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The Bubble Next Time

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Peter Boone is chairman of Effective Intervention, a charity based in Britain, and a research associate at the Center for Economic Performance, London School of Economics. Simon Johnson, a professor of entrepreneurship at M.I.T.'s Sloan School of Management, is the former chief economist at the International Monetary Fund.

Ben Bernanke gave a great speech in 2002, mapping out exactly what the Fed should do if the United States faced a deflationary price spiral — falling wages and prices — that could wreak havoc on the economy. He outlined a series of steps: starting with lowering short-term interest rates to zero, then making purchases of longer-dated Treasury securities, then purchasing securities issued by Fannie Mae and Freddie Mac. All of this is has come to pass since mid-2007. Surely, Mr. Bernanke was well prepared for the crisis, and is a shoo-in to be reappointed as chairman of the Fed early in 2010.

But is this the right version of history? Mr. Bernanke's speech focused on how to resolve Japan's deflation — the aftermath of Japan's rapid credit expansion in the 1980s. During the 1990s, Japan was saddled with lower real estate prices, banks had many toxic assets, and consumers and companies wanted to save rather than spend.

The United States did not have those problems in 2002, but it did by 2007. Why? In part because of our great 2001-02 fear of deflation, articulated by Mr. Bernanke and acted on by Mr. Greenspan. The Fed lowered rates to 1 percent for almost two years — to universal acclaim from our financial sector, which made great profits under such conditions. Those low rates ignited a new credit bubble to replace the old dot-com bubble, and from 2002 to 2007 the American consumer and home builder pulled us out of a downturn and up to the edge of a new cliff.

The next global bubble is already under way. What happens when the most powerful nation in the world, with a reserve currency everyone trusts and holds, decides to push a big credit expansion — again, at the instigation of our financial sector? The creditworthy borrowers this time are not in the United States — they are in Asia, Latin America, and even Africa. They have little debt and great prospects; for a mere 1 percent per year they can borrow American dollars, spend the funds at home, and turn paper money into real assets. Every great bubble begins with a truly convincing shift in fundamentals.

In the 1990s this was called the "carry trade." You borrowed from the Japanese at 1 percent and bought anything outside Japan that yielded a bit more (including United States subprime mortgages). The coming American carry trade is the same thing: it weakens the dollar, lifts the economy out of recession through exports, and creates inflation that reduces the real value of our debts. This can last quite a while — both the Treasury and the Fed are sure that early attempts to tighten policy prevented serious recoveries in Japan in the mid-1990s and in the United States toward the end of the 1930s.

The balance of global power is shifting. Japan was perceived as a great powerhouse until 1990 — deflation, the lost decade, and demographic decline have ended that. America and Europe both have years ahead of low interest rates, balance-sheet problems, and sluggish growth. Brazil, China, South Korea, Russia and the like used to be called emerging markets; now they'll be known simply as the New Rich.

Perhaps this is the greatest foreign-aid package of all time. But are we re-establishing our global leadership, albeit in a strange way, or just throwing all pretense to strategic leadership out the window? And are we laying the foundation for a truly massive international debt crisis?