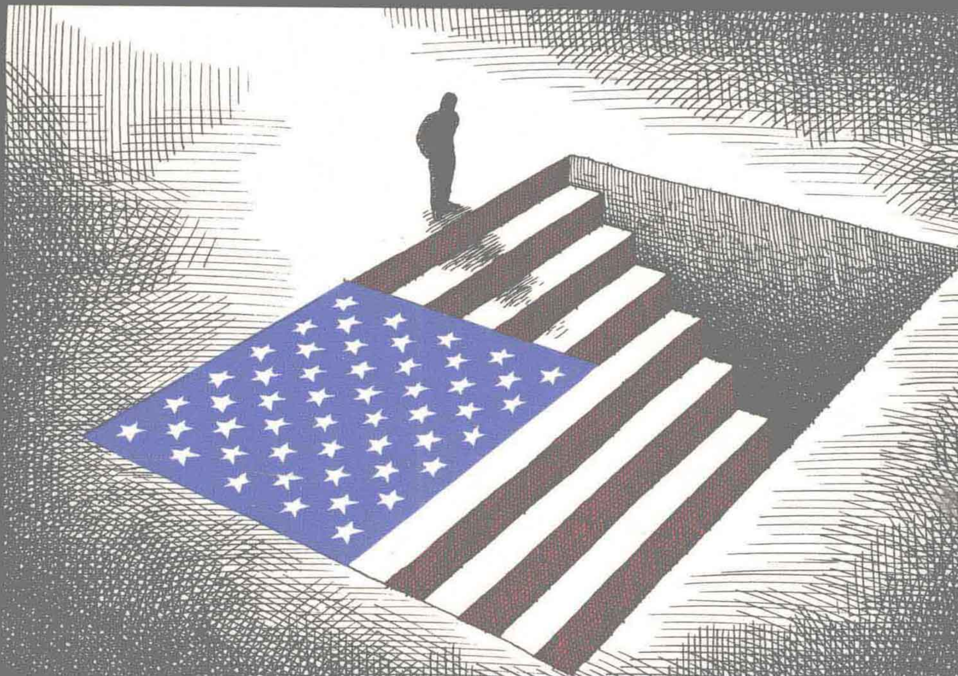
PAUL KRUGMA



THE

Age OF *DIMINISHE* EXPECTATION

EVISED AND UPDATED EDITI

The Age of Diminished Expectations

U.S. Economic Policy in the 1990s

revised and updated edition

Paul Krugman

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The Age of Diminished Expectations

Foreword

Today economic writing is better than ever it used to be. But now there is so much of it—often arguing at cross-purposes—that you as an intelligent and motivated reader are more up in the air than ever. What to do?

Needed is a competent guide, prepared by a tested and proved researcher, a briefing book to select the essentials for emphasis and sort them out in a good-sense way that will earn your confidence and understanding. That is a tall order. But Paul Krugman is the economist to try to do the job. And I see that he has succeeded wonderfully well.

I am proud of my generation of policy economists. You know their names: Walter Heller, Milton Friedman, John Kenneth Galbraith, Arthur Okun, Herbert Stein, Peter Drucker, and many more. But, as some sage has said, science progresses funeral by funeral. Paul Krugman is the rising star of this century and the next, and the world beats a path to his door. International finance is his thing, but that is only one of the many strings to his fiddle. The World Bank, the IMF, the Bank of Japan, and the Boston Fed—all seek to tap his fountain of wisdom and new ideas.

The Age of Diminished Expectations is a tour de force. To economists and noneconomists using it as a chart to navigate through the mysteries of inflation and recession, supply-side economics and productivity, floating exchange rates and bouncing stock markets, I say *Bon Voyage!*

Paul A. Samuelson
May 1990

Preface

There are three kinds of writing in economics: Greek-letter, up-and-down, and airport.

Greek-letter writing—formal, theoretical, mathematical—is how professors communicate. Like any academic field, economics has its fair share of hacks and phonies, who use complicated language to hide the banality of their ideas; it also contains profound thinkers, who use the specialized language of the discipline as an efficient way to express deep insights. For anyone without graduate training in economics, however, even the best Greek-letter writing is completely impenetrable. (A reviewer for the *Village Voice* had the misfortune to encounter some of my own Greek-letter work; he found "equations, charts, and graphs of stunning obscurity . . . a language that makes medieval scholasticism seem accessible, even joyous.")

Up-and-down economics is what one encounters on the business pages of newspapers, or for that matter on TV. It is preoccupied with the latest news and the latest numbers, hence its name: "According to the latest statistics, housing starts are up, indicating unexpected strength in the economy. Bond prices fell on the news . . . " This kind of economics has a reputation for being stupefyingly boring, a reputation that is almost entirely justified. There is an art to doing it well—there is a Zen of everything, even short-term economic forecasting. But it is unfortunate that most people think that up-and-down economics is what economists do.

