

Paul Krugman: “I focus on crises”

Ten years ago in his book *The Return of Depression Economics*, Paul Krugman* warned of the problems that would lead to the current crisis. Last year the professor and trenchant columnist was awarded the Nobel Prize for Economics. In the interview below with Daniel Huber, Credit Suisse’s Head of Publications, he talks of the reasons for the crisis, the lessons to be learned, and life as a winner of the Nobel Prize.

Daniel Huber: There are very few winners emerging from this crisis, but you seem to be one of them, because foreseeing this crisis a decade ago probably won you the Nobel Prize for Economics.

Paul Krugman: Well, I think I'm enough of a humanitarian to wish things hadn't turned out this way.

Would you consider yourself a pessimist or a realist?

In my view, it seems they're the same thing right now. But over the course of my career I have become focused on crises, as they have always interested me. I look at the current situation through this lens too. In other words, I'm more interested in a potential problem than the possible upside. I think I'm a realist, but with a pessimistic streak in the things I focus on.

Why did nobody listen when you first warned of an emerging global economic crisis 10 years ago?

First of all, the housing bubble helped to make things look good for quite a while. People were very reluctant to question that bubble for a variety of reasons. Part of it was just a general tendency to assume that the market must be right, while some of it was an unwillingness to quarrel with what looked like a successful model. When people are making lots of money, to tell them that their success is based on unsound foundations is not a popular thing. When you get through a crisis, as we did in the late nineties, the natural inclination is to pat yourself on the back and persuade yourself that it was your own wisdom and foresight that got you through it. But privately you say to yourself: Oh my God, that was a close miss.

Looking back, where do you see the major cause of the current economic crisis?

For me this is quite clearly the steady expansion of debt, particularly in the United States. But this is actually a trend that dates back around 25 years. The indicator I use most often is household debt relative to income, which had been stable for a generation until the beginning of the 1980s, when it began rising inexorably and eventually reached 100% of GDP on the eve of the crisis. However, this alarming development was even welcomed by many people, who saw it as a confirmation of markets functioning properly. But in retrospect you have to say that people were taking on much more than they could handle. It is worth nonetheless recalling some of the excesses of recent years in particular: The limitless granting of credit, the excesses in Eastern Europe, and other developments that have now come home to roost with a vengeance.

Have we already passed the nadir of the crisis?

Short-term economic forecasting is a bit like staring into a crystal ball. But nonetheless it appears that the pace of decline has now slowed, and that the worst of the crisis is over. You no longer have to brace yourself for yet more horrible news when you turn on your computer in the morning. There are still negative surprises, of course, but there are also now positive ones. Overall, it still does look like things are getting worse, but at a slower pace than before. That's an important step forward, but it doesn't mean that we can now say we're on the road to recovery. We have a long way to go before we reach that stage. The falling-off-the-cliff stage may have been stopped for now, but that doesn't mean that normal times are just around the corner. The current economic situation can be compared to a patient who has been rushed to the emergency room in critical condition and only just saved. Sure, we may have succeeded in warding off the Great Depression version 2.0, but that doesn't mean the patient is ready to leave the hospital. Quite the opposite: He's still very sick and we have no idea when he will recover.

Are there any examples from the past that could point a way out of the current crisis for us?

The answer to that is rather depressing, as there are no good historical role models for recovering from this kind of slump. The only appropriate example is Japan, which experienced a lost decade of economic stagnation, and then had a quite convincing recovery from 2003 onward on the back of a strong surge in exports. However, this recovery was almost exclusively driven by a growing trade surplus thanks to exports to China and the United States. This time the whole world is caught in a slump, so unless we can find another planet to absorb our global trade surplus, that's not a route out. Going back further, you have the historical precedent of the Great Depression, which was ended by a very large job creation program better known as World War II. Two observations can be made here with respect to the current crisis: First, that any program of any comparable size in the modern era would be impossible, except in the event of another major military conflict. Second, governments came into the last world war in relatively good economic shape in terms of their debt levels. So they had more leeway to pursue an expansive economic policy.

