

Transformation of East Germany:
Treuhandanstalt, Privatization, and Today

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Prospectus

My paper will investigate the privatization process of East Germany that occurred with the unification with West Germany after the fall of the Soviet Republic. More Specifically, I will be examining the privatization process of the *Treuhandanstalt* (Trust Agency for the People's Property), the government agency overseeing the economic overhaul. I will first introduce the economic situation in East Germany on the eve of the fall of Communism, setting the backdrop for the beginnings of economic reform. The research will introduce the workings of the *Treuhand* agency, and the objectives or guidelines that were put forth to achieve privatization. How did they follow through with those objectives? How successful were the strategies pursued by the agency? What challenges or obstacles did *Treuhand* face in their mission? I will also try to examine how far East Germany has gone since *Treuhand* and unification. How are the living standards and economic outlook today?

I will be utilizing books and articles written at the time of unification, 1990. I will also be drawing on material written up to the new millennium as well. I will be analyzing data collected by economic scientists in Germany as well as from other areas. I will also be drawing on material from economic journals, such as *The Economist* and other journals. I also have access to excellent primary sources, such as an interview with the Birgit Breuel, the man who was president of *Treuhandanstalt*.

Historical Background

How can we ever forget November 9th, 1989? This day, many would agree, was marked by one of the most striking and pivotal events in the latter half of this century: the fall of the Berlin Wall. Decades of emotions spilled forth in front of the world when East Germans and West Germans streamed through the Brandenburg Gate in both directions, as border guards watched tearfully. The Berlin Wall, a symbol of a divided city, a divided country, and a divided people, disappeared almost as swiftly as it had appeared in August 1961. With its decision to permit free travel between West and East Berlin, East Germany's leadership reversed nearly three decades of separation overnight. This policy reversal was a response to weekly demonstrations against the regime, the daily exodus of nearly 2,000 East Germans into West Germany, and the reform policies of Soviet leader Mikhail Gorbachev for liberalization. Ironically, the political and economic reform policies that Gorbachev initiated between 1985 and 1991 contributed significantly to the turbulence in East Germany and to the eventual fall of the Wall. Rather than appeasing the regime's opponents, his reform policies unleashed the very forces of change that led to the Soviet system's demise. His program of *glasnost* (openness) and *perestroika* (restructuring) helped bring an end to the Cold War between the USSR and the West.¹

This political opening led to calls for democratic elections and to a growing interest in East German unification with the Federal Republic of Germany (FRG)

instead of internal reform. Yielding to popular pressure, the communist leadership scheduled a national election for the parliament for March 18, 1990. The election became a referendum on the German Democratic Republic's (GDR) future, and the clear victory of *Allianz*, a conservative alliance advocating quick unification, solidified the country's reorientation to the West. After taking office, the *Allianz* government negotiated a monetary, economic, and social union with West Germany on July 1st, 1990, which transferred East German fiscal and monetary sovereignty to West Germany. The governments in Berlin and Bonn then worked out a Unification Treaty which became law on October 3, 1990 that transferred East German political sovereignty to West Germany through the dissolution of the GDR and its admission into the Federal Republic of Germany.² In just those few months, the German Democratic Republic, once part of the Soviet regime, renounced its statehood and was reunited with West Germany.

The task of reorienting the East German economy from command to market structures fell to the *Treuhandanstalt* (or Treuhand for short), the trust agency set up by the still communist regime of the GDR on March 1, 1990. As owner of all state property, Treuhand was responsible for administering and restructuring the economy, with an aim towards a mixed economy with a large sector of market-oriented public enterprises. Yet the newly elected, pro-unification parliament modified Treuhand's mandate in a second law. The law instructed Treuhand "to privatize so as to cut back the state's involvement in the economy as quickly and extensively as possible" and to

distribute all proceeds from privatization to GDR citizens. Treuhand took over and owned initially 8,500 industrial enterprises with some 4 million employees, making it the world's largest industrial enterprise.³ Due to break-ups, divisions, and de-merges, the number of enterprises increased to around 13,000, all of which were to be privatized or liquidated.

