HELP ?

The return of depression economics

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Abstract:
Even if all the current crises are weathered, the mere fact that they could happen - and that conventional policy responses have turned out to be either ineffectual or unavailable - is an ominous warning. The problems of the 1990s have distinct similarities with the problems of the 1930s; so do the solutions. We had better all start relearning our Depression economics. It is difficult to avoid concluding that sooner or later we will have to turn the clock at least part of the way back: to limit capital flows for countries that are unsuitable for either currency unions or free floating; to reregulate financial markets to some extent; and to seek low but not too low inflation rather than price stability. We must heed the lessons of Depression economics, lest we be forced to relearn them the hard way.

Full Text:
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A WHIFF OF THE 1930S

IN THE SPRING of 1931 Austria's largest bank, the Credit Anstalt, was on the verge of collapse. The Austrian government could not simply stand by and let it fail, but when it came to the bank's rescue with large sums of freshly printed domestic currency, the resulting capital flight rapidly depleted Austria's gold and foreign exchange reserves. The obvious answer would have been to abandon the gold standard and let the currency float. But this solution was unacceptable-not just because a drop in the schilling's value would magnify the burden of foreigncurrency-denominated debt, but because a currency devaluation would deal a devastating blow to the confidence of a country whose memories of post-World War I hyperinflation were still fresh. Austria pleaded for help from its neighbors and the then-new Bank for International Settlements, but the offered assistance was too little, too late. In the end, the desperate government resorted to capital controls.

It is a familiar story to economic historians. It is also astonishingly modern-sounding: if the plot does not exactly fit any one of today's crisis-ridden economies around the world, it does sound very much like a pastiche of recent events in Indonesia, Malaysia, and Brazil. The main difference now is that financial rescue attempts from the international community have become routine. When a country gets in trouble today a swAT team from the International Monetary Fund and the U.S. Treasury quickly arrives on the scene. Suppose, however, that the IMF could use a time machine to send its best money doctors back to that Vienna spring of 1931, but without the ability to offer a huge, no-questions-asked credit line on the spot. What would today's experts say? What could they tell the Austrians that they did not already know? 1

Most modern economists-to the extent that they think about it at all-regard the Great Depression as a gratuitous, unnecessary tragedy. They believe that what might have been an ordinary, forgettable recession became a nightmarish slump thanks to the stupidity (or at least the ignorance) of policymakers. If only the Federal Reserve had not been preoccupied with defending the gold standard instead of the real economy; if only Herbert Hoover had followed an expansionary fiscal policy instead of trying to balance the budget; if only policy in general had not been governed by a "liquidationist" philosophy that saw shortrun economic pain as a necessary purgative for previous excesses-then the catastrophe could easily have been avoided. And since we know better now, it cannot happen again.

Or can it? As little as two years ago I and most of my colleagues were quite confident that although the world would continue to suffer economic difficulties, those problems would not bear much resemblance to the crisis of the 193os-because economists and policymakers had learned the lessons of that decade and would never again perversely tighten monetary and fiscal policy in the face of recession. True, Mexico suffered a severe slump in 1995 and Japan's economy had stagnated since 1991, but these appeared to be special cases, easily rationalized as the result of exceptionally misguided policy.

Perhaps we should have known better and realized, for example, that the dilemma Austria faced in 1931 could just as easily arise in the modern world, and that now as then there are no good answers. In any case, there is no mistaking the lesson of the terrifying economic and financial events of the last two years: the economic crisis in Asia, its spread to Latin America, the deepening slump in Japan, and the brief but ominous panic that swept bond markets last autumn. The truth is that the world economy poses more dangers than we had imagined. Problems we thought we knew how to cure have once again become intractable, like temporarily suppressed bacteria that eventually evolve a resistance to antibiotics. More specifically, the problem of aggregate demand-of getting people to spend enough to employ the economy's productive capacity-is not, as we might have thought, always a problem with an easy solution. While it may often be possible for countries, especially large, stable, self-sufficient economies like the United States, to handle recessions simply by printing more money, we are finding an increasing number of cases in which countries find either that they cannot apply that same medicine or that the medicine is ineffectual. There is, in short, a definite whiff of the i93os in the air.

