main reasons proffered for the slower than expected investment (and privatization) response has been the rigidities and uncertainties in the real estate market, notably the inefficiency of the old east German land registry system and the uncertainties created by the adoption of the restitution principle.

Inadequate infrastructure in east Germany has also played a major role. The result has been a tendency for private entrepreneurs to "wait and see" rather than invest.

Sixth, the east German experience yields some useful insights, although unfortunately not a full range of answers, regarding the crucial problem of establishing effective enterprise ownership. The growing legal preference being given to investment cum compensation over restitution represents an important step toward resolving the problem mentioned above, although other East European countries would be well advised to avoid restitution, if at all possible. In addition, the east German experience suggests that retail trade, restaurants and hotels can be privatized fairly quickly on a decentralized basis by establishing simple and effective central guidelines.

The privatization of industrial companies is more complex and less tractable. The East European countries will have to decide on their approach according to their own objectives and institutional setting. There could be risks in setting up an all-embracing agency similar to the Treuhand. These include undue political influence on the privatization process, lack of transparency in decision-making, and doubts about the extent to which restructuring should be carried out in the public sector. Pending privatization, the rapid growth of wages in east Germany underscores the importance of establishing effective ownership of enterprises remaining in the state sector by imposing a hard budget constraint.

Seventh, geographical considerations alone suggest that over the medium- and long-term, the markets of the U.S.S.R. and other East European countries should remain important for all former CMEA countries in the region. However, artificial maintenance of this trade in the short-term through the provision of export credits and export subsidization--reflected, for example, in the special Hermes terms for east German exports to the U.S.S.R.--could both create significant costs for the budget (a cost less easily borne by the East European countries than by a united Germany) and effectively slow the structural transformation of the economy. A higher priority would seem to be to establish as quickly as possible the competitiveness of a country's products on world markets in general, which would also put its exporters in the strongest position to compete in former CMEA markets in the medium-term.

Finally, the east German experience suggests that the thorough transformation of these economies will require sizable external assistance, particularly in the form of imported technology, know-how and help in the retraining of the existing managers and labor force. This flow of resources is likely to come in a greater volume, and more quickly: (i) the more rapid is the process of institution building (which itself depends in part on external technical assistance), and (ii) the more favorable is government policy to the inflow of private capital, which ultimately must be the main bearer of the technology and know-how needed for the transformation.