

Don't Look Down

By Paul Krugman

During the 1990's I spent much of my time focusing on economic crises around the world—in particular, on currency crises like those that struck Southeast Asia in 1997 and Argentina in 2001. The timing of such crises is hard to predict. But there are warning signs, like big trade and budget deficits and rising debt burdens.

And there's one thing I can't help noticing: a third world country with America's recent numbers—its huge budget and trade deficits, its growing reliance on short-term borrowing from the rest of the world—would definitely be on the watch list.

I'm not the only one thinking that. Lehman Brothers has a mathematical model known as Damocles that it calls “an early warning system to identify the likelihood of countries entering into financial crises.” Developing nations are looking pretty safe these days. But applying the same model to some advanced countries “would set Damocles' alarm bells ringing.” Lehman's press release adds, “Most conspicuous of these threats is the United States.”

O.K., let's run through some reassuring counterarguments.

First, economists are very good at devising models that would have predicted past crises, but each new crisis tends to happen where and when they didn't expect it. So even though our budget deficit is bigger relative to the economy than Argentina's in 2000, and our trade deficit is bigger relative to the economy than Indonesia's in 1996, our experience needn't be the same.

Second, nasty crises in third world countries have a lot to do with the fact that their debt is in foreign currency, usually dollars. As a result, when the peso or the rupiah plunges, debts explode while assets don't, and balance sheets collapse. By contrast, thanks to the special international role of the dollar, America's burgeoning foreign debt is in our own currency.

Finally, financial markets are generally willing to give advanced countries the benefit of the doubt. Even when an advanced country seems to be deep in a financial hole, lenders usually assume that it will somehow find the resources and political will to climb back out.

So is America safe, despite its scary numbers?

Third world countries typically suffer from institutional weaknesses. They have poor corporate governance: you can't trust business accounting, and insiders often enrich themselves at stockholders' expense. Meanwhile, cronyism is rampant, with close personal and financial links between powerful politicians and the very companies that benefit from public largesse. Luckily, in America we don't have any of these weaknesses. Oh, wait. . . . (Isn't that all history? No. According to *The Wall Street Journal*, we are again hearing warnings that “optimism is based on massaged earnings.”)

Still, there's no question that the U.S. has the resources to climb out of its financial hole. The question is whether it has the political will.

There is now a huge structural gap—that is, a gap that won't go away even if the economy recovers—between U.S. spending and revenue. For the time being, borrowing can fill that gap. But eventually there must be either a large tax increase or major cuts in popular programs. If our political system can't bring itself to choose one alternative or the other—and so far the commander in chief refuses even to admit that we have a problem—we will eventually face a nasty financial crisis.

The crisis won't come immediately. For a few years, America will still be able to borrow freely, simply because lenders assume that things will somehow work out.

But at a certain point we'll have a Wile E. Coyote moment. For those not familiar with the Road Runner cartoons, Mr. Coyote had a habit of running off cliffs and taking

several steps on thin air before noticing that there was nothing underneath his feet. Only then would he plunge.

What will that plunge look like? It will certainly involve a sharp fall in the dollar and a sharp rise in interest rates. In the worst-case scenario, the government's access to borrowing will be cut off, creating a cash crisis that throws the nation into chaos.

I know: it all sounds unbelievable. But would you have believed, three years ago, that the U.S. budget would plunge so quickly from a record surplus to a record deficit? And would you have believed that, confronted with that plunge, our leaders would offer excuses rather than solutions?