The Way Out of the Slump

Paul Krugman and Robin Wells

The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession
by Richard C. Koo.
Wiley, 296 pp., $45.00; $24.95 (paper)

Fault Lines: How Hidden Fractures Still Threaten the World Economy
by Raghuram G. Rajan.
Princeton University Press,
260 pp., $26.95

Crisis Economics: A Crash Course in the Future of Finance
by Nouriel Roubini and
Stephen Mihm.
Penguin, 353 pp., $27.95

Tony Dejak/AP Images

President Obama after speaking about the economy at Cuyahoga Community College, Parma, Ohio, September 8, 2010

1.

How can the economy recover? Of the three books under review, Raghuram Rajan's *Fault Lines* says almost nothing about the question. He seems mainly concerned with preventing future bubbles, going so far as to call for an immediate rise in interest rates despite the depressed state of the economy. Nouriel Roubini and Stephen Mihm warn that recovery may be very slow—but they offer no solution, instead criticizing the solutions proposed by others. Only Richard Koo has something positive to propose—but his answer appears outside the realm of political possibility.

Most of the time, we count on central banks to engineer economic recovery following a slump, much as they did after the 2001 recession. Normally, when recession strikes, the Fed, the European Central Bank, or the Bank of England cuts the short-term interest rates it controls; market-determined longer-term rates fall in sympathy; and the private sector responds by borrowing and spending more.

The sheer severity of the slump after the 2008 housing bust means, however, that this normal response falls far short of what's needed. One way to revive the economy is to consider the so-called Taylor rule, a rule of thumb linking Fed interest rate policy to the levels of unemployment and inflation. Applying the historical Taylor rule right now, with inflation very low and unemployment very high, would mean that the Fed's main policy rate, the overnight rate at which banks lend reserves to each other, should currently be *minus* 5 or 6 percent. Obviously, that's not possible: nobody will lend at a negative interest rate, since you can always hold cash instead. So conventional monetary policy is up against the "zero lower bound": it can do no more. We're in the classic Keynesian liquidity trap, in which the economy is so awash in liquidity that adding more has no effect. What's left?

One answer is fiscal policy: the government can step in to spend when the private sector will not. We've already argued—in the first part of this review[1]—that a rise in government deficits played a key role in preventing the crisis of 2008 from turning into a full replay of the Great Depression. Why not use more deficit spending to push for a full recovery?

That's a question that deserves more serious consideration than it has received so far. Leave aside the political considerations: if you believe that deficit spending is an effective way to reduce unemployment—as, for example, Roubini and Mihm clearly do—why not advocate going all the way and spending enough to restore full employment?

Yet that is a recommendation few economists have been willing to make.[2] Instead, even those with a clearly Keynesian view of how the economy works tend to balk at following that view to its logical conclusion. Thus, according to Ryan Lizza of *The New Yorker*, back in December 2008 Larry Summers prepared a memo for the president-elect that made the case for fiscal stimulus to fight the recession—but then explicitly rejected the idea that the stimulus should be large enough to restore full employment. Summers argued that too much spending might create worries about the US government's long-run fiscal position, and thus lead to a sharp rise in US borrowing costs.[3]

In their *Crisis Economics* Roubini and Mihm similarly seem to shy away at the last minute from the implications of their own analysis. In Chapter 7, titled "Spend More, Tax Less?," they begin by making a strong case for Keynesian fiscal stimulus. They argue that the New Deal's error was spending too little on recovery, and that World War II ended the Great Depression precisely because it led to truly enormous deficit spending. But the clarity of their argument then dissolves into a fog of cautions and caveats, mainly focused on warnings that deficit spending might drive up interest rates. Such warnings are, of course, very much the fashion these days.

But Richard Koo, the chief economist of the Nomura Research Institute, will have none of that. At a time when demands for fiscal austerity are all the rage, Koo takes quite a different view. Most economists discussing Japan's experience over the past two decades treat it as a cautionary tale: year after year of large budget deficits, steadily rising public debt, yet still no full recovery. Koo, however, sees Japan as a qualified success story. In his view, the financial wreckage that occurred when Japan's bubble economy of the 1980s burst could easily have led to a depression-level slump. Japan, however, managed to avoid that fate. The key, he argues, was those much-maligned budget deficits. Japan's fiscal gap, he declares, "is a perfect example of a *good* deficit," which sustained the economy while the private sector gradually restored its balance sheets to health. The only times Japanese policy went wrong, in Koo's view, were those occasions when policymakers tried to return to budget orthodoxy, in each case setting off a new recession.

Koo argues that today, with the world as a whole in balance-sheet recession, the governments of major economies need precisely to run large fiscal deficits, and to continue doing so until the private sector is ready to spend again. Only then, with the economy no longer dependent on government support, would it be appropriate to shift to deficit reduction.

But can governments really continue to borrow and spend? Yes, says Koo: like the world Keynes saw in the 1930s, today's world is awash in savings with nowhere to go:

> Even in low-savings countries such as the US and the UK, the current recession is the result of the private sector *saving more* at a time when there are not enough borrowers to go around. In other words, the savings necessary to finance deficit spending are actually generated domestically. Nor is there any risk of crowding out—financial institutions are happy to lend the $100 to the last borrower standing....

