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Wage bargaining systems, monetary authorities and persistent German unemployment

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Summary

There now exists a broad based consensus that much of the 'unemployment gap' between the US & Europe[1] is due to a combination of two factors: **real wage rigidity** and **distortions in the labour market behaviour** of 'outsiders' and 'insiders'. It is argued that European, (in contrast to US) real wages did not adapt enough to the increased unemployment brought about either through the oil price induced recessions or were not flexible enough to deal with changes in demand for various workers. Thus unemployment increased in a step-like fashion where each time an economy emerged from recession it did so with a higher level of unemployment. This real wage rigidity is to a large extent dependent on high unemployment/welfare benefits which reduces incentives of those without employment to take jobs on lower levels of pay, while high minimum wages reduces the incentives of employers to take on new staff. Further, labour market practices such as collective wage bargaining ignore the effects on 'outsiders' while wage compression effects can hinder the efficient allocation of wages across regional and skill differentials.

Explanations for high European unemployment have thus understandably focussed on the structure of the labour markets. Laynard, Nickell and Jackman (1991), for example, have argued that powerful unions will generally increase wage pressure inevitably leading to higher unemployment. Whilst undoubtedly many European labour markets, such as Germany's, urgently need reforms and deregulation, the belief that such policies are likely to eradicate European unemployment may be misplaced. The problem with such an analysis is that, with the exception of the UK (an EMU non-participant), many Euro land countries, such as Germany, still exhibit high levels of deeply (often institutionally) embedded systems of co-ordinated wage bargaining and coverage. Further, alongside such arguments exists empirical studies (Nickell 1997, Calmfors 1993) that show that if wage setters are able to co-ordinate wage setting and recognise the negative externalities that are to be avoided from union power then the negative effects of such labour market imperfections can be mitigated. Thus co-ordinated wage setting *can*, according to the OECD (1997), enable countries to achieve a low rate of unemployment, and as Blanchard and Wolfers (1999) note, they are

[1] 'Europe' here is used as shorthand to describe economies characterised by co-coordinative, regulative and high welfare state features, rather than a geographical notion including more liberal economies, such as the UK.

one of the factors which help to explain whether adverse economic shocks have persistent effects on unemployment. Calmfors and Driffill (1988), posited that that the optimal inflation/unemployment outcomes exist at opposite ends of a 'humped-shaped' co-ordination curve. That is that either complete deregulation (through self clearing labour market mechanisms) or complete centralisation (through the capacity to avoid the negative externalities of non-wage restraint) are consistent with low inflation and full employment.

Yet given that many European economies have a long and embedded tradition of unionisation and/or co-ordinated bargaining systems and given that, suggested by the theory above, there *may* be benefits to be reaped by wage co-ordination why has the experience been increasingly heterogeneous? The answer, this paper argues, lies in the fact that the success of co-ordinated wage setting systems is dependent on other factors including the following:

- the structure, independence and credibility of the monetary authority,
- the structure of the bargaining system, (sheltered v traded led, union density v coverage)
- the degree of openness of the economy.

This paper argues that heavily unionised economies with accommodating monetary authorities of the post war era were unable to deal with the increasing internationalization of product and capital markets[2] and structural changes that occurred during the 70s and 80s. To return to the Calmfors Driffill curve, the centralization spectrum of the curve became unobtainable as the effects of labour organizations' wage demands could no longer be internalized.

Such an analysis explains the unemployment/inflation performance of various European countries better than cross comparisons of labour market structures – many of which pre-date the rise in unemployment. Thus Germany, (despite much labour market rigidities and inefficiencies) was up until the 80s relatively well placed to retain its institutional model as its monetary authority was able to enforce wage restraint with a wage co-coordinating system that had the strategic capacity to respond to market signals. This experience stands in stark contrast to that of the Netherlands or Sweden during the same period. However as countries adjusted to the new monetary conditions two models of low unemployment wage restraint became observable.

[2] A number of econometric studies, such as Bayoumi (1990), measure the increasing rate of capital market integration over the 70s and 80s.

Firstly, deregulating labour markets such as in the UK and New Zealand allied with dismantling wage setting systems in combination with central bank credibility and free currency floating[3]. Secondly, the option pursued by countries such as Ireland and the Netherlands[4]. These also deregulated labour market practices (such as freeing regulations on part time work) but did so in combination with an exchange rate targeting monetary regime and nationally co-ordinate wage restraint. In comparison with both these models, Germany's economy has during the 90s increasingly under performed.

This paper argues that not only is this under-performance a function of the lack of deregulation in labour markets, but that it is increasing as Germany loses the comparative advantage of monetary policy autonomy. The national systems of wage restraint adopted by countries such as the Netherlands were a response not just to dysfunctional labour markets but to declining monetary autonomy. As open, trading economies operating under increasing levels of capital integration could no longer internalize the consequences of unrestrained wage behavior so they adopted strict monetary credibility and either no wage co-ordination or centralized wage restraint. As the monetary anchor economy, the large German economy was to a certain extent shielded from such pressures. However with the ECB now replacing the Bundesbank, Germany is now doubly exposed. It has failed to reform its labour markets sufficiently and has lost the advantage of monetary policy autonomy afforded it by the Bundesbank.

[3] In the UK's case the Bank of England independence was passed as law by the Labour government in 1997, while the currency has floated since leaving the ERM in September 1992.
[4] Examples include the *Wassenaar agreement* in the Netherlands in 1982, the *Solidarity alternative* in Norway 1992and several wage agreements achieved in the Republic of Ireland in the 80s and 90s.

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