

Overview

Unemployment: A German View

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As a central banker, I belong to that class of people who, as Robert M. Solow has claimed, display "dignity without responsibility" in their attitude to unemployment in Europe.¹ I cannot speak for Europe as a whole; instead, I would rather confine the following remarks to (western) Germany, since in my opinion, the causes of the high unemployment rates in Europe — notwithstanding what one may read in many U.S. studies—differ quite considerably from country to country. This is suggested, for instance, by one symptom: the relatively low level of unemployment among young people in Germany and the high level in our neighbor and partner, France.

Nor has it escaped me, as a central banker, that the level of unemployment in western Germany has increased steeply in the past three decades. Taking the average of the 1960s, the unemployment rate was 1 percent; during the 1970s, it was 2 1/2 percent; in the 1980s, 7 percent; and currently, it is 8 1/2 percent. As has frequently been described, the rises generally occurred in steps, in the wake of recessions; as each successive recession was overcome, unemployment was left at a higher level than before. Largely in accordance with this pattern, the European Community commission² is expecting a further increase in unemployment in Europe in the further course of this decade.

In keeping with Solow's above-quoted prejudice against central

bankers, I regard the unemployment in western Germany as very largely being a structural phenomenon. It is primarily due to a whole series of factors which I cannot spell out comprehensively here, but only illustrate with the aid of a number of examples.

(1) In western Germany, there is, in several respects, a mismatch between supply and demand on the labor market. It is reflected among other things in the fact that high unemployment and substantial unsatisfied demand for labor coexist simultaneously. Even in the middle of the recession year 1993, the number of unfilled vacancies amounted to approximately three-quarters of a million—that is, to roughly one-third of the number of **unemployed**.³ The reasons for this mismatch can be inferred from the fact that the percentages of jobless people who had not completed their schooling or vocational training, and of unemployed persons with health problems or of advanced age, were far higher than the corresponding percentages among the employed. There is no need to explain at length that—in line with the hysteresis hypothesis—it is precisely among these groups with unfavorable labor market characteristics that cyclical unemployment has changed over time into structural unemployment; the trend growth in the percentage of the long-term unemployed likewise derives from these groups. This mismatch has been evident for a long time in regional terms, too.

(2) The interaction of wage substitutes and social security benefits on one hand, and the burden of taxes and social security contributions on the other, lessen the incentive to work, particularly among the lower income groups. The wage substitutes in Germany are generous in two respects: the replacement ratio is comparatively high, and the wage substitutes are granted practically unlimited. Those who are not entitled to unemployment benefits or unemployment assistance receive welfare benefits. It can be demonstrated (with the aid—admittedly—of some rather extreme examples) that the differences between disposable income from employment and such wage substitutes are so small that starting work on the official labor market is not worthwhile. Even a wider gap between disposable income and wage substitutes does not necessarily imply any incentive to take a job on the official labor market. After all, the "gray" labor market, which owes its existence mainly to the heavy burden of taxes and social security contributions, in many cases provides the option of a spare-time job

yielding untaxed additional income. The result is that part of long-term unemployment seems to represent voluntary unemployment.

(3) Although there are hardly any regulations in Germany which directly impede employee recruitment, there are quite a number of provisions that build up high barriers to dismissals, and thus hamper such recruitment indirectly. For one thing, in the context of employee protection, dismissals are possible only after a notification period of between four weeks and six months. For another, dismissals for personal reasons must be "fair" and those for economic reasons must be "socially fair," with the courts having wide discretion in interpreting these criteria. They usually take advantage of this leeway to stress social considerations in favor of the dismissed employees; not infrequently, the outcome is severance awards amounting to several monthly salaries. Larger scale dismissals by enterprises employing more than twenty workers are subject to even stricter rules which provide, among other things, for generous compensatory payments to the dismissed employees in the context of what are known (and notorious) as "social plans." All in all, employee protection in Germany seems to be so far-reaching in its social motivation that it involves the unsocial outcome of hampering the employment, not least, of people with unfavorable labor market characteristics.

