COURTESY REUTERS

FROM THE ANTHOLOGY: FROM THE ARCHIVE: POWER AND THE UNITED STATES EXPLORE THE ANTHOLOGY

ESSAY May/June 1998 Issue United St... Asia

Debate: America the Boastful

By *Paul Krugman*

WHAT HAS NOT GONE RIGHT

The late 1980s were a good time for Europe: growth accelerated, unemployment fell, and dreams of European unity seemed within reach. A mood of almost giddy optimism -- Europhoria -- swept the continent. Even non-Europeans were caught up in the spirit. As late as 1992 the economist Lester Thurow's bestseller Head to Head proclaimed that "future historians will record that the 21st century belonged to the House of Europe."

So in 1987, when the Brookings Institution published a collection of papers entitled Barriers to European Growth: A Transatlantic View, which focused on the syndrome of slowing growth and rising unemployment that had become evident over the previous 15 or so years, many European commentators dismissed the volume as a case of fighting the last war. Europe, they insisted, was on the move; energized by the transition to a single market, it had entered a period of renewed growth and technological vigor.

In retrospect, European elation was, to say the least, premature. The structural problems that underlay Eurosclerosis had not been resolved; they had merely been masked by an upswing in the business cycle. When the next recession arrived -- and there is always a next recession -- it raised unemployment rates not merely to their previous peaks but, in most of Europe, to levels not seen since the 1930s. All in all, it was an object lesson in the difference between cycle and trend: one swallow does not make a spring, and a few good years of growth do not necessarily signal a turnaround in economic fundamentals.

While Europeans may have learned that lesson, Americans have not. Although until quite recently titles like Donald Bartlett and James Steele's America: What Went Wrong? typified commentary about the U.S. economy, and economic journalism was dominated by scare headlines about downsizing, after a mere two years of good news America's mood has become startlingly triumphalist. In the view of many business and political leaders America has entered the era of the New Economy, in which traditional limits to economic expansion are no longer relevant. And because America has a New Economy and the rest of the world does not, it is once more indisputably number one, and the rest of the world must adopt its values and emulate its institutions if it wants to compete.

To anyone with a sense of history, this is all deeply worrying. If pride goeth before a fall, the United States has one heck of a comeuppance in store. Yet the strengths of the U.S. economy are not merely a matter of boasting. The task is to separate the realities from the myth. What has gone right with America, and what has not?

HOW NEW AN ECONOMY?

By any standard, 1997 was a very good year for the U.S. economy. GDP grew by almost 4 percent, well above the 2.4 percent average over the past 20 years. Unemployment fell to 4.6 percent, a 25-year low. Meanwhile inflation remained quiescent, at less than 2 percent.

How should we view this success? A year of fast growth, even without inflation, is not that unusual: in 1983 the economy grew by almost 7 percent, also without inflationary pressure. Yet morning in America did not signal a long-term increase in the economy's growth rate: growth over the following decade averaged only 2.4 percent annually. How can we tell whether 1997 was a similarly temporary surge or something to which we should become accustomed?

To answer this question, it is essential to take on board a bit of economics that, though rudimentary, is often ignored in public discussion: the distinction between growth in the economy's productive capacity and fluctuations in the utilization of that capacity -- or, to put it another way, the difference between trend and cycle.

Think of the economy as a machine that can be run at variable speed. It may sometimes be possible to increase what is produced by running the machine faster; however, if it is run too fast, it will overheat. Thus while it is possible in the short run to get more output by using the economy's capacity more intensively -- especially if the economy starts from a point where capacity is severely underused -- over the long run the only way to achieve a sustained increase in production is to increase what the machine is capable of making, that is, to increase the amount it can produce at a given speed.

This discussion may sound abstract, but it is possible to make a fairly clear distinction in U.S. economic data between growth due to fuller use of existing capacity and growth due to expanded capacity. The unemployment rate turns out to be a pretty good indicator not only of the utilization of the labor force but of the utilization of economic capacity in general. There is a remarkably good (though not exact -- this is economics, not physics) rule of thumb known as Okun's Law, which relates changes in the economy's utilization of capacity, as measured by the unemployment rate, to its growth rate. Here is how Okun's Law works. In a year in which the unemployment rate does not change, the economy typically grows about 2.4 percent; every percentage point decline in unemployment adds 2 percent to that growth rate (while every percentage point rise subtracts 2 percent). That 2.4 percent growth when the unemployment rate is constant is the growth in the economy's capacity; the extra growth when the unemployment rate declines (or growth shortfall when unemployment rises) represents a change in the utilization of that capacity.

