Revisiting times of economic crisis for an idea to resolve difference between fact and theory

The Return of Depression Economics and the crisis of 2008

Paul Krugman

Publisher: W. W. Norton, 2009
Price: 24.95$(US)
Pages: 224
ISBN: 978-0-393-07101-6

Reviewed by Tarandeep S Khurana

In this book Paul Krugman gives a lucid account of the entire major economic crisis from the period of ‘The Great Depression’ of the 1930s. Paul Krugman is the recipient of the 2008 Nobel Prize in Economics. He is a professor of economics and international affairs at Princeton University, and is the author of about twenty books. In this book complex economic terms and situations are described in a simple form so that readers with limited economic knowledge could also comprehend the theme of the book. The anecdotes used are practical and easy to understand. One of the common models used by the author to explain complex situations is that of ‘Baby Sitting Coop at Capitol Hill’. This model is used to explain demand and supply, recession, economic boom etc.

The book is divided into ten chapters. Each chapter is devoted to one crisis or the other. Quite often the wrong treatment of one crisis leads to a second subsequent crisis. Each crisis though being different is common in one way or the other. According to the author the collective failure of policy makers and their lack of foresight have contributed to impose each crisis on their respective nations. In the introduction of the book the author points out of what to expect in the book. The author points out that though the writing style is not serious, yet the content surely is.

In the first chapter- “The Central Problem Has Been Solved” the author says that due to the strong periods of growth experienced by global economy, most economists and policy makers were in a state of illusion that the ‘Great Depression’ like crisis won’t occur again. This was due to the spectacular success of capitalism. After the failure of communism in Soviet Union, capitalism was touted as the saviour of the world economy. This triumph made the policy makers naive enough to believe that no ill can occur again. So regulation gave way to economic imprudence.

The second chapter- “Warning Ignored: Latin America’s Crisis” deals with crisis in Latin America. According to the author this crisis could have been learning for the whole world. Yet wrong lessons were learned by the policy makers to make the saying ‘History Repeats Itself’ sound true. In the 1990s Latin American countries witnessed strong economic growths. However there was systemic failure of policy makers. Reforms were there but not in totality. Mexico for example took advantage of globalization but soon oligarchs took centre stage. Then the steep rise in Mexican currency ‘peso’ compounded the problem. This halted the economic growth as exports became uncompetitive. Mexican government did some damage control by devaluing its currency. However the speculators made a killing. Ultimately IMF and USA had to bail out Mexico. But it was more a strategic decision of US rather of any economic foresight.

The third chapter- “Japan’s Trap” gives an account of the Japan’s rise and subsequent fall of economy. Japan was once the second largest economy (currently it is China). It was tipped to surpass US economy. However the picture is not that rosy now. What went wrong or rather what could have been is what this chapter describes. It is learning for the whole world so as not to repeat the same mistakes. In two decades from a largely agricultural nation, Japan became the world’s largest exporter of steel and automobile. The success of Japan was due to good fundamentals-excellent basic education and high saving rate. However later it turned out ‘crony capitalism’ a hand in glove relationship between the government and the businessmen that fuelled the economic growth. It was soon realised that the economic growth was nothing but a bubble due to speculation in property prices financed by bank loans. A term ‘moral hazard’ is described in this chapter. It describes how creditors commit the mistake of lending to persons in hope of better returns without checking into the details of business plans. This is the common way by which private players swindle innocent small investors. Then Japan was in a state of ‘growth depression’. Japan did try to kick start its economy by resorting to Keynesian practices of social welfare. The government initiated projects in order to create jobs and demand be restored. But these steps proved to be too little and too late. From 2003 Japan is on the path of recovery; however the rate of growth is very low about 2%.

In the fourth chapter-‘Asia’s Crash’ the author describes the Asian Financial Crisis that gripped much of Asia beginning in July 1997. The crisis started in Thailand with the financial collapse of the Thai baht caused by the decision of the Thai government to float the baht, cutting its peg to the US dollar, after exhaustive efforts to support it in the face of a severe financial overextension that was in part real estate driven. At the time Thailand had acquired a burden of foreign debt that made the country effectively bankrupt even before the collapse of its currency. As the crisis spread, most of the Southeast Asia and Japan saw slumping currencies, devalued stock markets and other asset prices and a rise in private debt. Finally IMF the world’s lender of last resort intervened to bail out these countries. It was one of its kind intervention that was heavily influenced by US and the Asian countries had to tow IMF’s line of policies.

