Why We Need a New Macroeconomics

Since the 2008 financial crash, our country has been reeling without getting its economic policy right. What we needed then, and need now, is a new kind of macroeconomics; one that aims for investment-led growth, not consumption-led growth. But investment-led growth can’t be achieved by a temporary stimulus. It requires a very different kind of strategy and policy. Investment-led recovery requires a clear identification of our society's longer-term needs, needs that can be filled through complementary investments by the public and private sectors. Think of railroads and farms in the late 19th century; highways, cars, and suburbs in the 1950s; and information technology, smart grids, and low-carbon energy for our time. And it requires a set of public policies to spur those investments, in part by using smart public investments to help leverage a private-sector investment boom.

Therefore, it is very frustrating to read Paul Krugman again today write about our current stagnation with so little reflection on his part that his own preferred stimulus policies can't solve the problem. It's of course even worse to hear this from Larry Summers, who Krugman quotes favorably today. Summers was the architect of Obama's economic policies during the first term, and now he tells us that the administration's policies haven't worked.

Both Summers and Krugman subscribed to Keynesianism, the
idea that larger budget deficits and short-term stimulus after 2008 would revive the economy. Neither of them reflected on how the macroeconomic policies after 2008 should respond to the causes of the crisis. If they had, they might have recommended a very different strategy. And the debt-to-GDP ratio might not have doubled in the meantime as a result of the reliance on Keynesian stimulus policies.

When the financial crisis broke out in the fall of 2008, I warned against the Keynesian approach to recovery. In 2009, I had this to say about the administration's economic plans:

The White House and Congress are attempting in every way they can -- through tax cuts, rebates on home buying, and cash for clunkers -- to boost total spending. The cash-for-clunkers epitomizes the shortsightedness of it all. We paid billions of dollars for individuals to trash their existing cars and buy new ones. In general, the neo-Keynesians think about "stimulus" -- that is, aggregate demand -- without thinking much about the various needs and uses of public and private spending, or about the longer-term consequences of budget policies... Yet none of this will work. The U.S. economy, and the world economy, cannot recover sustainably by propping up consumers for yet another binge.
Consumption-led recovery was the wrong way to go then and it still is now. The entire crisis of 2008 began with a debt-financed consumption and housing binge that went wrong. By 2009, consumers were broke and exhausted. Wages of median workers had not risen for decades (!). Did the administration and Krugman really believe that a two-year temporary demand stimulus would truly do the job? They sure acted that way. Krugman wanted an even larger stimulus, which would have caused an even greater surge in the debt-to-GDP ratio than we've had. But it would again have been at best a temporary salve, and most likely done little to spur a permanent recovery.

Keynesians like to say that there is a savings glut (an excess of saving over investment). They try to remedy it by spurring
consumption. This is a mistake. There is an investment shortfall, because the financial, regulatory, and policy barriers to high-return investments have not been addressed. America urgently needs investments in modernized infrastructure, advanced science and technology, and job skills appropriate for the 21st century. We are sitting on top of an information revolution and nanotechnology revolution that could positively reshape healthcare, education, transportation, low-carbon energy systems, green buildings, water conservation, and environmental safety.

What are we doing about it? Very little, alas. Just look at the paucity of actual investments being made. There is so little dynamism. The wondrous IT revolution, with its potential to remake our economy as a world leader in efficiency and quality of services, needs to be much more than new apps for smartphones and new ways to sell online advertising through social media.

Obama's political advisors were woefully shortsighted in 2009, and the president himself was badly misled by the simplicity of Keynesian stimulus, to the point of believing that "shovel-ready" projects would surge with just a little fiscal pump priming. How sad. What a lost opportunity. There were no such shovel-ready projects, as the president later acknowledged.

Large-scale investments remain impeded because the U.S. lacks basic strategies in all key sectors. We have no national energy strategy other than fracking; no modern transportation strategy; no coastal protection strategy; no jobs-training strategy. The list of "no strategies" goes on. The result is that we have little investment dynamism where we need it, and continue to hope for spending in the old standard-bearers: housing, cars, and consumption goods. In the meantime, competitors like China are shaping their economies for the technological advances of the 21st century.

We need, in short, a new macroeconomics that moves us beyond
the tired debates over public debts and short-term stimulus. Here's what I wrote about such a new framework back in 2009:

Macroeconomists trained in the past 30 years believe that demand increases depend mainly on interest rates and deficit or tax levels. Yet increased spending on renewable or nuclear power plants, a robust power grid, carbon-capture and sequestration, wastewater treatment facilities, fast inter-city rail, higher education, urban co-generation of electricity and heat, green buildings, and countless other new sustainable technologies, will depend on establishing a policy framework that harmonizes regulations, land use, public financing, and private investment. Large-scale stimulus, in other words, requires the nitty-gritty of public-private planning, technology assessments, demonstration projects, and complex project financing.

The new tools of macroeconomics, therefore, are quite different from the existing tools. The new tools begin with a medium-term (say, ten-year) budget framework, so that tax policies are not pulled out of thin air or campaign rhetoric, but reflect the calculated needs for public outlays; a medium-term set of income distributional goals and strategies, especially to break the back of child-poverty, rising school drop-out rates, and training for low-skilled workers; structural objectives regarding the rebuilding of infrastructure and the transition to a low-carbon economy; and a new set of institutions to carry out these policies. The new institutions might include a National Infrastructure Bank, as Obama mentioned during the campaign, to help finance public-private partnerships in energy, water, and transport. The Energy Department might be reconstituted as the Department of Energy and Climate Change, to bring the requisite expertise and financing for the low-carbon economy under one roof.

Many progressives will no doubt say that I'm being unfair to the Keynesians, and that they too would favor an investment strategy if the Republicans didn't block them. I hope that's true. Yet
Keynesian stimulus repeatedly takes our eyes off the long term. We need a new approach to growth, not another quick fix. And if the time is not right politically for an investment-led approach, it will become right the more we prepare and advocate for it.