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ADDRESSING CHALLENGES OF A NEW ERA: AGAINST RULE-OF-THUMB ECONOMICS

The most pressing economic problems of our time require pragmatic remedies closely tailored to context

In recent decades, mainstream economics has become closely associated with a particular set of policies labeled "neoliberalism." The neoliberal policy paradigm favors expanding the scope of markets (including global markets) and restricting the role of government action. Today it is widely recognized that this approach failed in a number of important respects. It widened inequality within nations, did little to promote the climate transition, and created blind spots ranging from global public health to supply-chain resilience.

The neoliberal era did witness a major achievement. Record economic growth in many developing economies, including the most populous, brought a massive reduction in extreme poverty around the world. Yet the countries that did best during this period, such as China, hardly subscribed to neoliberal rules. They relied on industrial policies, state enterprises, and capital controls as much as they did on freer markets. Meanwhile, the performance of countries that adhered most closely to the neoliberal playbook, such as Mexico, was abysmal.

Was economics responsible for neoliberalism? Most of us know that economics is a way of thinking rather than a set of policy recommendations. The tools of contemporary economics yield very few generalizations that offer immediate policy guidance. First-order principles—such as thinking at the margin, aligning private incentives with social costs and benefits, fiscal sustainability, and sound money—are essentially abstract ideas that do not map into unique remedies.

China itself offers the best illustration of the plasticity of economic principles. Few would dispute that the Chinese government took advantage of markets, private incentives, and globalization. Yet it did so through unconventional innovations—the household responsibility system, dual-track pricing, township-and-village enterprises, special economic zones—that would be unrecognizable in standard Western policy recommendations but were needed to relax domestic political and second-best constraints.

In economics, the valid answer to almost any policy question is “it depends.” Economic analysis comes into its own precisely when it scrutinizes this contextual dependence—how and why differences in the economic environment affect outcomes, such as the consequences of policies. The original sin of the neoliberal paradigm was the belief in a few simple, universal rules of thumb that could be applied everywhere. If neoliberalism was economics in action, it was bad economics that was on display.

New challenges, new models

Better economics must start from the premise that our existing policy models are inadequate for the range and magnitude of challenges we face. Economists will have to address these challenges imaginatively, applying the tools of their trade in a way that takes into account differences in economic and political context in different parts of the world.

The most fundamental challenge is the existential threat posed by climate change. In the economist's ideal world, the solution would be global coordination around a three-pronged approach: a high enough global carbon price (or equivalent cap-and-trade system), global subsidies for innovation in green technologies, and a substantial flow of financial resources to developing economies. The real world, organized around individual sovereign nations, is very unlikely to deliver anything approaching this first-best solution.

As recent history shows, the adoption of green policies will require messy domestic political bargains. Each nation will prioritize its own commercial considerations while bringing opponents and potential losers from green policies on board. China's industrial policies to promote solar and wind have been much derided by competitors but have done the world a great service by bringing renewables prices down sharply. The Inflation Reduction Act in the US and the Carbon Border Adjustment Mechanism in the EU are both predicated on domestic political bargains that entail some shifting of the costs to other countries. Yet they are likely to do more for the green transition than any global deal will likely achieve. If they are to be useful, economists will have to stop being first-best purists, or focusing simply on presenting the efficiency costs of such policies. They will need to be imaginative in crafting solutions to the climate crisis that address second-best and political constraints.

> Economics can help only if it expands our collective imagination instead of reining it in.

If climate change is the most severe threat to our physical environment, the erosion of the middle class is the most significant threat to our social environment. Healthy societies and polities require a broad-based middle class. Historically, well-paying, secure jobs in manufacturing and related services have been the foundation of a growing middle class. But recent decades have not been kind to the middle classes in advanced economies. Hyperglobalization, automation, skill-biased technological change, and austerity policies have combined to produce labor market polarization, or a shortage of good jobs.

Addressing the problem of good jobs will require policies that go beyond those of the traditional welfare state. Our approach must put creation of good jobs front and center, focusing on the demand side of labor markets (firms and technologies) as well as the supply side (skills, training). Policies will have to target services in particular, since that is where the bulk of employment opportunities will be generated in the future. And they must be oriented toward productivity, since higher productivity is the sine qua non of good jobs for less-educated workers and a necessary complement to minimum wages and labor regulations.

Such an approach calls for experimentation with novel policies—the development of what are effectively industrial policies for labor-absorbing services.

Developing economies have their own version of this problem, which manifests in the form of premature deindustrialization. Competing successfully in global markets calls for technologies that are increasingly skill- and capital-intensive. As a result, peak levels of formal employment in manufacturing are being reached at much lower levels of income, and employment deindustrialization sets in much earlier in the process of development. Premature deindustrialization is not just a social problem; it is a growth problem. It prevents today's low-income countries from replicating the export-oriented industrialization strategies of the past. Economic growth through integration into world markets no longer works when the tradables sectors are highly demanding in terms of skills and capital.

The implication is that developing economies must in the future rely less on industrialization and more on productive employment in services, just like advanced economies. We have considerable experience when it comes to the promotion of industrialization. Services-oriented development strategies, especially with regard to nontradable services dominated by very small firms, will require entirely new, untested policies. Once again, economists must be open-minded and innovative.

Globalization's future

Finally, we need a new model of globalization. Hyperglobalization has been undermined by distributional struggles, the new emphasis on resilience, and the rise of geopolitical competition between the US and China. Inevitably, we are in the midst of a rebalancing between the demands of the global economy and competing economic, social, and political obligations at home. Although many worry about a new era of rising protectionism and the prospect of an inhospitable global environment, the outcome need not be all bad. During the Bretton Woods period, national economic management was significantly less restrained by global rules and the demands of global markets. Yet international trade and long-term investment rose significantly, and countries that pursued appropriate economic strategies, such as the East Asian Tigers, did exceptionally well despite higher levels of protection in advanced economy markets.

A similar outcome is possible today too, provided the major powers do not prioritize geopolitics to such an extent that they start to view the global economy through a purely zero-sum lens. Here too, economics can play a constructive role. Instead of expressing nostalgia for a bygone era that produced mixed results and was never sustainable in the first place, economists can help design a new set of rules for the global economy that assist in the rebalancing. In particular, they can craft policies to help governments attend to their domestic economic, social, and environmental agendas while avoiding explicitly beggar-thy-neighbor policies. They can develop new principles that clarify the distinction between domains where global cooperation is necessary and those where national action should take priority.

A useful starting point is the trade-off between the gains from trade and the gains from national institutional diversity. Maximizing one undermines the other. In economics, “corner solutions” are rarely optimal, meaning that reasonable outcomes will involve sacrificing some of both sorts of gains. How these contending objectives should be balanced in trade, finance, and the digital economy is a challenging question on which economists could shed much light.

Economists who want to be relevant and useful must offer concrete solutions to the central problems of our time: speeding the climate transition, creating inclusive economies, promoting economic development in poorer nations. But they must avoid cookie-cutter Econ 101 solutions. Their discipline offers much more than rules of thumb. Economics can help only if it expands our collective imagination instead of reining it in.

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