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Rapid growth or stagnation: An economic policy choice

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Abstract

Why has the American economy performed so poorly in the past decade, especially in comparison with the two prior decades? This paper makes the theoretical and empirical case that a series of economic policy decisions provides the most satisfactory explanation and that policy reform will restore good economic performance. The paper also considers alternative explanations including the idea of a new secular stagnation unrelated to policy and the view that the deep financial crisis inevitably delayed recovery from the recession.

Keywords: Rapid growth; Stagnation; Policy choice

1. Introduction

Among his many innovative contributions to econometric modeling, Lawrence Klein was a pioneer in exploring the reasons for policy differences between models and the economists who build and estimate them. The Model Comparison Seminar that he ran during the 1980s, for example, helped economists understand why the impacts of changes in fiscal and monetary policy were different from model to model.

I will always be grateful to Professor Klein for inviting me to join his Model Comparison Seminar and to add to the mix a new kind of model with rational expectations and sticky prices which I was developing at Stanford in the 1980s. The model was an estimated version of what

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would come to be called a "new Keynesian" model, and the other models in the comparison would thus logically be called "old Keynesian." They included such famous workhorse models as the Data Resources Incorporated (DRI) model, the Federal Reserve Board's model, the Wharton Econometric Forecasting Associates (WEFA) model, and Larry Meyer's Macro Advisers model. It was probably the first systematic comparison of old and new Keynesian models and was an invaluable opportunity for someone developing a new and untried model.

The performance comparison results were eventually collected and published in a book (Klein, 1991a). In the opening chapter of that book Klein (1991b) reviewed the comparative performance of the new and old Keynesian models, noting differences and similarities: "The multipliers from John Taylor's model. . .are, in some cases, different from the general tendency of other models in the comparison, but not in all cases. . ..Fiscal multipliers in his type of model appear to peak quickly and fade back toward zero. Most models have tended to underestimate the amplitude of induced price changes, while Taylor's model shows more proneness toward inflationary movement in experiments where there is a stimulus to the economy." Klein was thus shedding light in why government purchases multipliers were so different – a controversial policy issue that is still of great interest to economists and policy makers as they consider and evaluate the stimulus packages of 2008 and 2009 and other recent policies.

In this paper I review the role of policy in economic performance in recent years. Although the paper is not technical, much of the results are based on the type on empirical modeling and comparison research that Lawrence Klein favored, including "New Keynesian versus Old Keynesian Government Spending Multipliers," in which John Cogan, Tobias Cwik, Volcker Wieland and I evaluated recent policy (Cogan, Cwik, Taylor, Wieland 2010).

2. Economic policy and economic performance

The performance of the U.S. economy during the past decade has left much be desired. The 2007–2009 recession was very deep – made worse by the severe financial crisis, and the recovery from the recession has been weak. Job growth since the recovery began has been so slow that the employment-to-population ratio has not increased at all. Economic growth has been so slow that the gap between real GDP and its pre-recession trend has not materially closed. It's a particularly unsatisfactory performance in comparison with the 25 years before the recession when the economy was performing so well that economists call the period the Great Moderation or the Long Boom. By the measure that macroeconomists regularly use to assess the macroeconomic stability – the standard deviation of real GDP from trend GDP – economic performance has deteriorated by a factor of three or four since 2006. The low economic and employment growth has harmed many people, and is a tremendous setback for macroeconomists whose job it is to recommend and implement policies to prevent such poor macroeconomic performance.

Like other macroeconomists, I've been researching possible explanations for the poor performance, recognizing that in order to recommend something to deal with the problem one has to have a good diagnosis of the problem. This research has led me to the conclusion that the basic problem is a series of economic policy decisions – a diagnosis which implies that reforming policy is the best way to address the problem. Whether the American economy returns to strong sustained growth or continues its substandard performance is thus a matter of policy choice.

The simplest way to understand this diagnosis is to examine the broad changes in policy that occurred during decade from around 2003 to the present. This period includes the years leading up to the recession of 2007–2009, the financial panic, the recession itself, and the weak recovery. During this decade, as I document in this paper, there was a dramatic move across a whole range of

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