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Structural Forces Weighing Down US and European Economies And the Inability of Customary Policymaking to Bolster Them

Edmund S. Phelps[1]

I am delighted to have this opportunity to offer a commentary on where the economies of the West appear to me to be headed and on what economic policy initiatives are needed to improve our economic prospects.

I will first look at the cross-currents driving the American and European economies with emphasis on the financial sector and asset prices. In this discussion I will highlight the uncertainties arising or soon to arise and suggest how such uncertainty reduces the level of economic activity, as measured by employment or GDP, and may cause some overshooting of the economy's path as it seeks the lower plateau around which it will expect to fluctuate. Then I take up some points where I think present-day policy discussions are sadly mistaken. Finally I will venture to suggest the need for some more basic therapies if – in the absence of dumb luck – if the American and the European economies are to gain the dynamism they need for high employment and high productivity and if they are to be able to achieve the high inclusion that has long been a promise and never an achievement.

[1] McVickar Professor of Political Economy, Columbia University, Director of the Center on Capitalism and Society, Columbia University, and Winner of the 2006 Nobel Prize in Economics.

The Elements of the Problem: Real Estate, Banking and Oil

It is a misdiagnosis to believe that the problem is one of "aggregate demand," or, as Keynes called it, "effective demand." Consider the end of the housing boom. The ongoing decline in the prices that real estate speculators and others are willing to pay to own houses represents an ongoing structural contraction in the demand for labor in the housing industry, which is relatively labor-intensive: aggregate employment could recover only if construction workers would accept far lower real wages to work in that industry or if they fanned out over the rest of the economy and accepted some lesser cut in real wages in order to work there – but, at unchanged levels of wealth, they will *not* be willing to do that, so employment will have to decline. (Of course, real wages may decline as a result of the decline of employment but that will not serve to avert the employment decline.)

Needless to say, a shrinking of the construction sector tends to bring with it a shrinking of the financial sector, particularly the banking industry, which has been heavily engaged in mortgage lending to home buyers, home builders and speculators. The decline in the number of loan officers required by the banks tends to mirror the decline in the number of new houses coming onto the market.

It now appears perfectly safe to say that a significant part of the price rise between early 1997 and early 2007 was a *bubble*: maybe 40% of the price rise will be given up. In that case, 60% of the price rise will be seen in 2009 or 2010 as justifiable – as a correct anticipation of the higher future demand for second homes and better homes, much of that demand brought about by the strong rise of wealth and productivity from 1990 and especially from 1995 to about 2005. That there have been serious ill-effects of this bubble component is not in question. The bubble has left a legacy of overexpansion in the banking sector – more precisely, an enormous increase in the banks' assets (mostly their loans) relative to the banks' capital. This *leveraging* must now be followed by a *deleveraging,* which entails both raising increased capital and reducing the stock of loans outstanding. (I will take up the uncertaint

Yet in *one* respect the cost of the bubble is somewhat exaggerated. *Even if there had been no bubble component,* the construction boom would still have *come to an end*. In the long run, with the expansion on the stock of houses completed, home construction would have subsided to the level needed to house the increase in population and to replace the part of the (somewhat larger) existing stock that reached the end of its useful life. [DIAGRAM: Fig. 1]

I would comment in passing that the public seems to think that there is no such thing as a desirable boom and that the good things in the economy are all *sustainable* – contrary to healthy human experience in general, in which most good things are frequently changing. But the public and the politicians are right that something has to be done to reshape the financial sector.

More recently there has been a speculative rise in the price of oil (with no reduction of reserves so far, as I understand) and this too may well prove to be in significant part a "bubble." In any case, the oil speculation is different in that it appears not to have stimulated an appreciable increase of output in the US energy sector nor in the European energy sector – perhaps because added employment would not produce added output. What is more remarkable is that stockpiles of oil are reported to have decreased; this suggests that industry professionals have been speculating against the retail speculators; but, contrary to some public comment, that does not mean that retail speculators could not be a source of the high price.

It is commonly supposed that economics offers some compelling reason to believe that an increased oil price is also (alongside the end of the housing boom) a structural force pulling down employment – pushing up structural unemployment and perhaps contracting the labor force? Maybe so, but it is not obvious to me. The percentage fall in the marginal productivity of labor that results from having less oil may be about equal to the percentage fall in the marginal productivity of capital. And if suppliers of labor, once they see that that their real non-wage incomes have fallen as much in percentage terms as their real wages have, are content to go on supplying the same labor as before – to swallow the drop of their real wage – the economy will then be able to continue with unchanged employment and perhaps an unchanged sense of prosperity – not the sense of overflowing prosperity felt in late 19th century Vienna or even the prosperity in 18th century London but much the same sense of prosperity as before.

