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THE FUTURE OF CAPITALISM

Rethinking Macroeconomics

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The crash of 2008 exposed deep failures at the core of macroeconomic policymaking and macroeconomic thinking in the United States. The crisis's rapid spread from its epicenter on Wall Street to nearly the entire world underscored the interconnectedness of the global economy. The American purveyors of the *ancien régime* hope that a few superficial fixes will get us back on our way. This is not to be. Sustained and widespread future prosperity will require basic reforms in global macroeconomic governance and in macroeconomic science. Such reforms are never easy, as they require new ways of thinking. Yet business as usual could prove calamitous. This essay describes the reform path.

To set our new direction, we must understand how we arrived at the current impasse. The financial crisis of 2008 was not an accident. It was the result of a long period of political decadence in the United States aided and abetted by a growing hole in economic science. Decadence is a tough word, but the truth is that the US walked headlong into the fury. Because of the central roles of both the dollar and Wall Street in the global financial system, and because of the centrality of US economic thinking in shaping global economic policies and institutions, the rest of the world has been carried with it into the fury. This dominance will come to an end with this crisis, however.

From the Presidency of Ronald Reagan, beginning in 1981, until today, US economic policy has operated with a flawed set of assumptions, perpetuated by both Republican and Democratic Administrations and by the Federal Reserve Board. There have been heated debates, to be sure, between neo-Keynesians and free-market economists (variously grouped under the rubrics of supply-side, rational expectations, and efficient-market theories). These debates have, however, obscured a large and ultimately damaging consensus on economic thinking.

The differences between the two schools of thought are well known. Neo-Keynesian economists emphasize active aggregate demand management, with little attention to the uses of that spending. Free-market economists of various stripes (such as the rational expectations, efficient markets, supply-side, and real-business-cycle schools, all close cousins) generally call for tax cuts and deregulation, and believe in the stabilizing role of efficient financial markets and financial market expectations.

Yet these two broad schools of thought share five assumptions (often implicit) that are even more consequential than their differences. First, both the Neo-Keynesians and free-market schools believe that economic policy making should largely remain the purview of individual countries (or in the case of Europe, the purview of the Euro-zone). Global cooperation is not much needed, except perhaps to set a few regulatory standards. Second, both schools focus on price stability, low unemployment, and high economic growth as the main

objectives of macroeconomic policy. Third, both schools regard the management of key macroeconomic aggregates as the way to achieve price stability and high growth. For Keynesians, the main aggregates are the budget deficit and monetary policy, managed so as to stabilize aggregate demand. The free-market school prefers low marginal tax rates and a predictable money supply. Fourth, both schools of thought view issues of income distribution as peripheral to macroeconomic management, perhaps interesting morally or politically but not especially relevant to growth and inflation. Fifth, both the neo-Keynesians and the free-market school regard structural issues such as energy, climate, and infrastructure to be of little macroeconomic significance. Perhaps these factors require a modicum of policy attention, but they are certainly not regarded as critical to restoring jobs, growth, and prosperity, and could even be a hindrance in the short term; for example, if climate-change policies hike up the price of energy.

These five assumptions played out in the US in a consistent and increasingly deficient set of macroeconomic policies from the early 1980s until today. Three main policies prevailed. First, the top marginal tax rates were cut in the early and mid-1980s and kept low thereafter. The wealthy prevailed in keeping the lid on top tax rates through Republican and Democratic politicians alike, in part through their ever-increasingly bi-partisan generosity in funding political campaigns. Second, the Fed encouraged the *maximum* growth of credit consistent with price stability, as measured by the consumer price index, or CPI. The Fed pushed interest rates down as far as possible whenever the economy weakened, as long as CPI inflation remained low. A second strategy of the Fed has been to champion all manner of financial deregulation, opening the door for securitization, sub-prime mortgages, and the blending of commercial and investment banking, as long as the resulting credit boom did not create inflation. Third, federal budget spending, other than for the military and entitlements spending (Medicare, Medicaid, Veteran's benefits, and Social Security), was chronically starved for cash. Structural challenges like energy, climate change, higher education, public health and infrastructure were not treated as economic priorities.

