Big Ideas

An Economic Recovery Program for the Post-Bubble Economy

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> *America needs a bold and optimistic economic recovery plan that goes beyond conventional thinking and harnesses the economy to two important new growth drivers: public infrastructure investment and rising global demand for efficiency-enhancing technology.*

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The American economy is in trouble. Battered and bruised by the collapsing housing and credit bubbles, and by high oil and food prices, it is having trouble finding its footing. The stimulus medicine the Federal Reserve and Congress administered earlier this year is already wearing off, while home prices are still falling and unemployment continues to creep upward. By the time a new president is sworn in, there is a good chance the economy will have stalled again, and the hope for a relatively quick rebound will have given way to the fear of a protracted slowdown.

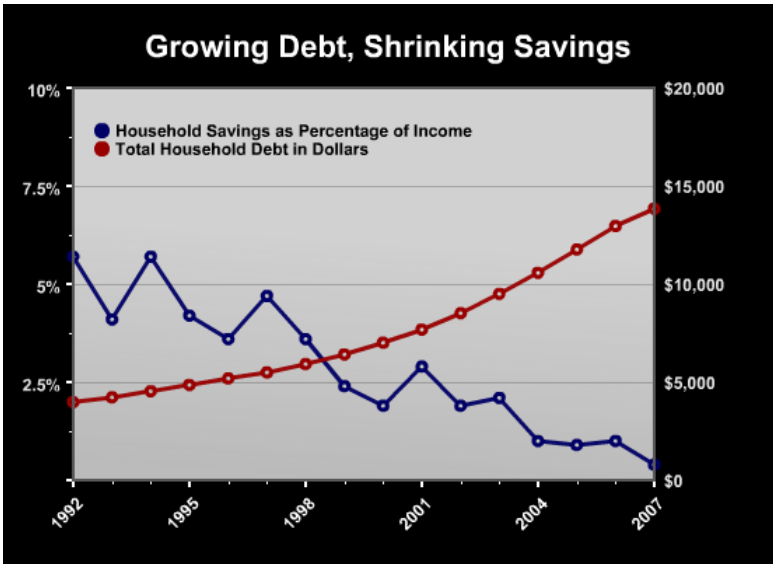
The next administration must therefore have a second dose of medicine ready that is stronger, more enduring, and different in kind from the first stimulus program of tax rebates and tax cuts for business. Tax rebates may have been appropriate for an economy entering a standard cyclical downturn. But this is clearly not a normal business recession. It is a post-bubble slowdown involving a painful de-leveraging of America's household and financial sectors. This means that consumers and housing will be struggling for some time, and that new sources of growth are needed.

A longer-term economic recovery program must therefore steer the economy onto a new growth path that is less dependent on the debt-financed consumption that has driven economic growth over the past decade. The most promising new sources of growth are America's enormous public infrastructure needs and the increased global demand for American technology created by the drive for greater efficiency in economies around the world. An economic recovery program built around public infrastructure investment and demand for American technology would be more effective in stimulating the economy in the short term, and far better for it in the long run, than would another round of tax rebates for American consumers.

Getting the Diagnosis Right

The experience of Japan and Sweden in the early 1990s should be a warning to those who believe that all the economy needs is a bit more of the standard countercyclical treatment-a few more tax cuts or rebates here, a little bit more unemployment insurance there, and perhaps some assistance to state and local governments. Japan and Sweden both experienced serious prolonged recessions after the bursting of their property and financial bubbles in the early 1990s, and it took extraordinary fiscal and monetary measures before either enjoyed a real recovery.

The U.S. economy is more dynamic and more flexible than Japan's or Sweden's. Still, there are reasons to worry about the effectiveness of standard countercyclical measures in today's post-bubble economy, notwithstanding our economy's many strengths. To begin with, measures like temporary tax rebates are too transitory to generate a sustainable recovery. Businesses may act quickly to restore profitability by adjusting inventory levels and cutting costs, but households generally take much longer to put their balance sheets in order and increase spending again. This is especially the case when many Americans are already overleveraged and experiencing a decline in the value of their homes. With home prices falling, many households will not be able to maintain consumption levels by tapping home equity as they have in the past. Moreover, with unemployment rising, they cannot easily or quickly replace the credit they previously relied on with new sources of income. Thus they will have no choice but to cut consumption and increase savings gradually. In light of the fact that housing markets by their nature are slow to correct, this household de-leveraging process could take years to play out. Household consumption, which at its peak accounted for more than 70 percent of the economy, may thus be a drag for some time to come-at least until wages rise or home values begin to increase again.