Table: Assets of the Treuhandanstalt	
I. Nationalized economic sector	
Incorporated enterprises	
as of July 1, 1990	8,482
as of Dec. 31, 1994	13,815
Incl.: places of business	Ca.45,000
Small businesses and retail establishments	21,569
II. Agricultural and forestry assets	
Agricultural land	17.2 bio. Sqm.
Set to be privatized	10.0 bio sqm.
Forestry land	19.6 bio sqm.
Set to be privatized	5.1 bio sqm.

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Privatization

The right to own private assets is a fundamental principle of Western economies, and privatization of state-owned assets was mandated in the German unification treaty. Treuhand was the vehicle chosen to enact the government's

privatization policy. In addition, the agency was also responsible for the restitution of properties. In this section, the focus will be on the privatization in the industrial sector. What steps were taken in privatization and to whom?

Preparation and Evaluation

Before any privatization could occur, Treuhand needed critical information regarding its holdings. According to Birgit Bruel, President of the Truehandanstalt at the time, they “did not know even their names, let alone such details as products, customers, debts, bottom-line results, and production capacities...No facts or figures.”⁵ The agency distributed a policy announcement in “The Policy Guidelines of the *Truehandanstalt*” in October of 1990 which stated that the agency should privatize “as fast and as far as possible” and shut down firms “that could not be turned into competitive businesses,” while paragraph 6 stated that restructuring should take place, “wherever possible, through private owners.”⁶ To follow through with this mandate, the agency used needed a firm’s business plan as the key determinant for financing restructuring operations as well as recommending firm closure. Already in July 1990, therefore, the agency had requested all firm managers to develop a business plan for their enterprise by the end of October. The agency instructed managers to identify the products they could sell, the market segments they could

target, and the personnel, investment, and financial measures they could take to improve their firm's productivity.

Once firm managers submitted these plans, the agency referred them to a team of experts for an independent appraisal. Their evaluations classified firms into one of six categories which were based on firms' viability and did not take into account local employment or supply networks. According to this system, group 1 firms operated profitably; group 2 firms were approaching profitability; group 3 firms had feasible business plans; group 4 firms seemed salvable but required alternative business plans; group 5 firms did not seem salvable, but required further investigation; and group 6 firms were not salvable. Firms falling in the first four categories were eligible for restructuring, while the firms in the last two categories were designated for closure.⁷ Restructuring was not an end but only a preliminary stage to later privatization. The evaluation concluded that 70% of the enterprises were potentially viable.⁸

How to privatize and to whom?

The primary sales strategy of the Treuhand focused on finding buyers who were willing to commit for a substantial long-term investment in the enterprises and could offer the management skills suitable for the respective businesses. In aiming to match management with the enterprises' assets, the agency in turn placed emphasis

on a sound financial background. These qualitative requirements came to be mainly fulfilled by Western investors.

The possible privatization procedures available at the time can be broken down into two groups: standard procedures and complex procedures. In standard procedures, the price of the highest bid is the relevant factor. Standard procedures require the specification of the package ex ante (before action) and is thus not open to bargaining. Some examples of standard procedures include auctioning off of enterprises, public tender offers of company shares on stock exchanges, and auctions of company shares by means of investment vouchers. In complex privatization procedures, the package on offer is specified flexibly through solutions reached in bargaining; in these procedures, selection criteria other than price are allowed. Complex negotiated solutions make it possible to agree on complex contracts. These procedures include bilateral and multilateral bargaining.⁹

The Treuhand, legally, was free to choose its privatization procedure. The choice between privatization procedures resulted from the Treuhand's primary objectives: the objective was not to maximize revenues and returns, but instead, to increase the volume of employment and investment by subsidizing rehabilitation investments.¹⁰ The privatization procedure of the Treuhand was therefore to sell enterprises via complex negotiations with one or more interested parties, which would later come to include management and employee buyouts and buyins. The procedure chosen also depended on the nature of the enterprise, its size, location, etc. The

Treuhand primarily chose the negotiating procedure with selected bidders for large and very complex enterprises within the shipbuilding, steel, iron, and chemical industries. In these industries, potential investors are limited. Auction procedures were used only in the “small privatization” which included retail, trade, and small service enterprises and businesses that were of no great importance. Nevertheless, the agency limited as much as possible the use of standard procedures like auctions on the grounds that price was not the ultimate factor. Importance was placed on the continuation of the enterprise, future investment, and assurance of jobs, and thus the negotiation model was favored.¹¹ What was the nature of these negotiations?

