

The 2008 Global Financial Crisis in Retrospect
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Trying to Improve a Future that is Seriously Unknown

by Edmund Phelps*

One of the major questions posed by the conference organizers is *whether* the “innovations in regulations are likely to reduce the frequency and severity of a banking crisis in the *future*” in the United States and the world economy. That set me thinking about how well or badly we do, in general, as policymakers and policy thinkers. I see two sorts of problems that have to be tackled. One is to determine the *efficacy* of a policy – novel or not. The other is to determine the *cost* of practicing the policy.

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First, the efficacy: It has long been understood that some of the policies we practice may be useless or positively harmful on balance, yet we did not recognize this when instituting the policy – and still don’t recognize it – because economics is hugely complex – more complex than we grasped. As Kenneth Arrow liked to say, price depends on quantity in *two* ways. Then there is the interest rate, capital stock, information and also industry knowledge and scientific knowledge. There is also spirit and confidence!

As a result, many policies supposed to be effective may not be effective. In the area of *macroeconomic* policy, a number of beliefs are questionable. It has come to be widely believed that fiscal stimulus, sustained for a significant period of time, pulls up employment – up to some natural level of employment, at any rate. Thus, many policymakers in the West maintain

that, in countries where it was instituted, a policy of fiscal “stimulus” – new public spending or cuts in tax rates – pulled employment from the depths of the Great Recession; and in countries where “fiscal austerity” was the policy – where there was a pretty tight rein on public spending and little in the way of tax reductions – there was little or no recovery.

Figure 1, however, gives *no evidence* that the speed with which employment recovered between 2011 and 2017 from the Great Recession tended to be greater in countries where the fiscal deficits added up to a larger increase in the real public debt relative to the GDP. In fact, the estimated relationship failed to be upward-sloping at all: The result suggests to me that the fiscal profligacy in Spain, Portugal and Italy *may have* gotten in the way of recovery. How, you may ask, could that happen? I was much too young to be aware of it, but Keynes warned Franklin Roosevelt in 1933 to beware of policies that might dampen business confidence.¹

It is widely believed too that monetary stimulus, in the form of open-market purchases of debt by the central bank, also pulls up employment as long as there is involuntary unemployment – especially if unemployment is well below the “natural” rate. I would guess that all of us here have a lot of confidence in that power of the central bank, though I don’t recall seeing any evidence. (By the way, an econometrician at Carnegie-Mellon years ago found evidence that the unemployment rate in the US exhibits a tendency to be pulled back to some “natural” path.²)

¹ If that is so, how did the UK avert a similar contraction? (It is also a conspicuous out-lier.) Perhaps the government *increased* its borrowing by *much less* than the other countries, as it was already borrowing more than most and business had already grown accustomed to that level of borrowing.

² [footnote referring to paper by ...]

Figure 2, however, likewise shows *no evidence whatsoever* that the “speed of recovery” between 2011 and 2017 tended to be *greater* in countries where the central bank’s cumulative asset purchase – normalized by the country’s 2010 GDP – amounted to a larger increase in the real public debt relative to the GDP. True, we may wonder whether this negative finding results from errors in the data or from random disturbances and too few observations. Many of the countries have the same central bank, namely the ECB, so there are not many “degrees of freedom.”

However, this odd result could be wholly or mainly a consequence of reverse causation. How would that work? Where the speed of recovery was more rapid, I would suggest, the central bank had relatively little time in which to accumulate assets, so it acquired relatively little of them. But what was driving those relatively speedy recoveries? It *could be* Keynes’s “business confidence” again.

But I suspect there is a *another* explanation for this statistical result: It may be that a nation with a relatively high level of *dynamism* – overflowing ideas for new products and new methods and widespread zeal to develop and market them – would be relatively quick to take advantage of empty shops, closed plants and discharged workers with no job yet. So we can expect that the relatively dynamic economies – the US and the UK come to mind, but also Sweden and to a degree Germany – to achieve a relatively rapid rate of recovery, *regardless* of how little monetary stimulus is poured on the fire. (The Austrian School surely understood this, though I happened on the point only some two years ago.³) So let’s test *this* promising theory.

³ I wrote that “in healthy economies, a contractionary demand shock sets off two types of responses fueling recovery. Adaptations to opportunities... [and] indigenous innovation...” See “Supply Side, Demand Side or Innovation Side,” Project Syndicate, May 19, 2016.

Now, of course, we are not sure there is much dynamism left in those high-flyers of the West's glorious past. As my book *Mass Flourishing* maintains, innovation has declined in nations where it had been strong though in the US it *arose* in a narrow set of *new* industries – leaving a net slowdown of American innovation.⁴ My research team and I have found a way to estimate indigenous innovation. But here I will use the long-term growth rate of total factor productivity as a proxy for the rate of innovation.

Figure 3 shows a strong statistical relationship between this proxy for dynamism – and thus for innovation too – and the speed of recovery. These 3 results suggest that fiscal stimulus and monetary stimulus are side-shows – that the main driver of recovery is dynamism – the same dynamism that drives everything good: from wage growth to job satisfaction and life satisfaction.

The apparent potency of an economy's dynamism in pulling up employment out of a downturn leads inevitably to the question, if dynamism is so hot, does it fuel economic performance in other dimensions too? If it is not an all-purpose elixir, does that cast doubt on its efficacy in treating depression and recession?

Figure 4 examines the effect of dynamism, proxied as before, on the *level* of labor force participation rate as customarily measured by the OECD in some normal, health year. In 2006, these participation rates are shown to be generally higher in the countries with relatively high dynamism in 1990-2007. It might be considered more acceptable to relate the dynamism measures to participation rates in some year *after* 1990-2007, so I prepared **Figure 5**, which shows these participation rates in 2016.

⁴ This thesis set out in Part 3 of Phelps, *Mass Flourishing: How Grassroots Innovation Created Jobs, Challenge and Change* (Princeton, Princeton University Press, 2013).