Okun's Law works well in accounting for the growth surge of 1983. As the economy recovered from the recession that had raised unemployment to a postwar high of 10.7 percent in the fourth quarter of 1982, the unemployment rate fell by 2.2 percentage points. The rule says that the economy should therefore have grown by 2.4 + (2 x 2.2) = 6.8 percent -- very close to the actual growth. The same rule also works well for last year: since the unemployment rate fell from 5.3 percent in late 1996 to 4.7 percent in late 1997, we should have expected growth of 2.4 + (2 x 0.6) = 3.6 percent -- close enough to the actual 3.9 percent to be well within the normal fuzziness of economic statistics.

The point of these exercises in arithmetic is that because the same rule that accounted for fluctuations of growth around its long-run average 15 years ago continues to work today, there is no reason to believe that the rate of growth of the economy's capacity -- and therefore its long-run growth rate -- has accelerated.

What may have changed is the ability of the economy to make use of capacity without getting overheated. Until a few years ago, typical estimates suggested that any unemployment rate below about 6 percent would lead to a gradual but inexorable acceleration of inflation. But here we are with an unemployment rate of less than 5 percent, and with prices still stable. Does this situation represent a fundamental improvement in the economy's ability to deliver full employment?

The answer is definitely ambiguous. Some have argued that tight labor markets no longer cause inflation because international competition now prevents companies from passing on increases in wages or other costs in higher prices. However, there is no evidence for this view (which is dubious in any case for an economy dominated by non-traded services). Rather, the proximate explanation for low inflation in recent years has been that costs themselves have, for a variety of reasons, risen less than one might have expected given how hot the economy is running. The most important restraint on inflation has been a squeeze on worker benefits, mainly due to the switch to managed health care. In the last two years the strength of the dollar and the economic woes of Asia have also pushed down import prices, helping keep inflation low. But for these special and necessarily temporary factors inflation would probably already have started to show clear signs of returning. Wage increases have been accelerating steadily since 1995, and, with the shift to health maintenance organizations more or less complete, benefits have started to rise again. Sooner or later the need to keep inflation in check will probably force the Federal Reserve to allow (or engineer) a rise in the unemployment rate.

Nonetheless, the sustainable unemployment rate has probably fallen. Weaker unions, reluctance on the part of workers to demand wage increases in an era of downsizing, reluctance of employers to grant such increases in an era of greater competition, and a more flexible labor market due to the growth of temporary work may all imply that 5 percent unemployment is not what it used to be. Taking recent experience into account, a middle-of-the-road estimate of the unemployment rate that is now consistent with stable inflation would be somewhere between 5 and 5.5 percent. The administration uses 5.4 percent for its budget estimates; it is possible, though difficult, to make the case for 5 percent.

In sum, despite the rapid growth of 1997, nothing in recent experience suggests that the U.S. economy is capable of more than about 2.5 percent growth in an average year. It is, however, likely that the sustainable unemployment rate has fallen, perhaps as much as a percentage point. Remembering Okun's Law, this means that the amount the U.S. economy can produce in an average year is at most about 2 percent higher than we thought it was. This is good news -- 2 percent of U.S. GDP is more than $150 billion -- but hardly a revolutionary improvement.

Of course, low unemployment has benefits that go beyond mere economics. A tight labor market disproportionately benefits marginal workers, those who tend to be last hired, first fired; for those attempting to take the first step out of the underclass, the difference between 6 percent and 5 percent unemployment may be large indeed. But in terms of the economic might of the United States and its ability to generate wealth (and perhaps to convert that wealth into power), the news in recent years has been relatively small change.

Or at least that is what the numbers say. But might the numbers be wrong?

A HIDDEN BOOM?

