



The Hangover Theory

Are recessions the inevitable payback for good times?

by Paul Krugman

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A few weeks ago, a journalist devoted a substantial part of a profile of yours truly to my failure to pay due attention to the "Austrian theory" of the business cycle—a theory that I regard as being about as worthy of serious study as the phlogiston theory of fire. Oh well. But the incident set me thinking—not so much about that particular theory as about the general worldview behind it. Call it the overinvestment theory of recessions, or "liquidationism," or just call it the "hangover theory." It is the idea that slumps are the price we pay for booms, that the suffering the economy experiences during a recession is a necessary punishment for the excesses of the previous expansion.

The hangover theory is perversely seductive—not because it offers an easy way out, but because it doesn't. It turns the wiggles on our charts into a morality play, a tale of hubris and downfall. And it offers adherents the special pleasure of dispensing painful advice with a clear conscience, secure in the belief that they are not heartless but merely practicing tough love.

Powerful as these seductions may be, they must be resisted—for the hangover theory is disastrously wrongheaded. Recessions are not necessary consequences of booms. They can and should be fought, not with austerity but with liberality—with policies that encourage people to spend more, not less. Nor is this merely an academic argument: The hangover theory can do real harm. Liquidationist views played an important role in the spread of the Great Depression—with Austrian theorists such as Friedrich von Hayek and Joseph Schumpeter strenuously arguing, in the very depths of that depression, against any attempt to restore "sham" prosperity by expanding credit and the money supply. And these same views are doing their bit to inhibit recovery in the world's depressed economies at this very moment.

The many variants of the hangover theory all go something like this: In the beginning, an investment boom gets out of hand. Maybe excessive money creation or reckless bank lending drives it, maybe it is simply a matter of irrational exuberance on the part of entrepreneurs. Whatever the reason, all that investment leads to the creation of too much capacity—of factories that cannot find markets, of office buildings that cannot find tenants. Since construction projects take time to complete, however, the boom can proceed for a while before its unsoundness becomes apparent. Eventually, however, reality strikes—investors go bust and investment spending collapses. The result is a slump whose depth is in proportion to the previous excesses. Moreover, that slump is part of the necessary healing process: The excess capacity gets worked off, prices and wages fall from their excessive boom levels, and only then is the economy ready to recover.

Except for that last bit about the virtues of recessions, this is not a bad story about investment cycles. Anyone who has watched the ups and downs of, say, Boston's real estate market over the past 20 years can tell you that episodes in which overoptimism and overbuilding are followed by a bleary-eyed morning after are very much a part of real life. But let's ask a seemingly silly question: Why should the ups and downs of investment demand lead to ups and downs in the economy as a whole? Don't say that it's obvious—although investment cycles clearly *are* associated with economywide recessions and recoveries in practice, a theory is supposed to *explain* observed correlations, not just assume them. And in fact the key to the Keynesian revolution in economic thought—a revolution that made hangover theory in general and Austrian theory in particular as obsolete as epicycles—was John Maynard Keynes' realization that the crucial question was *not* why investment demand sometimes declines, but why such declines cause the whole economy to slump.

Here's the problem: As a matter of simple arithmetic, total spending in the economy is necessarily equal to total income (every sale is also a purchase, and vice versa). So if people decide to spend less on investment goods, doesn't that mean that they must be deciding to spend more on consumption goods—implying that an investment slump should always be accompanied by a corresponding consumption boom? And if so why should there be a rise in unemployment?

Most modern hangover theorists probably don't even realize this is a problem for their story. Nor did those supposedly deep Austrian theorists answer the riddle. The best that von Hayek or Schumpeter could come up with was the vague suggestion that unemployment was a frictional problem created as the economy transferred workers from a bloated investment goods sector back to the production of consumer goods. (Hence their opposition to any attempt to increase demand: This would leave "part of the work of depression undone," since mass unemployment was part of the process of "adapting the structure of production.") But in that case, why doesn't the investment boom—which presumably requires a transfer of workers in the opposite direction—also generate mass unemployment? And anyway, this story bears little resemblance to what actually happens in a recession, when every industry—not just the investment sector—normally contracts.

As is so often the case in economics (or for that matter in any intellectual endeavor), the explanation of how recessions can happen, though arrived at only after an epic intellectual journey, turns out to be extremely simple. A recession happens when, for whatever reason, a large part of the private sector tries to increase its cash reserves at the same time. Yet, for all its simplicity, the insight that a slump is about an excess demand for money makes nonsense of the whole hangover theory. For if the problem is that collectively people want to hold more money than there is in circulation, why not simply increase the supply of money? You may tell me that it's not that simple, that during the previous boom businessmen made bad investments and banks made bad loans. Well, fine. Junk the bad investments and write off the bad loans. Why should this require that perfectly good productive capacity be left idle?

The hangover theory, then, turns out to be intellectually incoherent; nobody has managed to explain why bad investments in the past require the unemployment of good workers in the present. Yet the theory has powerful emotional appeal. Usually that appeal is strongest for conservatives, who can't stand the thought that positive action by governments (let alone—horrors!—printing money) can ever be a good idea. Some libertarians extol the Austrian theory, not because they have really thought that theory through, but because they feel the need for some prestigious alternative to the perceived statist implications of Keynesianism. And some people probably are attracted to Austrianism because they imagine that it devalues the intellectual pretensions of economics professors. But moderates and liberals are not immune to the theory's seductive charms—especially when it gives them a chance to lecture others on their failings.

Few Western commentators have resisted the temptation to turn Asia's economic woes into an occasion for moralizing on the region's past sins. How many articles have you read blaming Japan's current malaise on the excesses of the "bubble economy" of the 1980s—even though that bubble burst almost a decade ago? How many editorials have you seen warning that credit expansion in Korea or Malaysia is a terrible idea, because after all it was excessive credit expansion that created the problem in the first place?

And the Asians—the Japanese in particular—take such strictures seriously. One often hears that Japan is adrift because its politicians refuse to make hard choices, to take on vested interests. The truth is that the Japanese have been remarkably willing to make hard choices, such as raising taxes sharply in 1997. Indeed, they are in trouble partly because they insist on making hard choices, when what the economy really needs is to take the easy way out. The Great Depression happened largely because policy-makers imagined that austerity was the way to fight a recession; the not-so-great depression that has enveloped much of Asia has been worsened by the same instinct. Keynes had it right: Often, if not always, "it is ideas, not vested interests, that are dangerous for good or evil."