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NOT AGAINST THE LAWS OF ECONOMICS – HANS-WERNER SINN AS A PUBLIC INTELLECTUAL

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Introduction

Hans-Werner Sinn has been a professor of economics for more than 30 years and President of the Ifo Institute for more than 15 years: under his stewardship the Ifo Institute has developed into an internationally renowned research institution. But Sinn is more than an outstanding academic and an exceptional manager of science. He is also an influential public intellectual who has shaped every major political debate over the past few decades by injecting economic arguments into it.

Kurt Tucholsky once said that: “to have an effect on other people, you must first speak to them in their language”. And Hans-Werner Sinn did exactly that. Like few other German economists, he was able to make economic arguments accessible to the public. More than a dozen books, hundreds of opinion pieces and numerous radio and television interviews are proof of this. They provide a great translation service from the often model-based arguments of the economic profession to a language that the public is able to understand. In doing so, he was sometimes polarising, often trenchant and always battlesome – but these are defining characteristics of a public intellectual. Public intellectuals argue their cases passionately. They have an attitude and not just an opinion. This is indispensable to ensure that their public statements encourage others to form their own opinions and to engage in a discourse.

For Hans-Werner Sinn, interacting with the public was never an end in itself. It is one of his firmly held convictions that no policy maker can permanently ignore what he calls the laws of economics. Because doing so would eventually turn out to be extremely costly. He is convinced that politicians are always tempted to ignore the laws of economics because taxpayers often discover the true price tag of a policy measure only years later. Hans-Werner Sinn therefore wanted to alert the public early about when policies were inconsistent with economic principles. “It is my duty to speak publicly about economic and fiscal policies and to initiate debates”, as he put it in an interview. It is this motivation which gave rise to his enormous number of public interventions.

Even if I wanted to, I could not give you the full list of topics he has covered. I will highlight just three issues that have been milestones over the last 25 years of Germany’s economic history. And they all bear some lessons for today’s economic challenges in Europe. The first stop on our journey through German economic history will be Germany’s economic unification.

Germany’s economic union: incomplete convergence

When East German companies entered into the economic, monetary and social union with West Germany in 1990, their productivity lagged far behind that of their western competitors. In their book ‘Jumpstart: The Economic Unification of Germany’, Hans-Werner Sinn and his wife, Gerlinde, pointed out that, to avoid rising unemployment in the eastern part of Germany, wages there would have to remain below those in the western part until eastern German companies had increased their capital stock, and thus labour productivity, sufficiently. But at that time, policy makers were already confronted with a strong migration movement from eastern to western Germany. Huge differences in wages between the two parts of Germany would have further accelerated this movement. So, maintaining large discrepancies in wages

was not the preferred option for most policy makers. They accepted that labour unions and employers’ associations agreed to fully adjust wages to those in western Germany in as little as five years.

The book ‘Jumpstart’ correctly predicted that it would be “completely impossible that productivity of the East German economy could increase quickly enough to make these wages compatible with full employment or at least low unemployment”. And indeed, in the first five years of economic unification, unemployment in eastern Germany rose from virtually zero to almost 17 percent. Unemployment in the western part increased only by 3 percentage points.

But to be fair, other factors may have also contributed to the increase in unemployment. One was the currency conversion. Some of you will remember the controversial debate about how to convert the East German Mark into the Deutsche Mark. In the end, wages in eastern Germany were converted one to one into the Deutsche Mark. The then President of the Bundesbank Karl-Otto Pöhl had warned – for the same reasons that Hans-Werner Sinn put forward – that this was to the disadvantage of companies in eastern Germany. However, he later acknowledged that there was hardly any alternative, as “political realities were stronger than economic logic”. The high level of unemployment in eastern Germany was cushioned by transfers from the western part. While the exact amount of these transfers is difficult to calculate, Hans-Werner Sinn once estimated that transfers paid up to the present day amount to around 1.8 trillion euros – roughly the size of the German GDP in 1991, but this number certainly comprises more than just the transfers via the social security system.

A central tenet of ‘Jumpstart’ is that it would have been much cheaper to compensate employees for accepting lower wages than to compensate the unemployed for their job losses. ‘Implement distributional objectives through transfers and not by altering factor prices’ was the economic principle that Hans-Werner Sinn saw violated in the formation of the economic union between the two Germany. And he feared that this would allow wages to remain above the market clearing level for too long. And also the distributional objectives were only partly achieved: not least because unemployment in eastern Germany is still higher than in the western part, per capita income in eastern Germany is still only 71 percent of that in western Germany.

