The Difficult Road to Germany's Reunification:

Prospects for the Forgotten Outsider

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In November 1989 the Berlin Wall came down. It represented the end of a divided city and nation. People across the world sat in euphoric disbelief as the wall of political, economic, social, and cultural differences came down, thus freeing millions who had long been separated from their family and friends. The world experienced a short glimpse of serenity and harmony on that day as the east and west Berliners joined together in singing, "Such a day, so wonderful as today."

This event was one of many during the great milestone year of 1989. Cries of joy and freedom echoed from all corners of the world as the former communist countries of Eastern Europe broke down, bringing about the collapse of the "Evil Empire" that the free nations had grown to know and fear. But the real problem turned out to period of collapse that people throughout the globe had long anticipated brought with it, however, new uncertainties and problems of vast proportion that had not been included in the thoughts and rhetoric about the end of the cold war. The only problem expected was the transition from the centrally-planned economies to free market economies. The reality included the transition from political systems, social structures, and cultural traditions embedded in the lives of every individual who lived in such rigid regimes.

From a Western perspective, I believe, it was largely perceived that these new problems would quickly be solved, that these economies would be reconstructed into the shape of western free-market democracies, and that the world would then go on about its business. In light of the 1989 events, there was a resurgence of economic literature on the functions of Soviet-style economies as well as new articles and books on transition. Debates ensued on
topics of privatization, macro and micro stability, adjustment in the fiscal sector, etc. All this literature was valuable and necessary, but seemed only to have considered half of the situation. As we should have learned by now, progress and change rarely take such a simple, and admittedly one-sided, form. Instead, progress and change tend to move in a more dialectic fashion, similar to that suggested by Hegel and Marx. With this in mind, it should seem obvious that the breakdown of Eastern Europe would not simply be fixed by the West, and its economy added to the growing world economy as new, unexploited markets at Western disposal. Eastern Europe, on the other hand, would dramatically influence the Western world, especially the region in close proximity, namely Western Europe. Eastern Europe would form a new synthesis from the old and the new on both sides of the east-west wall. Joachim Nawrocki notes Germany's specific importance in Europe when he writes:

Germany lies in the heart of a merging Europe. It is not merely a bridge between the East and West but a country with an economic and political potential on which many people, especially in Eastern Europe, pin their hopes... Furthermore, it continues to be one of the Communities most productive members in spite of the massive economic problems requiring solution in the new federal states.

This kind of synthetic change, or impact, appears to have affected the Western nations largely through the changes in focus of politics in Western countries, changes in domestic and international economic policies, and changes in the world markets. As far as the political and economic policies,

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1 This refers to Hegel's philosophical view of change through, what he called *Aufhebung*: the dialectical process that contains the simultaneous destruction, creation, and sustenance of the thesis and anti-thesis. This process in turn leads to the formation of a third, new state which Hegel called, synthesis. Furthermore, I refer here to Marx's application of Hegel's dialectic to the physical as well as the metaphysical world. Here we can view the western Länder before 1989 as the thesis, and the eastern Länder before 1989 as the anti-thesis, and, therefore, whatever the future outcome of Germany's reunification will be the synthesis.

this change can best be seen in the change in defense spending in the USA.
One of the most obvious examples in a broader sense, however, is the collapse
of the European exchange-rate mechanism (ERM). Since Germany had been the
anchor and source of stability for the ERM its economy subsequently became the
source of instability for the ERM after reunification. As Germany's
Bundesbank raised its interest rates to keep inflation under control the other
ERM members were forced to raise their interest rates to avoid depreciation of
their currencies against the D-mark. This worsened the recession outside
Germany where demand was already slowing. Finally, in August of 1993 the ERM
loosened its margin of fluctuation from 2% to 15% and thus the ERM ceased to
effectively exist.3

Inside the new Germany (east and west) the signs of a hegelian Aufhebung
are more noticeable. As Vogt has pointed out, "the basic problem is... how to
fit a less advanced, substantially protected economy into a more advanced
economy guided by a strategy of globalization."4 Vogt's idea is actually very
complex and closer to the wholistic approach to transition which is needed.
By this I mean, he recognizes the need for more than a mere transition for the
former East. Unfortunately, however, it is clear that Vogt himself overlooks
the need for extreme change in the west German side as well. In the above
mentioned excerpt he even states that the problem is "to fit" the old "into"
the new. While he was at least partially right, he ignored that the process
was not one of adoption but one of unification, which implies the union of two
parts to form a new whole and thus requires reform on both sides.
Economically, this process has drained Western Germany's financial resources,

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3 "Europe's Monetary Union: From here to EMU." Economist, October 23,
1993, p. 25.
4 Roy Vogt, "Transforming the Former GDR into a Market Economy,"
simultaneously raising income taxes to the highest level in Europe and increasing the federal deficit to 5.25% of GDP in 1993 and still higher in 1994. For example, in the former East the capital goods remain old and geared toward distorted environmental and energy costs. The trade structure is still distorted. This is because it was oriented to the COMECON which had many distortions. These distortions resulted in 72% of its exports going to COMECON countries. On the positive side, recently it has been noted that there is some strong economic growth in the eastern states, notably in the manufacturing sector.

