

FINANCIAL MARKETS IN RELATION TO EMPLOYMENT AND UNEMPLOYMENT

HANS TIETMEYER

I. INTRODUCTION

An important trigger for the development of Catholic social teaching in the second half of the 19th century was the problem of labor in the incipient industrial society. Since then, there have been profound changes in the technical, economic, political and social fields, not only in the industrial countries but also in the so-called newly industrializing countries and the developing countries. Owing to technical developments, changes in the international division of labor and many regulations, the problem of unemployment, in particular, is becoming increasingly evident world-wide.

The task of Catholic social teaching, namely to formulate modes of thought, criteria of judgment and principles of action for shaping working life which conform to the basic tenet of respect for the dignity and rights of the working population, has gained new dimensions and received new points of emphasis as a result of these changes. While a hundred years ago the primary objective was to overcome class antagonisms, to improve the extremely poor standards of living of the workers and to enforce the basic rights of employees which have meanwhile become a matter of course, the focus of interest today is primarily the demand to establish a "culture of work". By "culture of work" Catholic social teaching understands the protection of the human right to work. Work is to serve personal self-realization and the discharge of the social commitment.

The first normative demand, therefore, is to facilitate and safeguard a high level of employment so as to take account of the right, but also the duty, to work. In addition, respect for human dignity in working life is to be ensured; employees are to be treated as subjects and not as objects. Furthermore, work is to foster the realization of men as social beings, i.e.

working conditions should promote, and not counteract, inter-human solidarity.

In order to arrive at concrete, appropriate and realistic conclusions in respect of this economic, labor-related and social dimension, a dialogue with modern social sciences and an analysis of their findings are imperative.¹ This applies all the more as — given the upheavals in working life which are already under way or on the horizon — the question of ensuring a humane future of labor is a crucial, perhaps the paramount social challenge. Only an interdisciplinary approach in which all fields of social sciences with their specific emphases work together, will be able to give promising answers.

In the present paper the problems of employment are analyzed from the point of view of economics. In line with the subject, it concentrates on the aspect of financial markets in relation to employment or unemployment. The first section focuses on the significance of the financial markets for growth and employment. Initially, the relationship between real capital and labor is explained before the allocative function of the capital market and the necessary underlying conditions for functioning financial markets are dealt with. Subsequently, the paper analyses whether selective intervention in the capital market is appropriate to stimulate growth and employment. The second main section highlights recent developments in the financial markets, on the one hand, and on the labor market, on the other, as well as possible correlations. The contrast between the great dynamism and the innovative power of the financial markets and the much slower reforms on the labor markets will become evident. Finally, some conclusions are drawn as to the possible further trends on the labor market.

The link between the financial markets and the labor market is extremely complex, and labor market problems as such differ considerably from country to country. The following statements focus on the situation in developed economies so as to keep within our set terms of reference. The annex then deals specifically with labor market trends in western Europe and some of the dominant causes of unemployment in the region.

¹ Johannes Schasching SJ rightly refers to the need for such a dialogue in the final section of his paper *Katholische Soziallehre und Arbeit* (Catholic Social Teaching and Employment).

II. THE SIGNIFICANCE OF FINANCIAL MARKETS FOR GROWTH AND EMPLOYMENT²

1. *The relationship between capital and labor*

In order to deal with the question of the link between financial and capital markets,³ on the one hand, and economic growth and employment on the other, the basic relationship between (real) capital and labor has to be clarified first. Both phenomena — the wide spread of dependent employment, as a result of specialization and the division of labor, and capital accumulation in the sense of consumption restraint and the systematic redeployment of what has been saved in this way for the purpose of more production — are salient features of the transition from feudal to capitalist society. The associated radical transformation of the economic system at the same time stimulated the emergence of modern economic theory. It therefore comes as no surprise that “capital and labor” have been a basic subject of economics ever since. The points of emphasis which are made in this respect differ considerably, however.

Some schools of thought focus on the problem of distribution, which is based on the distribution of overall income by “wage and salary earners”, on the one hand, and “capital owners” on the other. An extreme position is taken by Marxism in this context. In view of the class antagonisms existing in the early stage of industrialization, it posits a contradiction between capital and labor, a contradiction which, it asserts, is constitutive for capitalism. It claims that, in order to earn their living, workers are forced to sell their labor power to the owners of the means of production and thus to subject themselves to exploitation. According to Marx’s economic doctrine, the value of a commodity corresponds exactly to the labor contained therein (labor theory of value). Means of production are seen as “crystallized” labor. Only living labor produces value, whereas capital as such is not productive. Consequently, the mere ownership of capital and the provision of capital should not be remunerated. The income flowing to capital owners corresponds to what is produced by the workers over and

² A good survey of a number of the problems discussed below — also with reference to the developing countries — is given in the World Development Report 1989, Financial Systems and Development, The World Bank, Washington 1989.

³ Financial markets are generally understood to be the markets for financial resources. Depending on the maturity of lending, a distinction can be made between capital markets as markets for longer-term financing and money markets as markets for shorter-term financing. In contrast to this financial terminology, which is used in the major part of this paper, the capital market can also be construed as a market for real capital from the real economic point of view, a perspective which has been chosen in section 11.1.

above the subsistence income required for their reproduction, so-called surplus value. The appropriation of this surplus value by the capitalists is exploitation.

This viewpoint in such an extreme form probably prevails only in isolated cases today. After nearly 200 years of experience of capitalism in the industrial countries (whose specific economic systems differ considerably, however), wage and salary income there is far higher than the "cost of reproduction", and countries with a long capitalist tradition all have a comparatively high material standard of living.

The view that income from capital is morally suspect has not yet been dispelled everywhere, however. Such a view fails to recognize, however, the fact that labor and capital are not opposites but rather complements on the way towards increasing prosperity. In addition, in developed economies the functions of a "capitalist" and an "employee" frequently coincide in one and the same person as many employees now receive investment income, although there is still scope and the need for improvements in this respect in many countries. What is decisive, however, is that the interests of capital and labor are also allied insofar as only the two together can guarantee sufficient growth and widespread prosperity. This touches directly upon the production-technical or allocative dimension of the relationship between capital and labor. The scarcity of the production factors labor, capital (and land) is the real cause of the scarcity of goods, and only by an efficient combination of all factors in the production process will it be possible to mitigate this problem.⁴ Growth — in quantitative and qualitative respects — presupposes investment in the form of an increase and/or an improvement in the resources to be employed.

The production of capital goods is initially at the expense of the production of consumer goods because certain quantities of the available factors of production have to be set aside from the direct production of consumer goods. Refraining from possible current consumption — the real economic side of saving — is the first necessary step towards forming real capital. In a second step the production factors freed from the direct production of consumer goods must be used to produce capital goods. This is the real economic side of investment. The final purpose of this process of saving and investing is, of course, the future production of consumer goods; in this sense capital formation is a roundabout form of production. The

⁴ I should like to stress explicitly that the treatment of labour as a factor of production is a methodological convention in economics without which certain economic facts cannot be analysed appropriately. However, this should not be seen as implying a general restriction of human labour to this dimension.

advantage of round-about production consists in its additional yield, i.e. the increase in productivity of the production process.⁵ The disadvantage is that people have to wait longer for the result of production and its use.

This disparity between consumption restraint in the present and higher productivity in the future exists in any economy. However, the problems of sufficient capital formation become particularly clear in economically difficult situations, for example in the extension of the infrastructure in developing countries or in the transition of a country from a centrally planned economy to a market economy. The availability of sufficient capital, either from savings of its own or from savings of other economies, is of key significance for a country's economic development.

Sufficient capital accumulation is therefore also important for the employment situation. Additional investment leads to employment in two respects: firstly, demand in the capital goods industry rises, and secondly, new jobs are created in the investing sectors, if investment in capacity extensions and not in rationalization measures is involved. In addition, over and above its effect of increasing labor productivity, investment generally provides scope for lasting increases in real wages without jeopardizing jobs. The interests of "capital" and "labor" are insofar allied in most cases.