But why didn't the world slide back into depression when the war was over?

My theory is that private sector balance sheets were massively repaired during the war as no new credit was available, so that indebtedness fell sharply in proportion to income as a result of growth and inflationary effects. The consequence was that both households and companies emerged with very little debt. And this in turn led to a very strong economy even after wartime spending came to an end. But if that's the moral of the story, you have to ask yourself: Can we now envision government fiscal policies being sufficiently sustainable to permit that kind of recovery of private sector balance sheets? After all, let's not forget that governments came into this crisis with relatively high levels of debt to GDP.

How does Europe stand compared to the US with respect to recovery?

Even though the center of gravity of the crisis was in the US initially, the European recession is every bit as bad. So it's hard to say which recovery will take place sooner. One thing that is clear, however, is that although the decline in GDP looks similar on both sides of the Atlantic, the human cost is disproportionately great in the

US. This is above all due to the weakness of the US social safety net and the lack of employment protection. True, time and again we hear how important it is to have a flexible labor market, but when a crisis of this magnitude comes along, a certain degree of rigidity in the labor market is something of an advantage. For all these reasons, the Americans are suffering much more than Europeans in the current crisis. On the other hand, I am convinced that the UK will be the first of the major European economies to emerge from the recession. As the country is not part of the eurozone, it has seen a much greater depreciation of its currency, a factor that is going to be very much to Britain's advantage over the next year.

What role does China have to play in this crisis? With its huge potential, might it not act as a kind of locomotive and thus limit the extent of the crisis?

China is the economy of the future. Though didn't we use to say that of Brazil? And now we say – Brazil is the country of the future and always will be. But with China it's different: This country is not just a perpetual land of the future, but will sooner or later actually be the world's largest economy. If we go by the estimates of purchasing power parity, the Chinese economy is already half the size of the US economy, and maybe even bigger. However, the market value of Chinese GDP is substantially less than that. So, even a large rise in Chinese economic growth, while obviously helpful, wouldn't change the fact that China isn't even remotely big enough to act as the world's locomotive just yet. In 20 years it may be a different story, but not now.

My town council is about to give away 50 franc vouchers to each local resident in the near future in order to stimulate spending. Do you think that measures of this kind can help beat the crisis?

The Japanese have tried to do exactly that. The problem, first of all, is that funds of this kind cannot – at least in practice – be earmarked for a particular purpose. If you give somebody a 500 dollar spending voucher, irrespective of what products it's supposed to be spent on, the recipient can simply reallocate his or her spending so that it's just like having an additional 500 dollars in income. And given that it wouldn't be a permanent program, people would probably save most of it – even though they would have to spend the thing itself, they would offset this by saving elsewhere. And it will add to government debt, unless you're literally throwing cash away, without resolving the problem. Far better from my viewpoint would be to simply spend the money, for example by building bridges or investing in other infrastructure projects. However, this is a long process that would also lead to an increase in indebtedness.

Many people fear that the Fed has printed vast amounts of money and that sooner or later we will end up with severe hyperinflation.

There has been a slight increase in the money supply in the US, although we don't know exactly where this is distributed. Among other things, this has to do with the fact that it costs nothing to hold cash with interest rates at zero percent, as well as reflecting the fear that banks are not totally safe, despite all reassurances to the contrary. In the 1990s, the only consumer durable that was selling well in Japan was safes. But mostly what's happened is that banks are accumulating huge reserves at the Fed on which interest is paid. That's very different from printing money. What this actually amounts to is the Fed becoming America's bank. The banks themselves have been reluctant to lend. Instead, they're parking their money either in treasury bills or at the Fed. The Fed is then going out into the market and buying up asset-backed paper. In other words, the Fed is taking over a significant part of the financial

intermediary role. But the fact remains that we certainly don't have any real inflation right now, nor do I anticipate our seeing any in the near future.

So when and above all how can we bring about recovery?