It goes without saying that, while dynamism is an elixir that heightens participation rates, job satisfaction and wage rates, other forces count too. **Figure 6** gives evidence that, although injecting a fiscal *deficit* does *not* unambiguously speed up recovery – to any significant extent, at any rate – the *level* of government debt to which the economy has adjusted *does* matter for the *level* of participation. (In contrast, ultra-Keynesians hold that, by increasing “demand,” public debt boosts employment and participation – the ultra-Keynesians that maintains a higher level of *wage rates* would raise employment and participation.) It is refreshing to find that, as the standard theory holds, public debt, in increasing *wealth*, decreases participation.

Figure 7 investigates whether small changes in the size of government, relative to the GDP, have any pronounced effect on participation rates – it might have been interesting to look also for effects on job satisfaction and wage rates. I estimated a linear relation between male labor force participation rate and the size of government spending. I find it striking that male participation diminishes with size of the government. (Oddly, total participation – women and men – responds much less.)

Now, what about financial reform? In view of the uncertain *efficacy* of some *macroeconomic* policy steps and doubts over some political economy initiatives as well, it seems quite possible that the new *financial* regulations will likewise fail to deliver the desired effects. How can we be sure that *non-bank* financial institutions will not foil the effort to reduce speculation?

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The other problem I mentioned at the beginning is whether, especially in the modern economies with all their complexity, some of the new financial regulations will come at the cost of some other things we value. I can’t help

recalling the great sociologist (and good friend of mine), Robert Merton, who enunciated the *law of unanticipated consequences*. In view of the surprise and controversy that surrounds macroeconomic policy measures and political economy initiatives, it seems possible that the new financial regulations will be found to have unanticipated consequences for employment, growth and even economic stability.

With regard to bank regulations, one could legitimately worry – I think some people do worry – that heavy restrictions on how much the banks may lend will cost the country more in economic growth than it will gain in economic stability. Richard Robb, a member of Columbia’s Center on Capitalism and Society, responded in 2009 with a proposal to the Group of 20 to levy a small tax rate on each dollar of financial assets a bank held so as to nudge the bank not to go wild with such purchases. (Ultimately, he says, Basil III pretty much did what he had proposed.)

This obsession with stability seems rather strange to me. After all, the US economy is not a bucking bronco. A working-age person employed in the private sector might not know what would be best for him or her, However, I feel that we in the West are in desperate need of more innovation and the attendant investment in the hope of lifting up people’s satisfaction with their “working lives.”

Let me come to my concluding theme: In the public discussion, the focus is still on the Global Financial Crisis of 2008 and the ensuing recessions in many countries. With exceptions, it is only in discussions among business people and economists that the focus is on the 50 year-old Great Western Stagnation and the ensuing symptoms: Investment weak, rates of return generally poor, mark-ups increasingly enlarged, job satisfaction down, total

labor compensation barely growing. No wonder growth of productivity and wages continues at a snail's pace. And no wonder labor force participation is still down despite a spending boom and some governments nearly broke.

I have to say that we ought to be worried about the recurring craving for considerable micro-control over the economy. The proposals of Elizabeth Warren and Jeremy Corbyn to place representatives of the state and of the public on corporate boards are ominous. They show no grasp of previous attempts to exchange capitalism for something else. There was Germany's Weimar Republic in the 1920s, with its deep intervention in the conduct of companies, which was followed by awful economic performance: near-zero innovation. Then in the late 1940s came the quasi-socialist initiatives of the Labor government in Britain, followed by a near cessation of indigenous innovation. Then, in 1981, the corporatism of Mitterand came to France, bringing to an end the high innovation of *les Années Trente*. Elements of corporatism have entered the US from Roosevelt to Nixon and Trump.

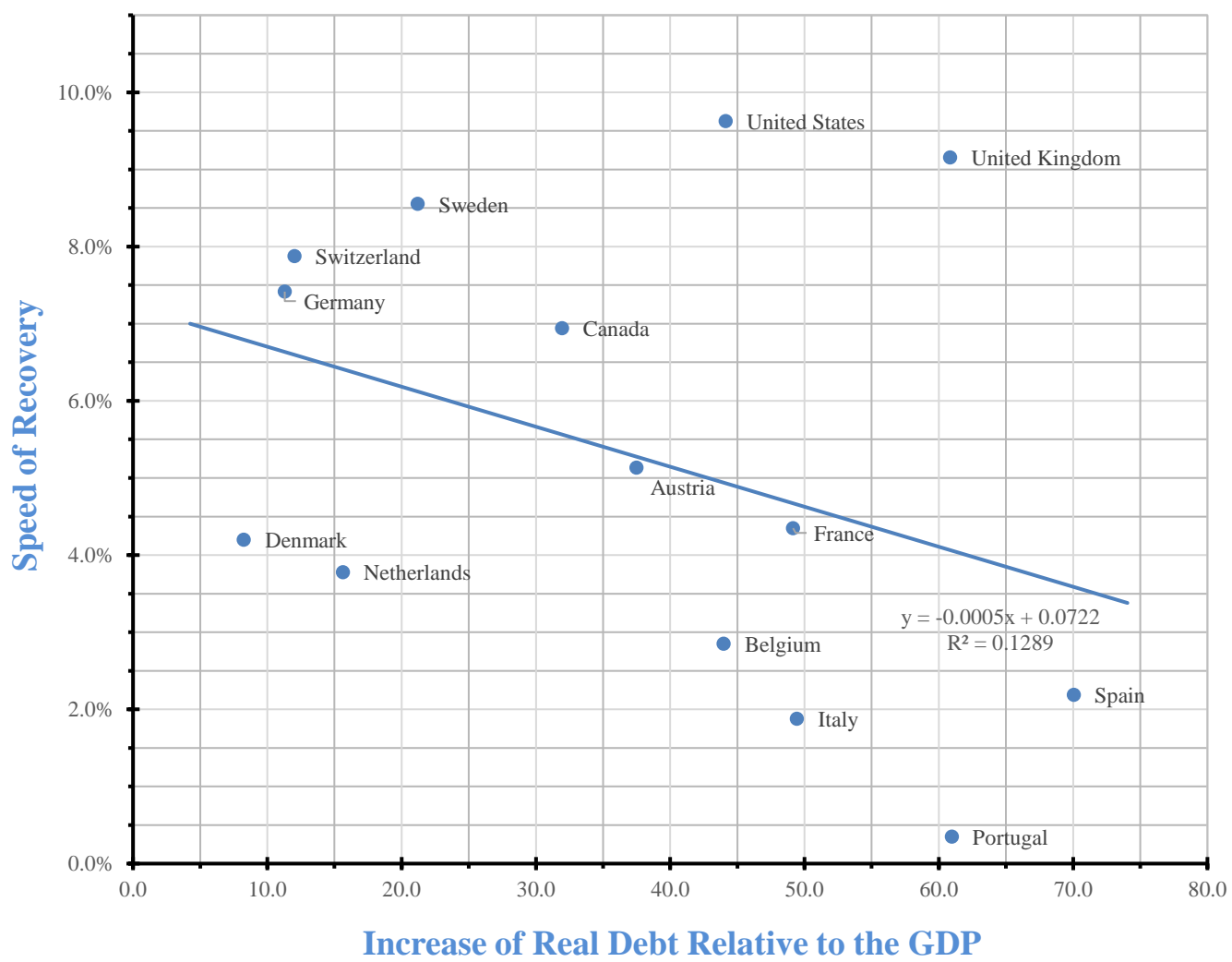
We economists have to concern ourselves with initiatives causing too much regulation and reform as well as times of too little.