Growth and employment in an economy will be all the higher over the long term the better it has been ensured that both capital and labor are put to their most efficient macroeconomic use. Experience has shown that this is most effectively achieved through the guiding function of the market. However, inefficiencies on the labor market may become more evident if the efficiency of the capital markets increases. This fact is gaining additional significance with the growing internationalization of capital allocation. To an ever-greater degree, capital now flows across national borders. This is directly obvious in the case of monetary capital, but the link applies indirectly, too, to real capital — through direct investment. An improved efficiency of international capital allocation implies higher prosperity worldwide, but not necessarily for every national economy, let alone every industry or every enterprise. I shall deal with this question in more detail below.

2. *The allocative function of the financial markets*

In order to identify the significance of financial markets for the efficiency of capital allocation, the monetary dimension of saving and

⁵ See Eugen von Bohm-Bawerk: *Kapital und Kapitalzins. Zweite Abteilung: Positive Theorie des Kapitals* (Capital and capital interest rates. Second section: Positive theory of capital), 4th edition, Jena 1921.

investment needs to be examined. Restraint in consumption, which releases factors of production for real capital formation, initially takes the form of monetary savings. Potential investors demand financial resources to attract — indirectly — the factors of production released, if the investment total exceeds their own savings. It is therefore the task of the financial markets to pass on financial balances from economic agents with surpluses to those with deficits.

Investors (capital demanders) and savers (capital suppliers) will normally have divergent preferences with regard to the maturity, lot size and risks of loans or participating interests. The capital market can align the wishes of capital suppliers and capital demanders by performing certain transformation functions.

First of all, maturity transformation is to be mentioned: the borrower or capital demander may raise longer-term funds, yet the individual saver is not compelled to exercise restraint in consumption for an equally long period, but may sell bonds or shares prematurely in the secondary market. Secondly, the splitting of bond or share issues enables lot-size transformation: a high amount of capital can be raised by numerous investors. Finally, there is a risk transformation in the capital market: by diversifying his portfolio and with the help of hedging strategies, the investor may assume a risk position that is detached from the risk of an individual project. In many cases the aforementioned transformation functions are not performed directly by the securities markets but by financial intermediaries — such as banks or other institutional investors. By resorting to their specific knowledge, both investors and borrowers are able to save information and transaction costs.

The better a financial system succeeds in performing the above-mentioned functions, i.e. the better and more cost-effectively the preferences of individual investors and capital demanders can be met, the more efficient capital allocation will be. A smoothly functioning interest rate mechanism is likewise crucial for the allocative efficiency of the capital market. Only if the loan carries market interest rates will the capital input be comparable in all its alternatives and different maturities. For from the point of view of an investor, it is essential to know whether and to what extent the expected yield on a particular investment exceeds the costs of financing it. Besides performing equalizing functions between capital suppliers and capital demanders, the interest rate therefore has an important signaling function with respect to the profitability of alternative capital uses.

3. Conditions for smoothly functioning financial markets

The permanent capability of the financial markets to function depends on a number of determinants, the most important of which are a suitable regulatory framework, adequate prudential regulations and a stable macro-economic environment.

(a) Regulatory framework and prudential regulations

Products and market techniques that meet the requirements of capital suppliers and demanders will be developed in the capital market, and market prices will form only if fair competition is ensured. Since competition will not be ensured lastingly without a minimum of state regulation, the first approach to a capital market policy is the need to create an appropriate regulatory framework. Specifically, this involves, for example, the guarantee of free market access and appropriate measures to prevent action restricting competition. At the international level, the free convertibility of the currency, free capital movements and the admission of foreign banks are major components of a pro-competitive environment.

Furthermore, the confidence of market participants in the soundness of the financial system is of great significance for an efficient financial market. Without a minimum of confidence-building rules, a functioning market and therefore lastingly functioning competition will not come about because they are prevented, say, by asymmetries of information flows in the financial markets. As a rule, a capital demander is considerably better informed about his own economic situation and about the properties of an investment project to be financed than are potential lenders. In his own interest the borrower will be prepared to disclose information. However, to ensure that this information is reliable and meets certain minimum standards and, moreover, to minimize information costs, for example, legal regulations or agreed rules on standardized disclosure requirements on the part of issuers in the capital market definitely make sense. In addition, regulations on creditor rights and the reliable enforceability of contracts are essential. An efficient legal system or a system of rules, which contains, inter alia, effective regulations on collateralising loans and compulsory execution, is therefore a necessary prerequisite of a smoothly functioning capital market.

Furthermore, public or collective supervision of the institutions and markets of the financial sector appears to be indispensable for an efficient financial market. It is only in this way that in highly complex financial systems fraudulent conduct by individual players, such as insider offences or business practices which, in the extreme case, may undermine the stability of the entire financial system, can — at least largely — be avoided.

Banking supervision can also help to prevent an excessive accumulation of risks by individual banks which may lead to insolvency or illiquidity if business and market trends are unfavorable.⁶ Since frequently small investors, in particular, are hit hard by bank failures and are scarcely able to protect themselves, investor protection by public supervision measures in the form of general rules conform to the welfare state principle as well.

Although some public encroachments on the freedom of action of market participants seem to be indispensable so as to increase the crisis resistance of the financial system or to avoid its abuse, ways must be found which hamper competition as little as possible. For each impairment of competition tends to hinder efficient capital allocation. With this in mind, indirect forms of intervention, for example, in the banking sector capital requirements for certain transactions weighted according to their risk content and transparency regulations, are to be preferred to direct requirements or prohibitions.⁷ In general, public supervision measures should be subject to the regulatory principles of private-law autonomy and the subsidiarity of government activities; in other words, financial market supervision oriented along market economy lines ensures the stability of the financial system as far as possible without relieving financial market participants from their responsibility for business policy decisions. Otherwise the regulatory net will soon become very closely knit, personal initiative will be hampered, self-responsibility impaired and market efficiency unnecessarily weakened.⁸

(b) Stability of the macroeconomic environment

Apart from suitable regulatory and prudential measures, the capability of the financial markets to function depends mainly on the stability of the

⁶ Financial market operations are subject to different kinds of risk. The most important are the default risk, i.e. the risk that interest and redemption payments will not be made, and the price risk, which carries the danger of losses as a result of interest rate or exchange rate changes.

⁷ Such indirect methods of risk limitation also mitigate the so-called moral hazard problem which is associated with additional crisis compensation mechanisms, such as deposit protection schemes, if the public safety net increases market participants' willingness to take risks from the outset.

⁸ Despite the far-reaching internationalisation of the financial markets, financial market supervision is still mostly performed at the national level. However, as early as the eighties, the so-called Group of Ten Central Banks drew up joint recommendations which have been further developed on several occasions and today largely apply to all national supervisory rules as common guidelines (so-called Basel Capital Accord); see, for example, Report on International Developments in Banking Supervision, Report Number 6, Committee on Banking Regulations and Supervisory Practices, Bank for International Settlements, Basel, September 1988.

macroeconomic environment and particularly, on the degree of price stability. High and often sharply fluctuating rates of inflation discourage longer-term financial investment, and financial intermediaries will be willing to effect maturity transformation on a limited scale only. For if there is great uncertainty about inflation, it is virtually impossible to gauge the real proceeds of a financial investment to be expected in the future. The market for longer-term lending will largely dry up. Consequently, enterprises can only borrow over the short term and, owing to the associated higher financial uncertainty, the real economic planning horizon will shrink. Investment projects which would have been profitable at low inflation rates are not realized. The results are lower growth and higher unemployment. Under capital market policy aspects, too, the strict orientation of monetary policy to the goal of ensuring monetary stability makes sense.⁹ The requests of market participants to abolish certain regulations or to admit new financial products are likewise to be measured by this demand. They should be considered only if they do not perceptibly restrict the room for maneuver of a monetary policy geared to the aim of safeguarding monetary stability.

