

Cover



GDP





Europe, America and China Have the Same Economic Problem

By Edmund Phelps

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Each of the world's major economies – the European, the American and the Chinese economy – is slipping into its own “new normal” and each one is unhappy in its own way. These economies offer an escape from poverty. But Europe is seriously lacking in self-support. America is woefully lacking in prosperity. And all of them are, to varying degrees, lacking in human flourishing.

The European Union

Measured by its gross domestic product, the economy of the European Union is very large – larger than American and Chinese economies. Its decline acts to reduce wages in the rest of the world. More important, Europe was – for more than a century – a major source of new products and a key source of advances in science and the arts. We will all be the poorer if Europe goes on failing to recapture its brilliant past.

In the past two decades it has become apparent that the European economy is in very poor condition. It is common ground that, now, in 2015, the aggregate output – the Gross Domestic Product – of the European economy is far below the previous trend path – below the trend line we might fit to historical data up to 1995. Yet European economists believe with few exceptions that nothing is radically wrong with the European economy – nothing that would require structural rehabilitation extending to the entrepreneurial heart and innovative brain of the economy. Nevertheless it is interesting to note what these economists, observing that the economy is not well, are diagnosing and

prescribing. And we may learn something that may sometime be useful in our own economies.

Many economists speak of a loss of competitiveness, particularly in the south of Europe – in Greece, Italy and Spain. They imply that output is down, relative to trend, largely because wages got out of line with productivity, forcing firms to cut back – a case of wage misalignment. Taking this perspective, German economists argue for wage deflation in the affected economies; the Keynesian economists argue for monetary stimulus in order to raise prices (relative to wages) and state investment in infrastructure to create some more jobs.

The background to the adoption of this perspective is the sharp productivity slowdown that hit Germany, Italy, France and Spain around 1998; and Britain around 2005. Although wage rates have remained in line with productivity in Germany and Britain – and employment has held up pretty well there – wages got out of line with productivity in Italy, Spain and Greece during the boom years of the late 1990s, and in the early 2000s wages got ahead in France and farther ahead in Greece. These wage misalignments may very well explain the drop in the employment of men – relative to the population of men – from the period 1990-1995 to the period 2010-2012 in Italy and Spain as well as Greece. But, in Italy, France and most conspicuously in Germany, we see a bigger drop of the employment-to-population ratio from the 1970s

(in Germany and Italy) or the 1980s (in France) to the 1990s. Were those drops in employment also the result of wage misalignments? Is every fall of employment a market failure? Of course not! No one would believe it is mainly an accumulation of such misalignments that has brought declining employment and thus output not keeping up with its trend path. There must be some other forces at work.

Economists have staged a fierce debate over two warring schools. In the classical view, which I myself have expounded (in the *Financial Times*), it is to some extent a contraction of labor supply that has led to a decline of employment – and thus to lagging output. And it is largely outbreaks of fiscal profligacy in Europe, most pronounced from the mid-1990s to the mid-2000s, that led to that contraction: In Greece, Italy and, to a lesser extent, France, there were tax cuts and spending increases, which added to households' estimates of their private wealth in relation to their wage income, and there were expansions of entitlements to future benefits, which added to people's estimates of their social wealth relative to their income. (The European Union also donated lavish "structural funds" to Spain and Greece, which further increased people's wealth relative to their productivity. Brussels made some of them rich. Even public sector wage rates rose to the sky in Greece.) Bloated with wealth, many employees must have lost some of their incentives to perform well, so companies' costs of production went up;



and many households cut back their labor force participation – delaying employment or retiring sooner.

