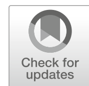
Solving the Problem in Italy and Much of Western Europe



Edmund S. Phelps

Abstract What are the deep, structural problems in Italy—the problems that preclude a "good economy"—even if everything else goes right? Much of the problems have to do with innovation, "indigenous" and "imported." Innovation is generally necessary if people are to have gratifying working lives and rising living standards, though some kinds of innovation create a problem. How has Italy fared in this dimension?

1 Innovation in Italy

Long ago, several nations enjoyed an *explosion* of *indigenous* innovation (innovation originating within the nation and not imported from abroad), a large part of it *capital-saving* more than *labor-saving*: America and Britain around 1820, France and Germany around 1870—and Italy around 1950. By my calculation, Italy in that year ranked in fourth place in the big country rankings—as Italy pulled up, Germany fell back. (That surprised me because I understood the magnificent history compiled by Gianni Toniolo as concluding that the Italian economy had yet to attain sustained innovation at a good rate[1]). With that hugely fruitful innovation going on, these nations enjoyed a "golden age" from 1950 to 1970: real wages streaked ahead of wealth, leading to increased labor force participation; and the passion for new

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[1]Gianni Toniolo, ed., *The Italian Economy since Unification* (Oxford, 2013).

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methods and products brought high job satisfaction and consumer satisfaction.[2] (As the song goes, "I remember it well." I remember the model-building we were all doing at the RAND Corporation, the Lamborghinis in a Wilshire showroom, the Beatles, the Boeing 707s—and much more).

But these good times were losing some of their shine. Estimates by Raicho Bojilov and me at the Center on Capitalism and Society show that indigenous innovation was *gradually slowing* in Italy as well as France over the postwar period; and it was much *slower* throughout the period in Germany than it had been in its heyday under Bismarck.

Since 1970, there has been tumultuous structural change in the West:

- *First*, indigenous innovating has been markedly *slower* over the period from 1970 to 2012 in the U.S.—aside from the years of the internet boom—and also in the U.K. and France. The sharp slowdown of "imported" innovation in Italy and Spain may be caused in large part by the contraction in the importable innovations that were available in this period—not just by similar internal developments. However, these slowdowns have brought a major slowdown of total factor productivity and labor compensation, which has caused social discontent. They have thrown events into reverse: wages lag behind wealth, leading to decreased labor force participation, decreased job satisfaction and boredom borne of stagnation.

I suspect you are wondering whether there is any factual basis for these conclusions. My book *Mass Flourishing* points to *evidence* drawn from the *World Values Surveys*.[3] It shows that in 1990–91 the mean level of reported *job satisfaction* was very low in the countries suffering low levels of indigenous innovation—Italy and France, for example—and relatively high in countries with relatively high indigenous innovation—notably Switzerland, Denmark and America. Now, the same research team has found evidence from 2008 data in the *European Values Surveys* that further supports this theory.[4] It shows that among 13 economically advanced western European countries, those ranking *lowest* in reporting "high" or "somewhat high" job satisfaction—Spain, France and Italy—ranked very low in indigenous innovation as well (9th, 11th and 13th respectively) and those ranking *highest* in job satisfaction—Switzerland and Denmark—ranked very high in indigenous innovation (in 2nd place and 4th place, respectively).

- *Second*, and perhaps more serious over the near term, the *losses* of this innovation, made so fruitful because it was predominantly capital-saving, are now

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[2]I came across this characterization in an op-ed suggesting that "[t]he period after the two world wars was in many ways a Golden Age." See Antar Haldar, 'Is there a future for capitalism? It doesn't have to become an uncontrollable monster,' The Independent, May 18, 2018.

[3]The data are from the *World Values Survey*. See *Mass Flourishing* (Princeton: Princeton University Press, 2013), pages 196 and 197.

[4]Data in the *European Values Surveys* are usually found in *World Values Surveys* but not in cases where American data to accompany them are not available.

> accompanied by *gains* of innovation coming from the "digital economy"—in the U.S. and many other countries too. And this new innovation is much more labor-saving. (Amazon and Microsoft are good examples; I think; perhaps Google is an example of capital-saving.) It has caused major job losses in the affected factories. In regions with many such job losses, there has been a wholesale withdrawal from the labor force: America's Rust Belt in Appalachia and adjacent regions, Britain's West Midlands and France's Lorraine region.

It is interesting that the countries which have always been regarded—historically, at any rate—as "innovation nations"—are the ones that have these distressed regions, while the countries that have always been regarded as "trading nations"—Germany and Holland, for example—have not been afflicted with such regions. I have to leave it up to you to decide whether Italy fits in the first group or the second.

If Italy is suffering from the same rust belt phenomenon, the country is in a double bind: There is less of the unambiguously good innovation and more of the problematic.

You may be interested in knowing what I believe Italy and other countries must try to do to reverse the decline of the good innovation. I have written some pages suggesting measures that state and society could take. The most thorough presentation is in the 8½ pages at the close of my book *Mass Flourishing*—pages 316–324. Society must cultivate in students and young people an eagerness and capability to innovate.

Further, society must stop vested interests and corrupt officials from blocking or discouraging new product or methods—at least those not judged against the public interest.

