

PAUL KRUGMAN

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THE GREAT UNRAVELLING



FROM **BOOM** TO BUST
IN THREE **SCANDALOUS** YEARS

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PREFACE

METAPHORS CAN BE TRICKY THINGS, but Manhattan's "debt clock" is as good as they come.

A public-spirited businessman installed the clock in 1989, hoping to shame politicians into acting responsibly. Huge numerals counted off the ever-rising national debt—ever-rising because each year the federal government spent far more than it took in, and was forced to borrow the difference. But in the late 1990s a funny thing happened: the government's tax take soared along with the stock market, and those mammoth budget deficits first shrank, then turned into record surpluses. In September 2000, the owner of the clock pulled the plug.

In July 2002, with the nation once again facing deficits as far as the eye could see, he turned it back on.

There's much more to recent American history than the way the federal government declared victory in its long struggle against deficits, only to see the red ink quickly return. But as the budget went, so went many other indicators of our national well-being. In the early 1990s we were a depressed nation, economically, socially, and politically: a best-selling book of the era was titled *America: What Went Wrong*. By the end of the decade we had, it seemed, pulled ourselves together. The economy was booming, jobs were plentiful, and millions of people were

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getting rich. Budget deficits had given way to record surpluses. The long crime wave that began in the 1960s came to an end; major cities were suddenly, amazingly, safer than they had been for many decades. The future seemed almost incredibly bright.

Then the good times stopped rolling. By 2003, the fabric of our economy—and, perhaps, of our political system and our society—seemed once again to be unraveling. The nation was gripped by anxiety, with polls showing a majority of the public feeling that the country was headed in the wrong direction.

This book is, first of all, a chronicle of the years when it all went wrong, again—when the heady optimism of the late 1990s gave way to renewed gloom. It's also an attempt to explain the how and why: how it was possible for a country with so much going for it to go downhill so fast, and why our leaders made such bad decisions. For this is, in large part, a story about leadership—incredibly bad leadership, in the private sector and in the corridors of power. And yes, it is in particular an indictment of George W. Bush. Helen Thomas, the veteran White House correspondent, has called Mr. Bush “the worst president in all of American history.” I'm not sure about that—he has some stiff competition. But the really terrible presidents of the past led a nation in which presidential incompetence and malfeasance mattered far less either to the nation or to the world than it does today.

Most of this book consists of columns that I wrote for *The New York Times* between January 2000 and January 2003. I hope that readers will find that the sum is more than the whole of its parts—that taken together these columns tell a coherent story. I'll talk shortly about how I came to write those columns. But first, let's recall the background.

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The dreary years

During the late 1990s, as everything seemed to be going right—as jobs proliferated, stocks soared, budgets moved into surplus, and even the crime rate plunged—the dreary mood of the decade’s early years faded from memory. By 2000, few people remembered the national funk that prevailed in 1992. Yet that funk is essential background to what came later.

If you are one of those people who thinks that national greatness is defined by military success (and such people are running the country right now), the nation’s foul mood in 1992 may seem puzzling. Militarily, America was on top of the world. Communism had collapsed. A war in the Persian Gulf that many had feared would become another Vietnam turned instead into a spectacular demonstration of American military prowess. We had already become what we remain today, the world’s one and only superpower.

But glory doesn’t pay the bills. A tag line of the time—drawing attention to the contrast between American stagnation and the seemingly relentless rise of Japan—said, “The Cold War is over. Japan won.” Whether or not you bought the thesis that America was the victim of unfair Japanese competition (it wasn’t), it was a time of national disillusionment.

Though Japan wasn’t the villain some people imagined—and it was soon to experience economic setbacks that are a cautionary tale for all of us—America’s economic woes were real enough. True, by 1992 statisticians had declared the recession of 1990–91 over. But in 1991–92 it was still a “jobless recovery”—that is, a period in which GDP grows but unemployment continues to rise. As far as ordinary Americans were concerned, it was a continuing recession. Nor were things all that

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great for workers who managed to keep their jobs: the real wage of the typical worker had been stagnant or falling for almost 20 years. Traditional industries like autos and steel, in which ordinary workers could earn good wages, seemed to be in steady decline. Poverty was rising, not falling—more than 20 percent of children were living below the poverty line, the highest percentage since 1964.

