

O P I N I O N

Turnaround in the German Labor Market?



The New Year brings cause for cautious optimism. The German economy has left the path of stagnation in 2004. In the tradition of previous upswings in Germany, a thriving global economy and strong exports have eventually energized our economy. Real economic growth reached an after all remarkable 1.7% last year. And the conditions in 2005 seem favorable for a continuing expansion as positive domestic factors coincide with a substantially improved global economic environment. We expect growth to accelerate slightly to 1.8% this year and 2% in 2006. Compared to the three lean years between 2001 and 2003, this would mark a significant improvement.

The labor market, however, has not yet profited from the economic upturn. Employment in Germany is expected to rise from 38.4 million in 2004 to a mere 38.6 million in 2005 and 38.9 million in 2006. From a macroeconomic perspective, the unemployment figures will not drop con-

siderably until 2006, when the number of unemployed could decrease by 400,000. Since the potentially strong effects of the recent labor market reforms cannot yet be evaluated due to their microeconomic nature, they are not included in this estimate.

While the boom of the global economy is beginning to fade, it remains on a high level. This applies not only to the United States, but particularly to Asia and Eastern Europe. Neither the high oil price nor the weak dollar poses a serious threat. The economic situation in Germany's important export destinations will further stabilize. But domestic demand will nonetheless need to be revived in order to create a self-sustaining upswing. In view of the massive budget deficits at all levels of government, this much-needed increase in domestic demand will depend on private investment and consumption. The signs are good for private investment to pick up soon due to postponed replacement investment decisions, the rise in global demand, and the growing confidence in the reform efforts of the German government.

The most important component of the German labor market reform went into effect in January. The program referred to as "Hartz IV" abolishes parts of the unemployment benefit system that originated in times of full employment. Benefits for the long-term unemployed are no longer based on previous wage income. In most cases they are reduced to a level close to social welfare. The goal of the initiative running under the motto *Fördern und Fordern* ("supporting and demanding") is to improve counseling services for the unemployed while at the same time increasing their willingness to accept lower-paid jobs. This may help to stimulate the underdeveloped low-wage sector in Germany, which offers viable job prospects particularly to low-skilled workers who suffer most from unemploy-

ment. In fact, Hartz IV is nothing short of a small revolution as it has eradicated a practice that was no longer financially sustainable and offered too little employment incentives.

Policymakers are therefore well advised to maintain course. Germany is now sailing moderate macroeconomic seas. Fiscal policy is slowly stabilizing, and the European Commission is likely to implement reforms this year that would add credibility to the Stability and Growth Pact. This must be applauded because it is a precondition for a steady and solid restructuring process of our economy. However, it is an open secret that economic success will ultimately depend on effective incentive mechanisms and an efficiently organized economic and social system. We cannot do without further reforms in the fields of federalism, healthcare, pension funding, education and research. We still need more competition in most of these areas. If our policymakers muster the courage to undertake additional steps in this direction, confidence in Germany as a business and investment environment will rebound. If this does not happen, a sustainable upswing with a lasting labor market effect will be difficult to achieve.

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