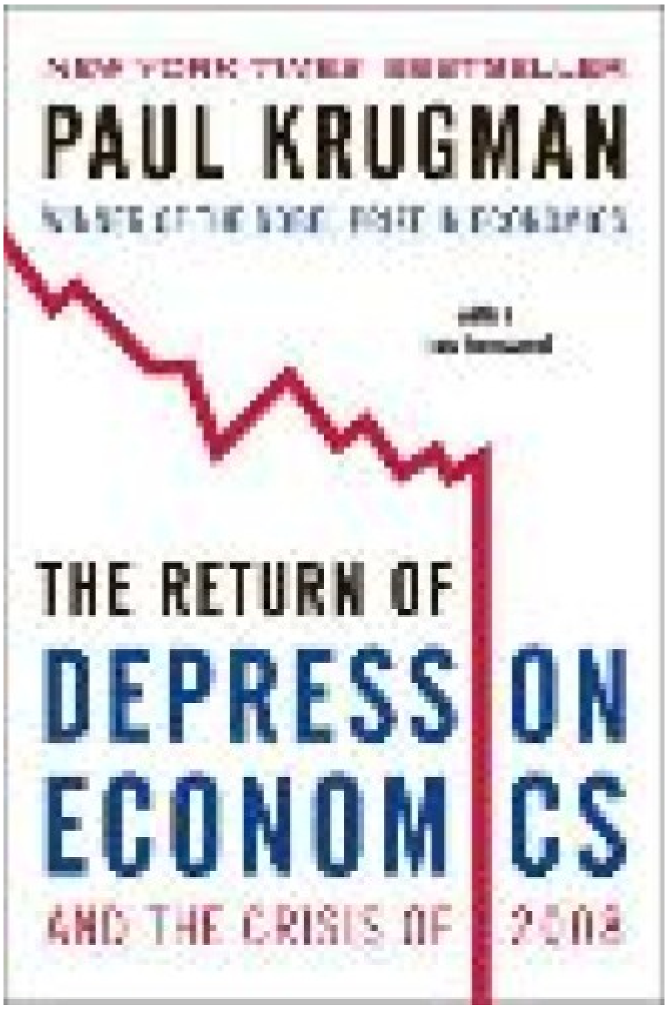
How the boom went bust

By James Halteman in the June 2, 2009 issue

In Review



The Return of Depression Economics and the Crisis of 2008

Paul Krugman
Norton

Paul Krugman is one economist who can analyze the complexities of an economic crisis, propose solutions and make the discussion intelligible to the general public. In ten chapters Krugman diagnoses the current economic disaster from a historical perspective, suggests solutions, and along the way teaches readers a great deal about how the economy works. After the Asian financial crisis of the late 1990s Krugman analyzed the world economy and the prospects for a return to a depression environment in a book called *The Return of Depression Economics*. The new volume is an updated version of that book from the perspective of the current world economic crisis.

Those who believe that free markets are self-adjusting mechanisms will be concerned about Krugman’s Keynesian policy suggestions. Others will wish for more targeted policy proposals, with an emphasis on how lower-income groups might be helped or how certain types of socially desirable consumption might be induced. Everyone who reads this book should benefit from the stories that help explain how we got where we are and how we might avoid future crises.

Krugman begins with an account of the triumphal march of capitalism since the fall of the USSR in the early 1990s. He tells how noisy critics were kept on the fringes as the lives of millions were at least somewhat improved. But there were inconvenient warning signs that kept popping up around the world. First came problems in Latin America stemming from financial mismanagement in Mexico and Argentina. Then financial and real economies in Japan and some parts of Asia nearly collapsed. Finally, the United States created an environment of unsustainable growth that led to asset-price bubbles and then a collapse into what is at best a recession. Krugman searches through these events to find the warning signs that we should have heeded and that we need to heed in the future. He suggests strategies for dealing with the crisis and offers hope that this will only be a bad recession and nothing worse.

In order to follow Krugman’s line of reasoning, it is important to recognize that free economies are complex and interconnected political organizations. An open economy must find ways to balance an array of factors, including foreign trade practices, domestic monetary and fiscal policy, currency ex change rates and investor confidence. All of these factors are coupled with the particular characteristics and history of a given country. Market capitalism assumes that most of the coordinating can take place automatically if given the chance, but political involvement in domestic monetary and fiscal policy cannot be avoided. Swings of optimism and fear have feedback loops that drive economic cycles, which do not correct themselves on their own—or correct themselves only after intolerable pain.

