

1 Introduction

Since the early 1980s, the German economy is beset by high unemployment. Moreover, the much more satisfactory labor market performance in other industrialized countries makes the persistently high unemployment rate in Germany even more distressing. A prominent example for the former is the United States, but other examples include also European countries like the Netherlands and the United Kingdom, which managed more recently to reduce their unemployment rates to relatively low levels.

The causes of the increase in the unemployment rate from very low levels in the 1960s to almost ten percent since the early 1980s and the appropriate policy responses by the central bank, fiscal policy, and trade unions are the subject of an intense debate in public and in academia. Broadly speaking, the arguments exchanged in this debate can be categorized as belonging to one of two camps. One stresses that the high unemployment rate in Germany reflects rigid labor markets, which prevent real wages from adjusting to clear the labor market. This camp points to the more flexible labor market arrangements in the United States, and argues that this underlies the more successful performance of the United States labor market. The other camp believes that the Bundesbank has maintained overly tight demand conditions over a long period of time in its attempt to disinflate the economy and maintain price level stability, and that this policy has contributed substantially to the persistently high unemployment rate in Germany. According to this line of argument the Federal Reserve Bank of the United States maintained in general more favorable aggregate demand conditions than the Bundesbank did because of the Federal Reserve Bank's obligation to pursue not only a price level stability goal but also to maintain full employment. Hence, critics of the Bundesbank regard the supposedly more successful demand management policies of the Federal Reserve Bank as a key factor for the maintenance of a relatively low unemployment rate in the United States.

Since the policy debate in Germany has been going on for almost 30 years, one objective of this study is to take stock of this debate. The second objective is to provide new empirical and theoretical evidence relevant to this debate, thereby hoping to advance the debate. A central element of the policy debate is the role of monetary policy for stabilizing the real economy. Thus, this study is going to focus on the effectiveness of monetary policy regarding real variables in theory and practice. A particularly important question, which will be at the center of this study, is whether monetary policy can have long-run effects on real variables like output and unemployment, since this long-run effectiveness is a central tenet of

the position of the second camp. This study reviews this question from different theoretical viewpoints and presents empirical evidence on the basis of several econometric methodologies.

To take stock of the policy debate, Chapter 2 begins by outlining the Keynesian and monetarist positions, since the controversy between these two theoretical schools can be considered as the origin of the current debate. In fact, in many instances the public debate continues to be best understood in terms of the Keynesian and monetarist positions. A key difference between the two schools of thought is the long-run effectiveness of monetary policy. Keynesians believe monetary policy has significant long-run effects on real variables, while monetarists are convinced that monetary policy has only long-run effects on prices or other nominal variables.

Testing empirically the long-run effects of monetary policy is complicated by the fact that this requires overcoming a difficult identification problem. In this paper, I employ for this purpose a methodology proposed by King and Watson (1994) based on the structural vector autoregression methodology. Since this methodology has not yet been widely used, the methodological appendix provides an introduction. The King and Watson approach addresses the identification problem by imposing either Keynesian or monetarist identifying restrictions on the model, which allow testing the long-run effects of monetary policy both from a Keynesian and monetarist perspective. Moreover, with this approach I can construct time series reflecting the two viewpoints on business cycle fluctuations. This will prove useful when showing that the two camps are not only separated by different theoretical viewpoints, but also by a different interpretation of macroeconomic events in the past thirty years.

Beginning in the second half of the 1970s, the introduction of rational expectations began to change macroeconomics fundamentally. In Chapter 3, I provide an outline of the rational expectations revolution, and discuss several strands of macroeconomic research that emerged from it. The resulting models have potentially far-reaching policy implications; particularly controversial is the role of anticipated monetary policy, since some rational expectations models imply that anticipated policy is ineffective. Since most monetary policy actions represent a systematic response to economic conditions, they are anticipated. If the ineffectiveness proposition were true, monetary policy would have neither short-run nor long-run effects. In this case, stabilization policy would become futile and, moreover, any claim that tight monetary policy could have contributed to Germany's persistent unemployment problem becomes untenable. However, in response to these theoretical developments the so-called New Keynesian research agenda emerged, which aimed to show that anticipated policy can have real effects even in an environment with fully rational agents. I conclude Chapter 3 by presenting an outline of the building blocks of New Keynesian models.

By the late 1990s, New Keynesian models have gained widespread acceptance in the academic literature. This reflects mostly the fact that New Keynesian