

JEAN-PAUL AND I: COLLABORATIONS AND SOME DIFFERENCES 1984-2022

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I first met Jean-Paul Fitoussi in 1984. We became good friends during my year as a visiting scholar in 1985-86 at the European University Institute in Fiesole, and were the closest of friends in the ensuing years. He and I were different: I was an American coming up from a New York suburb and Amherst College to a career in American academia and Jean-Paul was a Tunisian coming up from La Goulette, the University of Strasbourg and a career at Science-Po. Perhaps it was the differences in our backgrounds that made us interesting to each other.

Our interactions in Fiesole and Paris led to our first collaboration with our Fall 1986 Brookings Paper, "Causes of the 1980s Slump in Europe." As a closed-economy theorist, I wasn't familiar with whatever recent studies might have found on the effects of shifts in a nation's policy measures aimed at boosting employment *at home* on the employment levels *abroad*. (It was not my field.) But I had heard one or two economists quote the old saying, "A rising tide lifts all lifts all boats."

Jean-Paul came to believe that a policy shift in America that *raises* the world real interest rate drives *down* aggregate *demand* in Europe. I came to believe that a rise of the world real interest rate drives *down*

This is the text of the invited lecture that Edmund Phelps gave at the conference organized to honor Jean-Paul Fitoussi by Sciences Po and OFCE, on December 7, 2022.

aggregate *supply* in Europe as firms respond by pushing up the mark-ups in “customer markets.”¹

So, Jean-Paul and I – *he* worried about the “steadily rising unemployment rapid disinflation” in Europe, *I* concerned with whether that *new theory* would hold up against the evidence – proceeded to begin a rather wide *investigation* of the causes of the European slump.² We wanted to understand “*why* capacity has not been sufficiently *profitable* to operate and to expand.”³ This joint work of ours was published by Basil Blackwell in the 1988 book, *The Slump in Europe: Reconstructing Open Economy Theory*. “With this book,” we wrote in the Preface, “we present a new explanation of the slump in Europe *built upon* central features of the 1980s.”⁴

The book began by noting errors or weaknesses in the *prevailing* explanations of this slump:

- A *popular* explanation ... one appealing to Keynesian economics, points to the *fiscal austerity* in Europe: the shrinkage of public services and public sector capital expenditures, and the maintenance of tax rates at pre-slump highs. ...

But this hypothesis forgets some offsetting mechanisms: ... In Keynesian theory, reduced public expenditure or increased tax rates – whether in an open economy with a freely fluctuating exchange rate or in a hypothetical closed economy – ... *reduces* ... employment only insofar as it *lowers* the rate of interest ... [an event that] slows the velocity of money. However, there is *no evidence* of *either*. Interest rates and [the] velocity [of money] have been *high* in recent years.⁵

These remarks – which may be Jean-Paul’s writing – are very good, I think. The point was that a *Keynesian* slump typically results from a downward shift of the IS curve sending the economy down its LM curve – and this would be evident in a *reduced* rate of interest. But no

1. Edmund Phelps and Sidney G. Winter, “Optimal Price Policy under Atomistic Competition,” in *Microeconomic Foundations of Employment and Inflation Theory*, ed. Edmund Phelps (New York: Norton, 1970), 309-337.

2. Jean-Paul Fitoussi and Edmund Phelps, *The Slump in Europe: Reconstructing Open Economy Theory* (Oxford: Basil Blackwell, 1988), 7.

3. Fitoussi and Phelps, *The Slump in Europe*, 7.

4. Fitoussi and Phelps, *The Slump in Europe*, 1.

5. Fitoussi and Phelps, *The Slump in Europe*, 2.

such fall of interest rates had occurred. We didn't observe reduced interest rates in Europe in the 1980s.

The book's introductory material makes another point:

- The same theory also says that the nations with the greatest *fiscal austerity* will suffer the most.