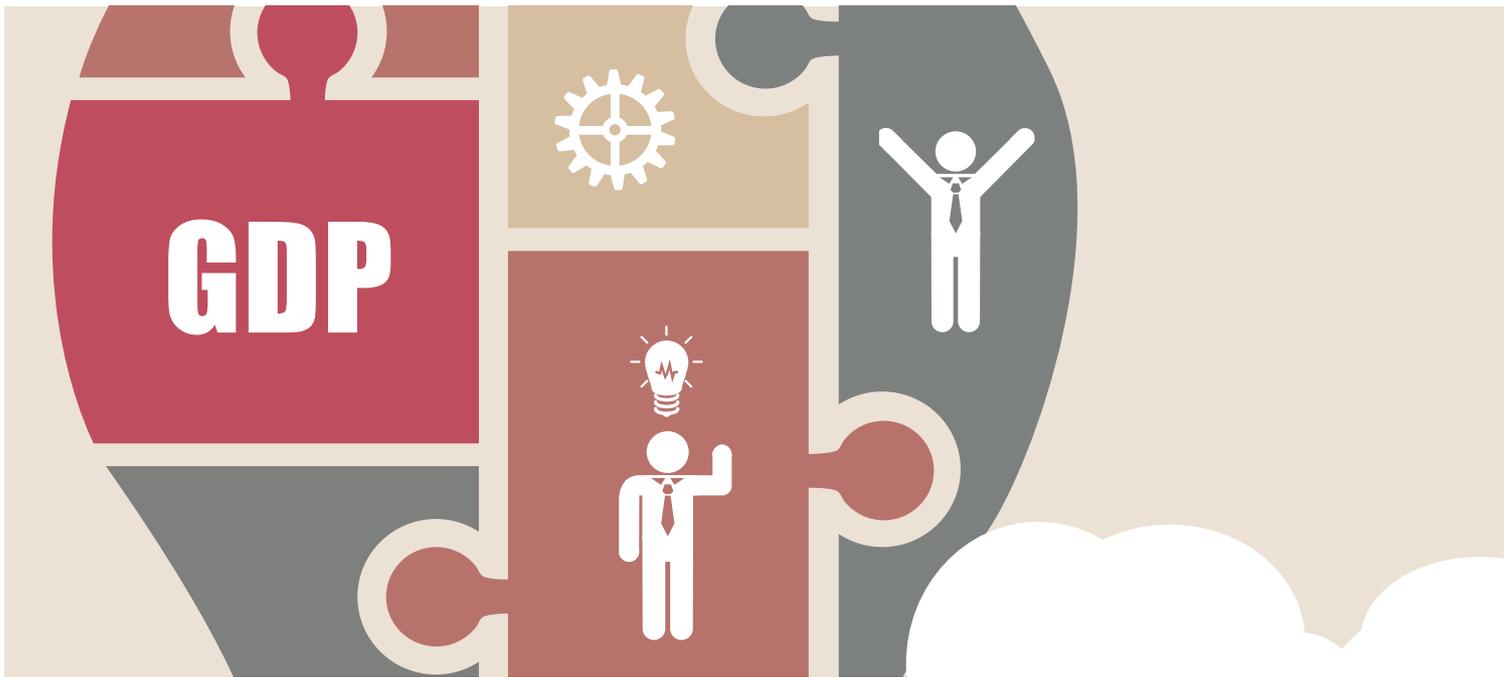
In the Keynesian view, an increase in household wealth serves to raise employment by adding to consumer demand. Keynesians suppose it is a decline of “aggregate demand” that has reduced employment, pulling output down with it. As they see it, southern Europe needs more of that fiscal “profligacy,” not the “fiscal austerity” forced on them, to reverse the fall of employment. (There is statistical evidence on the classical side: There is a negative relationship between the household wealth-to-income ratio and (1) labor force participation as a ratio to active-age population as well as (2) employment as a ratio to active-age population size.

However, this current debate between “Keynes” and the “classics” misses the big picture. The major cause of the huge losses of output – relative to the historical trend – ever since the 1970s or 1980s is the sharp slowdown of European productivity. This slowdown is the result of two losses of innovation. First in the 1960s, European innovating, though never very strong in the postwar years compared to what it was in the previous 100 years, appears to have slackened, so that Europe was totally dependent for sustained productivity growth on American innovation. Second, in the 1970s, American innovating slackened. Europe was able to draw further on the pool of past American innovations until that pool was virtually exhausted in the

mid-1990s. That helps us to understand why European productivity growth slowed so sharply.

Right now, in early 2015, southern Europe is suffering a slump of employment – mainly due to lingering uncertainties about finance in the aftermath of the recent financial crisis and about monetary and fiscal policy. Few businesses are investing, so few workers are hired to produce capital goods. But, even if Europe soon recovers from this slump, Europeans in the north as well as the south have to face the consequences of an economy that has had no significant productivity growth for two decades and has no prospect of achieving such growth – on its own, at any rate – in the near future. Europeans are going to have to go without the wage increases to which they became accustomed in the postwar decades. Europeans are going to go on facing companies in which few employees are involved in any engaging, challenging or creative work. Finally, Europeans are going to face the fact that employment will go on being weak owing to poor current productivity growth and poor expectations of productivity growth over the foreseeable future.

Worse yet, Europe will find itself in a vicious circle: Already a half million young Europeans have begun a new life overseas just in the past two years and a quarter-million or so can be expected to leave every year as long as there is a dearth of opportunities for rewarding, gratifying work in Europe. And as Europe goes on hemorrhaging its best talent, its possible ways out of its



stagnation will become even narrower.

This ongoing implosion of Europe presents not only the known dangers – the loss of trade and investment opportunities for the rest of world as a whole – but also unknown dangers. We have not seen in a very long time a prolonged stagnation of a high-income economy extending over a whole continent.

America

What came to be called the “Great Productivity Slowdown” appeared in America in the late 1960s. The annual growth rate of Total Factor Productivity, the productivity of labor and capital combined, after running at an average rate of 2 percent since 1922, slowed by 1972 to an average of 1 percent ever since. Americans, including me, had no idea how disastrous this would prove to be.