Finally, airport economics is the language of economics bestsellers. These books are most prominently displayed at airport bookstores, where the delayed business traveler is likely to buy them. Most of these books predict disaster: a new great depression, the evisceration of our economy by Japanese multinationals, the collapse of our money. A minority have the opposite view, a boundless optimism: new technology or supply-side economics is about to lead us into an era of unprecedented economic progress. Whether pessimistic or optimistic, airport economics is usually fun, rarely well informed, and never serious.

But what is there for the intelligent reader who wants to be well informed but doesn't want to study for a Ph.D.? The answer, unfortunately, is not much.

In 1989 the *Washington Post* approached me with the idea of writing a short book about the U.S. economy that would be accessible to a nonprofessional public while maintaining intellectual quality. They envisioned this as a pilot for a series of briefing books on a variety of issues, from national defense to the environment, where the specialists and the educated public had ceased to speak a mutually intelligible language. This book is the result.

The title of the book, and its theme, came to me when I tried to put my finger on what airport economics gets wrong. The most important problem with the books at the newsstand, it seemed to me, is that they allow no middle ground between disaster and bliss. Either the economy is about to disintegrate or things will be wonderful—and since the economy rarely disintegrates, those people who are not in a doom-and-gloom mood will usually conclude that we are doing fine. Yet avoiding crisis and doing well are not the same thing.

The simple fact is that the U.S. economy is not doing well, compared with any previous expectation. In the late 1960s, nearly everyone expected the great postwar boom to continue. *Fortune,* for example, predicted in 1967 that real wages would increase by 150 percent by the year 2000. In fact, real wages are no higher now than they were at the time of the article. While a few Americans have prospered to an unprecedented extent, poverty in America has been increasing in both extent and severity. A persistent trade deficit has accelerated America's relative decline in the world economy, to the point where we may well be the third-ranked economic power by the end of this decade.

When will these disappointments come to a head? Quite possibly never—which is why airport economics is so misleading. One can have stability without progress, avoid a depression without achieving sustained economic growth. That has been the basic story of the U.S. economy since the early 1970s, and will probably be its story for the 1990s.

One might have expected that America's economic problems would have come to a head in another way, through the political process. Relative to what almost everyone expected twenty years ago, our economy has done terribly; surely one should have expected a drastic political reaction. I find the lack of protest over our basically dreary economic record the most remarkable fact about America today. Whether it is a sign of our political strength or weakness, it is astonishing how readily Americans have scaled down their expectations in line with their performance, to such an extent that from a political point of view our economic management appears to be a huge success.

This, then, is my theme. We live in an "age of diminished expectations," an era in which our economy has not delivered very much but in which there is little political demand that it do better. In this book I try to document both our economic failures and our successes. More important, I try to explain *why* we are not making more of an effort to do something about our disappointing economy—which comes down in large part to the painfulness of the measures that we would have to take if we were serious about making a difference. And I try to chart the eventual consequences of continuing our present policy.

Along the way this book tries to convey a number of things that professional economists know but that the broader public generally does not. It is important to understand why inflation is less costly to endure and more costly to stop than most people realize; why protectionism, while usually a bad thing, does not cause depressions; how the savings-and-loan debacle was created by misplaced free-market rhetoric. On these and other issues I have found that the simple truth is widely regarded as shocking and heretical.

I hope that America will eventually be roused from its slumber and once again begin to face up to problems instead of letting them slide. The beginning of action must, however, lie in understanding. This book is not a political tract or a call to arms. It is something rarer: an attempt to describe the way things are, and explain why.

Contents

Introduction

Bill Clinton's advisers knew what issue could win them the election, and to remind campaign workers they put up a celebrated sign in his Little Rock headquarters: "The economy, stupid." Four years earlier, George Bush was swept into office on a wave of economic contentment; in 1992 he was swept out by a pervasive sense among voters that something was very wrong with the American economy.

But what was bothering voters? The immediate problem was a lack of jobs. In 1990 a seven-year era of declining unemployment rates came to an end, and during the next few years news of major layoffs by once-proud companies became a daily feature of the nation's press. The job drought was particularly shocking because it affected groups and regions that had traditionally been insulated from economic distress. For the first time ever, more white-collar than blue-collar workers were unemployed; the major state most deeply stricken by the new unemployment was California, which once thought itself recession-proof.

Still, unemployment alone could not explain the deeply pessimistic public mood. Even at its peak in August 1992, the unemployment rate was only 7.7 percent, far short of the 10.7 percent peak reached during the previous recession of 1981–82.

By early 1993 the rate had dropped to 7 percent, no higher than in 1984, the year in which Ronald Reagan campaigned on the triumphant slogan "It's morning in America." It's true that any given unemployment rate feels much worse when the economy is on the way down than when it is on the way up, but still dismay over the U.S. economy was out of all proportion to the short-term economic setbacks.