It is clear now that such a revitalization of the economy might have the "side effect" of giving a boost to the problematic innovation—the innovation that drives down wages to a lower growth path. As a Chinese proverb says: "Beware that you get your wishes!" Is there a way out of this conundrum? It appears so, once we understand the dynamics of labor-saving innovation.

In a couple of theoretical models that Hian Teck Hoon and I built over the past year or more, a single, purely labor-saving innovation—more precisely, a single innovation that adds a bunch of robots to workforces in the way a wave of immigration adds workers to workforces—would drive down the wage rate. But the resulting increase in the capital stock would pull the wage rate back up to where it had been before the robots came.

And the bulge of profits on private capital and the rise of tax revenues appear to be enough to compensate for the dip in wage rates. Perhaps the lesson to draw is that the nation's safest strategy is to take measures to slow the procession of robots that arrive to do the kind of work done by the humans.

My conclusion from all this is that Italy as well as America, Britain and France must take all reasonable measures to boost the dynamism of their economies while they also take steps to ensure that the influx of technologies proceeds sufficiently slowly so that wage rates and employment of the affected workers can be cushioned through government compensation paid for out of the rising tax revenues.

The euro, growth and employment I do think from time to time about other issues in the West. We have all been hearing for a very long time the contention that Italy has a serious problem with the euro—whether or not there is also a problem of deficient innovation that is independent of any currency problem.

I think we should be skeptical about these claims. (My friend Stefano Micossi once congratulated me for being skeptical about everything.) But it is impossible for the proponents—all of them highly reputable economists—to prove their claims *beyond any doubt.* So we should take seriously their arguments.

There is the *slow recovery* claim and the *slow growth* claim. The former claim is that Italy could depreciate its currency in pre-euro times and now it can't. Of course, one of the arguments *for* the institution of a common currency was that it would put an end to devaluations and resulting inflations. (I heard other arguments from Robert Mundell and Tommaso Padoa Schioppa. I also had conversations with Dominick Salvatore.) One might wonder why the Italians are not grateful that the euro has averted the need for a catastrophic depreciation.

The complaint against the euro that we hear is that the *lack* of a devaluation has been a drag on the speed of recovery in Italy after it hit bottom following the global financial crisis. The recent book by Mario Baldassarri, *The European Roots of the Eurozone Crisis*, is perhaps a definitive source.[5] The data in FRED, a standard source of G7 data, show that Italy's so-called employment rate, seasonally adjusted, climbed from its low in July 2010 of 56.6–58.2 % in October 2017. That is a slow speed of recovery, to be sure. But if the euro is at fault, we should expect to see a poor result also in France and Spain. In France, the same employment rate climbed from its low of 63.9% in October 2010 to 65.2% in October 2017. The speed of recovery there is also poor. But in Spain, the employment rate climbed from its low of 56.0% in April 2012 to 61.6% in October 2017. This is a much faster speed of recovery. Some other countries in the Eurozone also show a relatively speedy recovery: Holland climbed fast from its low of 64.5–67.2% and Portugal—bless its heart—has exploded from its bottom of 59.3–68.9%.

Denmark also sprinted back to normal. Tentatively, I would lay all or most of Italy's poor performance to structural causes. We do not know how Italy would have performed had it chosen to operate with a flexible exchange rate.

There is also a theoretical point to be made: although Keynesian theory has a well-deserved place in understanding the initial employment effects of a contractionary shock, it is implausible to attribute a weakness of employment to a decrease of aggregate demand more than a dozen years ago. Nominal wages and prices ultimately adjust. Start-ups find openings.

The slow growth claim is that the overvaluation of Italy's currency has brought *slower growth* in Italy since the advent of the euro in 1999. I wonder: Is the euro the cause of that deceleration? My great colleague and dear friend, Joseph Stiglitz, points out that from 2000 to 2016 the eurozone GDP has shrunk noticeably relative to the US GDP—if my arithmetic is right, from 88.5 to 80.0%. But until 2005 or so,

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[5] Mario Baldassarri, *The European Roots of the Eurozone Crisis,* (Palgrave, 2017).

the US was enjoying the extraordinary rapid growth brought by the buildout of the internet. Furthermore, this relative shrinkage of the eurozone countries ought to be compared with what happened to the relative size from, say, 1985–2000. We need to recall that in the 1980s there was the deep “slump in Europe,” which Jean-Paul Fitoussi wrote about in our book *The Slump in Europe*[6]*:* The European slump was deeper and longer than the slump in the U.S., so Europe was losing ground in the ‘80s—long before the euro. And it lost still more ground in the 1990s when, as I noted, the US began to develop the internet. We called it the second Great Depression!

However, the heart of the matter is whether the euro is the cause of still slower *productivity growth* in Italy—and, by the same logic, France and Spain too. I would note that the estimates by Bojilov and me show gradual *slowing of indigenous innovation* in Italy in the ‘50s, again in the ‘70s and again in the mid- ‘90s—with no further slowing whatsoever after 1999 till the last year, 2011.

I would interpret these very preliminary findings as suggesting that real, not monetary forces, are at work in the West. I feel that future data will show even slower indigenous innovation in the U.S., the U.K. and France leading to a *further* slowdown of productivity and investment throughout the West. Certainly, the increased weakness in investment and real wage rates is apparent.

If that is so, the West must address the need not for a new monetary system but for a revival of the spirit of innovation. That is needed if the West is to regain the prospering and flourishing of its Golden Age.

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