"The state must bolster the innovative strength of companies."
Nobel laureate Edmund S. Phelps on lessons from the crisis

The recent crisis has brought about a change of heart in Edmund S. Phelps, Nobel Laureate in Economics. Once considered a radical free-marketeer, the economist now believes that some parts of the market are not sufficiently regulated. Looking ahead, he sees a role for the state in monitoring prices on the capital market and providing funding to banks dedicated to lending to companies for innovative investment projects. This, he argues, is the only way the state can help ensure that companies remain versatile and innovative – and contribute to greater prosperity.

The Focus: Where are we in the economic cycle? Has the economic crisis already hit bottom? Are there better times ahead?

Edmund S. Phelps: Given the current situation, that's a difficult question to answer. But there are causes for optimism. The first signs of a recovery can be seen: The demand for labor has started to rise again and many countries have seen modest economic growth. Historically speaking, however, the economy has been very slow to recover from this kind of shock. Some banks became insolvent and many others have been unable to lend. Some households went broke and are unable to borrow.

The Focus: When we compare the current economic situation to the Great Depression of the 1930s, can we draw some conclusions about the economic developments that may await us in the coming years?

Phelps: At the very least, we can look at those experiences to gain an understanding of how things might develop now. Past events demonstrate how long it can actually take for economic growth to offset the severe drop in GDP caused by such a crisis. During the Great Depression, it was four years before employment began to recover and many more years before it returned to pre-depression levels. Even by the end of the 1930s, unemployment rates were much higher than they had been in the 1920s. We can expect the current recovery to take a similar course. Even if annual economic growth is higher than usual, productivity growth resulting from improving use of recent innovations will slow the rise of employment.

The Focus: Looking back at the current recession also raises the questions of why economists didn't see the crisis coming and why they didn't warn us of the dangers in time. Do you reproach yourself at all on that score?

Phelps: Of course I've asked myself what I thought and said before the beginning of the crisis. When housing prices first began to soar, I tried to find an explanation for the dramatic ascent. Sometime around 2003 I came

PHOTOS: JÜRGEN FRANK

RESUMÉ Edmund Strother Phelps

Edmund Strother Phelps was born in Evanston, Illinois on July 26, 1933. After teaching economics at Yale and the University of Pennsylvania, in 1982 Phelps was appointed the McVickar Professor of Political Economy at Columbia University, New York. In 2006 he received the Nobel Prize for Economics for his analysis of "intertemporal tradeoffs in macroeconomic policy." The key finding of his research was that economies cannot reduce the unemployment rate by accepting high inflation, something that economists had, until then, assumed to be the case, based on the Phillips curve. Phelps now showed that this kind of Keynesian economic policy did not work. The reason: if public spending increases, all the economic agents expect to see higher inflation, higher wages and higher taxes in the future. This nips the desired economic growth and the associated fall in unemployment in the bud. Among his fellow economists, Phelps is best known for his "Golden Rule of national saving," which states that it is not per-capita production that should be maximized, but per-capita consumption. This is achieved when all wages are consumed and all interest income is saved, so that the interest rate corresponds to the rate of growth.

to the conclusion that the prices were unreasonably high. I must admit, though, that I was not one of the intrepid economists who first pointed out how damaging the price correction would be. When the crisis broke, I was genuinely surprised that the banks had placed themselves in such a vulnerable position – that they could be brought down by the collapse in housing prices. But this is precisely what many banks had done to themselves. They had so many bad loans for residential real estate on their books that sooner or later the system was bound to implode.

The Focus: Can you explain why the banks acted as they did?

Phelps: Initially many people involved in the market believed that the rising housing prices were the result of the low interest rates set by the central banks to boost the economy in the wake of the recession of 2001 and 2002. However, banks and property buyers obviously failed to take into account that a portion of these low interest rates was just temporary. Today, many commentators like to talk about how the greed and recklessness of the bankers touched off the crisis, but this explanation is far too simplistic. We don't criticise Japanese fishermen for over-fishing. It is important to say that the banks failed to recognize the true extent of the risks they were taking. They were entirely too focused on originating and distributing residential mortgages, and this made them hugely vulnerable when housing prices fell.

The Focus: So neither bankers nor economists recognized that the economy was headed for disaster. How could this happen?

Phelps: The banks were obviously under such pressure from their competitors that they believed these spiraling levels of risk were their only option. Because everything went well for a time, the risks just kept getting bigger. Economists also failed to see the inherent dangers. The majority of my colleagues were simply not capable of believing that the market could fail. After all, they spent the past thirty or forty years preaching that whatever price the market sets must be right.

So there were many economists who were fundamentally unwilling or unable to recognize that the prices for residential and commercial real estate were absurdly high.

The Focus: Before the crisis broke, you always warned against excessive state intervention in the market. With

hindsight it appears the state could have prevented this crisis through stricter regulation of the banks and stronger financial oversight. Has this changed your mind on the role of the state in the economy?
Phelps: There are certainly parts of the market that were not sufficiently regulated in the past. I'm now of the opinion that we need a governmental body that sounds the alarm when an asset price has become much too high or much too low.
Every country should establish a monitoring agency and give it the authority to intervene in the market when necessary. Of course it would have to be staffed by financial experts who could use their experience to contribute to the public good.

