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Seeds of Recovery after the Financial Crisis

Edmund S. Phelps*

Minister President Koch, Mr. Tietmeyer, Mr. Methfessel, Ladies and Gentlemen.

The powerful downswing in economic activity in the past two years is not the only disturbing downswing experienced in the western world after the 1930s.

The depression that developed in the U.S. and Western Europe over the late 1970s and early 1980s was also very powerful. The unemployment rate reached 10% in the US and 12% in Europe. It was also very disturbing: it provoked serious social unrest in the U.S. We did not understand well at the time what the cause was. It turned out the explanation was mainly a slowdown in "technical progress," thus in productivity growth. Fortunately, productivity growth revived to a degree around 1990 and the period 1996 to 2006 was one of pretty fast productivity growth.

This time the origins of the downswing are known – details aside – and there is no social unrest. Yet we have had little experience with downswings resulting from asset price collapse leading to near-insolvency and financial crisis.

For that reason, it has taken considerable thought to understand the reasons this present downswing not only caused an end to he housing boom but also the beginning of a slump, or depression.

One classical mechanism was obvious: When speculators abandoned their expectations that housing prices were headed for a new and higher plateau, classical theory implied that housing process would immediately drop like a stone – though not to a level so low as to be below the old plateau. (The classical two-sector explanation can safely be omitted.) On this account, employment would drop too –

* McVickar Professor of Political Economy and Director, Center on Capitalism and Society, Columbia University. The author is the winner of the 2006 Nobel Prize in Economics.

though not to a level at or below the “natural” level, which I suppose was roughly the level prevailing before the boom. (With house construction below the level required to replace the housing stock as units were retired, the stock of housing would then be on a further, slowly descending course to its normal level. Hence rentals would be rising relative to house prices, so housing output and employment would also be subsiding back to its normal level.)

Another classical mechanism was wealth. With the bulge of the housing stock brought by the housing boom, real wealth, measured in units of standard housing, was still elevated. This must have sapped older workers’ drive to go on earning. (All those houses to enjoy and look after!) So, even from a classical standpoint, employment might decline to a level *below* the old normal level from which the economy started when the boom began. (My analysis had reached this point when I spoke at the Milan Stock Exchange in spring 2008 and the BIS conference in summer 2008.)

To explain how the unemployment could rise to a level as large as 10% we needed something more. One reason was the insolvency problems at the banks, which led to a massive *credit crunch*. Banks were forced to call in loans or to continue lending only to bad borrowers in which a bank had a stake.

Another reason was the *increased uncertainty premium* resulting from ignorance of how far the downswing would go and thus what the prospects were for asset results and loan repayments in the future. Thus a collapse of share prices will tend to follow the collapse of housing prices. (At the Banco Central in Buenos Aires in September 2008 I showed the theoretically contractionary effect of this premium.)

Now the question is, what are the mechanisms of the upswing? Why should employment, after going down, turn around and go up? Why should we expect an upturn?

The usual answer is that inventory investment will have to turn around once inventories have fallen sufficiently far. But we don’t really know whether output will rise to equal spending once again or whether spending will fall to equal output!

Another answer is that, empirically, markets tend to overshoot. Having done so again, they will now pull output and employment right back up. But how big is this overshoot? Maybe it is not big enough to hang your hat on!

A powerful answer is that once employment and output level off, the *uncertainty will lift*. That in turn will send share prices up, which had been so hard hit by the increased uncertainty during the downswing. Also, the *credit crunch will let up* once the number of non-performing loans stops increasing. (Banks have not been lending much during the downswing since they have been having doubts about the ability to repay.)

Another, familiar answer is that, as long as investment activity is not enough to cover the retirement of the capital stock because of age and obsolescence, the useful capital stock is shrinking. As the stock shrinks, producers continue to feel encouraged that they could sell an unchanged amount of output sooner than before; so they continue to step up their production – until production is big enough to cover replacement needs. (The trouble with that argument is that it is hard to build a model in which shrinking capital raises prices of capital goods rather than prices of the consumer goods that capital is used to make.)

I would *not* say that a weaker dollar (or euro) is a solution – a recipe for return to high employment. We have a weaker dollar, of course. The problem is that this weakness, will terrific for exporters, such as manufacturers of tradable products, tends to *lower* the relative price of *non-tradable* goods, which are relatively labor-intensive. So recovery through this mechanism will tend to produce a recovery of output with little accompanying recovery of jobs.

However, all of this has a mechanical tone. It is a mistake, I believe, to think that the level of investment, on which (in my view) the level of employment depends, is driven almost exclusively by the capital requirements of current production. The economy will be on a sort of war footing – in which only current consumption needs are addressed – as long as companies do not want to employ people for *future* projects. Getting from, say, 7.5% back to 5.5% will require a return of the old prosperity to innovate. Really high employment will require really high investment and the latter will require *dynamism* – a high propensity to invest in general, not just when the sun is shining.

The organizers asked me to discuss the outlook. I've just discussed the "bounce" back to, say, 7.5%. Will the US economy have the dynamism to get to 5.5%, as in the mid-1990s, let alone the lower level enjoyed in the good internet boom and the bad housing boom? I have observed several disquieting signs of reduced dynamism.

One bad sign is that investors have withdrawn their funds from the venture capital firms in Silicon Valley. It is said that they became disillusioned by a decade of very poor earnings on their investment. The venture capitalists explain that there few if any good entrepreneurial projects in sight – with the possible exception of new developments in solar energy. But in such a vast economy, how could it be that there were no good projects out there? Maybe the VCs make excessive demands on the start-ups – in interest charges, for example.

In his recent book, *Financial Darwinism*, Leo Tilman, a colleague at the Center on Capitalism and Society, argues that the banking industry has been over-crowded in the past decade and must therefore shrink. Presumably the contraction of credit that will produce will be offset by the emergence of new financial companies, such as hedge funds. (In America we love them. The British do too. Keynes ran a hedge fund in London in the early 1930s. There were hedge funds in Scotland in the 18th Century.) My main proposition in this context is that the outlook will continue to be poor until the existing banks do shrink and make room for new banks. In an essay to appear in Harvard Business Review in January 2010, Leo Tilman and I advocate that the federal government create a system of “merchant” banks that would lend to and invest in businesses for investment projects of an innovative character – including large-scale long-term projects. (Hedge funds are naturally too small for this purpose.)

Another deficiency in the system is the terrible short-termism in the business sector. There is a fixation on earnings in the next quarter. We have all been so caught up the housing boom, the commercial real estate boom, the explosion of exotic new financial products as banks struggle to avoid Darwinian extinction, etc. that we have not noticed the possibility that that the business sector and the financial sector are both no good anymore.

To sum up, the outlook in the US is not bright. We can be hopeful for the very long run, after a fundamental *refounding* of Anglo-Saxon capitalism. But in the medium term future and for somewhat longer than that, I do not now expect good economic performance. And if a bad political reaction sets in as a result, the situation could go from bad to worse.