Chapter five – “The Policy Perversity” - This chapter starts with the description of period of 1930’s. Here the author gives an account of how Keynesian economies put the US economy on path of recovery after The Great Depression. According to Keynes, during a slump demand can be restored by Government intervention, by cutting taxes, increased spending and lowering interest rates. However the Asian crisis was escalated as the policy makers did not resort to such measures due to the Fear of Speculators. Further in this chapter, exchange rates are discussed – Fixed vis-à-vis Free Floating ( merits & demerits). An example of Australia is quoted, that how it escaped from this fate of its neighbouring countries. Its currency did fall, but investors reposed faith and its economy was back to the path.
of recovery. US and IMF were pursuing faulty policies of relying solely on investor sentiments and market confidence. Too much emphasis on the two factors caused Brazil to fall in a vicious cycle of allowing massive budget deficits and yet allowing higher interest rates & taxes and reduced government spending to continue. Infact the antithesis of Keynesian rule. The market confidence ruled the roost. In a way the crisis was further escalated.

In chapter six- “Masters of Universe” the economic crisis of the 1990s is described. It was the mischief of hedge funds that disturbed the markets world over. One of the biggest hedge funds was led by George Soros whose ‘Quantum Fund’ not only led caused the currency crisis of Britain but also disturbed the markets of Hong Kong. Malaysian markets were affected by the activity of these funds to such an extent that their Prime Minister had to intervene. These hedge funds indulged in massive speculation thereby wiping out the small scale investors. World over there was a demand to regulate these funds.

In the seventh chapter- “Greenspan’s Bubbles” the author describes the policies and decisions of Alan Greenspan who was the chairman of the Federal Reserve for about 18 years. He was responsible for the monetary policies of US during the period of high growth and dominance over world economy. The author criticises Greenspan as according to the author he should have been more proactive. Greenspan did not take the warnings of some economists who warned of a looming crisis. His inaction proved costly not only to US but to the whole world as the housing bubble spread to all quarters of the financial spectrum.

In chapter eight- “Banking in the Shadows” -the author describes how banking started with people who were dealing in jewellery. Then the banking reforms of 1913 are described. The author describes the concept of a new kind of banking system ‘shadow banking’ and how this shadow banking increased the ‘The Great Depression’. According to the author it was the unregulated expansion of the shadow banking systems that led to crisis for the financial system and economy as a whole.

Chapter nine- “The Sum of All Fears”. In this chapter the housing bubble in the US that lead to the present ‘World Economic Crisis’ is described. Here the complete genesis of how bad home loans (sub prime) and the subsequent fall in home prices led to the collapse of shadow banking system. Now there are no institutions left in the market to provide credit. All across the economy, some business were losing access to credit, while others found them paying higher interest rates as the Federal Reserves were trying to push rates down. Then the ‘Decoupling’ is described and how it has saved the world economy. The author describes that the crisis has now spread to all major economies of the world and the tipping point was the fall of ‘Lehman Brothers’.

Chapter ten “The Return of Depression Economics” –The final chapter tries to draw out the lessons that need to be learnt from the number of crisis discussed. In a way the author says that depression economics makes a stunning comeback. The author makes a strong case that the misdeeds of non regulated non banking institutions created the foundation of US economic crisis. The author says that at first the US economy should be put to the path to recovery and then the system as a whole be reformed and safeguards put in place so that past mistakes are not repeated.

On a final note the author highlights the true essence of Depression Economics. According to the author- Depression economics, is the study of situations where there is a free lunch, if we can only figure out how to get our hands on it, because there are unemployed resources that could be put to work. The true scarcity in Keynes’s world – and ours was therefore not of resources or even of virtue but of understanding.

The author wants a fresh set of ideas to be put into practice so that obsolete doctrines can be discarded and a vibrant system be made.

doi : 10.5214/ans.0972.7531.221213

Tarandeep S Khurana
Sri Guru Gobind Singh College of Commerce
(SGGSCC ) Delhi University, INDIA