Thanks you for your attention.

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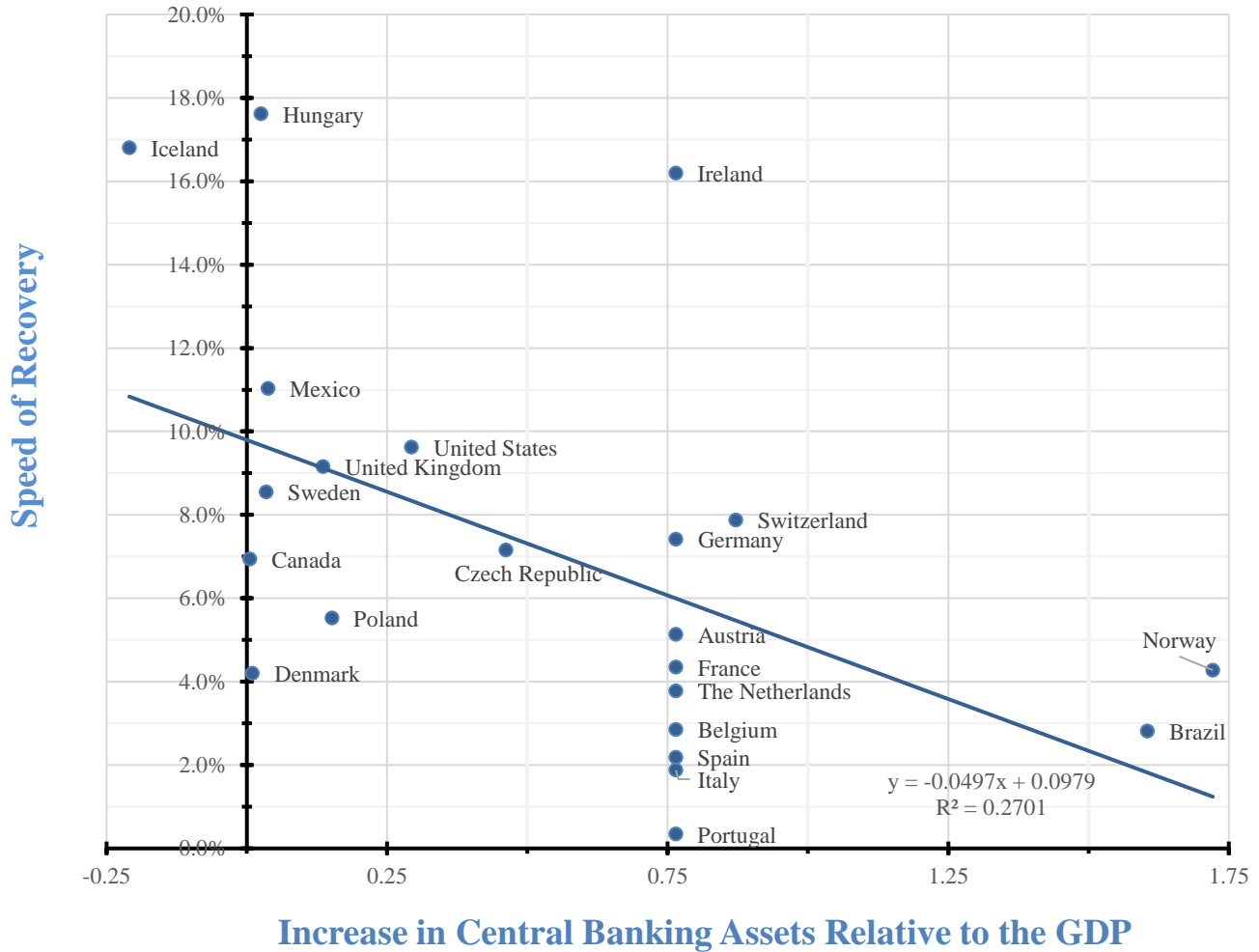
He thanks Catherine Pikula for her editorial and preparation of the slides and thanks his colleague Richard Robb for reviewing the ms. He is grateful too to Max Porlein, now a student at MIT, for his help with the investigation of the effectiveness of fiscal stimulus in speeding recovery (Fig. 1), later the effect of dynamism on recovery (Fig 3). He is also grateful to Jake Sindelar, a student at Columbia College, for his work on the effect of monetary stimulus (Fig.2), the effect of dynamism on labor force participation (Figs. 4 and 5) the effect of public debt on participation (Fig. 6), the effect of government size on participation (Fig. 7) and on employee compensation (Figs. 8 and 9.)

