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About economic dynamism

The economies of western continental Europe are in the doldrums. Several are still suffering from a sharp productivity slowdown – Holland's in 1995, Germany's in 1996, Spain's in 1997, France and Italy's in 2001 – which is all the more disappointing in view of the productivity speedup of Ireland in 1999, and of the U.S., Finland, Korea and Japan in 2002. In the former group, unemployment rates did not immmediately climb, yet most have climbed in the past few years in contrast to the falling unemployment in the latter group.

This episode is a challenge to economists. It can be viewed from many different perspectives and we cannot be sure how to weigh the plausible explanations.

From one perspective, the causes of the Continent's present ills are the domestic policies on the Continent, such as the monetary policy of the ECB, and market forces internal to Europe, such as the Continent's demographic prospect.

From another perspective, the causes derive from the position in which the Continent now finds itself in the global economy. Patrick Artus remarked on some of the imbalances.

From yet another viewpoint, the Continent's symptoms stem from economic institutions that are obstructive or unhelpful for economic dynamism – institutions that must be reformed or, in many cases, exchanged for better ones if the Continent is to flourish.

From the fourth angle, the root cause and a direct influence in itself is the economic culture peculiar to the Continent. We heard the remarks by Mr. Bourguinon on that today.

I incline to adopt the third perspective – the institutional view – though I believe that economic culture may play a direct part too. But I sense that I have been invited here to focus on market forces, domestic and international. So I will devote much of my time to the part played by the Continent's demographic prospects and, subsequently to the part played by global economy. Later I will get around to how the Continent's institutional base combined with the ICT revolution may have contributed to the recent slowdowns and may impede or even limit the recapture of lost ground. But I do not want to let this opportunity to speak to distinguished French economists and politicians go by without suggesting the part that the Continent's institutional base plays in the recent slowdowns and how it may impede and even limit the Continent's catch-up with the technological high flyers. I will close with my thoughts on the road the Continent had best take if it wishes to regain the high economic performance it enjoyed – relative to the UK and the US – a hundred years ago: if, in other words, it seeks to regain its former economic dynamism.

Internal market forces

A specter hanging over the Continent today is not an impending revolution of the workers, as Marx thought, but rather the social insurance entitlements of the workers as they sail into retirement. As is well known, the future explosion of social insurance claims will be huge in relation to the capacity of the economy to produce because the bulge of baby boomers now coming close to retirement is huge and because medical science has hugely increased the longevity of retirement-age people. What is less well known is that, according to fresh estimates by the OECD, the largest *increases* in entitlement spending calculated to occur between this year and 2050 are found mostly among the Continental countries: 6% of GDP in the Netherlands, 5½% in Canada, 5% in Germany, 4% in France (which is the OECD average). In contrast, the increase in the U.S. and in Australia is only 2½%, in Italy 2%, in Japan 1½% and the U.K. 0%.[1]

What are the effects of such a prospect on expectations and thus on the economy in the present? A paper by Hian Teck Hoon and myself examines the consequences of expectations of such a bulge of entitlement claims within some (small) interval in the medium-term future.[2] In the present era, where Rational Expectations still holds sway, the custom is to suppose that households correctly forecast their future tax bills and their future entitlement benefits. When Hoon and I do that, we find there is still a serious problem for a capitalist or even a corporatist sort of market economy – an economy in which investment decisions are largely made by private actors rather than at the behest or command of the government.

An implication of the analysis is that, in an open our economy having perfectly correct expectations about the coming bulge of entitlement spending and its «collateral damage», the value per unit put on each of the business assets is steadily falling as the bulge draws nearer. And the value per unit of these assets is *already depressed* relative to what they would otherwise be in view of the still-more-depressed values that will prevail in the years of the entitlement bulge. What weighs on the value per unit of every business asset is the prospect that tax rates must be high over the future to finance the elevation of social insurance outlays and the real exchange rate must be weak in order to accumulate the overseas assets for drawing down during the years of peak benefit outlays. (In this model, *when* tax rates are raised is less important than the certainty that they will have to be high in the future.)

