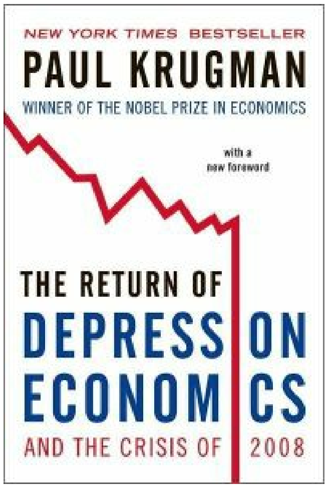

Book The Return of Depression Economics and the Crisis of 2008

Paul Krugman
W.W. Norton, 2008
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Recommendation

Nobel Laureate and economic scholar Paul Krugman investigates the forces that drive economic growth and recession. His ability to maintain the essence of a topic while simplifying complex economics with examples and analogies is a hallmark of his work. Despite its gloomy title, this book is not depressing, because Krugman concludes that another Great Depression is not looming. Capitalism has, overall, provided the foundation for prosperity in advanced and developing economies alike. Indeed, the information age has introduced entrepreneurs who have generated wealth while becoming romantic heroes for succeeding in spite of – or without the help of – giant corporations. However, Krugman stays alert for dark forces, warning against panic in the international financial markets, where multiplying negative feedback can overwhelm the effects of monetary policy. *BooksInShort* recommends Krugman's in-depth analysis to anyone with an interest in world economics and financial markets.

Take-Aways

- The crisis of 2008 will probably not develop into a 1930s-style depression.
- For the first time since WWII, "failures on the demand side of the economy" have become the greatest hazard to prosperity. This is depression economics at work.
- Excess supply, relative to demand, characterizes an economic slump.
- Recessions are normally caused by the public trying to accumulate cash and can usually be cured by printing money.
- Capitalism has redeveloped a romantic hero: the independent entrepreneur.
- Indecision in a financial crisis is deadly. The Thai government learned this in the mid-'90s.
- Southeast Asian countries are strongly tied together in the minds of investors. Negative perceptions regarding one country have a negative impact on all countries.
- Alan Greenspan's fiscal policies neither created nor prevented recent bubbles.
- Unregulated "shadow banks" were the main cause of the 2008 credit crisis.
- To ward off the economic downturn, governments must get credit flowing, and support and boost spending.

Summary

The Need to Want More

The global economy will not enter a depression reminiscent of the 1930s. However, a large part of the world must become sensitive to the forces of "depression economics," the types of fiscal problems not witnessed since the Great Depression. In fact, for the first time since World War II, low levels of economic demand, including insufficient private spending, have become the greatest hazard to prosperity for many economies.

The Success and Romance of Capitalism

The return of depression economics does not signal the failure of capitalism. In fact, depression economics has returned in the midst of the triumph of capitalism. The former Soviet Union – once the financier of worldwide socialist movements – has lost its ability to support other nations. Russia's economy is in a miserable state. In addition, Hong Kong's capitalist system, virtually untouched despite the island's return to China in 1997, shows the world that the free market is too valuable to destroy, even in the eyes of the People's Republic.

> "Economics inevitably takes place in a political context."

Not only has capitalism brought economic success and prosperity to many nations, it has developed a new kind of romantic hero. After Henry Ford, giant corporations dominated the economy. They were not run by romantic innovators, but by bureaucrats who might as well have been government officials. However, the information age now has created a renaissance of independent entrepreneurs whose heroic tales are chronicled in business magazines.

The Mechanics of an Economic Slump

Excess supply, relative to demand, characterizes an economic slump. Workers outnumber jobs and production capacity exceeds demand. Purchases of some goods may increase or decrease depending on shifts in preferences or costs, but it is less obvious why the overall demand for all goods might fall. Because the real economy is very complex, a simple analogy provides the best explanation.

> "Who can now use the words of socialism with a straight face? I can remember when the idea of revolution, of brave men pushing history forward, had a certain glamour. Now it is a sick joke."

A babysitting co-op was set up for 150 couples with young children. At the start, the organizers distributed a set number of coupons evenly among the families. When one couple babysat for another, they earned a coupon. After a certain period, members began to sense that there was a shortage of coupons in circulation. As a result, they became anxious to babysit in order to earn more coupons. At the same time, fewer members wanted to spend their coupons. Subsequently, opportunities to earn coupons diminished and the co-op entered a recession.