It may be concluded from the above that the primary task of a capital market policy which pursues the goal of a permanently functioning capital allocation is to realize a maximum degree of financial market efficiency and stability by means of appropriate regulatory and prudential measures and by a strict anti-inflation policy.

4. *State intervention in the capital market — a means to stimulate growth and employment?*

In the recent past, public agencies have often been called upon to intervene directly in the capital market, over and above taking the measures indicated to ensure the smooth functioning of financial markets. The explicit objective of such calls is frequently the promotion of growth and the creation and preservation of jobs. In most cases, however, such demands are likely to be counterproductive, precisely with respect to these objectives.

(a) *Direct intervention in the allocation of capital*

Direct interventions in the allocation of capital, in particular, are associated with major problems. In market economy systems they involve,

⁹ In *Centesimus annus* the significance of a stable currency for a smoothly functioning market economy system has been emphasised for the first time in a papal encyclical (item 48). Monetary stability is, moreover, of particular importance with a view to achieving the postulate of social justice.

for example, granting more favorable credit terms for certain sectors or giving direct state subsidies. Measures aimed at preserving and shaping structural patterns pose specific problems in each case. In developed economies, in particular, capital is often allocated to economic sectors, with the aim of preserving structural patterns, which would no longer be able to survive in conditions of free competition. One argument used in favor of this is the preservation of existing jobs. However, the capital tied up in this way is at the same time not available for other more profitable projects which promote employment and growth. The justification given in such cases of safeguarding jobs and incomes within existing structures is therefore not valid in macroeconomic terms but, at best, from the point of view of specific groups. But even this is true only over a short-term perspective. Experience has shown that adjustment processes rendered necessary by the market can only be delayed but cannot be stopped altogether. For those affected, these adjustment processes are later on often more radical than they would have been if appropriate measures had been taken in time.

Within the scope of a so-called structural policy, which was widespread even in the developing countries for a time, public means are used to selectively allocate capital to such sectors which are regarded as key industries with a promising future. The intention is mostly to achieve a strengthening of the long-term growth trend, with corresponding employment effects. However, the advocates of an active shaping of economic trends by political planners mostly neglect their cognitive restrictions. An appropriate investment steering strategy by policy makers presupposes that state agencies have a better knowledge about future market-dependent supply and demand patterns. This is not very plausible, however, and contradicts most experience based on the supposedly superior information in this respect of state bureaucracies compared with potential private investors. In addition, the risks of incorrect planning, which would otherwise be distributed among many investors, are concentrated in the case of a public investment agency. To this extent, such state intervention in the allocation of capital often involves the danger of incorrect decisions, a waste of resources, less growth and higher unemployment. The allocation of capital should therefore be left to market forces as far as possible.

(b) Indirect intervention in the capital market

Apart from such direct interventions in the market mechanism geared to structural policy, indirect economic policy measures to stimulate business activity and employment likewise often start with the financial markets. By way of illustration, I would like to consider briefly the example of an anti-cyclical, interest-rate-oriented monetary policy over a business cycle. Such a

policy tries to influence relevant market interest rates in such a way that overall demand and thus also output and employment move in the desired direction. Most experience shows, however, that such a monetary policy strategy has substantial weaknesses. In particular, our knowledge to date about the economic transmission mechanisms of monetary policy interventions (for instance, changes in central bank interest rates) does not suffice by far to fine-tune business activity successfully over the long term. Economic policy stimuli often make themselves felt only with long and, moreover, variable time-lags, which involves the danger of wrong timing and thus of a destabilisation of economic developments.¹⁰ In addition, the theory of rational expectations rightly emphasized that, depending on their experience, economic agents adjust their behavior in response to economic policy strategies and try to anticipate future economic policy measures.¹¹

A monetary policy geared primarily to cyclical policy will therefore often generate at best short-term growth and employment effects, as experience has shown. Over the medium and longer term it mostly results merely in more inflation, however, with its negative impact on macroeconomic allocation and distribution, to say nothing of the injustices it involves. There is much to be said for trusting, in principle, in the self-regulatory forces of the market and for conducting economic policy in such a way that it does not itself trigger real economic fluctuations. In most cases it has proved to be more efficient in respect of the goal of achieving a high level of employment to pursue steady monetary and fiscal policies, i.e. to gear them to the long-term growth trend.

III. EMPIRICAL FINDINGS

1. *Trends in the financial markets*

Above all, in the past two decades, a profound structural change has occurred in the national and international financial markets which has been characterized by the emergence of new financial instruments, financing techniques and market segments, an increasing interlinking of the national financial markets with one another and with the international financial markets and by an associated internationalization of the financial services business.

¹⁰ See Milton Friedmann, "The Role of Monetary Policy", *American Economic Review*, Vol. 58 (1968), p. 16.

¹¹ See, for instance, Thomas J. Sargent and Neil Wallace, "Rational Expectations and the Theory of Economic Policy", *Journal of Monetary Theory*, Vol. 2 (1976), pp. 169-183.

(a) *Increasing internationalization*

These upheavals were fostered mainly by changes in the macro-economic and institutional underlying conditions. By the beginning of the seventies, the destabilising effects which different national economic policies of the industrial countries were having on international capital transactions could no longer be coped with even by capital controls; the result was the collapse of the post-war monetary system of Bretton Woods in 1973 and the transition to flexible exchange rates, accompanied by a dismantling of capital controls.

An important impetus for the internationalization of the markets was the emergence of financial requirements which could no longer be met from domestic financial sources and of surplus savings which could not be accommodated in the national markets. There was a first "wave" of such disequilibria following the sharp oil price rises in 1973-4 and 1979-80. Some of the countries relying on crude oil imports were forced to raise loans abroad, whereas the oil exporters were looking for investment opportunities world-wide for their massive revenues. In addition, many developing countries tried to accelerate their economic development through progressive capital imports and a sharp increase in their foreign indebtedness. The restrictions on international capital movements, which still existed in many cases at the time, moreover, fostered the development of financial markets for certain currencies outside their respective currency areas. A second "wave" of external financing needs occurred from the middle of the eighties when many countries (particularly many industrial countries) strongly expanded their already high indebtedness by virtue of sustained deficits of the public sector or the social security system. The frequently needed financing of the public sector deficits through capital imports strengthened the international integration of the national financial markets, notably the securities markets.

The strong momentum in the financial markets would not have been conceivable, however, without the rapid progress in data processing, communication and payment system technologies and without the deregulation of the financial markets in many industrial countries and the liberalization of the international exchange of financial services. The dismantling of administrative restrictions of pricing and business opportunities in the financial services sector, as well as the abolition of capital controls and of restrictions of the right of establishment extended the legal scope of financial market participants. Technological progress created unprecedented options for action. It facilitated the development of extremely complex new financial instruments, reduced the transaction costs of portfolio restructu-

ring and ensured real-time access to the same information world-wide. The search for profitable investment and favorable borrowing terms — supported by communication technologies — is today conducted on a global basis.

*(b) Innovative financial instruments*¹²

The structural change in the financial markets is mirrored in innovative instruments just as in the growing significance of new market players. Innovative financial instruments open up new investment and financing alternatives, provide additional options for the transformation and reallocation of risks and for liquidity provision at low cost. The upheavals in the securities markets are particularly notable. In some countries, especially in the United States and the United Kingdom, there have already been marked shifts away from the traditional bank loan towards securitised financing. The rise in fundability and liquidity of assets associated with securitisation has contributed greatly to the strong turnover growth in the financial markets.

The growing use of derivatives is likewise a reflection of the high innovation potential in the financial markets. These are financial instruments whose value is derived from the market price or a corresponding index of an original underlying instrument. Their common denominator is a future-oriented contractual element. The central economic function of derivative instruments consists in the low-cost and flexible design of individual risk positions. In contrast to traditional risk transfer operations, derivatives make possible the protection against risks or the selective assumption of risks at a comparatively low input because the underlying instrument itself need not be transferred. Through the use of derivatives, the features of existing financial instruments can, moreover, be changed in such a way that new assets emerge which were not available before.

