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ESADEgeo-CENTER
FOR GLOBAL ECONOMY
AND GEOPOLITICS

7 Book Reviews on global economy and geopolitical readings

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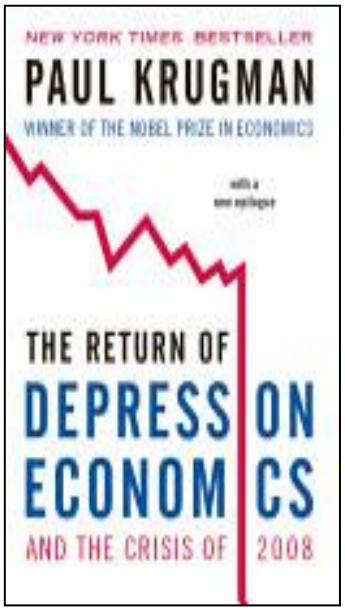
Fundación REPSOL

Obra Social "la Caixa"

The Return of Depression Economics and the Crisis of 2008

Paul Krugman (2009) W. W. Norton & Company



I would like to say that this crisis does not resemble any we have seen in the past, but it would be more accurate to say that it is identical to everything we have seen in the past, with the peculiarity that, on this occasion, all of the following elements occur simultaneously: the bursting of the real estate bubble, comparable with events in Japan at the end of the 1980s; a succession of banking panics like those of the 1930s (although now the main party affected is, above all, the shadow banking system and not conventional banking); a liquidity trap that reminds us once again of what happened in Japan; and, more recently, an interruption of international capital flows and a series of currency crises all too similar to what occurred in Asia at the end of the 1990s.

Basic idea and opinion

Up until a few years ago, the economists and politicians of our time were convinced that economic science had come so far since the Great Depression that nothing like it could possibly happen again. Krugman wrote the first version of this book, in 1999, with the intention of warning against this false confidence. In 2009, he wrote the second version of the book, when his “terrible prophecy” of 1999 had already been fulfilled. He adopts a deliberately straightforward and informal style to explain how this catastrophe came about.

The author

Paul Krugman, born on 28 February 1953, is a North American economist, publisher and journalist, whose thinking leans towards neo-Keynesian theories. He is Professor of Economics at the University of Princeton and a columnist on the New York Times. In 2008, he was awarded the Nobel Prize for Economics.

Depression economics

The central problem has been solved. In the mid-1990s, many economists considered that the central problem of the macroeconomy up until that time, the control of the economic cycle, had already been solved. It was known how to avoid recessions or to ensure that they were mild and brief; and now the economy only had to concentrate on how to promote long-term economic growth. After the collapse of socialism, capitalism no longer had a rival. For some time now the economic cycle had been tamed thanks to monetary policy: "recessions can be fought by simply printing money." Only a few critics noticed the weak points of the world economy: prolonged stagnation in Japan, high unemployment in Europe, growing inequality in the US, exploitation in the emerging countries, or the exclusion of Africa from the benefits of globalisation. But no one took the possibility of a new depression seriously.

Warning ignored: Latin America's crises. The signing of the Free Trade Agreement with the US in 1990 meant that Mexico irreversibly opened its doors to foreign capital. However, the enormous sums of capital that flowed in during the period from 1990 to 1994 never produced spectacular growth. For some, the explanation was an excessively strong peso, which made the country's exports uncompetitive. Mexico opted to devalue the peso in 1994, but this measure was clearly insufficient, and speculators were encouraged to act with further devaluations on the horizon. Foreign capital began to take flight, the peso dropped to half of its value, and Mexico's debt indexed to the dollar shot up. The Mexican financial crisis—the "tequila effect"—saw the country's GDP plunge 7% and the crisis spread throughout Latin America, affecting Argentina in particular. Nevertheless, the rescue operations were successful and recovery arrived quickly after one year and a half. The lesson learnt from the Mexican debacle—the wrong lesson—was that this crisis was not of relevance to the rest of the world. Only a few asked themselves the questions "why was such a large punishment [a devastating financial crisis] meted out for such a small crime [insufficient devaluation]?", "why did the financial crisis have such a devastating effect on the real economy?", and "why was conventional monetary policy incapable of preventing a recession?".