> "For the first time since 1917...the unpleasant aspects of a market system – inequality, unemployment, injustice – are accepted as facts of life."

The babysitting slump occurred due to a lack of effective demand, not due to poor quality babysitting, a change in babysitting technology or even corruption. The problem had two basic solutions. The first was to require each couple to go out at least twice a month. The second, preferred by economists, was to increase the supply of babysitting coupons. Upping the supply had magical results. Couples were more willing to go out, and the co-op generated more opportunities to babysit and earn more coupons. As a result, the gross babysitting product (the number of children babysat and parent outings) soared and the co-op enjoyed a high standard of living. The lesson: Recessions normally stem from the public trying to accumulate cash and can usually be cured by printing money.

The Asian Miracle

During the third quarter of the 20th century, the developed world saw the countries then known collectively as the Third World as economically backward, poor and hopeless. These countries were trapped in a pattern of exporting low-valued agricultural products and raw materials. Then a combination of globalization factors, such as reduced tariffs, improved telecommunications and less costly air transport, changed everything. Suddenly, a number of industries, particularly in Asia, found that the local availability of cheap labor offered them an adequate competitive advantage for breaking into world markets. This export-led economic growth resulted in very measurable standard-of-living benefits for many people. However, neither foreign aid nor the benign policies of national governments created this sudden increase in Asian economic growth. Instead, it grew from the rather selfish motivations of local entrepreneurs and multinational corporations who profited from the opportunities offered by cheap labor.

The Thai Crisis

The devaluation of the Thai baht on July 2, 1997, the day after Hong Kong returned to Chinese rule, sparked the Thai financial crisis. An increase in Japanese competition as the yen depreciated and a decrease in demand for Thai exports both precipitated the devaluation. Most importantly, devaluation resulted from a significant reduction in access to credit from foreign investors due to the unsurprising failure of some earlier speculative investments.

> "Much of the world...is grappling with a financial and economic crisis that bears even more resemblance to the Great Depression than the Asian troubles of the 1990s."

To some extent, this credit reduction became a self-reinforcing process that reduced the flow of new loans, further reducing confidence. This slowdown resulted in an increased demand for foreign currencies and a decreased demand for the baht. This required the Bank of Thailand to purchase baht to support the currency. Controlling deflation is much more difficult than controlling inflation because the central bank can print local currency to control inflation, but it cannot print foreign currency to control deflation. In addition, many banks, finance companies and Thai businesses were highly exposed to exchange rate slides because they had large debts in dollars.

> "What happened to Japan is both a tragedy and an omen."

Indecision was the Thai government's most critical mistake. It was unwilling to let the baht depreciate and also unwilling to take harsh domestic measures. Speculators observing this unwillingness could thus predict that the baht would eventually fall. Therefore, during the period of indecisiveness, they borrowed in baht, which required the central bank to buy even more baht to prevent devaluation. This process carried on until the bank's reserves were essentially depleted and, on July 2, the Thai government let the baht go.

Asian Crisis Contagion

The Thai economic crisis spread quickly and dramatically through the "Asian tiger" countries. This was surprising because, despite their geographic proximity, their economies were quite distinct. South Korea, for example, was a relatively distant economy, geographically. In 1996, its GDP was twice as large as Indonesia's and three times as large as Thailand's. So how did this happen? First, the countries had some direct linkages – Malaysia is a market for Thai products and vice versa – and they often sold similar products, such as textiles, to third parties. However, all economic analysis indicates that this was not the major force driving the spread of the crisis.

> "The Great Depression was brought to an end by a massive deficit-financed public works program, known as World War II."

More likely, direct financial linkage was the driving force of contagion. "Emerging market funds" that lumped all of these economies together were a major source of capital flow into the region. This created direct mechanical links among these countries' finances. The association of Asian economies in the psyches of investors was an even greater force. Investors perceived that these Southeast Asian countries all shared the "Asian miracle"; therefore, negative perceptions about one country had a negative impact on all the related countries.