Popular culture reflected a deep sense of disillusionment. Among the big movies of the early 90s were *Falling Apart*, about a laid-off worker who erupts in rage, *Grand Canyon*, about the menace of crime, and *Rising Sun*, about American decline and the rise of Japan.

What about the promise of new technology? In the early 1990s, this seemed like a promise broken. For sure, new technology was all around us—but it didn't seem to be delivering much in the way of results. More and more workers were equipped with computers, every office had a fax machine, cell phones and e-mail were starting to become widespread, but none of it seemed to pay off in employment or higher living standards. One prominent economist—he would later be a notable American triumphalist—told me privately that he regarded high tech as “high bull——.”

Above all, the American people were disillusioned with their leaders, private and public. Every airport bookstore featured rows of volumes with samurai warriors on their covers, promising to teach readers the secrets of Japanese management; the point was not just that the Japanese seemingly knew how to run modern corporations, but that the people running American companies seemingly didn't. All the latest gadgets seemed to come from Japan; not only had “made in the U.S.A.” ceased to be a guarantee of quality, many consumers had come to distrust domestic products. CEOs of major corporations were

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mocked as bumbling, overpaid incompetents—when President George Bush took auto company executives to Japan to demand economic concessions, the affair turned into a public relations disaster.

The loss of respect extended to our politicians. The most remarkable thing about the 1992 election wasn't that Bush lost. It was that H. Ross Perot, a candidate completely out of the mainstream, took 19 percent of the vote. In a nation where third parties have never flourished, that was a huge vote of no confidence in conventional political leaders.

In short, it wasn't the best of times—and many observers expected things to keep getting worse. Yet over the next eight years the nation would experience an amazing economic and social turnaround.

The good years

It took quite a while before people realized that things had really turned for the better. You might say that pessimism had become a national habit. As late as the winter of 1995–96, despite a steadily falling unemployment rate, the newspapers were full of alarmist headlines about job loss and downsizing. In the 1996 presidential campaign, Bob Dole's economists attacked the Clinton administration for what they claimed was a sluggish, below-par economic recovery. Less partisan economists knew better, but they remained cautious, having seen too many false dawns. Yet eventually the evidence became too strong to deny: the U.S. economy really was on the mend. And so, it began to seem, was our society.

Given our current state of renewed disillusionment, it's tempting to dismiss everything that went right in the Clinton years as a mirage. Indeed, the manic optimism of the late 90s

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got ahead of the reality. But the nation's real achievements were spectacular.

First and foremost for the lives of most people, by the end of the 90s jobs were plentiful—more plentiful than they had been for decades. Between 1992 and 2000, U.S. companies added 32 million workers to their payrolls, driving the unemployment rate to a 30-year low. Full employment meant jobs, and a chance of escape, for families that had been caught in the poverty trap: poverty rates fell sharply, for the first time since the 1960s. Partly as a consequence, social indicators like crime rates showed spectacular improvement: by the end of the 90s, New York City was as safe as it had been in the mid-1960s.

If job growth was impressive, the increase in productivity—the amount produced per worker—was even more impressive. In the 1970s and 1980s, low productivity growth—barely 1 percent per year—was the greatest failing of the U.S. economy. Poor productivity performance was the most important reason why living standards stagnated for typical American families: an economy without productivity growth can't deliver a sustained rise in wages. But during the 1990s productivity took off; by decade's end it was rising faster than ever before in American history, and wages had ended their long stagnation.

Why did productivity surge? The main answer, probably, was that information technology had come of age: all those computers and networks were finally showing what they could do. But business leaders, understandably, took much of the credit. As Japan faltered, American business regained its confidence, and American businessmen became heroes. It was the age of the CEO as superstar. And if those superstars took home super-sized paychecks, why not? America, it seemed, had devised a system in which big incentives produced big results.