Figure 1 Fiscal Stimulus and Speed of Recovery, 2011-2017



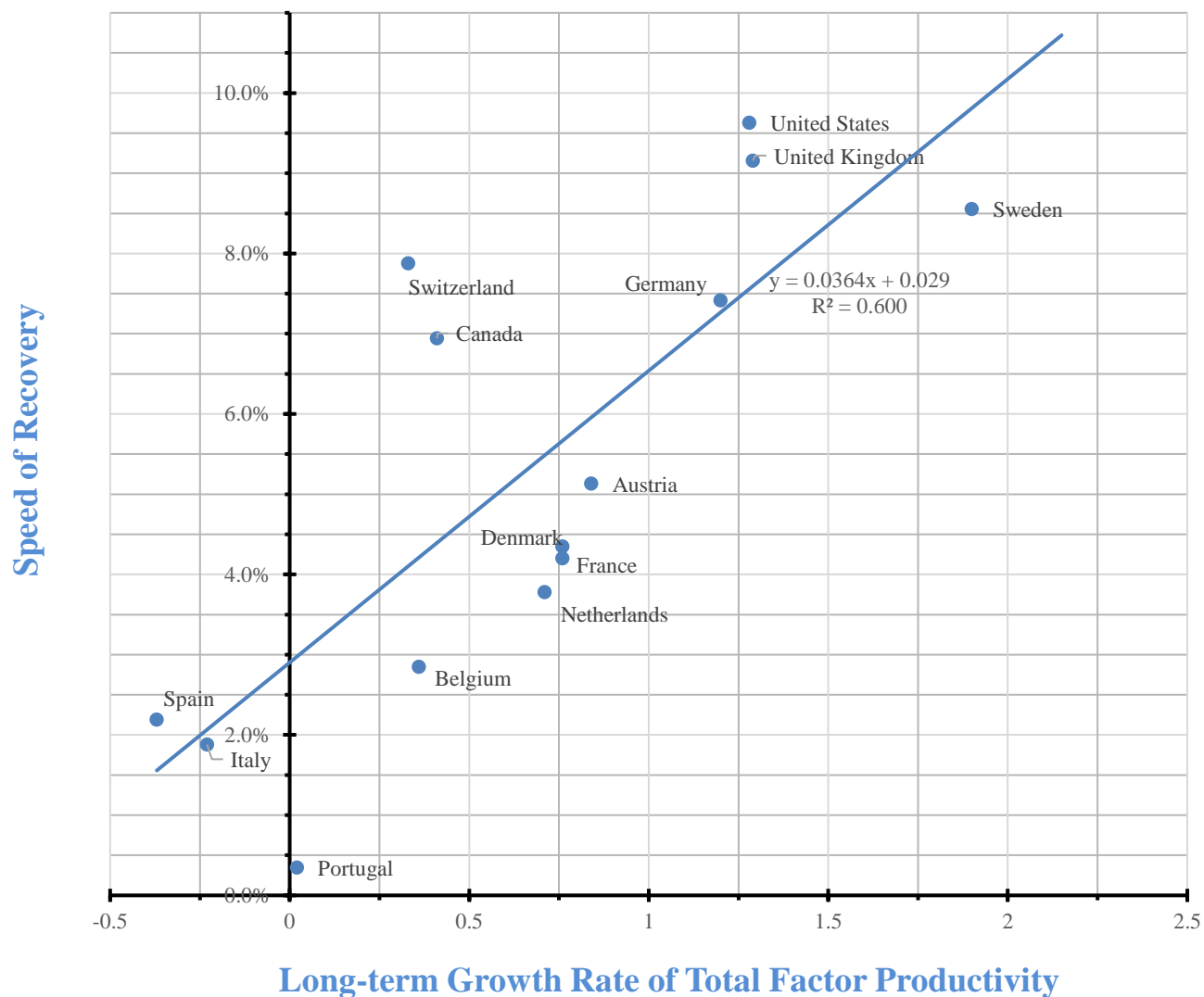
Notes: The chart shows the rate of growth of employment, 2011 to 2017, plotted against the absolute change in public debt normalized by the country's 2010 GDP in its individual currency.

