

## Paul Krugman on the Prospects for Recovery

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August 4, 2009



*Paul Krugman is a professor of Economics and International Affairs at Princeton University, and the author or editor of 20 books and more than 200 papers in professional journals and edited volumes. His field of expertise is in international trade and finance, with his current academic research focused on economic and currency crises. Mr. Krugman also writes for a broader public audience, including his Op-Ed columns for the New York Times, Foreign Affairs, and Scientific American. Professor Krugman received the 2008 Nobel Prize in Economics.*

*We interviewed professor Krugman on July 25, 2009.*

### **Will we be ultimately better or worse off as a result of the government's massive stimulus spending?**

It's helpful to think about this question from a national point of view. The money funding our deficit spending will come from eventual increased economic output. It's not coming at the expense of private investment. By making the economy stronger, it's actually promoting private investment. So the stimulus doesn't make us poorer, but richer as a nation in the long run.

No question the government is taking on an extra liability, which has to be covered through higher revenues. Higher taxes are a real cost to the economy. But I believe our country's systemic fiscal problem is primarily due to rising health care costs. Our current deficit spending is only marginal in effect compared to this issue.

Ultimately, the question comes down to whether there is a real alternative to large government stimulus. Without deficit spending, would our long-run prospects be better or worse? I can't come up with any analysis that suggests we would be better off without the deficit spending, both in the short- and long-run.

### **Are you concerned about the potential inflationary effects?**

Is it possible? Yes. Likely? No, because I don't think inflation is that hard to contain.



I don't believe under the present circumstances a big increase in the monetary base necessarily implies future inflation. Remember, the Fed has not been printing vast quantities of money. We've had the Fed lending large amounts of money to the banks, which has led to a surge in bank reserves. The Fed is acting as a financial intermediary of last resort, doing what the banks don't want or can't do. So when banks start to lend again, all the Fed needs to do is to stop providing monetary support and start reeling in what they already allotted to banks. The Fed just needs to stop increasing the size of its lending facilities, and it has already been doing this to some degree.

However, if banks start to shift these reserves out of the deposits of the Fed and into the economy, then the Fed would need to soak up the money either through borrowing or by selling off some of the bank assets it has acquired. Either way, it's just a matter of unwinding positions the Fed already holds.

### **How do you determine what stimulus spending is growth producing?**

I believe in old fashioned-Keynesian thinking. Any spending in the short-run will produce short-run growth and jobs. Of course ideally you'd rather get the most out of every dollar spent. But in terms of what spending will stimulate GDP in the third and fourth quarters--there isn't good spending or bad spending. Anything that will lead to an increase in effective demand will restart the economy.

It's important to remember that the stimulus package has barely kicked in, a point that is lost in the 24/7 reporting on the economy. According to a recent Goldman Sachs report, only \$2 billion, or less than two percent of funds allocated to infrastructure, has actually been spent. So there's a lot more stimulus to come. And this is just a small part of the President's overall recovery plan. Most of the package involves tax cuts and aid to state and local governments.

### **What type of stimulus approach do you think is most effective?**

Aid to state and local governments probably has more significant impact on growth over the long run than most people can imagine because it helps avert spending cuts that will be very bad for the long term. If you're cutting things like education and transportation infrastructure projects, that will crimp potential GDP growth far into the future. And I think expanding health care access would be a good thing as a way of making people's lives a little less miserable and getting money into the economy. Research and education are also important long-term public investments.

### **But can additional health care and educational spending be efficient stimuli?**



I didn't say these were necessarily efficient investments. But these systems aren't systemically broken either, and much good can come from expanding their reach. Lower-income Americans have an undeniable need for improved health care access. Additional spending on health care would be good for the economy as well, while also freeing up the spending power of individuals and families whose resources would otherwise be swallowed up by health care costs.

On the educational front, preventing the firing of large numbers of teachers and making necessary infrastructure repairs to school buildings would help sustain educational levels. This would promote spending directly and indirectly, through monies spent by teachers and workers who may otherwise be laid off. And all of this will help preserve our future prospects in both health care and education.

