Today’s challenges go beyond Keynes

By Jeffrey Sachs

For more than 30 years, from the mid-1970s to 2008, Keynesian demand management was in intellectual eclipse. Yet it returned with the financial crisis to dominate the thinking of the Obama administration and much of the UK Labour party. It is time to reconsider the revival.

The rebound of Keynesianism, led in the US by Lawrence Summers, the former Treasury secretary, Paul Krugman, the economist-columnist, and the US Federal Reserve chairman Ben Bernanke, came with the belief that short-term fiscal and monetary expansion was needed to offset the collapse of the housing market.

The US policy choice has been four years of structural (cyclically adjusted) budget deficits of general government of 7 per cent of gross domestic product or more; interest rates near zero; another call by the White House for stimulus in 2013; and the Fed’s new policy to keep rates near zero until unemployment returns to 6.5 per cent. Since 2010, no European country has followed the US’s fiscal lead. However, the European Central Bank and Bank of England are not far behind the Fed on the monetary front.

We can’t know how successful (or otherwise) these policies have been because of the lack of convincing counterfactuals. But we should have serious doubts. The promised jobs recovery has not arrived. Growth has remained sluggish. The US debt-GDP ratio has almost doubled from about 36 per cent in 2007 to 72 per cent this year.

The crisis in southern Europe is often claimed by Keynesians to be the consequence of fiscal austerity, yet its primary cause is the countries’ and eurozone’s unresolved banking crises. And the UK’s slowdown has more to do with the eurozone crisis, declining North Sea oil and the inevitable contraction of the banking sector, than multiyear moves towards budget balance.

There are three more reasons to doubt the Keynesian view. First, the fiscal expansion has been mostly in the form of temporary tax cuts and transfer payments. Much of these were probably saved, not spent.

Second, the zero interest rate policy has a risk not acknowledged by the Fed: the creation of another bubble. The Fed has failed to appreciate that the 2008 bubble was partly caused by its own easy liquidity policies in the preceding six years. Friedrich Hayek was prescient: a surge of excessive liquidity can misdirect investments that lead to boom followed by bust.

Third, our real challenge was not a great depression, as the Keynesians argued, but deep structural change. Keynesians persuaded Washington it was stimulus or bust. This was questionable. There was indeed a brief depression risk in late 2008 and early 2009, but it resulted from the panic after the abrupt and maladroit closure of Lehman Brothers.
There is no going back to the pre-crisis economy, with or without stimulus. Unlike the Keynesian model that assumes a stable growth path hit by temporary shocks, our real challenge is that the growth path itself needs to be very different from even the recent past.

The American labour market is not recovering as Keynesians hoped. Indeed, most high-income economies continue to shed low-skilled jobs, either to automation or to offshoring. And while US employment is rising for those with college degrees, it is falling for those with no more than a high school education.

The infrastructure sector is a second case in point. Other than a much-hyped boom in gas fracking, investments in infrastructure are mostly paralysed. Every country needs to move to a low-carbon energy system. What is the US plan? There isn’t one. What is the plan for modernised transport? There isn’t one. What is the plan for protecting the coastlines from more frequent and costly flooding? There isn’t one.

Trillions of dollars of public and private investments are held up for lack of a strategy. The Keynesian approach is ill-suited to this kind of sustained economic management, which needs to be on a timescale of 10-20 years, involving co-operation between public and private investments, and national and local governments.

Our world is not amenable to mechanistic rules, whether they are Keynesian multipliers, or ratios of budget cuts to tax increases. The UK, for example, needs increased infrastructure and education investments, backed by taxes and public tariffs. Therefore, spending cuts should not form the bulk of deficit reduction as George Osborne, UK chancellor, desires. Economics needs to focus on the government’s role not over a year or business cycle, but over an “investment cycle”.

When the world is changing rapidly and consequentially, as it is today, it is misguided to expect a “general theory”. As Hayek once recommended to Keynes, we instead need a tract for our times; one that responds to the new challenges posed by globalisation, climate change and information technology.

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