The point is not that all of the current economic difficulties will necessarily get worse. There is a reasonable chance that 1999 will see some economic recovery in Asia, if not the beginning of a real climb back to economic health. Through prompt Federal Reserve action (and luck), the United States managed to avoid a financial panic last fall. Even Japan could do better in 1999 than it did in 1998. But even if all the current crises are weathered, the mere fact that they could happen-and that conventional policy responses have turned out to be either ineffectual or unavailable-is an ominous warning. The problems of the 199os have distinct similarities with the problems of the 1930s; so do the solutions. We had better all start relearning our Depression economics.

IT'S THE SHORT RUN, STUPID

BEFORE THE 1930S most economists regarded the business cycle the alternation of recessions and recoveries-as a relatively minor issue. Whatever the causes of such fluctuations, economists believed that slumps were self-correcting and that the economy always tended to restore full employment in the long run. Hence, the fundamental economic problem was to ensure that resources were used efficiently, not to ensure that they were used at all. True, as early as 1923 John Maynard Keynes famously took his colleagues to task, admonishing them not to ignore the short run:

This long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the sea is flat again.

But not until the Great Depression did economists realize that "short run" shortfalls of demand were crucially important. Perhaps slumps were still self-correcting in the long run, but would the economy survive to reach that long run?

Given the experience of the Depression, one might have thought that classical economics was gone for good. But the success of Keynesian economics in damping down the business cycle meant that the old focus on the full-employment long run could reemerge with a new justification. It was once again reasonable to assume that the economy would always tend quickly back to full employment-not because of any automatic mechanism but because intelligent policymakers would use monetary and fiscal policy to get it there. Like traditional European wine grapes that survived the great phylloxera epidemic by being grafted onto American root stock, classical economic theory survived the Great Depression by being grafted onto the assumption that activist monetary and fiscal policy would ensure more or less full employment. In the 195os Paul Samuelson dubbed the resurrection of classical full-employment economic theory the "neoclassical synthesis." It remains to this day the position of those who appreciate but do not worship free markets. Here, for example, is what I wrote in Slate two years ago in an article entitled "Vulgar Keynesians":

In reality the Federal Reserve Board actively manages interest rates, pushing them down when it thinks employment is too low and raising them when it thinks the economy is overheating. You may quarrel with the Fed chairman's judgment-you may think that he should keep the economy on a looser rein-but you can hardly dispute his power. Indeed, if you want a simple model for predicting the unemployment rate in the United States over the next few years, here it is: It will be what Greenspan wants it to be, plus or minus a random error reflecting the fact that he is not quite God.

But putting Greenspan (or his successor) into the picture restores much of the classical vision of the macroeconomy. Instead of an invisible hand pushing the economy toward full employment in some unspecified long run, we have the visible hand of the Fed pushing us toward its estimate of the noninflationary unemployment rate over the course of two or three years.

To an adherent of the neoclassical synthesis like myself, then, the really disturbing thing about the world's current problems is not so much the possibility that they will spiral into a new Great Depression, which still remains unlikely and indeed seems to have receded in the last few months. Instead, the problem is that for the first time since the 193os, we cannot be sure that governments can or will increase demand when we need it.

THE UNHOLY TRINITY

WHAT HAS gone wrong? On the face of it, there seem to be two quite separate issues: the problems of developing countries threatened with hot money flows and those of mature economies facing a "liquidity trap." As the Bretton Woods system of fixed exchange rates that had governed postwar world monetary affairs began to show signs of strain in the 196os, a number of economists began to argue that there was a fundamental dilemma-or, more precisely, a "trilemma"-at the heart of international finance. Analysts such as the Canadian theorist Robert Mundell suggested that, as a fundamental matter of economic logic, countries could not get everything they want and that any exchange rate system involves sacrificing some important objectives to achieve others.

Three conflicting objectives in particular, sometimes dubbed the "irreconcilable trinity," have preoccupied would-be international financial architects. First, countries would like to retain scope for independent monetary policy-that is, they would like to be able to cut interest rates to fight recessions and raise them to counter inflation. Second, they would like to have more or less stable exchange rates because erratic fluctuations in the value of their currency create uncertainty for business and can sometimes cause severe disruptions to the financial system. Third, countries would like to maintain full convertibility--that is, they would like to assure businesses that money can be freely moved in or out of the country, if only to avoid the bureaucracy, paperwork, and opportunities for corruption inevitably associated with any attempt to limit capital movements.

