

By **PAUL KRUGMAN**

In popular legend, the Great Depression was the second act of a morality play — punishment for sins of the past, a hangover from the excesses of the Roaring Twenties. Sensible economists, however, have never subscribed to that view. On the contrary, they regard the Depression as an unnecessary tragedy: what might have been a more or less ordinary recession, soon forgotten, became a nightmarish slump thanks to the stupidity (or at least ignorance) of policy makers.

If only the Federal Reserve had not been preoccupied with defending the gold standard instead of the nuts and bolts economy. If only Herbert Hoover had not followed Secretary of the Treasury Andrew Mellon's advice to "liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate — purge the rottenness out of the system." Then, most of us believe, the catastrophe could easily have been avoided. Since we know better now, it can't happen again.

Or can it?

As recently as two years ago, like most of my colleagues, I was quite confident that while the age of economic crises was by no means past, 1930's-type crises, in which the world slumps simply because businesses and consumers spend too little, were obsolete. Economists and policy makers had learned the lessons of that decade and would never again perversely tighten monetary and fiscal policy in the face of recession.



Chicago 1933

Now I'm not so sure.

For one thing, many countries have tightened credit and reduced spending in the face of recession — not because their leaders are stupid or ignorant, but because global capital markets leave them no choice.

Consider the plight of Brazil. The country has a problem: it is running a budget deficit that must be brought under control, though a cool look at the figures would suggest that the Government's solvency is not in any immediate danger. Still, markets have fixated on deficit reduction as a symbol of the Government's determination to act responsibly. So taxes must be raised and spending cut.

A tighter fiscal policy, however, will reduce overall economic demand. So, will the Government compensate by cutting interest rates in order to avoid a recession? Certainly not. To cut interest rates would be to risk capital flight, which would undermine the value of the currency.

Indeed, to defend the Brazilian real the central bank has twice actually raised interest rates sharply — once last fall in an attempt to prevent a devaluation and again in January to keep the devaluation that took place anyway from triggering even greater capital flight. In short, fear of speculators has forced Brazil (and many other smaller economies) not only to live with the risk of recession but to follow policies that will deepen the prospective slump.

Larger, richer economies are not so helpless. The United States, the European Union and Japan are big enough to brush off the sort of speculative attacks that terrorize less fortunate nations. Yet even these powerhouses have lately been experiencing a bit of Depression economics.

Take Japan. Over the past two years the Japanese economy — which was already operating well below capacity — has gone into a tailspin. So why don't the Japanese get their economy moving with monetary and fiscal stimuli? The answer is that they are doing everything they can within the conventional limits of sound policy, and it still isn't enough.



Indonesia: 1998

Interest rates are near zero (some deposit rates are actually negative), and the Government is running a budget deficit likely to top 10 percent of national income next year. That's as if the United States Government were to run an \$800 billion deficit, a fiscal stance worse by any measure than Brazil's. And still Japan's economy is heading south, with the usual forces of recession now compounded by accelerating deflation.

What's going on? Some will tell you that it's all due to problems specific to Japan: bad banks, over-regulation, inefficient corporations. I don't buy it. As recently as five years ago many of the things now smugly condemned as weaknesses (like the close relationships between banks and their customers) were hailed as the secrets of Japan Inc.'s success — and often by the same people.

No. What's happening is something more generic: Japan now finds itself in a classic "liquidity trap." Consumers are so worried about the future that they try to save a high proportion of their income. Businesses, also worried, are unwilling to invest all those savings, even at a zero interest rate. While the Japanese Government can try to fill the hole with its own deficit spending — in effect, offsetting the private sector's excess saving with public dissaving — gigantic deficits lead to questions of the Government's own solvency. Indeed, Moody's has just downgraded Japanese Government bonds.

Don't get me wrong. The world is probably not headed for another Great Depression. The big developed economies are not going to experience crises

such as those in Brazil or Indonesia; nor are there signs of Japanese-style problems emerging in North America and Europe. But, I wish I were as confident as I used to be. The eerie resemblance of many of today's problems to those our grandfathers faced — the way Indonesia in 1998 is reminiscent of Austria in 1931; the similarities between contemporary Japan and the United States in the 1930's — sends chills up my spine.

What does it mean that we have managed to reprise the great slump, if only in a minor key? One lesson is that economists were far too self-congratulatory. It is true that we understand economic cycles much better than people did in the 1930's, but we do not understand them as well as we thought we did. Anyway, knowledge is not always power: the Brazilians understand the risks of their economic policy, but don't see a better option.

The other lesson may be even more disturbing. In the aftermath of the Depression, almost all of the world's governments rejected traditional economic virtues. In place of free markets, they introduced heavy regulation; in place of sound money, they resorted to inflationary expansion.

With time, however, economists and politicians once again began to appreciate the ancient virtues, and once again the world became a place of more or less free markets and more or less stable prices. Sure enough, along with the rediscovery of old-fashioned rectitude has come the rediscovery of old-fashioned crises. Free markets, we find, are too often unstable, while a world without inflation all too easily becomes a world of uncontrollable deflation.

This doesn't mean we should turn the clock back to, say, 1970. The evils of excess regulation and the costs of inflation were not figments of our imagination. Neither were the risks to which those bad old policies were themselves a response. What the world needs now is a way to regain stability without condemning economies to inefficiency. I'm open to suggestions.

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