the return of depression economics and the crisis of 2008

By Paul Krugman
Penguin Books
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review rating

In 2008 Paul Krugman was awarded the Noble Prize in Economics and he is eminently qualified to tackle this daunting subject. He is a prolific writer, both in textual form (20 books and journal articles), and for the New York Times where he pens a twice weekly column. He is a professor of economics and international affairs at Princeton University.

This book has a very lively and punchy style and resonates as part of the foundation for Krugman's extensive lecturing on the subject matter. It is not redolent with formulae, or technical language – in fact quite the reverse. The author reverts to rather earthy comments that exhibit a degree of frustration with the ignorance of some contemporaries. Thus, towards the end at p 182, when dealing with the nature of Depression Economics, he describes supply side economics as a "crank doctrine" of "foolish ideas" and then to theoretical disputes within economics resulting in filtering out ideas in a "garbled form". It is this direct and lucid style that makes the heavy subject matter of this work, so readable.

As the title suggests, this work traces economic history and events from the Great Depression in the 1930s to the current crisis. He deals with each stage seriatim and in detail: from the Latin American crisis, to Japan's trap, to the Asian Crisis (where he is an acknowledged expert), to the banking practices of the later 80s that set the seeds of destruction, and then to Greenspan's bubbles (note the plural), the shadow banking system and then a fearful entry into the crisis. Strangely, and yet like so many other books in finance and economics, there is no clear cut statement of the writing cut-off date (eg, the law as stated to xxx). The book was published in 2008, and latest temporal reference I can see in the text is to October 2008, and hence Krugman takes us close to the crescendo of TARP, but not to the recovery in 2009. Interestingly, there is no reference to sovereign debt, which, on current observations, would appear to be the next phase of the crisis.

Krugman explicitly draws links and a common thread between the inexorable incidence of various economic crises, and his fundamental contention seems to be that we simply do not learn much from history. The first edition of this book was written in response to the Asian crisis in the 1990s, and he observes that the Asian crisis has turned out to be "a sort of rehearsal for the global crisis now in progress" – and that, notwithstanding that both crises were/are "precisely the sort of thing we thought we had learned to prevent". There was a high degree of confidence in the 80/90s, that whatever problems might occur (eg, he also deals with Mexico and the tequila crisis), they would not be anything like the magnitude of the 1920/30s. So much for preventative policies and the wisdom of central bankers. The current crisis, as for the Great Depression, hit us all out of the blue. This is the foundation for the opening chapter: "The central problem has been solved" wherein he refers to the declaration from Robert Lucas in 2003 that depression-prevention had been solved for all practical purposes. That was followed by Ben Bernanke (Krugman's former professor at Princeton), who in 2004 (ie, before he became Fed Chairman) gave a speech to the same effect titled "The Great Moderation", which implied that problems associated with the business cycle had been cured with available macro-economic policy options.

Importantly, the book is not simply a history lesson, it is an analytical tract about why these events happened, and this analysis is achieved in layman's terms. As he says: "one temptation that often afflicts writers on economics, especially when the subject is so grave, is the tendency to become excessively dignified". Mercifully he has avoided that.

In this opening chapter, Krugman introduces the reader to his Capitol Hill baby-sitting co-op (a mini economy), which he uses to good effect throughout the text to illustrate straightforward driving forces of supply and demand economics – broadly by using a barter system.

We are introduced to the infamous "bubble" concept when dealing with the Japan Trap, where the reader is reminded of the incredible asset inflation in Japan in the 1990s: eg at the beginning of the 1990s the market capitalisation of Japan's companies was larger than that of the US, which had twice the population and over twice Japan's GDP. This phenomenon is covered in considerable detail, and took me back to personal experiences in dealing with Japanese banks – then most of the AAA rated banks in the world. Krugman explains the global epidemic of moral hazard which preceded the Crash in 1987, and then the stealthy depression that followed in Japan.

Coverage of the Asian Financial crisis is masterful, in that it well explains just how quickly and devastatingly contagion can occur … and how hopeless it is to try to hide from it, as was the case in Malaysia. The impact of currency exchange rates, the agonising decisions governments had to face in relation to FX management, and all the issues that spin out of this are covered. If you need reminding of what a "classic currency crisis" is like when it is in full swing, look no further. And these laws of physics have not changed, as Europe is now being reminded. Krugman takes us through currency "meltdowns", eg, the 15% fall in the pound in one day, and above all the psychological forces that drive panic that "whatever sets them off, validates themselves – because the panic itself makes panic justified" the classic example being a bank run.

In "Policy Perversity" Krugman analyses some of the more difficult (to the lay reader) aspects of policy errors of the past decades, starting with the Keynesian compact. He explains the evolution of different currency regimes and how different countries have coped with this – with plaudits to Australia on how it used its effective floating exchange policy to avoid the Asian crisis. He then deals with the operations of the IMF and its critics, notably Jeffrey Sachs.

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Under the heading Masters of the Universe, there is a step-by-step tract on how George Soros attacked sterling, for those hedge funds who wish to engage in this activity. The chapter on Greenspan's Bubbles is an unforgiving account of why everything ended up going off the rails. Sure, credit is given for the handling of LTCM, but in the six years to the end of Greenspan's reign in 2006, some ominous seeds were planted, which most observers completely ignored – Robert Shiller being the notable exception. Matters were made worse by the widespread adulation and praise heaped on Greenspan when his term ended in 06.

Krugman explains what is generally understood to be the meaning of the "shadow banking system" and this leads nicely into the 07 crisis and how the banking collapse was managed, in macro terms, into late 08. He has the gift of communicating the fear that gripped markets, he feels for the misery, and takes shots at the causal identities and the folly that got us here. He is scornful of the fall of Lehman, and the dithering for three weeks before a reversal of the TARP strategy, ie to inject equity (like the Brits and Europeans) rather than buying troubled assets.

This book does not close with a grand plan to get us out of the hole. Rather, he retreats to the wisdom of Keynes, who observed at the start of the Great Depression, that: "We have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand". Krugman closes with a plea for financial reform (so as to ameliorate some of the blundering), and he rests his case by agreeing with Keynes that it is ideas "not vested interests, which are dangerous for good or evil."

Martin Earp
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