How Depressions Work

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On Capitol Hill sit many powerful people — Congressmen, Senators, Justices — but also numerous others who do the daily work of keeping government running. And, like anyone with such a weighty responsibility, they sometimes want a break: a chance to see a movie or eat out with their spouse.

Kids always make these things difficult, so in the late 1950s someone thought of starting a Capitol Hill Babysitting Coop. The idea was simple: a bunch of families would get together and dole out scrip — little fake money — amongst themselves. Anytime you wanted to go out, you could just hire another family in the coop to watch your kids: one piece of scrip per hour. Later, of course, you'd earn the money back by watching someone else's kids.

It was a brilliant system and much beloved, until sometime in the 1970s. See, when people left the babysitting coop, they got to keep the balance of their scrip. And so, over the years, the amount of scrip in circulation fell. Soon scrip was in short supply and people begun hoarding theirs for fear of losing it forever. There were few opportunities to babysit (and thus earn scrip) so people didn't want to lose the scrip they had by paying it to a sitter. Which, of course, meant even fewer babysitting opportunities, making more people want to hoard their scrip, and on and on in a downward spiral.

Since the coop consisted largely of lawmakers and lawyers, they attempted a legislative solution to the crisis, requiring everyone go out at least once every six months. The proposal just made things worse. Eventually, someone tried the idea of handing out more scrip to everyone, and soon, the coop's delicate balance was restored.

In the 2000s, house prices started rising and everyone started sinking their money into them. Average people would buy houses and mortgage them, banks would buy mortgages, investors would buy mortgage derivatives from banks, and so on. Pundits published books with titles like *Why the Real Estate Boom Will Not Bust* and many people just assumed housing prices would go up forever. At the peak of it, we had roughly $80 trillion in global financial assets.

Of course, it was clear to anyone who looked closely that this couldn't go on forever — and that when it stopped, it would bring a lot down with it. And, sure enough, today housing prices are almost back to their usual level and we now have only $60 trillion.

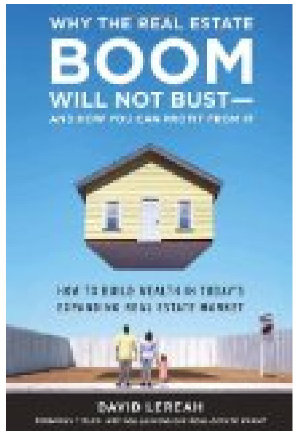

Figure 1: Book cover: Why the Real Estate Boom Will Not Bust

Just like people taking scrip out of the babysitting coop, an enormous amount of money has been taken out of the economy. So naturally people want to hold on to what's left. So they don't spend their money, which means there's less employment opportunities, which means more people want to hold on to their money, and on and on in a downward spiral.

Normally when this happens, as in a recession, the government has an easy solution: lower interest rates. What happens is the country's leading bankers meet at the Federal Reserve and vote to lower interest rates. Let's say they decide to lower them (as they've done a lot lately). Then the Federal Reserve Bank in New York starts buying up Treasury Bills (government IOUs) for cash, injecting money into the economy. This allows banks to lend out more money, lowering the interest rate at which money is lent out, and thus encouraging people to start spending again. (Later, when the economy is doing well, they'll raise the rates again, pulling money out and making sure things don't get out of hand.)

But this isn't simply a recession. The Fed's lowered the interest rate to zero — *zero!* they're giving money away — and unemployment just keeps rising. Losing a quarter of global financial assets hurts. But now the Fed has a problem: it can't lower the interest rate anymore. Interest rates don't go any lower than zero.

Which means, as J. M. Keynes foresaw back during the first Great Depression, we need another way of getting money into the economy. This isn't rocket science — Keynes suggested stuffing bills into bottles and burying them down mineshafts; Milton Friedman once proposed tossing cash out of helicopters. But as long as the government is spending money, we might as well spend it on something useful. And thus, fiscal stimulus.

We spend the money to build roads and trains and high-speed Internet connections. We give away health care and hand out welfare checks and mail people tax rebates. We do whatever it takes to get more money into the economy. Which people then turn around and spend on all the things they normally start spending money on and the engine of capitalism once again start to turn.

Keynes' genius came in seeing that the Depression wasn't a moral problem. We're not being punished for our exuberance or our stinginess, just as the folks on Capitol Hill weren't at fault for not wanting to go out. In both cases, the problem wasn't legislative, but merely technical: there just wasn't enough money to go around. And the technical problem has a technical solution: print more money.

The moralists insist it's irresponsible for us to just print more money. After all, they say, debt got us into this mess; is more debt really going to get us out? This is what they told FDR, causing him to hit the break on a recovery that was pulling us out of the Great Depression. This is what they told Japan, ending their recovery and plunging the country into a "lost decade" of unemployment.

It's not irresponsible to spend money; it's irresponsible not to. Factories are lying idle, people are sitting at home unemployed, and our economy is slowing. We can spend money to make use of it all, or we can just continue downward spiral. The choice is ours.

Further reading:

- Sweeney and Sweeney, "Monetary Theory and the Great Capitol Hill Baby Sitting Co-op Crisis" [PDF]
- DeLong, "The Financial Crisis of 2007-2009: Understanding Its Causes, Consequences—and Its Possible Cures" [scribd]
- Krugman, *The Return of Depression Economics*
- Baker, Why Stimulus Won't Increase the Debt