The U.S. economy's productive capacity is, by definition, the number of employable workers multiplied by productivity, or output per worker. The reason why the growth in that capacity seems rather slow is that productivity, according to official estimates, has risen at a modest pace -- just over one percent annually during the 1990s to date, a rate similar to that during the previous two decades.

But many observers do not find these official estimates credible. After all, these are the days of reengineering and total quality management, of the Internet and intranets, an era in which many businesses boast of having achieved dramatic increases in productivity. Surely, the believers in a New Economy insist, so many tales of a productivity revolution cannot be mere hype, and surely the reality of much more rapid productivity growth than the numbers describe is validated by the economy's unexpected ability to grow rapidly without inflation.

To parse these claims, it is essential to distinguish between two questions. One is whether official estimates are missing a lot of productivity improvement, to which the answer is yes, they are -- but they always have. The other is whether the unmeasured productivity gains that are surely taking place can explain the economy's good measured performance, to which the answer is definitely no.

Few economists question the proposition that official measures tend to understate true growth in a technologically progressive economy. In essence, official measures of productivity are always backward-looking: they ask how much more of a given good a worker can produce this year than he could last year. But what if a worker produces something that simply was not available last year? How do you compare the productivity of electricians with that of lamplighters, of auto workers with that of carriage makers, of doctors prescribing antibiotics with that of those who had little to offer beyond aspirin and sympathy? Because such qualitative improvements are inherently difficult to put into an index, productivity and economic growth in general have surely been understated throughout the past century and a half.

But are they more severely understated now than before? Certainly we talk more about technological progress than we did a couple of decades ago, but that may have more to do with who does the talking than with the progress itself. Here is how the Berkeley economist Bradford De Long responded to one New Economy advocate in the December 9, 1997, issue of the on-line publication Rewired:

"Kevin Kelly [the executive editor of Wired, writing in the September 1997 issue] has made an elementary mistake. He remembers the goods of the industrial revolution from automobiles to washing machines, railroads to container ships to airplanes to radios -- from his childhood. So he assumes that they must have always existed, and that the pace at which they changed must have always been glacial.

But revolutions in productivity in the economy's shifting set of leading sectors have been ongoing since 1760 or so, the beginning of the industrial revolution. In fact, that's why the age starting in 1760 or so is called the age of the industrial revolution.

Microelectronics as one of the leading sectors of technological change -- microelectronics as an industry -- is new to our generation, but productivity advances in leading sectors that are fast enough to be called industrial revolutions have not been news for two and a half centuries . . .

So what, then, is new about our post-industrial economy? What is new is that for the first time since the invention of printing, information processing and distribution has become one of the leading sectors. Previous leading sectors changed the conditions of the lives of weavers, spinners, transporters, framers, blacksmiths, and so on. Our leading sectors are changing the conditions of life of those who use information to direct enterprises -- managers -- and they are also changing the conditions of life of those who use information to decide what to buy -- consumers. Perhaps most of interest, however, society's information processors and distributors include its intellectuals.

So we intellectuals are, quite naturally, incredibly excited. And we are very, very articulate."

In other words, the belief that official statistics must be doing an especially bad job of tracking technological progress right now is grounded, at base, in a lack of historical perspective.

Of course, when businessmen enthuse about the supposed technological revolution in America, they also tend to enthuse about the institutions that supposedly make that revolution possible: an entrepreneurial culture, capital markets eager to back risky start-ups, labor markets that do not burden employers with annoying regulations (or unions), and so on. They also congratulate themselves on having become lean, mean, and competitive.

Perhaps the main point to make about this institutional optimism is that it involves a lot of implicit theorizing. Do we really know that highly flexible capital and labor markets are such wonderful things? As recently as five years ago the conventional wisdom was exactly the opposite: Japanese companies, in particular, were supposed to be superior to their Western counterparts because they were insulated from the pressure of capital markets and hence able to take a long view, and because inflexible labor markets, also known as the lifetime employment system, made them better at accumulating human capital. Why such a reversal of opinion? The answer, presumably, is that now we can see that American institutions foster higher productivity -- except that the productivity surge is itself merely hypothetical, invisible in the data.

