The Accidental Theorist

And Other Dispatches from the Dismal Science

Paul Krugman

W. W. Norton & Company
New York London

Printed in the United States of America
First published as a Norton paperback 1999

The text of this book is composed in Adobe Caslon with the display set in Adobe Caslon.
Composition by Chelsea Dippel
Manufacturing by The Maple-Vail Book Manufacturing Group.
Book design by BTD/Mary A. Wirth

Library of Congress Cataloging-in-Publication Data

Krugman, Paul.
The accidental theorist : and other dispatches from the dismal science / by Paul Krugman.
p. cm.
ISBN 0-393-04638-9
1. Economics. I. Title.
HB74.5.K78 1998
330—dc21 97-51717
CIP

ISBN 0-393-31887-7 pbk.

W. W. Norton & Company, Inc., 500 Fifth Avenue, New York, N.Y. 10110
http://www.wwnorton.com

W. W. Norton & Company Ltd., 10 Coptic Street, London WC1A 1PU

4 5 6 7 8 9 0

What Is Wrong with Japan?

When the world's second largest economy, after forty years of impressive economic growth, stagnates for six years with no real recovery in sight, one would think that people would regard the causes of that economic stagnation as a truly burning issue. Yet even now there is a strange casualness in the way that most people—including, unfortunately, many Japanese—discuss the nation's problems. Instead of a serious, thoughtful analysis, all one usually hears is a long list of things wrong with Japan. The

Originally published in *Nihon Keizai Shimbun.*

country, we are told, has a weak financial sector; it is overregulated; there is not enough competition; Japanese firms are moving production to Southeast Asia; and so on. All of these things are true; nonetheless, a list is not the same as a real analysis. And in fact the tendency to explain Japan's problems in terms of a long list of factors does real harm, because it encourages a sort of fatalism in the face of economic stagnation. After all, if there are so many problems, we cannot expect a quick fix.

The truth, however, is that matters are not that complicated. Japan has many problems—but what country does not? The main obstacle to Japanese recovery right now is not the long list of structural difficulties but a simple lack of clear thinking and courage.

For one thing, most of the items on everybody's list of what is wrong with Japan are things that make the economy inefficient. That is, all of these things reduce the ability of the economy to produce goods and services—they limit its supply capacity. But the immediate problem with the Japanese economy is not too little supply—it is too little demand. The problem is that the economy isn't using the production capacity it already has—a problem for which many of the items on the usual list are simply irrelevant.

Now as a general rule modern economies are not supposed to suffer from prolonged periods of inadequate demand. There is usually nothing easier than increasing demand: Just have the central bank (i.e., the Bank of Japan) increase the money supply, or have the government spend more. Why, then, has Japan suffered from low demand for more than half a decade?

Well, there are some structural reasons. Japanese consumers still save an unusually high fraction of their income, which means that companies must correspondingly be persuaded to maintain a high investment rate if the economy is not to have too little demand. The problem is aggravated because the troubles of the banking system have restricted the flow of credit. So to push demand high enough to get the economy back to more or less full use of its

capacity would require a big stimulus. Still, why not provide that stimulus?

The standard answer goes like this: Interest rates are already very low, so the Bank of Japan has done all it can. Meanwhile, the government has a severe fiscal problem, so it cannot increase spending or cut taxes. There is, in short, nothing to be done except pursue structural reforms and hope for an eventual turnaround.

This answer sounds hard-headed and responsible. In fact, however, it is based on a completely false premise—the idea that the Bank of Japan has reached the limits of what it can do.

The simple fact is that there is no limit on how much a central bank can increase the supply of money. Could the Bank of Japan, for example, double the amount of monetary base—that is, bank reserves plus cash in circulation—over the next year? Sure: just buy that amount of Japanese government debt. True, even such a large increase in the money supply might not drive down interest rates very much, since they are already so low. But an increase in Japan's money supply could ease the economic problem in ways other than lower interest rates. It is possible that putting more cash in circulation will stimulate spending directly—that the extra money will simply "burn holes in people's pockets." Or banks, awash in reserves, might become more willing to lend; or individuals, with all that cash on hand, will bypass the banks and find other ways of investing. And even if none of these things happens, when the Bank of Japan increases the monetary base it does so by buying off government debt—and therefore makes room for spending increases or tax cuts.

So never mind those long lists of reasons for Japan's slump. The answer to the country's immediate problems is simple: PRINT LOTS OF MONEY.

But won't that be inflationary? Well, remember that the Bank of Japan is supposed to be impotent: If it prints more money, people will simply hoard it rather than spend it. But printing money is only inflationary if people spend it, and if that spending exceeds the economy's capacity to produce. You cannot first argue that monetary policy is ineffective as a way to increase demand, then reject a proposal to print more money on the grounds that it will cause inflation.

So why doesn't the Bank of Japan just go out and print lots of money? The best theory I have heard is that the bureaucrats at the Bank of Japan and the Ministry of Finance are still mesmerized by the memory of the "bubble economy"—the wild speculation of the late 1980s, which pushed the prices of stocks and real estate to crazy levels (remember when the grounds of the Imperial Palace were supposedly worth more than the whole state of California?). They believe that loose monetary policy created that bubble—which may be true—and that the bursting of the bubble caused the slump of the 1990s—which may also be true. And so they are afraid to increase the money supply now for fear of repeating the experience.

There is an old joke that may be useful here: A driver runs over a pedestrian, who is left lying in the road behind his car. He looks back and says "I am so sorry—let me undo the damage"—and proceeds to back up his car, running over the pedestrian a second time. Japan's economic managers are acting like that driver. They do not realize that 1997 is not 1987, and that doing the opposite of what they did then only compounds the country's problems.