

END THIS DEPRESSION NOW! A REVIEW OF PAUL KRUGMAN'S BOOK (W. W. NORTON & COMPANY, NEW YORK, 2013)

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Paul Krugman is an American economist, professor and columnist. In 2008 he received the Nobel Memorial Prize in Economic Sciences for his contribution to the literature on international trade. He is the author of more than 20 books and 200 scholarly articles, ranging from international economics through income to taxation.

His most recent book, *End This Depression Now!* became a New York Times best-seller in both hardcover and paperback. It focuses on examining how to recover from the depression, contributing to the discussions about whether to apply a Keynesian fiscal stimulus or implement austerity measures. In the paperback version, on which this review is based, the author evaluates whether the findings presented in the hardcover version remain well-founded after recent major political and economic events (the US elections, and European austerity measures), and finds that the essential message remains unchanged.

The book provides an easily comprehensible explanation of the depression, to even readers with a limited knowledge of the economic and financial sciences, although there are parts where Krugman dives deeper into specific details and offers a deeper understanding for more expert readers as well.

Krugman's main thesis is that the economic disaster was just a minor malfunction of the economic engine which could have been avoided with more intellectual clarity and willingness to act by people in a position of power. Knowledge about previous depressions should be used more intensely, and the main remedy should be job creation instead of austerity measures. Although the financial sector suffered major losses, Krugman considers the human impact to be most important. Due to the crisis the unemployment rate doubled, and jobs which were available were downgraded or became lower paid. The high level of

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unemployment was driven by the lack/decline of demand due to the high level of private debt. Depressions can impact the political sphere as well: the rise of extremist politics (radical nationalist movements) and a loss of democratic values (reversion to an authoritarian regime in Hungary).

Krugman starts with an explanation of how the system reached such a state of malfunction. The financial instruments developed over the latest decades, thought to be able to provide more stability—and which indeed brought an extraordinary increase in wealth for the richest few—turned out to be one of the drivers of the financial collapse as regulation put in place in the 1930s to prevent banking crises was dismantled in the 1980s, or, even more significantly, was not updated to fit modern financial circumstances. This, along with the overconfidence of the banking system, led to a surge in debt. The primary principle in the functioning of a banking system is the fact that not all depositors want to withdraw their funds at the same time. A sudden loss of confidence may create panic, which will cause banks to go bankrupt, and contagion to spread. This may also happen occasionally when many people try to pay down debt at the same time.

In this paradoxical economy, an increase in the desire to save creates not a higher rate of investment but a general economic depression (the ‘paradox of thrift’), while if a large number of economic actors try to pay down debt this will make the debt problem more severe (the ‘paradox of deleveraging’), and a general reduction in wages will leave everyone with lower income and the same level of debt (the ‘paradox of flexibility’).

Krugman disagrees with the view that if demand declines, then money still available remains for disposal in other areas. As an example, Krugman uses the story of a babysitting co-op. This association of babysitting couples used coupons to make sure everyone accepted their fair share of responsibility for looking after kids. When the tendency to hoard coupons became so general that most people preferred to save instead of investing, scarcity increased and the volume of cooperation sharply declined. Individuals may start saving, but the co-op as a whole could not: without spending, there can be no income, and economic performance may drop to a point where there is substantial underperformance.

Krugman refers to Hyman Minsky, an economist at Washington University in St. Louis who warned several times that a crisis would definitely happen. By 2008, public debt compared to GDP reached a similar level to that which it reached during the recession of the 1930s, by which point anything could have triggered a recession. Robert Frank of Cornell also points to the existence of an “expenditure cascade”: income growth benefited the top 1% and their lifestyles could only be achieved by lower classes by increasing their debt level.

Krugman considers the lack of political willingness to be one of the main obstacles to a proper response to the crisis. Rising inequality was mostly driven

by politics, explaining why warning signs were not noticed and the reaction to the crisis was so inadequate. In some cases, the senators who passed acts that supported financial deregulation either received campaign support from financial actors, or were members of managements or boards that had the financial background to be elected to the political leadership. The inadequate use and the ignorance of Keynesian solutions and the fear of running up a long-term budget deficit and inflation, along with individual political and business interests, overruled the need to fight unemployment.

The crisis of 2008 can be considered a clear example of a Keynesian world in which technocratic measures were not enough to solve the problem of insufficient demand, and more government spending and active support would have been required. The Keynesian approach has been feared as a step down the path to socialism and populism, and a way to undermine business trust, along with a way of legitimizing government intervention in general. Such a perspective became widespread with the assistance of the absurd notions of academic sociology. The efficient-markets hypothesis started to dominate, with its claim that financial markets always get prices right (i.e. prices perfectly match the intrinsic values of products and services), and that capital should be generated by the financial markets. Even the 2008 crisis was perceived to be a rare exception in a perfect system. For some economists this was due to their unwillingness to admit to making a misjudgment, but by doing so they undermined the implementation of potentially effective responses to the depression.