This is, needless to say, a view very much at odds with the current conventional wisdom—but these days the conventional wisdom is looking very foolish. Ever since the crisis began, establishment figures have warned that the bond markets are about to lose faith in nations with big budget deficits; yet interest rates keep falling rather than rising. At this point all of the major advanced-country governments can borrow long-term at an interest rate of less than 3 percent. These low long-term rates show that markets aren't worried that current budget deficits will undermine the long-run fiscal viability of these governments. The low rates also suggest that there are no obstacles to a policy of supporting the economy with temporary deficit spending, whether that spending takes the form of investment in infrastructure, aid to the unemployed, or rebates to taxpayers.

Such falling interest rates are, Koo tells us, exactly what we should have expected given Japan's experience: even as Japanese debt mounted, the yields on Japanese government bonds steadily fell. "This happened despite dire warnings by fiscal reformists of all colors, who argued that Japanese interest rates would skyrocket and bring the economy crashing down. Their doomsday scenarios never came to pass...." Interest rates remained low, he argues, because during Japan's balance-sheet

[1]"The Slump Goes On: Why?," *The New York Review*, September 30, 2010.

[2]But see Paul Krugman, "Optimal Fiscal Policy in a Liquidity Trap," The Conscience of a Liberal (New York Times blog), December 29, 2008, which makes the case for going all the way.

[3]Ryan Lizza, "Inside the Crisis: Larry Summers and the White House Economic Team," *The New Yorker*, October 12, 2009.

slump private borrowers weren't competing with the government for funds.

In our view, Koo makes a persuasive case. Unfortunately, it's not a case currently making any headway in American politics. In particular, at this point there is zero chance of getting any significant stimulus through the US Congress, let alone the kind of large, multiyear stimulus Koo advocates. So are there any alternative policies that might at least help promote recovery?

If there are any options left, they probably involve actions by central banks, especially the Federal Reserve. As we've already noted, conventional monetary policy has reached its limits. But there may still be room for unconventional monetary policies.

Proponents of unconventional policy often quote from a 1999 critique of the Bank of Japan written by none other than Ben Bernanke, in his pre-Fed days.[4] Like the Fed today, the Bank of Japan had pushed conventional monetary policy to the limit. But it had not run out of options, Bernanke argued: "Far from being powerless, the Bank of Japan could achieve a great deal if it were willing to abandon its excessive caution and its defensive response to criticism." As many people have noted, much the same could be said of the Fed today.

What could the Fed do? It can't push short-term interest rates on government debt lower. But it could try to reduce other interest rates. Interest rates on long-term government debt normally contain a premium demanded by investors in return for locking up their funds; the Fed could reduce this premium, and hence long-term rates, by buying long-term government debt directly. Interest rates on private debt normally involve an additional premium, because of the possibility of default; again, the Fed could reduce this premium by buying such debt directly. (Such unconventional bond purchases have come to be known, rather confusingly, as "quantitative easing.")

The Fed could also try to change expectations by announcing its intention to keep short-term interest rates low for a long time. And there's a strong case in theory for raising the Fed's inflation target. Today, the Fed is generally believed to aim at an inflation rate of about 2 percent, which means that investors believe that it will start raising interest rates if inflation looks likely to rise to about that level. Raising that target to, say, 3 or 4 percent would make borrowing more attractive by reducing the real cost of repayments, raising both investment and consumer spending. A higher inflation rate would also reduce the real burden of existing consumer debt, currently about 108 percent of personal income.

All three of the books reviewed here, however, end up arguing against the use of unconventional monetary policy. This isn't surprising in the case of Rajan, who doesn't seem concerned at all about promoting recovery. It's more surprising in the cases of Roubini-Mihm and Koo, whose underlying analysis would seem to favor bold action from central banks.

In the case of Roubini and Mihm, rejection of unconventional monetary policy seems of a piece with their unwillingness to follow the logic of their own Keynesianism. Possible changes in policy end up being constrained by fear that the bond markets will lose faith in America:

> As the United States accumulates ever more staggering loads of debt, some of its creditors fear that it may try to deliberately depreciate the dollar by "monetizing" the deficit.... If the United States were an emerging market, it would have long ago suffered a collapse of confidence in its debt and its currency.

One wonders how they know that creditors have such fears, since the reality is that US interest rates keep hitting record lows; one also wonders why they think a fall in the dollar would be a bad thing, because it would in fact be a boon to US exporters and a stimulus to the economy.

Koo, meanwhile, adopts what seem to us to be contradictory positions. He argues early in his book that monetary expansion and an attempt to raise expectations of future inflation are ineffective in an economy with balance-sheet problems. Then he argues, late in his book, that quantitative easing would threaten to create widespread inflation. We're not sure how he can believe both things; we're also unclear why he doesn't regard significant inflation as a desirable way to reduce debt burdens, which are made worse by deflation. (The 72 percent rise in US consumer prices between 1940 and 1947, which greatly reduced the real value of private-sector debt, is arguably one major reason the US economy didn't relapse into depression after World War II.)