Alas, these objectives are indeed irreconcilable. The iron law of international finance is that countries can achieve at most two of the three. The logic of this law becomes apparent when one considers what happens if a country tries to have it all. Suppose that a country, like the members of the European Monetary System, were to maintain free capital mobility and also commit itself to keeping its exchange rate fixed, buying or selling its currency on the foreign exchange markets as necessary. Could it cut interest rates to fight a recession? Not for long. If France were to try reducing its interest rates below German levels, investors, knowing that the exchange rate was fixed, would see a profit opportunity in the "carry trade." That is, they would borrow in French francs, exchange the proceeds for Deutsche marks, and invest them in Germany. To prevent this increased supply of francs and demand for marks from driving down the value of its currency, the Bank of France would have to sell marks while buying francs itself. Even if the bank started with tens of billions of marks in its account, it would quickly find those reserves exhausted. At that point a choice would have to be made. France would either have to give up on its attempt to cut interest rates and abandon the goal of independent monetary policy, or let the franc drop and give up on the goal of exchange rate stability. Alternatively, it could impose some kind of capital controls, limiting investors' ability to convert francs into foreign currency

The trilemma of international finance forces countries to choose among three basic exchange regimes: a floating exchange regime, which allows complete freedom of international transactions and lets the government use monetary policy to fight recessions at the cost of erratic fluctuations; a fixed rate, which purchases stability at the expense of monetary independence; or capital controls, which can reconcile a relatively stable exchange rate with some monetary independence but only at the cost of other problems.

Since World War I broke up the classical gold standard, all of these regimes have been tried repeatedly. The conventional wisdom about which regime is most desirable has itself gone through cycles. But two years ago the majority opinion among economists-and less decisively in the international policy community was clearly in favor of floating rates. There had once been considerable sympathy for attempts to limit exchange rate variation: for example, the "adjustable pegs" of the Bretton Woods era, under which rates were normally held within narrow bands but adjusted on occasion as circumstances warranted. But experience showed that the

mere hint of a possible devaluation in the face of highly mobile capital provoked massive speculative attacks. So such compromise systems broke down, with countries either giving up and floating their rates or averting speculation by ruling out any possibility of future changes in currency values. And that meant that adopting any sort of fixed exchange rate required in effect giving up completely on monetary adjustment.

Hong Kong offers a classic example. Economic turmoil in the rest of Asia and the devaluation of many neighboring countries' currencies have left Hong Kong clearly overpriced and led to record unemployment. No law would prevent the textbook solution-a one-time devaluation of the Hong Kong dollar. But the city's economic authorities have concluded that the only way to prevent massive speculation against that currency every time there is an economic downturn is to commit themselves firmly to keeping its value in U.S. dollars constant. A recession must therefore simply be endured. A country could avoid locking its exchange rate by reinstituting capital controls of the kind that prevailed for the first two decades of Bretton Woods, which allowed the pegs of that system to be truly adjustable, but the costs of such controls seem a high price to pay. A freely floating exchange rate, then, appears to be the lesser of three evils. Even economists who are generally pro-floating agree that tightly integrated regions that form "optimal currency areas" should adopt the ultimate form of fixed exchange rates, a common currency. (Whether the new eurozone constitutes such an area is another question.) But as a general rule, the preferred alternative of most economists is a floating exchange rate. In particular, it is the one most consistent with the neoclassical synthesis, because it leaves countries free to pursue both free-market and full-employment policies.

FREE FALLIN

THE PROBLEM iS that while a freely floating exchange rate seems fine for some countries, it does not appear to work for others. On one hand, the United States is well served by its general policy of benign neglect toward the foreign exchange value of the dollar. While the dollar-yen and dollar-mark rates may go through irritating gyrations, this annoyance is surely minor compared with the freedom of action that the absence of an exchange rate commitment gives to the Federal Reserve, which can cut interest rates sharply and immediately when a recession or financial crisis looms. Some smaller advanced countries also seem to thrive under floating rates. Australia's willingness to let its currency slide has so far allowed that economy to ride out the Asian crisis with remarkably little damage, even though most of its exports go to either Japan or the troubled tigers. So far, investors perceive the depreciation of the Australian dollar as a buying opportunity, and this stabilizing perception has allowed the currency to experience a moderate devaluation that has helped keep the economy humming. On the other hand, a prime lesson of the last few years seems to be that developing countries cannot play the same game. For these economies, attempts at modest currency depreciations have repeatedly failed, because the initial decline sets in motion a vicious circle where expectations of ever-greater devaluation become self-fulfilling prophecies.

