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The long shadow of the wall on Europe's economy

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The economic consequences of the wall are still visible twenty years after its fall. East Germany is still visibly different from West Germany: income per capita remains much lower and unemployment much higher in the so-called 'neue Länder'.

But the fall of the wall also had much wider consequences. Given the way unification was handled this event led to extreme imbalances in the European economy and had a profound impact on the process of monetary unification, which was at a very delicate stage at that time.

In retrospect, the sequence of events was quite simple: within one year, the fall of the wall led to the unification of Germany, which in turn led to a U turn in German economic policy. While Germany had achieved a balanced budget just on the eve of unification (1988), its fiscal policy was now burdened by the huge expenditure necessary to rebuild the dilapidated infrastructure and housing in the former GDR. Chancellor Kohl had promised that unification would rapidly result in "blooming landscapes" (blühende Landschaften) without any need to increase taxes. As a result the federal budget deficit reached 4% of GDP in a couple of years. Moreover, East German wages were quickly brought close to the West German level, leading to large unemployment as productivity remained low, but also a huge increase in purchasing power of the population in the new Länder (especially as pensions had been increased as well).

In response to this extraordinary demand impulse, the German economy grew quickly, but this led to inflationary pressures to which the Bundesbank reacted in a predictable manner: it increased interest rates. Other central banks in Europe could not follow suit because their countries had no unification boom and, in the case of Italy, had to keep interest rates low to keep a lid on the interest payments their treasuries had to make on their huge public debt. The indirect consequence of the fall of wall was thus not only a boom in Germany, but also upheaval in the European Monetary System, which essentially fell apart between 1992 and 1995.

The drivers of growth in Germany and most of the rest of continental Europe then became mirror images of each other: For a few years following the fall of the wall (1990-95), Germany's economy experienced exceptionally strong domestic demand, but a weak export performance. Conversely, most of the rest of Europe suffered from high interest rates whose negative impact on growth was only partially offset by the huge depreciation of the Italian lira and the Spanish peseta.

After 1995, the tables turned and the traditional pattern returned whereby domestic demand became weak (and remained persistently so) in Germany, but domestic demand (both in terms of consumption and

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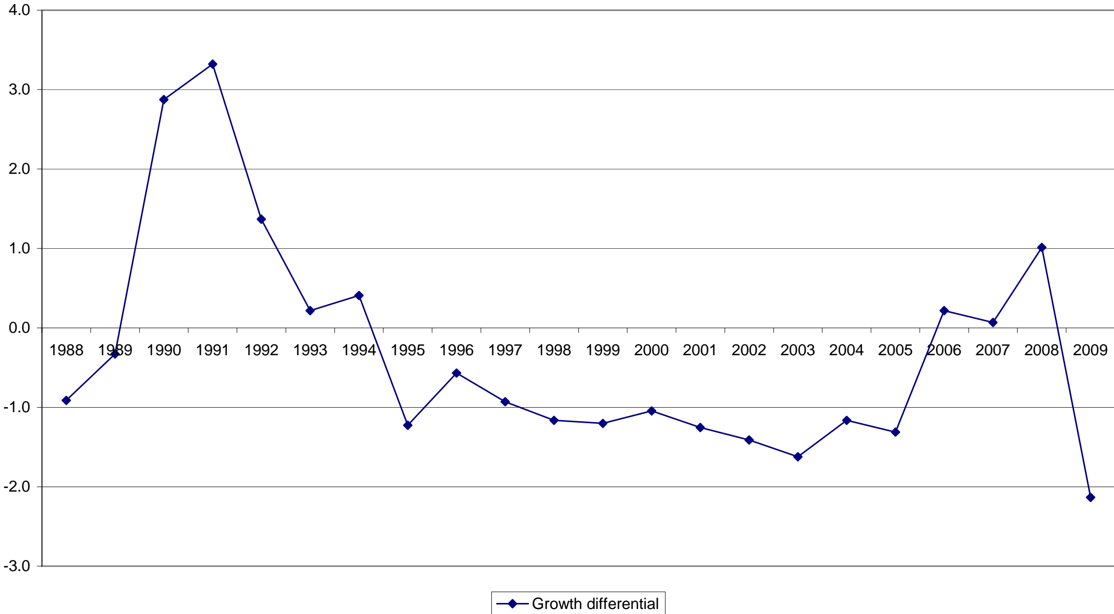
construction) took off in the rest of Europe, especially in those countries that enjoyed a sharp fall in interest rates as they prepared for EMU membership (France, Italy and Spain).

The year 1995 acted as the watershed, in which three elements came together: the peak in the tightening cycle of the Bundesbank, the end of the unification-related fiscal expansion in Germany and the sharp appreciation of the DM. These three elements together ended the boom in Germany. Competitive exchange rates together with lower interest rates as EMU approached brought about the opposite in the rest of Europe: a revival of growth, first based on exports, but later increasingly based on domestic demand.