Privatization process of Informal Bargaining

The better part of enterprises held by Treuhand were privatized by means of informal bargaining with one or more bidders and the details of the process strongly reinforce the agency’s objective for employment, investment, and sound management. The potential investor’s business concept or rehabilitation concept formed the basis of the sales talks. This business concept had to be founded on the continued existence of the enterprise in question, and it was to include a business plan, an investment plan, a financial plan, an employment plan, and a statement of intent on anticipated business relations with suppliers and customers.¹² The bidder was also expected to provide proof of their financial standing. Basically, potential investors not only had to justify

his financial and managerial profile, he also had to prove that the enterprise had a promise for the future in terms of a substantial market for its output as well as research and development plans.¹³ During negotiations, the Treuhand essentially weigh up the business plans and estimate their chances of success, comparing the quality and value of one bid against another whenever possible.

The nature of the negotiating allowed for much needed flexibility in ironing out complex contracts. Each and every contract had different parameters with respect to its terms. Aside from employment and investment commitments, purchase price, outstanding liabilities, and Treuhand liability commitments for environmental clean-up costs, for example, were individually established.¹⁴ The advantage of such a flexible sales approach was that it offered the best way of keeping firms in business. Negotiations of this kind fit better in selling ailing enterprises to risk-averse potential investors.

Property Restitution

One of the main problems of privatization was and still is restitution. Implementing private property rights was a key priority. According to the Einigungsvertrag, everybody who was expropriated between 1933-1934 and after 1949 had the right to reclaim property. During those times, the Soviet Union had carried out a land reform which took property away from many people. From the

legal point of view, it seemed to be logical to return property to the former owners, and a large majority of German parliament voted in favor of restitution.

In practice, the allocation of property titles proved to be extremely difficult. It was very difficult to relate former property to the actual enterprise and ownership of land. Secondly, land registers and title records were neglected under the Communist GDR and are incomplete. It was therefore not unusual to find many claimants for one piece of property or enterprise.

The arising difficulty of identifying the owner was the major critical point regarding restitution. After unification, 40,000 ownership claims on 17,000 enterprises were filed.¹⁵ Until June 1992, only 4,700 of these cases were settled. The establishment of ownership through reinstatement of the previous owner became the bottleneck of privatization and successful restructuring in East Germany. The mere restitution claim on a whole enterprise or the real estate it was on, produced an immediate obstacle and blocked the sale or restructuring process of the Treuhand until legal settlements could be made. Another negative effect was the time-consuming nature of filtering through all the frivolous or fictitious restitution claims. At the end of 1994, the government received a total of 3,324,510 inquiries for restitution, and 92% of those claims proved to be false or unapproved.¹⁶

The essential pillars of a free market economy are clear cut property rights. As long as these rights do not exist or are not clearly defined, the market cannot work efficiently. The lack of clear guidelines brought about uncertainty which led to high

macroeconomic costs such as lower growth rates, lower investment rates, and more unemployment.

Administration should have considered a policy of compensation over restitution. Costs from both strategies are arguably equivalent, considering the costs for administrative work. In addition, pursuing a compensation strategy would have had the advantage of separating the procedure of assigning original ownership from privatization. In this way, the potential investor could have become legal owner regardless of the status of the settlement of compensation. The duration of the settlement would not have caused the delay in investment and thus restructuring that occurred with the restitution strategy. The longer the delay, the worse off enterprises become and eventually will have to close down.

Yet, the counter-argument is that ownership rights should be safeguarded even under the most difficult circumstances. In the case of East Germany, the fundamental ideal of ownership diverged from the essential ideal. In the free market economy, private ownership is an incentive and a means for prosperity, progress, and innovation. Private property is not just the end in itself. This was the problem with the *Einigungsvertrag* (Property Law), for the way it treated ownership created obstacles to full, efficient transition.

