Who Mislaid the Wirtschaftswunder?

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The 10th anniversary of the reunification of Germany provides an obvious occasion on which to reflect on the course of subsequent economic developments. 1990 was a watershed -- a year in which not just the former German Democratic Republic but the whole of the Soviet bloc began the transition to the market. But the two economies on opposite sides of the Oder, to draw the obvious contrast, did so under very different conditions. The five new German lander received massive financial transfers from the Federal Republic. Poland, in contrast, received only limited foreign aid; there was no new Marshall Plan for the East. The five German lander imported their economic and political institutions from the FRG lock, stock and barrel. The Bundesbank and the deutschmark, a mature party system, an independent judiciary, and the social market economy were all parachuted into place. Poland, in contrast, could not import such a framework and had no choice but to embark on the painful and time-consuming process of building it from scratch.

These two instances of transition therefore provide a revealing study of how much difference institutions and external support make. Asked for a prediction, circa 1990, about how these two economies would fare, the pundits would have all but universally agreed. In one of these cases, where the institutional and financial prerequisites for a rapid transition were in place, economic growth over the subsequent decade would resemble West German's post-World War II *Wirtschaftswunder*. In the other, it would instead resemble that in the rest of troubled Central and Eastern Europe, which similarly lacked the institutional preconditions for sustained and successful growth.

The forecast was right, of course, except for the minor surprise that it was Poland, not eastern Germany, that experienced the *Wirtschaftswunder*, and eastern Germany, not Poland, that endured a decade of stagnation and more closely resembled the rest of Central and Eastern Europe. In the accompanying figure, the five eastern lander behave identically to the Eastern European average, except that their post-unification recession was sharper as East German goods were immediately pushed off the shelves, as was their immediate recovery. It is Poland, in contrast, whose economy most closely approximates the experience of Germany after 1945 -- it may not match the *Wirtschaftswunder*, but it's halfway there. If the first rule of forecasting is "Give them a number or a date but never both," then the GEMU variant is "Give them two forecasts for two countries, but don't say which is which."

What explains the surprise -- that Poland did so much better than the five new German lander despite the receipt by the latter of generous financial assistance and their acquisition of an instantaneously robust, credible and efficient institutional framework? The answer, obviously, is policies, whose importance tends to be lost amidst the currently-fashionable preoccupation with institutions. A policy of high wages, imposed on eastern Germany by fiat, posed a serious obstacle to the establishment of the small firms that are the engines of growth in successful transition economies like Poland. This same policy limited direct investment by western (including West German) companies that might have otherwise been attracted to existing industrial enterprises. Excessive subsidies for investment reinforced the incentive for inefficiently capital-intensive production in a region with a literate, numerate labor force. These were policy mistakes that even the best of institutional frameworks could not overcome.

How are we to understand these blunders? In a nutshell, the interests of the citizens of western Germany, who dominated the polity, were not well aligned with those of the residents of the five new lander. The citizens of Germany's west were preoccupied to the point of phobia with the specter of large-scale migration from the east. The counterproductive policies adopted in the 1990s were the polity's attempt to fend off this exaggerated fear, by paying high wages and making large transfers to induce the residents of the east to stay in the east. We now know that proximity to family and friends, access to affordable housing, and reasonable employment opportunities are enough to induce the vast majority of workers to stay home, wage differentials or not. In other words, fears of large-scale migration were exaggerated. But the damage was done.

Now, with preparations for the accession of Poland, Hungary, the Czech Republic and other transition economies to the European Union, similar fears are beginning to resurface. We hear almost daily in the *FT* from those who warn that Germany and Austria will be overrun by Eastern European labor. This leads to suggestions that EU enlargement be delayed or, even stranger, that the border be opened only selectively to labor flows. Nothing could be more counterproductive, and less warranted. One hopes that this expensive lesson of German unification has been learned.

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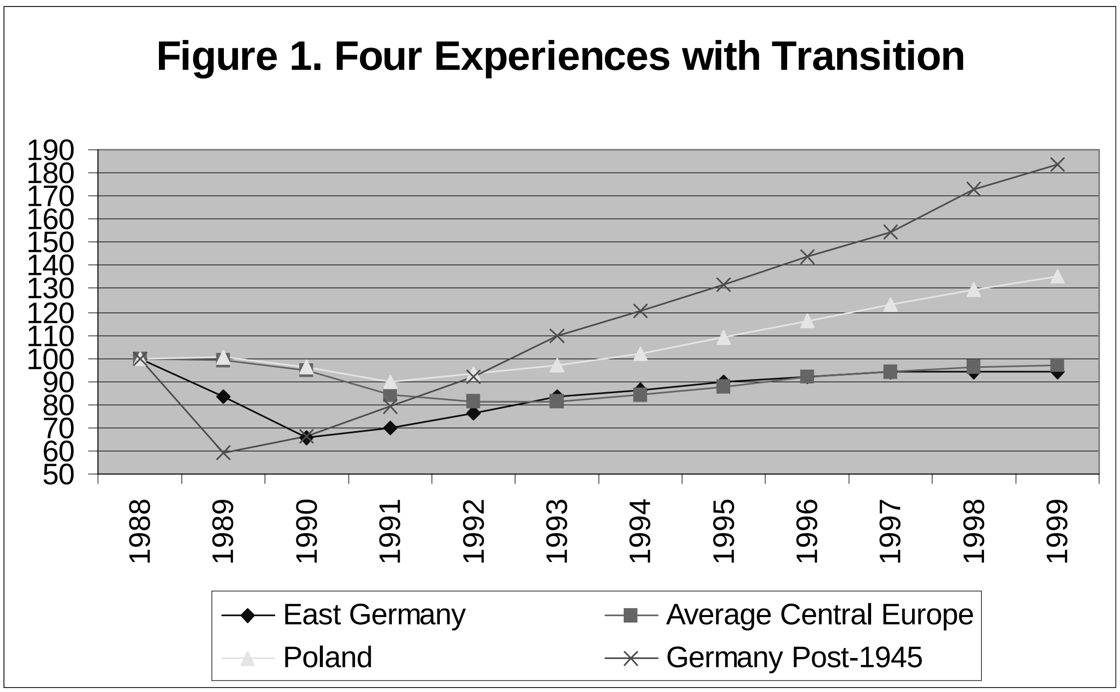

Figure 1. Four Experiences with Transition
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East Germany
Average Central Europe
Poland
Germany Post-1945