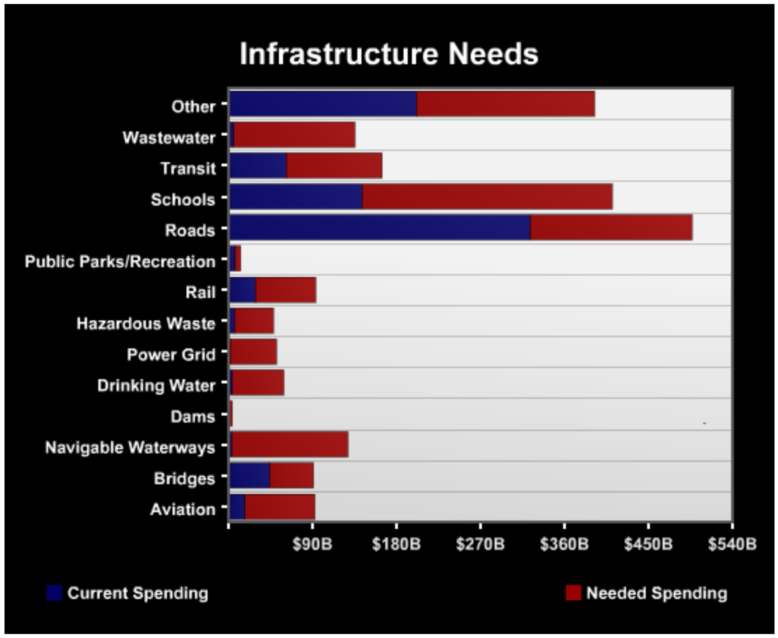


Second, standard stimulus programs generally are too modest to make a substantial difference to the parts of the economy affected by the bursting of the housing and credit bubbles. The Democratic leadership in Congress is considering a supplemental stimulus package of $50 billion. But $50 billion would count for little in a $13.8 trillion economy. David Rosenberg, chief economist at Merrill Lynch, estimates that the unwinding of the housing and credit bubbles, together with rising unemployment, will create a $475 billion reduction in consumer spending. Rising food and gas prices, he estimates, will drain another $300 billion from discretionary spending. Together, these sums dwarf the current $150 billion fiscal stimulus and suggest the need for a larger and more potent economic recovery program. Even the bursting of the tech bubble, which had relatively little impact on most Americans, required a fiscal stimulus the equivalent of more than 6 percent of GDP (measured by the increase in the budget deficit) over a three-year period, in addition to 16 cuts in the federal funds rates to 1 percent. In light of the much larger effect housing has on consumption, the unwinding of the housing and credit bubbles will require a stimulus of comparable size at the very least.

Third, the standard stimulus measures are too focused on consumption and not enough on investment. Thus, to the extent such measures were successful, they would merely reinforce a suboptimal and ultimately unsustainable pattern of economic growth that over the past decade has been too dependent on debt-financed consumption and inflated asset prices. The root cause of this suboptimal pattern of growth has been the excess savings generated by the Asian export economies and the petrodollar states of the Persian Gulf, which were recycled into the U.S. financial system, fueling the credit and housing bubbles. The housing bubble in turn helped inflate consumption, as U.S. households took advantage of poorly regulated new financial instruments to purchase more expensive homes and tap rising home equity. U.S consumption in turn helped drive Asian export growth, resulting in even higher trade surpluses. The weakness in this pattern of economic growth lay in the fact that U.S. consumption was made possible not by real wage and income gains but by unsustainable increases in home prices and household debt.

Seen from this perspective, the bursting of the housing and credit bubbles was a necessary, albeit painful, adjustment in the pattern of U.S. and world economic growth. The goal of a new recovery program therefore must not be to recreate this pattern with more short-term consumer-oriented stimulus but to steer the economy onto a more sustainable growth path. Future economic growth will need to be driven less by debt-financed consumption and more by investment that leads to the creation of good jobs and rising wages, and by exports to those economies that have underconsumed for much of the past decade.

A new economic recovery program would not preclude measures such as the extension of unemployment insurance or assistance to state and local governments to ease the adjustment many households are now experiencing. But these worthwhile measures are not a substitute for what must be the overriding goal of a new economic recovery and growth program, namely finding a new big source of economic growth that can replace personal consumption as the main driver of economic growth in the short term and that over the medium term can lead to higher wages and incomes to support increased household consumption.



