Macroeconomics for a Modern Economy

Edmund S. Phelps

This article is a revised version of the lecture Edmund S. Phelps delivered in Stockholm, Sweden, on December 10, 2006, when he received the Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel. The modern economy, where fully adopted, has been transformative for nations — but much less so for economics. In neoclassical economics, the object of the theory is often not human endeavor as we know it — only « prices and quantities ». Trying to put people into economic models became my project, from the analysis of the determination of the unemployment rate to the study of the business of growth. In modern economies, marked by the feasibility of endogenous change, innovation mechanism and discovery largely shape the experience and the rewards of participating in the economy. Thus emerges the question of the good economy, i.e. an economy that produces the stimulation, challenge, engagement, mastery, discovery, and development that constitute the good life.

Keywords: Modern Economy. Macroeconomics. Growth. Good Economy.

JEL Classification: E24, E50, E6, O10, O11, O43.

Macroeconomics with Intelligent Autonomous Agents

Peter Howitt

This paper discusses a research agenda that has been advocated by Axel Leijonhufvud for studying the coordination process of a decentralized market economy. The research used agent-based modeling, an approach that assumes exogenous rules for adaptive behavior, thereby endowing agents with an autonomy that is impossible in a rational-expectations-equilibrium approach. The paper argues that this approach also endows people with more intelligence than would a standard optimizing approach. The analysis focuses on the role of business firms as coordinating agents who organize trading activities. Computer simulations show that a network of specialist trading enterprises can emerge.
from autarky when people follow simple myopic rules. The interactions between trading enterprises and households results in a multiplier process which can be shown to mimic time-series behavior of detrended real GDP in the United States. The analysis can also be used to illustrate the possibly destabilizing effects of excessive wage/price flexibility.


*JEL Classification*: B4, D50, D58, D83.

### Interaction Effects in the Relationship between Growth and Finance

**Philippe Aghion**

Various attempts have been made recently at explaining why productivity differences persist between rich and poor countries, and why some countries diverge from the world technology frontier in terms of their per capita GDP levels or growth rates, while other countries manage to catch up with the world frontier. We explore the role of credit market imperfections in explaining cross-country growth performance and cross-country convergence and divergence, following Lucas’s observation that capital does not flow from rich to poor countries even though the marginal return to capital is higher in the latter. We also analyse the interplay between credit market imperfections and macroeconomic policies. We show that interacting financial development with macroeconomic variables such as average productivity or output volatility in growth and finance regressions generates a rich set of new empirical predictions, e.g. on convergence and divergence, and on the growth effect of countercyclical macroeconomic policies.


*JEL Classification*: F21, F30, F4, F5, G1, O14, O16, O4.

### What Should we Mean by « Growth Policy »?

**Robert M. Solow**

For various reasons — empirical, technical and casual — modern (neo-classical) growth theory has centered its attention on steady-state exponential growth. When the models are intended to serve as a guide to policy, the tacit presumption is that the goal of growth policy is to increase the long-term growth rate. It seems more natural to define as
« growth policy » anything that permanently lifts the cyclically-corrected trend path of the model economy, even if it only adds a constant percentage to a pre-existing path. The deeper point is that once growth theory is freed of the need to generate exponential paths and ways to tilt them, the way is open to a more discriminating choice of assumptions, governed more by empirical validity and less by artificial convenience. If there is a general lesson for macroeconomic theory in these considerations, it is not that convenient simplifications should be avoided. It is rather that convenient simplifications have to be chosen with care.

Keywords: Growth Theory. Growth Policy. Macroeconomics.

JEL Classification: E60, O11, O40, O43.

Macroeconomic Policies and Institutions

Jean-Paul Fitoussi

The main purpose of this paper is to understand the course of macroeconomic policy in Europe in the light of several theories which have shown that it was barely adapted to the different shocks that have hinted the European economy in the last two decades. As a result, the performance of the EU economy in general and the Euro area economy in particular have been poor. The mainstream diagnosis of this situation is the structural « sickness » of the European economy, and more specifically of its « big » continental countries. This diagnosis certainly contains bits of truth, and even if it contains also a lot of rhetoric, it has become a common belief. Common beliefs, whatever their theoretical and empirical underpinning, act as social norms. I thus put forward the working hypothesis that a change in social norms may explain the course of macroeconomic policies in Europe — their non reactivity to unemployment and/or soft growth — if we admit that their implicit aim is to show that the only way out are structural reforms to adapt to the new social norm.


