Europe and Germany in Transition: Where Will the Economies Go?*

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The most recent "World Economic Outlook" published by the IMF in September presented the conclusion that, "Global GDP growth is expected to remain about 3% in 2003, rising to 4% in 2004." It added, however, the caveat that, "While the balance of risks has improved since last April, it remains slanted to the downside." Besides uncertainties about the further development of the dollar exchange rate and oil prices, it mentioned in this context again the negative aftereffects of the extraordinary equity bubble of the late 1990s.

This global picture, however, covers very diverging assessments for different parts of the world economy.

Asia Pacific in particular is, again, set to be the fastest growing region this year, and its growth is even expected to pick up further in 2004. For Japan, however, further growth is expected to be low, and additional measures to accelerate restructuring and to end deflation are seen as necessary.

Also in the next year, the main engine of global growth will very likely be the US economy, even if some of its growth until now has seemed to be based on special and probably not lasting incentives. For example, this is true in the case of special tax benefits, the special wealth effect for many consumers resulting from the combination of higher house prices and lower interest rates, and for the extreme increase in military expenditures which cannot go on for long. But despite these risks, the US economy is expected, once again, to be the main driving force in the world economy in 2004.

If this happens, all the other parts of the world economy will, at least in the short run, benefit from its strength. Besides Latin America and Asia, Europe in particular urgently needs this growth of, and trade with, the biggest and most developed economy in the world next year.

Europe is today clearly not in a position to play the role of a strong driving force in the world economy. Already, over the past two decades, its growth rates have been slightly lower than those in the US, and clearly lower than those in Asia Pacific. This gap has become even bigger over the past few years. Causes for the present low growth and relatively high unemployment are many-fold and many-sided.

Today, however, Europe can clearly not be measured as only one economy. Despite the establishment of a common market with, at present, 15 member countries, and despite the even broader free trade area, there are still big differences in the economic structure and performance. These differences are, on the one side, related to

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their level of development, and on the other to the longer run differences in their economic policies.

For example, most central and eastern European countries, or, as they are often called, “countries in transition”, are now growing much faster than most western European countries. They are trying to catch up. This is especially true for the ten countries which will join the European Union next year, to increase this union to 25 members.

In addition to this, the present 15 members of the union are split into two groups: the so-called euro group of 12 countries that share one currency and one monetary policy (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain); and the three countries that, until now, have stayed outside the economic and monetary union (EMU) (Britain, Denmark, and Sweden). Whether and when these last three will join the euro group is still an open question. Looking at their growth and employment figures over the past few years, and forecasts for next year, these three countries have done, and will likely do, at least in the near future, to some extent better than the euro group. One should, however, be cautious in attributing this better performance to their non-membership of the monetary union.

Even inside the euro group there were, and are, clear differences in last year’s growth and employment figures. While catching up countries like Spain, Portugal, Ireland, Finland and the Benelux countries have done better, the three bigger continental economies of Germany, France and Italy have faced over the past few years low, or even no, growth, while at the same time increasing unemployment. These three economies, though, cover close to 70% of the whole euro group GDP.

The present 12 euro economies share just over 15% of world GDP and just over 30% of world exports of goods and services. Today they are clearly behind the US, and yet constitute the second biggest economic and monetary area in the world.This second biggest area has, over the past two years, shown some of the lowest growth rates in the world, less than 1%. Low-side forecasts for next year see this area growing only by 1.9%.

These bad results and forecasts raise questions, of course. Why is the euro group as a whole, and especially the bigger economies within this group, not doing better? The answer is not as simple as some Anglo-Saxon analysts and commentators have sometimes argued. They sometimes criticize the monetary and even fiscal policies in the euro area , saying they are not sufficiently growth-oriented. They would like to see even lower nominal interest rates, lower than the present 2%, and at the same time an even more expansive fiscal policy.

