THE FRONTIERS OF GROWTH

The Road to Prosperity and Sound Markets

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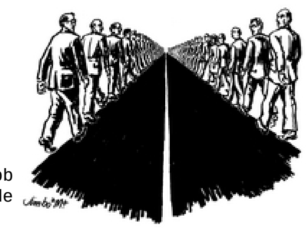
BERLIN – The near global financial meltdown and ensuing downturns left the Anglo-Saxon nations pondering what they should do both to set their economies on a path toward recovery and to avoid a similar crisis in the future. Some recommendations by members of Columbia University's Center on Capitalism and Society were sent to last April's G20 meeting. To create more jobs in the economy, I proposed that governments establish a class of banks that would acquire the lost art of financing investment projects in the business sector – the type of financing the old "merchant" banks did so well a century ago. I also renewed my support for a subsidy to companies for their ongoing employment of low-wage workers. (Singapore adopted this idea with enviable results.)



To protect commercial banks from risking their own solvency (and the whole country's solvency besides) once again, Richard Robb suggested that a small tax on banks' short-term debts be imposed in order to deter banks from over-borrowing. Amar Bhide suggested that commercial banks return to "narrow banking." If they did that, they could not borrow at all.

But despite all the policy action and talk since then, none of these suggestions has been adopted by G20 countries. Their emphasis has been on countercyclical measures intended to moderate the downturn rather than on restructuring. Such moderation, taken alone, is welcome, of course. But the measures taken may be delaying recovery.

Much of the fiscal "stimulus" to consumers causes companies to hang onto employees a little longer rather than to release them to export and import-competing industries that are expanding. Much of the stimulus to homeowners is propping up housing prices at unsustainable levels. This is slowing the absorption into the economy of the excess resources in the construction industry. Another round of global stimulus after the downturn is over or nearly so would push world interest rates up and drive investment activity down.

Government initiatives to rebuild "infrastructure" – to replace waning private investment with state investment in health care, climate control and energy conservation – do not have that downside. But as a means to job creation there are questions. Private investment is sustained by private innovation, which renews good opportunities. But would good opportunities for state investment be similarly renewed? Might the uncertainties raised by entering into such unknown territory exact a serious toll on private investment activity?

Governments must shake off the delusion that full recovery is just a matter of pushing buttons. Beginning with the astonishingly innovative economies that sprouted up in the 19th century, the tried and true method for gaining high prosperity – for an ample supply of engaging and challenging jobs – has been a system of innovative private enterprise in the business sector.

What governments ought to do is "stimulate" an innovative economy, not endless roads, wind energy and other building projects. The best way to shorten the downturn is to restructure the economy in such ways that it recovers to a higher "new normal" level.

This December, the Center on Capitalism and Society is meeting in Berlin, just weeks after commemorations of the fall of the Berlin wall. The meeting is intended to seek ways to streamline and buttress complex and stumbling economies so that they possess the dynamism that delivers high prosperity – plentiful jobs and ample job satisfaction.

Not all the instruments for creating that prosperity are known, of course. Yet many are. It is good to have a banking industry run by a diversity of canny financiers capable of recognizing and willing to fund innovative investment projects. It is good to have a business sector in which shareowners are not prey to self-dealing CEOs. It is bad to have fund managers that dump a company's shares if it does not hit its earnings targets for the next quarter.

Yet the goal of high dynamism raises a problem. Markets, being peopled by mere human beings, have trouble figuring out where profitable investment opportunities are (let alone the most profitable). A company's knowledge of the future results of a new business undertaking is imperfect to say the least. And the more innovative the undertaking the more imperfect is any advance understanding of its potential outcome.

An investor's knowledge of the results of a decision to buy this or that asset, financial or real, is likewise imperfect. Moreover, what others think – particularly, what rivals are doing – may have a big effect on the results of a decision and much of what others understand and plan is private, thus inaccessible. So an economy's dynamism depends on enough people daring to act in spite of how little they know.

Those of us who, at the Berlin conference and elsewhere, seek to rebuild economies for greater dynamism must do so with awareness of these economic realities. The market's magic powers are limited. Fortunately, there are some policy precepts and ideas that governments would do well to invest their political capital in if they want innovation and its attendant prosperity to resume.

A time-honored precept is to avoid shaking investor confidence unnecessarily. When John Maynard Keynes went to see President Roosevelt in the depths of the Depression, he advised toning down the administration's anti-business rhetoric. Yet governments must also avoid pumping up businesses with over-confidence, which could tempt them to raise mark-ups and hurt sales.

Simplifying financial institutions, especially those with an implicit government backstop, must also play a role in rebuilding a dynamic economy. Ratings that pretend to take into account "systemic risk" might prove as dangerous as ratings that ignore such risk. Hedge funds, venture capital firms that actually venture into new things, and recreated merchant banks are relatively well suited to make financial decisions that require judgment, the ability to engage the unknown, and to do so over a horizon not dictated by quarterly earnings.

There are also ideas to address speculative swings. They may induce wasteful investment and a loss in innovation. Their "corrections" may also have costs – a business slump and a further loss of innovation.

A conceptual framework – Imperfect Knowledge Economics – recently developed by a Center member, Roman Frydman, in collaboration with Michael Goldberg, shows how excessive swings in asset prices arise from market participants' imperfect understanding of the future rewards of their decisions. This framework provides a rationale for policy intervention in asset markets, and also has important implications for how regulators should measure and manage systemic financial risk.

The analysis acknowledges that, within a wide range, the market does a far better (though not perfect) job in setting prices than regulators could. But it makes the case for novel measures, including "guidance ranges" for asset prices and targeted variation of margin and capital requirements, to help dampen such excessive price movements.

Regaining a well-functioning capitalism may be a steep mountain to climb. Yet there are grounds to hope that it is within our reach.

For a podcast of this commentary in English, please use this link: http://media.blubrry.com/ps/media.libsyn.com/media/ps/phelps11.mp3

demandside 05:22 08 Dec 09

Phelps had no clue then, has no clue now. But it's nice to see him cite Keynes for support.

cheeheongquah 09:48 09 Dec 09

The only thing regulators should do on the financial sector is to get their hands off. Get another job instead.
The root of the debacle is the implicit rescue by the government, not market failures from imperfect information or whatsoever. Market power, I believe, is only second to the power of God.
Please don't raise all those market imperfections, boom and bust stories when we all know that the risk-return pricing model is greatly distorted by government guarantees.
Without the government guarantee, disruptive regulation and housing incentives, the prices would have factored in the so-called uncertainties and imperfections and the bubble would not have started or would have been greatly moderated.
Remember that the world functioned well when governments had no roles in manipulating monetary policy during the gold standard era. All hell broke loose when the standard was replaced with central banking.