JEL Classification: D50, E12, E24, E61, E65, H55.
The End of (Economic) History

Jean-Paul Fitoussi

Some papers, for reasons which remain partially obscure, leave a persistent trace in intellectual history. Such is the case with Keynes’ « Economic Possibilities for our Grandchildren » and its central questioning: Could the very functioning of the capitalist system lead to the solution of the economic problem and hence to the end of capitalism itself? This paper sustains that the answers given by Keynes to this question are grounded on three elements: arithmetic, the neurosis of capitalism and the communism of the elites. On the first element, Keynes is right; one may even argue that his reasoning anticipates Solow’s growth model. The second element is rooted in the context in which Keynes was writing and grounded on a false interpretation of Freud’s work which led him to a simplistic analysis of human needs. The third element unveils his aristocratic view of society. What is remarkable in « the economic possibilities » is the powerful intuition of Keynes and even more remarkable the nature of the questions he poses. What is deceptive is the naivety with which Keynes deals with human needs and even more deceptive his arrogance and the questionable moral which goes with it.


JEL Classification: A13, D11, D63, E12, E21, O47, P17.

The « Shadow G-8 » 2007

Joseph E. Stiglitz

A diverse group of concerned citizens from around the world (including former government officials and leading economists) met at Columbia University on February 9 2007, under the sponsorship of the Initiative of Policy Dialogue, the Friedrich Ebert Foundation, and Erlassjahr, to consider the major issues facing the world today, and how the leaders of the G-8, meeting in Heiligendamm on June 6-8, 2007, might most effectively make progress in addressing those issues. This was the first meeting of this « Shadow G8 ». Participants considered the announced agenda « growth and responsibility », what might or should be included in that agenda, and what they considered to be the minimum aspirations — the bar that the leaders should set for themselves in advancing this important agenda. The following is the Chairman’s summary of the debates.

Keywords: « Shadow G-8 ». Development. Aid. Global Governance.

JEL Classification: F13, F35, O19, O2.
From the First to the Second Globalization

Michel Aglietta and Jacques Le Cacheux

The current globalization process contrasts with the first globalization, in the second half of the XIXth century, with respect to international flows of production factors and to monetary arrangements: during the first globalization, Great Britain, the then dominant power, was a high saving, high population country, exporting capital and labour, and maintaining a stable, coherent international monetary system, the gold standard; in the first decade of the XXIrst century, the US is a low saving economy, and demographic dynamism is mostly in the rest of the world. With the US a net importer of capital, and international monetary arrangements not conducive to equilibrating evolutions, the current globalization is unsustainable. With the help of the OLG-CE, world model INGENUE, we explore a sustainable world growth regime based on equilibrating capital flows, from rich and ageing countries to poorer and demographically more dynamic regions.


JEL Classification: C68, D91, F21.

International Trade and Domestic Distorsions :
How to Govern Globalization ?

Jean-Luc Gaffard and Francesco Saraceno

Changes in the pattern of international trade inevitably create distortions that perturb the functioning of the economy. These distortions may not be reduced to malfunctioning goods or labour markets, and hence cannot be eliminated by simply choosing the optimal institutions. Domestic distortions call for domestic solutions. To explore these solutions it is useless to analyze the properties of equilibria before and after the opening to trade. Rather, we need to build an analytical framework suited to investigate the characteristics of a transition process whose success is not guaranteed ex ante. it appears that wage rigidity and an easy access to external financial resources are necessary in presence of fast pace of change, while if change is sufficiently slow the standard recipe of wage flexibility may be appropriate. These results may help in the institutional and organizational choices to be implemented in economies willing to profit from international trade and globalization.

Keywords: Globalization. Trade. Financial Constraints. Wage Flexibility. Firm Migration.

JEL Classification: F16, F41.
Making Sense of the European Globalization Adjustment Fund

Étienne Wasmer and Jakob von Weizsäcker

The recently established European Globalization Fund (EGF) is an attempt to better share the benefits of globalisation at the EU-level, targeting workers who loose their job due to trade-induced mass layoffs. We find that the typical income shock for trade displaced workers is a serious one. However, workers displaced not through trade suffer a similar income shocks. We argue that the trade focus and the centralization at EU level may be justified on political economy grounds because trade policy is also decided at the EU level. But current EGF rules leave too much room for discretionary decisions. Therefore, we propose that the EGF focus on two simple active labour market schemes: a wage insurance scheme and lump-sum mobility allowances.

