

Obama needs time to rescue US economy: Barack Obama a fresh start First in series: America is fac...

JEFFREY SACHS OPINION

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Obama needs time to rescue US economy

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First in series: America is facing enormous challenges. The solutions will be painful and will require years to bring to fruition



Barack Obama: a fresh start



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FOUR YEARS will soon seem like a very short time to president-elect Barack Obama. He has inherited a long-term economic and environmental mess with no short-term fixes. Many of the changes needed in the US will be painful, and will require years to bring to fruition. Mid-term congressional elections will loom in 2010, just around the political corner. If history is any guide, the Democratic Party will give up some of its recent gains at that point.

Perhaps equally important, congressional Democrats will fear those losses in advance, no matter what the future will actually bring, and so may press for short-term policies that are unhelpful in the medium run.

These are cascading problems without quick solutions. Most immediately, the collapse in consumer spending, the increase in unemployment, and the overall contraction of the domestic economy will not be reversed through a simple burst of confidence or a new stimulus package or a middle-class tax cut. US households were living beyond their means (and borrowing from abroad to do it), by as much as 5 per cent of GNP per year, during the blind years of the Bush era. It's most unlikely (and would be most unwise) to reconstruct that spending binge again.

A core idea behind Obama's economic strategy is that increased investments in sustainable technologies, including energy efficiency, mass transit, modernised infrastructure, and renewable energy sources will fuel a "green recovery".

This is exactly right, except for one detail. The shift to sustainable technologies will take years, indeed decades, and will not provide the magnitude of short-term macroeconomic stimulus that some seem to expect. I don't mean to cast doubt on the basic idea, which is sound, indeed vital. It's just that the hopes for a major green short-term stimulus programme are hard to imagine.

A few things can be done in the short term in the direction of a green recovery. The

federal government can help state and local governments cover the costs of mass transit and buy more buses or upgraded rolling stock for commuter rail. The federal government could subsidise home weatherproofing and other steps to improve energy efficiency. Though these steps might amount to some tens of billions of dollars in the next two or three years, these investments will be modest relative to the decline in annual household spending that could amount to almost \$1 trillion. Nonetheless, even these early steps would help to ensure the world that the Obama administration is making practical efforts to reorient the US economy towards one of environmentally sustainable growth.

The longer-term green agenda, vital as it is, is not yet ready for macroeconomic-scale deployment.

For example, the US needs a new modern high-voltage nationwide power grid to replace the ramshackle, regional-based power grid that was built up over decades. The new grid, eventually, will carry renewable energy from the wind farms of North Dakota and the solar fields of the Mojave Desert in California. Yet it will take up to a decade to design and deploy this new grid, even if things move very fast.

Similarly, the US will probably begin licensing and building nuclear power plants once again. It will undertake large-scale research on critical technologies, including concentrated solar power, high-performance batteries, and carbon-capture and sequestration.

These investments in research, development, and demonstration (RD&D) will lead to new industries. Yet all of these investments will take time, for research and development, project design, congressional approval, co-ordination with states, contracting with suppliers, and more.

Another difficulty will be the budget and financial policies. The fiscal deficit is exploding now. In fiscal year 2008, which ended on September 30th, the budget deficit reached a record \$454 billion. Next year's

deficit will probably end up at least twice that, if not more. With unemployment rising to 8 percentage points or more, automatic stabilisers like unemployment compensation and transfer payments to the poor will rise significantly. Even more important, tax collections will fall sharply as incomes decline.

The bank bailouts, coming to more than \$1 trillion in asset swaps, loans, and guarantees to this point, will turn into sizeable actual budget outlays as the Government absorbs losses on the assets that it has taken on. And the administration and Congress will call for new stimulus spending, mainly around transfers to state and local governments, increased public investment outlays, and further tax cuts and rebates.

A budget deficit of 6 per cent of GNP (roughly \$900 billion or so) might be justified as a short-run countercyclical emergency policy, but won't stand up as a longer-term strategy. Despite the rallying of the dollar against the euro in recent weeks – another bizarre misallocation of financial markets – an open-ended haemorrhaging of the budget will lead to a sharp decline of the dollar and a sharp rise of US long-term interest rates. The administration will have to present a medium-term budget scenario that has credibility. Here's another place where the politics will hurt. The US simply does not collect enough tax revenues to run a civilized nation any more. Our federal tax revenues have been running on the order of 18 per cent of GNP, with another 18 per cent of GNP or so collected by states and local governments.

The total tax take puts the US ratio of taxes to GNP at the lowest level of all the high-income countries of the Organisation for Economic Co-operation and Development (the high-income countries of North America, western Europe, and east Asia).