Results of Privatization

When the Treuhand closed its doors on December 31st, 1994 after its mandate had ended, it had virtually completed its mission. Below is an overview of the Treuhand's record as an agency for mass privatization.

Table: Treuhand results as of 31 December 1994	
Activity	Number
Privatisations	15,102
Re-privatisations	4,358
Small-business privatizations (restaurants, hotels, shops, cinemas)	25,030
Properties	46,552
Total Privatisations	91,042
Companies liquidated or in the process of liquidation	3,718

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The agency managed to essentially transform an entire command economy into a market economy within four-and-a-half years. There were still a few companies and a large portion of real estate holdings unsold in 1995. However, over 15,000 enterprise privatizations concluded, plus over 4,000 re-privatizations. There were over 25,000 small business privatizations that developed the small-business sector that had been largely missing in East Germany under the socialist rule. The job and investment guarantee clauses resulted in more than 1.5 million job guarantees, and future investments guaranteeing DM 211 billion.¹⁸ This rapid transformation is considered to be a minor miracle by some.

Criticisms of the Treuhand

Although the Treuhand can lay claim to many successes in the transition from a command economy to a market economy, its achievements were not without a price. The main criticism of the Treuhand is that its expenditures were enormous. At the close of Treuhand, the privatization activity left a debt of DM 256 billion. The chart below shows a breakdown of expenditures.

Table : Budget of the Treuhandanstalt	
Budget of the Treuhand	DM Billion
Subsidies(Transfer of existing debts of Treuhand	99
Environmental clean-up	43
Financial restructuring and shutting-down	153
Other expenses	37
Total Expenditures	332
Income of the Treuhandanstalt	76
Total Budget	256

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Because bargaining emphasis was on long term investment and employee guarantees instead of price, the income generated from sales of enterprises was extremely low. Some companies were sold for as little as one dollar in order for investors to put finances into long term investment in the enterprise. To finance the privatization costs, the government has had to impose higher taxes on German citizens and also borrow from Euromarkets. Many East German companies are still subsidized today, and some West Germans are angered by tax increases that some feel are being squandered away.

By far the most controversial Treuhand policy was its commitment to rapid privatization, a goal pursued relentlessly under the leadership of Rohwedder and then Breuel. Both believed that rapid privatization was the best medicine for the ailing East German firms. The policy, it was argued, would give the East German Economy a quicker, surer start in the new capitalist world because private owners would understand the necessity of investing in new technology, cutting labor costs, and bringing in managers who had the skills necessary to make organizations competitive by international standards.²⁰

Yet, in opposition to those views, there were those who believed that giving top priority to the privatization program in general was a serious mistake. Many trade unions and economists were quick to speak out in disapproval of the policy. They claimed that speed demanded increased levels of subsidy, adding unacceptably to the rising costs of privatization. There was also an additional risk associated with rapid privatization. It encouraged detrimental practices such as asset stripping and insider dealing on the part of investors and a few corrupted Treuhand employees.

Some research has also shown that the Treuhand possibly showed a large-firm bias in terms of quality treatment in privatization. Dininio claims that the organizational division of Treuhand firms by size did not lead to separate but equal treatment.²¹ Rather the central office, assigned to large firms, and the branch offices, assigned to small firms, differed in their ability to help firms restructure, a difference attributable to managerial talent as well as the sheer number of firms under their care.

In a sense, the small firms got the short end of the stick as the branch offices lacked the managerial talent to develop creative solutions for troubled small firms .