In the worst case we could face a decade or so of economic stagnation. It would be much better if someone could invent a groundbreaking new technology that required a great deal of investment that would then drive recovery around the world. So if you know of anything, please let me know. I actually have an optimistic and perhaps rather outlandish hypothesis that environmental policy will prove a big driver of recovery. If we actually move to do something about climate change – and the US does now appear ready to take this step – this will give a signal to businesses that they really should start investing in the reduction of their CO2 emissions, which in turn could benefit the economy at large. But I have no way of substantiating this view with any numbers, so I'm not going to start shouting this from the rooftops.

Let's talk about leadership. What traits should a good leader bring to the table?

A leader has to pursue a certain goal – they have to be leading for something. They also need a good dose of flexibility. I think it's important that leaders be capable of collaborating successfully with strong people around them, that they be willing to listen to others and not feel intimidated. In the political sphere, my view is that we had bad leadership in the US over the last eight years, because we had decision-makers at the top who didn't want to hear anything that contradicted their predetermined points of view. By contrast, I see the current leadership as competent, even though it's still early days. Whatever else you may say about the Obama administration, though they have their own political convictions they are open to new things and willing to entertain the alternatives. There's no doubt in my mind that the greatest 20th-century American president was Franklin Roosevelt. Certainly he was no intellectual or brilliant deep thinker, but nor did he pretend to be. His strengths lay more in surrounding himself with people who were. He was comfortable with himself and his vision of what the country should be – and that's precisely what we need.

Won't you miss the Bush administration a little bit? After all, it gave you plenty to write about in your columns for the New York Times...

Today I can devote the majority of my columns to genuinely serious discussions. Sometimes I'll be critical, at others I'll praise, while sometimes I'll suggest improvements. But the discussions are once again taking on a constructive nature instead of all this insanity that we had to deal with for such a long time.

How has your life changed over the past year since winning the Nobel Prize?

Probably less than you'd think. I was already a public figure before, participating closely in public debate through my columns. So I didn't suddenly go from cloistered academic life to the spotlight of the open world. However, the Nobel Prize did provide me with greater credibility. It's easier to persuade people that they should listen to me. I was working just as hard then as I do today, the only difference now being that my profile has risen. But I don't think it's changed my life all that much.

Were you expecting to get this award?

Not exactly. It was a possibility, but I didn't expect it at all this past year. Indeed, I made a point of putting it out of my mind. After all, you can spend 20 years waiting

and asking yourself "am I going to get it this year?" and that can drive a person crazy. So it actually came as a complete shock when I got the phone call.

You were informed by phone?

Indeed. Prizewinners are informed by telephone, but my first thought was that this was a practical joke with a very fake Swedish accent.

And what did you do then?

I went on the Nobel website to make sure it wasn't a practical joke. Then I called my wife, because I wasn't at home, I was in Washington for a meeting on the financial crisis. She was on the train at the time, and when I told her she was dumbfounded. And then after a moment's pause, she said "we just don't have time for this."

Heinrich Rohrer, the Nobel Prize winner from Switzerland, told me that at some US universities you get a reserved parking space when you're a Nobel prizewinner. Have you taken up your honorary parking place at Princeton?

You're not the first person to ask me that. The first time I heard it, I couldn't believe that such privileges existed. But it turns out that other Nobel laureates from Princeton have insisted on such a thing. Personally I refuse to do that, I find it ridiculous. <

Source: Credit Suisse – In Focus, July 21, 2009.

* Paul Krugman was born in New York on February 28, 1953. He is Professor of Economics at the University of Princeton, a highly respected columnist for the New York Times (on Mondays and Fridays), and the author of various works on economics. Last year he was awarded the Nobel Prize for Economics on the basis of his "analysis of trading structures and centers of economic activity," according to the official wording of the Royal Swedish Academy of Sciences. In addition to his academic work, Krugman has continually been in demand as a consultant, including in 1982 on Ronald Reagan's Council of Economic Advisers, as well as a decade later during the presidential candidacy of Bill Clinton. He is believed to have declined an appointment to the White House following Clinton's victory, however.