Simple arithmetic makes clear that the medium-term budget situation is untenable. Federal retirement and disability accounts, federal health care outlays, the military, and interest payments add up to around 16 per cent of GNP, and yet total revenues are

around 18 per cent of GNP (even lower in the recession). It's obvious that current taxes are insufficient to face the challenges of poverty, education, environment, energy, research and development, foreign affairs (including foreign assistance), public administration, and many other major categories of public expenditure, much less an aging population and increased debt servicing costs on the financial bailouts on other debts racked up in the coming years.

Little, alas, has prepared the American people for the adjustments that will be necessary to get the economy back on track. The electoral campaign was mostly unedifying. Senator John McCain promised tax cuts right, left, and centre, for rich and poor, households and corporations. Obama was more measured, but did promise tax cuts for households earning less than \$200,000.

Nobody explained the real long-term fiscal situation to the American people.

There is one more worry. The US capacity to feel aggrieved vis-à-vis the world is large and stirring. Here is a country which has abnegated responsibility on climate change, spent the very least on foreign aid for the poor as a share of GDP of any of the rich donor countries, launched an unprovoked and destabilising war, and most recently created a global financial mess of unprecedented proportions. Yet instead of humility, many congressmen are hopping mad – blaming other countries (read: China) for America's woes. It's all very dangerous if it weren't so absurd. Yet Obama will have to work hard against heated protectionist rhetoric and trade bashing in his own party.

The problems of the US and world economy are solvable, and Obama I believe has great gifts of leadership that will be necessary to bring those solutions to fruition. He is, most importantly, not only exceedingly intelligent but also a natural consensus builder, through calm explanation and uplifted vision.

Franklin Roosevelt inherited a situation vastly worse than today's, yet through character, perseverance, and vision, he helped lead America to safe harbour. I believe that

Obama will do the same. The key will be to avoid any sense of panic now, accept a recession that is certain, work to reduce its impact without undermining longer-term objectives, and then help the US and the world to the more significant structural changes that we need on a time horizon of five to 10 years.

Obama won't have time to accomplish this by the end of his first term to win re-election, since markets and the voters' mood will respond powerfully and positively to a clear and convincing direction, even if the actual changes are only on course and not yet fully in place.

The key steps in the coming months include the following. First, Obama should work closely with China to co-operate on macroeconomic policy making, to ensure that the US cutback in domestic spending is partly offset by a rise in domestic demand in China. A robust US-China macroeconomic relationship will be crucial for global recovery. This obviously means staying away from trade bashing and other finger pointing. Co-operation not conflict is the path to recovery.

Second, the US and China should agree on the outline of a new climate change agreement as well, to point the world, and the world's industries, in the direction of credible, understandable long-term sustainable growth. This will be the key to unlocking new long-term investments in energy, long-mileage automobiles, green buildings, and more.

Third, the new administration should undertake a fiscal stimulus geared around spending increases – especially on infrastructure and aid for states and cities – rather than on tax cuts.

Indeed fourth, the administration, sooner rather than later, should start to chart a path to new taxes and to gradually rising revenues as a share of national income. Fifth, Obama should continue to see structural change – in energy, transport, climate, health – as the keys to recovery, not as luxuries that need to be put aside in order to focus on the recession itself. Sixth, the same is true about America's role in

the fight against poverty, hunger, and disease. The achievement of the Millennium Development Goals is not only a commitment of the human spirit towards humanitarian ends. It is also an investment in a secure future, in which trade and shared prosperity replace military outlays as the foundation of national security.

Moreover, by enabling Africa to buy power plants, telecommunications systems, and power grids from the US and Europe, we will put excess capacity to work with the highest human returns of all. In sum, the restoration of growth depends on a renewal of confidence, investment, and (responsible) household consumption. By helping to show the American people and the world the path to a truly sustainable future, Obama will render the key service on behalf of economic recovery. He will show, as did Roosevelt in the Great Depression, that conquering our fears through a shared vision of a fairer and prosperous world, can shake off the consequences of short-term financial mismanagement and years of preceding political neglect.

Jeffrey Sachs is director of The Earth Institute at Columbia University in New York. He is also Quetelet Professor of Sustainable Development, and Professor of Health Policy and Management at the university. He is a special adviser to UN secretary general Ban Ki-moon. From 2002 to 2006, he was director of the UN Millennium Project and special adviser to UN secretary general Kofi Annan on the Millennium Development Goals, the internationally agreed goals to reduce extreme poverty, disease, and hunger by the year 2015.

He is president and co-founder of Millennium Promise Alliance, a non-profit organisation aimed at ending extreme global poverty. This article was written specially for *The Irish Times*

Tomorrow: Pat Cox on the future of EU/US relations

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