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[1] «Pension Tensions,» Financial Times, Table of OECD data, p. 11, Monday November 28, 2005.

[2] Hian Teck Hoon and Edmund Phelps, «Channels and Mechanisms Linking Future Budgetary Shocks to Present Asset Prices and Economic Activity,» with H. T. Hoon, 2nd Annual Conference, Center on Capitalism and Society, Reykjavik, 16-17 June 2005.

A corollary of the model is that investment activities are correspondingly depressed on account of the prospect of the entitlement bulge; they will be still more reduced in the future until the economy passes through the demographic bulge and gradually recovers. Theoretically, this weakness of investment activities – plant construction, acquisition of new customers (from foreign competitors), hiring and orienting new employees – implies in turn a level of employment that is already depressed and getting worse before it finally gets better.

In fact, the past several years (since 1997) have seen an appreciable cumulative increase of the unemployment rate in the Netherlands (6.3% from 5.4%) and Germany (over 10% from 9.2%) – France enjoyed a decline (to 10% from 12%) – while there were impressive decreases in the U.K. (5% from 7%) and Italy (8.5% from 11.8%) and little change in Japan and the U.S. There has also been an appreciable weakening of the euro and current account surpluses in the eurozone, especially the Netherlands and Germany, as the model predicts. We do not find Continental stock markets reflecting depressed business asset values. Perhaps the lower worldwide real interest rates of the past few years and the exchange rate weakness, in lifting up the income share going to profits, explains the puzzle.

So far, the part of the Continent's economic symptoms that can plausibly be attributed to its burdensome demographic prospects is not very large. But as the years of high social benefit outlays come closer the effects on share prices, asset valuations and business investment will only grow worse. If such a scenario does come to pass, there may be a further erosion of the satisfactions that people derive from working in the business sector of the Continent's market economies, particularly in the more entrepreneurial economies where job engagement has been relatively high. Perhaps market institutions will lose further support on the Continent.

Unevenness and imbalance in the global economy

I am much more accepting of unevenness and imbalance than some economists. A surprising number of economists seem to think that the global economy is not functioning right unless it is growing in a balanced-growth fashion – everything growing exponentially at the same rate. But that is a ridiculous position to take. We have to take as given the initial conditions left by history, which may be quite uneven. Many of the so-called imbalances are a healthy response to uneven features of the global economy, no matter that the unevenness and the imbalances transmit costs to other countries far away.

Everyone knows that current shocks or the lingering effects of past history, since they not strike all countries equally, create uneven opportunities across the global economy. Countries will thus tend always to exhibit differences in their prospective rates of return to investment. When during *les anneés glorieuses* -- from the mid-1950s to the 1970s (the end depending on the country) – the Continental economies were in their “catch-up” phase, the rate of return was relatively high – high relative to that in the rest of the world – and so their investment rates were correspondingly high. This operated to raise the world real rate of interest to a higher level than it would otherwise have reached and thus to crowd out investment in the rest of the world. As a result, productivity growth and employment were spectacularly high on the Continent, with accompanying current account deficits. Although the U.S. was fortunate in hitting upon some more innovations in that period, the 1960s saw relatively low investment, moderate productivity growth and employment, with current account surpluses. There is no doubt that the shoe is now on the other foot.[3]

Today the high tide of investment activity of various kinds – not only fixed capital investment, including housing, but also employee training, customer maintenance and so forth – is in eastern Europe, Turkey, Israel, India, China and other economies in the “catch up” mode. Furthermore, the U.S. economy is riding a second wave of the internet revolution, this one led by Google, following the first wave sparked by Netscape in 1996. It is to be expected, then, that the present period would see a reduction of investment activity in continental western Europe, where there is no current wave of innovation and catch-up opportunities are only just beginning to reappear (after their earlier exhaustion).