(c) Institutionalization of saving

As to the market players, the trend towards the institutionalization of saving is particularly evident. Institutional investors, such as investment funds, pension funds and insurance enterprises, are playing an ever-increasing role in attracting and investing monetary capital. Third-party

¹² See also Bank for International Settlements, *Recent Innovations in International Banking*, Basel 1986, and Bank for International Settlements, *Macroeconomic and Monetary Policy Issues Raised by the Growth of Derivatives Markets*, Basel November 1994.

management of assets has become an important industry. The fierce competition for the management of investible funds has led to a professionalisation of fund managers and of the methods they use. Together with this development there has been a tendency towards a reorientation of investment behavior. The traditional practice of buy-and-hold finance, under which securities once purchased are held until their final maturity, has given way to transaction-driven finance as portfolio management is geared more and more to short-term results. This is a further cause of the dramatic rise in trading in the financial markets, which today are partly detached from real economic processes.

2. Influence of financial market trends on the real economy

(a) Positive effects

At first sight it may appear that the aforementioned structural change in the financial markets has created a highly complex financial world which, largely detached from the real economy and in a way which is not very productive for the national product, is preoccupied with making more money from much money and whose development, at best, has only a marginal bearing on the subject of "labor and employment". This impression is misleading, however. The dismantling of previous restrictions and the resulting globalization and professionalisation have increased the intensity of competition in the financial markets. Thanks partly to the development of innovative financial instruments and financing techniques and to the saving of transaction and information costs as a result of the progress made in communication technology, the capacity of the financial system to perform its intermediation services has been further improved. This tendency towards more complete and more efficient markets ultimately benefits the suppliers of and demanders for capital, whose specific requirements regarding the shaping of payment flows and risk provision can now be met better than before. The basically positive influence of a greater efficiency of the financial markets on the real economy has already been mentioned (see section 11.2).

Using the example of derivatives, I would now like to briefly explain how certain trends in the financial markets may have direct positive effects on the real economy. As mentioned, derivatives make possible a low-cost design of the risk profile according to individual preferences; more than before, the individual market player has to decide which risks he assumes himself and which risks he transfers against payment to a third party. Previously existing microeconomic restrictions on the ability to act are

thereby reduced. An entrepreneur can separate the business policy risks of an investment from its financing risks and, moreover, design his financing terms more favorably. In macroeconomic terms, this improves the underlying conditions for investment decisions and for a steadying of capital formation. As a result, overall output might expand at a higher and steadier level. I have already said that this is associated with an increase in employment and possibly in remuneration, too.

(b) *Risks*

Besides these positive effects of structural change in the financial markets, the negative side of this development must be considered as well. The first thing which comes to mind in this context is the greater short-term volatility of financial market prices, at least in some periods.¹³ Basically the greater liquidity of individual markets and their closer links should contribute to a better absorption of shocks. It appears, however, that this was at times overlapped by other factors which contributed to making the markets more susceptible to changes in sentiment. As portfolio management is geared to performance over the short term, events which are of short-term relevance and short-run expectations are playing an ever-greater role. The real-time access to information, moreover, involves the danger of cumulative misassessments. The growing spread of computer-assisted trading, furthermore, leads to reflex-like action if data are entered "unchecked" and without careful interpretation. All this fosters the markets' propensity to more vehement reactions than before and leads to price movements which are "useless" in macroeconomic terms or even reduce efficiency.

A further concomitant of financial market trends which can be observed mainly in the Anglo-Saxon countries is the growing use of financial contracts with short maturities or money-market-related interest rates. Given such increasing short-termism, the uncertainties of planning are growing — as noted — and this tends to have a negative effect on growth and employment because investment projects which would be profitable over the long term are not realized and because hedging costs are higher.

In addition, some observers have detected a greater susceptibility to crises and an increased fragility of the financial system as a result of innovations in the financial markets. The focus of interest is once again the increasingly widespread use of derivatives. A consensus has not yet been reached on this question. The complexity and the resulting opaqueness of

¹³ For the effects of the greater exchange rate volatility on the labour market see also section 111.4.b.

these instruments for most people should not lead us, however, to assume that the attendant risks are automatically uncontrollable. A differentiated analysis is needed in this respect. What is important with regard to the risk of the emergence of financial market crises on a scale which jeopardizes the entire financial system is the capability of individual market players to bear the risks they have assumed without negative external effects. A key consideration in this context is that business in derivatives in some sectors is concentrated on a relatively small number of market participants worldwide. This involves the danger of knock-on effects if just one single important market participant defaults. Although derivatives as such are not the cause of a potential systemic crisis, the risk concentration on a few market participants is a latent danger for the stability of the system. This must not be underrated, because individual risk positions can fluctuate sharply in response to market developments in a way which is difficult to predict and impossible for outsiders to identify and which may soon erode existing capital reserves.

(c) *Interim balance*

To point to possible risks of certain developments does not mean, however, to reject the latter. In the upshot, the positive effects of recent trends in the financial markets are likely to be more important than the dangers they involve. This applies all the more as neither the participants in the financial markets nor economic policy agents are utterly exposed to events without any protection. There are possibilities of limiting or counter-acting potential dangers.

The experience of the last few decades has shown that a policy of an early and steady reduction in administrative restrictions, and one which integrates or subordinates any special individual interests of the financial services sector to macroeconomic interests, contributes to a steady development of the financial markets which is free from major distortions. On the other hand, a late and abrupt policy of liberalization, which is partly forced on policy makers by the circumvention of existing regulations, has led to surge-like changes in the financial systems of some countries. In such circumstances, market participants have no time to adjust to the changed scenario in a continuous learning process. An — at least partly — resulting slippage of several market participants was probably to blame to some extent for the crises of the recent past. These developments were, moreover, in most cases, supported, or even made possible at all, by a monetary policy which was overly lax at times. For example, such a financial market climate fostered the emergence of the bubble economy in some countries during

the second half of the eighties. The subsequent bursting of the price bubble resulted in rather high real economic costs. This should not be ascribed to recent developments in the financial markets themselves, however, but to the mistakes of the policy makers concerned and to the macroeconomic environment. The increasing short-termism evident in many countries can likewise be attributed, at least partly, to an inflationary environment over an extended period of time.

For the future it is important to curb the risks emanating from new financial instruments. The market players themselves bear special responsibility for financial market developments. Dealing with the new instruments appropriately places high demands on all market participants. Thorough training of staff members and a risk-conscious behavior on the part of management are major preconditions for averting future damage. A crucial condition for responsible action by market participants is, furthermore, the improvement of the transparency of off-balance-sheet transactions, particularly in the case of derivative instruments. In addition, general government regulations may be meaningful and necessary to protect third parties against possibly severe negative consequences. This is, above all, the task of an internationally harmonized system of financial market supervision, and this, in particular, is the aim of the efforts being made by the central banks of the major industrial countries in the context of their Basel cooperation.¹⁴

A return to the supposedly tranquil world of administrative restrictions and national protectionism is neither technically possible nor politically desirable. If we succeed in safeguarding the stability of the financial markets with the aid of general regulations in keeping with market conditions, they will make an important contribution to growth and employment. This may not be very obvious to some people. However, both theory and past experience prove clearly that the underlying conditions with which market players in the goods and factor markets are faced are of crucial importance for the trend in the real economy. The financial system is only part of this set of data; if it does not function, however, this inevitably spreads to the goods markets and indirectly to the labor markets. Financial markets which are as complete and perfect as possible are therefore a necessary prerequisite for the smooth functioning of the real economic sector. They are not a sufficient condition, however.