Japan's trap. The Japanese financial system enjoys strong government support. This type of support generates a strong tendency towards "moral risk" on the part of the banks—making risky investments with depositors' money: if things go well, the banks become richer; if they do not go well, they declare themselves bankrupt and let the government sort out the mess. Therefore, following the deregulation of the 1980s, during the 1990s money was lent with less control than ever, thereby creating an enormous bubble of speculation. When the Bank of Japan burst the bubble, raising the interest rates, the country's economy entered a long period of economic stagnation.

The traditional solution to fighting a recession—lowering interest rates, almost down to zero in the case of Japan—was not sufficient to set the country back on a path of growth.

Asia's crash. From the 1990s, following the impressive rise of its economy, Thailand abandoned financial self-sufficiency—investment supported by domestic savings—and began to finance itself by means of foreign investment coordinated by local financial companies. This change generated excessive investment, which created an economic bubble similar to the one observed in Japan in the 1980s. But when the Thai bubble burst, instead of the baht being devalued 15%—whereupon Thai exports would have become competitive once again—the currency fell 50% and triggered a devastating recession throughout South East Asia. "Why did a devaluation in a small economy cause a fall in investment and product in such a large area?", Krugman asks. His answer: due to a circular process—"a devastating feedback loop". Nobody realised just how powerful the feedback process between "confidence-financial markets-real economy-confidence" could become. And nobody was aware of how the financial markets were capable of transmitting the crisis began in Thailand to the remaining countries in Asia (Malaysia, Indonesia, South Korea), although there were few reasons for this. Given that foreign capital arrived through "funds" that grouped all these countries together, when Thailand began to experience problems, money flowed out of these funds and hence out of all the countries in the region. If the Asian economies were associated in the minds of investors acting in the financial markets, all these countries were equally vulnerable, however different their economic foundations might be.

Policy perversity. Today, the majority of economists consider that floating exchanges—which permit the free circulation of capital and the use of monetary policy to fight against recessions, but which generate economic uncertainty due to fluctuating exchange rates—are preferable to fixed exchange or adjustable fixed exchange systems. The possibility of reducing interest rates suddenly when the threat of a recession appears fully compensates the uncertainty caused by the instability of the exchange rate. What is more, when a currency is devalued because the economy has problems, in theory this fall should end up by limiting itself, given that investors will see the devaluation as an opportunity to invest in that economy more cheaply. But this forecast is only fulfilled if investors have a minimum of confidence in the possibilities of that country. If investors have no confidence in a country, when the devaluation begins, they stampede out, causing a financial crisis. For this reason, the floating exchange regime only works well for countries to which the financial markets are prepared to give "the benefit of the doubt", but it is a catastrophic regime for countries such as those in South East Asia that do not fall into this category. Due to the need to preserve the fixed exchange rate, interest rates are increased considerably, this being the only way to prevent the flight of foreign investors. Therefore—instead of responding to the economic crisis by lowering interest rates, cutting taxes and

increasing public expenditure, creating a deficit—developing countries pursue perverse policies.

The Masters of the Universe. Hedge funds, with their powerful speculative capacity, have played a very important role in the financial crises that have occurred since the 1990s. Their business depends on the financial markets fluctuating as much as possible. In effect, they invest some assets in the short term (they make money if the price of the asset falls) and others in the long term (they make money if the price of the asset goes up), and their long-term investments are financed with the liquidity obtained in their short-term investments. Since these were funds for big investors, they were barely regulated: governments do not have to worry about the risks taken by the richest. And, unlike the banks, "they did not seem to be key links" on which the stability of the financial system depended. Furthermore, due to their nature, they operated from tax havens, which would have made them very difficult to control. However, in reality they had an enormous influence on the world financial system. Why was this? Since they were such big players in the market, when they sold their assets to cover their "short" positions, the prices of the assets in which they had invested inevitably came down: "for many illiquid assets they were the market; when they all tried to sell at once, there were no alternative buyers."

