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Baby-Sitting the Economy

The baby-sitting co-op that went bust teaches us something that could save the world.

By Paul Krugman

Posted Monday, Oct. 13, 2008, at 11:24 AM ET

*Paul Krugman, who won the Nobel Memorial Prize in Economic Sciences today for his work on international trade patterns, was the lead economics columnist for **Slate** from the magazine's launch in 1996 to 1999, when he became a columnist for the* New York Times*. His "Dismal Science" column covered everything from puzzling economics of ticket scalping to the tenacity of supply-side economics in presidential campaigns. One particular favorite, which was included in **Slate**'s 10th-anniversary anthology, is "Baby-Sitting the Economy," a column about what a failed baby-sitting cooperative in Washington, D.C., can teach us about a global economic crisis. The article is reprinted below.*

Twenty years ago I read a story that changed my life. I think about that story often; it helps me to stay calm in the face of crisis, to remain hopeful in times of depression, and to resist the pull of fatalism and pessimism. At this gloomy moment, when Asia's woes seem to threaten the world economy as a whole, the lessons of that inspirational tale are more important than ever.

The story is told in an article titled "Monetary Theory and the Great Capitol Hill Baby-Sitting Co-op Crisis." Joan and Richard Sweeney published it in the *Journal of Money, Credit, and Banking* in 1978. I've used their story in two of my books, *Peddling Prosperity* and *The Accidental Theorist*, but it bears retelling, this time with an Asian twist.

The Sweeneys tell the story of—you guessed it—a baby-sitting co-op, one to which they belonged in the early 1970s. Such co-ops are quite common: A group of people (in this case about 150 young couples with congressional connections) agrees to baby-sit for one another, obviating the need for cash payments to adolescents. It's a mutually beneficial arrangement: A couple that already has children around may find that watching another couple's kids for an evening is not that much of an additional burden, certainly compared with the benefit of receiving the same service some other evening. But there must be a system for making sure each couple does its fair share.

The Capitol Hill co-op adopted one fairly natural solution. It issued scrip—pieces of paper equivalent to one hour of baby-sitting time. Baby sitters would receive the appropriate number of coupons directly from the baby sittees. This made the system self-enforcing: Over time, each couple would automatically do as much baby-sitting as it received in return. As long as the people were reliable—and these young professionals certainly were—what could go wrong?

Well, it turned out that there was a small technical problem. Think about the coupon holdings of a typical couple. During periods when it had few occasions to go out, a couple would probably try to build up a reserve—then run that reserve down when the occasions arose. There would be an averaging out of these demands. One couple would be going out when another was staying at home. But since many couples would be holding reserves of coupons at any given time, the co-op needed to have a fairly large amount of scrip in circulation.

Now what happened in the Sweeneys' co-op was that, for complicated reasons involving the collection and use of dues (paid in scrip), the number of coupons in circulation became quite low. As a result, most couples were anxious to add to their reserves by baby-sitting, reluctant to run them down by going out. But one couple's decision to go out was another's chance to baby-sit; so it became difficult to earn coupons. Knowing this, couples became even more reluctant to use their reserves except on special occasions, reducing baby-sitting opportunities still further.

In short, the co-op had fallen into a recession.

Since most of the co-op's members were lawyers, it was difficult to convince them the problem was monetary. They tried to legislate recovery—passing a rule requiring each couple to go out at least twice a month. But eventually the economists prevailed. More coupons were issued, couples became more willing to go out, opportunities to baby-sit multiplied, and everyone was happy. Eventually, of course, the co-op issued too *much* scrip, leading to different problems ...

If you think this is a silly story, a waste of your time, shame on you. What the Capitol Hill Baby-Sitting Co-op experienced was a real recession. Its story tells you more about what economic slumps are and why they happen than you will get from reading 500 pages of William Greider and a year's worth of *Wall Street Journal* editorials. And if you are willing to really wrap your mind around the co-op's story, to play with it and draw out its implications, it will change the way you think about the world.

For example, suppose that the U.S. stock market was to crash, threatening to undermine consumer confidence. Would this inevitably mean a disastrous recession? Think of it this way: When consumer confidence declines, it is as if, for some reason, the typical member of the co-op had become less willing to go out, more anxious to accumulate coupons for a rainy day. This could indeed lead to a slump—but need not if the management were alert and responded by simply issuing more coupons. That is exactly what our head coupon issuer Alan Greenspan did in 1987—and what I believe he would do again. So as I said at the beginning, the story of the baby-sitting co-op helps me to remain calm in the face of crisis.

Or suppose Greenspan did not respond quickly enough and that the economy did indeed fall into a slump. Don't panic. Even if the head coupon issuer has fallen temporarily behind the curve, he can still ordinarily turn the situation around by issuing more coupons—that is, with a vigorous monetary expansion like the ones that ended the recessions of 1981-82 and 1990-91. So as I said, the story of the baby-sitting co-op helps me remain hopeful in times of depression.

Above all, the story of the co-op tells you that economic slumps are not punishments for our sins, pains that we are fated to suffer. The Capitol Hill co-op did not get into trouble because its members were bad, inefficient baby sitters; its troubles did not reveal the fundamental flaws of "Capitol Hill values" or "crony baby-sittingism." It had a technical problem—too many people chasing too little scrip—which could be, and was, solved with a little clear thinking. And so, as I said, the co-op's story helps me to resist the pull of fatalism and pessimism.