Keywords: Globalization. Unemployment. European Globalization Fund.

JEL Classification: F00, F16, J62.

Macroeconomic Policies and Performance in the Euro Area: Institutions, Incentives, Strategies

Jérôme Creel, Éloi Laurent and Jacques Le Cacheux

Economic performance has been feeble in the Euro area since the monetary union process was put in motion in the early 1990s. While the cause for this under-performance remains subject to debate, we argue in this paper that the rules and institutions governing the Euro area are clearly not conducive to high coordinated growth policies. Because monetary authorities are too much concerned with price stability, the pro-cyclical bias of fiscal policies is reinforced and member states are even more pressured to pursue social disinflation policies by the misalignment of the exchange rate of the Euro. A more balanced interpretation of the European treaties should remedy the current predicament and foster macroeconomic policies oriented toward high sustainable growth and the preservation of social justice.

Keywords: Economic Performance. Euro Area. Macroeconomic Policies.

Social Norms and European Policies

Jean-Paul Fitoussi and Francesco Saraceno

This paper reviews the debate on the Stability and Growth Pact. Both empirical and theoretical arguments in favour of the Pact are weak, to warrant a different and plausible (even if extreme) hypothesis: We suggest the view that the Stability Pact is a public social norm, obeyed by countries because of the fear of reputation losses. Our simple model shows that reputation issues may cause the emergence of a stable but inferior equilibrium. Within this framework, the enlargement to more undisciplined countries may worsen the problems posed by the Pact.


JEL Classification: D63, D71, E62, E63.

How to Deal with Economic Divergences in EMU?

Catherine Mathieu and Henri Sterdyniak

Since the launch of the Euro, persistent and even rising disparities among Member States have made it difficult to implement short-term or structural common economic policies. The article gives an overview of Euro area disparities in terms of growth and inflation and imbalances, mainly unemployment and current accounts. Four explanations are considered: the benefits of the single currency for catching-up countries, the weaknesses of the euro area economic policy framework; the implementation of non-cooperative domestic policies which have induced excessive competition and insufficient coordination and hurt mainly the larger economies; the crisis of the European Continental model in a global world. Four strategies are discussed: increasing market flexibility; moving towards the knowledge society of the Lisbon Agenda; re-nationalising economic policies; introducing a more growth-oriented policy framework.

Keywords: European Economy. Policy-mix. European Social Model.

JEL Classification: E61.
Competition and Innovation in Europe: the Competitivity Dilemma

Jean-Luc Gaffard

Competition among firms as well as among countries is one of the main innovation engines. In this perspective, growth policy should be understood as the formulation and enactment of the rules that assure full competition. However, things are much more complex in reality. Innovation is a creative destruction process that implies the disruption of a given productive structure, and the construction of a new and different one. This process can succeed or fail. It brings about co-ordination problems, not only at the innovating firms’ level but also in relation with the environment. Focusing on the co-ordination conditions of the out-of-equilibrium process stirred by the choice of a given technology rather than on the incentives determining this choice has paramount analytical and policy implications. Monopolist practices as well as active macroeconomic policies thus appear as necessary means to guarantee the viability of the process of change. This view calls for trade-offs between conflicting objectives.

Keywords: Competition. Growth. Innovation. Viability.

JEL Classification: L1, L03, L04.

The European Environmental Strategy

Jean-Paul Fitoussi, Éloi Laurent and Jacques Le Cacheux

Environmental policy is an art of execution. Hence the fact that European Union member states have recently managed to agree on targets of emissions to fight climate change leaves open the question of how they will meet them. Economics can not but embrace the scientific consensus on climate change and can not say much about the efficiency of alternative technologies. Yet, its expertise is valuable to calculate economic effects and fairness of policies and to assess the relevance of incentives structures and effectiveness of institutions put into place to convert scientific consensus into action. This article is concerned with this latter point: does the EU have the right institutions to fight climate change? We claim that such is not the case, and offer to institute a « European Community of Environment, Energy and Research » to go forward.

Keywords: Environment. Climate Change. European Union.