In the public debate on unemployment, which usually takes the form of a lament over the shortage of jobs, in Germany at least the price of labor—that is to say, the wage and wage-related other costs—is all too often disregarded or not regarded enough. A large number of the problems I have just discussed seems to be closely associated with the fact that the cost of labor in Germany is generally too high, and that wage differentials are not adequate. I regard that as a cardinal structural problem of the German economy. I am well aware that this assessment is not shared by all professional economists. That owes a good deal to the fact that there is no accepted yardstick for measuring the contribution of excessive labor costs to the level of unemployment. Hence all that is left is merely the general statement that the price of labor is evidently not market-clearing.

The west German structural wage problem has come into being, as it were, in several stages. In the early 1970s, when the economy was

booming and the controls on inflows of workers from outside the EC were strengthened, it became the explicit aim of the west German labor unions to secure a larger share of national income for employees. At bottom, for a long time they were largely successful in this strategy—though partly to the detriment of the value of money, and partly at the cost of a much higher level of unemployment than before. Another characteristic feature of wage rate policy during the 1970s, moreover, was its social motivation, to the effect that the lower income groups were awarded above-average wage raises, particularly in the form of what were known as "basic" pay increases—which had the result that low-paid work, and therefore, in large part, less-qualified work, went up in price particularly steeply.

In the late 1970s and early 1980s, the labor supply in western Germany began to grow much faster, mainly owing to demographic factors; during the 1960s and early 1970s, it had risen only very moderately. With the advent of immigration toward the end of the 1980s and the influx of ethnic German resettlers and of commuters from eastern Germany, the supply of labor surged anew. It must be admitted that, after the recession in the early 1980s had been overcome and during the subsequent prolonged upswing, management and labor made successful efforts to exercise wage restraint. However, this restraint apparently went no further than that exhibited under the earlier conditions of a sluggishly expanding potential labor force; that is to say, in the changed circumstances, it did not go far enough.

At first sight, this looks like the familiar insider-outsider problem, but in fact, that does not apply altogether to Germany in a textbook-like fashion. Under our social security system, insiders have to pay for outsiders insofar as, by means of their contributions to unemployment insurance, they help to finance unemployment benefits to the jobless; a growing number of outsiders means an increasing burden on insiders as a result of rising contribution rates. However, I would not rule out the possibility of a kind of "wage illusion" arising among insiders which causes them to overlook this connection. Over the last ten to fifteen years, a selection process has taken place on the labor market in western Germany, in the wake of which, people with unfavorable structural labor market characteristics have become outsiders—gradually at first, but then increasingly. These persons have

often included poorly qualified employees, whose services remained comparatively expensive during the 1980s and 1990s, as well.

After all, wages policies and performance have changed in Germany, but the structure of wages has not followed suit in the past few years, although, in recent times, some first steps have been taken. Quite generally, inadequate wage differentials must be seen in close connection with wage movements, whereby labor and management in one industry or one sector, or in a particular region, acted as pacemakers for wage negotiations in the other areas of the economy. Wage drift likewise failed to generate more pronounced wage differentials; in recent years, wage drift has shown comparatively few, more or less cyclical, swings in western Germany. Against this background, the verdict that is commonly voiced in the literature to the effect that the spread of income from employment in western Germany has, if anything, decreased of late, as compared with the 1960s and 1970s, appears to me to be quite right.⁴

It is often asserted, particularly by U.S. observers, that only part of the unemployment in Europe, including Germany, is of a structural nature, while a not inconsiderable proportion is of a cyclical character, that is, due to lack of demand, which can be and must be remedied by means of familiar demand-management measures. As far as western Germany is concerned, the advocates of this hypothesis should be given pause by the various empirical studies on the non-accelerating inflation rate of **unemployment**,⁵ which exhibit such a wide spread that, in the extreme case, all the unemployment currently prevailing in western Germany is claimed to be of a structural nature.

To be sure, in the literature there are today only a few who believe that there is a long-term **tradeoff** between unemployment and inflation (on a stable Phillips curve). Yet I think a majority of economists believe that there is such a **tradeoff** in the short run. But even those who argue along these lines concede that, in the light of the large public sector structural deficits, there is no scope for a corresponding expansionary fiscal policy.

Therefore — it is argued — monetary policy must assume this role. In other words, we are back at the traditional call to central banks to lower

interest rates. And I have heard that song many times during the last few years and months. Now such demands are less frequent and loud. But they are still there.

