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Why East Germany did not become a new *Mezzogiorno*☆

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ABSTRACT

Economic integration is generally thought to favour convergence in the economic performance of previously separated regions; but this is far from universally true, as the experience of the members of the Eurozone testifies. The paper considers the two sharply contrasting cases of East and West German convergence following reunification and the enduring poverty of the Italian *Mezzogiorno* since Italian unification a century and a half ago. In both countries, political integration delivers much higher consumption in the lagging relative to the leading region than of per capita GDP. Consumption convergence can be supported by transfers but 'production' convergence ultimately requires catch-up in the production of tradeables. The paper demonstrates the radically different performance of the tradeable sector in the two cases, and suggests that this may be the result of differences in labour market flexibility, in investment performance and in the social norms required for the production of complex manufacturing.

Introduction

The presence of both convergence and divergence among countries, and among regions within national boundaries poses a challenge for economists. In a unified political area, there are common national institutions, and labour and capital, as well as tradeable goods and services, can move freely: models of comparative advantage and of growth with diminishing returns technology would predict convergence in living standards. 'New' growth and international trade theory provide, however, mechanisms that can drive divergence. There is renewed urgency in understanding these processes because of the resurgence of populism associated with regionally differentiated winners and losers from globalization and technological change (Autor et al., 2013).

This paper looks for lessons in a detailed case study of politically integrated areas. It shows that the experience of two regions – Southern Italy (or the *Mezzogiorno*, as it is known in Italian) and East Germany – has been radically different over the last two decades, and more modestly, provides a set of possible reasons for divergence in the Italian case and convergence in the German one that make sense conceptually and for which there is supporting evidence. Although the comparative case study setting is not conducive to nailing down a well-identified cause, there are features of this comparison that are helpful for interpreting the evidence. Italy and Germany were unified as nation states in 1861 and 1871, respectively. Both West Germany and Italy were founding members of the European Economic Community, the European Union, and in 1999 of the Eurozone. These arrangements define a common set of rules for the two countries in relation to cross-border trade and factor mobility as well as for the single market established in 1988. The regional economies of the *Mezzogiorno* and East Germany shared these 'external' rules of the game for the period of interest beginning with German reunification in 1991.

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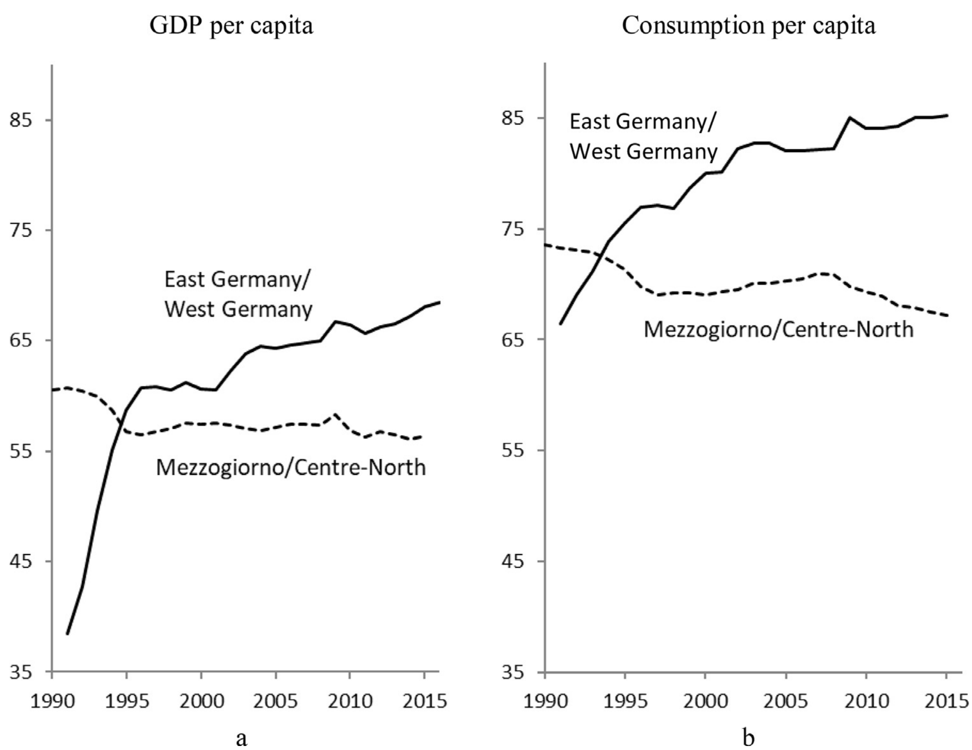

Fig. 1. Germany and Italy: The Regional Problem. ("poor" region's GDP per capita (left panel) and consumption per capita (right panel) in percent of "rich" region's; constant prices.) Sources: Statistische Ämter des Bundes und der Länder, Volkswirtschaftliche Gesamtrechnung der Länder; ISTAT, Conti e aggregati economici territoriali.

It was often argued, following this reunification, that the economic problems faced by East Germany resembled those that have long plagued the *Mezzogiorno*. Making explicit reference to the Italian experience, commentators feared that convergence in living standards between the Eastern and Western parts of the country might be very slow and that East Germany would for decades suffer from above average unemployment and relative poverty (e.g. Barro and Sala-i-Martin, 1991; Sinn and Westermann, 2000; Sinn, 2002; for dissenting points of view, see Boltho et al. (1997) and Heilemann (2005)).

The Boltho et al. (1997) paper, in particular, gave three reasons for expecting more favourable developments in Germany than had occurred in Italy. First, public intervention stimulating machinery and equipment investment, which had generated some convergence in the 1960s in Italy, had fallen back in the *Mezzogiorno*. By contrast, early East German experience saw the government actively sustaining investment in the region. Second, the competitiveness of the backward area (endangered by wage equalization across the country as a whole), while changing little, or even worsening, in Southern Italy over several decades, had shown tentative early signs of improvement in Eastern Germany, thanks to greater wage and trade union flexibility at a decentralized level. Third, social capabilities were arguably very different between the two poorer regions. Southern Italy had fallen prey to rent-seeking and corruption in ways which, at the time at least, seemed virtually unknown in East Germany.

Section 1 looks at the macroeconomic picture and examines whether GDP and consumption per capita convergence have occurred or not in the two areas over the last two decades. Section 2 considers how the mechanisms highlighted by the 'new' trade literature and the empirical results found for international trade can shed light on convergence in the regional context. Section 3 quantifies the importance of trade for economic growth within Germany and Italy. The next section then considers trends in productive investment, the evolution of competitiveness (including an assessment of the importance of the tradeable sector in the two economies) and the complexity of the two areas' exports. Section 5 assesses the presence (or absence) of social norms supportive of growth in the two regions that may help account for integration with divergence in Italy and with convergence in Germany.

1. Stylized facts

Fig. 1a (left panel) presents data on constant price GDP per capita since the early 1990s in East Germany and in the *Mezzogiorno*, expressed as ratios of the GDP per capita of the two countries' richer regions (West Germany and the Centre-North respectively).[1] The

[1] The compositions of the two "poorer" and "richer" regions are shown in the footnotes to Table 1. Berlin, following common usage, is considered as part of West Germany. It could be argued that the transfer of virtually all government activity from Bonn to Berlin might have benefited the neighbouring Brandenburg *Land* and thus given a boost to the economy of East Germany that was absent in Italy. It should be borne in mind, however, that the move created a non-tradeable sector that might have absorbed talent and promoted rent-seeking activities. This is almost certainly what happened in Italy when regions were given significantly greater powers in 2001.