While there has been great economic and - at least officially - political reunification, the social and psychological fabric of Germany has perhaps been torn further apart. As the new Laender are slowly being transformed into "the most modern region of Europe" the social differences and problems are quickly escalating. Along with economic freedom for the East Germans came the freedom "to face an uncertain future, freedom to lose a job, [and] to lose support nets." Furthermore, economic freedoms no longer seemed so great as Germany continually increased its government debt, and as its recession continued - caused in part by reunification during a world wide recession. Lastly, employment was made difficult due to an excess supply of labor (including asylum seekers) and the structural rigidities in the German labor market. Although some economic recovery has begun in Germany and is

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5 "Bundesbank: Overall Public Deficit To Reach Record Levels in 1993," The Week in Germany, December 17, 1993, p. 4.
6 The COMECON was the Eastern counterpart to the European Common Market in the West.
8 "Bundesbank Calls For "Wage Differentiation," Sees Recession Continuing," The Week in Germany, February 18, 1994, p. 4.
10 Ibid. p. 110.
expected to continue through 1994, Germany is still plagued with an increasing unemployment rate of 8.5 percent in the western states and a jobless rate of 16 percent in the new federal states. This appears to exacerbate the sociological and psychological problem of rising xenophobia in various regions.

The purpose of this paper is to acquire a better understanding of the impact reunification of Germany has had and will continue to have on the German labor market and Germany's high unemployment that has persisted since the early 1980s. A wholistic approach is attempted in the analysis of such a problem. Consequently, three different aspects of the German economy and society are used in an attempt to better understand and analyze the current and future problems in Germany.

First, we look at the problems associated with the transition of Soviet-type economies in their broadest context. The view is taken that changes are required not only in the former eastern countries, but also in the west. Furthermore, the changes mentioned impact the political and social realms as well as the economic, and should therefore be treated accordingly.

Second, we will look at the structure of the labor market in West Germany before unification. This analysis will use a modified insider-outsider model from Coe and Krueger and a combination the Phillips curve model and target-real-wage-bargaining model to look at the rigid

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bargaining structure of the labor market and their effects on quasi-equilibrium levels of unemployment.

Third, a study is done of the east-west migration in Germany from the mid-to-early eighties through reunification (migration is continuing as this paper is being written). Here no specific model is used consistently, but the information from several migration models are used in combination to gain greater insight into the determinants of migration. These include: wage differentials, the high, fixed up-front migration costs, the size of the home city, the age of the migrator, and the uncertainty involved in migration decisions. The last factor is largely restricted to uncertainty as it relates to the likelihood of finding a job in the new market. One of the conclusions drawn here is that wage differentials tend to play a smaller role in the decision to migrate than had been previously thought, in partial agreement with the literature on the value of waiting option.

The conclusion is then drawn that while the increased supply of labor as a result of migration flows from the eastern Laender may have maintained some upward pressure on the unemployment figures, the high unemployment is largely due to the labor market structures - both micro and macro - in Germany. As a result of these rigidities, unemployment will be perpetuated by many of the fiscal policies of Germany which are intended to keep inflation under control through high interest rates. Furthermore, assuming that future labor markets in Germany will behave similarly to the former west German markets and that restrictive monetary policies will continue to accompany Germany's reunification, we can predict with some confidence that high unemployment levels will persist in the future even after east-west migration has reached a natural equilibrium. Finally, the result of the most recent events are
analyzed using our various models in a hope to better understand not only the present but also the future situation in Germany.

In 1989, the Federal Republic of Germany (FRG) seemed to be continuing its decade long slow but steady economic upswing. In the face of possible capacity constraints, West Germany had managed to grow at a surprising 4 percent over the last year with well behaving inflation, a decreasing public sector debt and strong foreign and domestic demand. Furthermore, strong business investment suggested that supply constraints elicited a capacity widening response. This was confirmed by developments in the labor market where job creation exceeded the expanding labor force leading to a decline in the unemployment rate of 3/4 of 1 percentage point over the last year.\(^{13}\)

Despite this minor decline in the unemployment rate, unemployment remained a thorn in this growing economy's side. Unemployment in the Federal Republic of Germany had been unusually high throughout the 1980s, with an average rate of 7.82% from 1984 to 1989. As mentioned above, this persistent unemployment was partially a result of the rigidity in the German labor market. Due to cohesive unionization and its style of collective wage bargaining, the German labor market was able to maintain a quasi-equilibrium level of unemployment that exceeded the natural unemployment rate. One of the microeconomic explanations of high German unemployment distinguishes between insiders and outsiders in the wage bargaining process, where the unemployed (outsiders) have little influence on the bargaining. (See model presented below.) Following this microeconomic approach is an aggregate look at the

same problem using a combination of the Phillips curve model and the
target-real-wage-bargaining model. Both models are taken from Coe and
Krueger.¹⁴

Let us first examine a situation where the insiders (employees) have no
market power. (See Appendix A for graph.) The labor demand curve for
outsiders would be \( l^d_o \) (upper panel) which would face an elastic supply curve
at the reservation wage \( (w^r) \), which is a function of the good unemployment
benefits and other social nets in Germany. Under these conditions, there
would be an equilibrium at \( A \) which results in aggregate employment \( (E^*) \) (lower
panel) and an unemployment rate of \( (u^*) \), which reflects the voluntary,
natural, rate of unemployment.

Now let us look at the situation where the insiders - represented by
unions in Germany's case - have full market power and the outsiders have
little influence in the wage bargaining. First, assuming a constant level of
capital and technology, the firm is a price taker and attempts to maximize
profits by choosing labor inputs of insiders at wage \( w^i \) and outsider at wage
\( w^r \). Now the labor demand curve \( l^d_o \) would represent the demand for insiders
and the curve \( l^d_1 \) would represent the outsiders. The difference between these
two curves equals the turnover cost per employee \( c \) which is some function of
the training costs, as well as the severance pay or insiders ability to resist
being replaced by outsiders and their lack of cooperation with the new
employees.

