

Nobel Prize-Winning Economist PAUL KRUGMAN on the Fiscal Crisis

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Princeton economics professor, writer, and columnist Paul Krugman took time from his busy schedule to visit American Management Association in May 2009 to participate in AMA's podcast program Edgewise (podcasts.amanet.org/edgewise). Edgewise's editors share here a portion of their interview with the Nobel Prize winner and author of *The Return of Depression Economics and the Crisis of 2008*. In August 2009, prior to publication, Dr. Krugman reviewed his earlier interview and updated his remarks and comments for publication in *MWorld*.



Q. What were the warning signs that we should have been more mindful of that led to this financial crisis? And what role did lack of regulation or excessive Wall Street compensation plans play?

Krugman: The warnings were overwhelming. At the time, I didn't think it would be as bad as it turned out to be. But we clearly had a runaway financial sector. I mean, when profits in the financial sector reached 40% of total profits in America, we should have said, "Wait, there's something wrong here. That doesn't make sense." And the experience of Japan in the nineties should have warned us that dealing with the aftermath of a burst bubble is not nearly as easy as we tended to think.

Q. You mentioned the Japanese. In your book you reference the Latin American problems as well as the Japanese problems. Any other examples of what we're experiencing now?

Krugman: One of the things I've been saying about this current crisis is that it's not like anything we've seen before—it's like everything we've seen before, but all happening at once. So, if you look at what's happening in Ireland or in the Baltics, for example, it's very close to a replay of Indonesia in 1998 or Argentina in 2002. We're having currency crises—excessive capital inflows followed by a collapse of capital inflows.

We're seeing that the housing bubble was not just a U.S. phenomenon. It's happened to a similar degree in Spain. The only thing in this crisis that really never happened before is what happened in Iceland. I don't think we've ever seen a country turn into a hedge fund before. All of what we've seen had been seen before. And lack of regulation of those things that should have been regulated and the general attitude that the financial markets were efficient and consequently what they were doing had to be right, made this crisis possible.

Q. Do you think that we have too short a memory and consequently we will allow things like this to get out of hand again?

Krugman: Well, there were fifty years between the Great Depression and the return of largescale financial crises. You know, there were problems all along. But we did go a half century without anything like this. And it was only after 1980 that we started to see things spin out of control. So, can we do anything that will prevent the grandchildren of policy makers today from forgetting all about it and doing it all over again? Probably not.

Q. You've mentioned in interviews that you don't think that the Administration has gone far enough. Can you elaborate on that?

Krugman: Sure. What we think we know, or what I think I know, anyway, is that right now [August 2009], we're looking at a really deep, prolonged recession. Already, we're probably about 9 million jobs short of where we ought to be, and that's even if the economy levels off. That number is going to grow.

We've got a stimulus package that the Administration thinks will add three and a half million jobs at its peak relative to where we would otherwise be.

That should mitigate the situation but it's unlikely to actually produce recovery. The package is not big enough to prevent us from anything more than having a really prolonged weak economy.



The policy on the banks has been reminiscent of Japanese policy on the banks for the first seven years of "the lost decade." The Japanese provided enough cash and enough guarantees to keep the banks from collapsing but not enough to make them healthy. And that's what we're doing, too.

I think that the Obama Administration is intelligent. It understands the crisis, but all it has taken is half measures. They're enough to stop the house from falling down, which is a good thing, but they aren't enough to actually repair the leaks in the roof.

I'd like to have more regulation. Actually, I'm very concerned that the momentum for such regulation is waning: if we lose the sense of utter panic, people will start to say, "Oh, well, it's not so bad, actually." I heard on Bloomberg news someone say, "Oh, well, you know, the system wasn't really that bad, and it doesn't have to be changed in any fundamental way."

If that attitude grows, we may find ourselves right back in the same place we have been for several months a few years from now.

Q. Some people have talked about green shoots and what they're seeing in the economy. What would you consider to be a green shoot that you believe would represent the tide turning?

Krugman: That's an interesting question.

No, that may actually be two questions. One may be, when does the plunge come to an end? The other may be, when will the recession be declared over?

Q. Is there evidence that we might be getting toward the latter?

Krugman: Things are getting worse more slowly. The situation is at an inflection point. Things are decelerating. The new claims for unemployment insurance [August 2009] are still above 500,000, but they're not as high as they were. If they dropped to 400,000, for example, we might actually see employment stabilize.