Then there was the stock market. At the end of 1992 the Dow

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was at 3,500; by 2000 it had zoomed past 10,000. And yet Dow investors felt like losers: they had missed out on the really big gains, as tech stocks made many people instant millionaires. Not since 1929, and maybe not even then, had quick wealth seemed so attainable. And authoritative-sounding voices assured us that there was more to come, that the Dow would soon reach 36,000.

There were stock market skeptics; I was one of them. (I also had some initial doubts about the U.S. productivity miracle. By 2000 I was a believer, but I still thought stock prices were way out of line.) And those of us who followed foreign economies also worried a bit about what would happen when the stock market rediscovered the law of gravity. There were some undeniable similarities between the U.S. economy in the late 90s and Japan's "bubble economy" a decade earlier—and after Japan's stock market bubble collapsed, the seemingly unstoppable Japanese economy fell into a profound funk, which has continued to this day.

Yet the 90s had given us reason for optimism, even if the bubble burst. For the problems of Japan had been exacerbated by poor leadership—and the economic leadership of the United States was exceptionally good.

In the early years of the Clinton administration this wasn't clear to everyone. I myself was a pretty harsh critic of the new president's economic team, in the days before the ascendancy of Robert Rubin was fully established. But by decade's end "Rubinomics" was triumphant. First, Bill Clinton dared to raise taxes to help close the budget deficit—an action that was doubly brave. His predecessor, George Bush, had been vilified for his own tax increase (though even Ronald Reagan had retracted part of his own tax cut); and conservatives predicted that the Clinton tax increase would sink the economy. Nonetheless, he

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did the right thing—and got a booming economy and a budget surplus as his reward.

Moreover, Washington proved itself flexible and effective in dealing with crises. When the Mexican peso plunged in 1995, the administration—again braving harsh criticism from the right—came to our neighbor’s rescue. Then an even bigger financial crisis erupted in Asia. In the fall of 1998 the crisis spread to the United States, as Russia’s default on its debt led to the downfall of Long-Term Capital Management, a huge hedge fund. Financial markets briefly seized up: borrowing and lending came to a virtual halt. I was at a meeting in which one Fed official briefed us on the situation; when asked what we could do, he replied, “Pray.” Yet Rubin, together with Alan Greenspan, managed to exude a sense of calm—remember what it was like when people actually admired the Treasury secretary? And the markets recovered. Early in 1999 the cover of *Time* featured Federal Reserve Chairman Alan Greenspan, Treasury Secretary Robert Rubin, and Deputy Treasury Secretary Larry Summers, whom it dubbed—cornily, but with considerable justification—the “committee to save the world.”

At the beginning of the new millennium, then, it seemed that the United States was blessed with mature, skillful economic leaders, who in a pinch would do what had to be done. They would insist on responsible fiscal policies; they would act quickly and effectively to prevent a repeat of the jobless recovery of the early 90s, let alone a slide into Japanese-style stagnation. Even those of us who considered ourselves pessimists were basically optimists: we thought that bullish investors might face a rude awakening, but that it would all have a happy ending.

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America: What went wrong?

The satirical weekly *The Onion* describes itself as “America’s finest news source”—and for the last few years that has been the literal truth. The mock news story for January 18, 2001, reported a speech in which President-elect George W. Bush declared, “Our long national nightmare of peace and prosperity is over.” And so it has turned out.

What happened to the good years? For many people, the great emotional turning point—the moment when their dreams of security were shattered—was September 11, 2001. But for me the turn was slower and broader than that.

I don’t mean to belittle the horror. But anyone who followed Middle Eastern events knew that the United States was a terrorist target. You may remember that at first everyone assumed that the 1995 bombing in Oklahoma City involved Muslims. Experts on terrorism warned us repeatedly over the years that there would someday be a major attack on U.S. soil—though the sheer size of the mass murder on September 11 was a shock. We knew there were people out there who wanted to hurt us; it wasn’t that much of a surprise when they finally scored a hit.

The real surprise was the failure of leadership, private and public, right here at home.

Some people realized that there were business excesses in the 1990s, though they had a hard time getting themselves heard. But the extent and brazenness of the excesses was greater than anyone realized. The bull market, we learned too late, both encouraged and concealed corporate misbehavior on an epic scale. Who could have imagined that famous companies, lauded in business schools as the very models of a major

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modern corporation, would turn out to be little more than Ponzi schemes? (Actually, some people did say that, but they were dismissed as cranks.)