Figure 2 Monetary Stimulus and Speed of Recovery, 2011- 2017



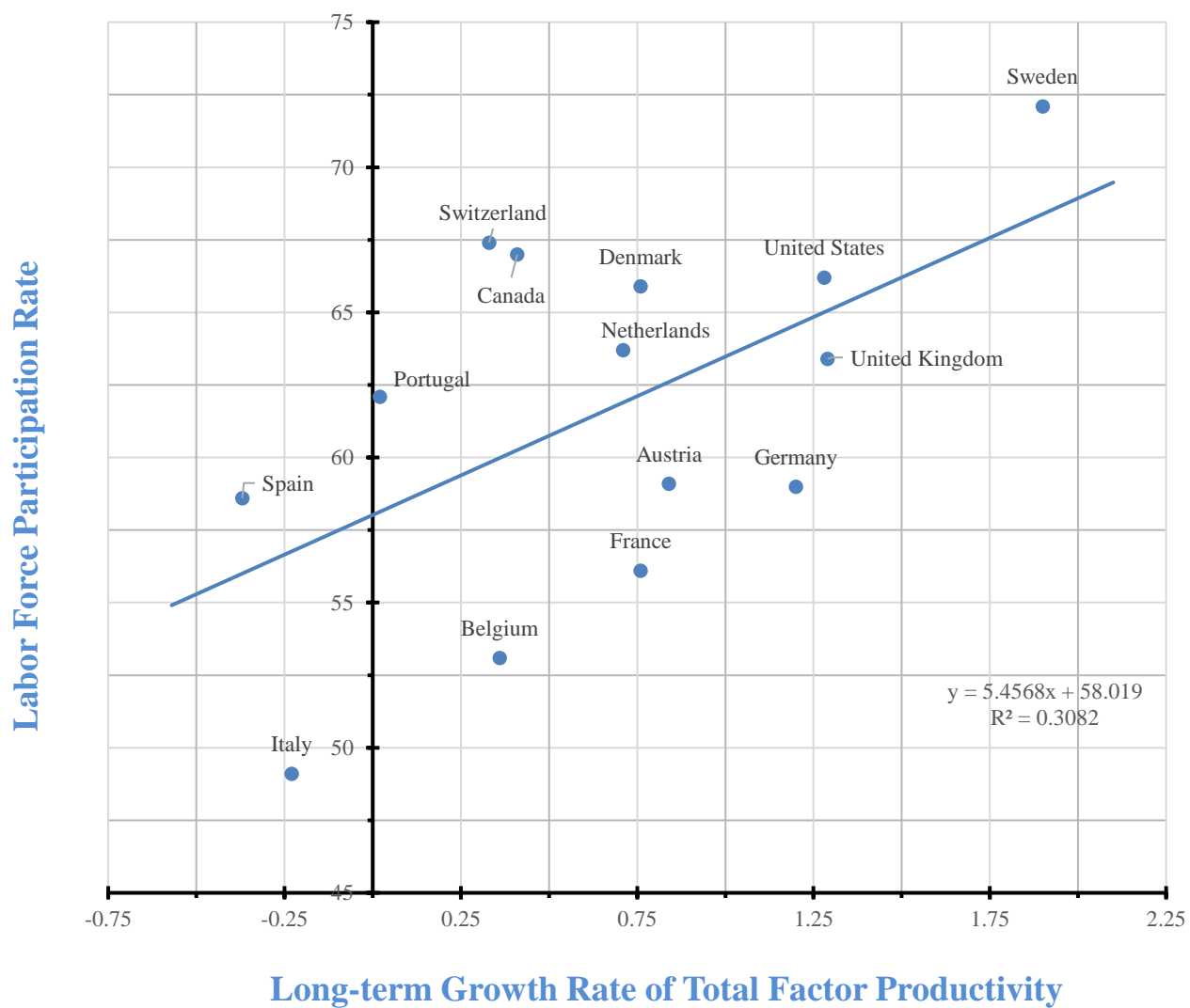
Notes: The chart shows the rate of growth of employment, 2011 to 2017, plotted against the central bank's cumulative asset purchase, 2011 to 2017, normalized by the country's 2010 GDP in its individual currency.

Figure 3 Dynamism and Speed of Recovery, 2011- 2017



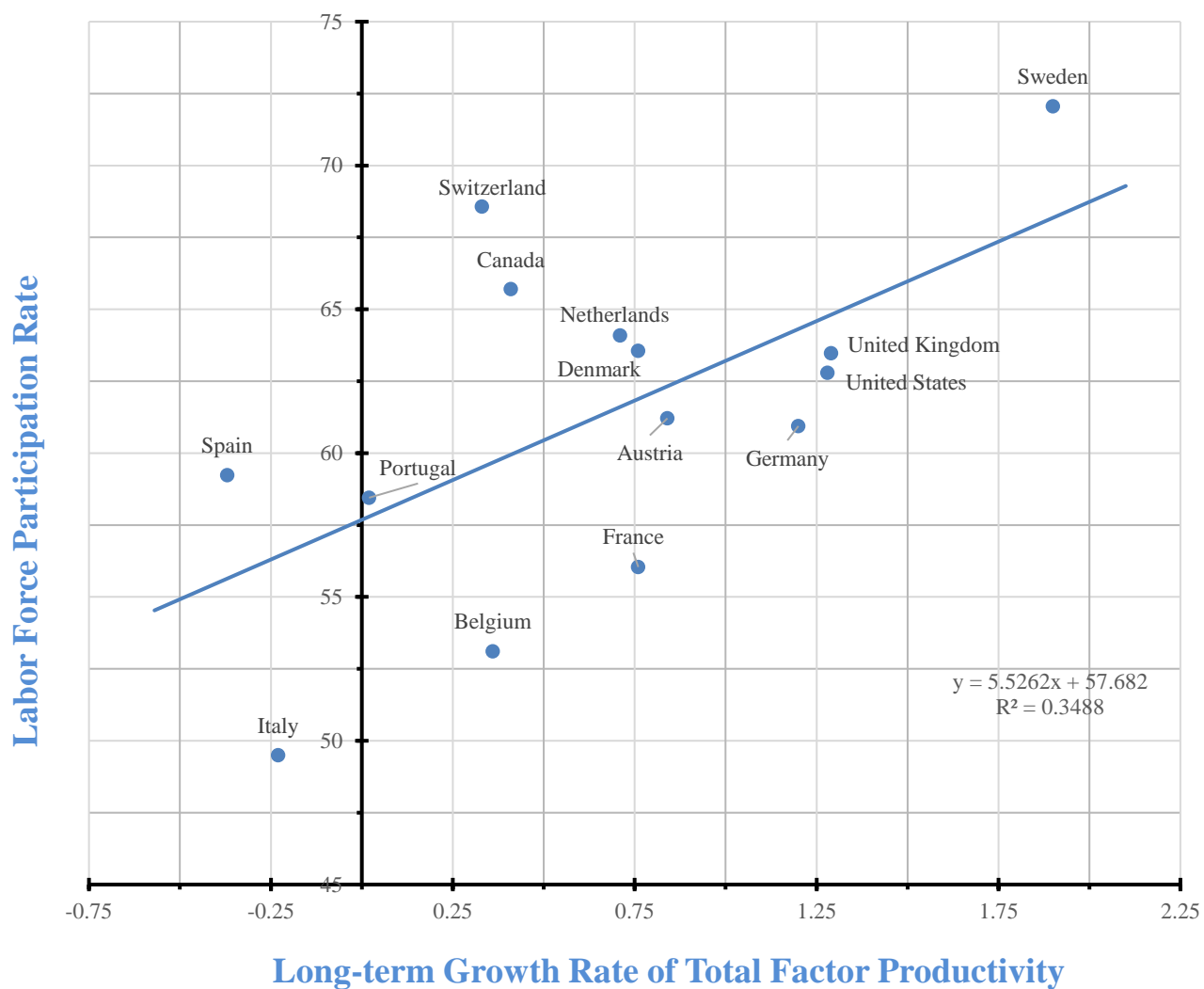
Notes: The chart shows the rate of growth of employment, 2011 to 2017, plotted against the rate of growth of TFP from 1990 to 2007.