In my view, such policies would likely be counterproductive. The weakness of growth in the euro area is neither solely cyclical, nor the result of a too-restrictive monetary and fiscal policy. The real causes for slow growth and growing unemployment, especially in the bigger euro economies, are much more deep-rooted. They are mainly of a structural nature and can only be addressed by appropriate

structural policy decisions. Only convincing efforts to correct and to improve the framework of the too-heavy public burdens and the too-rigid regulations can, and will, improve the prospective for future oriented decisions. These corrections will take great political courage and time.

In these countries, such short-term-oriented monetary and fiscal stimulation could even be counter productive because of its negative effect on confidence in the future political framework. Such policies could easily undermine trust in the new currency and could increase the already too-high public debt in these countries toward unbearable dimensions. These economies need convincing policies that really address the accumulated structural problems and shortfalls.

During the past decade some of the main structural problems in some countries had already become more and more visible. During the 1990s, most EU countries were able to improve their macroeconomic stability, but at the same time some failed to deliver satisfactory growth or employment. This underperformance was striking. It contrasted not only with earlier expectations based on the so-called Single Market Program of the EU initiated in the second half of the 1980s, but also contrasted with the past performance and recent accomplishments of the US.

The reasons for the present underperformance of such highly developed countries as Germany, France and Italy are to some extent, of course, different. But at the same time, these three have much in common. Their labor markets are more rigid than in most other countries. This is due to official regulations and not enough flexible wage developments. Their public welfare systems are so expanded that they cannot be appropriately financed. Very often they are giving the beneficiaries the wrong incentives.

Without fundamental change, big parts of these welfare systems will not be able to be financed any longer, especially because these countries will face growing changes in their demographic development. They must either fundamentally reform their public welfare systems, or else increase public debt, or else raise contributions and taxes.

Sometimes from within and without Europe alike, one hears that these fiscal and labor market problems were caused with the establishment of the monetary union in 1999. In my view, this argument is not correct. It is true, though, that the monetary union, with the creation of one currency and a single monetary policy by the European Central Bank (ECB) for all participating countries, has made all the already accumulated structural problems and differences between the countries more transparent, and has strongly increased the competition inside this union.

For more than four years now, all investors have been faced with the same monetary conditions, without any exchange rate risk between the participating 12 countries. Now, though, all the other competitive factors—like regulations, taxes and labor costs—are playing a much more important role inside the euro area. They are no longer compensated for with different monetary conditions or possible changes in the national exchange rate.

Germany in particular has been effected by this new dimension of competition. As long as it had the *deutsche mark* (DM) as a national currency, with its high international reputation, German interest rates were normally lower than those in most other European countries. But today, nominal interest rates are the same in all euro countries because of the single monetary policy. Real interest rates are now even higher in Germany than in most other euro countries because of the relatively lower inflation rate.

This new competitive dimension inside the euro area has created not only new opportunities, but also new challenges, especially for countries with highly developed public welfare systems and social protection, like Germany. Mentioning this does not in any way take away from the benefits produced by the monetary union. Inside the euro area there are now fewer exchange costs and risks, and consumers can now use their own currency in most European countries. But on the other side, there is also much stronger competition. A single monetary policy means that one interest rate must fit all member countries.

It took a long time to create the monetary union that is now found in Europe. Personally, I have been involved in this process since the 1970s. I was part of a special group of experts who, for the first time, outlined a plan to create an economic and monetary union (EMU) in Europe. Only after some 30 years, with a long time for preparation and some very serious European currency crises, it was agreed to start with such a union.

From the very beginning, this EMU was seen by some commentators as being, "An Awfully Big Adventure" (*The Economist*, April 11, 1998). They spoke of taking a very risky step. Some of them at that time, for example Milton Freedman and Martin Feldstein, even predicted that there would be a short-term collapse. In the meantime, most of their forecasts were more cautious. I did not share, and to this day do not share, their pessimistic view. But in public hearings across Europe, I have still many times had to underline the new dimension of competition inside a monetary union, and emphasize the need for more flexibility, especially in the German economy.

Looking back on more than four years of EMU in Europe, my personal assessment is that the monetary union itself has been an overall success for Europe. Internal monetary stability has been maintained and even improved in the euro area. Previous exchange rate risks inside the euro area have been totally abolished, and so hedging costs have been reduced. Consumers have especially gained from stronger competition and better transparency of prices in their neighboring countries.