For the twenty years of Alan Greenspan's tenure as Chairman of the Federal Reserve, from 1987 to 2006, these policies seemed to work. Of course there were shocks and challenges, including the disconcerting frequency of financial scares such as Black Monday (1987), Mexico (1994), East Asia (1997), Long-term Capital Management (1998), and the Dot.Coms (1998-2000). These were taken as one-off accidents, not as harbingers of more fundamental instability. There was little challenge to the basic policy framework or the stringent limits of the macroeconomic debate. The late 1990s are often regarded as the halcyon days of the policy regime, with their rapid growth, low inflation, and high employment. In retrospect, however, we also see in these years the

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collapse of private saving, the explosion of foreign borrowing, the Dot.com bubble, the start of the housing bubble, and the failure to address underlying structural problems.

The collapse of the subprime bubble has given some pause, but the old policy machine is still trying to rise from the rubble, something like a Terminator robot reassembling its parts after a seemingly shattering blow. In late 2008, America briefly recognized that its profligacy had led to the mega-collapse of 2008, but during 2009 the Obama White House, Congress, and Fed have attempted to re-create the preceding bubble. The Fed has once again put its foot on the accelerator, driving interest rates to nearly zero, even lower than the rates of 2002-2005. Credit policies and derivatives markets remain largely unregulated. 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 US economy, and the world economy, cannot recover sustainably by propping up consumers for yet another binge. Zero-interest rate policies will create a new carry-trade bubble of some sort, as Wall Street funds another Dubai-style real estate spending spree or some as yet unrecognized and destabilizing commodity play. Meanwhile, the crises of unemployment among the unskilled, uninsured, and poor eat away at American society, where one in three children now subsist on food stamps.

Every one of the five assumptions guiding economic policy since 1981 needs a basic rethink. Each of the consensus pillars of macroeconomic policy has become untenable. A new strategy of economic governance – one that is structural and global – is now needed, and a new science of macroeconomics must supersede the stale debates of Keynesian and rational expectations theories.

First, economic policy can no longer be taken one country at a time. Global cooperation now matters. Greenspan was in fact tricked by globalization. He thought that as long as inflation remained low, he could − and indeed should − spur credit expansion to the hilt, the better to maximize economic growth (and his repeated appointment as Fed Chairman). Yet in a globalized economy, the US overheating didn't show up in the CPI, but instead mainly as a massive trade deficit with Europe and Asia. (The credit boom also showed up in soaring housing prices, which are not properly treated in the US CPI). China, notably, was happy to provide on credit all of the goods that the US demanded and that the Fed policy encouraged. The CPI simply doesn't register the imbalance of an open economy importing heavily from the rest of the world. Now, to rebalance the

world economy, it's clear that the US must cut back on foreign borrowing while China and others must spur their own domestic demand. Global macroeconomic cooperation is needed to smooth this short-run transition and to avoid future mega-imbalances.

Second, the narrow policy focus on three short-term goals – price stability, low unemployment, and high economic growth – is woefully insufficient. By focusing relentlessly on three headline numbers – the CPI, the unemployment rate, and the GNP – policymakers and politicians allowed the US economy to become profoundly imbalanced in several ways. Poverty is now deeply entrenched. Much of the young workforce lacks the skills needed for good jobs. The infrastructure has been allowed to crumble during thirty years of neglect, and will need new public-private partnerships to revive and upgrade. Energy and climate insecurity similarly cloud the future. The next generation of large-scale investments – in renewable and nuclear energy, electric vehicles, sustainable buildings and urban design – are held hostage to the lack of clear public policies in these areas.

Third, the stimulus tools of standard macroeconomics are spent. Interest rates are near zero but debt-ridden, unemployed, and frightened households can no longer pick up the pace. Keynesians urge even greater budget deficits, though the $1.4 trillion hole in fiscal year 2009 must give pause. The federal budget gap is now so large that the deficit has itself become a major source of anxiety and uncertainty. Another tax cut would be more likely to frighten than stimulate the economy. Anybody who adds across budget columns will realize that the federal budget is at the breaking point, and needs higher rather than lower tax revenues. The Federal Government collects a mere 18 percent of GNP in revenues, which are fully swallowed up by spending on health and retirement, the military, and interest payments on the debt. The rest of government, including infrastructure, science, education, climate, energy, poverty reduction, and public administration, is financed by borrowing, with China the largest creditor.