At the same time, Treuhand officials suffered considerable manpower constraints. It was difficult to recruit professional talent to handle the privatization of an entire economy. In order to fill 2,500 positions within the first year and a further 1,250 in the second, the agency resorted to borrowing experienced workers and recruiting university graduates with little experience.²² However, even these measures proved inadequate in attacking the large scale of privatization. It was not uncommon for an associate at the central office would usually be responsible for selling 10 to 20 large companies (each with more than 500 employees) and for a section leader to supervise 6 to 8 associates, all with comparable workloads.²³

This chronic understaffing encouraged an atmosphere of expediency at the Treuhand. Faced with a heavy workload, agency officials aimed to accomplish more by focusing their efforts on projects where returns were greater. Though it took about as much effort to evaluate alternatives and negotiate contracts for a small company as for a large firm, the returns were greater on selling a large firm. Overburdened officials therefore focused their efforts on large firms in order to drive more economic activity into the private sector in a short time frame. From this, the Treuhand's policy of expediency drove them to practices which resulted in a bias towards large firms.

In addition, many East Germans feel that their former country has been sold for mere pennies and their industrial base dismantled. Some East German workers

have called the Treuhand the “job killer”, even though the agency labored mightily to save at least some of their jobs and forced investors to work out social plans as well.²⁴

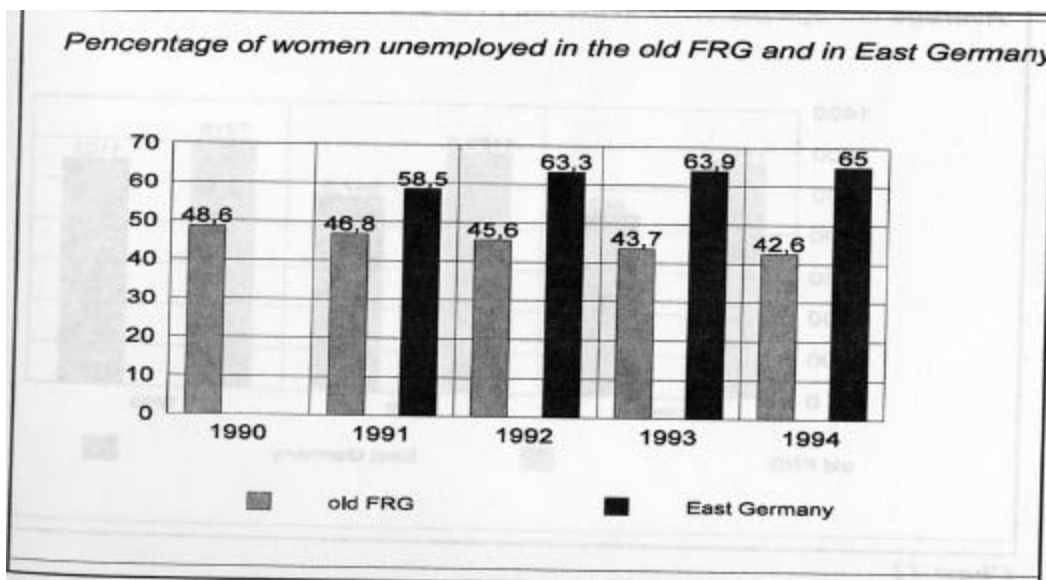
Unemployment is a serious issue in East Germany. The unemployment rate in East Germany rose from about 2% in 1990 to 17% in 1993.²⁵

Social Consequences

German unification brought many changes for the population of the former Communist GDR and issue of social consequences was a major concern. East Germans expected a rapid improvement in their living conditions after reunification. They expected their standard of living would approach the West German level very quickly, especially since Chancellor Helmut Kohl famously promised “prosperous landscapes” by the time of the next election. Some benefits were realized. For example, East Germans gained, for the first time, the freedom to unrestricted travel. Five years after reunification, incomes have improved for most East Germans, but working and living conditions are far from resembling those of their counterparts in West Germany. For example, the East Germans work on average longer than West Germans and receive in most cases only 70% or 80% of the wages received in West Germany. One can estimate that full equity in working and living conditions will take maybe ten to fifteen more years.