Some economies have clearly gained more than others. Countries that in previous times were faced with devaluation risk, and therefore had to live with higher internal interest rates, can now enjoy the same low interest rates as the previous hard core countries like Germany and the Netherlands. Because of higher inflation rates in some catching up countries, these economies have experienced in the early years even

lower real interest rates. But these "benefits", if they are such, are transitional and will be more and more eroded as we move forward.

A much more important factor are the differences in flexibility and structural rigidity among participating countries. Such factors now play a growing, important role. It becomes clearer day by day that the monetary union now exerts more and more pressure for necessary structural reforms, in particular in the already mentioned three bigger countries on the European continent: Germany, France and Italy.

At present, we see happening what *The Economist* predicted at the end of the already mentioned article in 1998. "The big potential for the EMU… [is that] it will bring pressure to bear on Europe to tackle long overdue structural reforms. These may cause social tensions, even a backlash of public opinion against the EU and the single currency. But the reforms have to come anyway, euro or no euro; things that are inevitable tend one day to happen. The Awfully Big Adventure is likely to make them happen faster, so on that basis it should be good for Europe." I cannot do more than agree, once again, with this conclusion, which I had already been underlining before it was presented by *The Economist*.

In the meantime, the European Union has finally realized how important it is that all European economies become more flexible and competitive. Last year, the Heads of State and Government agreed on a so-called "Lisbon Agenda". It set the goal that European economies should become as dynamic, flexible and innovative as the US economy within ten years.

But until now, such statements are only general programs. I doubt whether such EU statements and wordings can really bring Europe forward. What Europe needs are convincing structural reforms at the national level, particularly in the bigger member countries. Such reforms can, and will, of course also bring improvements for the euro area and for Europe as a whole.

The German economy is by far the biggest in the euro area. It constitutes close to one third of the area's GDP. But unlike previous times, for the past three years this economy has seen the lowest growth rates in Europe. Likely growth this year might only be close to 0%. Most forecasts for next year see German growth within the 1.5% to 2% range. That is on the low side of predictions for European economies.

This shows that the "European champion" of the past is now in a difficult transitional process. On the one hand, this economy is still one of the strongest producers and exporters of highly developed industrial products and machinery equipment. Its external balance is, after a few years immediately following unification, again in surplus. But on the other hand, for some years now there has been a lack of new dynamism, a lack of new investment, and even a lack of consumer demand. Overall growth over the past few years has been particularly low and the already high unemployment from before has grown to new records.

The obvious present weakness of the German economy should not, however, be misunderstood. It neither indicates that Germany has lost its former capabilities and resources, nor does it signal a loss of its "championship status" in Europe forever. Anyone making a comparison with the development of the Japanese economy in the 1990s should not forget that Germany did not experience a similarly sized real estate and equity bubble, as Japan did at the end of the 1980s.

The causes for the present weakness in Germany can be mainly attributed to the following factors:

- high rigidity in the labor market
- high labor costs
- an expansive welfare state
- a complicated tax and regulatory structure.

This list shows that these structural problems are mainly *not* the result of short-term developments. They have accumulated and developed over a long time. After German unification, though, their size and dimension became much bigger.

In 1990, East Germany not only got the *deutsche mark* at a conversion rate of 1:1 and the full benefits of the West's welfare state system. In addition, the trade unions pressed for a strong increase in wages during the first few years. Because of this, East Germany's living standard today—that is, wages—is close to 90% of the West's level. However, productivity in the East is still today only around 65% of the West's. This is a gap of almost 25%. Transfers made to East Germany through budgets and the public welfare system still today amount to close to 5% of the entire German GDP.

The problem with these West-to-East transfers is not only its amount, but also its composition. Transfers toward further developments in infrastructure (i.e., traffic, education, research, etc.) are productive investments in the future. However, transfers that simply subsidize the people's present income level are much less productive. It is precisely for that reason that it is of crucial importance to correct the entire social system across all of Germany, since clearly it cannot be done separately in only what was East Germany.