Insiders will set wage \( w^i \) to maximize their joint wage income. However,
they face potential competition for jobs with outsiders. Therefore, in order
to avoid being replaced by outsiders this wage \( w^i \) should not exceed the

¹⁴ David T. Coe and Thomas Krueger. "Wage Determination, the Natural Rate
outsiders reservation wage \( (w^r) \)\(^{15} \) by more than the turnover-cost differential. The insiders' labor supply curve depends on the number of insiders and becomes vertical at the level where insiders engage in the wage negotiating process. This reflects the assumption that insiders do not take the welfare of the outsiders into consideration. For an initial insider employment level of \( e_0 \), the resulting labor supply curve for insiders is \( l^S(e_0) \). Equilibrium is at A, where the labor demand curve for insiders intersects their labor supply curve. Although current wages exceed the reservation wage, outsiders are unable to find jobs because the turnover cost makes their employment unprofitable for the firm. Unemployment at \( U_0 \), which is above the natural rate of unemployment, can exist as a quasi-equilibrium because there are no forces in the labor market that would reduce unemployment to the natural rate.

Starting from the equilibrium at A, suppose the economy is subjected to an unanticipated negative demand or supply shock and that, at the time, agents perceive this shock to be permanent. To avoid complicating the graphs in Appendix A, let the labor demand schedule for insiders shift down from \( l^d_0 \) to \( l^d_1 \), the previous outsider demand schedule (the new demand schedule for outsiders is not shown here). The new equilibrium is at B, with lower wages \( (w^i_1<w^i_0) \) less aggregate employment \( (E_1<E_0) \), and higher unemployment \( (U_1>U_0) \) as some former insiders become unemployed, that is, become outsiders. Once the economy settles at this quasi-equilibrium there are again no forces in the labor market to reduce unemployment either to its previous level or to the natural rate.

Consider now a reversal of the initial shock and a return to the labor demand schedules to their original positions in Appendix A. Insiders would

\(^{15} \) The reservation is the minimum wage a worker will accept given their perceived worth and perceived employment opportunities. Often, it is also a function of the wage they received in their previous job.
prefer moving to the new equilibrium $B'$, but are constrained in their wage demand by outsiders competing for their jobs. To avoid being laid off, insiders will not demand wages higher than $(w^f + c)$. At this wage - plus an increased demand for labor - it is profitable for the firms to hire more additional workers $(e_2 - e_1)$ at the reservation wage. In the subsequent "period" these new entrants become insiders and a new equilibrium is reached where all employees receive a wage of $(w^f + c)$. The relevant insider labor supply curve becomes $S(t_2)$, and $D$ will be the new equilibrium. Even though the exogenous supply conditions have returned to their original levels, unemployment does not return to its pre-shock level $(U_2 - U_1)$.

The insider-outsider model shows how the German wage bargaining can lead to quasi-equilibrium levels of unemployment that exceed the natural rate when the insiders have the market power. Furthermore, it show how a series of supply shocks may ratchet up unemployment even when the supply shocks are subsequently reversed. The insider-outsider model appears to be consistent with the unemployment developments in West Germany during the 1970s and 1980s, but the assumptions concerning the differences between insiders and outsiders may be a bit extreme. Therefore, a look at the following combination of the Phillips curve model and the target-real-wage-bargaining model helps to shed further light on the stubbornly high unemployment rate in the FRG from a macroeconomic point of view with less extreme assumptions.

The typical Phillips curve expresses a direct relationship between inflation and employment. "The focus in this alternative to the Phillips curve is on the equilibrium relationship between the levels of - as opposed to the changes in - real wages and labor productivity implying that the growth of nominal wages will be determined, in part, by a catch-up variable reflecting past deviations of real wages from their target level." This difference has
serious implications for the inflation stability in Germany as it is related to the level of unemployment. By this I mean that such a model reveals how a quasi-macroequilibrium can be achieved with stable inflation and an unemployment level that remains higher than the natural rate. The following graphical illustration clarifies this relationship further.\textsuperscript{17}

The top panel of Appendix B shows the expectations-augmented Phillips curve (PC), which reflects the negative relationship between the nominal wage inflation ($\Delta w$) and unemployment ($U$). The vertical long-run Phillips curve represents the natural rate of unemployment at $U^*$. The aggregate demand schedule AD reflects a positive relationship between the nominal wage inflation and unemployment.

Consider the impact of a restrictive policy to reduce nominal wage and price inflation. Beginning at the equilibrium point A, with nominal wage inflation $\Delta w_0$ and the natural rate of unemployment $U^*$. First, aggregate demand would be reduced, shifting AD$_0$ to AD$_1$, and unemployment would increase from $U^*$ to $U_1$. Then the declines in wage inflation would be incorporated into the inflation expectations, the Phillips curve (PC$_0$) shifts inward to PC$_1$, which subsequently reduces real wages and unemployment. The Phillips curve continues to move inward (to PC$_2$) until it reaches the natural unemployment rate at $U^*$ and the wage and price inflation have reached $\Delta w_1$. Thus under normal Phillips conditions a restrictive monetary policy has achieved its goals, resulting in lower, stable price and wage inflation while reaching a new equilibrium at the natural rate of unemployment along the long-run Phillips curve.