Transition from a command economy to a market economy meant that there was no longer a guarantee of future employment. Families now have to worry about housing and employment. For example, after housing subsidies were removed, some rents increased tenfold.²⁶

Women in particular are suffering much hardship from the transition. Although each employee is now threatened by unemployment, women and older employees have been hit the hardest. While in Communist GDR 90% of employable women were employed in 1989, this number declined to 45% in 1992 and corresponds now with the share of employed women in West Germany (see chart). According to official statistics, not accounting for employment resulting from job creation measures, in 1994 in East Germany 65% of the unemployed were women



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In addition, various studies have shown that an unemployed male has a better chance of finding employment than an unemployed female.²⁸ The employed were largely

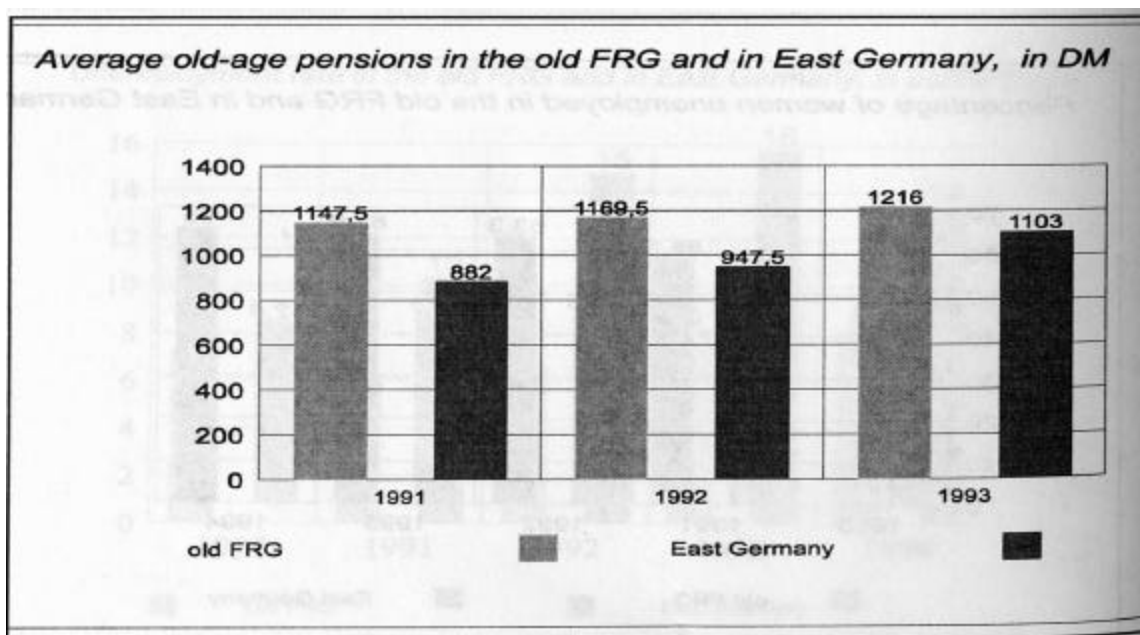
well educated, middle-aged men. Unfortunately, it seems that hiring managers still cling to old ways of thinking: women represent second wage-earners and men are the ones who are ultimately responsible for the family's financial security.

Not only were their employment opportunities reduced, childcare had to be arranged privately was difficult to find. Under communist rule before 1989, day care was universally available through a broad network of state- and factory-supported day care centers, kindergartens, after-school child care and school lunch programs. As of 1989, 80.2 percent of children aged one to three were in day care, 89.1 percent aged six to 10 were in after-school care.²⁹ Spaces were available free of charge. Another consequence has been a drastic drop in the birth rates and in marriages. Between 1989 and 1992, the birth rate dropped by 60% and marriages by 65%; such steep declines are very rare and only have been seen in the World War I years.³⁰

While employment opportunities have become uncertain for women and older people, other groups have clearly benefited from reunification and privatization. With the transfer of Western law into East Germany, people with property have increased opportunities for entrepreneurship. This has resulted in an even greater number of self-employed people. In 1995, their share in the active economic population reached 8%, only 2% lower than the percentage of self-employed people in West Germany.³¹

Retirees have also benefited from reunification. Since 1990, they have received a pension similar to the average West German pension. As the following chart shows, the average pension in East Germany in 1993 was already 91% of the

average pension in West Germany. The pensions of women in East Germany are on average already higher than in West Germany. That results from longer periods of employment. A working life of forty or fifty years is not unusual for female workers in East Germany.