Even more troubling was the revelation that our political system was far less mature than we thought, that the responsible leadership we had come to take for granted had been a sort of accident. In the 2000 campaign, George W. Bush offered a tax plan and a Social Security plan that were obviously, blatantly based on bogus arithmetic. Yet the media focused on the politics of personality, and avoided explaining the issues. Meanwhile, Alan Greenspan turned out not to be who we thought he was: the stern advocate of austerity and fiscal discipline when a Democrat was in office became an apologist and enabler for irresponsible tax cuts, even in the face of soaring deficits, once the White House had changed hands.

Moreover, the new team showed neither the long-run responsibility nor the short-term flexibility of its predecessors. The original Bush economic plan involved big, long-run tax cuts that phased in only gradually. By 2002 it was clear that this plan had it backwards. Like his father, Bush was presiding over a “jobless recovery”—that is, an economy that was growing, but too slowly to provide new jobs, so that most people found their lives getting worse. This economy badly needed a short-term boost, not a long-run tax cut. And the spectacular deterioration of the budget meant that long-run tax cuts were no longer remotely affordable. Yet Bush’s aides continued to insist that their program, formulated back in 1999 at the height of the bubble, was exactly the right solution for the economy’s current difficulties. And in early 2003, when they finally seemed to realize that something more was needed, the new “stimulus” plan was practically a clone of the original plan: hardly anything to

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stimulate the economy now, but lots of long-term tax cuts, mainly for the rich.

More ominously, it gradually became clear that something deeper than mere bad economic ideology was at work. The bigger story was America's political sea change, the central theme of this book's Introduction.

Why me?

I began writing for *The New York Times* in January 2000. Neither I nor *The Times* knew what I was getting into.

I was and am an economics professor by trade. International financial crises were one of my main specialties, and I spent much of the 1990s tracking and commenting on disasters abroad. Some of my work consisted of what I call "Greek-letter" economics, abstruse papers for the professional journals. But I also wrote about global economic issues for a wider audience. By 1998 I had two regular monthly columns, one in *Fortune* and one in the online magazine *Slate*; some of those columns are included in this collection.

In the summer of 1999 *The New York Times* contacted me about writing for the paper's Op-Ed page. Howell Raines, then the paper's editorial page editor, felt that in an age when, more than ever, the business of America was business, *The Times* needed to broaden its Op-Ed commentary beyond the traditional focus on foreign affairs and domestic politics. I was brought on in the expectation that I would write about the vagaries of the new economy, the impacts of globalization, and bad policies in other countries. I didn't expect to spend a lot of time on domestic politics, since everyone assumed that American policy would remain sensible and responsible.

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I have tried, as best I can, to cover economics and business. As you'll see, some of the columns in this book are straight economic analyses, without a political edge. But as events unfolded, politics inevitably intruded. More and more, I found myself speaking very uncomfortable truth to power.

Why me?

These days I often find myself accused of being a knee-jerk liberal, even a socialist. But just a few years ago the real knee-jerk liberals didn't like me at all—one magazine even devoted a cover story to an attack on me for my pro-capitalist views, and I still have the angry letter Ralph Nader sent me when I criticized his attacks on globalization. If I have ended up more often than not writing pieces that attack the right wing, it's because the right wing now rules—and rules badly. It's not just that the policies are bad and irresponsible; our leaders lie about what they are up to.

I began pointing out the outrageous dishonesty of the Bush administration long before most of the rest of the punditocracy. Why did I see what others failed to see? One reason is that as a trained economist I wasn't even for a minute tempted to fall into the he-said-she-said style of reporting, under which opposing claims by politicians are given equal credence regardless of the facts. I did my own arithmetic—or, where necessary, got hold of real economists who could educate me on the subjects I wrote about—and quickly realized that we were dealing with world-class mendacity, right here in the U.S.A. I wasn't entirely alone in this: one thing I've noticed the last few years is that business reporters, who know a bogus number when they see one, have often accused our leaders of outrageous mendacity even while political pundits celebrate those leaders for their supposed sterling character. But the writings of business reporters necessarily have a narrow focus, and rarely

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affect political commentary. With a wider brief, and a spot on the Op-Ed page, I attracted a lot more attention.