For a long time, governments in Germany denied or overlooked these structural problems. In the second half of the 1990s, the center right government under Chancellor Helmut Kohl started some reforms. They were, however, blocked in the second chamber by the then-ruling center left majority. Since then, this party has gone on to win the election of 1998, and also a majority in the first chamber of parliament. After taking over the federal government, they at first continued to neglect most of the problems. It has only been since the new finance minister, Hans Eichel, took office that they have started to cut expenditures in the federal budget and to introduce some tax reforms. But until the beginning of this year, the center left majority blocked further reforms.

Over the past few years, however, more and more economists and commentators have begun to strongly criticize this attitude of "benign neglect". But after some

hesitation in the first half this year, the federal government changed its position. In March 2003, Chancellor Gerhard Schröder addressed parliament and presented a new reform package, the so-called "Agenda 2010". This policy turn was clearly based on his and his colleagues' perception that, without some fundamental reforms, the future of Germany's economy is at stake.

Finally, some of these reforms have gotten onto parliament's agenda, and it will make a final decision this winter. Without going into details, I will mention only some of the most important points.

First, to reduce the labor market rigidities, the up-until-now very generous job protection found in Germany will be substantially reduced. At the same time, preconditions for unemployment benefits will be strengthened in order to reduce the present disincentives to accept a job. In addition, unions and entrepreneurs are being pressed to introduce more differentiation and flexibility in their wage contracts.

Second, to stop and to reverse the increase in labor costs, the required contributions into the social system should be reduced. This is all the more important because in Germany it is not so much the wages themselves, but these additional contributions that must be paid by the employer that have pushed up labor costs so steeply in the past decade. Therefore, in order to continue providing its services, the health care system, the pension system, and the unemployment benefits system must be fundamentally reformed. First steps are already being agreed upon by the two different majorities in both parliaments. It is to be hoped that fundamental and lasting reform will be soon approved.

Third, to simplify the system and to reduce the tax burden, there are now fundamental tax reforms on the table. Reforms of this nature are all the more important because the German system is so complicated; investors are often *de*-motivated to invest in Germany. The first step next year will very likely be a substantial reduction in tax rates. Negotiations are still going on, though, because the big budget deficits have to be reduced at the same time by even more cuts in public expenditures.

Fourth, to reform the political decision making process and to simplify official regulations, both houses of parliament have agreed to elaborate new procedures over the next few months. The aim is to establish more clear-cut lines of responsibility at the federal and the state levels.

I could go on listing the reforms that are now under way. Of course, at this moment, nobody can predict the real outcome of these efforts over the next few weeks.

One thing seems clear to me at this time. Over the past few decades, I have never seen such a strong reform package on the table. Even more importantly, according to public opinion polls the average German on the street now realizes more and more the need for fundamental reform. Besides just the experts, even *they* now realize that the German economy needs substantial reform in order to once again become a driving

engine of the European and world economies. Day by day, they realize that their own future is at stake if Germany does not undertake appropriate reform.

Of course, one cannot expect all people at all times to support the necessary changes; there are always winners and losers. But for the first time in many years, after many controversial debates, the mood in the country seems to now be moving more and more toward being in favor of reforms.

What we now need in Germany is strong political leadership, especially in both big parties. Policy decisions made today must be clearly explained, and outline the future framework and environment for any potential investor.

Decisions on fundamental reforms must balance a difficult tradeoff between short-term and long-term economic and political effects. Cutting public expenditures and social transfers can produce, for a lot of people in the first round, lower income and lower consumption demand. This can have a short run negative effect on the economy if it is not compensated with more investment, which in turn must be based on confidence in the future.

However, the more the political leadership can create confidence in the reforms and their lasting results, the more we can bridge this difficult transition process. It is to be hoped that our political leaders will understand this problem and will decide appropriately.

In Germany now, I am personally running a public campaign to reform our so-called "social market" system. In this context, I meet with political leaders from all the big political parties. From these conversations, I get the impression that most of them now really understand what is at stake.