This is not just true of the Asian crisis. Consider Mexico's attempt at a limited devaluation in December 1994. Many economists, myself included, believed that the peso was indeed overvalued-that Mexican costs and prices had risen too high compared with those elsewhere, and that this overvaluation was one important reason why, as Rudiger Dornbusch put it, Mexico's record was one of stabilization, reform, and no growth." But the same might have been said of the United Kingdom in the summer of 1992. One might have expected Mexico's decision to let its currency drop to have the same benign consequences as Britain's decision to do the same two years earlier. Yet whereas investors regarded the weak pound as a buying opportunity, the Mexican peso went into free fall and stabilized only after it had lost half its value. And even that came only with a $50 billion rescue package and with interest rates set at 75 percent or more for a year.

At the time, this catastrophic outcome of depreciation seemed a special case. Mexico has historically been a

crisis-prone country, and one could argue that the political uncertainties created by peasant uprisings, assassinations, and the still-powerful populist left made the country uniquely vulnerable to crises of confidence. But in light of subsequent events, the so-called tequila crisis must now be viewed not as an exception but as the exemplar of a new rule, summarized by some Washington policymakers with the slogan, "For developing countries, there are no small devaluations." When Ragnar Nurkse, whose 1944 book International Currency Experience provided much of the intellectual background for the Bretton Woods conference, wrote about market turmoil in Europe's interwar period, he might well have been writing about recent events in Asia and Latin America:

As people began to realize the one-way character of the movement, anticipations of further depreciation became a dominant influence on the exchange market. At that point exchange depreciation lost its power to attract foreign capital. Instead, it set afoot a cumulative process of capital flight.... In its effects on the balance of payments the capital flow became disequilibrating instead of equilibrating. The depreciation of one currency was apt to be taken as an example of the fate that might befall others.... In these circumstances, one country after another had to adopt drastic measures, with or without foreign help, to stop the decline and to stabilize the exchange rate.

What are these "drastic measures"? After the devaluation of the Thai baht in July 1997, one Asian country after another was obliged to raise interest rates sharply to arrest the plunge in its currency. In turn, the combination of high interest rates and currency depreciation, which inflated the burden of foreign currency debt, provoked a financial crisis and a severe slump. In Latin America, countries have generally responded preemptively to capital flight. Brazil has defended its real with interest rates of almost 50 percent, while Mexico, after allowing the peso to slide somewhat, has also sharply raised rates in its defense.

Textbook economics might suggest that countries feeling the need to raise interest rates could offset the effect on demand by adopting expansionary fiscal policies, such as raising government spending or lowering taxes. In practice, however, the perceived need to regain market confidence has pushed countries threatened with speculative attack in the opposite direction. IMF programs initially required that Asian economies adopt fiscal austerity; later the fund tacitly conceded that this had been a mistake and relaxed the requirements. But the countries have nonetheless been reluctant to try to expand their economies, either by running bigger budget deficits or by printing more money. In Brazil, reducing the budget deficit has become crucial not for strict economic reasons but as a demonstration of the government's seriousness. In Mexico, the government has also felt compelled to slash spending and raise taxes to maintain credibility with the market.

It is possible that the worst effects of this wave of perverse macroeconomic policy-raising interest rates, increasing taxes, and reducing government spending in the face of recession-are already behind us. Asian countries have for now stabilized their exchange rates convincingly enough to push interest rates back down to precrisis levels, and there are signs that the plunge in output and employment is bottoming out-although that slump has left so many companies effectively bankrupt that it is hard to see how a true recovery can get underway. The combination of tight fiscal and monetary policies still seems guaranteed to produce a severe recession in Brazil and at least a sharp slowdown in Mexico, but perhaps the damage will not be as bad as some of us fear.

