Razin lecture by Krugman

World on the verge of an economic breakdown?

Krugman: With all the major engines of growth faltering, the threat of a severe world economic breakdown cannot be ruled out.

The U.S. recovery is tepid, the recent economic figures for Europe are weaker than expected, and Japan has been in a decade-long slump. For Princeton University's Paul Krugman, the possibility that the world is on the verge of a serious economic breakdown cannot be ruled out. In a recent lecture at Georgetown University, he expressed frustration that policymakers are not acting vigorously enough to forestall the possibility of another Great Depression, even though the way to prevent one is well known.

Delivering the Razin Economic Policy Lecture, Krugman noted that early in the twentieth century, recessions were treated "very nearly as an act of God or as punishment for previous excesses." The Great Depression changed all that. It is more common now to think of recessions as, in some part, disasters of human origin that can be undone by policymakers.

Looser monetary policy needed

How did this turnaround come about? Krugman said that instead of reviewing economic history, it was more instructive to reflect on the experience of the Capitol Hill Baby-Sitting Co-op of Washington, D.C. This was an organization through which, in the 1970s, 150 couples agreed to baby-sit for one another. To keep track of who owed whom, the co-op adopted a system of "scrip"—pieces of paper each worth one-half hour of baby-sitting time. Couples could accumulate scrip by baby-sitting for others and use it later when they wanted an evening out.

In its initial days, according to Krugman, the co-op managed to work its way into a recession. There was so little scrip to go around that couples were reluctant to squander it by going out. Those who wanted to go out but didn't have scrip were desperate to get baby-sitting jobs. The couples, many of whom were lawyers, according to Krugman, tried amending the rules of the co-op to work their way out of the recession. For instance, some thought that the root of the problem was that some members were displaying antisocial behavior by not going out enough. So the co-op made a rule that everyone had to go out at least once every few months. But such legal solutions proved futile.

What was needed was the solution economists would have advocated—issuance of more scrip, or, in economic jargon, a looser monetary policy. Each member of the co-op was allotted 10 additional hours of scrip, and new members were offered more generous terms when they joined. Liberated from the fear that they would run out of scrip, couples became more willing to go out, opportunities for those who wanted to baby-sit and build up a balance of scrip increased, and the recession was over.

The economy's baby-sitters

The solution to the Great Depression of the 1930s, Krugman said, turned out to be just as simple as the solution to the recession of the Capitol Hill Baby-Sitting Co-op. In a memo to U.S. President Franklin Roosevelt, economists proposed "issuing more scrip" but this solution was dismissed as being "too easy." Ultimately, he said, the baby-sitters of economies, their central bankers and finance ministers, had to adopt looser policies to get the world economy out of the depression.

Current economic circumstances, according to Krugman, are not quite as dire as they were in the period preceding the Great Depression. Nevertheless, all the major engines of the world economy—the United States, the euro area, and Japan—are faltering, and the threat of a severe world economic breakdown cannot be ruled out. Economic policymakers in all three regions should try to eliminate this threat by easing their monetary and fiscal policies.

Krugman argued that, while policymakers had been taking the right steps, their actions had not been vigorous enough. Japan has been the worst offender. Its central bank achieved autonomy only six years ago

A family affair

The Razin Economic Policy Lecture is named in honor of Ofair Razin, who succumbed to a battle with multiple sclerosis in 1996, not long after finishing his Ph.D. in economics at Georgetown University. Ofair's father, the noted international economist Assaf Razin (see also "Assaf Razin at 60," *IMF Survey*, April 16, 2001, page 129) endowed an annual lecture in his son's memory. To date, the lecture series has featured addresses by Jeffrey Sachs, Michael Mussa, Elhanan Helpman, and Stanley Fischer.

Krugman said there was no way he could have turned down the invitation to present this year's lecture. With the presence in the audience of Assaf Razin, Georgetown's Susan Collins (and Ofair's thesis advisor), and the IMF's Robert Flood, the event was, for him, very much "a family affair."

and has been determined to follow the responsible monetary policies that would make it the "very model of a modern central bank" of the 1990s. But, at present, he suggested, "doing irresponsible things was the only responsible course of action" for monetary policy. While the Bank of Japan has, with much foot-dragging, pushed interest rates to zero, it needs to take unorthodox measures to pump liquidity into the Japanese economy.

The Europeans, Krugman added, have imprisoned themselves—rigidly following tight monetary and fiscal policies to secure their dream of a common currency. The European Central Bank is overly concerned with price stability, he said. It has not pushed interest rates down far enough even though it has room to do so. The region's fiscal institutions are a straitjacket. Something is wrong, Krugman said, when comments from the European Commission's president lead to the Stability and Growth Pact becoming widely referred to as the "Stupidity Pact."

By contrast, the U.S. government showed no fear of deficits, at least at the federal level. But Krugman questioned why the fiscal stimulus plans being considered were aimed at the longer term rather than the here and now. "Why are we stimulating the economy of 2010?" he asked. Moreover, the United States has "its own version of the Stupidity Pact"—requirements in many state constitutions that they balance their budgets year by year. Fiscal contractions at the state level are going to swamp any fiscal stimulus provided at the federal level, he reckoned.

Krugman was more favorably inclined toward the conduct of U.S. monetary policy. The Federal Reserve (the Fed) has aggressively lowered its policy interest rate to 1.25 percent. Moreover, newly appointed Fed governor Ben Bernanke signaled in a speech last year that the Fed would not hesitate to switch quickly to other methods of pumping liquidity into the economy in the event that interest rates hit zero. In that November 2002 speech, Bernanke noted that "the responsibility of preserving price stability . . . most definitely implies avoiding deflation as well as inflation"; hence, the "Fed would take whatever means necessary to prevent significant deflation in the United States. . . . The logic of the printing press example must assert itself, and sufficient injections of money will ultimately always reverse a deflation."

Krugman concluded by noting that the experience of the Great Depression had led to the discovery of a "miracle antibiotic" to ensure that the experience was never repeated. But because recessions since that time have been much milder, people have become used to using other, milder, remedies. The time has come, he said, to abandon "homeopathic remedies" in favor of the antibiotic of vigorous liquidity creation.

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For Japanese monetary policy at present, "doing irresponsible things was the only responsible course of action."
—Paul Krugman