At the same time, our European neighbors now closely follow the German reform process. Some years ago, they perhaps looked on with some malicious joy (*Schadenfreude*) at the beginning of difficulties in Germany. But today they are very much interested in successful German reform. They realize more and more the importance of a newly growing and prosperous German economy for their own economic development.

In particular, the move into the EMU and the creation of the euro have "sharpened eyes" in Europe. Euro countries now realize more than ever that with the single currency and the single monetary policy, they now sit in one boat.

Over the past few years, it has been sometimes possible to hear or read in international circles the rumor that the German banking system was, or is, somehow on its way toward a fundamental crisis. Some commentators even compared developments in Germany with the banking problems of Japan in the 1990s.

In my view, though, this comparison is clearly wrong. The bad loan problem in Japan was, and still is to some extent, mainly the consequence of the big bubble in real estate and equities which burst in the early 1990s.

In Germany, we did not have a bubble of such magnitude. Of course, the German financial institutions (not only the banks) were and are affected equally by the most recent worldwide equities bubble and its bursting at the beginning of this century. But the dimensions are not comparable with what the Japanese banks faced in the 1990s. German banks are at present faced with some other problems, though.

First, Germany is clearly over-banked and the costs of banking are too high. German banks have realized this. They are trying, now, to reduce their number of branches and to organize more cooperation. To develop such cooperation, though, is not always easy. Germany still has a so-called "three pillar" banking system. There are private banks, cooperative banks, and publicly-owned savings banks. Cooperation within these groups has already made big progress. But now discussions focus on the question of whether these pillar groups should not be opened to more cooperation, or even concentration, between the groups. I am pretty convinced that these processes will make progress over the next few years, and that the German banking system is on its way toward becoming more internationally competitive.

Secondly, besides this cooperation and concentration process, there has also been under way a change in financing methods. According to postwar German economic tradition, the banks, and especially the private banks, were very often stakeholders in the big industrial companies. These links are disappearing more and more, as the banks are interested in having a much more flexible portfolio.

Third, as this is going on, all three types of bank are trying to reduce their direct credits, or else to change the conditions. To some extent, this risk reduction is the consequence of the newly expected "Basel II" rules. But even independent from the "Basel II" rules, German banks are trying more and more to securitize their credits to clear up their own balance sheets. This change toward more securitization is often new, especially for medium sized enterprises that, in Germany, have been accustomed for a long time to financing their activities via direct credit. Only now are German financial institutions changing, whereas other countries' banks have done so much earlier.

Of course, all these financial changes pose new challenges to German business. But I am convinced that these reforms can, and will, be undertaken without creating a crisis, either for the banks or for the business community. Germany is only now doing what other economies have already done. And according to a new report by the Bundesbank, the worst seems to be already over.

There is a controversial debate going on now inside the euro area about the rules and application of the so-called "Stability and Growth Pact". For some time now, Germany, France and Portugal have all been seeing budget deficits bigger than the pact rules allow.

Let me first comment on why there are such rules in the EMU treaty. The construction of the EMU is unique. It has only centralized the *monetary* policy of the euro area countries. All other policies—including fiscal policy, tax policy, budget policy, etc.—are still in the hands of national, domestic authorities. The EMU carries merely a common surveillance procedure to see whether national policies are appropriate. For this assessment of appropriateness, the partner countries have lain down some rules that are outlined in the treaty.

The single most important rule is that the public deficits of any one participating country should, over the medium-term, be "close to zero", and that they should not go beyond 3% in any one year, except in years of lasting negative growth in the relevant country's economy. This, in my view, is a relatively flexible rule, but it is now being criticized as being too rigid.

From a purely economic point of view, one can, of course, dispute in this context any exact figure. As you know, economic effects at any one time depend on many other impacts. One should, however, not overlook the unique construction of this new currency area.

This economic area has no single state. There is no single parliament with one government. There is simply a currency area with one central bank. But at the same time, there are also 12 national states with their own fiscal policies. If a country, particularly a bigger one, follows a lax fiscal policy, it can harm the common monetary policy (i.e., the common economic area's currency) and can create tensions among participating countries.