What's striking, in the end, about the books reviewed here is that only one of them—Koo's—offers any kind of proposal for cleaning up the economic mess we're in. And Koo's proposal, while it makes a great deal of analytical sense, is a political nonstarter—yet he rejects all other ideas. In other words, it's hard to read current writing about the economic crisis without a sense of despair: economists don't even seem interested in solving the problem of continuing mass unemployment.

Yet the problem remains. What can be done about it?

2.

In the months immediately following the failure of Lehman Brothers, policymakers seemed to understand that we had entered a world in which the usual rules no longer applied—a world in which running huge budget deficits was an act of prudence, not folly, in which large-scale purchases of debt by central banks were a virtue, not a sin. But that understanding faded fast. Unconventional policies are as badly needed as ever; but policymakers have lost their nerve. Urged on by far too many policy intellectuals, they have reverted to conventional modes of thought.

Mark Peterson/Redux

A gathering outside Federal Hall in New York City, where President Obama gave a speech on the first anniversary of the collapse of Lehman Brothers, September 14, 2009

This is most obvious in the case of fiscal policy. From the halls of Congress to the corridors of the European Central Bank, dire rhetoric about the evils of budget deficits is the order of the day. The almighty markets, we're told, will punish those who fail to impose harsh fiscal austerity even in the face of very high unemployment—even though, as we have noted, the reality of falling interest rates shows no indication that the much-feared "bond vigilantes"—investors who will stage a run on the debts of major nations, driving interest rates sky-high, unless deficits are brought down quickly—have any real existence. There is no sign that the US government, in selling bonds, will have trouble borrowing in order to finance deficit spending.

Nor do many people seem willing to recognize the increasingly obvious failure of austerity policies in those countries that actually have lost the confidence of bond markets: harsh policies in Greece and Ireland have led to soaring unemployment, yet investors seem less willing than ever to buy those nations' debt. As one of us has noted, supposedly responsible policymakers are sounding more and more like the priesthood of some barbaric cult, demanding sacrifices in the name of invisible gods.

The reversion to misplaced conventionality is less dramatic in the case of monetary policy: those who, like Rajan, actually want to tighten policy in the face of falling inflation and mass unemployment are a minority. Yet it's hard to escape the sense that central banks, including the Bernanke Fed, have fallen into the "self-inflicted paralysis" Ben Bernanke saw in Japan a decade ago: inflation is far below target and sliding toward deflation; the Fed's statutory mandate to promote "maximum employment" clearly isn't being fulfilled, yet policy seems frozen.

So what would we recommend doing? Practically everything that might stimulate the economy. If more spending on infrastructure is politically impossible, at least make the case for it and pound its opponents for their obstructionism. (It's worth noting that President Obama's recent proposal for a national infrastructure bank is very similar to a proposal that has been endorsed by none other than the bitterly anti-Obama Chamber of Commerce.) Targeted, temporary tax cuts—like the temporary incentives for business investment also recently proposed by the Obama administration—aren't our preferred policy, but they would be better than nothing. And monetary expansion should be pursued through every route possible—yes, it's uncertain how effective any given measure would be, but that's no reason not to try.

We should also consider policies that enable borrowers to reduce the burden of their debt, such as allowing mortgages to be covered by personal bankruptcy procedures or, as Bill Gross of the bond fund Pimco has proposed, allowing Fannie Mae and Freddie Mac to engage in mortgage refinancing. (Although Obama's program for modifying mortgage obligations was a step in that direction, it has largely failed as a result of overly complex rules and stonewalling by lenders—a result of its cautious construction. Indeed, it has made many borrowers worse off.)

One more thing: just as global imbalances—the savings glut created by surpluses in China and other countries—played an important part in creating the great real estate bubble, they have an important role in blocking recovery now that the bubble has burst. Koo is right in saying that the essential problem of the world economy right now is an excess of saving, with not enough borrowers; countries that continue running large trade surpluses in this environment—like China and Germany—are propping up their own economies at the rest of the world's expense.

What this means, first of all, is that the United States should be taking a much tougher line with China than it has so far: China's deliberately undervalued currency is, purely and simply, a destructive policy from a global point of view. It also means that the rest of Europe needs to start holding Germany to account: the Germans may regard themselves as models, but their surpluses after 2000, by flooding the rest of Europe with cheap money, played a large part in creating the real estate bubble in Europe's peripheral economies. And Germany's continuing reliance on export-led growth is in effect a beggar-thy-neighbor strategy of growing at its neighbors' expense.

The conventional wisdom of the moment stresses the risks of action on any of these fronts: fiscal, monetary, or trade. But those risks are hypothetical and, we believe, greatly overstated. Meanwhile, everyone seems to be ignoring the risks of allowing the slump to go on. The economic crisis that began in 2008 is by no means over. And if governments fail to act, the worst may be yet to come. □

—September 16, 2010; this is the second of two articles.

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[4] Ben Bernanke, "Japanese Monetary Policy: A Case of Self-Induced Paralysis?," remarks presented at the ASSA meetings, Boston, Massachusetts, January 9, 2000.