I have also been willing to see things differently, and report on what I see, because I'm not properly socialized. The commentariat mainly consists of people who live in Washington and go to the same dinner parties. This in itself foments group-think; at any given moment there is a story line that shapes journalists' perceptions. Until September 11 this story line had it that George W. Bush was dumb but honest; after September 11 the new story was that he was a tough-minded hero, all determination and moral clarity, "Texas Ranger to the world." (Yes, one prominent pundit actually wrote that.) The overwhelming evidence that neither of these pictures bore any resemblance to reality was simply brushed aside.

But I'm not part of the gang—I work from central New Jersey, and continue to live the life of a college professor—so I never bought into the shared assumptions. Moreover, I couldn't be bullied in the usual ways. The stock in trade of most journalists is inside information—leaks from highly placed sources, up-close-and-personal interviews with the powerful. This leaves them vulnerable: they can be seduced with offers of special access, threatened with the career-destroying prospect that they will be frozen out. But I rely almost entirely on numbers and analyses that are in the public domain; I don't need to be in the good graces of top officials, so I also have no need to display the deference that characterizes many journalists.

Whatever the reason, I have spent much of the last three years providing a picture of the world that differs greatly from the vision of most other mainstream pundits. (Web-based commentators have done yeoman duty—but they don't land on a million doorsteps twice a week.) One of the columns in this book is titled "An Alternate Reality"; that about captures it. At a

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time when most pundits were celebrating the bold vision, skill, and moral clarity of our leaders, I saw confusion, ineffectuality, and dishonesty. It wasn't a popular point of view, especially in the early months after September 11. But have I been right? Read the book and decide for yourself.

About this book

I've tried to make this book more than a chronological sequence of columns. There is, of course, an element of chronology; each column was written on a particular date, and my views on some subjects have evolved, as new facts have come to light. But the columns are grouped according to major themes, and within each theme into "chapters" that focus on a particular subject. I've also added an Introduction that sets the political stage, and further additional material at the beginning of each thematic section, to put the columns into a broader perspective.

The columns begin with the rise and fall of America's stock market bubble, with all that went with it. As the pieces here show, I was always a stock market skeptic—though not, as you will see, skeptical enough. My focus on troubled economies abroad prepared me for the possibility that the United States would suffer serious economic difficulties once the bubble burst—though here again I initially understated the risks. What nobody realized was how thoroughly corrupted the U.S. corporate system had become; like everyone else, I played catch-up here.

The book turns next to the federal budget and the fate of Social Security. It's the story of a debt foretold. From the beginning it was obvious to me that George W. Bush's plans didn't add up, that he and his people were simply lying about all the important numbers, and that their plans would dissipate the

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budget surplus. It has played out just as I feared, but sooner and more forcefully than I expected. As I write these words, the administration has just conceded that the \$230 billion surplus it inherited has been converted into a \$300 billion deficit—and you know that’s an underestimate.

How was such a misstep possible? In Part III, I go beyond economics pure and simple, trying to understand what has gone wrong with American politics. It seems to me now that many reasonable people, liberals and conservatives alike, still don’t get it—as I explain in these columns, the real world of politics is much tougher and uglier than the picture most of us carry in our heads.

The last few years didn’t just shake my faith in our political system; they were also a reminder that free markets, while often a very good thing, can sometimes go very badly wrong. Part IV describes some of the shocking failures of the market system in the last few years, from the California energy crisis to the catastrophe in Argentina.

Of course, there’s more to the world, even the world of economics, than the ups and downs of the United States. The book concludes with a wider view—a look at the global economy, and at the tools we use to understand it.

This is not, I’m sorry to say, a happy book. It’s mainly about economic disappointment, bad leadership, and the lies of the powerful. Don’t despair: nothing has gone wrong in America that can’t be repaired. But the first step in that repair job is understanding where and how the system got broken.