Larger picture: we're seeing savage cuts in state and local government involving education, health care, fire-prevention, and infrastructure. And that makes no sense from any point of view.

### **When will we see the major impact of the stimulus package?**

By the end of the second half of the year, I expect we'll see positive growth over the next few quarters. And that wouldn't be happening without the stimulus package. But it's not at all clear at this moment if the stimulus is large enough to keep unemployment from continuing to rise. Despite that metric being a lagging indicator, fear of higher unemployment is just one part of the reason I still don't think the existing stimulus package is big enough.

### **You don't believe that a portion of projected second-half growth is related to the economy having made some major corrections, which may now be abetting reinvestment and growth?**

I don't think there has been any fundamental correction. Yes, we will have a big inventory bounce in response to manufacturers having slashed production. As their inventories get depleted, they will need to gear up production to sustain supply levels. However, without additional government involvement, second-half growth would still be flat or negative. A reasonable guess is that with the stimulus, we will be seeing 2 percent GDP growth over the next several quarters. So I think whatever positive growth we see this year will be largely the result of government spending.



### **Should we reprioritize our national budget to reallocate resources to better propel recovery?**

Reallocating budgetary priorities does nothing to generate more demand. Whether you spend a billion dollars on a jet fighter that doesn't work in the rain or preserve elementary education—either way, it's a billion dollars spent.

There's always this temptation to mix macro- and microeconomics. There is a clear distinction between what will help sustain spending and employment now and what will help sustain long-term growth. These are not the same issues. The Great Depression was only broken by totally destructive spending.

So you don't want to think that doing the right thing in terms of long-run budgetary priorities has much to do with whether we get a recovery right now. That said, we do need to cut useless and unproductive spending so that we have a better chance of achieving long-term goals given our limited resources.

### **Is the stock market responding to the potential second half growth?**

God knows. I think Nouriel Roubini's variation of the Paul Samuelson's line has it about right: - the stock market has forecast six out of the last zero recoveries. The stock market is right where it was in January, when we were already in a severe economic crisis. All that's happened is that "end-of-the-world" scenario has given way to a bit more realistic but still fairly negative view.

### **Are valuations then excessive?**

By historical valuation standards, stock prices don't look wildly undervalued, nor do they look overvalued either.



**As you mentioned, our huge spending will need to be financed to a large degree by higher taxes. A study prepared a while back by Christina Romer, Director of the President's Council of Economic Advisors, suggested that for every \$1 increase in taxes, private investment is reduced by \$3. Your thoughts?**

This is an old paper of hers in which she tried to identify clean historical examples of changes in taxes and investment, which were the direct result of government fiscal policy, not simply a reaction to what was going on in the economy. The only significant examples she could find in the post-WWII record in terms of changing tax policy that affected private investment, however, were tax cuts. In these cases, what happened to the economy thereafter seems to have suggested that the effect of these tax cuts on private sector spending was much larger than it actually was.

The raw empirical correlation she found suggests that fiscal policy does have significant effects on investment. But it wasn't about tax cuts versus spending increases, because she didn't actually have any examples of spending increases to consider. So there is a lot of misrepresentation of what her findings were all about.

Accordingly, I don't think you want to read too much into any of this. She found some interesting correlations in the historical data. But her report was not the same as policy analysis.

**So let's talk about the impact of tax increases on private spending.**

Nobody is seriously talking about raising taxes any time soon. Doing this in the middle of a recession is not a good idea. But we will not always be in a recession. We are talking about raising taxes several years out when the existing slump will hopefully be over and when we will definitely need more revenue and when the private sector will be able to manage this additional expense.

**But what about letting Bush's temporary tax cuts expire, resulting in higher taxes by the end of 2010?**

It's possible that the slump might still be on at that time. And if it is, we certainly could consider delaying their expiration or providing some alternative temporary tax relief. I would prefer the latter because the former are primarily benefiting very high-income taxpayers.