While a sense of history might lead one to be agnostic about claims of a productivity revolution in the United States, doesn't the experience of high growth without inflation show that something new and good is happening? Well, no. For one thing, the quiescence of inflation in the face of declining unemployment seems to be fully explicable in terms of other, less glamorous factors -- mainly the sluggish growth in wages and benefits. Furthermore, a technical point is critical here: official estimates of productivity are constructed using the same data that are used to construct estimates of GDP. Indeed, official estimates of productivity are nothing more than GDP per worker. Any understatement of one must therefore imply an equal understatement of the other -- hence unmeasured productivity growth cannot be responsible for the high measured GDP growth.

This seems to be a surprisingly difficult point to grasp. A parable may help. Imagine a New Economy advocate who discovers that he has a problem with his car. Whenever he drives too fast -- whenever the needle on his speedometer goes above 40 -- the car develops a dangerous shimmy. So he carefully drives the car to his mechanic, never letting the needle go past 39. Alas, the mechanic informs him not only that he cannot fix the shimmy, but that the car has another problem: something is wrong with the speedometer, which is consistently understating the car's speed. Indeed, when the needle is at 40, the car is actually going 55. To the mechanic's surprise, the New Economy advocate is delighted with this news: "What you're telling me is that the shimmy doesn't start until I'm actually going 55. That means I can drive home 15 miles an hour faster than I drove here!"

Nobody would make this mistake in daily life, but many New Economy advocates make exactly the same mistake with regard to productivity and growth. Last year the U.S.

economy grew by 3.9 percent, which is about 1.5 percent more than its long-run sustainable rate. But New Economy enthusiasts argue that productivity growth is severely understated. And suppose, they say, that productivity is actually growing 1.5 percent faster than the numbers say; then the sustainable rate of growth of the U.S. economy is really 3.9 percent, not 2.4. And doesn't that mean that last year's growth did not put any strain on capacity after all -- which explains why it did not cause inflation (the shimmy)?

The point should now be obvious: since measured productivity growth is simply GDP per worker, if productivity has been understated, so has GDP, by exactly the same amount. So if productivity growth was really 1.5 percent higher than the numbers say, even though the sustainable rate of growth would be 3.9 percent, the economy would really have grown by 5.4 percent -- and the failure to show signs of inflation is as much (or as little) of a puzzle as ever.

That means that the recent ability of the United States to combine high measured growth with low inflation provides no evidence for the putative hidden boom in productivity. Even if official statistics understate true productivity increases, the economy's rapid measured growth over the last two years has sharply increased its capacity utilization -- just as driving with the speedometer needle at 55 means driv ing faster than with the needle at 40, even if the speedometer consistently understates your true speed. So invoking unmeasured productivity growth does not help explain why the acceleration of inflation that normally occurs when capacity utilization is high has not yet materialized; that good news must and can be explained by other factors. Conversely, the fact that inflation has remained low despite high growth offers no evidence in support of claims of a hidden productivity boom -- if A can't cause B, then observing B provides no evidence in favor of A. The supposed productivity revolution remains purely hypothetical.

What, then, is left of the New Economy? We have had a favorable turn in the business cycle, abetted by some temporary factors that have helped keep inflation down, and probably also by shifts in the labor market that have reduced the bargaining power of workers and therefore allowed fuller employment without accelerating wage increases. The New Economy, in short, looks a lot like the Old Economy. It has about the same long-run growth rate but can run at slightly lower unemployment. Things could be worse, but nothing fundamental has changed -- the amount of good news is not enough to justify the triumphant rhetoric one now hears so often.

LAGGING RIVALS

If the U.S. economy is not doing as well as advertised, why the sense of renewed American preeminence? One answer may be that other economies -- in Europe and in Asia -- have fallen short. In a world of stagnation and crisis, a country that continues to make even modest progress may be entitled to some self-satisfaction.

There is no question that much of the world has disappointed expectations that were widely held only a few years ago. The days when Thurow could confidently predict, "Over the next five years Europe will move to full employment," and the journalist James Fallows could declare, in the January 1994 Atlantic Monthly, "Like it or not, we live in the world that Asian success stories have shaped. We need to figure out how to compete in it," seem distant now. But just as pronouncements of American triumph turn out, on close examination, to be overstated, so do the dismissals of European and Asian prospects that one now hears. Let's take a quick tour of the world to examine how matters actually stand.