The only plausible explanation for this slowdown is that the rate of aggregate innovation in the American economy fell in the 1960s and has remained low. On Wall Street, this interpretation is resisted. “Don’t you know,” they say, “that Silicon Valley in California and Route 128 in Massachusetts have been prodigiously innovative?” The misunderstanding is resolved by noting that innovation has declined sharply in the older industries, which are found mostly in the heartland of America – in the interior of the country. Silicon Valley and Route 128 are still not big enough to offset a near-dis-

appearance of innovation over most of the economy. The entrepreneur and angel investor Peter Thiel, who has a deep knowledge of Silicon Valley, believes that Silicon Valley is no longer radically innovative – it has been mainly engaged in elaborations of a few radical innovations in the past.

For the growth rate to be maintained, each year’s innovation must be proportional to the current stock – while the stock is getting higher and higher. So maintaining the old growth rate constantly requires human imagination to be increasingly far-reaching. Yet America did it for more than 100 years.

What forces might have caused America such a large drop in the rate of growth in its stock of innovations? My book *Mass Flourishing* contains a lengthy discussion and here I will identify several of its hypotheses.

For widespread innovation in a nation the people must have the “dynamism” required to spark it. I suppose young Americans are still growing up with an undiminished “desire” to innovate – to conceive the new and to make a difference in the world. However, it appears from interviews and surveys that a great many young people who would have been expected to be aspiring innovators a generation ago are inhibited from pursuing such a life. American society has come to place less value on individual exploration and creativity. Family, friends and community put increased pressure on the individual not to break away or to stand apart. The rush to sever ties and “go west” to take part in its development would

be unimaginable today. Money has become the metric for assessing a person's success and main satisfactions: Parents and spouse urge a young person to opt for high pay and job security rather than to embrace uncertainty and to journey into the unknown. Pathological materialism leads to rampant short-termism in business and finance. No wonder people who grew up hoping to embark on a career of challenge and adventure forget this dream and drift into a lesser life.

Questions can be raised about whether, in recent decades, young people throughout American society have possessed the intellectual equipment – the capacity – required for innovating. In general, an innovator had to have insights into whether the newly conceived product would succeed in the market – insights typically born of business experience as well as “talent.” The baby boom generation brought into the labor force many people who were much less familiar with the world of business than the people of the previous generation and much less interested. The new generation may be different.

Societies must give aspiring innovators wide latitude if innovation is to be widespread. Yet huge blocks to innovation have been erected in America. Vested interests, such as established companies – their owners, the management and the work force – feel entitled to be defended against the competition that new innovators would bring and to bailouts in the event they suffer losses of market share to new competitors. Politicians,

for their part, feel entitled to curry the favor of interest groups. This is the culture of social protection. A result is that any aspiring innovator contemplating an attempt to bring a new product or method to an established industry will realize that he or she would be doomed to failure because the state will protect the incumbent companies from losing their market share. In the past couple of years, some young giants in the so-called technology fields, such as Google, have begun to invade traditional industries.

The prospect for the foreseeable future, therefore, is a near-stagnation of productivity and wages, a deficiency of engaging work, and weak employment – similar to Europe, but not as severe as long as new industries, with their new products or methods, are conceived, developed and some are successful.

Now, in early 2015, America has achieved the semblance of a recovery. A rough recovery from a crisis is a natural result of a bulging shelf of new ideas still unexploited and the accumulation of retained profits waiting to be invested. Recent data put the unemployment rate at about the level of 1995-96 – after the recent recession and before the internet boom. We could even go as far as to say that a boom is going on – in the midst of long-term stagnation – thanks to the innovation called “fracking” and to the flight of capital from Europe and elsewhere, which has made it easier for investing and innovating to obtain finance. Yet labor force participation has plumbed new depths, growth of

real wage and productivity remains meager and no rise in job satisfaction has been reported.

Much ink has been spilled over the Keynesian thesis that it was a rejection of “fiscal austerity” that enabled the American economy to “recover” while Europe did not. But there has not been much in the way of permanent increases in government expenditure in the aftermath of the financial crisis, only a welter of temporary spending measures now generally expired; and no permanent tax cuts. Quite the contrary, many tax rates were increased and huge numbers of government employees were terminated until the public payrolls were leaner than before. Furthermore, it is quite possible that we shall see the boom peter out – that the boom will end in a year or two, just as all booms do.

China’s economy

We all know that China through a combination of trade, investment, relocation of labor and “transfers” of technology from abroad has achieved a stunning wage growth, better jobs and higher employment. But it should be clear that these avenues for continued economic growth go only so far. Efforts along these lines are running into diminishing returns.

The economy will have to offer much broader opportunity for work that is stimulating and fascinating – for mass flourishing!

For both these reasons, China will soon be in the same situation as Europe and America are. It must begin to find ways to expand its indigenous innovation from the elites in the tech industries to all kinds of industries and all sorts of people down to the grassroots of society – just as Europe and America must do if they are to regain wide prosperity and mass flourishing.

What is required? Boost the enablers of innovation such as education. Boost the dynamism for innovation by removing the inhibitors created by traditional cul-

tures. And remove the blocks like social protection and smothering regulations.

It is clear that the Chinese want to aim for precisely that – for grassroots innovation and what they call “self-development.” Most Americans do too. We will have to see what the Europeans want.



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