**What are your thoughts regarding the study by Barro and Perotti suggests that for each dollar increase in government spending, private investment is reduced by the same amount.**

If the economy is at full employment, then increases in government spending would almost certainly crowd out spending by the private sector because the economy can't produce more. But we are far from that scenario.

Barro and Perotti were looking at WWII, when there was a big increase in public spending while there was a decline in private spending. This was supposedly demonstrating their point. But I found myself scratching my head, because during WWII there was rationing and people weren't allowed to increase consumer spending. You needed permits to engage in construction. So private investment declined as a result of *force majeure*. So in using this example, they concluded that surges in government spending crowded out private spending. This is completely ignoring the historical context.

**The \$787 billion stimulus legislation was a massive document. How did you become familiar with it?**

I relied on many people who know how to read legislative language, especially people from the Center of Budget and Policy Priorities, who did go through it and summarized the key elements.

**Did the bill make sense to you?**

I had problems with substantial pieces of it. I felt that about one-quarter of it was not really stimulus, but simply extending the patch on the Alternative Minimum Tax. Even if you treat that as new stimulus, it's not likely to be effective because the people who are benefiting from it are not likely to spend much of the money, and because this move was something the markets expected anyway. So I didn't think it would improve overall sentiment and actual stimulus.

Another sizable chunk of the plan with which I don't agree is the tax cut for middle-income families. I understand the politics that made it important for Obama and congressmen to pledge these tax cuts. But I don't think they'll have much impact on growth because most of that money will be saved or used to pay down debt.

The real stimulus elements that made sense to me--infrastructure spending, aid to state and local governments, and temporary expansion of aid to social security recipients—were not an overwhelming majority of the bill. The latter two points are the quickest ways to stimulate the economy.



## **What are your thoughts on regulating financial institutions going forward?**

In a nutshell, anyone who borrows short and lends long and who offers safe assets for savers but invests in riskier products is a bank and needs to be regulated like a bank. Otherwise, our system remains prone to the catastrophic meltdown that we're experiencing.

What made this crisis possible was that the banking system expanded beyond traditional banking, which was covered by the safety net built in the 1930s. The system of deposit insurance and regulated lending was undermined as banking activities expanded beyond regulatory control. So I believe we ought to be expanding old fashioned banking regulations to a much wider range of institutions and activities.

The ideal solution is to subject all such institutions to bank-type capital requirements. They should have a well-defined set of government guarantees that apply to a wide range of assets, financed through an equally well-defined set of premiums like those that banks currently pay into the FDIC, to help finance rescues when necessary. If you are a hedge fund, for example, you should be subject to the same kind of regulation and oversight as any other financial institution.

Depending on how it's applied, an administration proposal which would allow the Fed to identify systemically important institutions and subject them to regulations, would pretty much do what I'm proposing. Take a business that sells auction-rate securities, something that technically does not involve bank deposits, but sure as hell functions like one. We'll say that you will have capital and reserve requirements like an ordinary commercial bank because for all practical purposes, you're doing the same thing.

Key to all of this is codifying principles-based, not rules-based, policy. This would more likely inhibit the financial industry, with their very good lawyers, to find ways to evade legislative intent.

## **Is recent bank profitability indicative of industry recovery, and how much of it is the direct result of government assistance?**

Much of the profits are coming at taxpayer expense. Even if the government doesn't end up taking large losses on the TARP, the government accepted a huge liability. We set up a situation where heads the banks win, tails the taxpayers loses. There is a huge implicit subsidy, and that's what we're seeing in bank profits right now.

Listen, I understand that when a house is burning down, you don't argue over how you put out the fire; you just do it. But the *quid pro quo*--which should have been and still could be demanded--is much stiffer regulation. This is what happened in the 1930s



when the government rescued the banking industry. The same thing should be happening now.

We made a huge gift to the banking sector, and we should expect something in return. We have a moral right. And this is not the end of the story, and there needs to be follow-up regulation that ensures that this meltdown never happens again. There is an administration proposal that addresses this matter. But as of this moment, there's no actual bill pending.

