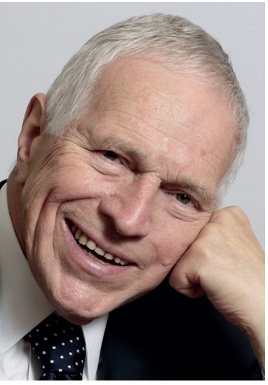

Hans-Werner Sinn and Germany's Natural Unemployment Level

Edmund Phelps*

Over my several stays in Germany I came to feel involved in the country. And I came to sense unease among some economists there, despite the impressive postwar reconstruction, over the direction that the country's political economy was taking. In a conversation around 1975, Herbert Giersch, then Head of the Kiel Institute, spoke about the costs of the corporatism emerging in the German economy and, in a conversation around 1990, Heinz König, the previous President of the ZEW Mannheim, expressed his worries about developments in corporate governance. Now responsibility to sound the warning has passed to the next generation – of which our honoree is right in the middle (and I at the senior end).

Hans-Werner Sinn, it is safe to say, has done more than any economist of his generation to raise the question of the future of Europe. On a personal note, I would add that I did not find this surprising. I first met him in 1983, I think, in Mannheim where he came to teach a course and I came to finish my introductory textbook. He struck me as both the smartest and most trenchant of the economists I had met in Germany. We met next in December 2002 at a conference of the Ifo Institute, where he was President and I was the keynote speaker. I well remember that night with him and his engaging wife Gerlinde Sinn touring the Christmas stalls in Munich's center and exchanging over dinner our thoughts about what is missing in Germany. So when I needed a partner to co-organize with me and my Center on Capitalism and Society a 2006 conference on what ails Europe, it was obvious that Professor Sinn and his Ifo Institute were the right partners.

* The 2006 Nobel Laureate in Economics, Director of the Center on Capitalism and Society at the Columbia University, and Dean of the New Huadu Business School, Zurich.

The event, held in Venice that summer, was perhaps the first large-scale meeting to confront a range of data indicating a decline of economic performance in continental Europe. And, to my knowledge, it was the first to propose that the problem was a 'dearth of dynamism', resulting in a rate of commercial innovation that pales in comparison with the rapid innovation in Continent's brilliant decades. The conference looked widely for causes of a loss of dynamism, not just at market forces such as aging, institutions such as corporate governance, and economic policies such as taxation and welfare programs. Economic culture was also studied: have the values that grew to spark the long epoch of innovation in 19th Germany and France century somehow been overcome by some other values inimical to innovation? Of course, there were not many firm conclusions reached by any of the authors, let alone a consensus among the authors. Yet this conference and the volume that came out of it, *Perspectives on the Performance of the Continental Economies*, constituted a watershed for several of the participants – Professor Sinn and I included.

In his contribution Sinn focuses on the interaction of two forces: the forces of globalization and the welfare state. His thesis is that full-time equivalent employment in German manufacturing declined by 1.21 million from 1995 to 2005. Where did they go? They "went to the welfare state, into state-financed unemployment". German readers know that this is a theme in his best seller, *Ist Deutschland noch zu retten?* yet he was shy about referring to that book at the conference or even the volume that followed. (I became aware of the book only when he sent me the book in its 2007 English edition, *Can Germany Be Saved?*)

Was he right? The truth is hard to determine. While the employment-to-population ratio for men age 15–64 fell from 79.26 percent in 1990–1994 to 76.24 percent in 2000–2004, it bounced back to 81.20 percent in 2005–2009 and even to 83.60 in 2010–2012. The truth might be that those cast out of their jobs were reeling for a while from the shock, though most continued to keep an eye out for a job, thus remaining in the labor force. But new employers gradually found round pegs for their round holes, with the result that employment recovered. The 'natural rate' lives! And the 2004 Schroeder reforms may have pushed the natural boosted employment to a level above the 1990–1994 level.

Yet the world is generally evolving. No one could have foreseen that the loss of competitiveness in southern Europe toward the end of the previous decade would give a further boost to German employment – in the short run at any rate. And no one can be sure that the long-run effect of Germany's new real exchange rate is not a rise of mark-ups, a resulting decline of domestic sales and thus ultimately a fall of employment. And no one can be sure that the Schroeder reforms will survive this new phase. So Sinn may have the last laugh.

I have learned from Sinn's thesis. We have to wonder whether the remarkable exodus of Americans from the labor force participation proves to be permanent, aided by government programs, or whether what is left of the dynamism of the American economy will be strong enough ultimately to take up all the people who left the labor force during the financial and fiscal crisis. We have to wonder whether the Greek economy will have the dynamism – meager though it is – to draw into new jobs the many people who lost their jobs during the crisis.

Science advances through the interplay of ideas from many minds.