Figure 1 shows the growth rate of Germany relative to that of its main continental European partners (France, Italy and Spain).

Figure 1. Relative growth performance: Germany versus the rest of the euro area



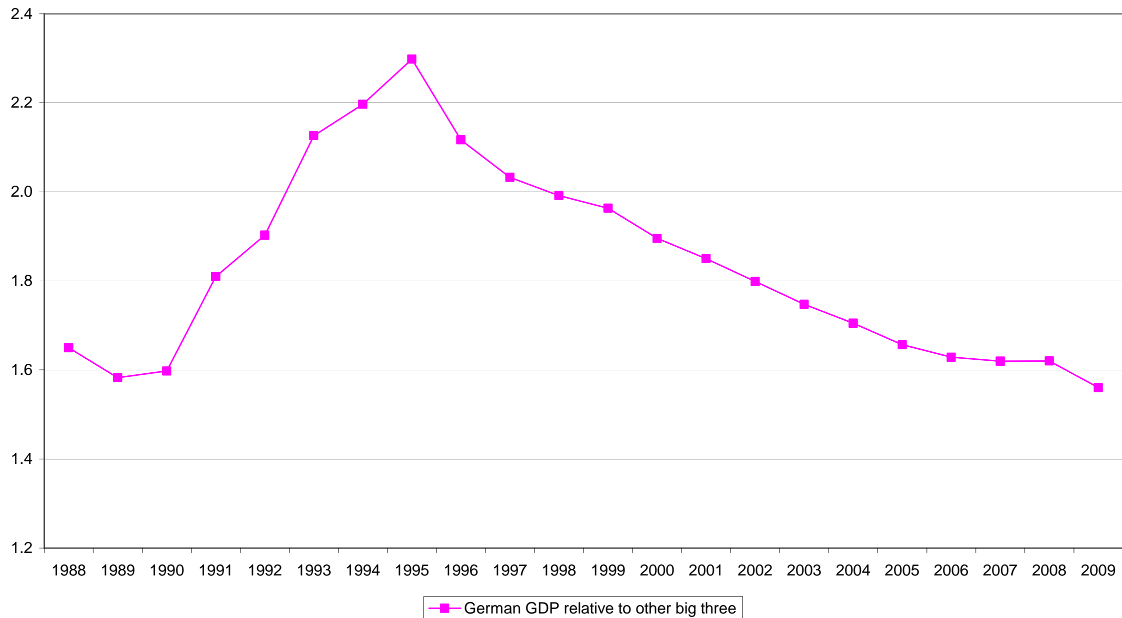
Source: AMECO (European Commission data base).

What could not have been anticipated at the time was that the unification boom would last only five years, to be followed by a period of under-performance by Germany lasting twice as long, as can be seen from Figure 1.

These broad swings in economic policy and drivers of economic growth had important political consequences: during the unification boom Germany appeared almighty, but then its star faded and after years of near stagnation it was (and by some is even now) regarded as one of the weaker elements in the European economy.

The simplest measure of economic size, and hence potential power, is the GDP of a country. Figure 2 shows the ratio of the GDP of Germany to that of the average of its three partners mentioned above. The value of 1.6 for 1989 means that at the time the wall fell the German economy was on average about 60% larger than that of France, Italy or Spain. By 1995 the value reached its peak at 2.3, implying that the German economy was 130% larger than that of its partners. From then on, it was downhill all the way (in 2009) to a level even lower than that of 1989 (although the German population had permanently increased by almost 20 million). Those who predicted that unification would drastically alter the balance of economic power in Europe seemed thus for a time vindicated, but twenty years later it seems that the *status quo ante* has been re-established.