Even if this particular crisis is contained, however, we should be deeply disturbed by the fact that it could happen at all. The modern world economy should be far better placed to prevent such episodes than the economy of the interwar years. We understand the nature of recessions much better than our grandparents did. Unlike Austria in 1931, we also have in place both an institutional framework devoted to providing help and a long tradition of international financial rescue operations. Yet when the crisis struck in 1997, both

individual governments and the international community found themselves obliged to behave very nearly the same way that policymakers had in the early 1930s. So much, in other words, for the neoclassical synthesis.

Fortunately, advanced countries have not found themselves in the same situation. They apparently retain the ability to fight recessions effectively and face an economic slump with lower interest rates and higher budget deficits instead of the reverse. But in some advanced countries these policies seem-in another alarming echo of the 193os-to have become ineffective.

LESS THAN ZERO

A COUNTRY that does not need to defend its exchange rate can fight recessions easily simply by cutting interest rates as low as necessary, even all the way to zero. But what if a zero interest rate is not low enough? What if, even at a zero rate, businesses do not want to invest as much as consumers want to save? This is the dreaded "liquidity trap," in which monetary policy finds itself "pushing on a string." Attempts to expand the economy by easing credit fail because banks and consumers alike prefer holding safe, liquid cash to investing in risky, less-liquid bonds and stocks.

On the face of it, the U.S. and British economies seemed to approach a liquidity trap during the 193os. The average interest rate on U.S. Treasury bills during 1939 was only 0.023 percent. But in the postwar years some economists, notably Milton Friedman and Anna Schwartz, argued that monetary policy could nonetheless have been effective in the 1930s if only the Fed had tried harder. Others questioned whether a true liquidity trap is even possible in principle. In any case, the topic seemed to become one of purely historical interest. By 199o the general view was that a liquidity trap did not happen and will not happen again.

Enlarge 200%
Enlarge 400%

It could happen to you, too: bankrupt Wall Street investor, New York, 1929

Then came Japan. After its "bubble economy" burst in 1991, Japanese authorities were at first reluctant to cut interest rates for fear of reinflating the bubble. Since 1996, however, short-term rates have been well under one percent and have now slipped to a quarter of one percent. Yet these extremely low rates were unable to prevent a slide into recession, let alone reverse the stagnation that has plagued the Japanese economy since 1992. Since few economists believe that shaving the last few decimal points off interest rates would make any significant difference, Japan really is caught in a classic liquidity trap, where zero is not low enough.

As already stated, until 1992 many economists believed either that such a situation could not really develop or that it was unlikely to happen in the modern world. Even if a liquidity trap were to have emerged, economists seemed to have a ready answer: pump up demand with deficit spending. As long as the government is solvent, and as long as there is no Brazil-like need to limit budget deficits to retain investor confidence, a liquidity trap should not be a cause of a persistent downturn. It merely signals that policymakers need to reach deeper into

their toolbox. And yet the Japanese economy has stagnated for seven years and now is in a serious slump. Why have the Japanese not been able to come to grips with the problem?

On the face of it, they tried to stimulate the economy, but their efforts did not work. Japan's budget went from a surplus of z.9 percent of GDP in 1991 to a deficit of 4.3 percent in 1996 (over $zoo billion), and interest rates steadily fell. Yet output grew an average of only 1.5 percent annually, less than half its average in the 198os and well below most estimates of potential growth. It is true that some of this increased deficit was a consequence rather than a cause of slow growth, but even the Organization for Economic Cooperation and Development's estimate of Japan's "structural" budget balance (adjusted for this effect) went from a surplus of 1.9 percent of GDP to a deficit of 4.o percent over the five-year period.