The idea that an increase of oil prices is contractionary for employment grew up in the recession in the mid-1970s after the 1973 oil shock. Some economists, including me, worried that the higher oil prices would cause an increase in the *unit cost* of producing national output, given the *money wage*, which might *exceed* the increase in the *price* that buyers of national output would be willing to pay, given the *money supply*. (A secondary contraction of output would then occur, leading to a contraction of employment.) But today the central banks do not keep their hand on the money supply – they set interest rates and let the money supply increase freely with any increase in the demand for it. Whatever the money price we have to pay for our bread, our central banks will be there for us! Furthermore, oil today receives a much smaller share of the GDP than it did three decades ago. In the 1970s we economists were not aware of the extent to which the increased unemployment of that decade was caused by the end of the extraordinary productivity growth (from the mid-1950s to the early 1970s), not energy prices.

Stepping back from all this, it seems that the US economy and several western European economies were saved from a rather dreary decade by their housing booms. You could argue along the lines of the Austrian school of economics that had there been no housing boom that would have helped the US economy to provide resources for a fuller and faster development of the internet and mobile communications. But in this age of the Global Economy, it is not plausible to suppose that the housing boom "crowded out" an equal and offsetting amount from the internet boom. To some extent the US economy could have both booms – and it did. Now it looks like the US faces a future with no boom at all.

In my analysis, the decline in aggregate investment activity resulting from the end of the housing boom has another contractionary effect on total employment. At an unchanged level of GDP, the *decline* in (residential) investment would generally require a real exchange rate depreciation to boost exports or cut imports, and that depreciation would better shield domestic producers from foreign competitors; that would encourage domestic producers to contract their supply to existing customers at any given price (or, equivalently, to raise their markups at any given output); and that would, in turn, cause job losses and an unavoidable fall of total employment.

It would be naïve to imagine that none of the structural forces acting on our economies are positive. In fact, the demand for exports in the US and also for exports in many of the western European economies has been rising strongly, thanks to the rapid growth in Singapore, South Korea, China and elsewhere in Asia. Does such export growth create more jobs than it destroys through import growth? I think it can be argued that it does. At an unchanged level of GDP, an *increase* in export demand would generally require a real exchange rate *appreciation* to restore exports or cut imports, and such an appreciation would induce firms to supply more to their customers (equivalently, to shave their markups); and that would cause new jobs to be created and an unambiguous increase in total employment.

The data on magnitudes suggest that the decline of investment demand has been stronger over the past 12 months or so than the rise of export demand.

Uncertainties as an Added Factor

The mechanism of the bank overexpansion involved the merger of commercial banks with investment banks and the introduction of *securitization*, through which banks could continue to package the heterogeneous and un-transparent mortgages and sell them on to hedge funds and other financial entities. In this way virtually the entire financial sector came to hold assets that were highly uncertain in value.

One effect of this increased uncertainty about the values of their asset holdings is that the financial sector has been less willing to roll over old loans and make new loans to the business sector. Another effect has been that financial firms have been less willing or more reluctant to lend to one another, which is evident from the increased spreads in both Europe and the U.S. between the interest rates on inter-bank loans and the short-term interest rate (the policy rate) set by the central bank; so the financial sector faces more uncertainty from a given loan position than it did before.

In the models I use, uncertainty requires the value put on an added unit of a business asset to cover both the cost of acquiring the added unit *plus* what has been called the "uncertainty premium." If you prefer, the premium drives a *wedge* between the value of an added unit of the asset and the cost of acquiring it. Increased uncertainty widens the wedge. As a result, the rest point to which the economy tends – the new and lower plateau that it will tend to fluctuate around pending any new major forces – exhibit a lower level of activity than the rest point would previously have exhibited. Furthermore, the entire path of the employment will lie lower than it would otherwise do. [DIAGRAM: Fig. 2]

Groundless Assumptions in Current Policy Thinking

Unfortunately almost all of the policy discussion about economic prospects is restricted to debates about the appropriate settings of the conventional policy instruments – monetary policy and fiscal policy. And much of that discussion seems to me to be wrongheaded.

Regarding monetary policy: there is, first of all, an elementary distinction between an apparently one-time rise in primary goods prices (which Keynes called semi-inflation) and an inflation process manifested by the development of *expectations* of inflation at an unacceptable rate. What we call *inflation stabilization* does not mean monetary action by the central bank to prevent or repeal every price increase above (or decrease below) some trend path, even a large increase: in most conceptions, it is all right if the price level rises to a higher path or falls to a lower one. Inflation stabilization means keeping under good control people's expectations of inflation -- and particularly their expectations of "wage inflation" – over some medium term horizon.