The Force of Panic

Investor panic is a powerful force that can override otherwise sound macroeconomic policy. Panics are so powerful because they can be self-reinforcing and, as a result, can validate themselves. The negative impact moves in a circular pattern, increasing as it goes. This could result in a devastating feedback loop, though it does not necessarily have to do so. Why doesn't any shock to an economic system result in a devastating panic? Again, an analogy is useful. A microphone in an auditorium always creates a feedback loop. The microphone picks up sounds from the speakers and sends the signal back to the speakers to be amplified, and so on. However, this is usually a "damped" process and so the feedback loop doesn't cause a problem. However, if the room has a significant echo and the gain is turned up too high, the sounds from the speakers that return to the microphone exceed some critical threshold, the feedback loop increases the recycled signal's amplification and the sound system malfunctions.

> "Subprime loans were...made by loan originators, who quickly sold [them] to financial institutions, which...sliced and diced pools of mortgages into collateralized debt obligations (CDOs) sold to investors."

The key is that the feedback mechanism is always present, but it does not have a destructive effect unless the critical threshold, which is unique to the system, is crossed. Identifying the critical feedback threshold in an economy is impossible, but understanding the concept is useful. Panic is only dangerous if the threshold is crossed; otherwise its effects are dampened and unimportant.

"Greenspan's Bubbles"

Alan Greenspan chaired the Federal Reserve for more than 18 years. During that time, he was hailed as possibly the greatest central banker in history. He presided over an era of relative stability, with low inflation and just two brief periods of recession. However, once his tenure was over, the true consequences of his policies became visible.

> "There are probably around 12 million American homeowners with negative equity as this book goes to print."

One of his most famous speeches warned of "irrational exuberance," hinting at a bubble in stock prices. However, warning and hinting were all he did. He neither raised interest rates to curb the markets nor imposed margin caps on investors. Although Greenspan's policies led to "spectacular" job creation during the Clinton years, they also allowed two massive bubbles to form and subsequently pop: the dot-com bubble of the 1990s and the subprime crisis of 2008.

Subprime Loans and Shadow Banking

Rather than stemming from securitization pioneers, such as Fannie Mae, or from deregulation, the subprime crisis developed from the gung-ho risk taking of shadow banks – institutions that function like banks, but that are neither regulated nor properly equipped to cope with crises. They prospered during the George W. Bush administration when regulation was out and "financial innovation" was in vogue. What took place in 2008 runs parallel to the Panic of 1907, which arose from the collapse of institutions operating outside the regulatory system.

> "The end of the housing bubble will probably...have wiped out about $8 trillion of wealth. Of that, around $7 trillion will have been losses to homeowners. [The other $1 trillion loss] has triggered the collapse of the shadow banking system."

The fall of Lehman Brothers in September 2008, the crisis in emerging markets and a plunge in consumer confidence all indicate that the globe is facing the worst recession since the 1980s. However, despite the scale of the crisis, it is not a depression, and probably will not develop into one.

Solutions in Sight

To battle the downturn, policy makers must attack on two fronts: They must get credit flowing again and engage in spending. People have lost their faith in banks. Governments in affected nations must support their financial institutions by investing heavily in recapitalization. So far, the amounts involved have been too small. Current governments must take a leaf from Japan's book: It rescued its banks with a whopping $2 trillion cash injection. To make sure banks don't just sit on the extra capital, governments may have to go as far as temporarily nationalizing a large part of the financial system.

> "Greenspan acted like a parent who sternly warns teenagers against overdoing it but doesn't actually stop the party, and stands ready to act as designated driver when the fun is over."

To jumpstart their economies, governments should increase spending. Rather than providing mere tax breaks, they should invest in "roads, bridges and other forms of infrastructure." This has two advantages: First, it commits the government to spending the money and, second, it provides something of value.

> "Nobody likes the International Monetary Fund; if anyone did, it would be a bad sign...Lenders of last resort are supposed to practice tough love."

Looking to the future, countries should broaden and intensify their financial regulation. In fact, the rule of thumb should be this: Anything that might need rescuing during a financial crisis must be regulated. Policy makers must also consider how to handle financial globalization – it has turned out to be more risky than first believed, and must be controlled regularly, not just in times of crisis.

About the Author

Paul Krugman received the Nobel Prize in economics in 2008. He is a prolific scholar, and teaches economics and international affairs at Princeton University. *Fortune* magazine claims that he "writes better than any economist since John Maynard Keynes," and the *The Economist* describes him as "probably the most creative economist of his generation."