



Book Review

The Return of Depression Economics and the Crisis of 2008

Paul Krugman. 2009. *The Return of Depression Economics and the Crisis of 2008*. New York: W. W. Norton & Company. 214 p. ISBN: 978-0-393-33780-8.

Paul Krugman is an economics professor at Princeton University and Nobel Prize winner for Economics in 2008. This book is an update of the author's 1999 edition which had been written to analyze the Asian financial crisis of the 1990s. In this 2009 edition, the author revises and updates the original work to explain the banking crisis, from a historical perspective. He constructs an easy-to-understand model of how the economy operates as framework for his analysis. The book's main message is that we need to review and learn from the Asian crisis because it was a dress rehearsal for the global financial crisis we face now. The current financial crisis has reached the core of the global financial system and its persistence has been destructive for the global financial system and banks that operate internationally. The introductory chapter is not so much about what happened as to why it happened. The book can be broadly divided into two sections. The first comprising chapters 1-4 provides a history of financial crises. The second comprising chapters 5-10 discusses how the modern global financial system evolved over time touching on the gold standard, IMF, hedge funds, Federal Reserve, Alan Greenspan, economic bubbles, regulation and deregulation, and the shadow banking system. Economic policy makers, Krugman argues, should relearn the "Keynesian compact" to enable them to pursue policies that allow market forces to work and to achieve full employment.

In Chapter 1, the author draws our attention to the interplay between economics and politics. The collapse of socialism had heralded a sense of triumphalism capitalism with the economic success of all the major industrialised countries. This is reflected in Robert Lucas' the presidential address at the American Economic Association Conference in 2003 in Washington D.C. that the "central problem of depression prevention has been solved for all practical purposes". A year later the Federal Reserve chairman said the same thing. Posner (2009) now argues that loose monetary policy and the deregulation of the banking system helped cause the current crisis, which he prefers to label as a "depression". Posner, a leading figure of the Chicago School of

Economics and an eminent jurist, has changed his views and is very critical of Lucas and his colleagues of the Chicago School who have pioneered such theories as the rational expectation theory and the efficient market hypothesis. It was the efficient-market hypothesis which provided the theoretical foundation for the deregulation of the banking system under Alan Greenspan. Gray (2010) points out that deregulating the financial system left banks free to speculate, often with reckless enthusiasm. The result was a build-up of toxic assets that threatened the entire banking system. Bailing out the banks shifted the burden of toxic debt to the state. Cooper (2008) argues that markets possess internal forces that are inherently unstable causing waves of credit expansion and asset inflation and rejects the model of steady state of market equilibrium. This is, therefore, also a rejection of Eugene Fama's assertion that the notion of market efficiency could not be rejected without simultaneously rejecting the idea of market equilibrium. Cooper rejects the efficient market hypothesis and advocates going back to the Keynesian basics.

Krugman opines that the economic trouble that Asia experienced a decade ago, and that we are all experiencing, is precisely the sort of thing we thought we had learned to prevent. But then in the 1990s, economic problems reminiscent of the Great Depression had popped up in a number of countries including Japan. He describes those events and draws analogies to help readers understand the economic reasoning of the boom-bust cycle of capitalism. The lesson is bad things can happen to good economies.

In the next chapter, Krugman provides the chronology of events in the 1990s starting with the tequila crisis in 1995 when Mexico experienced a 7% decline in real GDP and a 15% decline in industrial output. The crisis spread to other Latin American countries and severely affected Argentina. Sweeping economic reforms were introduced in the mid 1980s in Mexico and in the late 1980s in Argentina. However there was the question of appropriateness of the exchange rate given the economic circumstances prevailing by the end of 1993 in both Mexico and Argentina. Their currencies were overvalued. Krugman refers to Dornbusch and others who argued for a devaluation of peso – a onetime sufficient reduction of the dollar value of the peso, which would get the economy moving, as happened with the British pound in 1992 that turned a recession into a boom. Mexico eventually devalued the currency but not big enough to stem the speculative tide. Argentina with a currency board that the government thought would insulate the economy from the vagaries of speculation also fell victim to currency speculation. As a result of the crisis both Mexico

and Argentina went from euphoria to terror. Krugman explains how it all happened.

