

# Structural Booms

by [Edmund S. Phelps](#)



[Edmund S. Phelps](#)

Why are there economic booms and busts, those long swings between expansion and slowdown? Traditional explanations focus on bad monetary policy. My research argues that they are usually structural, the result of powerful shifts in expectations about future productivity and profitability.

In the Interwar period, big swings were marked by hyper-inflations and deep deflations. Small wonder that for the Austrian, Keynesian and Monetarist schools it was always “cherchez la monnaie”. After World War II, however, long swings in economic activity continued, while only moderate price and inflation patterns emerged. In the 1960s, unemployment nearly disappeared in several European countries, but without rising inflation. In the 1990s, employment soared in several industrial countries, again with little or no inflation.

I see these powerful upswings as investment booms as having structural causes and effects. Entrepreneurs foresaw new opportunities for profitable use of capital in the medium-term future. So they stepped up investment in new facilities, new customers and new employees. Most business investing leads through non-monetary channels to higher employment – without inflationary over-heating.

The turn-of-the-century German school, led by Arthur Spiethoff and Gustav Cassel, viewed the pre-WWI booms in the same non-monetary way. They didn’t deny that “excesses” of speculation may arise. But they held that structural booms may die of natural causes – with no necessity for the over-building, purge and catharsis depicted by the later Austrian school.

In recent research I conducted with Gylfi Zoega, we hypothesised that such shifts in expectations, and thus in future economic expansion, can be detected in advance from tell-tale shifts in the stock markets. Share prices may serve as a kind of proxy for the expectations and attitudes of businessmen. It turns out there that is extensive evidence that a sustained shift in share prices is followed by a gradual change in unemployment.

Since 1900 at least, there has been a pronounced long-term relationship between share prices and employment in the US and the UK, and over a somewhat later period in France, too. Since 1960, when figures for more OECD countries are available, there is the same statistical link in all of those countries except Sweden: the higher the share prices, the lower the unemployment rate.

The strength of this relationship depends on a country's economic institutions. Some OECD economies have long been relatively capitalist – the US, the UK, the Netherlands, Canada and Australia. Within them, new businesses have relatively easy access to finance (domestic and foreign) and can enter or exit a wide range of industries without big hurdles.

Other countries have long been more nearly corporatist – Italy, Germany, Austria and Japan. They have a rather closed system of big corporations and big labour unions loosely directed by an interventionist government with the collaboration of big banks. Statistical evidence shows that the same given change in share prices is followed by a greater change in employment in the more capitalist economies than in the more corporatist ones.

To what particular labour and capital-market institutions might responsiveness to share prices be strongly linked? We argued that more responsive economies have fewer employment protections to scare entrepreneurs away from starting new firms, and have less industry-wide or economy-wide wage bargaining, which may also deter entrepreneurs. Evidence confirms that the most responsive OECD economies scored well on these counts.

We also hypothesised that more responsive economies would be less encumbered by bureaucratic “red tape” that raise the costs of starting and developing firms. Further, they would have a well-developed stock market, since stock options help motivate entrepreneurs to start new businesses and venture capitalists will want an exchange in which to sell the shares in the start-ups they acquire. Finally, they would show large numbers with a university education.

Countries that scored poorly in responsiveness to share prices tend also to score badly on the OECD's index of “red tape” and on university education. We measured the progress of each country's stock-market by the level of stock-market capitalisation as a ratio to GDP in 1988, a decade before the late 1990s investment booms began. We found that the greater the level of capitalisation, the more responsive employment was to share prices. With these capitalisation figures alone you could have predicted which OECD economies would boom in the late 1990s.

If my thesis is right – the root cause of big booms in capitalist economies over recent decades (as well as during the pre-WWI decades) is a structural shift in expected future profitability – what does it mean for the choice of an economic system and for economic stabilisation?

Many Western nations react to perceived flaws by drawing back somewhat from capitalism through increased public sector employment, public expenditure, and social control over the private sector. Countries that, in the past, pursued some such policies include Norway, Austria, Italy, Germany, Sweden, and France. It is plausible – though not a certainty – that an economy dominated by large public expenditure and public employment is capable of greater stability. Yet countries that continued with these policies in the 1990s were deprived of the once-in-a-generation investment boom enjoyed in the more capitalist countries.

Now a cultural shift appears underway in several of those economies, with more possibly to come. “Shareholder value” has gained force; access to an organised stock exchange has widened. If so, these countries will be exposed to wider swings. What then?

It is doubtful that there is a positive benefit – net of future cost – from jiggling tax rates to stabilise employment. Yet governments can attack speculative excesses and thus reduce job instability by doing for capital markets what they have long done for product and labour markets: set up systems to monitor markets for the safety of investors, ensure transparency, and promote good corporate governance. The job instability that remains would be a small price to pay for the stimulus, excitement and progress that a well-designed capitalism brings.