Why might deficit spending not have worked in Japan? One answer might be that Japanese consumers took deficits now to mean higher taxes later, so that tax cuts were saved and public works spending offset by reduced private consumption. On the other hand, as the economist Adam Posen has noted, short-run swings in Japanese fiscal policy have had the normal effect. A move toward greater deficits in 1995-96 did start a noticeable, if short-lived, expansion, while Prime Minster Ryutaro Hashimoto's ill-advised tax increase in 1997 did much to provoke the current recession. So why did the long-run move toward fiscal stimulus not work? Perhaps because it did not really happen. Posen and others, myself included, have argued that standard estimates of Japanese potential growth are understated. Hence, Japan's "structural" budget deficits actually include a substantial cyclical component. In plain English, Japan has a budget deficit largely because it is in a deep recession, not because it is actually following an expansionary policy. In that case, the question really becomes one of political economy rather than economics: Why would a sophisticated nation like Japan fail to take the standard measures to revive its economy?

The logic of inaction seems to involve two factors. First, Japan's awkward demography-its aging population and the prospect of a steady decline in the number of working-age adults over the next several decades-is one of the likeliest reasons for the liquidity trap. Japanese consumers are saving for retirement, even while firms are unwilling to invest, because they expect a shrinking market. But it is also a long-run source of budgetary concern. Like other advanced countries, Japan worries about paying social insurance to retirees in the next century. As a result, the government is reluctant to run up debt. Indeed, it was concerns about such long-run solvency issues that motivated Hashimoto's tax increase in the first place.

At the same time, it is all too easy to misinterpret sustained slumps due to inadequate demand as a fundamental slowdown in the economy's potential growth. Once that revolution of declining expectations has taken place, appropriate short-term expansionary fiscal policy gets reinterpreted as an irresponsible structural deficit and politicians find themselves under pressure to pursue "sound" policies that abort whatever recovery may have been in progress. (Last November, just as Japan announced a new fiscal stimulus package that still seemed far from adequate, Moody's fired a warning shot against further stimulus by downgrading the government's bonds.)

Japan's experience shows not only that advanced modern economies can get into a liquidity trap, but that the easy assumption that fiscal policy can get an economy out of that trap is far too optimistic. We may castigate Japan's leaders for their failure to act decisively, but similar mistakes could easily be made in the United States or especially Europe.

Are other advanced countries at any risk of finding themselves in the same situation? The conventional answer is no, that Japan's problems are uniquely severe. But ten or even five years ago few economists would have taken seriously the possibility that Japan could be in its present predicament, and thus the emergence of

liquidity traps elsewhere is no longer inconceivable.

Indeed, in the early 199os some economists worried that the United States might be approaching liquidity-trap territory. The recession of 199o-91, brought on by a slump in consumer spending together with financial difficulties in the banking sector, was relatively mild but hard to turn around. In order to engineer a recovery, the Federal Reserve had to cut the benchmark federal funds rate to 3 percent-more than 6 percentage points below its 1989 peak. Right now, at the peak of the business cycle, the Fed's base rate in the United States is only 4.75 percent, while the corresponding rate in Europe is only 3 percent. In other words, an interest rate reduction on the same scale is literally impossible. Nor are economic shocks that would require large interest rate cuts hard to envisage. Until recently, most economic crisis scenarios in the West focused on a possible crash in sky-high stock prices. But last autumn the United States experienced a completely unexpected panic that briefly caused much of the nation's financial mechanism to seize up and had many normally optimistic observers suddenly talking about unavoidable recession.

Like so much of what has happened lately, the 1998 financial crisis was a blast from the past. Banking panics-in which depositors lost confidence in the system, rushed for the exits, and produced a crisis that validated their panic-were a common occurrence before the 193os. But in modern economies banks are doubly protected from such panics, both by explicit government insurance of deposits and by the understood willingness of central banks to come to the rescue with as much cash as necessary. So financial panics were supposed to be an outdated concern.

It turns out, however, that bank runs need not happen only to banks. In the United States much investment is financed via clever arrangements that allow investors to hold "liquid" assets-things that can be readily converted into cash-even though the underlying basis for those assets is quite illiquid. For example, investment in real estate, which cannot be sold at a moment's notice, is ultimately financed by the issuance of "mortgage-backed securities," which can. This works well as long as some people are always buying when others are selling, but if everyone tries to sell at once, prices plunge and a self-reinforcing panic can result. For a few weeks last autumn, it looked very much as if such a panic had set in. Prompt action by the Fed did restore calm to the markets-but Fed officials have the sense that they narrowly dodged a bullet, and that the sniper may still be out there.