In Chapter 3, Krugman deals with the world's second (now third after the U.S. and China) largest economy, Japan. He provides an overview of the emergence of Japan as an economic power and the expansion and collapse of the bubble economy. Japan was a creditor nation but spent most of the 1990s in slow to negative growth. Japan went through a decade – long growth recession verging on growth depression. The economy continued to stagnate but without panic. Krugman is telling us that a country can experience a recession even with the economy appearing to be sound, the result of lack of growth in money supply or more precisely a liquidity trap, which so depressed the economy that even zero interest rates failed to stimulate the economy. His solution is for Japan to increase money supply to stir inflation. This would lead to a fall in the real value of money over time. The expected inflation would encourage people to spend more and get the economy moving. There are two issues to consider related to his prescription: (i) The expected rate of inflation ought to be high enough for Japanese consumers expectation to change to spend more given their proclivity to save. The question is how high should that be? (ii) Once inflation has done its job, taming it may result in a period of recession before the economy can get moving again.

The next chapter analyzes the Asian financial crisis in 1997 with the devaluation of the Thai Baht, which triggered a chain reaction of currency crises affecting much of Asia. Thailand started to become a newly industrializing economy in the 1980s with foreign investment primarily from Japan and the economy recording impressive growths. Much of the investment, however, came from the savings of the Thais themselves. During the 1990s Thailand's financial self-sufficiency started to erode mainly because of external events. A combination of a changing political landscape in Europe and economic landscape in Latin America made investment in third world countries (now called "emerging markets") respectable. Capital started to flow into Thailand and other emerging Asian markets, mainly from Japan and Europe to take advantage of higher interest returns. Money pouring in fuelled a massive expansion of credit resulting in a wave of investment, some on actual investment in residential and office buildings but a large proportion in pure speculation, mainly in real estate and stocks.

Krugman points out that by early 1996, the economies of Southeast Asia were starting to bear a strong resemblance to Japan's "bubble economy" of the 1980s. To curb the speculative boom, central banks tried to sterilise the capital inflows, but the effort failed and credits kept on

growing. The policy to maintain a fixed exchange rate prevented an adjustment in the money market, in other words to let the baht rise. The government thought that a stronger baht would make Thai exports more expensive and that a stable exchange rate was good for business confidence. Soaring investment and a rising domestic demand led to a surge in imports with Thai exports becoming less competitive as production costs rose. The net result was a huge current account deficit which grew to 8% of GDP resembling Mexico before the tequila crisis.

The crisis that hit on July 2, 1997 was preceded by a slow down in speculative investments. Faced with extremely difficult policy options, the Thai government dithered. It would not allow the baht to depreciate or take harsh domestic measures to stem the loss of reserves. As reserves dwindled, the government wanted the reserve to look larger through unannounced currency swaps. That did not work either and on July 2, 1997, the government let the baht go as the central bank's reserves depleted. The currency went into a free fall. The baht price of a US dollar went up by 50 percent. A further fall in the value of baht was prevented by a sharp increase in interest rates. He ascribes such a fall to "panic". He puts the panic in the context of a feedback loop which may start with loss of confidence in the currency and the economy leading to investors pulling out of the country causing the baht to depreciate and then the central bank raising the interest rates and pulling the baht out of circulation to defend the currency. Higher interest rates made baht-denominated debt harder to service so that companies had to cut back on spending causing a recession. A decline in the currency's value would make dollar-denominated debt increase in term of baht, making it more onerous to service. The bad news spreads and meltdown begins. Foreign investors pulled out in panic and recession sets in.

Following the Thai baht, Malaysia's ringgit took a battering while Indonesia within three months of Thailand's devaluation was in worse shape than the rest of Southeast Asia. It was one of the worst economic slumps in world history. The crisis spread all the way to South Korea. Krugman points out the one thing these economies had in common: susceptibility to self-validating panic. They had become more vulnerable partly because they had opened up their financial markets and become better free market economies. They had also grown vulnerable by running up huge debts to the outside world. These debts intensified the feedback from loss of confidence to financial collapse and back again, making the vicious circle of crisis more intense. Unlike the old ones, the new debts were in dollar, which turned out to be the economies' undoing. However,

Krugman appears to be unable or unwilling to offer any specific prescription for these countries except to say that a government must act decisively in a financial crisis.

In Chapter 5, Krugman introduces us to how the modern global financial system evolved or for that matter not evolved. He says we now know enough to prevent economic slumps through what he describes as “Keynesian compact” which is normally honoured in most advanced economies. But deviation from such a compact appears to become the norm in dealing with emerging market economies’ economic problems. This happened at the behest of the IMF and the U.S. Treasury based on what is labelled as the Washington consensus. Why such a perverse policy? The answer is fear of speculators. He then provides a detailed analysis of the role of currency speculators in precipitating a financial crisis. As a result strengthening the market sentiment or restoring confidence has become the overriding policy objective and that’s how the Keynesian compact was thrown overboard. Countries faced with economic crisis were urged by Washington to raise interest rates, cut public spending and increase taxes. He then goes on to say that international economic policy ended up having very little to do with economics and becoming an exercise in amateur psychology.

