2 Keynesian and Monetarist Views on the German Unemployment Problem

As argued in the introduction, persistently high unemployment rates in Germany have led to a lasting controversy on the causes of unemployment and the appropriate policy response. The opposing viewpoints, and in particular the public exchanges on these issues, have often been based either on Keynesian or on monetarist theories of business cycle fluctuations, leading to very different conclusions regarding the causes and the cure of the unemployment problem. Since this debate is going on since 30 years and is nowhere near a conclusion, this chapter attempts to take stock and offers a review of the arguments exchanged between both sides.

A major contribution of this chapter is the new empirical evidence on the Phillips curve relation in Germany. This relation is central to the controversy between the two schools of thought because the slope of the curve is a key parameter determining whether demand policies can have a lasting impact on real variables like the unemployment rate. Since Keynesians and monetarists sharply disagree on this parameter for theoretical grounds, this chapter estimates the Phillips curve using both a Keynesian and a monetarist identification scheme. In addition, the role of demand and supply shocks for fluctuations in unemployment and inflation is investigated using the historical decomposition technique. This serves to explore empirically the explanations offered by the two Phillips curve models regarding the causes of the secular increase in unemployment over the past 30 years.

The chapter is organized as follows. Section 2.1 offers a general introduction into the Keynesian and monetarist views on unemployment and inflation. Particular attention is paid to the role of demand management policies in the two paradigms for the stabilization of the real economy, since this is of central importance to the policy debate. This section contains also a discussion of the NAIRU concept, which modifies the traditional Keynesian view in some important aspects. Section 2.2 contains the empirical evidence on the Phillips curve in Germany. Before presenting the estimates of the slope of the Keynesian and monetarist Phillips curves, this section shows that at the business cycle frequency a stable Phillips curve relation is supported by the data. Next, it provides an introduction into the econometric technique used for testing the slope of the Phillips curve and discusses the identification of the Phillips curve models. Having estimated these models, the results for the Keynesian and monetarist Phillips curves

are presented, and the results of the historical decomposition are shown. Section 2.3 presents the conclusions of this chapter.

2.1 Keynesian and Monetarist Explanations of Unemployment and Inflation

2.1.1 The Keynesian Perspective

2.1.1.1 The Departure from Classical Economics

The characteristic difference between classical and Keynesian models is that the former assumes that prices (including wages) adjust instantaneously so as to equate supply and demand quantities on all markets, whereas the latter assumes that nominal wages do not adjust within the relevant period (McCallum 1989: 174ff.). The assumption of sticky wages makes it possible in Keynesian models that labor demand does not equal labor supply quantities. In particular, this allows for the existence of involuntary unemployment.[2] This departure from classical economics was prompted by the experience of widespread involuntary unemployment in the depression of the 1930s, which classical economics could not account for. Moreover, the observation that changes in aggregate demand, for example due to changes in government demand for goods, are an important source of short-run fluctuations in economic activity was also hard to reconcile with classical economics.[3] In Keynesian models sluggish wage adjustment accounts for both observations. For example, a fall in demand in product markets will reduce labor demand if wages do not fall sufficiently, thereby leading to involuntary unemployment. If prices also adjust sluggishly, the fall in labor demand reduces product demand further. This leads to a situation where recessions are the result of deficient labor and product demand reinforcing each other (Snower 1997: 20). That is, workers are unemployed because firms are not producing enough goods and services, and firms do not increase production because there is not enough demand; and demand is deficient because people are unemployed. Besides accounting for recessions, another implication of sluggish wage adjustment is that the classical dichotomy between real and nominal variables fails, because it is the *nominal* wage which is slow to adjust (Romer 1993: 5). Hence, movements in nominal variables like the money supply can have large effects on real variables such as output and employment.

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2 Other variants of Keynesian models assume instead of sticky wages that prices are sticky. See Romer (1996: 214ff.), for an extensive discussion.

3 See Romer (1993: 5) on these two points.