Economic and political mistakes may even be "penalized" all the more

¹⁴ See, for instance, Public Disclosure of the Trading and Derivatives Activities of Banks and Securities Firms, Joint Report by the Basle Committee on Banking Supervision and the Technical Committee of the International Organization of Securities Commissions, Basel November 1995.

harshly the more efficient the world-wide allocation of capital is. Enterprises respond to an adverse locational quality in their own country by increasing their direct investment abroad; investors demand compensation for monetary policy, fiscal policy or structural shortcomings in the issuer's country in the form of higher risk premiums and therefore higher nominal interest rates. As a rule, however, such reactions are likely to provide stimuli for adjustment; the result is that over the long term, the positive effects of functioning financial markets will prevail here, too. To this extent, the financial markets today exercise some control over the quality of economic behavior and policies of individual countries.

In addition, the change in the financial markets has direct effects on employment. Following the new opportunities brought about by liberalization and technical progress, particularly in the field of data transmission and processing, the macroeconomic significance of the financial sector has so far increased perceptibly in all major economies. Banks, investment companies and other financial intermediaries as well as the stock exchanges are important employers today.¹⁵ Other sectors, too, are being positively influenced indirectly, be it the construction industry, the catering trade or other areas. Recently, however, there have also been signs of some structural changes which might reduce the direct positive effects which financial market developments have had on employment to date. The advance of telephone banking, computer banking and electronic money might cut the number of employees in the banking sector during the next few years.

3. Special features and trends on the labor market

On the face of it, trends on most labor markets stand in marked contrast to the internationalization of the financial markets. There are only a few free international markets for labor. The geographical mobility of labor has increased appreciably compared with the past, and differs distinctly from country to country, but it remains relatively small. Scientific and technical specialists, show business stars and top athletes are exceptions which, although very much in the limelight, are ultimately not typical. A more important factor are the movements of refugees and asylum-seekers, which are quite often motivated, inter alia, by employment and income considerations.

The clear limitation of the regional expansion of the labor markets

¹⁵ In Germany, for example, the share of persons employed with the banks alone has more than doubled since 1960 (from 1% to 2.5% of the total labour force).

compared with the financial markets, a limitation which is particularly pronounced in Europe owing to historical, linguistic and cultural differences, can be explained mainly by the integration of people into their social environment; this integration does not play a role in the case of real means of production. Falling transportation costs, for example, have led to greater geographical integration of the labor markets and a previously unknown separation of place of residence and place of work; by contrast, commuters or migrants without a fixed abode are gaining in significance but are still rather rare.

On the other hand, the geographical mobility of capital is frequently overrated. The appearance of highly organized international markets for financial capital often conceals the fact that real capital, which has more in common with human labor, is often tied to a certain location. The decision in favor of a production centre constitutes an investment, just as does the decision in favor of a place of residence or work; the costs of that investment are often tied up over the long term and can be recovered only by generating output and income at that centre. Of course, this does not apply to the same extent to investment in capacity extensions and rationalization measures.

Whereas the regulation of national and international financial markets is much more efficient today in many major countries than it was as recently as the sixties, and whereas reforms have not only accompanied, but in some cases even paved the way for, technical and organizational progress, there are no similar developments discernible particularly on the labor markets of western Europe, where the regulations are both far more numerous and stricter. Some statutory underlying regulations are undoubtedly necessary to ensure a balance between employee and employer interests; however, the question arises of whether the framework which emerged over the years, *inter alia*, in industrial and corporate constitutional law, in labor and labor protection legislation and, above all, in collective bargaining law between employer and employee organizations has not become so narrow that it unduly restricts the labor market.¹⁶ Much the same applies to real capital as well, however. Investment is frequently subject to time-consuming authorization procedures which jeopardize the utilization of market opportunities.

The difference between labor and capital seems to be more significant in another respect, however. The problem of an underemployment of capital over extended periods does not exist. Faced with the alternative of

¹⁶ An analysis of labour market trends in western Europe is given in the annex.

low pay or no pay, capital owners regularly decide in favor of low pay, whereas employees and their organizations quite often opt for no pay, that is, for unemployment cushioned by government or social security assistance.

4. The internationalization of financial and goods markets and the problem of underemployment

(a) International trade and employment

The rise in underemployment in western Europe since the middle of the seventies has taken place in a period of increasing internationalization of the financial and goods markets; as a result, some observers concluded that underemployment was also a consequence of internationalization. In part this is quite justified, although unemployment in most cases arose only because the structural adjustments associated with the progressive international division of labor clashed with the supposed vested rights and immobilities of those affected. However, in general, productivity growth in the major industrial countries likewise abated during the same period. The reconstruction and catching-up process after the end of the Second World War, which was accompanied by rapidly rising incomes and thus a relaxation of the distribution conflicts, had come to an end. As wage trends in the west European industrial countries adjusted to the narrower scope for distribution only with a time-lag of several years, unemployment increased sharply in the interim.

Whether the growing internationalization of the markets ultimately promotes or hampers the employment trend depends on the capability and willingness of an economy to adjust and on the prevailing economic and social system.¹⁷ On the one hand, with the interpenetration of economies, competition from imports increases and crowds out less competitive enterprises and industries while, on the other, the best enterprises and industries of a country and the persons employed in them benefit from the additional sales opportunities. The capability to adjust therefore becomes a key variable for the future trend in employment and prosperity. It is not only more flexibility and differentiation in the field of wages which is called for, the willingness and capability of employees to move geographically and adapt professionally is likewise of crucial importance.

The growing international integration of the markets promises greater stability. Regional disturbances have a lesser effect on the international

¹⁷ See the World Bank, World Development Report 1995: Workers in an Integrating World, Oxford et al. 1995, Part II: Is International Integration an Opportunity or a Threat to Workers?

markets and are scarcely felt by individuals. The problem of famine, for example, to the extent that it originated in local crop failures, has largely been overcome owing to the world-wide integration of the agricultural markets. Similarly, local sales crises do not immediately jeopardize jobs if production surpluses can be sold abroad; and if the propensity to invest declines, savings can be invested in other countries without curbing business activity in the form of shortfalls in demand.

(b) International mobility of capital, exchange rates and employment

The potentially positive effects of the increasing international integration of national goods markets crucially depend on adequate stability and calculability of exchange rates. The foreign exchange market, as an important segment of the international financial markets, is therefore attracting greater attention. Over the longer term, changes in exchange rates should largely balance differences in inflation, in particular. Empirical experience shows, however, that exchange rate movements over the short term and quite often over the medium term as well, clearly exceed the balancing of differences in inflation. The fact that, in a world with huge amounts of highly mobile capital, the external value of a currency is largely determined over the short term by the investment decisions of internationally operating professional financial market players is of crucial importance in this respect. The foreign exchange flows arising from the international exchange of goods and services, by contrast, have comparatively little influence on exchange rate formation over the shorter and medium term.

Owing to their inter temporal character, investment operations in the financial markets are greatly determined by expectations. Today, as already mentioned, expectations are formed rationally, i.e., using all available information. This information includes not only economic fundamentals but also separate assessments of future market trends and of a country's political prospects. Resulting sustained and distinct deviations from purchasing power parity may have a lasting effect on the profitability of existing production plant and jobs. Changes in sentiment in the financial markets triggered by expectations may, moreover, cause sharp short-term exchange rate fluctuations. The associated greater uncertainty hampers the international exchange of goods and services.

Although — as a result of innovations in the financial markets — exchange rate risks can be limited by means of instruments such as futures contracts and options, additional costs arise. Hedging against longer-term exchange rate movements is often not available, with the result that the

risks remain with the enterprises. This jeopardizes investment in export sectors, which are often particularly productive, with corresponding consequences for employment. This applies especially to countries whose currencies have appreciated excessively. Depreciating countries, by contrast, often get a worse rating in the foreign exchange markets in the ensuing period as well and therefore have to pay additional risk premiums on interest rates; as a result, capital investment and the servicing of public debt become costlier, with corresponding consequences for growth and employment.

In the light of this experience, it seems at first sight understandable that some critics wish to throw a spanner in the works of the international financial markets in order to counter short and medium-term fluctuations of exchange rates (and interest rates).¹⁸ When making such proposals, however, their proponents often forget that the welfare gains of free trade in goods can be enjoyed only under the condition of free payment flows, which inevitably include free capital movements. Attempts to separate cross-border payments for goods and services from those for capital transactions have proved not very successful, at least until now. Under the present and future technical and organizational conditions, financial flows can no longer be controlled or separated according to their link to real economic processes.