JEL Classification: F59, O52, Q48, Q54, Q58.
Unresolved Issues in the Rise of American Inequality

Robert J. Gordon and Ian Dew-Becker

This paper provides a comprehensive survey on six aspects of rising inequality in the US: changes in labor’s share, inequality at the bottom, inequality at the top, labor mobility, inequality in consumption as contrasted to inequality of income, and international differences in inequality, particularly at the top. We conclude that changes in labor’s share play no role in rising inequality of labor income. Within the bottom 90 percent as documented by CPS data, movements in the 50-10 ratio are consistent with a role of decreased union density for men and of a decrease in the real minimum wage for women, particularly in 1980-86. There is little evidence on the effects of imports, and an ambiguous literature on immigration which implies a small overall impact on the wages of the average native American, a significant downward effect on high-school dropouts, and potentially a large impact on previous immigrants working in occupations in which immigrants specialize. The paper concludes that data on consumption inequality are too fragile to reach firm conclusions, and offers a perspective on international differences that blends institutional and market-driven explanations.

Keywords: Inequalities. Income. US.
JEL classification: D31, D33, I32, O33.

Merit and Justice

Amartya Sen

The rewarding of merit and the very concept of merit itself depend on the way we see a good society and the criteria we invoke to assess the successes and failures of societies. The « incentive view » of merit competes with the view of merit based on « action propriety ». The presence of inequality and others drawbacks can lead to some psychological tension, especially since the rewarding of merit is not directly valued under the incentive approach. Even though the incentive-based argument for rewarding merit tends to be, in principle, accepted as the main justification for such a reward system, the main interpretations of the meritocracy are unnecessary and inconsistent with the incentive approach. The common additional features include: (1) confounding merit of actions with that of persons (and possibly of groups of people), (2) overlooking the instrumental nature of the incentive argument and seeing the rewards of merit as intrinsic entitlements or
Perceptions of Economic Inequalities and Feelings of Social Justice

Michel Forsé and Maxime Parodi

The analysis of the 1999 International Social Survey Programme opinion polls in 8 of the participating countries shows that the interviewees tend to underestimate the largest income inequalities and consider themselves closer to the average than they really are. Their macro-justice feelings are based on the gap between what they think the inequalities are and what they ought to be. They do not demand absolute equality. The income hierarchy is accepted, providing it is reduced. Their micro-justice feelings are linked to a « solidaristic » relative deprivation and to the degree to which they wish to decrease macro-inequalities. The principle of equity is not rejected but the salaries-by-merit as a mere result of the market lead to too strong inequalities which, according to them, should be reduced to obtain more justice.

Keywords: Social Justice. Inequalities. Equity.  
JEL Classification: D 63.

Fighting Gender Discriminations: Simple Ideas, Complex Realities

Françoise Milewski

Public policies aimed at promoting gender equality should not be elaborated without making sure that their goals are consistent. Among a number of factors, such policies must crucially take into account labour market conditions and social protection dynamics. This paper deals with the importance of these factors and begins with an overview of European objectives in terms of gender equality. It then offers an analysis of the contrasted trends in the recent evolution of women’s integration in the labour market. It is shown that public policies adopted in the EU and in France reveal inner contradictions that can threaten their efficiency. On the one hand, when the effort to promote gender
equality is only a part of the wider effort against social precariousness, the specific cause of woman precariousness can be neglected. On the other hand, when only immediate goals are considered without attending to deep rooted causes, gender inequalities remain untouched. Further debate is thus needed on the issue of gender equality policies’ efficiency.


*JEL classification*: D63, I3, J16, J21, J71, J78.

The French Welfare State in the last 25 Years: Changes and Questions for the Future

*Mireille Elbaum*

The French Welfare state has experienced important changes in the last 25 years, with contrasted and even opposite consequences in terms of solidarity. Individual responsibility has been emphasized, as well as the potentially negative effects of social expenditure. The institutional framework of the social protection system has become more complex, with an extended role of additional insurances and local authorities. The problems of finances and labour cost have constantly been on the agenda, while unemployment and part-time or short-term labour contracts have made social protection less effective. Ageing now implies new collective choices, especially in terms of funding, in order to preserve solidarity in the face of social risks. Yet, the financial incentives implemented in the fields of retirement, health or minimum income are neither fair nor effective, when benefit recipients have no real capacity of choice, and when financial responsibility is not extended to other actors such as firms or health care providers. The paper also focuses on the issues of universal versus targeted benefits and individualisation of the tax-benefit system.


*JEL Classification*: H50, H51, H53, H55, I0, I8, I30.