In this connection, it is all too often overlooked how far central bank interest rates in Germany have actually been lowered since the early autumn of 1992. In mid-September 1992, the discount rate stood at 8 3/4 percent; the Lombard rate, at 9 1/2 percent; and the rate for securities repurchase transactions, at 9 3/4 percent. Since then, these rates have been reduced to 4 1/2 percent, 6 percent, and 4.85 percent, respectively. In any assessment of these interest rate reductions, it has to be borne in mind that, quite generally, the interest elasticity of domestic demand differs considerably from country to country. For instance, the west German economy responds distinctly less than the U.S. economy to changes in interest rates; this presumably owes something to the fact that, particularly in the area of private residential investment—the textbook example of an especially interest-elastic demand component—but by no means only there, government subsidies undermine the impact of the interest-rate mechanism.

Moreover, the cyclical effects of short-term interest rates in western Germany are exceptionally limited. According to our research, four-fifths of all bank loans (the primary source of enterprises' external financing) are of a longer-term nature; in the past two years, only new loans of this kind have been granted on balance. The greater part of them have been placed on terms oriented toward the capital market rate. This indicates that in my country interest rates at the long end of the market are of much greater significance than shorter-term rates.

The German capital market rate, which had stood at about 7 percent since mid-1989 and had risen to around 9 percent before and immediately after German reunification, fell to barely 5 1/2 percent, and thus almost to an all-time low between the beginning of 1991 and the beginning of 1994; this owed a great deal to capital inflows from abroad, which were no doubt mainly caused by exchange rate movements and expectations, as well as by confidence in the stability of the deutsche mark.

The different movement of central bank interest rates and the capital

market rate should really have brought it home to many critics of our policy of "little steps," who were calling for a drastic reduction in official interest rates by one-and-a-half or two percentage points at a time, that the assumed mechanistic connection between interest rates at the short end and those at the long end of the market simply does not exist. At the longer end of the market, expectations—and that means the credibility of anti-inflationary policy—play a major role. In actual fact, an accelerated lowering of central bank rates would have involved the danger (especially in view of the overshooting of our intermediate target M3) of that being interpreted as a departure from our stability-oriented policy stance, which might have given rise to a loss of confidence, especially on the part of foreign investors. Ultimately, this would no doubt have resulted in an early upturn in interest rates at the long end of the market, which would have been counter-productive, at least insofar as investors are subject to money illusion.

Now that an upswing has got under way in western Germany, there is probably even less prospect of the success of any similar attempt to counteract an increase in interest rates at the long end of the market, particularly since the international environment has changed. By and large, in my view the Bundesbank, by deploying its interest rate policy, cannot successfully hold the longer-term interest rate durably below the level set by market forces.

This means that a reduction in unemployment due to a temporary deviation of the interest rate level can hardly be sustainable. And yet such an episode of central bank policy, which may result for instance, from overrating the cyclical component of unemployment, invariably gives rise to dangers of inflation, the causes of which can be traced not least to a corresponding response on the part of wage-rate policy.

Especially in Germany—given the attitude of our population, which in the wake of two hyper-inflations is particularly averse to inflation—we must try harder than some other central banks, maybe, to avert such risks. Against this background, it is also necessary to warn—as far as Germany is concerned—against the experiment suggested by Charles R. Bean in the course of this meeting, to the effect that a reduction in real wages should be aimed at by temporarily tolerating a faster pace of inflation.⁶

For the reasons I have mentioned, monetary policy cannot be expected to make an active contribution to a (lasting) reduction in unemployment. Instead, the no less arduous task of the Deutsche Bundesbank, at least, consists in creating the underlying monetary conditions that foster greater monetary stability. At the same time, this will pave the way for the responsible policy areas doing their bit toward reducing the level of unemployment.

This primarily constitutes a call to management and labor to make a higher level of employment possible by means of corresponding ongoing wage settlements, as well as by structural reforms of the wage-bargaining conditions. Parliament must embark on reforms in the same direction as well. For the individuals affected, measures of this kind may well be painful; what is more, only gradually do they promise to yield economic benefits. Both these factors together explain why such reforms will make headway only in small steps, at least in Germany.