It is this experience which explains at least partly why many German economists are sceptical about establishing a transfer union in Europe, as at the European level these problems are aggravated by the fact that the balance between control and liability would be thrown further out of kilter. Decisions would mainly be taken at the national level, while the consequences of those decisions would be spread across the entire euro area. Many proposals in terms of risk sharing and mutualising liabilities have been put forward over the last years, including Eurobonds or the establishment of a common deposit guarantee scheme, but little has been said about the necessary transfer of fiscal sovereignty. Without a transfer of national fiscal powers to the European level, such a set-up would undermine the incentives for sound and sustainable policy decisions in the member states. I will come back to this point later on.

Germany’s welfare system and the forces of globalisation

Hans-Werner Sinn’s impetus to explain to the public when policy makers try to defy basic principles of economics struck again in the early 2000s. In another round of public interventions, he warned that the German welfare state was ill-equipped to deal with the forces of globalisation. Germany’s reform of the labour market is the second stop on our journey into the past. The key economic principle at stake was again the same: distributional objectives should not be aimed at by changing factor prices.

With regard to the entry of China and India into the global markets, Hans-Werner Sinn was convinced that this would put downward pressure on the wages of the less skilled workers in Germany: trade in goods and mobility of capital creates a common labour market, and on such a labour market there can no longer be substantial differences in wages. He was rightly concerned that Germany’s approach of using wage substitutes to compensate the losers of globalisation would define an implicit minimum wage that would prevent wages from adjusting. This was another attempt to defy economic forces. And as a result, globalisation produces unemployment rather than gains from trade. So a way had to be found to compensate the losers of globalisation without preventing the market from adequately determining factor prices. Together with other economists, the German Council of Economic Experts and also the Bundesbank he therefore called
for a change in the welfare state paradigm: to rely more on wage subsidies and less on wage substitutes.

This made Hans-Werner Sinn one of the trailblazers of the so-called Agenda 2010 reforms that were enacted between 2003 and 2005. A central element of the reforms was to shorten the period of eligibility for unemployment assistance and to tighten work availability requirements. In return, the government began topping up low wages. Germany’s welfare system now paid, as Sinn put it, “more for taking part and less for staying away”. And the recipe worked as predicted: unemployment began to trend downwards and employment began to rise. The full truth is, however, that this was also supported by a changing behaviour on the part of trade unions and employers’ associations, resulting in more moderate wage policy and the strengthening of establishment-level agreements as trade unions reacted to the further increase in the already high level of unemployment. These changes allowed Germany to rise to the multiple challenges stemming from German unification, the competitive pressures from EU enlargement to the east, and globalisation.

By the way, even today and against the background of almost full capacity utilisation the wage settlements are still mindful of their employment effects. The Bundesbank’s focus with regard to wages is purely analytical. The crucial question is here, whether their development is in line with our main objective: price stability. And in this regard we have in particular to check for second-round effects. According to our analysis such second-round effects can currently be denied for Germany. This perspective on wages is not a policy recommendation. Not only because we do respect the autonomy in wage bargaining but also because we agree with Hans-Werner Sinn that wage negotiations should not be overburdened by aiming other policy goals – for example by targeting the current account.

Recent economic policy decisions, however, such as the introduction of the minimum wage and the option to draw a full pension at 63 offered to long-term contribution payers can be seen as a roll-back of the Agenda 2010 reforms. And again, these decisions illustrate the key challenge related to policy advice I mentioned earlier: in the short run, where the economic situation and employment is relatively stable, the minimum wage, for example, might even have positive economic effects, as it leads to an increase in the income of the workforce. And consequently, the Bundesbank assumed in its macroeconomic forecasts for last year that the minimum wage would have a slight, stimulating growth effect. In the medium term, the consequences of the minimum wage are certainly less benign and will first of all depend on whether a politicisation of the work of the Low Pay Commission can be avoided.

Reforms for a more stable monetary union

The last stop on our time travel expedition is the euro-area crisis, which is also one of Hans-Werner Sinn’s central points of focus in his academic and political work. In his book ‘Der Euro’ he writes: “the tension in Europe stems from a fundamental conflict between wish and reality – or what has been dubbed the primacy of policy over the laws of economics. For years, policy makers have been able to get their own way and pretend that fiscal constraints, laws of economics, and mathematics simply do not exist”. In his description of the euro area’s current state he is rather negative: “today the Eurozone is a shambles, staggering from one crisis to the next”.

As Hans-Werner Sinn knows, I am not as pessimistic as he is with regard to the state of the euro area. This is not only because of the difference in age and the fact that as life advances, recollection takes the place of hope – to quote the German writer Wilhelm Raabe. After all, there has been some progress in the euro-area countries and institutions. But I agree with him that one important reason for the euro-area crisis was the limited success of capital markets in constraining public and private indebtedness in the euro-area member states, which found its expression in an exaggerated convergence of risk premiums for lending to governments and households in the euro area after the introduction of the euro.

This convergence could be partly explained by the elimination of the exchange rate risk because of the introduction of the euro. But the convergence in risk premiums went even further as investors mispriced the risks associated with the increase in public and private debt levels. While the rescue mechanisms that were put in place prevented the crisis in the euro area from escalating, they did so by a bailout of creditors to banks and sovereigns. The principle of creditor liability was further undermined.

