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PAUL KRUGMAN

Revenge of the Glut

Remember the good old days, when we used to talk about the "subprime crisis" — and some even thought that this crisis could be "contained"? Oh, the nostalgia!

Today we know that subprime lending was only a small fraction of the problem. Even bad home loans in general were only part of what went wrong. We're living in a world of troubled borrowers, ranging from shopping mall developers to European "miracle" economies. And new kinds of debt trouble just keep emerging.

How did this global debt crisis happen? Why is it so widespread? The answer, I'd suggest, can be found in a speech Ben Bernanke, the Federal Reserve chairman, gave four years ago. At the time, Mr. Bernanke was trying to be reassuring. But what he said then nonetheless foreshadowed the bust to come.

The speech, titled "The Global Saving Glut and the U.S. Current Account Deficit," offered a novel explanation for the rapid rise of the U.S. trade deficit in the early 21st century. The causes, argued Mr. Bernanke, lay not in America but in Asia.

In the mid-1990s, he pointed out, the emerging economies of Asia had been major importers of capital, borrowing abroad to finance their development. But after the Asian financial crisis of 1997-98, these countries began protecting themselves by amassing huge war chests of foreign assets, in effect exporting capital to the rest of the world.

The result was a world awash in cheap money, looking for somewhere to go.

Most of that money went to the United States — hence our giant trade deficit, because a trade deficit is the flip side of capital inflows. But as Mr. Bernanke correctly pointed out, money surged into other nations as well. In particular, a number of smaller European economies experienced capital inflows that, while much smaller in dollar terms than the flows into the United States, were much larger compared with the size of their economies.

Still, much of the global saving glut did end up in America. Why?

Mr. Bernanke cited "the depth and sophistication of the country's financial markets (which, among other things, have allowed households easy access to housing wealth)." Depth, yes. But sophistication? Well, you could say that American bankers, empowered by a quarter-century of deregulatory zeal, led the world in finding sophisticated ways to enrich themselves by hiding risk and fooling investors.

And wide-open, loosely regulated financial systems characterized many of the other recipients of large capital inflows. This may explain the almost eerie correlation between conservative praise two or three years ago and economic disaster today. "Reforms have made Iceland a Nordic tiger," declared a paper from the Cato Institute. "How Ireland Became the Celtic Tiger" was the title of one Heritage Foundation article; "The Estonian Economic Miracle" was the title of another. All three nations are in deep crisis now.

The making of a meltdown that spread around the world.

For a while, the inrush of capital created the illusion of wealth in these countries, just as it did for American homeowners: asset prices were rising, currencies were strong, and everything looked fine. But bubbles always burst sooner or later, and yesterday's miracle economies have become today's problem cases, nations whose assets have evaporated but whose debts remain all too real. And these debts are an especially heavy

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The big dither

In his big speech to Congress last month, President Barack Obama argued for bold steps to fix America's dysfunctional banks.

"While the cost of action will be great," he declared, "I can assure you that the cost of inaction will be far greater, for it could result in an economy that sputters along for not months or years, but perhaps a decade."

Many analysts agree. But among people I talk to there's a growing sense of frustration, even panic, over Obama's failure to match his words with deeds.

The reality is that when it comes to dealing with the banks, the Obama administration is dithering. Policy is stuck in a holding pattern.

Here's how the pattern works: First, administration officials, usually speaking off the record, float a plan for rescuing the banks in the press. This trial balloon is quickly shot down by informed commentators.

Then, a few weeks later, the administration floats a new plan. This plan is, however, just a thinly disguised version of the previous plan, a fact quickly realized by all concerned. And the cycle starts again.

Why do officials keep offering plans that nobody else finds credible? Because somehow, top officials in the Obama administration and at the Federal Reserve have convinced themselves that troubled assets, often referred to these days as "toxic waste," are really worth much more than anyone is actually willing to pay for them — and that if these assets were properly priced, all our troubles would go away.

Thus, in a recent interview Treasury Secretary Tim Geithner tried to make a distinction between the "basic inherent economic value" of troubled assets and the "artificially depressed value" that those assets command right now.

In recent transactions, even AAA-rated mortgage-backed securities have sold for less than 40 cents on the dollar, but Geithner seems to think they're worth much, much more. And the government's job, he declared, is to "provide the financing to help get those markets working," pushing the price of toxic waste up to where it ought to be.

What's more, officials seem to believe that getting toxic waste properly priced would cure the ills of all our major financial institutions.

Earlier this week, Ben Bernanke, the Federal Reserve chairman, was asked about the problem of "zombies" — financial institutions that are effectively bankrupt but are being kept alive by government aid.

"I don't know of any large zombie institutions in the U.S. financial system," he declared, and went on to specifically deny that AIG — AIG! — is a zombie.

When it comes to dealing with the banks, the Obama administration is stuck in a holding pattern.

This is the same AIG that, unable to honor its promises to pay off other financial institutions when bonds default, has already received $150 billion in aid and just got a commitment for $30 billion more.

The truth is that the Bernanke-Geithner plan — the plan the administration keeps floating, in slightly different versions — isn't going to fly.

Take the plan's latest incarnation: a proposal to make low-interest loans to private investors willing to buy up troubled assets. This would certainly drive up the price of toxic waste because it would offer a heads-you-win, tails-we-lose proposition. As described, the plan would let investors profit if asset prices went up but just walk away if prices fell substantially.

But would it be enough to make the banking system healthy? No.

Think of it this way: By using taxpayer funds to subsidize the prices of toxic waste, the administration would shower benefits on everyone who made the mistake of buying the stuff.

Some of those benefits would trickle down to where they're needed, shoring up the balance sheets of key financial institutions. But most of the benefit would go to people who don't need or deserve to be rescued.

And this means that the government would have to lay out trillions of dollars to bring the financial system back to health, which would, in turn, both ensure a fierce public outcry and add to already serious concerns about the deficit. (Yes, even strong advocates of fiscal stimulus like yours truly worry about red ink.) Realistically, it's just not going to happen.

So why has this zombie idea — it keeps being killed, but it keeps coming back — taken such a powerful grip?

The answer, I fear, is that officials still aren't willing to face the facts. They don't want to face up to the dire state of major financial institutions because it's very hard to rescue an essentially insolvent bank without, at least temporarily, taking it over. And temporary nationalization is still, apparently, considered unthinkable.

But this refusal to face the facts means, in practice, an absence of action. And I share the president's fears: Inaction could result in an economy that sputters along, not for months or years, but for a decade or more.