Figure 4 Dynamism and Labor Force Participation Rate in 2006



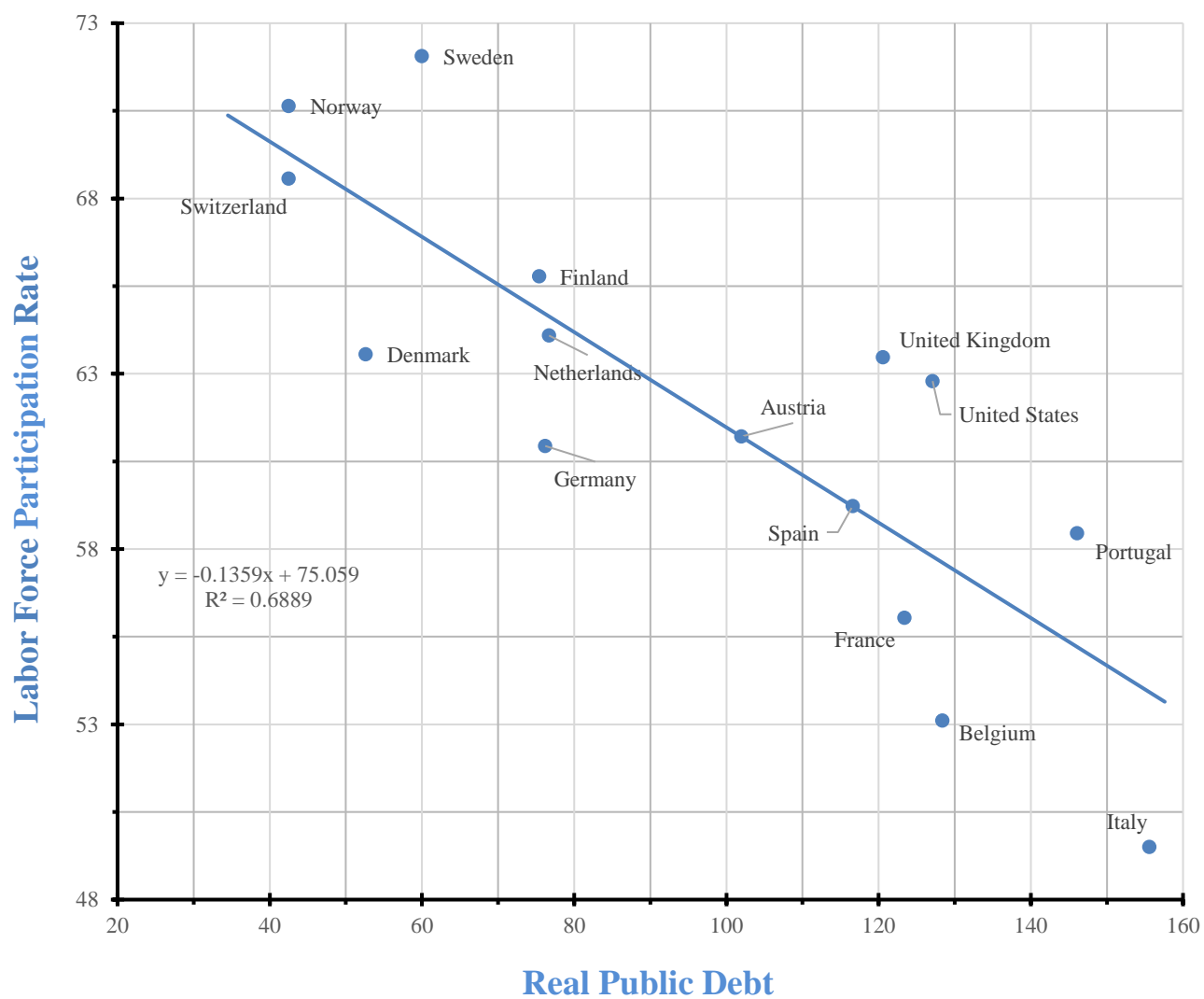
Notes: The chart shows labor force participation rate in 2006 plotted against the rate of growth of TFP, 1990 to 2007.