This helps us also to understand why Germany, Switzerland, and the Benelux economies (as well as the Nordic nations and Japan) have large current account surpluses: Investment has moved away to the new high-return economies, so net foreign investment must fill the gap created between domestic saving and domestic investment.

The large current surpluses of these Continental economies (a few others run small deficits) imply a current account deficit in the rest of the world as a whole. Yet the picture is somewhat more complicated. One might think that if “dynamic Asia” (*including* China) has the world’s highest marginal productivity of capital, its investment must equal the world’s saving, which is in turn larger than saving in dynamic Asia; so investment in dynamic Asia must exceed national saving there; hence dynamic Asia must have a current account deficit. Yet dynamic Asia is running a current account surplus (though not as large as that of Germany plus Japan). It is making positive net foreign investment on top of its huge domestic investment.

Thus dynamic Asia complicates the pattern I have been describing. A discrepancy between reality and the model is that dynamic Asia keeps out or impedes much of the foreign saving that would otherwise enter. Another discrepancy is that dynamic Asia is saving at

[3] Phelps, «Understanding the Great Changes in the World: Gaining Ground and Losing It since World War II, » Lecture, 14th World Congress, International Economic Association, Marrakech, 29 August-2 September, 2005.

such a high rate, in significant part though budgetary surpluses in contrast to the budgetary deficits in the West, that if the two regions were to invest domestically what they save it would be Asia that had the lower rate of return.[4] (Dynamic Asia would have the higher rate of return if its investment rate were the same as that in the Europe, US and elsewhere.)

The current account deficit in the rest of the world that counterbalances the current account surplus on the Continent is actually traceable to the United States. The U.S. current account deficit alone is big enough to accommodate the world's big current account surpluses – those on the Continent, those in dynamic Asia and those in the Middle East. This deficit is primarily a product of the strong investment demand in the U.S., including residential investment. (I will take up the U.S. fiscal deficit later.)

What are the effects on the Continent of dynamic Asia's saving in excess of its domestic investment – thus its current account surplus? Of course, the extra saving means less import demand and greater export supply. Certainly the increased export supply has disruptive, relocational "micro" effects on the Continent and indeed the entire West. This impact hits disadvantaged workers particularly hard. I would not want to dismiss those at all. Yet the discussion in the West is deplorable for its bias against China and its narrow focus. I have not seen economists complaining about the booming supply of exports from Germany, which must affect the rest of the Continent, and those from Japan. And the surplus countries do not receive credit for the benefits in other dimensions.

There are two "macro" benefits from China's outsize saving and consequent current account surplus. One of these benefits is that China, in pushing out all these exports, is offering us better terms of trade here in the West. Another macro benefit is that China is offering better interest rates in our capital and bond markets. The effect of the latter is higher levels of investment, employment and growth than would otherwise have occurred.

Easy monetary policy in the U.S. I come back to the U.S. Its current account deficit has other sources besides the strong investment demand I identified above. Another source of that deficit is the sustained reduction of interest rates by the U.S. central bank, the Federal Reserve. Yet another source is the spending stimulus from the two huge tax cuts enacted in 2001 and 2003. Much of the European press regards both these policies as courageous moves that have propped up the world economy against the end (or pull-back) of the late 1990s investment boom and the subsequent overhang of excess capacity.

In the popular mind, the easy money policy of Alan Greenspan boosts employment both in the U.S. and the rest of the global economy. Ironically, though, the workhorse of the textbooks, the Keynes-Mundell-Fleming model, implies no such thing. It says that in a

[4] Why China saves more than its domestic investment is addressed in Amar Bhide and Edmund Phelps, «A Dynamic Theory of China-U.S. Trade: Making Sense of the Imbalances,» CCS Working Paper No. 4, Center on Capitalism and Society, Earth Institute, Columbia University, July 2005.

monetarist system of freely fluctuating exchange rates, a shift to easy money in the U.S. would weaken the dollar and strengthen the euro. The euro would have to strengthen, thus lowering aggregate demand in the eurozone, until the demand for money had fallen enough to decrease eurozone interest rates to the reduced level of the U.S. rates. Thus, employment on the Continent would fall. An ECB uncomfortable about the lower interest rate might reduce the eurozone money supply of money, which would lower employment more.