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Conclusion

Regardless of the criticism attached to the Treuhand, it did manage to privatize more than 95% of its total enterprises within its lifespan. True, the process has had tremendous costs, and mistakes have been made. Yet, no one had ever attempted such a transformation of this magnitude before. There was no set manual on how mass privatization should be done in a post-unification nation. Additionally, no one really knew what the detailed economic condition of East Germany until Treuhand was

established. President of Treuhand, Birgit Breuel, stated that they “did not know what we had to work on. Not a clue about what lay in store of us.”³³ The results they produced can be seen as monumental.

What are some potential lessons that can be drawn from the Treuhand experience? In response to this question, Treuhand officials tend to stress the uniqueness of German unification. They agree on the emphasis of speed and also the value of an independent privatization agency. A good reasoning behind rapid privatization is that “fundamental economic transformation must exploit the window of optimism and tolerance which accompanied the East European revolutions.”³⁴ A common view within Treuhand is that the level of East German discontent in 1994 would not have allowed the degree of socio-economic dislocation carried out in 1990 and 1991. Nevertheless, this model cannot be readily applied to other countries because of the uniqueness of the German unification. A vital component of the whole transformation was the access to huge sums of financial transfers from West to East Germany.

The Treuhand was given a colossal task and has done a considerable job of fulfilling that task. Mistakes were made, and East Germany still faces very pressing issues of rising unemployment and inadequate productivity. Yet, there are signs of hope for the future. Productivity levels are predicted to rise and East Germany’s share of overall German GDP has been rising. German economic policy must now address

pressing recovery issues in order to develop East Germany and the nation as a whole into a stronger power.

Endnotes

- ¹ Howard, Jutta E. *The Treuhandanstalt and Privatisation in the Former East Germany* (Burlington: Ashgate, 2001): 1.
- ² Dininio, Phyllis. *The Political Economy of East German Privatization* (Connecticut: Praeger, 1999): 2.
- ³ Brücker, Herbert. *Privatization in Eastern Germany: A Neo-Institutional Analysis*, (Portland, Frank Cass, 1997): 141.
- ⁴ Brücker, 143.
- ⁵ Muth, Michael. 'Taking a whole economy private: an interview with Birgit Breuel, President of the Treuhandanstalt', *The McKinsey Quarterly*, 1, Winter: 3, 1993.
- ⁶ Dininio, 42.
- ⁷ Ibid.
- ⁸ Spangenberg, Sabine. *The institutionalized Transformation of the East German Economy* (New York: Physica-Verlag Heidelberg, 1998): 147.
- ⁹ Brücker, 159.
- ¹⁰ Ibid.
- ¹¹ Issa, Gabriel, *Treuhandanstalt: German Privatization Program* (1995).
- ¹² Ibid.
- ¹³ Spangenberg, 149.
- ¹⁴ Howard, 30.
- ¹⁵ Issa.
- ¹⁶ Spangenberg, 165.
- ¹⁷ Howard, 31.
- ¹⁸ Ibid.
- ¹⁹ Howard, 32.
- ²⁰ Howard 149.
- ²¹ Dininio, 49.
- ²² Dininio, 45-6.
- ²³ Ibid.
- ²⁴ Merkl, Peter H. *An Impossible Dream? Privatizing Collective Property in Eastern Germany*, 213.
- ²⁵ Erdmann, Yvonne. "The Outcome of German Reunification for the East Germans: Three different views." *Germany Reunified: A Five-and Fifty-year Retrospective*. Ed. Peter M. Daly and Walter Frischkoph. New York: Peter Lang, 1997, 182.
- ²⁶ Howard, 124.
- ²⁷ Howard, 183.
- ²⁸ Howard, 178.
- ²⁹ <http://www.foothill.fhda.edu/unification/woman.html>
- ³⁰ Howard, 124.
- ³¹ Ibid.
- ³² Howard, 184.
- ³³ Muth.
- ³⁴ Nagengast, Emil. "Eastern Europe and Germany's Treuhandanstalt," *East European Quarterly*, Summer 1995, 189.

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