But if it's all so easy, how can a large part of the world be in the mess it's in? How, for example, can Japan be stuck in a seemingly intractable slump—one that it does not seem able to get out of simply by printing coupons? Well, if we extend the co-op's story a little bit, it is not hard to generate something that looks a lot like Japan's problems—and to see the outline of a solution.

First, we have to imagine a co-op the members of which realized there was an unnecessary inconvenience in their system. There would be occasions when a couple found itself needing to go out several times in a row, which would cause it to run out of coupons—and therefore be unable to get its babies sat—even though it was entirely willing to do lots of compensatory baby-sitting at a later date. To resolve this problem, the co-op allowed members to *borrow* extra coupons from the management in times of need—repaying with the coupons received from subsequent baby-sitting. To prevent members from abusing this privilege, however, the management would probably need to impose some penalty—requiring borrowers to repay more coupons than they borrowed.

Under this new system, couples would hold smaller reserves of coupons than before, knowing they could borrow more if necessary. The co-op's officers would, however, have acquired a new tool of management. If members of the co-op reported it was easy to find baby sitters and hard to find opportunities to baby-sit, the terms under which members could borrow coupons could be made more favorable, encouraging more people to go out. If baby sitters were scarce, those terms could be worsened, encouraging people to go out less.

In other words, this more sophisticated co-op would have a central bank that could stimulate a depressed economy by reducing the interest rate and cool off an overheated one by raising it.

But what about Japan—where the economy slumps despite interest rates having fallen almost to zero? Has the baby-sitting metaphor finally found a situation it cannot handle?

Well, imagine there is a seasonality in the demand and supply for baby-sitting. During the winter, when it's cold and dark, couples don't want to go out much but are quite willing to stay home and look after other people's children—thereby accumulating points they can use on balmy summer evenings. If this seasonality isn't too pronounced, the co-op could still keep the supply and demand for baby-sitting in balance by charging low interest rates in the winter months, higher rates in the summer. But suppose that the seasonality is very strong indeed. Then in the winter, even at a zero interest rate, there will be more couples seeking opportunities to baby-sit than there are couples going out, which will mean that baby-sitting opportunities will be hard to find, which means that couples seeking to build up reserves for summer fun will be even less willing to use those points in the winter, meaning even fewer opportunities to baby-sit ... and the co-op will slide into a recession even at a zero interest rate.

And this is the winter of Japan's discontent. Perhaps because of its aging population, perhaps also because of a general nervousness about the future, the Japanese public does not appear willing to spend enough to use the economy's capacity, even at a zero interest rate. Japan, say the economists, has fallen into the dread "liquidity trap." Well, what you have just read is an infantile explanation of what a liquidity trap is and how it can happen. And once you understand that this is what has gone wrong, the answer to Japan's problems is, of course, quite obvious.

So the story of the baby-sitting co-op is not a mere amusement. If people would only take it seriously—if they could only understand that when great economic issues are at stake, whimsical parables are not a waste of time but the key to enlightenment—it is a story that could save the world.

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We could move the story a bit closer to the way real economies work by imagining that couples could borrow and lend coupons; the interest rate in this infant capital market would then play the role that the "discount rate" of the co-op management plays in the text.

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Well, maybe not so obvious. The basic problem with the winter co-op is that people want to save the credit they earn from baby-sitting in the winter to use in the summer, even at a zero interest rate. But in the aggregate, the co-op's members *can't* save up winter baby-sitting for summer use. So individual efforts to do so end up producing nothing but a winter slump.

The answer is to make it clear that points earned in the winter will be devalued if held until the summer—say, to make five hours of baby-sitting credit earned in the winter melt into only four hours by summer. This will encourage people to use their baby-sitting hours sooner and hence create more baby-sitting opportunities. You might be tempted to think there is something unfair about this—that it means expropriating people's savings. But the reality is that the co-op as a whole *cannot* bank winter baby-sitting for summer use, so it is actually distorting members' incentives to allow them to trade winter hours for summer hours on a one-for-one basis.

But what in the nonbaby-sitting economy corresponds to our coupons that melt in the summer? The answer is that an economy that is in a liquidity trap needs expected inflation—that is, it needs to convince people that the yen they are tempted to hoard will buy less a month or a year from now than they do today.

The diagnosis that Japan is in a liquidity trap—and proposals for inflation as a way out of this trap—has been widely publicized in the last few months. But they have had to contend with a deep-seated prejudice that stable prices are always desirable, that to promote inflation is to cheat the public out of its just reward for saving to create perverse and dangerous incentives. Indeed, some economists and commentators have tried to claim that despite all appearances, Japan is *not* in a liquidity trap, perhaps even that such a thing can't really happen. But the extended baby-sitting story tells us it can—and that inflation is actually the economically correct way out.

Paul Krugman writes a twice-weekly column for the New York Times *and is professor of economics and international affairs at Princeton University. His home page contains links to many of his other articles and essays.*

Article URL: http://www.slate.com/id/2202165/