\textsuperscript{16} Ibid. p.118
\textsuperscript{17} For a mathematical explanation see Appendix C.
In the lower panel of Appendix B, the real-wage-bargaining curve (RWB) replaces the Phillips curve. The difference between the two curves lies in the catch-up variable which has been added and influences the nominal wage growth so that it reflects the deviation of real wages from their target level (as displayed in equation (1) in Appendix C). The real-wage-bargaining curve will shift - as did the Phillips curve - with changes in expected inflation.

Given the same restrictive monetary policy to reduce price and wage inflation, consider the impact on the real-wage-bargaining model. As before, initially, aggregate demand is reduced from $AD_0$ to $AD_1$, nominal wage growth declined to $\Delta w_1$ and unemployment increases to $U_1$. Real wages and their target levels also decline with the rise in unemployment. After the increase in unemployment has been incorporated into the real-wage-bargaining curve as a reduction of the target level of real wages, there is no further downward pressure on the growth of real wages resulting from low employment. Furthermore, aggregate demand shifts further down and labor demand declines relative to the previous situation implied by the Phillips curve because real wages do not continue to decline. Also, as the wage inflation's decline is incorporated into expectations, there is extended downward pressure on nominal wage growth. Finally, the real-wage-bargaining curve (RWB) shifts down until inflation is reduced to $\Delta w_2$.

The main difference in the results of these two models is obvious. While both attain stable levels of price and wage inflation, the Phillips model returns the economy to an equilibrium level equal to the natural rate of unemployment and the real-wage-bargaining model brings the economy to a quasi-equilibrium level that exceeds the natural rate of unemployment.

"Empirical tests of the alternative models indicate that aggregate wage
developments in west Germany are better described by the real-wage-bargaining model than by the Phillips curve/natural rate model."  

In brief, the relationship between these two models and Germany's economic problems is a circular one. By allowing the unions and other "insiders" greater clout in the labor market than the "outsiders" leads to higher wages and unemployment. The German government fears inflation partially because of the high wages and therefore, choosing low inflation over low unemployment, keeps the interest rate high. A high interest rate in turn slows down the economic recovery which prevents new jobs from being created, thus keeping unemployment high through a slow economic recovery. This high unemployment furthers the power of the "insiders" relative to the "outsiders" thereby bringing us back to the beginning of the circle.

Using these two models - Insider/Outsider and the Target-Real-Wage-Bargaining - a tight monetary policy and a high level insider market control will lead to stable high unemployment that exceeds the natural rate of unemployment. At first glance, a reversal of some of these shocks may be suggested, but as we saw in the example used with the micro model this may lead to even higher unemployment due to the rigid bargaining structure. Moreover, such a prescription merely leads to short term solutions. A better solution might be to attempt to lower either the reservation wage or the turnover cost. A retraining program for the unemployed - especially for those workers laid off due to structural changes - would certainly lower the turnover cost by removing, or at least greatly reducing, the firm's training cost per individual hired. On the other hand, this could easily raise the reservation wage. Provided the change in the turnover cost exceeds the change in the reservation wage ($\Delta c > \Delta w^r$), a decrease in unemployment should follow.

\footnote{ibid. p.120}
At the very least, this should narrow the range of wages in which the insiders bargain, thus reducing some of their market power.

However, a better outcome may result naturally in the future. As Germany continues its training policy in the new Länder, these new workers will be trained for industrial jobs. As in our earlier example, this outcome should lower the turnover cost to firms. Furthermore, as many of these new and trained workers migrate from east to west, the labor supply will increase, thus putting downward pressure on the reservation wage. Here, the squeeze of the bargaining range for insiders would be narrowed greatly and, hopefully, result in a greater decrease in unemployment. This, of course, assumes the reservation wage to be affected by the labor supply in a Classical sense.

The issue of migration has many ramifications in our analysis of the German labor market during reunification. There are obvious problems for east Germany. First, there is an initial "brain drain" of the top and brightest workers, researchers, and scholars in the east who migrate west. Second, since migration appears to also be a function of age, more young workers migrate out of the east than do older workers. Third, while there is some reverse migration, "reverse migrants are often close to retirement and are likely to engage primarily in consumptive activities... Migration may

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19 Recent reports suggest that such training practices are being undertaken in Germany with around 50 billion DM being spent on these programs in the former east. Source: "Economic Trends in Unified Germany 1992-1993-1994," Dokumentation, Treuhandanstalt, December 1993, p. 4.
therefore have negative consequences for capital formation and economic development in East Germany."\(^{20}\)

Migration is nothing new to Germany. "Migration of ethnic Germans from Eastern European countries and the eastern parts of the German Reich began with the retreat of the defeated German army at the end of World War II."\(^{21}\) After the war, nearly 18.4 million Germans who had previously lived in the eastern part of Germany were outside the east German borders. Many were expelled from these outside countries between 1945 to 1950. During this time, nearly 4.1 million people moved back to east Germany and nearly 8 million to west Germany.\(^{22}\)

Throughout the 1950s and 1960s, immigration from Eastern European countries continued at a slower rate. However, migration within the German borders increased during this period (from 1950 to August 13, 1961 when the Berlin wall was constructed) and over 2.6 million people migrated from east to west Germany (see Appendix D). Over the next period, 1960-69, there were only around 800,000 migrants and even less (around 500,000) between 1970 and 1979. It was not until the 1980s when the communist block collapsed that migration returned to over half its post-war levels. It is this most recent time period in which we are most interested. Now, let us turn to the factors that affect the decision to migrate and see how they relate to the labor models previously explained.