The point, again, is not that a major financial crisis that will plunge Europe or the United States into a Japan-style slump is just around the corner. It is that whereas two years ago it seemed inconceivable that other advanced nations could find themselves in such a liquidity trap, that kind of crisis now seems entirely conceivable-and Japan's experience shows how hard it can be, once in such a trap, to get out again.

WHY NOW?

IF IT IS TRUE that the ghosts of the 1930s are once again stalking the earth, the obvious question is why now, after all these years? The standard answer is that some nations are paying for their failure to obey the necessary dictates of free markets. Asian economies, in particular, are being punished for the sins of crony capitalism. And every country that has gotten into trouble does turn out, once the crisis puts its policies in the spotlight, to have made major mistakes.

It allowed banks to take unsupervised risks yet retain implicit government backing, encouraged corporations to take on excessive debt, and so on. Yet the idea that economies are being punished for their weaknesses is ultimately unconvincing on at least two grounds. For one, the scale of the punishment seems wholly disproportionate to the crime. Why should bad investment decisions lead not merely to a slowdown in growth

but to a massive collapse in output and employment? Furthermore, if the fault lies with the countries, why have so many of them gotten into trouble at the same time?

A parable may be useful here. Imagine that some stretch of road has recently been the scene of an unusual number of accidents. Those who get into accidents naturally become the subject of special attention, and it becomes clear that in just about every case the victims of accidents were themselves partly to blame: they had had too much to drink, their tires were bald, and so on. The investigators therefore conclude that the problem was not the road but the drivers.

What is wrong with this conclusion? It is doubly biased. First, virtually any car or driver, if subjected to close scrutiny, will turn out to have some flaws. Are these victims clearly more flawed than average? Second, even if they are somewhat worse drivers than normal, the fact that so many of them had accidents here rather than somewhere else suggests that the fault does lie largely with the road, all the same.

To spell it out: Troubled Asian economies have turned out to have many policy and institutional weaknesses, but if America or Europe should get into trouble next year or the year after, we can be sure that in retrospect analysts will find equally damning things to say about Western values and institutions. And it is very hard to make the case that Asian policies were any worse in the 1990s than they had been in previous decades, so why did so much go so wrong so recently?

The answer is that the world became vulnerable to its current travails not because economic policies had not been reformed, but because they had. Around the world countries responded to the very real flaws in post-Depression policy regimes by moving back toward a regime with many of the virtues of pre-Depression free-market capitalism. However, in bringing back the virtues of old-fashioned capitalism, we also brought back some of its vices, most notably a vulnerability both to instability and sustained economic slumps.

Consider four kinds of policy reforms in particular. First is the liberalization of international transactions. In the 193os and 1940s, experiences like Austria's led to the near-universal adoption of controls on international capital movements, in many cases as part of a general system of exchange control. The original Bretton Woods system was, in fact, crucially dependent on such controls as a way to prevent the "rigidification" of exchange rates by the threat of speculative attack. But over time exchange controls came to be seen not simply as a nuisance but as a source of major abuses, distortions in incentives, and corruption. So first advanced countries, then many developing countries, moved toward full currency convertibility and free capital movement. But in so doing they left themselves vulnerable once again to destabilizing speculative attacks.

Second is the liberalization of domestic financial markets. In the shadow of the 193os, almost all countries established tightly regulated, heavily guaranteed banking systems. These systems tended to be safe but inefficient, paying depositors low returns and doing a pretty bad job of transferring savings to their most efficient uses. Over time, a loosening of regulation made financial systems far more competitive and efficient. At the same time, however, it revived the possibility of destabilizing financial panics like the one that almost derailed the U.S. economy last autumn.

Third is the reestablishment of price stability. In the postwar era most countries experienced substantial inflation, with a worldwide explosion of prices in the 1970s and early ig8os. This inflation needed to be brought under control and ultimately was. Almost all nations now have achieved remarkably stable prices and credibly established the belief that they will continue to maintain price stability in the future. But it turned out that inflation had some unappreciated advantages. For one thing, countries that found themselves with

substantial internal debt could simply inflate that debt down to manageable proportions, as Japan did with bad real estate loans in the 1970s. More important, a country with five percent inflation and eight percent interest rates has much more room to cut rates to fight a recession than a country with stable prices and three percent interest. In other words, advanced countries would be far less vulnerable to liquidity traps had they not been so assiduous about pursuing price stability in the 198os. (The argument that it is a good idea to maintain some expectations of inflation so that real interest rates can go negative if necessary was vigorously promoted by none other than Deputy Secretary of the Treasury Lawrence Summers in his pre-administration days.)

