*Capitalism and Society*

*Volume* 3, *Issue* 3 | 2008 | *Article* 4

# Edmund Phelps: American Economic Association Luncheon Speech Honoring the 2006 Nobel Laureate in Economics

**Joseph Stiglitz,** *Columbia University*

**Recommended Citation:**
Stiglitz, Joseph (2008) "Edmund Phelps: American Economic Association Luncheon Speech Honoring the 2006 Nobel Laureate in Economics," *Capitalism and Society*: Vol. 3: Iss. 3, Article 4.
**DOI:** 10.2202/1932-0213.1043

The following speech was given at the American Economic Association Annual Meetings, New Orleans, January 5, 2008.

It is a great pleasure for me to participate in this lunch in honor of my Columbia colleague, fellow Amherst graduate and longtime friend Ned Phelps. There is so much to say about Ned's contributions, and so little time in which to say it, that one does not know where to begin. Perhaps I should begin by paying tribute to our college: we both bear testimony to the value of a strong liberal arts education, to the value of teachers committed to teaching, to the spirit of enquiry and questioning that is the foundation of a liberal education. It is perhaps no accident that two of the teachers that Ned describes as having the most influence on him, James Nelson and Arnold Collery, were, along with Ralph Beals, the very same teachers that had the most influence on me.

Of Ned's rich and diverse contributions, there are three that I would like to highlight. First, his work in macro-economics: by the 60s, it was clear that a major task facing the economics profession was the reconciliation of macro-economics and micro-economics, providing micro-foundations to macro-economics. There were two routes: one to scale up the perfect markets, perfect information, competitive equilibrium mode—a model whose limitations had already been identified in the work of Arrow and others, and which would shortly be questioned further as the consequences of information asymmetries, imperfect competition, and incomplete risk markets became better understood. The other route, both more ambitious and more fundamental: to reinvent micro-economics. It was this riskier route that Phelps embarked upon, with results that revolutionized the field.

Along the way, a huge number of important, new, and fundamental ideas were generated—not only ideas like the expectations-augmented Phillips curve, which have had such influence on the conduct of monetary policy, but ideas which have had an equally profound effect on micro-economics, such as the efficiency wage model and the Phelps-Winter models of the firm, to name but two. It became clear that this was a fundamentally different paradigm than the competitive equilibrium model even when that model became complexified with rational expectations and dynamic programming.

Both then, and in his most recent work, Phelps has been trying to understand how the capitalist system works—and I want to emphasize the distinction here between an understanding of the capitalist system, with, for instance, its important roles of innovation and entrepreneurship, and the competitive equilibrium model.

A second set of contributions, which by themselves might have deserved a Nobel prize, are, in fact, his contributions to the theory of innovation, his own work with our Columbia colleagues Richard Nelson and with Phoebus Dhrymes.

In a sense, the two strands are but one: innovation is one of the fundamental sources of uncertainty and change, which give rise to the short run macro-economic problems just discussed. As Ned put it forcefully in his Nobel lecture:

> Last but not least, positing rational expectations equilibrium is not just inaccurate as a way to close the model in the same sense as postulating rational choice is taken to be inaccurate: It is inappropriate to impose on the model. In a highly innovative economy and thus one subject to change, firms…are all *thinking differently*. (Emphasis in original)

He goes on to observe:

> …[T]he public cannot form 'rational expectations' about future probability distributions when the future is being created currently by the new ideas and consequent plans of entrepreneurs to which the public has no access and of which the entrepreneurs themselves are uncertain." (2006)

If an economy possesses dynamism, so that fresh uncertainties incessantly flow from its innovative activities and its structure is ever-changing, the concept of rational-expectations equilibrium does not apply and a model of such an economy that imposes this concept cannot represent at all well the mechanism of such an economy's fluctuations."

These are deep insights, the full import of which, I believe, have not yet, regrettably, been fully absorbed. But I will return to Phelps's contributions to the theory of innovation.

In the years following Solow's pioneering work in growth theory, a number of scholars, including Arrow, Shell, Nordhaus, Uzawa, Atkinson, Stiglitz, Dasgupta, and Phelps and his colleagues developed a set of theories of endogenous technological change, explaining not only the pace *and direction* of innovation, but also the diffusion of ideas, and among the most influential and pathbreaking were those of Phelps and his colleagues.

Finally, Phelps work has reminded us that the job of the economist is not just to describe the world, but to work to improve it; that if we are to do this well, we must have a grounding in basic principles of social justice, including intertemporal equity—hence Phelps's important contributions in this area. But finally, economists have the opportunity and the responsibility to use their knowledge and creativity to put forward proposals for improvements. In a sense, that is a theme running through all of Ned's work: from that concerning the conduct of monetary policy to his work on fair wages—his book *Rewarding Work: How to Restore Participation and Self-Support to Free Enterprise*—to his pioneering work with Jean Paul Fitoussi on structural slumps, to his work with another Amherst graduate, Robert Pollack, on savings.

DOI: 10.2202/1932-0213.1043 

For your ideas, for your commitment, and most of all, for your warm friendship, we salute you on this well deserved honor.

REFERENCES:

Phelps, Edmund S. (2006), *"Macroeconomics for a Modern Economy."* Prize Lecture for the Nobel Prize in Economics, December 8.