(1) There appears to be a negative relationship between the individual's age and the desire to - or utility derived from - migrating.\(^{23}\) This

\(^{22}\) Ibid.
relationship shows that, at least for some, the marginal benefit of migrating minus the fixed costs associated with such an activity may not always not exceed the marginal benefit of remaining in the home region, especially for older individuals.\textsuperscript{24} Since more young than old workers will migrate the skill of these more productive and healthier workers will leave the already less productive east and proliferate the productivity differential between the east and west in the future. This productivity in the east was estimated in 1990 to be anywhere from one-third to one-half that of the west.\textsuperscript{25} Furthermore, this means that in an area which badly needs to modernize, the workers most capable of improvement and further education are the most likely to leave. This helps insure that the future potential for improvement in productivity related areas will be slow going.

\textit{(2) It appears that "current wages and recent wage growth are irrelevant [to the migration decision], once human capital and other variables are controlled for."}\textsuperscript{26} This evidences some support in favor of the value option of waiting hypothesis, which says an individual may derive utility from not migrating, as shown in (1). It also has important policy implications that will be elaborated later in the next section of this paper. Briefly, it suggests that wage differentials needed not be removed between the regions in order for an equilibrium in the flow of regional migration to be reached, further implying that the up-front fixed costs of migration may be substantial.

\textsuperscript{23} Burda, "Determinants in East-West Migration," p. 458.

\textsuperscript{24} Burda refers to this as the 'Marshallian Trigger', which is the return at which the project (here migration) has zero present value, such that "the return to projects in such an environment must exceed by a positive margin the 'Marshallian Trigger' before they are undertaken." (For further information see: Burda, "The determinants of East-West German migration," p. 454-156.)


\textsuperscript{26} Burda, "Determinants in East-West Migration," p. 458.
Understanding migration might help us determine that there exists some validity to the insider-outsider model previously explained. By this I mean that there is certainly little downward pressure on the wage inflation since labor supply (at least as it relates to levels of migration) is not largely influenced by the level of wages. This is in contrast to classical thinking that claims the higher the wage level in one area relative to another the greater the supply of labor in the higher wage area - as long as the marginal benefits exceed the marginal costs of changing jobs - in the long run lowering wages. The wage differential would reach an equilibrium level where the only wage differential would be related to differences in working conditions (i.e., if in the same industry, the wage difference would reflect the number of hours worked, levels of stress, non-wage benefits, etc.) However, the independence of the migration decision from the wage levels shows that insiders are left with much more market power than outsiders. In short, this factor does not say that the wage determination is completely independent of the labor supply, but that the portion of the labor supply that is made up of the increased number of migrants from the east is not merely due to the higher wages in the west. The wage structure is a function of other factors which have been explained in the insider/outsider model and not a function of the factors in the migration decision, although the two are related.

(3) "The role of uncertainty seems to be a two-edged sword: while increases in uncertainty raise the option value of waiting, risk aversion on the part of agents may encourage migration as a risk reduction measure."\textsuperscript{27} Here uncertainty is mainly seen in its relation to job prospects in the "home" and "abroad" markets, where increases in unemployment in a given market increase the uncertainty for individuals in the same market. Using the idea

\textsuperscript{27} Ibid.
behind the 'Marshallian Trigger' we can see that the side of the proverbial sword on which a worker finds himself depends on the marginal levels of uncertainty in each market. Therefore, we can logically conclude that as long as unemployment remains higher in the new Laender than it is in the west, there will continue to be some unspecified level of migration from the east to west which is positively related to the unemployment differential between the two regions. With the benefit of hindsight we might also conclude that this helps explain the extremely large labor flows at the initial reunification, given the high levels of uncertainty in the east with respect to not only the unemployment levels but also the uncertainty of microeconomic stability, such as availability of food and other essentials, as well as the insurmountable political and social uncertainty that existed at the time. Furthermore, until the other Eastern European countries get their economic and political situations under control, continued migration from these countries should be expected.

(4) Finally, there appears to be strong statistical evidence that suggests a negative relationship between the size - or degree of urbanization - of the "home" city and the decision to migrate. This is possibly explained in that the greater the degree of urbanization, the better the opportunities in a given city, thus the more reason to stay. In our previous terms, this would mean a higher value is given to the option to wait, implying that future migration should slow - for reasons other than merely the improvements in the standard of living and wage levels in the new Laender - as modernization is continued.

Now that we better understand some of the factors that influence the decision to migrate for the individual, let us turn to the social and

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political impact migration has in aggregate on Germany. After World War II xenophobia and anti-foreigner sentiment was necessarily low in Germany. During this same time period, however, immigration into Germany was very high, but the German economy was growing at an astounding rate due to the so called Wirtschaftswunder (Economic Miracle) which consequently kept unemployment levels low. Furthermore, because of this rapid economic expansion, foreign workers were not only accepted, but necessary to meet the growing market demands. Until the late 1970s, this appears to have remained the case.

Germany has had a history of being led from the top, meaning the government or governmental leaders. Bismarck led Germany's unification in the 19th century from the top. Hitler led Germany into World War II and controlled the economy from the top through what is called negative corporatism. Now government and business in Germany - and many other European nations - work together in what is called "market socialism". It should therefore not be surprising that the labor market also has a few (insiders) who have much insider control over the market from the top. This is not only the corporate top, but also the governmental top where labor leaders hold bureaucratic positions and negotiate with governmental officials for greater worker power and benefits. Perhaps over time such a top-down power structure has become part of the German culture, but whatever the cultural outcome, it has led to strong rigidities in the labor market that are capable of stable quasi-equilibrium levels of controlled inflation and high unemployment. Furthermore, when Germany's economic boom slowed after the oil shocks of the late 1970s these rigidities produced unusually high unemployment. Consequently, the foreign workers became scapegoats for the unemployed.

