

Q&A with Paul R. Krugman on the Economy

The winner of the 2008 Nobel Prize for Economics—currently professor of economics and international affairs at the Woodrow Wilson School of Public and International Affairs at Princeton University and a *New York Times* columnist—discusses his insights on the current state of the economy.



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Financial institutions have received billions of dollars in bailout money that was supposed to melt the credit freeze. But the credit freeze continues, and it's affecting many companies and people, including real estate owners and investors. What is it going to take to get credit flowing again in the United States?

That's not an easy answer. If you look at some pieces, you see a little flow and less of a spread on high-quality corporate bonds and commercial paper. So, it's not as if nothing has happened.

Certainly, the bailout saved us from a worse situation. But we need to rebuild the capital in our financial system. [Large as they are,] the government injections through the government purchase of the stock of financial institutions still leaves those institutions undercapitalized.

So, we will probably see, temporarily, a lot of lending by the government. Most mortgage lending comes from Fannie and Freddie, which are effectively nationalized, although they are not being run that way. Mortgage rates have come down, but they are still high compared to the Treasury's cost of borrowing.

In effect, we are looking at partial temporary nationalization of the lending process. We have already moved in this direction. The U.S. Federal Reserve, for example, is buying commercial paper. Taxpayers own 80 percent of AIG. In our financial system, the public sector is lending to the private sector. That's a mitigation, not a solution, but it will help us get through until confidence returns.

When do you see confidence returning to financial systems?

No prediction. I am guessing that we will see some upturn in late 2009 because the economic stimulus will start arriving in force. But for the financial market, I cannot say for certain.

Is there a new crisis looming on the horizon with the potential collapse of commercial real estate markets? Rents are falling and vacancy rates are rising, so many owners don't have enough income to service their debt and pay other bills. Plus, owners cannot refinance their short-term loans. Even if the credit freeze unthaws, they will not have adequate income to justify a new loan.

The possible crisis in commercial real estate has been looming for quite some time, and it's been a widespread topic of discussion in the better blogs, like *Calculatedrisk.com*. To me, the surprise is, why has it taken so long?

A bubble formed in commercial real estate, just like housing. When the commercial real estate bubble bursts—and it was starting to happen in late 2008—it will be nasty. We worry about the effect of vacant houses on neighborhood property values. Soon, we will worry about gaping holes in shopping malls, empty office towers, and empty office and industrial parks.

Wouldn't the ramifications of a commercial real estate collapse have major consequences beyond huge losses for the property owners? Pension funds, insurance companies, and many others derive part of their income from these investments. If things got bad enough, could they face trouble in meeting their financial obligations?

Pension funds and insurance companies already have a lot of exposure from residential real estate. Commercial real estate, when all is said and done, is a smaller sector than residential, but it is another big hit on weakened balance sheets and markets.



The financial destruction from commercial real estate will be more limited because we now have got so much of a de facto nationalization in place to provide capital. We are better prepared for a crisis than in mid- to late 2008. We are probably not going to see as many surprises with a commercial real estate decline. This time I am not so much worried that we face near catastrophe, as happened after the collapse of Lehman Brothers in mid-September.

If the economic crisis originated with a collapse in housing prices and a rise in bad mortgages, should programs to boost housing be a key foundation of any eco-

conomic stimulus package? If so, what initiatives do you recommend?

The answer to your first question is no. You don't have to fill a flat tire through the hole. In 2006, we had an overblown housing sector, and it has imploded with many serious secondary consequences. Ending those secondary consequences doesn't require that we have an overblown market.

Crude calculations suggest that housing is still overvalued even now. By measures like all-important price/rent ratios, we are not back to pre-bubble 2000 levels. It's not clear how much we can do. We can bring mortgage rates down for new sales and refinancing, and avoid some of the foreclosures, and provide better workouts for troubled homeowners.

It's a widely held view that those programs are where the core of the economic stimulus will come from, but I don't share it.

What's your opinion of bailouts? Everybody wants one, including the commercial real estate industry.

