

## IZA Prize in Labor Economics 2005

Award Ceremony – Berlin – October 24

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### Laudation by Gerard A. Pfann

(Maastricht University)

It is with great pleasure and pride to deliver the Presentation Speech for the IZA Prize in Labor Economics 2005 tonight in honor of Professor Dale Mortensen from Northwestern University and Professor Christopher Pissarides from the London School of Economics.

Almost twenty years ago, in 1987, Chris Pissarides accepted an invitation from the Netherlands Graduate Network of Economics to give an advanced course in labor economics. As a PhD student at the time I was lucky to be allowed to attend his class. Chris's lecture notes were called "Equilibrium Unemployment Theory." They were published by Blackwell in 1990. The book was destined to become a best-seller. Dale Mortensen and I met for the first time in 1991 during a semester visit at Northwestern University. I remember Dale telling me about a fascinating project Steve Davis from the Chicago Graduate School of Business was working on. In firms at all states of the business cycles job creation and job destruction could coexist, and most new jobs were created by existing firms.

Two years later the Mortensen's allowed me to borrow their white Chevy Cavalier during a Fulbright exchange visit to the University of Chicago, when Dale and his wife Beverly were travelling to Europe. They were visiting Dale's befriended colleague and co-author Ken Burdett in Essex. Meanwhile in London Chris and Dale were about to finish an exciting joint project implementing Steve Davis and John Haltiwanger's ideas about job creation and job destruction into an equilibrium search model. The papers "The Cyclical Behavior of Job Creation and Job Destruction" published in a conference volume in 1993 and "Job Creation and Job Destruction in a Theory of Unemployment" published in the Review of Economic Studies Symposium on Search and Matching Models of Unemployment in 1994, not only resulted from one of the most influential and successful matches between two brilliant labor economists, but they also marked a fundamental change in the way economists in Europe were thinking about the problem of unemployment.

In Europe, remember, this was the era, the high tide of disequilibrium modelling, and downward wage rigidity was considered a fact of life. Academics advocating equilibrium labor market theories were scarce. Against the odds, Dale Mortensen and Chris Pissarides successfully developed their dynamic equilibrium unemployment theory. Their model starts with the idea that employers' investment decisions to create new jobs are irreversible; workers meet with jobs; matching wages are the result of a bilateral bargaining process between the job providers and the employees. An equilibrium is a time path of the number of jobs and matches. Simulations showed that their equilibrium matching model is capable of endogenously reproducing some important labor market dynamics that could not be accounted for before. For example, cyclical shocks cause job creation and job destruction to move in opposite directions. But job creation is less volatile than job destruction. In the model's steady state this is accounted for by an asymmetry in job creation that in anticipation of new shocks is less volatile in a boom than in a recession. In the short-run, or rather as part of the model's equilibrium correcting dynamics, an asymmetry in job destruction exists as

more jobs are made redundant faster at the beginning of a period of contraction than it slows down at the start of an economic upsurge.

The new structural models of equilibrium unemployment have given young academics, economic analysts, as well as policy makers a complete and novel framework to understand better the effects of aggregate shocks inducing negative correlation between job creation and job destruction, and to think of better policies to dampen socially undesirable fluctuations.

Charles Bean, then editor of the Review of Economic Studies, was constantly looking for new and interesting ideas that could contribute to solving the unemployment problem. Almost entirely on his own he selected a sequence of excellent labor market papers, among which the acclaimed Euroclerosis paper by Samuel Bentolila and Giuseppe Bertola. But it took a combination of American and European labor market knowledge to create the Mortensen-Pissarides Dynamic Theory of Equilibrium Unemployment. This paper was the best piece of work Charlie selected for publication in the REStud in the early 1990s.

And now it is 2005. And we are here in Berlin to celebrate. To celebrate the merits of equilibrium matching and how the matching process can be most successful. Or how Lou Reed once said it:

*In Berlin by the wall  
you were five foot ten inches tall.  
It was very nice  
Candlelight and Dubonnet on ice.*

*We were in a small cafe  
You could hear the guitars play.  
It was very nice  
Oh, honey, it was paradise.*

We celebrate the fact that a decade ago two modest and very kind persons, who dedicated their lives to labor market research, decided to join forces and combined their intellectual gifts to work on solutions for a better world with less unemployment, to work for a world with more prosperous opportunities for more people. Many of you, here in the audience today, are involved in German labor market policy one way or another. In these times, some of you may sigh and say, OK fine, but to me it seems as if unemployment is here to stay. But exactly that is an unacceptable principle for a labor economist. Professors Mortensen and Pissarides have shown indeed, through their exemplary academic contributions, that something can be done about it. They are to be applauded for that achievement. The IZA Prize in Labor Economics 2005 and its Committee couldn't have found a better destination. Chris and Dale, congratulations!

When someone asks you to deliver a Speech one can only say "YES". After all, with "NO" you run the risk to be asked the same question again the next time. So now I would like to give the floor to the IZA's President and CEO of the Deutsche Post, Dr. Klaus Zumwinkel, and to IZA's Director and President of the Deutsches Institut für Wirtschaftsforschung, Professor Klaus Zimmermann, who will be leading the Award Ceremony to handing out the IZA Prize in Labor Economics 2005. Knowing Dale and Chris a little bit, I expect they will say "YES". After all, with a "NO" they run the risk to be proposed again next year.