Yet this model leaves open a wide range of possibilities. A clever central bank could avoid the route to lower interest rates through lower employment (which lowers the demand for money) by a preemptive cut of the discount rate to match the U.S. cut in order to increase the supply of money and thus obviate the need for a decreased demand for money. Then the exchange rate would be restored and employment would actually increase.

This model is incomplete: If the money supply is so tight that unemployment rate rises above the natural unemployment rate, the price level will fall, which will tend to drive the unemployment rate down to the natural rate – and vice-versa if the unemployment rate falls below the natural rate. In the end, what matters is the fluctuations of the natural rate itself.[5]

Whatever the part played by eurozone monetary policy in the recent episode of slowed growth and generally higher unemployment, it is unfortunate that a great many economists on the Continent have blamed the entirety of its increased unemployment and reduced growth on the ECB. Even from the Keynesian point of view, why single out the central bank when there were forces weighing on aggregate demand in the Continental economies? What is the evidence for the belief that the ECB created or added to a deficiency of aggregate demand by declining to cut rates pari passu with the U.S.? And why suppose without investigation that the rise of unemployment in the past several years is in no part a rise in structural unemployment – a rise of the "natural" rate of unemployment? The incessant Keynesian call for the stimulus of easier money and bigger deficits, which has been heard since the mid-1990s, distracts attention from the acute need for a makeover of the Continent's economic institutions.

Non-neutral fiscal policy in the U.S. The last source of the imbalance in the U.S. is the fiscal deficit, though fiscal deficits are familiar to the Continent as well. There has been a vast departure from what I call a violation of fiscal neutrality. In a book I published on that subject in 1965 I argued that if tax rates are too low (too high) households are fooled into thinking they are more (less) wealthy than they really are; as a consequence they overestimate (underestimate) their lifetime consumption power.[6]

There is little doubt that the U.S. is in a non-neutral fiscal position. The U.S. is headed toward peak levels of government spending under various welfare and retirement programs

[5] A variable natural rate is studied at length in Phelps, *Structural Slumps*, Cambridge, Mass., Harvard, 1994

15 to 35 years from now. That will require tax rates to be very much higher than they are now. It has been estimated that the U.S., whose federal tax rate is something like 17%, will need the tax rate to be 28% if the tax rate is to be on a steady course the rest of the way on. Judging by the record-low saving rates, either Americans are underestimating the future tax rates entailed by the currently scheduled retirement benefits or they are overestimating the future pension and medical benefits they will receive if present tax rates are maintained.

This fiscal stimulus in the United States through under-taxation causes increases in the "natural" rate of interest throughout the global economy. The increase on the Continent, given the discrepancy (if any) between the market real interest rate and the natural real interest rate, operates to reduce the Continent's investment, employment and growth.

But before the Europeans blame the U.S. for raising the Continent's natural rate they should remember that the Continent has been pursuing a non-neutral fiscal policy too. The U.S. could complain that running deficits on the Continent, compared with tax adjustments to balance the budget, operates to reduce investment, employment and growth in the U.S.

It should also be borne in mind that the same ICT revolution that drove the late 1990s boom and the recent investment revival in the U.S. (and in Ireland, Finland and Korea) also creates the prospect of considerable future technical progress on the Continent, with many benefits. The Continent could look more at the bright side of the global economy. It will derive benefits from the wellsprings of dynamism here and there in the world – Google, Samsung, Lenovo, and the rest. At some point the gap between best technical practice on the Continent on the one hand and the leading-edge technologies in the world will have grown so wide that a process of catch-up will inevitably begin on the Continent. How soon this process will begin and how close the Continent can come to the "leading edge" technologies will depend on what the Continent does with its economic institutions.

