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The economics of depression

“There will be no interruption of our permanent prosperity.”

- Myron Forbes, President, Pierce Arrow Motor Car Co., January 1928.

“Stock prices have reached what looks like a permanently high plateau.”

- Economist Irving Fisher, October 1929.

“[1930 will be] a splendid employment year.”

- US Department of Labour, New Year’s forecast, December 1929.

“..the central problem of depression-prevention has been solved, for all practical purposes..”

- Robert Lucas, winner of the 1995 Nobel Memorial Prize in Economics, in his presidential address to the American Economic Association in 2003.

Hindsight, of course, is a wonderful thing. Scour Ben Bernanke’s 2004 speech, [‘The Great Moderation’](#) as much as you may, the text yields little by way of explicit hubris, although the soon-to-be Fed chairman does tend to suggest, as economist Paul Krugman – another Nobel Laureate – hints,

“much as Lucas had, that modern macroeconomic policy had solved the problem of the business cycle – or, more precisely, reduced the problem to the point that it was more of a nuisance than a front-rank issue.”

And it is certainly clear from Krugman’s ‘The Return of Depression Economics and the crisis of 2008’ (Penguin, 2008) that economists love few things more than bitch-slapping their academic rivals. So why are academic politics so vicious ? In a quotation that has been variously credited, amongst others, to Woodrow Wilson, Henry Kissinger, Richard Neustadt and Wallace Sayre, the response would seem to be: because the stakes are so low. Perhaps if economists were managing money, say, as opposed to footling with models and largely sterile theories in a hugely complex and fecund world, they might be more respectful of each other.

In any event, Krugman's book stands out amongst economic works in that it is highly readable, not to say outright chatty in tone. And for those investors still puzzling over why mature and ostensibly well-managed economies can suddenly be pitched into a savage recession or something worse, 'The Return of Depression Economics' also carries a charming educational *vignette*, albeit one created by Joan and Richard Sweeney back in 1978, under the title "Monetary Theory and the Great Capitol Hill Baby-sitting Co-op Crisis".

The analogy goes like this. The Sweeneys were members of a baby-sitting cooperative. A semi-formal federation of roughly 150 couples would share the responsibilities of baby-sitting each other's children. To ensure that everybody did their fair share, the cooperative issued scrip, which entitled the bearer to one hour of baby-sitting. Having discharged their cooperative duty of an evening, baby-sitters would be paid the appropriate number of coupons by the baby-sittees. Over time each couple would provide exactly as many hours of baby-sitting as they received.

The system broke down, however, when couples with several free evenings in a row, and with no immediate plans to go out, would try to accumulate coupons for future use. This accumulation would be matched by the exhaustion of other couples' reserves. The time came when too few coupons were circulating amongst members of the cooperative.

Couples who felt that their reserves of babysitting coupons were insufficient would become anxious to baby-sit (and reluctant to go out). But one couple's evening out was another couple's opportunity to earn coupons they could no longer earn if the first couple stayed in. Opportunities to baby-sit dried up. Couples became even more reluctant to spend their reserves, in turn making baby-sitting opportunities even scarcer.

The baby-sitting cooperative had discovered recession.

As Krugman points out, this little story happens to be "a powerful tool for understanding the not-at-all whimsical problems of real-world economies." The baby-sitting circle did not enter recession because it was doing a bad job, or because of "crony baby-sittingism". The problem was simply a lack of "effective demand". There was too little spending on goods (or baby-sitting time) because people were trying to accumulate cash (baby-sitting coupons) instead. Krugman's lesson for the real world ?

"..your vulnerability to the business cycle may have little or nothing to do with your fundamental economic strengths and weaknesses: ***bad things can happen to good economies.***" [Emphasis mine.]

And Krugman takes us on a breathless, whistle-stop tour through some of the world's most celebrated or at least infamous financial crises. Mexico's Tequila Crisis of 1995 has a cameo role, as does Argentina's hyperinflation of 1989, and Japan's lost decade of the 1990s gets a 'best actor' nomination. But perhaps the pan-Asian crisis of the late 1990s gives the most urgent early warning signs for our present rolling panic: first, because it spread from economically 'guilty' countries to economic 'angel' sovereign nations at a blistering speed; second, because it reached its zenith with the inglorious failure of hedge fund Long Term Capital Management (and its handful of Nobel Laureates): an eerie forewarning of the deflationary, deleveraging and panic-spraying role to be played by the rise of the shadow banking system – *and* the outright failure of regulation – this time round.

To return to the babysitters.. How was their recession resolved ? Intriguingly, the first response (in reaction to a perceived "structural" problem) required each couple to go out at least twice a month. (In a more directly economic context that sounds like brute intervention and the opposite

of a free market dynamic.) Eventually, following advice from economists, the cooperative changed tack, and simply increased the supply of coupons. “The results were magical: with larger reserves of coupons, couples became more willing to go out, making opportunities to baby-sit more plentiful, making couples even more willing to go out, and so on.” Krugman takes pains to point out that the couples hadn’t become better baby-sitters; rather, “it was simply because the monetary screwup had been rectified. Recessions, in other words, can be fought simply by printing money – and can sometimes (usually) be cured with surprising ease.”

But our current malaise is evidently more profound than just an absence of circulating money. In Krugman’s words,

“..for the first time in two generations, failures on the demand side of the economy – insufficient private spending to make use of the available productive capacity – have become the clear and present limitation on prosperity for a large part of the world.”

Yes, credit needs to flow again (perhaps with a keener eye on the quality of borrowers, this time around), and consumer-driven economies require a boost to spending, at least for as long as GDP is driven by consumption. Economics has a rather heartless way of describing the problem: as a fallacy of composition, and particularly as the paradox of thrift. Increasing saving makes sense for the individual, groaning under a burden of debt, but if everybody starts saving at an increased rate, the economy tips further into recession. To which one might fairly respond: whoever said that it was the individual’s duty to put the economy before himself ?

Happily for them, economists are not primarily concerned with the management of wealth, so they can indulge in *homo economicus* theorizing to their hearts’ content. For those of us that are, Krugman’s book serves as a handy reminder that economics doesn’t have all the answers. The critical questions now have no sure answers either: do we get deflation, or inflation, or some combination of the two ? Do we get a sequence of competitive currency devaluations and / or a continued flight from fiat currency that ultimately hits the US dollar ? Is it too early to get back into the stock market ? (Probably it is, unless on a highly selective basis, given the likely duration and severity of the recession / depression. Friday’s dire US GDP figures cannot be spun into anything more positive.) My best guess is that notwithstanding the enormity of the banking system’s spree of serial capital destruction, the monetary authorities globally are indeed stepping up to the plate. Which is indeed easy for them to do, since it’s not their money: they are redirecting much of the wealth of current and future taxpayers to shore up the banks. Investors globally meanwhile are succumbing to crisis fatigue. Perhaps the low point in the fragility of the financial system really is already behind us. The ‘nationalisation’ word may spook our American friends, but *de facto* that is where the banks largely are. To pretend otherwise is self-denial. Their 2006 era market capitalisations aren’t coming back. If you want real growth for your equity investments, back another horse.

The deflation horror story is probably somewhat overblown. That is not to say that an extraordinary (and shockingly globally synchronised) recession cannot last far longer than the current myopic consensus. It may be true that in Roosevelt’s words all we have to fear is fear itself. But isn’t that enough to be worried about ?

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