There are two areas of enormous pent-up demand on which such a recovery program can be based. The first and most important is the pent-up demand in the United States for public infrastructure improvements in everything from roads and bridges to broadband and air traffic control systems to new energy infrastructure. We need not only to repair large parts of our existing basic infrastructure but also to put in place the 21st-century infrastructure for a more energy-efficient and technologically advanced society. This project, entailing several trillion dollars in new government spending over the next decade, would provide millions of new jobs for American workers.

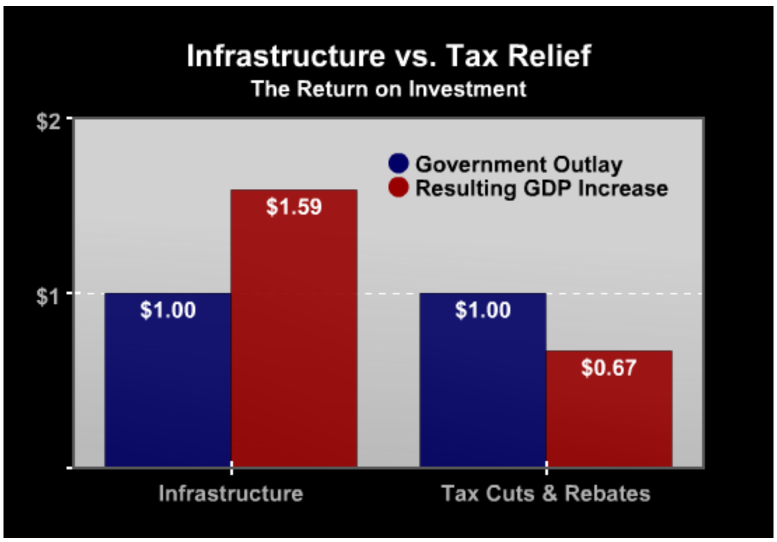
The other significant source of potential growth is the enormous pent-up demand in China and other emerging economies for both consumer goods and the productivity-enhancing and energy-efficient technology needed to sustain both corporate profitability and rising living standards. For years now, these economies have suppressed domestic demand at the expense of the living standards of their workers and have been able to use low wages to offset the rising cost of energy and other materials. But high energy prices, together with rising wages, are beginning to force a change toward more consumption-oriented economies that must do more to increase productivity and energy efficiency. This shift will increase demand for U.S. goods and services, allowing the United States to improve its trade balance and remove a drag on economic growth.

These two areas of potential growth in turn will help fuel both domestic and international demand for American technology across a broad range of new growth clusters where U.S. companies enjoy a leadership position or, with new investment, could do so in the future. These areas include not just such traditional American strengths as aerospace, information technology, and networking, but emerging growth areas associated with what might be called the "triple green revolution" in agriculture, efficiency-enhancing clean technology, and renewable energy sources. Increased world and domestic demand for American technology will help spur new investment and, with it, a new generation of technological innovation.

Public Infrastructure Investment

The main pillar of an economic recovery and growth program must be a massive increase in public infrastructure investment, in part because it has the greatest multiplier effect of any stimulus and also because it provides the foundation for private investment in the productive economy. There is increasing public recognition that two decades of underinvestment in public infrastructure has created a backlog of public infrastructure needs that is undermining our economy's efficiency and costing us billions in lost income and economic growth. The American Society of Civil Engineers estimates that we need to spend $1.6 trillion over the next five years to bring our basic infrastructure up to world standards. In addition, we need to spend sizeable sums in newer areas of infrastructure, like broadband access and new energy infrastructure for wind, solar, and clean coal.

Public investment of this magnitude would give a significant boost to the economy, filling the gap left by the falloff in housing construction and consumer spending, while laying the foundation for a more productive economy. Indeed, public infrastructure investment is the most effective way to increase demand and investment at the same time, and thus the best way to counter an economic slowdown caused by the unwinding of the housing and credit bubbles. If, in spite of low interest rates, companies will not commit to more investment spending because of weak demand or uncertainty, the best way to jump-start more investment will be to do so directly by increasing public investment outlays. Public investment in turn will help stimulate new private investment by increasing the efficiency and potential returns of that investment, and by adding demand to the overall economy.