The smaller euro countries have begun criticizing France and Germany for not following a national fiscal policy in line with the commonly established rules. I can fully understand these critics. I hope both countries will, in due time, come back toward the agreed rules. This will be very important for the long-term future of the euro. On the other side, however, Europe is not interested in having an overvalued euro either. So we hope very much that the present weakening of the dollar will not go too far.

The US dollar does have some weak points, like the big current account deficit and the present budget deficits. After the publication of the G7 statement in Dubai, there is especially a risk of a too-strong devaluation of the dollar. But looking at current accounts across the globe, the main counterweight to the US deficit today is the supplies in Asia Pacific. Europe has only a relatively small current account surplus, in contrast to the situation in the 1980s when we organized the Plaza and Louvre agreements.

Be that as it may, I very much hope that the development of the exchange rates over the coming few months will not endanger the expected economic recovery, either in Europe or in Asia. Thank you very much.

Questions & Answers

Q I would like to ask your opinion about the euro and the ECB. First, there are a lot of comments, particularly in *The Economist*, that say the system is under strain. As you noted, some countries are even breaking particular targets and are in fiscal deficit. This could endanger the euro and the whole system. Do you agree?

Secondly, it's not clear to me how the ten new members who are supposed to join next year will relate to the euro and the ECB (Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Slovakia, Slovenia, and Poland). Do you see them integrating into the monetary union?

A The two big countries', plus Portugal's, failure to meet the demands of the "Stability and Growth Pact" poses a special risk to the union. During my speech, I tried to elaborate on the construction of the treaty. It does not centralize all policy making in one place. It only centralizes the *monetary* policy, and in fact *de*centralizes fiscal policies. With the Maastricht Treaty, we established a procedure to supervise and to perform surveillance. We established reference points for fiscal policies. Over the next year, if France and Germany continue to fail to meet their Maastricht targets, it could really undermine the treaty.

If we were to follow Robert Mundell's plan for an optimum currency zone, which he elaborated in the early 1960s, the euro area would be fine. However, one of his pre-conditions was that there be enough flexibility and mobility of labor. This is absolutely not the case, and to some extent will never be the case, in the euro area with its different languages and different cultures. Only *part* of the population will ever be truly mobile.

Because of this, there needs to be more harmonization—I'm not saying complete harmonization, but more harmonization—at least between fiscal policies. If one country moves toward a big deficit, it can to some extent undermine the capital market's expectations for the whole euro area. In the long run, it will clearly make interest rates higher for all. All will then suffer the disadvantages. That is why we need some rules, and the rules have to be applied.

Two countries—Germany and France—are now moving strongly away from these rules. In my view, they must come back. If they do not, it could undermine confidence in the euro because conflict with monetary policy could come up. If the big countries follow a lax fiscal policy, it could mean that *because* of that the monetary policy has to be more stringent in the future. That would harm all the others.

If you live as part of a group of countries where only the monetary policy is centralized, but where other policies are decentralized, it is important to follow the rules. I am very disappointed with the conversations that are going on between some politicians when they say, "It doesn't matter." It *does* matter. Not probably today, but in the future.

As far as the new members are concerned, the three countries that already have a right to come into the euro area (Britain, Denmark and Sweden) must decide by

themselves. For the time being, I do not expect them to do so. Sweden just rejected the euro. The British government has always indicated it would come, but it has said the decision should be taken by the government, the parliament and the people. For the time being, I don't expect any of them to come in.

The other point is the new members in central and eastern Europe. If they actually join the European Union next year, according to the treaty they have the right to become members of the euro group only when they meet the entry criteria. In the treaty, though, it is clarified that at least two years must elapse before they are eligible to use the euro. So if they really become EU members next year, they cannot become members of the monetary union until 2006 or 2007 at the earliest.

I don't know which of the ten new countries will then become members of the euro. Three months ago, most of them were very much interested in moving in as early as possible. But today you also hear other noises. They are a little more reluctant and want to wait to see the outcome of the euro. They are not sure whether they should really join at the first moment possible. I cannot predict any more than to say that the earliest will not arrive until at least 2007.