The inventory cycle is better, too. So, I wouldn't be surprised if the end of the recession doesn't wind up being dated some time in the summer.

Unfortunately, that's not that helpful. The last recession officially ended in November 2001 but the unemployment rate didn't peak until June 2003. So, we could have the recession declared over except that things get worse for most people for a long time afterwards. What you'd want to see for a real recovery is a real driver of the economy back up to full employment. It would have to be something like a surge in business investment not just stabilization of the decline, but an actual rise in business investment. We'd need something to make up for the fact that American consumers are saving again,

something that would really take the place of the stuff that isn't coming back. We're not going to have a housing bubble.



We're not going to have a zero savings rate any time soon. So, we need something coming along to replace it. And there's no hint of that.

Q. What concerns you more right now? Future inflation, future job losses, or future problems in the banks?

Krugman: Oh, I think future job losses.

Most people know that the Fed will be eager to pull back the release of money at the first sign of inflation. We're past the stage of worrying about the banks. They won't collapse if only because everybody knows that the federal government won't let them collapse. So the panic over banks is over even if they may not be healthy.

Future job loss is what frightens me. We're heading for a prolonged period of high unemployment in a way that we have never had since the 1930s. And lots of things go wrong with that. The social safety net is full of holes. Lots of people are falling through the cracks. People are losing health insurance at a very rapid rate. And there's this downward pressure. Wages are falling in large parts of the economy. That creates the real possibility of a deflationary trap that's very hard to get out of.

Q. Are you disturbed by the recent press reports about Wall Street compensation starting to return to pre-crisis levels at the same time that salary cuts are being made elsewhere?

Krugman: Yes.

In the financial sector, we're seeing that the people who made this crisis really haven't learned anything from it. They believe that the watchful eye of the public is losing focus and that they can get away with it again. That's not a happy omen.

Q. How will the current financial crisis affect the future of global capitalism?

Krugman: Well, one thing that I think is gone is the days of the Washington consensus when the United States could lecture other countries, that is, tell them to do it our way because it works. We might still try to lecture them, but no one's going to listen to that.

There's certainly been a discrediting of more extravagant free markets. That said, I don't see any revival of socialism going on out there. You look out there and you don't see developing countries turning inward. There are constant warnings about events leading to protectionism, but you actually see very little of it out there. So, so far, global capitalism is not in danger. What we're seeing is at most what we're going to see for some time—some re-regulation in the heart of capitalism in the United States.

Q. Do you think there's a way to keep the American dream alive?

Krugman: I would have said that the American dream was actually endangered a long time before this crisis. The fact of the matter is that we've had rising income inequality and, as far as we can tell, falling social mobility in the United States. So, actually, the problem with the American dream is not this immediate crisis. It's a broader issue. If we really want that American dream, we need a situation where decent schools are available to kids of all income classes and a situation where decent health care is

available to kids of all income classes. Our dream of upward mobility really has persisted even as the reality has been slipping away. So, the need is to get those things back—and that's a bigger task than recovering from the recession.

Q. You have said that the hysterical phase of the financial crisis is coming to an end. What do you think will concern the world after this crisis?

Krugman: I think that ten years from now it will really be environmental issues that will be the most important question of interest. The final verdict of the Obama Administration will actually be not how it handled the recession, maybe not even how it handled health care reform, although that's terribly important, but what it did on climate change policy.



Q. Dr. Krugman graciously shared these final thoughts with MWorld. First, we asked him: How are we doing in reforming our financial system? What are some of the important issues that still need to be addressed?

Krugman: We really haven't done much at all, at least so far. What we need above all are enhanced capital requirements and some reform of compensation; it's not clear when or if that will happen.

Q. When do you see the economy reaching the point where companies begin to rehire?

Krugman: It's not clear when that will happen. I would be surprised if it happens this year; I won't be surprised if weak labor markets persist all the way through next year.

Q. What are the key statistics we should be monitoring and what can be done in these areas to change the financial perspective?

Krugman: I'm basically focused on jobs. I won't feel any sense of relief until we see some strong job growth.

For more insights from Dr. Krugman and the numerous other thought leaders who have been interviewed at Edgewise, visit <http://podcasts.amanet.org/edgewise>