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See Insider/Outsider and Target-Real-Wage-Bargaining models earlier presented.
individual's problems. Full blown anti-foreigner sentiment, however, did not reemerge at that stage since the economy was still growing at a steady pace. It was not until the wall went down and the world economy entered a recession that this negative emotion publicly returned. Unfortunately, the flow of immigrants and asylum seekers from former communist countries dramatically increased along with rising unemployment. While the relationship between the immigration and unemployment is largely spurious, many neo-Nazis and right wingers propagated the idea that the foreigners were taking German jobs, increasing unemployment for native Germans, and ruining the German economy (and culture, according to the rhetoric). Thus, they once again sparked a long suppressed anti-foreigner sentiment.

Evidence of this can be found in the fire-bombing of the Romanian Gypsies and Vietnamese refugees in Rostock, Germany. For five consecutive nights beginning on August 22, 1992, some eight hundred neo-Nazis fire-bombed an apartment building occupied by the aforementioned refugees while crowds of onlookers cheered. Rather than stomping out the neo-Nazis, on August 24 the authorities ordered all refugees out of the city. This created, in effect, the second "foreigner-free" city (the first was Hoyerswerda after a similar incident in 1991). "Most leading politicians, including Chancellor Helmut Kohl, focused on the need to change Article 16 of the constitution, which guarantees asylum for political refugees." (Article 16 was subsequently changed in 1993 and the number of asylum seekers entering Germany has greatly decreased since.)

30 The immigrants from the East were not alone. There were also other immigrants from less developed countries.
The governmental response was probably more surprising than the action itself. Furthermore, a public opinion poll taken after the violence in Rostock found that 19% of the voters in western Germany and 12% in eastern Germany would vote for "a party to the right of the Christian Democratic Union/ Christian Social Union." The neo-fascist Republican Party won 10.9% of the vote in the April election in Baden-Wuertemberg and 9.9% in the May election in Berlin.

Also, 25 neo-Nazis were tried for the Rostock fire-bombing and only received sentences of maximum prison time of eight months, suspended sentences, or probation orders. Police identified a 75% increase in proven acts of antiforeigner violence between 1991 and 1992 and during the first 10 months of 1993 at least 20 people were killed in racist- and fascist-related violence. On the other hand, hope remains since the percentage of votes has not yet reached extreme proportions and public opposition to the neo-fascist activity has increased. On November 8 more than 350,000 Germans marched in Berlin protesting the antiforeigner sentiment. Moreover, in February 1993 the interior minister of Mecklenburg-West Pomerania, Christian Democrat Lother Kupfer, was forced to resign after voicing 'a certain understanding' for the actions of the Rostock rioters. While this provides hope for a German future with less public support of neo-fascism, it insures a difficult and complex 1994 election year.

Briefly, we began with an overview of the changes which have taken place in Eastern Europe, focusing specifically on Germany and its labor market.

32 Ibid.
34 Ibid.
transition. It was stated that the study and understanding of such change is not only important for the country studied (here Germany), but also has many implications for the world as a whole as we move together toward the future.

Next, the previous state of the German labor market was examined using the Insider/Outsider microeconomic model and the Phillips curve, target-real-wage-bargaining macroeconomic model. It was shown that Germany's microeconomic structure encourages unemployment by allowing the insiders (the employed workers) to have much greater market power than the outsiders (the unemployed workers). Furthermore, according to the macro model used, the labor market rigidities in the bargaining process places upward pressure on the unemployment level as well, especially under strict monetary policies.

Lastly, we looked at the migration issues in Germany. Here, we showed that Germans have always been forced to cope with large levels of migration into their country. Moreover, past history shows that they have managed to do this while maintaining low levels of unemployment and a growing Gross National Product. It was interpreted from this that the current levels of migration from the former East, while possibly indirectly influencing the wage level through a lowering of the reservation wage, are not the cause of high unemployment figures. On the other hand, structural rigidities in the labor market (discussed in the preceding paragraph) appear to be a much more important cause of unemployment. In the end, it seems that migration mainly influences the political and social construction of the country in a negative way as the citizens wrongly blame the economic problems on the foreigners. This relationship was evidenced by the recent rise in right wing popularity and the anti-Ausländer (anti-foreigner) demonstrations against the Romanian gypsies and Vietnamese in Rostock in 1992 and the subsequent demonstrations in
the streets since that time. It should be noted here that, unfortunately for Germany, nationalism, xenophobia, and the growth of radical political parties all increase as unemployment rises. Therefore, the recent rise in these social attitudes and the growing popularity (albeit slowly) of the right wing should not come as a surprise in the face of both increased migration and increasing unemployment.

I would like now to turn our focus to the most recent events in Germany. While this paper is being written, the unemployment figures continue to rise, recent GNP figures promise some future economic growth (due in part to increased exports as America pulls out of the worldwide recession), the Bundesbank maintains a cautious and somewhat tight monetary stance, and the IG Metall workers union recently and successfully negotiated with employers over wage and benefit increases. Lastly, during this year, 1994, elections will be held throughout Germany and will decide on new leaders at all levels of the government, including the Chancellor's position, thusly named "The Super Election Year 1994". These events are not all independent of each other and are certainly not independent of the topics discussed in this paper.