Also, inflation stabilization does not entail an obsessive focus on expectations either: it can make sense to tolerate a worsening of expectations over some medium term in order to avert an avoidable rise of unemployment – just as provided by the Taylor rule. But it is one thing to *cause* or *aggravate* a worsening of inflation expectations for some time in order to *damp* a rise of unemployment and quite another thing to do the same for the sake of *slowing* a rise of unemployment the full extent of which will occur anyway. The former serves to shave off the troughs – the worst extremes of unemployment – while the latter merely serves to prolong low unemployment a little while longer before the inevitable trough materializes. It seems to me groundless of the Fed to believe that the economy will soon gain back some of its lost strength and dangerous to decide on that belief to hold down short-term interest rates as long as unemployment is high or appears to be heading high. Likewise it would be dangerous if the European Central Bank were to meet calls to freeze the short-term nominal interest rate in the face of increased expectations of inflation – that would be tantamount to *reducing* the *expected real* interest rate when inflation expectations are already too high and rising – merely to postpone for a time whatever rise in unemployment structural forces are going to impose. *Sooner or later* expectations of inflation (or of deflation) become so far from the target as to *force* a central bank to set the expected real interest rate at the level consistent with the emergence of the natural unemployment rate in order to prevent any further deterioration of inflation/deflation performance. (Absent such action, the inflation rate or the deflation rate would explode until it hits a natural ceiling or floor.)

Regarding fiscal policy: it is a misdiagnosis of the problem to think that a rebate of taxes on past income, such as the Bush-Paulson rebate last month, makes any sense if the problem is a structural problem – one that, in the absence of structural measures, will lead to a further rise of structural unemployment (a fall of structural employment). Furthermore, it is time to recognize that the nugget of wisdom in supply side economics – that a cut in taxes serves to increase present levels of disposable income and thus may open up new sources of finance for new firms and added innovations – has a limit. Each increase in the target ratio of government budgetary deficit to GDP ultimately increases the ratio of public debt to GDP in the same proportion. If it were true that each tax cut would continue to do more good than hard, without limit, then optimum fiscal policy would deficit-finance more and more of the government purchases and welfare payments: all government purchases and welfare payments would be deficit-financed. But this is absurd. Even supply-siders instinctively draw back from such a logical extrapolation of their policy advice. The trouble, as I see it, is that as the debt-to-GDP ratio is successively increased, interest rates could rise so far above the growth rate that tax rates would come to exceed their initial levels. And, at the same time, consumption demand would go higher and higher: as a result, the incentives to people to be employed and the incentive of employees to perform would grow worse and worse.

One of the novel fiscal ideas in decades is the recent proposal from several quarters to institute *subsidies* for the use of oil, gasoline, and so forth. The stated intention, whatever the latent function, appears to be to smooth the consumption levels of middle-income and low-income people hard hit by increased energy prices. But the rise in the price of energy is precisely what the world economy has needed in order to induce people to economize more on their consumption of energy. Moreover, merely stability of consumptions levels seems like one of the most trivial objectives ever entertained by policy makers. There exist unmet goals profoundly more central to human fulfillment than that.

In the present circumstances I would like to see the Fed begin raising the expected real rate of interest at the short end until it matched and finally exceeded the expected inflation rate. At this Gold Forum it is natural to comment that the price of gold can serve as one indicator of inflation expectations; but there are also structural forces, as I have said in this lecture, and these too can be responsible for a rise (or fall) in the price of gold and other primary metals and primary products generally. I would also like to see US fiscal policy begin a gradual shift toward fiscal surplus in order to gain the fiscal resources and stimulate the investment in overseas assets that will be required to provide the retirement benefits and the medical benefits so generously enacted by a succession of federal legislatures and signed onto by a succession of presidents from Nixon to Bush.

Possible Lines of Fresh Thinking

Whatever the truth about the best monetary policy and the best fiscal policy in the present situation, the fixation on monetary and fiscal policy has diminished the incentives anyone might have had to think “outside the box.” Who would listen?

But good ideas for new initiatives – and there must almost certainly be room for some such ideas – would be extremely valuable.

One of the prospects for the western economies over the medium-term future – until the next boom – is a dull labor market: the unemployment rate fluctuating between 5 and 6 per cent and very high unemployment rates for black males and latino males, hard hit by the end of the construction boom. This must be a principal focus of the new administration in Washington, just as it has continued to be a subject of concern in several governments in western Europe.

For about a decade I have been making the case for low-wage employment subsidies – paid to employers at firms over a certain size and graduated according to the pay rate. Such a subsidy program would serve to pull of wages and pull up employment among workers from disadvantaged groups. Thus it would contribute to an increase of economic inclusion and to gains in social integration. My sense is that this is the right time for this initiative.

Another of our economic prospects for the next few years at any rate is the absence of any wave of innovation – unless one begins to develop pretty soon. The US economy and also the European economies very much need to reexamine their institutional structure with an eye to increasing its dynamism: the financial sector seems not to be very oriented toward innovation; further, corporate governance in general and management practice in particular appear to need scrutiny and overhaul. In Europe there is the further need for liberalization of the labor market – job separation payments should be lifted from employers and paid for instead by the government. Above all, the west needs to regain the spirit of exploration, discovery, problem-solving, the development of talents (in Rawls's phrase) and the expansion of capabilities (in Sen's phrase). If this program can be carried out, we might see a return to the age of innovation such as Italy and Germany and France enjoyed – along with the US and the UK – in the last decades of the 19th century.