Public infrastructure investment would have the advantage of creating more jobs, particularly more good jobs, and thus would help counter the negative employment effects of the collapsing housing bubble. For example, the U.S. Department of Transportation estimates that for every $1 billion in federal highway investment, 47,500 jobs would be created, directly and indirectly. Similarly, an analysis by the California Infrastructure Coalition concludes that each $1 billion in transit system improvements, including roadways, would produce 18,000 direct new jobs and nearly the same level of induced indirect investment. If all public infrastructure investment created jobs at the same rate as transit improvements in California, $150 billion in infrastructure investment would create more than 2.7 million jobs directly, more than offsetting the jobs lost since the bursting of the housing bubble.

Public infrastructure investment not only creates jobs but generates a healthy multiplier effect throughout the economy by creating demand for materials and services. The U.S. Department of Transportation estimates that for every $1 billion invested in federal highways more than $6.2 billion in economic activity would be generated. Mark Zandi, chief economist at Moody's Economy.com, offers a more conservative but still impressive estimate of the multiplier effect of infrastructure spending, calculating that every dollar of increased infrastructure spending would generate a $1.59 increase in GDP. By comparison, a combination of tax cuts and tax rebates is estimated to produce only 67 cents in demand for every dollar of lower taxes. Thus, by Zandi's conservative estimates, $150 billion in infrastructure spending would generate a nearly $240 billion increase (or close to a 2 percent increase) in GDP in the first year.

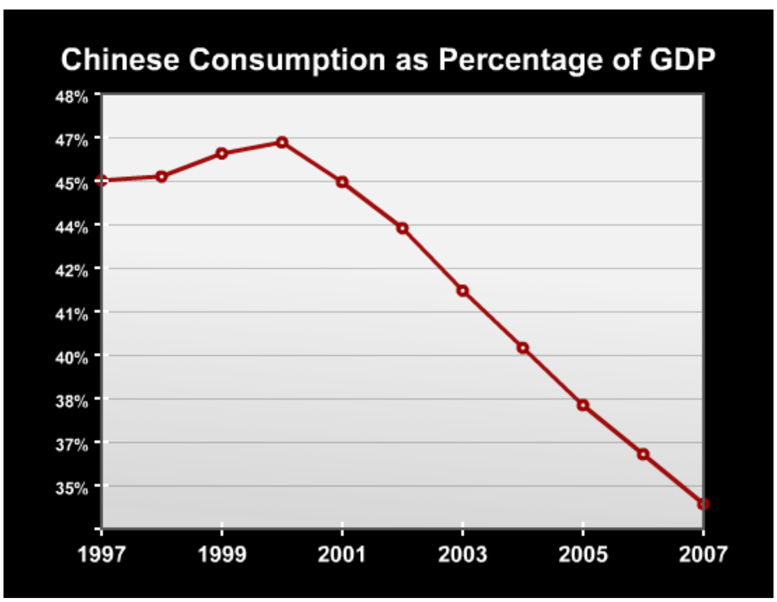
Public infrastructure investment would not only help stimulate the economy in the short term but help make it more productive over the long term. America's current economic structure-relying heavily on financial services, entertainment, and certain tech industries-reflects our low investment in public infrastructure over the past two decades. However, many of the potential new growth sectors of the economy in agriculture, energy, and clean technology will require major infrastructure improvements or new public infrastructure: new transmission grids to tap the potential of wind and solar power in the Southwest and the Great Plains, better broadband access and new airports to support the growth of agribusiness and new tech companies in the lower-cost areas of the American heartland, and a new generation of information technology to reduce traffic congestion and speed up all sorts of transactions.

In the first year, the increase in public infrastructure investment envisioned here could be funded as part of a second stimulus package. But to ensure adequate continued funding of public infrastructure over the next decade, the next administration will want to move quickly to establish a National Infrastructure Bank, along the lines proposed by Senators Christopher Dodd and Chuck Hagel, or a National Infrastructure Development Corporation, such as proposed by Congresswoman Rosa DeLauro. If properly structured, the proposed entities would enable the federal government to tap the private capital markets by issuing long-term special purpose bonds to help fund state and local infrastructure projects of national significance.

Inevitably, a massive increase in public infrastructure investment will raise concerns about the deficit. But, as we have noted, the government deficit will need to widen for the next year or two in any case to fill the gap created by the falloff in consumer and business spending. It is better that it increases as a result of public infrastructure investment than as a result of tax cuts and other spending, because spending on infrastructure will create more new jobs and economic activity.