The part played by institutions and innovation in the Continent's slowdowns

For me the first basic question about the Continent's doldrums is why the Continent's growth did not *speed up* in response to the many information and communications innovations introduced in the U.S. in the last half of the 1990s. After all, there was a dramatic period of fast growth on the Continent beginning in the mid-1950s that can be attributed to the opportunities to copy the innovations made in the U.S. and elsewhere in the 1940s, the 1930s and the 1920s. Why is it that this time the Continent's entreprenuers have not leaped once again at the opportunity to launch the new products in Europe and transfer the new technologies required?

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[6] Phelps, *Fiscal Neutrality toward Economic Growth*, New York: McGraw-Hill Book Co., 1965.

One reason, I suggest, is that catching up takes time before results start. Even in the early postwar years, despite the low-hanging fruit overseas, catch-up activity was modest. There are all sorts of bureaucratic, technical and legal hurdles to be surmounted before an overseas innovation can be identified, copied and adapted for use in another country.

But the puzzle is deeper than that first question. The growth rates in the Netherlands, Germany, Belgium and Italy did not simply fail to increase. They actual decreased. The Continent's productivity seized the opportunity to decelerate while in the contrasting economies of the U.S., Ireland, Finland and Korea, productivity actually accelerated.

There are two reasons, I believe. This time the overseas innovations are coming thick and fast, so that the Continental entrepreneur is unable to evaluate them all in a short space of time and is not sure about the wisdom of launching one of the innovations now rather than waiting for the situation to be clearer. In the 1950s the Continental entrepreneur could examine the success or failure of the U.S. innovations over a long history and thus be fairly confident in his judgment of such an innovation's potential profitability in Continental markets.

The other reason is that, this time, overseas innovations present far greater novelty to Continental firms than they did in the 1950s. The technology transfer is much harder. Perhaps more important, Continental consumers are not ready for the transformation that has occurred in the U.S., Korea, Japan, Finland and Ireland. The potential catch-up in prospect for a country has to be weighed against – or adjusted for – the novelty that consumers and producers will encounter on their way through the unfamiliar territory.

Yet, didn't the producers and consumers in Korea, Japan, Finland and Ireland balk at the novelty of what innovators launched? Why didn't innovators there fear that consumers and producers were not ready? There must be underlying differences between the Continental economies and the exemplary ones of Ireland, Finland and so on.

I believe that the Continental economies have had poor performance characteristics for many decades. These characteristics were overlooked during the glorious catch-up era. In a series of recent lectures I have been trying to put my finger on the fundamental cause of the poor performance characteristics of the economies of continental western.[7] In essence, I argue that the Continent is not good at dealing with novelty and, knowing that, the Continent's entrepreneurs cannot afford to create much of it. In fact, there is evidence that the Continent is not quick to capitalize on innovation opportunities and not quick about pioneering and spreading the use of an innovation that is introduced. I suspect that the

[7] See Phelps, «The Continent's High Unemployment: Institutional Causes and Some Evidence,» in Hans-Werner Sinn, ed., *European Unemployment*, Cambridge, Mass.: MIT Press, forthcoming 2006; Phelps, «The Economic Performance of Nations: Prosperity Depends on Dynamism, Dynamism on Institutions,» in W. J. Baumol and E. Sheshinski, eds., *Entrepreneurship, Innovation, and the Growth Mechanism of the Free-Market Economies,* Princeton, N.J.: Princeton University Press, forthcoming 2006; Phelps, « Understanding,» op. cit.

problems are rampant thoughout the Continental economies, permeating the financial sector, company law and family firms, labor law and education policy. Yet the presumed presence of such imperfections is not enough to convince Europeans of the need for reform. To make a persuasive case, if that is possible, it is necessary to start from the basics.