This is another of the economic laws, violation of which Hans-Werner Sinn warned would turn out to be
very costly. “Creditor liability is the core tenet underpinning the market economy”, he wrote. “Investors only act with caution when making their investments if they reckon with being held liable in case their investment fails”. Hans-Werner Sinn devoted at least three books to this issue, all of which contain impassioned calls to realign control and liability.

An important step in this direction with regard to investments in banks was made at the beginning of this year, when the Bank Recovery and Resolution Directive (BRRD) became effective. It helps to ensure that, in the future, the shareholders and creditors of a bank will be first in line to absorb any risks and losses. And in this context it is important to note that because of the new Basel III regulation, banks are now obliged to maintain higher capital buffers. This helps to increase bank shareholders’ liability if the bank has to be restructured or even resolved. To ensure that the principle of liability – or as Walter Eucken put it: “those who reap the benefits must also bear the costs” – is also respected with regard to sovereign debt, the founding fathers of the euro had incorporated the no-bailout clause into the Maastricht Treaty. It was the ‘linchpin of the construction of the euro’, as Hans-Werner Sinn wrote in one of his books.

But with the institutions and rules in place before the crisis, simply letting a sovereign default happen proved to be risky for the financial stability in the euro area. Because government bonds were treated, wrongly, as risk-free in the capital regime for banks, they held a significant stock of government bonds – the sovereign-bank nexus is strong in the euro area. Hans-Werner Sinn suggested a number of measures that would bring more market back to the sovereign debt market. Here, I would like to mention only two that strike me as being particularly important – and which are similar to points that I also make frequently:

• The first is to do away with the regulatory privileges afforded to public debt.
• The second proposal is to limit assistance from the rescue mechanisms to what is absolutely necessary to assess whether the situation at hand is one of illiquidity or insolvency.

While Hans-Werner Sinn tries to achieve this by limiting the time for assistance up to two years the Bundesbank has suggested to introduce an automatic three-year maturity extension for all government bonds – which would be activated the moment a government applies for an ESM programme – designed not to let private bondholders off the hook until it is clear that the problem is one of illiquidity and not insolvency. Addressing both issues is crucial to enhance the functioning of the Maastricht framework, which is – as it has to be recalled from time to time – still the legal foundation of the monetary union.

Last but not least, Hans-Werner Sinn unquestionably deserves special acclaim for pointing the public’s attention on the impact of central banks’ crisis measures. He anchored his criticism in the discussion at one specific keyword: the balances of the ‘Trans-European Automated Real-time Gross settlement Express Transfer system’, known as ‘TARGET for short. He even dared to write a book about that topic, which was previously known to only a handful of experts. I am sure that no one else than Hans-Werner Sinn could have taken such an unwieldy subject and propelled it to the top of the German bestseller list for business books.

I do not wish to rehash the whole Target debate here. The Bundesbank shares many of the observations made and conclusions reached by Hans-Werner Sinn. However, our opinions do differ in several points of analysis. For instance, we do not see the Target system as the problem per se, but rather as a system that reflects existing problems in the euro area. Above all, the underlying risks stem from the provision of liquidity and the liquidity provisioning framework, as well as in the subsequent cross-border distribution of liquidity. Similarly, in banking, it is the non-performing loan that is a potential risk, not the payment system through which the payments were routed. Consequently, our critical appraisal focuses on aspects of such liquidity provision where the boundary between monetary policy and fiscal policy is in danger of becoming blurred. For example, when emergency liquidity assistance is granted on a very large scale, the collateral framework is severely watered down, or when government bonds are purchased. This is doubtless in keeping with Hans-Werner Sinn’s views. But our views probably differ in our assessment of the risks that the Target system presents for Germany, say.

Despite some differences of opinion it is without any doubt one of Hans-Werner Sinn’s outstanding achievements that he has fostered intense broad public debate – even though the sometimes sharply pronounced arguments did not always make life easier for us in the Eurosystem.
Conclusion

Dear Hans-Werner Sinn,

Arthur Schopenhauer once wrote: “there is no greater consolation in age than the feeling of having put the whole force of one's youth into works which still remain young”. Well, I am not sure your age necessarily warrants the need for consolation. Looking at your latest publications, you seem to have maintained a lot of this force. And you have obviously saved some of your youth for a host of other achievements above and beyond those which I have discussed today.

But I hope that the short-time journey I have undertaken now through your public interventions over the past decades demonstrates at least one thing clearly: that your achievements will not age. They contain lessons that are still relevant today and will remain relevant tomorrow.

And there is no doubt that your publication list will become even longer. You already said in an interview that you were planning to write more books. I wish you the strength and energy for many more public interventions.