Rising Exports from More Balanced World Demand

Given the magnitude of the housing and credit bubbles, a massive public infrastructure program may not be enough to offset consumer weakness and jump-start new business investment. Therefore, rising exports must constitute the second pillar of an economic recovery and growth program. Thanks to a weaker dollar and strong growth in emerging economies, exports are in fact contributing positively to U.S. economic growth for the first time in more than 15 years. Over the past two quarters, the improvement in the net exports of goods and services has contributed the equivalent of 1 percent of GDP growth on an annual basis.



However, there is a danger that this export boomlet will be cut short as other economies begin to feel the effects of weaker consumer demand in the United States. The next administration must therefore adopt an international strategy to encourage China and other large current account surplus economies-Japan, Germany, and the large oil-exporting countries-to expand domestic demand to offset weaker U.S. consumer growth.

There are a number of factors that will give the next administration leverage to move China and other surplus economies in the direction of more balanced economic growth. As we have noted, one of the main factors is pent-up consumer demand and the accompanying political pressure for rising living standards within large emerging economies. Over the past decade, investment and savings have grown faster than consumption in Asian export-oriented countries as well as in oil-exporting economies. Thus, there are enormous pent-up consumption needs in these societies. China, for example, has one-half the televisions, one-quarter the computers, and one-third the cell phones per capita as Europe.

At the same time, higher food and energy costs are creating pressure on China and other Asian exporting economies to let wages rise in order to avoid political tensions. Higher wages would increase the purchasing power of Asian workers and augment consumer demand, which would help create a healthier balance between demand and savings in these societies. China has an unusually high savings rate of more than 50 percent, while consumption constitutes only 35 percent of GDP. This combination of extraordinarily high savings and low consumption is unique among newly industrialized economies.

Higher wages would also force companies in emerging economies to seek out new productivity gains to compensate for rising wage levels. The drive for more rapid productivity growth in emerging economies would in turn increase the demand for labor-saving and efficiency-enhancing technology. This would benefit many American technology companies that supply software and networking equipment, as well as American companies that are developing cutting-edge technology to improve energy and materials efficiency.

In short, there are both political and economic reasons for large surplus economies to shift their economic policy toward more balanced economic growth in the near term. The next administration needs to do a better job of sending the message to large current-account-surplus economies, including the advanced economies of Japan and Germany, that they need to do more to generate their own demand. In the case of China, it can do so by pushing Beijing on international labor rights, by encouraging currency appreciation to stem inflation, and by using the OECD and the World Bank to help create a social safety net and develop a home mortgage market. Because China lacks a real safety net and does not have reliable systems of health care and education, Chinese workers engage in enormous precautionary saving, which is holding down consumption. The best way to reduce this high level of precautionary savings is to encourage China to put in place a modern social safety net and do a better job of providing education and health care for its citizens.

The biggest threat to the favorable rebalancing of world trade now getting underway is higher inflation in emerging economies. If these economies tighten their monetary policy to stem inflation, the mini export boom that has kept the U.S. economy out of recession will be cut short and one of the new drivers of U.S. economic growth will come to a premature end. An early priority of the next administration, therefore, must be to reach an understanding with other economies about how to best handle the incipient global inflation threat. Inflation in many emerging economies is the result of their policy of pegging their currency to the dollar, whether formally or informally, in order to maintain export competitiveness. Hence, as the value of the dollar has fallen so have their currencies, raising the cost of imported food and energy. (The accumulation of large foreign currency reserves has also spurred monetary growth in these economies, in spite of efforts to "sterilize" capital inflows to reduce their effect on inflation.)

The alternative to relying solely on monetary tightening would be for these economies to re-peg their currencies-by letting their currencies appreciate against the dollar but without abandoning the dollar peg entirely. This would create the best of both worlds for the U.S. economy: it would provide continued support for the dollar while also increasing domestic demand within the Asian and oil-exporting economies, thus expanding the market for U.S. goods and services. For this reason, the next administration should move quickly to a new set of understandings about world currencies that would facilitate these currency adjustments. The goal of these understandings should be to manage the dollar over the next few years to assure that it does not appreciate too much so as to cut short America's export boom or fall too far so as to provoke a currency crisis.

Capitalizing on the Next Tech Boom

Expanded public infrastructure investment in the United States and the transition to intensive, energy-efficient growth in emerging economies will greatly increase the demand for American-made technology, setting the stage for new investment in a wide range of American technology companies. As we have noted, U.S. companies still enjoy a competitive advantage in a range of technology areas, from aerospace to business software to networking. What has been missing in recent years has been a new demand catalyst to drive new investment and innovation.