The next chapter discusses hedge funds and their role in triggering a financial crisis. “Hedge funds do not hedge but more or less do the opposite.” He provides interesting details of their role in the Asian crisis and before that with the British pound and how George Soros triggered a run on the rouble. By 1999 the competition among hedge funds intensified to such an extent that they were not making enough money. The narrower profit opportunities that the hedge funds were willing to accept created a prelude to a serious financial crisis in which the Federal Reserve had to intervene in order to forestall a full scale panic when a very large hedge fund, LTCM, got into trouble.

He moves on to Alan Greenspan, the legendary chairman of the Federal Reserve in the following chapter. Greenspan was hailed as the greatest central banker in history but the 2008 crash changed all that and most people blamed him for the country’s woes. How did it happen the way it did? Krugman provides a detailed analysis of his fall. Greenspan’s tenure as chairman coincided with a period of good economic climate in the U.S.A. but that had little to do with his monetary policy but mostly with the surge in productivity. Greenspan did speculate that productivity growth might have changed the historic relationship between low unemployment and accelerating

inflation, using this to put off any interest rate rise. Those were good times in the U.S.A. with low unemployment and low inflation. Inflation was reined in by Greenspan's predecessor Paul Volker with tight monetary policies. Greenspan coined the term "irrational exuberance" and warned against it but did not do much about it. Shiller (2000) did forewarn about the bubble created by irrational investor behavior but no notice of such a warning was taken by the relevant authorities. When the stock bubble burst, the U.S. economy fell into a short recession but unemployment continued to rise even after the recession had officially been declared over. Greenspan brought down the Federal funds rate to just 1%, and eventually it worked but through the housing market. Low interest rates helped home buyers to take on larger mortgages, which in turn pushed house prices up. When the housing bubble burst, its consequences were worse than any one could have imagined. Krugman says the reason was the financial system has changed in ways nobody fully understood. Eslake (2009) argues that interest rates were kept too low for too long resulting in the development of an ever growing range of increasingly risky investment products to cater to the growing demand for them including subprime mortgages. The Economist (2010) also considers that cheap money led to the wholesale underpricing of risks. Greenspan is now calling for tighter banking regulation in several areas and canvasses a more expansive view of the state's role (Chan, 2010).

In Chapter 8, Krugman provides a brief history of how the modern banking system has developed and the panics that gripped the U.S. financial system from the 19th to the early 20th century. One bank's collapse led to another. To deal with banking panics the Federal Reserve was created in 1913 but it did not eliminate the threat of bank runs; the most severe banking crisis in history happened in the early 1930s. The response was to create a much safer system. The Glass-Steagall Act of 1933 separated banks into commercial banks which accepted deposits and investment banks which did not. Commercial banks were restricted in their ability to take risks, in return they had access to credit from the Federal Reserve and deposits were guaranteed by the Federal Deposit Insurance Corporation (FDIC). Investment banks were not tightly regulated. The 1999 repeal of the Glass-Steagall Act enabled commercial banks to get involved in investment banking and take more risks. There arose a set of institutions and arrangements that act as "non-bank banks" which Krugman calls the "shadow banking system". These, in many ways, act like banks but are beyond the regulatory control of the Federal Reserve. Krugman argues that these institutions are at the centre of triggering the current financial crisis. He suggests that anything

that does what a bank does should be regulated like a bank. However, some advocates of free market argue that the deposit guarantee scheme created a moral hazard thus causing the crisis. I think they are missing the point. As *The Economist* (2010) points out, in the absence of strict limits, higher leverage followed naturally from low interest rates. The debt of America's financial firms ballooned relative to the overall economy.

In the next chapter titled "The Sum of All Fears" Krugman recounts that by August 2007 the great financial crisis of the 21st century has begun to unfold and it took on features of everything seen before: a bursting real state bubble comparable to what happened in Japan at the end of the 1980s, a wave of bank runs comparable to those of the early 1930s except it mainly involved the shadow banking system, a liquidity trap in the U.S.A., again reminiscent of Japan, a disruption of international capital flows, and a wave of currency crises all too reminiscent of what happened to Asia in the late 1990s.