Greenspan's bubbles. A key feature of the Greenspan era was not to intervene to curb the irrational exuberance—in the form of a bubble—of the financial markets. When in the year 2000 the dot-com bubble burst, interest rates fell dramatically. Due to this, the recession after the bubble burst ended after eight months. However, at the same time the next bubble began inflating: the real estate market bubble. Besides the low interest rates, a change in the principles that had traditionally governed the mortgage market contributed to the real estate bubble: lenders offered mortgages without demanding sufficient income, convinced that property prices would continue to rise and therefore that the risk assumed was not a problem. Moreover, lenders resold these subprime mortgages in the form of securities "to investors who didn't know what they were buying". The subprime mortgage securitisations (CDOs) obtained an AAA rating from the rating agencies, because they could only fail if the number of defaulters became very high (which it did in the end). Given that institutional investors only buy products with a triple A rating, the CDOs "opened up large-scale financing of subprime lending." Greenspan did nothing, convinced that it was "most unlikely" that property prices would fall.

Banking in the shadows. The consequences of the bursting of the real estate bubble, from 2006 onwards, were much worse than anyone could have imagined, because the changes made in the financial system had gone unnoticed by almost everyone. Financial innovations in investment banking in recent years created structures for handling investments free of all supervision. The assets of this "parallel banking system"—which could not count on the guarantees of the traditional banking system

and was therefore extremely vulnerable to a classic panic—totalled more than US$ 6 billion, when the entire (traditional) banking system had total assets of US$ 10 billion. According to Krugman, the main cause of the crisis of 2008 was not—as the right maintains—the imprudence of the banks Fannie or Freddie in giving mortgages to individuals who would not be able to pay them back. Nor—as the left claims—was it the repeal of the Glass-Steagall Act (of the 1930s), which allowed commercial banks to get back into the investment banking business. The problem was the growth of the "shadow banking system".

The sum of all fears. First fear: the bursting of the real estate bubble. The size of the bubble was so large—housing was overvalued by 50%—that no one escaped: in 2009, 12 million owners had a house that was worth less than their debt and the loss of value of their homes was calculated at US$ 7 billion; those who had invested in securities backed by mortgages lost US$ 1 billion, and this loss led to the collapse of the shadow banking system.

Second fear: panic in the shadow banking system.

Third fear: the liquidity trap. Once the crisis had begun, Bernanke lowered rates from 5.25% to 1% in two years and direct loans to banks went from zero to US$ 400,000 million. In a normal period, that would have been enough to restore credit. But this was not the case due to "a problem of replacement and size."

Fourth fear: the currency crisis. After the Asian crisis of 1997, the rise of financial globalisation led to the creation of 'drive belts', with the effect that the financial crisis begun in the US spread around the world.

The return of depression economics. "For the first time in two generations, failures on the demand side of the economy—insufficient private spending to make use of the prevailing productive capacity—have become the clear and present limitation on prosperity for a large part of the world." The new macroeconomy of demand is the only possible way to respond to the present crisis.

In the short term, Krugman highlights two emergency measures: the reactivation of credit and the encouragement of spending. Krugman proposes a recapitalisation of the banks on a larger scale than that performed to date, in exchange for greater control on the part of the government. Furthermore, in order to reactivate credit, Krugman proposes that the Federal Reserve should lend money directly to the non-financial sector; that these initiatives should be coordinated among all the developed countries; and that a global rescue plan should be drawn up for developing countries.

On the other hand, spending must be encouraged by means of the "old" Keynesian fiscal stimuli. It is necessary to spend more—up to 4% of the GDP—and to so do by means of government spending, basically on infrastructure.

Furthermore, everything that has to be rescued during a financial crisis—because it plays an essential role in the system—must be subject to regulation when there is no crisis, in order to avoid taking excessive risks. Finally, Krugman chooses to evaluate the possibility of imposing long-term restrictions on international capital flows and not only submitting them to temporary controls in times of crisis. “Financial globalisation has definitely turned out to be more dangerous than we realised”.