The recent outcome of the negotiation between German employers and the IG Metall worker's union can be viewed in terms of this paper as a negative influence on the German labor market and the economy in general. The result of the negotiation was clearly in the labor union's favor. Employers dropped demands for cuts in vacation time (which is currently the longest vacation time of all the G-7 countries), agreed to a 2 percent wage increase and
guaranteed no layoffs for the workers. In exchange, the workers agreed to a more flexible work week with a minimum of 30 hours per week (down from a 36 hour per week minimum) and will delay for one year a Christmas bonus increase of 10 percent, which brings the total Christmas bonus to 60 percent of one month's salary.

While the above outcome solves the short-term problem for Germany of a labor strike that could have crippled the German economy, it also reveals a relentlessly shortsighted approach to improving the German economy as a whole and will, in my opinion, lead to worse problems in the future which will require even tougher decisions to be made. By this I mean, that unless Germany lowers its wages and cuts back on its vacation time it will not remain competitive in the future world market where increasing competition from the East Asian tigers and Japan becomes daily more intense. In these countries not only are the wages lower but the worker productivity levels and the hours worked per week are higher with much lower vacation time. This does not include competition from the United States who is also more productive, works more hours per week, and has less vacation time than Germany. Furthermore, the U.S. has recently opened trade further through the NAFTA agreement which should lower the wage levels and help profits in the short run and increase competitiveness in world markets over the longer run. In the shorter run, as the other G-7 countries continue to climb out of the global recession the German interest rate will not be as high relative to other rates, thus, possibly leading to a counterproductive decline in capital formation in Germany even while Germans continue to call for international investment
incentives in Germany.\textsuperscript{35} In light of the models presented, the IG Metall negotiations further reveal the strength of the "Insiders", as represented by the labor union. Finally, the negotiations' outcome suggests there will be a continuance of involuntary unemployment resulting from structural rigidities.

These results could easily have negative consequences for Europe in general as well. Western Europe, at the time of this paper, is still submerged in the world recession and could very much use a strong Germany to help pull them out. Also, the budding European union continues to need support in completing its economic, monetary, and political union. Lastly, for Eastern Europe Germany remains an important factor not only in its financial development through treaties, trade, and assistance, but also simply as a model of transition which offers them hope.

The recent signs of stubbornly high unemployment in the newly unified Germany may also be viewed in terms of this paper as an obviously negative influence on not only the German economy but also the German political and social situation. As mentioned above, the German rates of unemployment are high, especially in the former East Germany. Economically this has many negative repercussions, but as we have seen, the social implications of high unemployment are possibly of greater importance, especially when coupled with immigration, by leading to increased xenophobic activity. As earlier stated, such activity is largely a response to a misperception of the economic situation (i.e. blaming the foreigners for unemployment rather than looking at the structural and policy related causes of unemployment). It is also, however, an attempt by an angry few to use foreigners as the scapegoat for deeper problems in the country itself, which encourages the previously

\textsuperscript{35} "G-7 Nations Meet in Detroit to Discuss the Unemployment Crisis and Ways to Resolve It." \textit{The Week In Germany}, March 18, 1994, p. 4.
mentioned misperception to be accepted by the many. This cycle, if continued, will lead in the future to higher levels of anti-foreigner activity and possibly further levels of dangerous violence and even the unfortunate election of radicals to positions of power.

To end on a positive note, the recent election, while looking ever worse for current Chancellor Helmut Kohl, has revealed a much welcomed resistance to the extreme political right. The official start of the "Super Election Year 1994" began with votes on Parliament in Lower Saxony. The largest percentage was 44.3 percent which went to the Social Democrats. Helmut Kohl's party, the CDU (Christian Democratic Union), received 36.4 percent of the vote, down from the 42 percent in 1990, and will have 67 seats in the new parliament. The third major party, the Greens, won 7.4 percent. The best news is that the right-wing party, Republikaner, only received 3.7 percent which is not enough to win representation in the new Parliament. This helps to alleviate immediate fears of right-wing representation in positions with some decision making capabilities. Two things should, however, be noted here: 1. this is only the beginning of the elections, therefore there is a chance, albeit slim, that the Republikaner party may still win some seats; 2. if the current high interest, high unemployment policies are continued, the future chances of right-wing power will be increased due to the sustained high unemployment levels. After all, although the 3.7 percent of votes for the Republiker was not enough to win seats, it was an increase from the previous 1.5 percent.

\[36\] Germany requires a 5 percent win in the polls in order to obtain seats in the Parliament.
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Where:

- $l^s$ = labor supply curve
- $l^d$ = labor demand curve
- $w^i$ = insider wage
- $w^r$ = outsider (reservation) wage
- $c$ = turnover cost per employee
- $e$ = level of employment
- $e^*$ = level of employment
- $L$ = total labor force
- $E$ = aggregate employment
- $U$ = aggregate unemployment
- $n$ = number of identical firms

Diagram: A graph showing the interaction between labor supply and demand, with key points labeled and axes indicating various economic variables.
Where: \( \Delta w \) = nominal wage inflation

\( AD \) = aggregate demand

\( PC \) = Phillips curve

\( RWB \) = real-wage-bargaining curve

\( U \) = unemployment
Appendix - C

The Phillips Curve and The Target-Real-Wage-Bargaining Model

Using the combination of the Phillips curve model and the target-real-wage-bargaining model presented by Coe and Krueger (Coe and Krueger pp. 118-120), we find that the focus in this alternative to the Phillips curve is on the equilibrium relationship between the levels of - as opposed to the changes in - real wages and labor productivity implying that the growth of nominal wages will be determined, in part, by a catch-up variable reflecting past deviations of real wages from their target level.