The great U.S. housing boom began to deflate in the autumn of 2005, but took some time for people to notice. The key rationale for the subprime lending was based on the assumption that home prices would continue to rise. As such credit worthiness of borrowers was not an issue. Modigliani and Miller (1958) defined the value of an asset as the discounted present value of cash flows to be derived from this asset in the future. Therefore as expectations for the future rise, so does the value of current assets. This is the logic behind the expansion of the subprime mortgage lending. As house price kept rising, the risk of lending even to borrowers with no credit standing disappeared. But when the home prices started falling, default rates began rising. At that point the ugly truth became apparent: loans could not be fully recouped. Loan rescheduling was also not possible as subprime loans were mostly not made by the banks but by loan originators who quickly sold those to financial institutions, who in turn sold them to investors as collateralised debt obligations (CDOs), leaving the management of loans to loan servicers who had neither the resources nor much incentive to restructure the loans.

Krugman believes that housing was overvalued by more than 50% by the summer of 2006. As the severity of the housing bust sank in, it became clear that lenders and investors of mortgage backed securities were going to lose a lot of money. It also triggered the collapse of the shadow banking system; businesses and individuals were finding it difficult to access credit. The author moves on to the international dimension of the crisis. Along with the growth of the shadow banking

system was the rise of financial globalization, with investors in a country holding large stakes in other countries. Another special point of vulnerability for the emerging markets was the so called “carry trade” which involved borrowing in countries with low interest rates and lending it in places with high interest rates, such as Brazil. Sheng (2009) illustrates how the Japanese zero interest rate to fight deflation contributed to the emergence of carry trade, which eventually led to the Asian crisis. The latest round of panic also hit the carry trade causing large capital losses, in some cases affecting hedge funds. The financial system is responsible for enabling the real economy to run more efficiently. As always, all financial crises negatively eventually affect the real economy.

Krugman closes with an upbeat assessment of the current crisis. He does not believe that the world economy is in depression or likely to be in a depression, but that depression economics has staged a comeback. Depression economics, as Krugman puts it, is the study of situations where there is a free lunch if only we can figure out how to get our hands on it, because there are unemployed resources that could be put to work. Krugman believes that the only important structural obstacles to world prosperity are the obsolete doctrines that clutter the minds of men. Krugman shows how the regulatory regime failed in its primary task in dealing with a financial system that went berserk leading to the greatest financial crisis since the 1930s. Krugman is appalled by how little we have learned from history and how we clung to economic orthodoxy. He laments the straying of the economics profession into amateur psychology delving more in investors' sentiment rather than practicing economics. Orthodox economists consolidated their position by claiming that they have the better understanding of market forces but the present crisis has reinforced the importance of the Keynesian compact to maintain a relatively stable market with low levels of unemployment. While Krugman brilliantly connected the present financial crisis with other financial crises, in particular with the 1930s depression, somehow he failed to connect the present crisis with other contemporary crises that have enormous economic significance such as food, energy and climate change. In particular, the role of speculative capital in agriculture and energy needs attention.

Krugman also failed to emphasise that the very high level of protectionism which marked the 1929-1932 period led to the breakdown of the global trading system. This rise in protectionism is believed to be a major contributing factor to the Great Depression and a hindrance to economic recovery. The U.S. pioneered in protectionism with the Smoot-Hawley Act, 1930. But the world

economy is now different. Under the auspices of GATT/WTO, there is a more open global trading environment. Another aspect that needs mentioning is the huge inflow of capital especially from China in recent years as a consequence of the U.S. running huge current account deficits. Bergsten (2009) argues that the huge inflows of foreign capital contributed to the low interest rates, excessive liquidity and loose monetary policies that – in combination with lax financial supervision – brought on the overleveraging and underpricing of risk that triggered the meltdown. Posner (2009) believes that excess savings flowing from Asia also contributed to the current crisis.

Given the complex nature of the financial systems in a globalized world with ever innovative financial products, there is always a possibility that something could go wrong with the systems. Policy makers must be ready to deal with them effectively when they do go wrong. But the book cites plenty of examples of policy responses that were ineffective, misguided or too little too late. Past banking crises have demonstrated that while some banks go bust others reform themselves. This also offers an opportunity to the regulators for self-reflection and to undertake appropriate reform measures to further strengthen the financial system. As *The Economist* (2010) points out rules will have to be both tightened and better enforced to avoid future crises, but all the reforms in the world will not guarantee total safety.

The book covers a wide range of countries in various stages of development and how each of them has been affected by major financial crises. At its core is the importance of learning lessons from the Great Depression. I believe the book makes an outstanding contribution to our understanding of financial crises. The book is a must read for those who are concerned with the financial crisis and its impacts on millions of people around the world. One may disagree with the certain aspects of his explanation and perspective on the history of financial crises. Nonetheless, the book can be a reference point for debate over policy responses to the crisis. Some of the chapters would be useful reading to stimulate discussions in undergraduate macro, international, financial or development economics.

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