Under the present conditions the attempt to fix exchange rates administratively is likewise possible to a limited extent only. Such a fixing presupposes lasting harmony of underlying national developments and policies or the subordination of fundamental aspects of national policies to supranational determination. However, only very few countries are willing and able to surrender their national sovereignty in this way. Experience in western Europe of the European Monetary System has shown how difficult it is to achieve such an integration and subordination over the long term. It remains to be seen whether and to what extent the planned European monetary union will lead to more sustained exchange rate stability in Europe. The selection of participating countries¹⁹ and, in addition, their willingness to form a lasting political community of solidarity will be crucial for its success.

The recipe for correcting "wrong" exchange rates and for stabilizing the exchange rate system is often seen world-wide as the increased international cooperation of national policy makers. Experience of the Plaza and

¹⁸ See, for example, James Tobin, "A Proposal for International Monetary Reform", *The Eastern Economic Journal*, Vol. 4 (1978), pp. 153-159, and Rudiger Dornbusch, "Exchange Rate Economics: 1986", *The Economic Journal*, Vol. 97 (1987), pp. 1-18.

¹⁹ These participants must meet the criteria of an optimal currency zone.

Louvre Agreements in the eighties shows, however, that international cooperation can only be successful if it is accompanied by credible measures to correct misalignments in the participating economies. Concerted interventions in the form of foreign exchange purchases and sales by the central banks may set signals for the initiation of a process of adjustment of exchange rate patterns, but they are no substitutes for eliminating the economic misalignments in the participating countries. Lastingly successful international cooperation also presupposes that the participating countries recognize that the adjustment measures to be adopted in the national sphere are ultimately in their own interests. An exchange rate policy actively geared to the depreciation of the national currency, which aims at increasing employment by improving the international competitiveness of the domestic export sector, is ultimately counterproductive because any exchange-rate-related competitive advantages are canceled out by a higher domestic price level.

(c) The significance of the mobility of capital and labor

With the mobility of capital, the costs for employment of an inappropriate wage policy increase. While even in a closed economy an aggressive wage policy does have consequences, these are aggravated if capital owners find better investment opportunities abroad. This is especially dangerous as, owing to the long-term nature of locational decisions, production centres that are relocated abroad do not necessarily return even if wage policy is corrected later on.

Following the dismantling of numerous external barriers and the economic policy reforms in many countries, these have become more attractive to investors from highly developed industrial countries. The world-wide gain in freedom should increase prosperity as a whole; however, it may prove — temporarily — to be a disadvantage for employees in the western industrial countries because east European centres, for example, now compete for scarce capital with those in western Europe. Accordingly, the standard of living in the countries in transition may rise more rapidly than would be the case if they could resort only to domestic savings. Such capital-reducing effects may, however, for a time necessitate a stagnation or perhaps even a reduction in real wages in the high wage countries of western Europe if increasing underemployment there is to be countered.

With the opening-up of the markets, a further step forward was taken in western Europe. The basic freedoms of the European single market include the free movement of employees and the freedom of establishment for self-employed persons as well as the freedom of payments (and thus of

the financial markets). Basically, this also meets the preconditions for a single European labor market, which in this way could keep pace with the internationalization of the financial markets.

One consequence of the freedom of migration, however, is a tendency towards price adjustment, although this is occurring extremely slowly compared with the financial markets. Since the open labor market is now tending to move in the direction of equalizing wages, insiders who have been protected by the domestic wage bargaining cartel have recently started resisting foreign outsiders and requesting government intervention to restrict competition. In Germany, for example, a special statute is to declare that domestic pay rates in the construction sector are minimum wages in order to ward off competition from foreign construction workers and so prevent social dumping.²⁰ This would enable management and labor to prevent foreign competition through setting sufficiently high wage levels. Such an intervention would undoubtedly impair the internal market.

IV. CONCLUSIONS

If the ability of a market to function is measured — as is customary in economics — by its capability to allocate efficiently the goods traded on it, the financial markets, on the one hand, and the labor markets, on the other, should be given different marks. If the financial markets — despite some exaggerations — are said to be making a positive overall contribution and the labor markets (at least that of western Germany, see annex) to be showing distinct shortcomings in their functioning, this may seem a generalization, but it nevertheless gets to the core of the matter. This is not so much due to a basic difference between “capital” and “labor”, even though the differences should not be underrated. Instead, it is, above all, the partly divergent approaches of capital market policy, on the one hand, and labor market policy, on the other, which have contributed much to the differing performance of the markets. Most national labor markets are far removed from the deregulation progress in the financial markets. This is the point to start — taking account, of course, of the longer-term social effects; otherwise “unemployment” might remain the key issue during the coming decade, too.

²⁰ See Luder Gerken et al., *Der Entwurf eines Arbeitnehmer-EntsendeGesetzes in ökonomischer und rechtlicher Sicht* (Bill Preventing Wage-dumping especially in the Construction Industry from an economic and legal point of view), *Der Betriebs-Berater*, Vol. 50 (1995), pp. 2370-2375.

In a world in which, thanks to the progressive mobility of knowledge, capital and labor, there are hardly any unassailable locational advantages any more — apart from favorable climatic conditions — the basic setting shaped by people and policy makers is becoming more and more important. In the first place, legal certainty and the acceptance of peaceful competition are to be cited as the predominant features for all markets. This by no means implies that we are necessarily moving towards a world which is controlled exclusively by market relations and in which there is no room for social protection and inter-human help.

On the contrary, a smoothly functioning social system which is not in contradiction to economic laws but makes use of them is a positive locational factor in international competition. Neither social unrest nor a confiscatory burden of taxes and levies and restrictive regulations are a recommendation for a location. Not least for that reason it is important for the developed countries to overcome their underemployment problems by initiating suitable reforms, particularly as in the long run an increasing proportion of the population cannot be financed by those in employment without the burden of taxes and levies rising to an intolerable level.²¹ Cuts in the social security network which are made too late and are then necessarily abrupt may cause unrest because they scarcely improve employment prospects in the short term and that unrest, in turn, may hamper the social and economic recovery.

As mentioned, the international financial markets are increasingly assuming the function of a guardian of national policies. After the opening up of the markets, capital can more easily flow out of those countries in which earning opportunities are comparatively poor. This increases the pressure on policy makers to improve locational conditions. One may regret that pressure; it is, however, inevitable because it is a consequence of the unavoidable opening of the borders and the internationalization and globalization of the financial markets. Ultimately, this trend should ensure that economic mistakes in monetary, fiscal and labor market policies are increasingly banished.²² For countries in transition it is often particularly painful, but useful for disciplining policy makers, that — judging by all past

²¹ Nearly all industrial countries are anyway facing a difficult adjustment challenge with respect to their current old-age and health insurance systems, a challenge which results from the change in the age pyramid and increasing life expectancy.

²² In the short term, this need not be true so strictly because the adverse macroeconomic effects of public borrowing — especially in the form of rising interest rates — may be smaller if access to open and flexible international capital markets is ensured. The “penalisation” by the international financial markets mostly starts only when debt has reached a high level.

experience — financial markets have a long memory. Borrowers in countries which had a mistaken policy in the past often have to pay high risk premiums even if there has been a fundamental change in economic policy there in the meantime. In the assessments of financial markets the credibility of policies in the countries concerned plays an increasing role.

Owing to the sensitivity of the financial markets and their significance for growth and employment in the individual countries, the willingness to seek better international economic policy coordination has increased with the progressive integration of the world economy. This does not mean growing regulation at the international level but rather coordinated deregulation and more free trade, although the transition is taking place increasingly in blocks, so that some residual discrimination against outsiders remains. Internationally coordinated measures beyond this are doomed to fail — this at least is the experience of the past — unless they are accompanied by confidence-building reforms in the participating countries themselves.