Even so, there is no longer any reason today for fatalism and pessimism. In the 1993 wage round, and even more in this year's wage round, management and labor in western Germany — admittedly, under the impact of the deterioration of conditions in the labor market due to the recession — agreed on rates of wage increase which, if retained over the medium term, are certainly likely to yield a higher level of employment. True, the continuation of such wage restraint in the later stages of the upswing that is now under way is by no means assured.

The moderate wage-rate policy of 1994 was accompanied by a turnaround that almost merits the epithet "historic," inasmuch as management and labor for the first time reached agreement on greater flexibility of labor costs and **working** hours. For instance, the latest pay settlement in the chemical industry for the first time opened up an opportunity of recruiting long-term unemployed persons at a pay level below the agreed negotiated rates. This means that, for the first time, a settlement was reached from which outsiders benefit as well as insiders.

In the metal industry, in order to safeguard employment, enterprises can now reduce the agreed weekly working hours from 36 to 30,

without full pay being mandatory, at times when order books are thin. Moreover, Parliament has meanwhile taken initial steps toward reform, or such moves are impending. Among other things, private job placement, which hitherto has been permissible only for a few professional groups, has been allowed since the middle of this year. Under a new proposal by the federal government, the granting of unemployment assistance, which at present is virtually unlimited, is to be limited to two years. Furthermore, the replacement rate of unemployment insurance has been lowered by three percentage points; for recipients with at least one child, by one percentage point.

None of these are by any means spectacular measures, but rather initial small steps, but they do at least warrant hopes for the future. If this route is followed further in wage-rate policy and in dismantling structural impediments, there are certainly good prospects of pessimistic labor-market forecasts, such as those of the EC Commission, not coming true.

All of this applies in principle to eastern Germany, too, where the reasons for the present unemployment rate of 15.1 percent are, of course, far more complex. There is little doubt that the high level of unemployment in eastern Germany is mainly due to the sudden opening of the frontiers, the abrupt introduction of the deutsche mark, and the transfer of a not-very-efficient economic system into a full global competitive situation. This external shock has entailed profound changes in production and sales structures. At the same time, completely different patterns of behavior on the labor market are required.

The adjustment process in eastern Germany is undoubtedly taking place more dramatically and more rapidly than in the other former CMEA countries of central and eastern Europe. On the other hand, it is also being fostered more strongly by transfers of financial resources and know-how from western Germany. A relatively high level of unemployment is presumably inescapable for a transitional period, since the changes in structures and patterns of behavior will take time. In my view, however, some of the present unemployment might well have been avoided.

It seems to me that a gradual introduction of monetary union (for instance, with variable exchange rates to begin with) was impossible. This is because that would have necessitated the preservation of the Wall for a time as the border between the two Germanys. Moreover, I think that the impact of the conversion rate of one-to-one for current payments chosen upon the introduction of the deutsche mark is overrated (especially by foreign observers), much though I personally would have preferred a different rate.

To my mind, the crucial reason for the current unduly high level of unemployment in eastern Germany is the largely unprepared transfer of the west German system of wage formation, of the education system, and of social legislation to eastern Germany, and the overly rapid harmonization of the general wage level without taking due account of the differences in productivity between east and west and between the individual economic sectors and enterprises.

But in this area, too, there are meanwhile initial signs of a possible moderation of the pace of wage harmonization between east and west and of greater flexibility in wage levels between enterprises. And yet, the impatience in eastern Germany to reach at an early date a standard of income which is fully comparable to that in western Germany remains unmistakable, and is understandable, too, in some respects.

In this connection, the economists still have a major job of persuasion to do. We at the Bundesbank are taking pains in our publications to do our bit to help, even if this is not always much appreciated by those concerned. As I see it, however, independent central bankers not only bear responsibility for good monetary policy but also have a duty to **enounce** economic truths and draw attention to economic relationships, regardless of whether that suits those to whom it is addressed.

Endnotes

¹Solow (1994).

²EC Commission (1993).

³Institut für Arbeitsmarkt-und Berufsforschung (1994).

⁴Franz/König (1986), Layard and others (1988), Flanagan (1987), Franz (1987), Gordon (1988).

⁵OECD (1993).

⁶Bean (1994).

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