In search of a more dynamic economy

By Edmund Phelps

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Many people see every downturn of employment from a long-sustained plateau as a fall of aggregate demand - "effective demand" in Keynes's terms. They would have the central bank cut interest rates to restore that demand.

If employment is down because of aggregate demand, the problem can be addressed at zero cost through rate cuts and the ensuing rise in the money supply. Many central banks like to do that: to "lean against the wind".

This time, though, there are forebodings of "stagflation" - lower employment without the solace of lower inflation. Some economists instinctively feel that the present downturn is the effect of structural shifts in the economy, not a shift in aggregate demand. They doubt that a central bank should retard effects it cannot prevent.

If employment is down because of shifting structures, gearing the money supply to attempt to prop up employment would generate ever-rising inflation. Inflation expectations would break loose from their moorings and the attempt would fail. Some central banks are refraining from rate cuts.

We have a difference of opinion and of policy. But the structuralist case needs to be argued. What are the primary forces of a structural nature? And, crucially, what are the nonmonetary channels through which these forces have structural impacts on the economy - on the size of the labour force and the natural rate of unemployment?

One force having structural effects relates to housing. Something like 70 per cent of the rise in the inflationadjusted price of houses in the US and the UK from 1997 to 2007 appears here to stay, justified by increased rentals on residential units in many big cities from London to Los Angeles. So a corresponding spate of house building would have developed on the strength of the justifiable price rise alone. But even such a precision boom comes to an end once the thirst to own more houses has been met. Home building must then subside to the level needed to replace old properties and house fresh increases in population. Construction workers and loan officers will then suffer job losses even as market prices and rentals on houses remain high.

The market is giving back the excessive part of the rise in real house prices - the part not justified by rentals. The ongoing slide in prices is causing a further structural contraction in the demand for labour in the housing and banking industries. With the loss of jobs in construction, which is extremely labour-intensive, a net reduction in total employment must result, since a full re-employment elsewhere would require wage cuts that would exceed what some workers would accept.

A related force is the overextension of credit, largely subprime mortgages, and loans of declining and uncertain value on the books of the banks. A result is a reduced capacity to lend for business investments and a general increase in the uncertainty premium that is required on loans for innovative projects.

Another structural force is the perception of a productivity slowdown during the past couple of years. This damps companies' expectations of the productivity growth they might obtain from any new methods or products.

Finally, steeper prices of imported oil and commodities may also cost jobs. These last three forces all lower the value, or "shadow price", that businesses place on having one additional unit of their business assets - the customer, trained employee and office space. The effect is to cut investing and further lower real wages and jobs.

The same forces exert structural effects through an additional channel in open economies. When asset prices drop, resulting declines in plant and equipment demand and in consumer demand weaken the real exchange rate. Higher prices on foreign oil and commodities weaken the exchange rate very directly. Exports are stimulated. But domestic companies, now better shielded from overseas rivals, will act more like monopolists: raising their mark-ups and cutting their supply. Jobs may suffer.

This exchange rate effect is not yet fully realised. That suggests that the unemployment rate is still short of its newly increased medium-term natural level - the level to which the equilibrium road leads. If so, monetary policy in the US is odd. Past policy was to set interest rates higher, not lower, when the unemployment rate was seen as below its medium-term destiny.

Things fall into place. We will have a bout of inflation. Employment will be weak. Much investment will go abroad. Innovation may hold up. Yet I believe we need an economy of even greater dynamism to regain prosperity.

The writer is director of the Center on Capitalism and Society, Columbia University, and winner of the 2006 Nobel prize in economics. This column is based on his speech at a BIS conference available at www.bis.org/events/conf080626/phelps.pdf