The relationship between the Phillips curve and the target-real-wage-bargaining model can be expressed in the following wage equation that combines the two models:

\[
\Delta w = \Delta p^{\text{exp}} + \Delta q^\sigma + \tau_1 + (U - U^*) + \tau_2(w - p - q^\sigma - \tau_0) - 1
\]

Let \( \tau_1 < 0, \tau_2 \leq 0, \) and \( \tau_0 \) define the equilibrium relationship between the real wage level and trend average productivity \( (q^{tr}) \). When \( \tau_2 = 0 \), the equation is close to the standard Phillips curve except that Coe and Krueger explicitly state the trend productivity growth and the natural rate of unemployment. When \( \tau_2 < 0 \), equation (1) is converted from a growth relationship between real wages, productivity, and unemployment, to a level relationship between the same variables. This is shown by the long-run, stationary ready-state form of equation (1), assuming that \( \Delta p^{\text{exp}} = \Delta p \):

\[
(1') \quad w = p + q^\sigma - \left(\tau_1\right)(U - U^*) + \tau_0
\]

Since the level of wages is related to the level of unemployment, the growth of wages is related to the changes in unemployment. In this model, the

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target real wage \((w-p)^t\) is determined by trend productivity and the labor market gap, which can be thought of as a proxy for the bargaining power of labor:

\[(w-p)^t = q^\sigma - (\tau_2^t)(U-U^*) + \tau_0.\]

Consider an equilibrium where expectations are realized \((\Delta p^{exp} = \Delta p)\) and real wages grow at the same rate as trend productivity \((\Delta w - \Delta p = \Delta q^\sigma)\). In the Phillips curve model \((\tau_2 < 0\) in equation (1)), it is evident that such an equilibrium requires the unemployment to be at the natural rate \((U = U^*)\). In the target-real-wage-bargaining model \((\tau_2 < 0\) in equation (1)), a quasi-equilibrium can exist where unemployment is above the natural rate provided that the real wage target level has been reduced relative to the level of trend productivity; in terms of equation (1), it would be required that the last two terms sum to zero:

\[\tau_1(U-U^*) + \tau_2(w-p-q^\sigma-\tau_0) = 0.\]

Empirical tests of the alternative models indicate that aggregate wage developments in West Germany are better described by the target-real-wage-bargaining model than by the Phillips curve model. Therefore, we could view the persistence of high inflation in the Federal Republic of Germany to be the result of aggregate wage formation rather than merely a high natural rate of unemployment.
Table 1: Federal Republic of Germany: Immigration from the East

<table>
<thead>
<tr>
<th>From Eastern European Countries</th>
<th>From GDR</th>
<th>Total</th>
<th>Unemployment Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950-59</td>
<td>439,714</td>
<td>2,203,107</td>
<td>2,642,821</td>
</tr>
<tr>
<td>1960-69</td>
<td>221,516</td>
<td>618,345</td>
<td>839,861</td>
</tr>
<tr>
<td>1970-79</td>
<td>355,381</td>
<td>148,695</td>
<td>504,076</td>
</tr>
<tr>
<td>1980</td>
<td>52,071</td>
<td>12,763</td>
<td>64,834</td>
</tr>
<tr>
<td>1981</td>
<td>69,455</td>
<td>15,433</td>
<td>84,888</td>
</tr>
<tr>
<td>1982</td>
<td>48,170</td>
<td>13,208</td>
<td>61,378</td>
</tr>
<tr>
<td>1983</td>
<td>37,925</td>
<td>11,343</td>
<td>49,268</td>
</tr>
<tr>
<td>1984</td>
<td>36,459</td>
<td>40,974</td>
<td>77,433</td>
</tr>
<tr>
<td>1985</td>
<td>38,968</td>
<td>24,912</td>
<td>63,880</td>
</tr>
<tr>
<td>1986</td>
<td>42,786</td>
<td>26,178</td>
<td>68,966</td>
</tr>
<tr>
<td>1987</td>
<td>78,523</td>
<td>18,958</td>
<td>97,481</td>
</tr>
<tr>
<td>1988</td>
<td>202,673</td>
<td>39,832</td>
<td>242,505</td>
</tr>
<tr>
<td>1989</td>
<td>377,055</td>
<td>343,854</td>
<td>720,909</td>
</tr>
<tr>
<td>Total</td>
<td>2,000,698</td>
<td>3,517,602</td>
<td>5,518,300</td>
</tr>
</tbody>
</table>


Table 2

<table>
<thead>
<tr>
<th>Federal Republic Of Germany</th>
<th>1991</th>
<th>1992</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Total Weekly Earnings in Industry (DM)</td>
<td>845</td>
<td>885</td>
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</table>

<table>
<thead>
<tr>
<th>New Laender</th>
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</thead>
<tbody>
<tr>
<td>Average Total Weekly Earnings in Industry (DM)</td>
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</table>

<table>
<thead>
<tr>
<th>Index of Net Production</th>
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</thead>
<tbody>
<tr>
<td>Consumption Goods (West) (1985 = 100)</td>
</tr>
<tr>
<td>Consumption Goods (East) (2nd half 1990 = 100)</td>
</tr>
<tr>
<td>Consumption Goods (East and West) (2nd half 1990 = 100)</td>
</tr>
</tbody>
</table>

Source: Statistisches Bundesamt, 1993 Bundesrepublik Deutschland in Zahlen.