EUROPE. Compared with the optimism that prevailed at the beginning of this decade, Europe's economic performance has indeed been a huge disappointment. Particularly distressing to those who place their faith in European unity has been the failure of measures aimed at reinforcing that unity -- the creation of a single market, the drive toward a common currency -- to jump-start the continent's economy. Indeed, a good case can be made that the efforts of European countries to meet the criteria for entry into the European Monetary Union (EMU) at the end of this year have actually aggravated the problems of slow growth and unemployment.

Will the achievement of EMU transform the situation? Almost surely not. There has been a massive and occasionally bitter debate over whether on economic grounds Europe really should have a single currency. EMU advocates have failed to make a convincing case for large gains, but EMU opponents have also failed to make a conclusive case for large losses. One thing that seems clear, however, is that establishing a single currency will have little if any impact on Euro sclerosis: the forces that keep unemployment high and job creation low will be as strong on January 2 of next year as they are today. My own amateur prediction is that this persistence will lead to a period of great political disillusionment: having spent many years suffering under the disciplines of the Maastricht treaty, Europe will arrive at the promised land and find that it looks an awful lot like the desert.

That said, in some respects the European economy continues to show considerable resilience. Given the general sense that the United States has once again seized the technological high ground, it is surprising to learn that the already small gap in productivity between the United States and advanced European countries has continued to narrow during this decade, and has indeed become so small as to be within a reasonable margin of error (see table). And while slow growth in employment means that per capita income has not converged as rapidly as productivity, even there most advanced countries have continued to narrow the gap.

At a more impressionistic level, it is also far from clear that Europe really is lagging behind in technology. True, the United States dominates the high-profile sectors of the moment, microprocessors and computer operating systems. But the main economic payoff from these technologies lies not in their production but their application, and here the picture is mixed. The United States has taken more rapidly to the Internet and e-mail than most European countries, largely because of low telephone charges, although the most wired country in the world is, surprisingly, not the United States but Finland. Europeans, on the other hand, have technologically superior cellular phones. Which matters more for business? Never mind; the point is that Europe and the United States are operating at essentially the same technological level, with each side of the Atlantic having a small edge in some things.

Europe, in short, has a poorly functioning labor market, as it has for the past generation, and as a result has a dreary employment picture. But on other fronts the gap between Europe and the United States has narrowed or vanished, not widened. The only sense in which Europe has fallen behind is its failure to live up to unrealistic Europhile expectations.

Japan. Japan, unlike Europe, has underperformed not merely relative to the expectations of its naive admirers but compared with almost anyone's forecast. An economy that grew at an annual average rate of four percent during the 1980s has grown hardly at all since 1991. What went wrong?

The truthful answer is that nobody quite knows. The odd thing about Japan's economic stagnation is that many of the strengths that powered the economy's growth during the previous 40 years seem intact. High-quality manufacturing, innovative product design, even the famed skill at exporting seem still to be there. Japan, remarkably, managed to run trade surpluses during the mid-1990s, even though the yen was at a level that seemed to make the country's products radically uncompetitive.

In some ways Japan seems to resemble nothing so much as the United States during the 1930s: a highly productive industrial society that managed to stumble into a financial crisis (the stock market crash of 1929, the bursting of the bubble economy in the early 1990s) and has not been able to get itself restarted despite near-zero interest rates and intermittent efforts to pump-prime the economy with deficit spending. Part of Japan's problem is rooted in a banking system that cannot function effectively because it has never come to terms with its bad loans; part of the problem also lies in a service sector that, because it is overregulated and lacks competition, cannot supply the investment demand the economy needs to get moving again. Japan's once-fabled Ministry of Finance also shares much of the blame. It has consistently raised taxes whenever the country has shown signs of recovery, seemingly determined to keep the economy depressed. Whatever the nature of the malady, Japan's stagnation unquestionably makes the United States look good by comparison.

But we should bear in mind the comparison with the United States in the 1930s: the strengths of its economy then were real, and once a recovery began in earnest it was the Depression, not the Roaring Twenties, that began to look like an aberration. Japan may well be back.