To generalize from the cases Krug man presents, a boom-and-bust cycle goes something like this: First, new technology, political stability or structural changes produce optimism that things will keep improving. Consumers and investors buy, and production expands. If public policy accommodates and encourages credit and spending, asset values rise, permitting more purchasing and borrowing, which drives production steadily upward. Exports and imports rise, and foreign capital links foreign assets in a web of interconnected accounts.

Speculators pump up demand in asset markets, fulfilling their own prophesy of appreciation and profit. In classic examples, stock and real estate assets are bought with smaller and smaller down payments. Then unregulated investment banks, hedge funds and all manner of financial intermediaries create instruments that leverage long-term loans with short-term savings. If something minor goes wrong in the system, small federal policy adjustments are expected to take care of the problem. If a massive collapse threatens, bailouts are likely because the financial intermediaries play an essential role in the system. The likelihood of bailouts bends the system toward the taking of unjustified risks.

When policy adjustments are either ill advised, late or ineffective, the entire system can unravel—as in the case of Latin America and Asia in the 1990s and the world economy today. The delicate balance of the components of the world economy is disturbed, making investors fearful and cautious. Short-term money flees to safe assets like U.S. Treasury bills, draining the resources of the lending firms whose assets, such as home mortgages, are long-term and illiquid. As asset values fall and loans go into default, the lending agencies fail. In the unregulated and uninsured financial institutions, sometimes referred to as the parallel banking system, savers create a run on the banks, salvaging what they can before the cash is gone. The flow of credit on which the economy depends rapidly dries up. Both the financial and the real economy start reeling out of control as major sectors all but collapse.

Some variation of this story ap peared in each of the cases Krug man describes, and it is instructive to observe how much could have been learned had leaders been attentive to the warning signs. It didn’t help that policies over the last few decades were piecemeal and failed to instill stability and confidence. All countries want their own monetary policy, stable exchange rates, and a business climate that allows the unrestricted buying and selling of currency. Only two of these three can be attained at once, and because each country looks out for its own interests first, global coordination is far from optimal.

After diagnosing the problems of the three crises of the past two decades and illustrating the policy mistakes made in those cases, Krugman closes with suggestions for limiting the current recession. First we must recognize that we are in a depression-type economy, which means that we are not demanding the amount of goods we can produce. This was the Keynesian diagnosis of the Great Depression of the 1930s. Supply-side economic policy, with its efforts to increase capacity, are irrelevant to this case, so policies like tax cuts for business are not the answer. Fiscal stimulus, with federal spending and tax cuts for consumers, is essential now, but it will be thwarted unless credit is available again from a trustworthy banking system. The unregulated banking sector that loaned out close to one-third of the credit in the country is virtually gone, and while commercial banks can still lend, they cannot make up for the lost portion of lending, so regulation should be extended to all operations that perform banking functions in order for trust to be restored.

True to his training in positive economic analysis, Krugman does not engage in moral reflection on the issues. He presents operators of risky hedge funds as misguided rather that greedy; contends that rather than excessively satisfying materialistic desires, consumers behaved rationally given the incentives; and says that policy makers, with rare exceptions, made bad decisions because they wanted quick and easy answers, not because they had devious goals. This leaves the reader to fill in the moral and ethical dimensions of the crisis. Krugman’s suggestions do provide a framework within which such reflection can proceed. Many Christians will advocate for government stimulus that promotes stewardship of creation, aid to the most needy, and incentives for responsible lifestyle choices.

This book is important for several reasons. First, it is written for a lay audience and gives readers a good feel for the complications of the global economy. Second, it places current problems in historical context and suggests what we can learn from previous cases. Third, it dissects our present dilemma and offers suggestions to help minimize the damage and prevent a depression.

For those who have never taken an economics course, it will take a while to grasp the mechanics of modern banking and the interconnectedness of interest rates, foreign trade and currency exchange rates. Economists may wish for more documentation and data to verify some of the claims. Those who still believe that supply-side policies work in a deep recession may be disappointed at the Keynesian proposals that Krugman offers. However, most will agree that given the global nature of the financial crisis and the depth of its impact on employment and output, the economy will not likely correct itself without significant fiscal and monetary policy intervention, coupled with more regulation of the parallel banking structure.