### **Are we past the need for nationalizing some banks?**

I don't know. I had wanted temporary nationalization of the weakest banks. This would've cleaned up their balance sheets, recapitalized them, and enabled the taxpayer to share in the profits when they do recover. Whether we are truly past this need depends on whether bank profits are going beyond transitory gains, favorable changes in accounting standards, and reduced competition. It's too early to know if these earnings are for real and sustainable over the next two years.

### **What are your thoughts on the Public-Private Investment Program?**

So far, it has turned into kind of a joke. There's just not much happening. The banks simply want to hold onto their assets for more than what people are willing to pay for them, even with the implicit subsidy the government is providing potential buyers.

### **Does that mean we should stop trying to clear the toxic assets off their balance sheets?**

I don't know what we should do about those assets. It's always been hard for me to see how we get the banks to clear these troubled assets off their books without nationalizing them first. So I don't think we will be getting anywhere soon on this particular front.

### **How can we control private sector leverage?**

If we subject the shadow banking industry to regulation, then the incentives to over-lend would be greatly reduced. Look at the ratio of household debt to income. It was stable between the 1950s through the early 1980s. Then right after the big bank deregulation of 1982, we started to see this ratio climb sharply upwards. If we are serious about banking regulation, there will be less securitization, less subprime abuse, and less of the equivalent.



### **Where are we in the housing crisis?**

Looking at price-rent ratios or price-income ratios, which indicated a bubble early on, we are likely near the bottom. But I think we will bounce along the bottom for a long, long time.

### **Should we ever again let another major financial institution like Lehman Brothers fail?**

Experience says no. That's why you need to regulate these institutions up the wazoo so that you can't let them fail. But before that occurs, I would definitely be against letting another major institution like Lehman collapse. In fact, I was shocked when the government didn't save Lehman.

### **What are the largest threats to the US and global economies?**

I have three basic concerns. First, while the giant banks seem to have been stabilized, we may have a second smaller wave of financial crises focusing on smaller banks. They could be especially hard hit by declining commercial property activity and values. This can cause substantially greater credit problems. The residential mortgage market could take an additional hit from higher monthly payments coming from Option ARMs and Alt-A mortgages resetting.

But we now have a lot more implicit government guarantees in place, and it's hard to imagine that the magnitude of losses could be as large as what we just experienced with subprime. But I don't think European officials have fully recognized both the real and potential scale of continental property and bank losses.

Second, there's a danger of the economy slipping back into recession if the recovery doesn't gain traction. This is especially possible if unemployment continues to rise or remains high and if consumer spending continues to decline because people just don't have the money. Anecdotally, just look at the proliferation of vacant storefronts. So I'm concerned if recovery hasn't taken hold once the stimulus spending runs out, what then will happen? We'll get a real sense of this by year's end.

Third, this malaise may simply just drag on and on like the Japanese experience. I'm worried about wage deflation given that wage growth has virtually ended. A second stimulus package of say \$400-500 billion would help sustain economic growth and avert the potential disastrous effects of deflation.



**Can you give us a quick roundup of your macroeconomic projections for the next 12-24 months?**

As I mentioned earlier, I see real GDP growth in the second half of this year and in 2010. But it will be modest, somewhere between one and three percent. This makes me less optimistic than the Fed. And I don't think it will be enough to put much of a dent in unemployment.

Accordingly, the jobless rate will head higher. I agree with Goldman Sachs' economists who think the unemployment will top out at 10.8 percent and then stay there for quite some time.

Huge federal deficits will continue over the next year or two, but then decline significantly. However, what happens beyond that depends on policy, such as what we end up doing with taxes and health care.

Will heavy demand for financing hurt the dollar? Hard to say. I don't have a strong view on the greenback. Pressures on the currency are actually less than what they are perceived to be, in part because the US will likely emerge from recession earlier than most other developed market economies.

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