But Italy, which least exhibits fiscal austerity, had *not* been spared the slump.⁶

Much of our book's contribution is to point out the importance to a nation's economy of the real interest rate, which is largely determined in the *rest* of the world. The "slump" in Europe, the book argues, *derived* to a large extent from forces that had *driven up real interest rates*. (In the Index there are nearly twenty items under the heading "interest rates." Jean-Paul got a hold of something there.⁷)

My contribution to our book was mainly to show that a development somewhere abroad causing a rise of real interest rates in financial markets around the world, induces nations in customer markets to raise their markups and cut back their stock of employees – thus adding to the nation's unemployment rate until that rate has reached its new equilibrium time-path.⁸ It could also have been argued that the rise of *world real interest rates* to extraordinarily *high* levels *drove down* both the share-prices in the stock markets used by corporations to value new capital projects and the valuations that corporations put on new ventures in general, thus *reducing* further both the current stock of job opportunities and the prospects of new job openings in the near future.

It is no wonder, I must remark, that the rather *low* unemployment rates this year in my country, America, have been accompanied by extraordinarily *low levels* of real interest rates here.

6. Fitoussi and Phelps, *The Slump in Europe*, 4.

7. In chapter 4, *The Slump in Europe* cites J.-P. Fitoussi, J. Le Cacheux, F. Lecoine and C. Vasseur, "Taux d'intérêt, réel et activité économique," *Observations et diagnosis économiques*, no. 15 (April 1986).

8. The theory of mark-ups was developed in Phelps and Winter, "Optimal Price Policy under Atomistic Competition."

The Campaign for Low-Wage Subsidies

Soon after my year at the IUE in Fiesole, I was invited by Jean-Paul to visit the OFCE as a policy consultant from 1990 to 1993 (and later as a visiting scholar from 2000 to 2013). It was a stressful time. Since the 1970s, a gulf had opened between the wages of the low-paid workers and those of the middle class – no doubt fanned by the economic slow-downs that had begun in Europe in the '70s and in the U.S. in the early 1980s. This concern had prompted proposals to remedy the situation in America by David Hammermesh in 1978 and in Britain by Richard Jackman and Richard Layard in 1986. John Rawls's *A Theory of Justice* (1971) also widened interest in nations' treatment of the working poor.

It was not surprising then that government policy toward low-wage workers was a frequent subject of the many discussions Jean-Paul and I had in the 1990s. I ventured my first discussion of the subject on October 19-20, 1990 in a conference paper, "Agenda for Economic Justice to the Working Poor," given at the Jerome Levy Institute in Bard College. Then, working at OFCE over the summer of 1996 and completing the work in the autumn, I published the book, *Rewarding Work: How to Restore Participation and Self-Support to Free Enterprise* with Harvard in 1997. Although the book had no co-author, the moral and intellectual support that Jean-Paul gave me in this project was important.

It seems that Jean-Paul became further involved in this cause. Some officials at the OECD, learning that I was to be working there in the summer of 2000, invited me to give the opening address on the idea of government subsidies to low-wage employment, which I had written about in *Rewarding Work*. Although Jean-Paul never took credit for this invitation, I was sure he arranged it.

The Controversy over 'Fiscal Austerity'

I have been struck by the reference to "fiscal austerity," quoted above. In the past decades, the Greek dissenter, Yanis Varoufakis, writing in the pages of the website *Project Syndicate*, called on the Greek government to run *large fiscal deficits* (for the indefinite future) on the belief that such deficits – by enabling more consumer demand or financing increased government spending – would pull up wage rates and employment among Greek people.

I objected to the Varoufakis proposal, arguing that the resulting build-up of public debt – thus a huge rise in the (paper) wealth of the people – would divert resources *toward* consumption and *away* from capital accumulation, which would bring a *mounting* net loss of annual economic welfare.⁹ If people would have valued *consuming more* at the cost of *saving less*, they would have done so! There were better policy responses than that.

This, after all, was a theme of mine in my first book, *Fiscal Neutrality of Economic Growth*, published by McGraw-Hill in 1965. The theory developed there is that the injection of public debt, in adding to wealth, drives a *wedge* between the stock of wealth and the stock of capital. (Both David Ricardo and Franco Modigliani opposed a sustained public debt.)

I came to sense that Jean-Paul may have had a position different from mine – whether or not he agreed with it when we were writing the introduction to our book, *The Slump in Europe*. (He had appeared to me to have supported a paper by another author expressing sharp disagreement with the view that I had taken on debt-financing of government spending.)