The Focus: European countries seem to be taking a different approach. Right now they are considering regulating hedge funds and private equity investors. Does this make sense?
Phelps: No. In our economic system, companies are able to exercise their own judgment as to what types of assets they want to hold and when they want to hold them. If you regulate hedge funds and private equity, this constricts and therefore weakens the entire system – and it increases the cost of capital for businesses trying to raise money to invest in innovative ideas. I think Europe is making a mistake in this regard. Many Europeans seem to hold the belief that our economic system generates too many risks, and they want these risks to be contained. But it isn't going to work.

The Focus: Does that mean we have to limit the regulation of the financial sector even though the problem originated there?
Phelps: It means we shouldn't get carried away. Banks and other lenders of capital are very important to our economic system because they provide financing for innovations. When banks and financial institutions are shackled, it becomes very difficult for companies to raise capital for projects with uncertain outcomes.

The Focus: Do banks still fill this purpose nowadays? After all, a lot of small businesses complain that access to capital has become much more restricted.
Phelps: That is correct. A lot of banks are too focused on their own problems right now. And it is often the innovative companies that have problems with financing. Large, established firms are not as affected because they can finance themselves, for example by issuing

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corporate bonds. But small and medium-sized companies have less access to capital. This limits their ability to innovate – much to the detriment of the public good.

The Focus: How can this issue be resolved?
Phelps: The state needs to fill the gap caused by the withdrawal of the banks by providing funding for innovation. Governments should create a new type of bank that is dedicated to supplying innovative companies with capital. This will ensure that investment in new products and technologies does not fail for lack of financing.

The Focus: In the past you have warned that state intervention should be the exception, not the rule. Is intervention necessary in this case?
Phelps: Yes. In the present situation, I believe state intervention can help strengthen innovation, which is why I support it. Innovation is the life blood of a healthy economy – productivity growth and high employment levels depend on it.

The Focus: What else can the state do to make the economy more flexible and less vulnerable in the future?
Phelps: A resilient and flexible company is one that steps off the beaten track and tries something new, in the hope that its new path will take it to a better place in the future.
The role of the state is to create an environment in which companies can try innovative ideas, even when no one knows in advance whether they are going to be successful. We depend on innovation to rejuvenate the economy. The prosperity of a country bears a direct relation to its dynamism and its openness to innovation. The state must be careful not to hinder this dynamism by regulating markets unnecessarily and impeding companies' flexibility – their ability to adapt to new situations and challenges. The state also has a role in ensuring that its citizens remain flexible and innovative. The economy will reap the rewards in the form of strong productivity growth, low unemployment rates and happier people.

The Focus: One aspect of your work has focused on how economies can become or be made more dynamic.
Phelps: There are three dangers that governments must avoid if they want to promote and maintain the dynamism of economies. First, economic policymakers cannot create an outsized welfare state that completely insulates people from market forces, because this would rob economic incentives of all their power. Second, the state must safeguard the ownership rights of business owners, managers and investors so they can defend their interests in the face of opposition from other stakeholders, such as employees. And third, governments must ensure that their own economies are open in allowing the import and export of goods and capital. With these conditions in place, dynamism will develop of its own accord.

The Focus: You've often been criticized for calling on states to deregulate labor markets and limit the rights of employees. How does this help companies to become more innovative?
Phelps: My views on this subject are no longer as radical as they were in the past. It would certainly be an exaggeration to say that employees in Europe feel so secure that they don't save enough, and that because private saving is down, not enough capital is available for companies to make investments. However, I still believe there is a fundamental relationship here. The less frequently employees have to look for new positions in which they need to exercise their full potential, the more the innovative strength of companies declines. Models such as the co-determination that is practiced in Germany can be particularly harmful. For example, if a decision to move a plant from one town to another was submitted to the employees, they would always vote no, even though it might be in the best long-term interests of the company and society.

The Focus: You have put forward the theory that it is the mentality of the people in a state that determines the dynamism of its economy. Why?
Phelps: The mentality of a nation's citizens determines what principles are used to organize the economy; for instance, whether or not they want a strong role for the state. Of course, this mentality is not something that can be influenced to any great degree, because it is rooted directly in the culture of the country. And the differences are often astonishing. In many countries, for example, people don't like to take orders, while in other countries they don't like to give orders.

The Focus: In the past year, countries all over the world have introduced massive stimulus packages. Would you expect this to boost innovation?
Phelps: The stimulus packages primarily benefit industries that are doing poorly. These companies are now failing to adapt their capacities and access new markets. Effectively the state is cementing encrusted structures and obstructing the process of economic renewal and the efficient allocation of capital and labor. If money is pumped into the construction industry, for example, this prevents workers in this industry from switching to sectors of the economy that are prospering.

The Focus: What advice would you give to corporate leaders? What should they do today to be prepared for future crises?
Phelps: I think corporate leaders should see the present period as an opportunity to review the way things are done, to see whether they can make some radical improvements in the organization of their companies. During an economic boom, the senior management is primarily concerned with the day-to-day operation of the business – with producing the product and getting it out to the users. Paradoxically, during a slump they have more time to think about ways to boost performance. This has led to productivity gains in the past. In the United States, output per person and per man-hour grew phenomenally during the Great Depression. A lot of that simply came from organizing the company more efficiently, but it was also the result of new and better products. And the current crisis will have exactly the same effect.

The interview with Edmund S. Phelps was conducted in New York by Lisa Blais, Egon Zehnder International, Boston, (left) and Ulrike Mertens, THE FOCUS.