We need to ask an important question: what are we trying to do? If you want to say no bailouts, no way, you must face up to the consequences. When Lehman Brothers collapsed in mid-September, many conservative commentators said that it was a good thing. The market was working. Today, we look back and we see that the failure to bail out Lehman almost destroyed the world as we know it.

But with bailouts, we shouldn't just hand them money with no questions asked. We must evaluate the benefits and make sure that government—and taxpayers—are getting a good deal. There's a lot to be said for buying shares in financial institutions to keep them up and running—to keep the larger financial system operating. Definitely.

In the case of bailouts for the automobile industry, that's a much tougher call, because the auto industry, specifically the Detroit auto companies, may not be viable. We know that when the dust settles from the current crisis, we will still have a financial system. When the dust settles on the auto industry, we don't know if the Big Three will survive.

With the auto bailouts, we may be setting the stage for an orderly bankruptcy. What you really want to do here is a Chapter 11 bankruptcy, where you can abrogate contracts to manage the legacy costs. The point with the auto industry—and why I think that something must be done—is that you cannot do Chapter 11 reorganization. They won't have

the financing to operate day to day under Chapter 11. But they will have very short-term financing to get through each day right now. Without those funds, they could not.

Plus, the problem with autos, as opposed to airline tickets, is [that] you don't buy a car from a company that might not exist soon. If you want to give the Detroit automakers a chance to exist, you must give government warranties that the car will be serviced, no matter what happens. We are talking about a fairly elaborate package to achieve the functional equivalent of a conventional Chapter 11—a lot of government involvement. The point is, in late 2008 and early in January, we were not able to get a package together with a lame-duck president and lame-duck Congress. The loans, given at the end of 2008, were simply to kick the can down to the next administration.

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President Obama has promised to go through the federal budget line by line to remove waste so that we have adequate funds for the economic stimulus package and other essential programs. What would you cut from the budget?

Oh boy. We know there is a lot of junk in the military budget—stuff that is not contributing to the national security. I get cynical about waste, fraud, and abuse—not because it doesn't happen, but because any large organization has waste, fraud, and abuse, and it's not that easy to make it disappear. When people start ranting about government waste, the examples are stupid and small, like John McCain going on about earmarks that were real and outrageous, but ludicrously small amounts of money.

Since Obama is planning to be a big spender, the burden of proof is on him to be more careful about spending. Presumably, Obama isn't

promising to go through the budget line by line personally. Somebody—many people—will have plenty to do.

The Obama Administration is proposing a huge infrastructure program as part of its larger economic stimulus package. How long will it take for the infrastructure program to have any kind of impact on the economy? Can we spend so much money, so fast, in a smart way?

Will it be a large program? Yes. Optimal fiscal stimulus would be getting us back to full employment. Then you try to figure out how big the program should really be.

Timing and speed are tough—really tough. We have very limited quick options. We only have a limited supply of truly shovel-ready projects ready to break ground in six months, so peak employment and spending are down the road. It's very hard to get a huge infrastructure program going on short notice. It's not easy to roll out.

So, the Obama Administration will be forced to have other economic stimulus programs besides infrastructure as part of its first-year actions. The Administration cannot spend so quickly that it won't be done properly to achieve economic goals. They have been told this. Indiscriminate spending will be a problem politically, so they must be careful.

A large part of Year One will consist of two things. First, aid to state and local governments. Most state governments are cutting their budgets because tax receipts are falling and because they—unlike the federal government—typically must balance their budgets. Those cuts are dragging down the national economy. Aid from Washington will enable states to keep good programs, which generate jobs, too. Aid will also allow states to keep their own infrastructure projects going. It takes time to start a project. It's faster to keep projects going rather than put everything on hold, as California did with its construction projects in late 2008.

The second thing that the Obama Administration must do, which I don't much like, is significant tax cuts and rebates, because they *can* be done quickly.

The innovative infrastructure projects take time to study and prepare. We hope that this recession will be over by then. The Obama Administration faces a tension between its desire to do good things and the desire to get spending power out there fast. **UL**