I see now that, in general, there is more to be said on the matter: When a temporary development that threatens a temporary loss of employment and incomes breaks out, there is broad agreement among economists that the government ought to enact increases in government spending or cuts in taxes despite the prospect of fiscal deficits for some time – for unknown duration. I *do* agree that a policy of easy money is not enough.)

From this perspective, some of us would have been more approving of the tax cut that Varoufakis proposed if there had been some expectation – or some hope – that the problem addressed would *go away* in the foreseeable future. It is the lack of any expectation that such a proposal, if adopted, would be ended at some time in the foreseeable future that repelled some of us. And it may have been just that expectation that encouraged Jean-Paul and some others to approve of the idea.

9. See Edmund Phelps, "What Greece Needs to Prosper," *Project Syndicate*, August 6, 2015; and Edmund Phelps, "The Foundations of Greece's Failed Economy," *Project Syndicate*, September 4, 2015.

Another Difference of Opinion

I argue in my 2013 book *Mass Flourishing* that the *good economy* is the kind of economy offering the *good life*. Here Jean-Paul and I may have differed. As you may know, many economists – including Jean-Paul – are proponents of a concept that has come to be known as the *quality of life*. By a life of high “quality” they mean mainly ample consumption and ample leisure. For several years they stressed several public goods: clean air, healthy food and safe streets; also civic amenities such as municipal parks and sports stadiums. (This could be viewed as a fleshed-out version of the European ideal, traceable to ancient Rome.)

Of course, I too appreciate these services and amenities – and I would not argue against their provision by the state. But they are *not* what the philosophers’ concept of the “good life” is all about. (Aristotle, founder of that concept, joked that we need those public services in order to recharge our batteries for the next day’s work.)

The philosopher-economist Amartya Sen – another dear friend – points out that all this *consuming* leaves out something: the need of people to “do things” This widens the concept of human wants, yet it appears to me not to go far enough. People want *more* than to be enmeshed in a program of work in which they have no autonomy.

For a *good life*, people need in their work to have an adequate degree of *agency*. What exactly do they want to do with this “agency”? As some philosophers have said, people value having some room to *express themselves* – to have the initiative to voice their thoughts or show their talents.

As some others have said, people value *attaining things* – through their own efforts and insight. I have before used the word *prospering* (from the Latin *prosperare*, meaning “as hoped,” (or according to expectation) to refer to the experience of succeeding in one’s work: a craftsman’s gratification at seeing his hard-earned mastery result in better terms for the work he does, a merchant’s satisfaction at seeing “his ships come in,” or a scholar’s sense of validation from being awarded an honorary degree.¹⁰

10. See Phelps, “Europe’s Losses of Innovation: The *Individual* as well as *Societal* Harms,” Working Paper 89, Center on Capitalism and Society, Columbia University, May 2016. Presented at the conference “The Future of Europe,” Oxford Martin School, 27 April 2016.

People also value the experience of *personal growth* that may come from work and a career. Following some others, I use the word *flourishing* to refer to the satisfaction from a journey into the unknown, the fascination of uncertainty and the excitement of “acting on the world.”¹¹ (I would note in passing that attaining, prospering and flourishing all refer to *experiential* rewards – not merely any money that comes with the experience.)

What sort of an *economy* would offer this good life? History suggests it would be an economy full of *people* alert to unnoticed opportunities, searching for better ways of doing things, and exercising their initiative to try out new things. Even better, it would be an economy full of *innovative* people – people exercising their creativity, people imagining new things, and people developing new concepts into commercial products and methods, and marketing them for use in society.

In a career in which Jean-Paul must have given countless public speeches and published innumerable comments and essays, it would be bizarre if there was *nothing* in any of his immense output with which I would disagree (or some others would disagree). But he and I never let any differences of opinion bother us. I don’t know whether Jean-Paul ever changed his mind about that or, more broadly, how he evaluated these views of mine advanced in *Mass Flourishing*.

But I do know without any doubt that Jean-Paul and I were *always* the *closest of friends* for almost 40 years.

11. See Phelps, *Mass Flourishing: How Grassroots Innovation Created Jobs, Challenge and Change* (Princeton, NJ: Princeton University Press, 2013).

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