Institutional change for long-term improvement of performance

The beginning of wisdom is to shed the outmoded and simplistic notions of economic performance, such as GDP, or GDP per head, or GDP per man/hour. I maintain that we economists have to get back to the core European truths that began with Aristotle in ancient Greece ("All men desire knowledge") and continued in fits and starts through Montaigne and Nietzsche at least to France's Henri Bergson's *elan vital* in the early 20th century. This line of philosophers saw that the mental challenge of problem solving and creating things, discovery of talents, the widening of one's capabilities – "becoming" rather than "being" in Bergson's words – are central to human satisfaction and personal growth.[8] It is sad that European students these days (and American students too) do not know this European philosophy of *vitalism* – to use the name that it sometimes goes under.[9] Significantly, perhaps, while the Continent was forgetting this philosophy in the past century, various philosophers writing in America were embracing and elaborating it – James, Dewey, Rawls, Rorty and Sen.[10]

At the same time, people generally need to participate in the commercial economy, specializing and collaborating with others, in order to obtain various material gains from their labor. So if most people are to experience such challenge and development on an intensive and long-term basis it will have to come through their careers – through their work in commercial economy. (Raising children is a challenging job but does not last long.) And there will have to be new challenges at work, inspired by new commercial ideas, if this challenge and development is to be generated in the workplace. So a country's business economy must be one subject to frequent innovation, at least some innovative adaptation of leading-edge innovations abroad and some pioneering adoption of the innovations that are introduced; and this innovation, if it is to be sustainable, must be disciplined by an able financial sector. I also argue that if an economy of "dynamism" is built, it will also lead to higher productivity, higher employment and reduced unemployment.

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[8] Aristotle, *Nicomachean Ethics*, and H. Bergson, *Creative Evolution* (Paris, 1907).

[9] The term *vitalism* is used frequently by Columbia's humanist scholar Jacques Barzun. See his chapter on late 19th and early 20th century thought in *Chapters in Western Civilization*, Vol. II (NY: Columbia University Press, 3rd edn, 1962) and his book *A Stroll with William James* (NY, Harper, 1983). It is also used by Yale's literary scholar Harold Bloom in discussing Cervantes and Shakespeare. (The term originates with the debate in biology over whether the behavior of an organism can be understood by the sum of the mechanisms governing its parts.)

[10] William James wrote, « My *flux*-philosophy may well have to do with my extremely impatient temperament. I am a motor, need change, and get very quickly bored.» (Cited in Barzun, *James*, op. cit., p. 265.) By «motor» he did not mean anything like a mechanical device, as Barzun remarks.

Fortunately the business sector appears to lend itself to innovation, at least in economies that do not impede or discourage it – more at any rate than childraising or the priesthood, which appear not to have changed a great deal in the 100 years, or the arts, which on the whole appear not to have not changed much at all in the past 50 years.

If these thoughts are on the right track, we really should not be talking so much about the impact on France and on the Continent of this or that market force or social policy. I think the big issue for the European continent, including France in spite of its relatively good record in the past 10 years, is the performance of its economic institutions and economic policies from the point of view of their effect on the dynamism of the economy, hence on innovating and ultimately on the vitality of business life. What is needed is both an increase in the entrepreneurialism among existing firms in the Continent's businesses, with all that such an improvement entails, and better institutions in the Continent's financial sector. What is not needed – what cannot lead to a return to dynamism – is an accumulationist policy of stepped-up investment rates in machinery, scientists and public infrastructure.

In the past several years France has made changes in its economic institutions and industrial practices that promise an increase in the vitality of business life there. A desire for improved base of economic institutions is also stirring on the rest of the Continent. It is hard not to believe that a range of further institutional changes will be made over the next couple of decades that will substantially increase the dynamism of the French and all or most of the Continental economies.

Let me attempt to sum up this winding tour: There are ample reasons to believe that the Continent will regain its previous growth rates and even make up some (though I doubt all) the lost ground vis-à-vis the frontrunners. Yet, in my view, Continental economies are not structured for high performance and have not been for a long time –as far back as the interwar years. I don't see how Europeans can look forward to the good life, whatever the details of that might be, until they have fixed their economies.