Higher commodity and energy prices are also helping drive a new tech boom in other areas. In addition to benefiting many American producers, high commodity prices are setting the stage for new growth industries aimed at tapping scientific breakthroughs in agriculture, biotechnology, nanotechnology, the life sciences, energy extraction, and materials. The United States needs to position itself to take advantage of potential huge returns from new investments in the emerging growth industries of the triple green revolution: agriculture and biotechnology, clean technologies and energy and resource efficiency, and new energy sources.

We have potential competitive advantages in each of these areas. We still lead the world in agricultural production and in related agricultural products and services, as well as in the life sciences. While parts of the world have resisted some American innovations in genetically modified seeds and materials, the need for new drought- and disease-resistant crops capable of greater yields is increasingly apparent. American agricultural companies turned biotech companies, like Monsanto, stand to benefit from the pressure to feed more people and improve the diets of millions of new members of the global middle class.

In the area of energy and resource efficiency, rising commodity prices and concerns over global climate change are creating a huge demand for technology that can help make traditional industries more efficient and eco-friendly. Technology for squeezing more production out of existing oilfields, for example, is in great demand. So is technology for extracting minerals in a more environmentally friendly way. These same factors are also leading to a new cluster of clean technology companies, which specialize in technology to enhance energy efficiency and reduce carbon emissions. The demand for such engineering solutions has the potential to create a rebirth in America's industrial heartland, especially in the old mining and commodity belt of the Upper Midwest.

High oil prices have also spurred a mini investment boomlet in new renewable energy companies-wind and solar power, second-generation biofuels, and clean coal. Wind technology has advanced to the point that it is now cost competitive with traditional sources of electricity generation, and U.S. companies are becoming competitive with their European counterparts. Solar is not far behind. However, as we have noted, the lack of appropriate energy infrastructure is an obstacle to future growth. Wind and solar power is plentiful in what energy investor T. Boone Pickens calls the "Saudi Arabia of wind and solar"-namely the Southwest and the Great Plains-but this is the region that least needs more electricity generation. Future growth therefore will depend on new transmission lines to get the electricity to those parts of the country that need it most.

In order to fully capitalize on these technological trends, the United States needs a more conscious technology and competitiveness strategy. One of the main short-term goals of this strategy should be to help start-up companies that are developing new energy technology grow by helping sustain demand for energy efficiency, not only domestically but globally. The government can do so by putting a floor under oil and gas prices and by mandating ever higher energy efficiency standards so that any temporary fall in prices does not deter further investment. Another goal should be to create incentives for new technology companies to invest and create more high-value-added jobs domestically. A technology competitiveness strategy would lower the cost of doing business in the United States by providing better infrastructure and more skilled workers, eliminating the tax incentives for companies to move their operations abroad, and adding tax incentives for companies to increase investment and job creation in the United States.

With the right technology and competitiveness policies, we will be able to take advantage of the increased global demand for technology to spur investment in a cluster of new growth companies. In the process, we will be able to broaden the productive base of the American economy and create millions of new jobs that pay middle-class wages, helping to reverse the slow growth in wages that has held back living standards over the past several decades.

A Strategy of Mutual Prosperity

In the short term, the new economic recovery and growth program outlined here will help sustain U.S. and global economic growth during a period of painful adjustment following the bursting of the housing and credit bubbles. Over the longer term, it will put the U.S. and emerging economies on the path to mutually reinforcing productivity revolutions and mutually rising living standards. Increased public investment in the United States will lead to increased private investment and greater productive capacity, enabling American-based companies to take advantage of rising export demand for their goods and services. It will also lead to rising wages, enabling households to reduce their debt burdens without cutting back on consumption.

Meanwhile in large emerging economies, higher wages and more consumer spending will increase domestic demand, allowing these export-oriented economies to weather a slowing of U.S. consumer demand. Rising living standards in turn will accelerate the transition in these economies to more sustainable growth based on rising productivity and resource efficiency. This new growth orientation in turn will open up even greater growth opportunities for American companies at the forefront of the triple green revolution.

It will be up to the next administration to turn this opportunity into reality. To do so, it must have a bold and optimistic economic recovery plan that goes beyond conventional thinking and harnesses the American economy to the new growth drivers of public infrastructure investment and rising demand for efficiency-enhancing technology.

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