Q In the case of Korean unification, could you perhaps suggest what kind of benchmark or exchange rate we should use between the North Korean and Korean wons? Secondly, do you have any thoughts about Asian monetary integration and, based on your European experience, how do you suggest we approach such a union?

A Korean unification is a big issue. Let me only say that we, in Germany, made mistakes. I hope that in the case of Korean unification you will have more time than we had.

The fall of the Berlin Wall and the opening of the borderline in Europe was really a change of worldwide proportions, not merely of German proportions. Germany merely reflected the overcoming of the borderline by one of the two systems. It could not have been stopped or slowed down. In the context of these worldwide developments, German unification was under a lot of pressure.

I have the impression that if Korean unification were to come, it would not be the same today as it was for us in 1989. Here, this is not a question anymore of two worldwide systems. South Korea is part of the Western system, but what is North Korea doing? Do they have a big empire behind them? I don't think so. Korea simply needs a transitional period in order to avoid the rush that hampered the German unification process. That would give a little more time for the transition.

Secondly, in Germany we had an established policy to come to unification as early as possible. That means that when the borderline was opened from the eastern side, the West could not stop it. Nobody was aware, either, whether there would be a unification in the future. The West was interested in unifying in a very short time. But nobody knew who would be the next Gorbachev, or what the situation would be like in the Soviet Union. There was pressure to unify quickly.

There was a quick election campaign in early 1990, and the people of East Germany voted in favor of unification. It should be noted, though, that a lot of West German party campaigners went to East Germany and ran the whole campaign there. That means they promised a lot of things. They promised a *deutsche mark* conversion rate of 1:1, they promised that the welfare state would be transferred, and they promised that the people of East Germany would soon be at the income levels of the West. Since then, these policies have created a lot of problems. But at that time it was much more difficult to decide on proper policies. So I just hope the Koreans will have more time and will be able to learn from this experience.

Also, though it is often said that the exchange rate was the crucial factor, this is not entirely the case. The exchange rate was only one factor. The most important point was the wage contracts transferred to the East from the West. They brought a strong wage increase. Similarly there were problems with the introduction of the West's social security system. It was a one-off transfer of the entire system. It was not done in steps. That was, and is, the problem. Korea can learn from these German failures. It has the privilege of not being the first.

Q You mentioned that there are some European economies that are a bit stagnant these days. Also, can you provide some quick comments on building the EU, and how countries here in Asia Pacific can overcome any similar difficulties?

A In Europe, it took from the 1960s to 1999—more than 30 years—to form the present European Union. I don't know if there is any likelihood of building such free trade areas, internal markets and institutional frameworks in Asia Pacific. I can only refer to the developments in Europe.

In terms of structure, there should not be one, single dominating country. In Europe, the entire integration process was made very much easier because of the German situation after World War II. Germany came in from down on the ground. It had to start again. It was not a dominant power. It was a defeated power. In Germany, and especially in France, politicians came to the conclusion that it is better to grow together. It was Robert Shuman and Konrad Adenauer who really established the first community. After that, it was subsequently developed by enlarging the membership and by developing the cooperation and integration.

Q You ended on an optimistic note about the German and EU economies. But in my view, once populist policies are implemented and the populist institutional infrastructure is in place, it will be very difficult to undo it. It will take a long, long time to reverse it.

In that regard, there is all probability that a transitional period during Korean unification would be too long. This should be very much emphasized for Koreans. I am personally very much concerned that we are moving toward that direction. Once we go that direction for some time, it will be very difficult for us to reverse the policy when we realize all the problems.

A I agree. Policy reforms are difficult. But the entire process is the point. We in Germany postponed real reforms for much too long. We started late. The real question now in our country is to do it properly, and to do it in a confidence-creating manner that will bring confidence to investors. Germany is trying to reform. I hope very much, though, that I was not too optimistic. But at any rate, one should not underestimate the fact that, up through to today, Germany retains its high GDP and its high income. That is not at stake. What is at stake, are the possibilities for the future. We have to do the job now to create the opportunities for the future.