Figure 2. Germany waxes and wanes vis-à-vis the rest of euro area

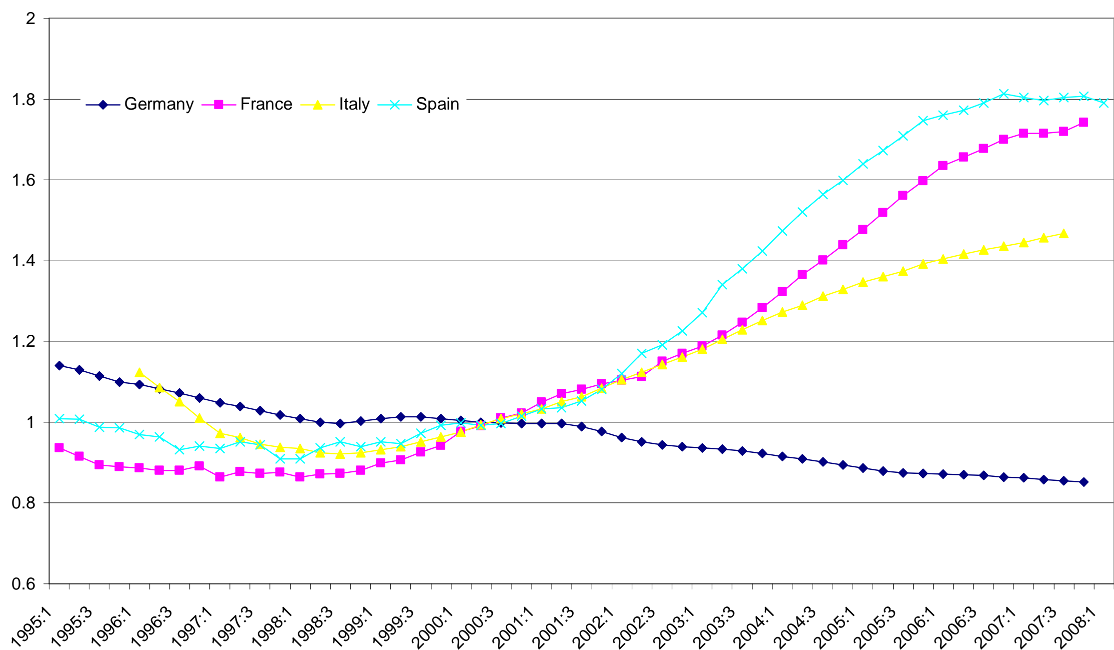


Source: AMECO (European Commission data base).

After 1995 these swings in relative growth rates and economic weight were largely driven by huge divergences in house prices, which increased spectacularly in most of Europe, but continued to decline slowly in Germany.

Figure 3 illustrates this intra-euro area divergence by showing the price/rent ratio. It is apparent that in the three major euro area countries aside from Germany prices rose considerably more than rents over the last decade. Even France, an otherwise relatively stable economy, saw in increase in the price/rent ratio of over 60%, which is only slightly less than experienced in Spain.

Figure 3. Price/rent ratios in Germany, France, Italy and Spain



Source: OECD.

This difference in the evolution of house prices had important macroeconomic consequences. Higher house prices in France, Italy and Spain fostered two key components of domestic demand – consumption and construction.

With housing prices now retreating quickly in these countries, one should expect a decade in reverse as the overvaluation (relative to Germany) is corrected. One would thus expect the next decade again to be a mirror image of the last one, with demand being relatively more stable in Germany than in the rest of the euro area.

One finds a similar pattern in fiscal policy: in the end Germany adjusted its public finances under difficult conditions, mainly by reducing expenditure. Others did not do so, France and Italy *in primis*, or relied too heavily on easy revenues driven by a housing boom (Spain). When the crisis hit Europe, Germany was thus well prepared, whereas the other large euro area countries are likely to face a protracted struggle to bring their deficits under control, given that expenditure had not been reduced during the bubble years and revenues are now suffering as the housing boom turns into a crash.

Looking at the broad pattern of economic policy on the eve of the current crisis, one can find striking parallels to the situation on the eve of the fall of the wall: In both cases (1988 and 2007), fiscal policy had been brought under control in Germany, but not the rest of Europe. In both cases the German economy had been driven mainly by exports, but by domestic demand in the rest of Europe.

However, while some of the starting conditions appear very similar, one key condition is radically different: Europe has already achieved monetary unification so that the reaction of monetary policy this time around is different: the ECB does not look only at conditions in Germany, as the Bundesbank had to do then. It bases its policy on euro area-wide averages. This should make this shock easier to absorb for the European economy. However, the German economy is still likely to regain some of its former pre-eminence in Europe.

Twenty years after the fall of the wall, Germany’s relative position is thus in many respects similar to where it stood just before this momentous event occurred. But this is only a snapshot. It looks as if the fall of the wall continues to exert a decisive impact on the European economy via the long-term cycle of divergences in house prices that it helped to set in motion more than two decades ago. This divergent cycle is likely to continue with a synchronised change of phase: House prices in France and Spain are likely to be weak for a long time, probably also over a decade, whereas prices in Germany might now recover under the impact of near-zero interest rates. Until recently the challenge for the ECB and the EU institutions presiding over the Stability and Growth Pact had been to manage a combination of weakness at the core (Germany) and excessive strength at the periphery (Spain, Ireland, etc.). From now on, the pattern will be reversed, closer to the traditional one, pre-unification, with a relatively strong German economy and public finances, but weakness in the periphery.

This is not only a challenge for the EU institutions, but also, perhaps mainly, for policy-makers in the periphery who, for the first time in over a decade, will have to grapple with the problem of how to adjust to a long term downturn.