Asia. Rarely in the course of economic events has a region's reputation suffered as severe a reversal as that of Asia's emerging economies since last summer. Events are now moving too quickly to be sure how far and deep the crisis will reach, although it has already exceeded anyone's worst expectations. The best available diagnosis of the crisis is that it was made possible by runaway Asian financial institutions that in effect gambled with other people's money, and that the inevitable failure of many of them was hastened and reinforced by a circular process in which collapsing asset values undermined banks, and an imploding banking system not only further depressed asset values but disrupted the normal functioning of business. Meanwhile, foreign investors, whose excessive optimism had helped create the bubble, ran for the exits. The success of International Monetary Fund-sponsored stabilization plans is still in the balance.

While the scene has been astonishingly grim, however, Asia's present failures need to be viewed with as much perspective as its past successes. An economy may suffer a severe financial crisis, then recover and grow as rapidly as ever. In fact, the susceptibility of an economy to financial crises and its ability to deliver sustained growth in general have little to do with each other. The United States economy between the Civil War and World War I was notoriously crisis-prone. Nor were catastrophes like the Panic of 1873 pure accidents: they were made much more likely by a business and political culture in which petty things like scrupulous accounting were disdained, wholesale corruption was a matter of course, and many business empires were built on the strength not so much of productive efficiency as of political connections. Yet despite a steady stream of scandals and the occasional devastating panic, the United States rose over those years to the position of economic preeminence that it now, rather prematurely, claims to have recaptured. In short, emerging Asia will be back.

AMERICA: FIRST AMONG EQUALS

Suppose that you had made a realistic assessment of the economic prospects of the world's major economies circa late 1992 -- say, at the time of President-elect Bill Clinton's famous economic summit in Little Rock. You would have noted that the one-time dominance of the United States -- that postwar peak of influence when America produced as much as all other market economies together, when American technology was superior in almost every industry -- had long since passed. Instead, we were in a world in which Europe, Japan, and the United States were all more or less on the same technological level and in which the economy of Europe as a whole was about the same size as that of the United States. But the U.S. economy was still larger than that of any other country, and it seemed likely to remain so for at least several decades. Europe was growing no faster than America. Japan was growing faster (4 percent versus 2.5 percent), but since its economy was less than half the size of America's, it would take more than half a century to close the gap even if that growth differential persisted. The only way the United States might be displaced as the world's leading economic power would have been for Europe to form a true federal union (which would have given it a political weight comparable to its already huge economic weight), something that looked almost as unlikely in 1992 as it does now.

How much has that assessment changed in the five years since? Hardly at all. Certainly there has been no revolutionary improvement in the performance of the United States. The U.S. economy is doing better than most economists expected, but as we have seen, the good news, while real, is fairly modest. Europhiles do have grounds for dismay, but mainly because their expectations five or six years ago were unrealistically high. Only in Asia has there been a true reversal of fortune, but it is too soon to count emerging Asia out, and even Japan may yet stage a recovery.

None of this is meant to suggest that the United States is in any sense on the verge of crisis; its economy does seem fundamentally sound. But the current sense that the United States is on top of the world is based on a huge exaggeration of the implications of a few good years here and a few bad years elsewhere. Let there be even a mild recession in the United States, a moderate recovery in Europe and Japan, and a rebound in emerging Asia, and talk of the return of American dominance will start to sound silly indeed. Future historians will not record that the 21st century belonged to the United States.

RELATED ARTICLES

MAY/JUNE 19… ESSAY

MAY/JUNE 20… RESPONSE

NOVEMBER/… ESSAY

WINTER 1992… ESSAY

DEC 9, 2016 SNAPSHOT

Debate: A Second American Century

Mortimer B. Zuckerman

Comparing Crises

Is the Current Economic Collapse Like Japan's in the 1990s?

Robert Madsen; Richard Katz

Irresponsible Stakeholders?

The Difficulty of Integrating Rising Powers

Stewart Patrick

The 100-Day Economic Agenda

Jeffrey E. Garten

The End of Globalism

Where China and the United States Go From Here

Eric X. Li