Finally, there is the restoration of fiscal discipline. Many countries ran huge budget deficits in the 1970s and 1980s. As a result the 1990s have seen a great push toward fiscal responsibility, with European deficit spending curtailed first by the Maastricht Treaty and now by the post-EMu "stability pact," while the United States finally eliminated its budget deficit. Although pushed by its slump into deficit spending, Japan has attempted whenever possible to reverse course and move back toward balance-and in so doing helped push the economy back into recession.

In short, the reason Depression economics has now reemerged as a real concern is not that governments did not do the right thing, but that they did. Truly, no good deed goes unpunished.

THE WAY OUT

COMPARED WITH the 1930s, one of the encouraging aspects of the current situation is that many public officials seem both aware of the danger and relatively flexible. Although "liquidationist" rhetoric is fairly common in the press and Japanese officials sometimes seem to confuse a strong yen with a strong economy, on the whole the push is toward reflation. The question is whether the kinds of measures now considered acceptable-such as special lending facilities to support developing countries, tax cuts and bank reform to get Japan moving again, and ad hoc bailouts of hedge funds-are enough.

The answer is probably not. In a world of high capital mobility, truly massive emergency credit lines would need to be available to immunize developing countries against private capital flight. Will such credit really be available? In 1944 the economist Nurkse pointed out that such schemes would imply "that the monetary authorities of the United States, for instance, would have had to hold large amounts of, say, Austrian schillings merely to enable Austrian citizens to hold United States dollars." Now as then, it seems hard to believe that creditor countries will cheerfully finance capital flight. Yet that means that no realistic lending facility is going to be big enough to solve the policy dilemma of countries that dare not let their currencies float. Nor does it seem that bank reform plus ordinary fiscal policy will be enough to get Japan out of its slump. It would also be foolish to imagine that there will be no more financial-market scares in the United States or Europe or to assume confidently that the modest room for interest rate cuts in the West will be enough to cope with all such events.

So what is the alternative? At the moment there is a sort of odd inconsistency in the attitudes of responsible people toward such issues as capital controls and inflation. Nearly everyone is glad that not all developing countries managed to liberalize their capital accounts before the 1997 crisis hit; in particular, China, thank heavens, still has a nonconvertible capital account. But a Malaysian-type reversion to capital controls is regarded with horror. Similarly, everyone sleeps better knowing that the United States has two percent inflation and five percent interest rates, not stable prices and three percent interest rates-but proposals that Japan should actively seek a target of three or four percent inflation are still an anathema. It is a good thing, in other words, to be there, but not to go there.

Still, it is hard to avoid concluding that sooner or later we will have to turn the clock at least part of the way back: to limit capital flows for countries that are unsuitable for either currency unions or free floating; to reregulate financial markets to some extent; and to seek low but not too low inflation rather than price stability. We must heed the lessons of Depression economics, lest we be forced to relearn them the hard way.

[Footnote]

IThe Credit Anstalt crisis is described in Barry Eichengreen, Globalizing Capital:A History of the International Monetary System, Princeton: Princeton University Press, 1996. The travails of the interwar monetary system-which bear a startling resemblance to today's issues-are also discussed in Maurice Obstfeld and Alan Taylor, "The Great Depression as a Watershed: International Capital Mobility Over the Long Term," in The Defining Moment: The Great Depression and the American Economy in the Twentieth Century, ed. Michael D. Bordo, Claudia Goldin, and Eugene N. White, National Bureau

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of Economic Research, 1998. For discussions of Japan's economy, see Adam Posen, Restoring Japan's Economic Growth, Institute for International Economics, 1998; Paul Krugman, "It's Baaack: Japan's Slump and the Return of the Liquidity Trap," Brookings Papers on Economic Activity, no. 2 (1998); and David Asher and Andrew Smithers, Japan's Key Challenges for the 21st Century, SAIS Policy Forum Series, March 1998.

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