The international availability of knowledge and the mobility of capital of themselves exert pressure for an adjustment of pay rates beyond the measure associated with free trade in goods. In the recent past, migration pressure on the rich countries has been added.²³ Many people think that this immigration jeopardizes these countries' prosperity and social stability. Mainly for that reason west European countries are at present not prepared to grant a general freedom of establishment analogous to the prevailing freedom of capital transactions, at least not for countries from which people would like to emigrate owing to the prevailing social and political conditions. To this extent, too, there seem to be limits to the parallels between trends in the financial and labor markets for, as a rule, fleeing capital is gladly accepted — in contrast to labor. However, since the fall of the Iron Curtain, the countries of western Europe have increasingly been repeating the experience of the United States that complete insulation against migration is a hopeless goal as long as the prosperity differential relative to the neighboring countries has not leveled off. In the long run, western Europe will have no alternative to making its labor markets more absorptive, on the one hand, and to supporting prosperity-increasing reforms in its neighboring countries, on the other.

Little would be gained, however, if the opening-up of the markets were linked to the prior condition of the international harmonization of social

²³ See Richard Layard et al., *East-West Migration: The Alternatives*, Cambridge, Ma./London 1992 and Klaus F. Zimmermann, "Tackling the European Migration Problem", *Journal of Economic Perspectives*, Vol. 9 (1995), No. 2, pp. 45-62.

policy, as is often called for. For the convergence of social policy advocated in this context does not aim at a better orientation to economic laws but at a harmonization at the level of those countries of western Europe which are rather unwilling to undertake reforms. Such a "social" component of internationalization would ultimately amount to forcing the poorer countries to adopt the social standards of western Europe which are often not very efficient; the consequence would be rising unemployment in these countries, too, and thus a growing pressure of migration to western Europe.²⁴ Instead, we should look for ways and means of shaping not only the regulation of the financial markets but also the labor market system and social policy in line with the challenges of our times.

²⁴ See Roland Vaubel, *Social Regulation and Market Integration: A Critique and Public Choice Analysis of the Social Chapter*, *Aussenwirtschaft*, Vol. 50, 1995, pp. 111-132.

ANNEX

Labor market trends in western Europe and some dominant causes of underemployment.

1. *Entrenched underemployment: the phenomenon of jobless or even job-killing growth*

In the past 20 years unemployment in western Europe has increased sharply, mainly in the member countries of the European Union. Underemployment is becoming less and less of a cyclical problem, which disappears more or less automatically once economic activity recovers, and is becoming more and more structurally entrenched.²⁵ One indication of this is the hard core of unemployed persons, which since the middle of the seventies has reached an ever-higher level at the start of each new economic recession and which suggests a growing global shortage of jobs; another indication is the high share of long-term unemployed, who include many older employees with simple qualifications, physical handicaps or other occupational disadvantages. Especially in some countries, it is becoming increasingly difficult for school and college leavers to find a job, with the result that this group of persons accounts for a large and growing share of the unemployed.

The increase in underemployment is taking place against the background of a growing labor supply for which a sufficient number of jobs is not available; either the level of employment changed very little over the economic cycles which is true for most European countries — or the increase in employment opportunities did not keep pace with the inflow of job-seekers, as in western Germany, where on balance as many as approximately 2 1/2 million new jobs have been created since the beginning of the eighties. The number of new jobs may seem impressive but it is dwarfed by the successes achieved in the United States.²⁶ During the same period

²⁵ For details see: *The OECD Jobs Study: Evidence and Explanations*, Part 1: Labour Market Trends and Underlying Forces of Change, Paris 1994.

²⁶ See: Ronald Schettikat, "The Macroperspective of the German Labor Market: A Comparison to the U.S. Labor Market", WZB Discussion Paper FSI, pp. 94-301, and *The OECD Jobs Study: Facts, Analysis, Strategy*, Paris 1994.

roughly 25 million additional jobs were created in the United States and — contrary to many claims — they are by no means confined to poorly paid services. However, real wages and salaries have hardly risen on average whereas their spread has become larger. But the trend in employment was on the whole much more favorable for job-seekers, and the unemployment rate did not reach anything like the European average. Moreover, the duration of unemployment is much shorter than in western Europe, where so-called long-term unemployment has become a particularly severe problem.

In the case of the long-term unemployed the consequences of underemployment are most evident. Apart from material losses, those affected often experience a loss of knowledge and work discipline which makes later reintegration into the work-force more difficult. In a society oriented towards employment, moreover, unemployment threatens to undermine the individual's sense of purpose; the feeling of no longer being needed is often followed after a time by an erosion of self-esteem. The result may be social demoralization which affects whole families and impairs the opportunities of their children. Long-term unemployment thus contains the seeds of future underemployment.

Since in the conception of a modern welfare society the unemployed, too, should participate in social life, wage substitutes are paid without a time limit in a number of countries, and some of these wage substitutes come very close to the wage level for comparable employment and often exceed the subsistence level.²⁷ The material incentive to look for a new job or to greater mobility is often very small in these cases.²⁸ For the employed the unemployment of others is, moreover, reflected in a higher burden of taxes and levies or in an increase of the cost of their labor unless the burden is passed on to future generations through public sector borrowing.

Underemployment, to the extent that it exceeds normal frictional unemployment associated with economic change, is on the whole undoubtedly detrimental both to the individual and society as a whole. But the big question is how it can be avoided. Here the dispute begins. Economists, when they analyze the basic features of underemployment with a dispassionate mind — but, more often than one thinks, with heated emotion — are often accused of equating the market for labor with that for goods. The application of tested methods of economic analysis to employment conditions may be repugnant to some people. But it is not the economic laws but unemployment that violates the dignity of the individual.

²⁷ See: *The OECD Jobs Study: Evidence and Explanations, Part II: The Adjustment Potential of the Labour Market*, Paris 1994, Chapter 8.

²⁸ See: Jennifer Hunt, "The Effect of Unemployment Compensation on Unemployment Duration in Germany", *Journal of Labour Economics*, Vol. 13 (1985), pp. 88-120.

2. Wrong explanation of unemployment and problematic attempt at a therapy

In spite of the varying experiences, one "explanation" of unemployment is exceptionally popular in western Europe: the old thesis, in ever-new forms, according to which the volume of work is limited and does not match the labor supply — which is said to be too great (lump of labor fallacy). Accordingly, most proposals for a therapy aim at a more "equitable" distribution of the existing work. Often a redistribution of employment by limiting overtime and by shortening working hours is suggested. Early retirement and longer periods for young people at training institutions are sometimes praised as a means to "relieve" the labor market.

Most west European countries have advanced a good deal down this road²⁹ without the problem of underemployment having been alleviated as a result. On the contrary, it has been exacerbated in almost all west European countries. Instead of reviewing this whole approach, however, many proponents of this thesis — who in Germany include many advocates in ecclesiastical circles — conclude from past experience that we have not advanced far enough along the path towards redistributing work.

Even though the various measures to reduce working hours have contributed little to overcoming the employment crisis — and indeed have even intensified it in some cases owing to the associated cost rises — they have meanwhile affected the sense of values of part of the population. Diligence is now sometimes regarded as an "unsocial" virtue. For example, those working overtime are often suspected of taking jobs from others. This is most evident in the changed attitude to early retirement. Whereas it tended to be feared in the past, it is now regarded as a vested social right by many people. In fact, the considerable costs of premature retirement burden the public budgets to a dangerous degree over the long term. In addition to ever-earlier retirement from the work-force, life expectancy is rising continuously, whereas working life is being shortened by longer training periods in many instances. In the long run, this might lead to a conflict between the generations, particularly as the demographic trend in the industrial countries suggest a "deterioration" of the age pyramid anyway.

3. The problem of wages and its significance in western Europe

The thesis of a fixed quantity of work stands, however, in sharp contrast to the realization that there is really much to do in today's world.

²⁹ *The OECD Jobs Study: Evidence and Explanations, Part II: The Adjustment Potential of the Labour Market*, Paris 1994, Chapter 6.