Figure 5 Dynamism and Labor Force Participation Rate in 2016



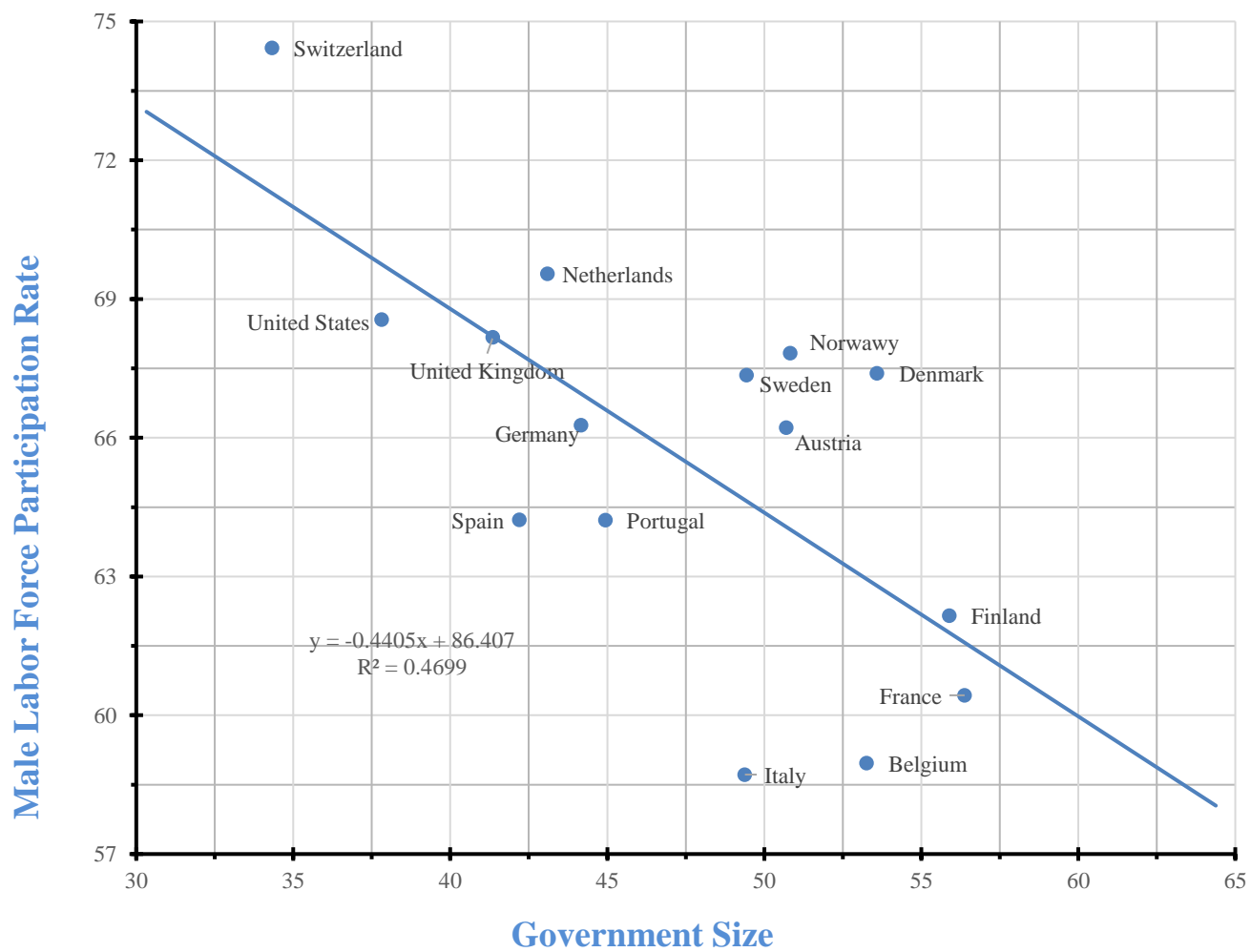
Notes: The chart shows labor force participation rate in 2016 plotted against the rate of growth of TFP, 1990 to 2007.

Figure 6 Real Public Debt and Labor Force Participation Rate in 2016



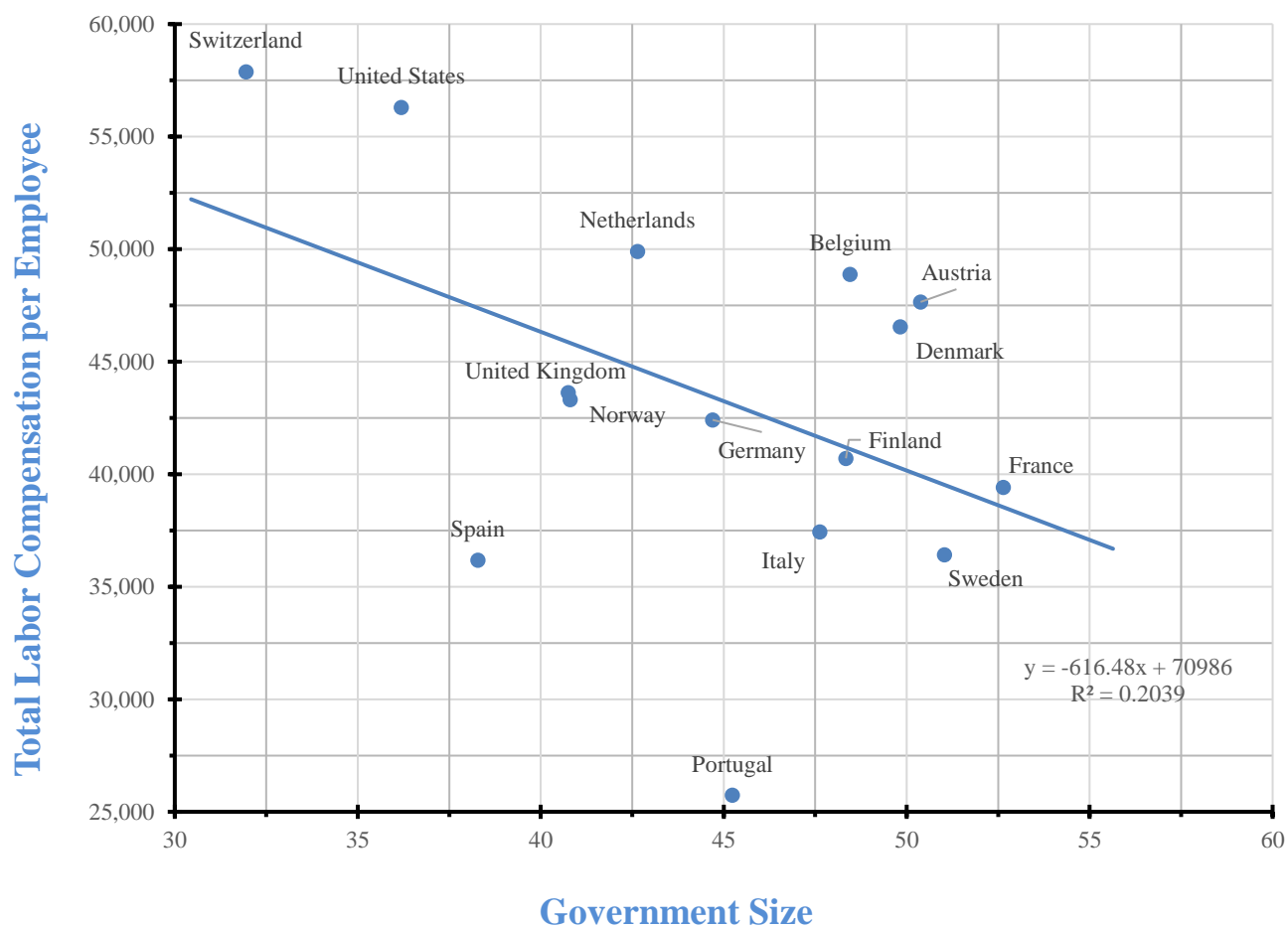
Notes: The chart shows the labor force participation rate in 2016 plotted against the real public debt in 2016.