Fourth, the sustained thirty-year neglect of income distribution is no longer tolerable either practically or morally. In the central cities, half the kids are dropping out of high school. There is an epidemic of dropouts from four-year colleges as well, as families can no longer meet tuitions. One in five US children are now growing up in poverty, and the rate is as high as one in three in the case of African-American and Hispanic households. The welfare reform of the Clinton era – "ending welfare as we know it" – sent poor single mothers out to work without providing childcare or early schooling for the young kids left behind each day. Yet even with this tsunami of social distress, Wall Street is readying to launch the biggest stink bomb of all, by pocketing the bailout support (including zero-interest credits from the Fed as well as overpayments for toxic assets) in a new round of mega-bonuses for the miscreants who caused the crisis in the first

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place. Yet Congress and the White House are set to let this happen, so as not to cross their campaign financiers in the lead-up to the 2010 elections. Decadence is the watchword.

Fifth, the fallacy of the long-maintained assumption that the economy can grow and provide high employment while neglecting structural challenges such as energy and infrastructure is exposed by the US economy's continuing weaknesses. Even with interest rates at near zero, the economy limps along, on the edge of a double dip. Unemployment remains perilously high and will stay so for low-skilled workers. Trillions of dollars of real demand, not makeshift jobs or last-gasp consumerism, are bottled up in infrastructure and low-carbon energy projects that can't get off the ground until the government creates a sound policy and financial environment.

Since the operating assumptions of macroeconomics from the 1980s onward are passé, so too is the policy framework that has dominated the US and the world economy for the past thirty years. Rather than championing low taxes as the key to growth, we need to champion an efficient and fair public sector that is large enough to meet the needs of infrastructure, science and technology, climate, higher education, and poverty alleviation. Taxes need to be seen not as dial to be tuned for stimulus, or only as impediment to private initiative, but as the means to pay for critical public goods that are complementary to the private-led economy. The US federal tax take of 18 percent of GNP is manifestly too low for this purpose.

Credit policy also needs a similar overhaul. The Greenspan and Bernanke rule – to maximize the growth of consumer credit subject to the inflation target – has put the US into unprecedented indebtedness. We should be pleased that households have cut back on consumption. Rather than trying to recreate the last bubble, we should be mobilizing the renewed propensity to save in order to invest in sustainable energy, food production, environmental conservation, skill formation, research and development, and other priority needs.

Third, we should aim for an investment-led rather than consumption-led recovery, by focusing on the complex complementarities of public and private investments. Macroeconomists trained in the past thirty 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.

These challenges might seem particular to the US but they are truly a global drama, replayed in virtually every country. What ails the US ails much of the world. The structural challenges of energy, climate, infrastructure, poverty, and education are common challenges. Some of them require a truly global policy framework, such as climate-change mitigation and a worldwide transition to sustainable energy systems. Moreover, given America's fragile finances and diminished global stature, the US cannot lead the world on these issues; it can only partner with others in efforts to find the solutions. We therefore find ourselves in an inevitably risky transition from a world with one dominant economic power to a multi-polar world where the institutions of economic cooperation are still very weak. In short, macroeconomics needs an overhaul not only in concepts and tools, but in global cooperation as well.

We must bolster international economic cooperation on the fly and in the heat of crisis. As a first step, the G20 should be bolstered as the new forum for macroeconomic decision-making. We have moved from a G7 that was largely a G1 (the US) to a larger grouping that rightly includes Brazil, China, India, Indonesia, and other emerging markets. Representation, broadly speaking, has expanded from one billion people in the G7 high-income world to 4.2 billion people represented at the G20 table. Still, the G20 must add the voices of the poor, especially of Africa, which would bring another one billion to the table. A permanent seat for the African Union would be a vital start.

Global representation must be bolstered in other ways. As a practical matter, strong regional cooperation would greatly facilitate stronger global cooperation as well. The European Union is the model here. While the EU has its countless critics, it has effectively balanced significant internal diversity and national sovereignty with deep and beneficent regional cooperation. If the African Union, East Asia, South Asia, NAFTA, and South America would emulate the efficacy of the European Union through similar regional institutions,

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the myriad tasks of global economic governance – whether at the United Nations or at the G20 – would be greatly simplified. The recent summits between the European Union and its African and East Asian counterparts signal the way forward.