Many things seem to be out of order which could be rectified only by more work — and not by more leisure. It is frequently countered that there is not enough money to pay for additional employment.

The fact that much useful work is not done because, despite underemployment, the employees' income claims and buyers' willingness to pay differ widely is often not clear to the individual employee since, in the modern world based on the division of labor, he usually works far away from the final product and is hardly able to attribute individual payments. Furthermore, in the west European countries it is difficult for an unemployed person to reduce his wage claims himself: in most cases pay is not negotiated individually but collectively and fixed in pay agreements.

Wage patterns, to which enterprises but also public employers adapt in their personnel planning, are typically negotiated in western Europe between representatives of the employers and the trade unions. The pay agreements covering an entire sector are, as a rule, binding for the individual employment contract. This gives rise to the classical insider-outsider problem:³⁰ since the unemployed are not represented in these negotiations, their concerns are usually taken into account only insofar as they do not clash with the interests of employees and their trade unions as they themselves see them. The result in many sectors is a labor cost level which prevents additional jobs from being offered.

But it is not only the labor cost level but also the lack of sufficient wage differentiation by qualification, industry and region which explains considerable parts of underemployment in western Europe. In many sectors the trade unions enforced disproportionate rises in the lower wage brackets with the result that first the pressure to rationalize and later underemployment were particularly high in this segment of the labor market.

4. Employment-curbing effects and fiscal consequences of social policy in western Europe.

The problem of labor cost in western Europe is often exacerbated by intermittent interventionism in the field of labor law and social policy. The starting points for this are, for example, supposedly pressing misalignments such as dismissals or the tendency towards entrenched unemployment among specific occupational groups. In such cases, measures are looked for which are to have an immediate and concrete effect. The interdependencies

³⁰ For details see: Assar Lindbeck and Dennis Snower, *The Insider-Outsider Theory of Employment and Unemployment*, Cambridge, Mass., 1988.

with other regulations and the long-term effects are frequently neglected. This is the result of a systematic shortening of the time horizon, a temptation to which many politicians succumb — not least as a result of the widespread tendency to think in electoral time spans:³¹ although it is generally obvious that full employment in the economy as a whole offers the best protection for employees against arbitrary corporate action and also reduces the fear of dismissals, direct intervention in the market is preferred because full employment cannot be achieved in the short term.

The detrimental effects of such intervention over the long term in most cases make themselves felt only later on and are rarely attributed to the measures originally taken. Often outright intervention spirals develop which are followed by others if an unsystematic attempt is made to correct the situation. In most west European countries, the social security system now resembles a patchwork structure, and hardly any regular pattern can be identified. On the one hand, intervention regularly involves an increase in labor cost as a result of the burden of taxes and levies; on the other hand, it leads to special disincentives for job-seekers and for the provision of jobs. This is illustrated by the protection of vested rights under employment contracts.

In western Europe dismissals are generally considered to be “unsocial”, irrespective of the reasons for which they are made. Labor law in most west European countries therefore includes far-reaching dismissal protection and rather costly indemnity provisions which make it difficult to terminate an employment contract today.³² With the increasing costs of dismissals, fewer employment contracts are terminated but to a disproportionate extent this also bears on recruitment because — owing to an extended dismissal protection — not more but, as a result of the associated costs, fewer jobs are profitable on the whole.³³

The effects of the far-reaching protection of existing employment go beyond this, however.³⁴ For one thing, during an upswing, when the sustainability of the additional demand for labor is difficult to assess, enterprises will try to satisfy this demand by overtime rather than new

³¹ See, in particular: Carl Christian von Weizsäcker, *Zeitpräferenz und Delegation* (Time preference and delegation), *Zeitschrift für Wirtschaftspolitik*, Vol. 43 (1994), pp. 121-139.

³² *The OECD Jobs Study: Evidence and Explanations*, Part II: The Adjustment Potential of the Labour Market, Paris 1994, Chapter 6.

³³ See: Gilles Saint-Paul, “The High Unemployment Trap”, *The Quarterly Journal of Economics*, Vol. 109 (1995), pp. 527-550.

³⁴ See: Assar Lindbeck, “The Welfare State and the Employment Problem”, *American Economic Review*, Vol. 84 (1994), Papers and Proceedings, pp. 71-75.

recruitment. For another, they will select candidates for new jobs even more carefully owing to the potential costs of dismissal. Accordingly, those who are at a disadvantage anyway have even fewer opportunities: older employees, handicapped people, candidates with a low level of formal education or unusual career histories are disregarded. The intervening welfare state then quite frequently reacts to their higher unemployment risk with the introduction of quotas, labor cost subsidies and other non-market measures.

The tendency towards entrenched unemployment is a particular burden on public authorities and social security funds. On the expenditure side, public authorities are called upon to assist the unemployed with wage substitutes. The fiscal burdens rise with increasing underemployment. The unemployed not only receive public assistance payments, they also pay no taxes or social security contributions linked to their market income. The public sector is therefore affected by unemployment on the revenue side, too.

In principle, the government has three options to counter this burden. It may either generate additional revenue through taxes and levies or borrowing or it may economize on the expenditure side. Most west European countries have continually postponed or limited cuts on the expenditure side. Only recently has there been an increasing willingness to curtail or cut expenditure. For a long time, however, in addition to credit financing, priority was given to the comparatively easy option of increasing tax and contribution rates,³⁵ although higher taxes and social security contributions have substantial detrimental side effects in macroeconomic terms. This, incidentally, applies not only to the high marginal tax rates payable on top incomes but also, above all, to the marginal social security contributions and the marginal tax burden on normal labor income which, in Germany, for example, are accumulating to rates of over 50% of gross labor cost, including employers' contributions.

High taxes and levies on labor income, however, have the effect of a tax on the division of labor and specialization.³⁶ Today it is often more worthwhile even for a highly qualified computer expert to renovate his home or repair his car himself than to work longer hours in his own special field and to utilize the advantages of the division of labor by buying outside services. This break with the division of labor and specialization, which is disastrous for future economic developments, is slowed down only by resorting to "moonlighting", which has meanwhile reached considerable

³⁵ See: *The OECD Jobs Study: Taxation, Employment and Unemployment*, Paris 1995.

³⁶ See: Assar Lindbeck, "Consequences of the Advanced Welfare State", *The World Economy*, Vol. 11 (1988), pp. 19-37.

dimensions in many countries of Europe; moreover, it causes substantial income losses on the part of the government and the social security systems and therefore necessitates higher tax and contribution rates in the "formal" sector. On the official labor market, by contrast, it is above all the demand for less qualified work which declines; as a result, the burden of taxes and levies itself becomes the cause of increasing underemployment. The rising burden of taxes and levies widens the price discrepancy vis-a-vis the "black market" and thus tends increasingly to strangle the "formal" sector.

The burden of taxes and levies, moreover, has an impact on the unemployed persons' willingness to work. They only have an incentive to resume employment if they can generate a net income which is clearly above the level of wage substitutes or social assistance. In many cases, however, the various branches of the social security and tax system are insufficiently coordinated; the result is that the resumption of employment is not worthwhile for less qualified labor. In Germany, for instance, social security benefits in some cases exceed the net labor income that can be generated. Such a level and structure of social security payments are clearly a disincentive to efforts to find a new job.

Not least owing to the increasing level and entrenchments of unemployment, the welfare state in western Europe has continuously expanded during the past few decades, so that now it has often reached or exceeded its limits. In the indispensable reform of the welfare state, the sustained improvement of the employment situation must be accorded priority. Both the unemployed and employers must be given incentives which lead to more employment. Above all, it must increasingly be ensured that income from wage substitutes is perceptibly below even low labor income. In the concrete design of the welfare state, the postulate of *iustitia socialis* must not be understood unilaterally in the sense of *iustitia distributiva*. Taking account of the *iustitia commutativa* as far as possible is indispensable, precisely for achieving a lastingly functioning and socially just economic and social order.