What happened, of course, was that short-term bad news brought to a boil simmering dismay over long-term poor performance. Even during the long economic expansion from 1982 to 1990, the U.S. economy didn't deliver the kind of unambiguous economic progress that previous generations had taken for granted. Although some people became fabulously rich, and a sizable fraction of the population achieved unprecedented affluence, the typical American family and the typical American worker earned little if any more in real terms in 1990 than they did in the late 1970s. Indeed, for the median American worker there has been no increase in real take-home pay since the first inauguration of Richard Nixon. And for Americans in the bottom fifth of the income distribution the years since 1980 have been little short of nightmarish, with real incomes dropping, the fraction of the population in poverty rising, and homelessness soaring.

There are, of course, bright aspects to the picture. During the 1970s and 1980s the American economy was remarkably successful at generating jobs, absorbing the baby boom and the massive movement of women into the paid labor force without a bulge in unemployment. Inflation, which seemed out of control in the 1970s, has subsided to a level that generates little discomfort. An impressive export boom in the late 1980s shrank the massive trade deficits that had created fears of economic crisis in the mid-1980s. The U.S. economy is not without strengths.

Yet overall our economy has done far worse over the past 20 years than anyone would have predicted, and it didn't do much better in the 1980s than in the 1970s. As long as unemployment was falling, many people managed to hold on to a kind of tentative optimism. But as soon as jobs became scarce, a heavy majority of Americans came to agree with what economists had been saying for a long time: we have entered an era in which economic progress has become a doubtful thing. Many Americans feel that they live worse than their parents; even more fear that their children will be worse off than themselves.

In the first edition of this book I coined a name for this new era: the age of diminished expectations. The name has caught on, and is now widely used even by people who didn't read my book.

Although Americans now freely admit that something has gone wrong, there is still great confusion about what the problem is, even among those who try to follow public affairs. Many concerned people are convinced that our difficulties are primarily financial, and could be cured if only the budget deficit could be eliminated. Others are convinced that our problem is essentially one of international competition, from Japan and/or the Third World. There are even a few die-hard supply-siders, who think that if only George Bush had been more like Ronald Reagan the boom years from 1982 to 1989 might have gone on forever.

What even the would-be informed public seems to lack is a sense of how the various policy issues that fill the newspapers and talk shows fit together. During the 1992 campaign Ross Perot promised to fix the economy by "raising the hood and getting to work on it"; but woe to the auto mechanic who starts poking around without a good idea of how a car works! What do the budget deficit and health care costs have to do with the international competitive position of U.S. manufacturing? What does that competitive position have to do with real wages and income distribution? Not many people have a good sense of the

Figure 1
Inflation declined after 1980. . .

Figure 2
. . .and unemployment remained relatively low after its 1982 peak.

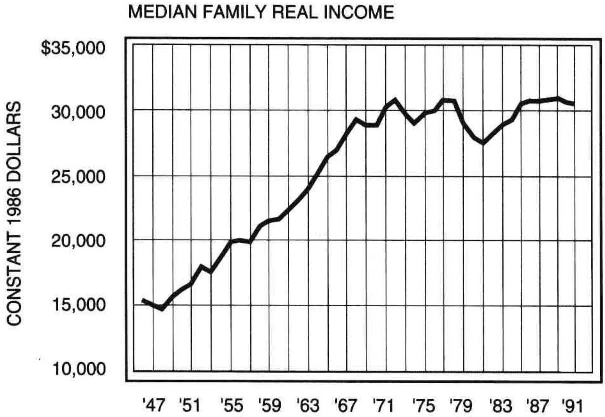

Figure 3
But the real income of typical families stagnated. . .

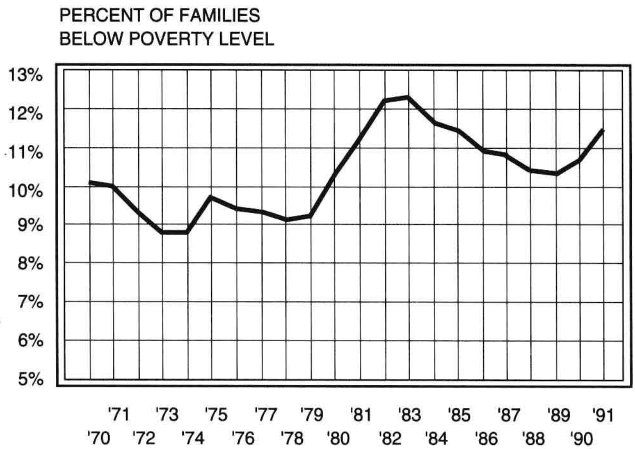

Figure 4
. . .and many more people were in poverty in the early 1990s than in the 1970s.