Regional cooperation will hasten reform of the international monetary system. The dollar can no longer serve as a stable linchpin of the global economy. The success of the Euro in weathering this crisis should give inspiration to East Asia to follow on with much greater regional monetary cooperation, including the gradual movement towards a common currency basket among the major economies. A harmonized policy in East Asia would have the virtue of easing China's transition from a dollar peg to a flexible rate. Flexibility of the Yuan within a system of East Asian exchange rate cooperation will be much more successful than a continued focus on the bilateral dollar-Yuan rate.

The structural challenges facing the world economy, notably around climate, water, energy, food supplies, and extreme poverty, require the spotlight. They are not the poor cousins of global macroeconomic management, but the key to it. Global macroeconomics should be reconstituted around these global challenges, since solutions to these problems will do more to promote and sustain global growth than further fiddling with macroeconomic dials. Yet as important as these areas are to our current and future economic wellbeing, we have a surfeit of words and a dangerous deficit of real actions.

The politicians posture without understanding the technical underpinnings of the structural challenges: their magnitude, timing, spatial extent, future dynamics, or costs of mitigation and adaptation. The real experts are very far from the podiums and negotiating tables. The macroeconomists, as I've stressed, don't even recognize that medium-term (decadal or even generation-long) programs to address energy, climate, and extreme poverty are vital for sustained economic growth. We will need, urgently, to strengthen global institutions so that they can provide reliable expert guidance, quantification, monitoring, and oversight of global cooperative actions. The data matter, and we are flying blind.

We would do well to start the new macroeconomics with three crucial and interconnected challenges: climate and energy security, food and nutrition security (including land use, water use and biodiversity), and poverty reduction. In each area, we need new institutions that can help the world to take the long view, making assessments of needs, investment priorities, and means of financing. These institutions would help to connect business, policy, and science, a three-way relationship vital for every major area of concern, but largely non-existent in an institutionalized manner. Many will shudder at the prospect of such planning, but the purpose is not rigid calculation but rather to design practical frameworks for action in which private and public actors will play complementary roles.

Climate change and energy security issues, for example, should be housed in a new Global Energy and Environment Organization (GEEO) to supplant the small-scale secretariat of the UN Framework Convention on Climate Change. The new GEEO would pull together the existing pieces of various international bodies and treaty secretariats into an effective unified structure, overseeing technical analyses, compliance with international agreements, and financial flows for climate-change mitigation and adaptation. The growing global food and nutrition crisis also needs a similarly powerful home that would combine the work of several existing agencies and treaty organizations involving agriculture and nutrition, perhaps in a new World Food and Nutrition Agency. The challenge of poverty reduction, vital not only for economic development but also for restoring peace in war-torn impoverished regions like Afghanistan, Sudan, and Somalia, requires a Global Sustainable Development Agency, built upon the leadership of the United Nations Development Programme. A stronger agency would have the mandate and wherewithal to coordinate the world's efforts to achieve the Millennium Development Goals.

One of the catchphrases of recent years in the international system has been that we should use "existing mechanisms" rather than create new institutions. This is a recklessly reactionary point of view. The existing institutions were born after World War II, in a different time facing a different set of challenges. The G20 is new because the world economy has been recast by the rise of the emerging economies. The world's macroeconomic challenges are new because we have hit generational roadblocks due to persistent poverty, escalating environmental threats, and deepening energy insecurity. While we have powerful new technologies to address our challenges, they will require public-private partnerships for testing and large-scale deployment. Macroeconomic aggregates will not produce the next generation of automobiles, the safe worldwide use of nuclear power, the protection of rainforests, or the global capture and disposal of carbon dioxide at coal-fired plants.

This essay began with interest rates and budget deficits and ended with international organizations, a category as far removed from mainstream macroeconomics as one can imagine. Yet bridging the divide of macroeconomics and global governance is exactly the challenge we face, both in policy and scientific terms. The issues which have burned so brightly in our recent macroeconomic debates – interest rates, monetary growth, fiscal stimulus packages, top marginal tax rates, financial deregulation – are not the variables that will truly determine our economic future. The new macroeconomics must be structural – concerning itself with poverty, education, food, energy, and climate over the CPI – if we are to find our way to sustainable recovery and development.

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