Figure 7 Government Size and Male Labor Force Participation Rate in 2016



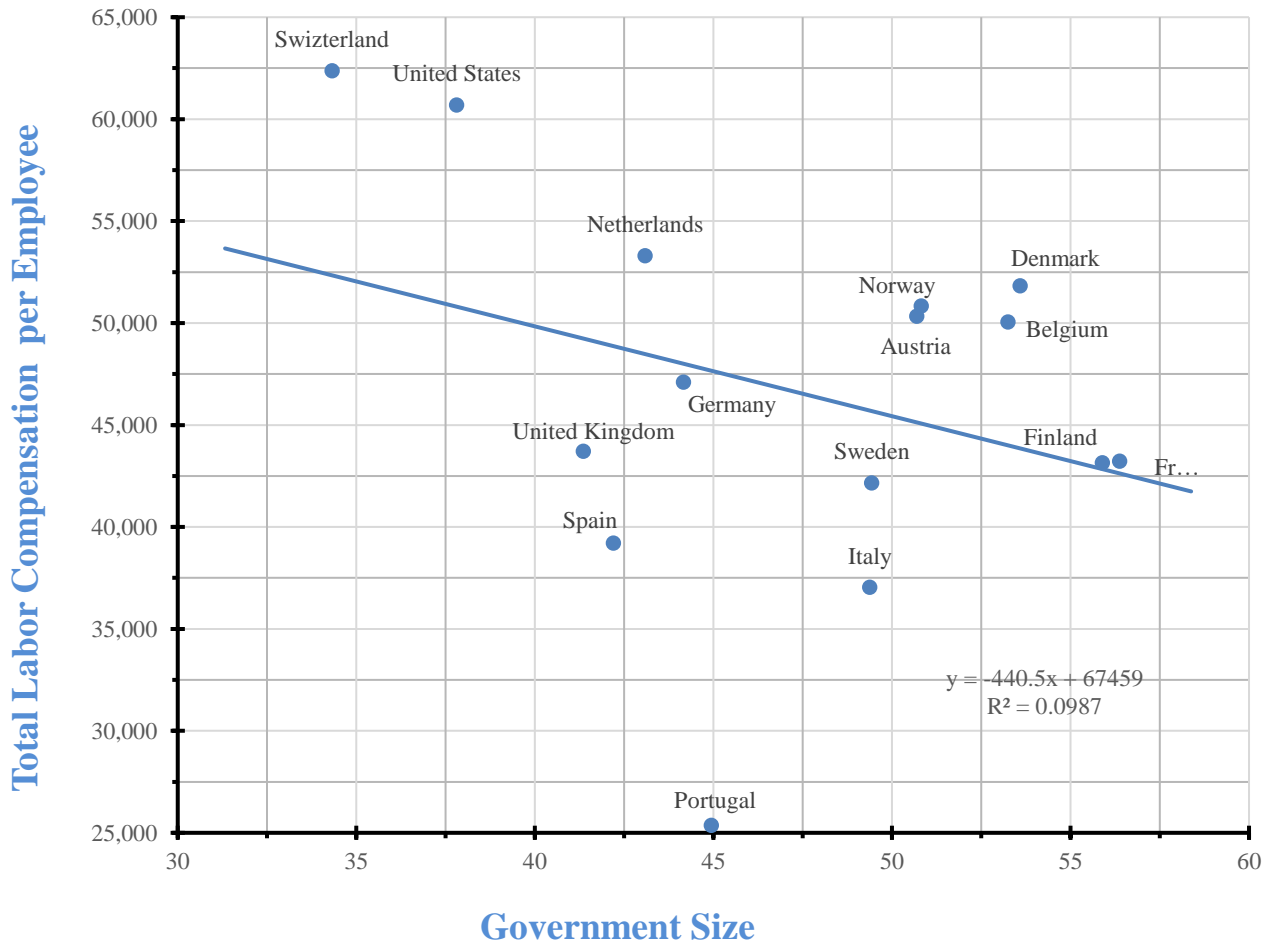
Notes: The chart shows the male labor force participation rate in 2016 plotted against the size of the government, measured by government spending as a percent of GDP in 2016.

Figure 8 Government Size and Total Labor Compensation in 2006



Notes: The chart shows total labor compensation per employee in 2006 US Dollars plotted against the size of the government, measured by government spending as a percent of GDP in 2006.

Figure 9 Government Size and Total Labor Compensation in 2016



Notes: The chart shows total labor compensation per employee in 2016 US Dollars plotted against the size of the government, measured by government spending as a percent of GDP in 2016.