Keynesian economics was fully ignored without any workable alternatives being provided by a macroeconomics built on micro-foundations: the new models could not explain recessions, but there was also no way of turning back and admitting the validity of Keynesian economics. Although a fraction of all schools of economics maintained their preference for a New Keynesian model, the general attitude after the crisis was ignorance about the idea of creating a possible stimulus, a situation which undermined effective action.

In addition to the above, the policymakers with a clear overview of what needed to be done were quite reluctant to act and too fainthearted to apply measures to their fullest extent; they also did not admit later on that the measures they applied were inadequate to resolve the problem. When Obama stepped up in 2008, consumer and business spending significantly declined. Interest rates were already at zero per cent, so the US Fed (Federal Reserve Bank) had no tools to create leverage with. A fiscal stimulus —an increase in government spending— remained the most feasible solution, but the size of the injection was only able to mitigate the recession, being too small to create real progress. Most importantly, the failure of the stimulus discredited the concept, apparently leaving no further options.

This failure was strengthened by the inadequacies of the mortgage relief system. Due to the high level of household debt the economy was vulnerable to crisis, especially as people were trying to spend less. One of the solutions could have been for the government to spend more. The other could have been to reduce debt. As foreclosures (impacting 20% of homeowners) would have been a bad deal for both borrowers and lenders, a mortgage relief program would have been beneficial to both. The Obama administration initiated such a program in 2009, but it ended up being unusable due to low political commitment. The political focus turned from unemployment to reducing the deficit, even though the harm of this to an economy in depression was quite hypothetical compared to that of unemployment. The fear of bond vigilantes ‘dropping’ a country’s bonds is not realistic; in these situations the market indicates that the state will borrow even more. The expectation that a rise in borrowing would significantly increase interest rates also turned out to be a false prediction during this recession. Although debt may burden the future, the size of this burden is not as great as the economy stands to lose by not maintaining an adequate level of economic growth.

When the political focus switched from job creation to debt, this meant an end to the stimulus and a move towards making large cuts in public investment. This made the liquidity trap more severe: with less income, people cut back spending more, leading to further declines in incomes and spending, as well as GDP. According to Krugman, the debt crisis could actually have been resolved by creating more debt. A debt is a liability to one individual, but an asset to another, so at the level of the market what really matters is who owes money to whom, not the overall level of debt. Debt relief or inflation can be a solution, but if unsuccessful, then a third party should enter in; in this case, the government: debt could have been taken off those economic actors who have a strong negative impact on the economy. The overall level of debt would have remained the same but the economy’s problems would have been reduced.

Printing money in general increases inflation, but not always, and it would not have this time. Prices go up when demand goes up, but not because the supply of money increases. So when the Fed purchases assets, it only creates inflation if this leads to higher spending and demand. But if the economy does not speed up as a result of “money-printing”, then there is no inflation, just like in the case of a liquidity trap when banks do not loan money: safe loans do not yield, and unsafe loans are risky. In 2011 those worried about inflation could not easily be convinced of the opposite problem, and when later on it turned out that inflation was indeed only temporary, they refused to accept this.

Using a broader perspective, Krugman summarizes that after the fall of Lehman Brothers, the general reaction of governments was to increase spending,

just as textbooks advised, until 2010, when the world's political elite decided instead to cut spending and proposed monetary and fiscal tightening as the best policy: an immediate shift to austerity measures. One of the main arguments for this was the proposition that the increase in the trust of the financial market would outweigh the losses from the economic downturn that would result from the slashing of spending; this Krugman calls the "confidence fairy". A reduction in interest rates or expectations of lower taxes may lead to increases in demand, but in the current case they would not have offset the dampening effect. Many countries were pushed to apply austerity measures in the hope of benefitting this way, including the United Kingdom, but its economy remained depressed and was entering into a new recession at the time of the writing of Krugman's book, without any clear political will for changing course. Even though austerity measures can be justified by the intention to avoid increasing the deficit, moves to increase interest rates—which the OECD did in 2010—at a time of high unemployment and low inflation is hard to understand. The general dislike of low interest rates in the world of finance was packed into several different arguments; some warned, for example, that low rates lead to risk-taking and spur price inflation, leading to the argument that this is an obstacle to economic adjustment. The economic doctrine that demanded austerity and rationalized social injustice was revived, snowballing into an austerity-based fiscal policy that rather focuses on deficits instead of job creation, thereby serving the interests of creditors.

In a separate chapter Krugman focuses on the differences between the USA and Europe. At the time of writing, Europe was harder hit by the crisis than the US. Having a shared currency has many benefits but it also makes devaluation—one way of adjusting to economic shock—impossible. For example, devaluation could provide an opportunity to decrease the value of local currencies in the case of a housing collapse to avoid the other possible response: a cut in wages. Fiscal integration disallows a state in crisis to receive aid from others. When the euro replaced local currencies, it lowered the risk that they would hold the debt of less economically strong countries, which resulted in a housing boom in Southern Europe, supported by a massive flow of capital from "core" Europe, creating a huge trade deficit—which ended with the collapse of the bubble triggered by the crisis in the US.

The main obstacle to solving the crisis is the misbelief that the crisis was essentially caused by fiscal irresponsibility: the creation of an unsustainable debt level. Krugman calls this "the big delusion"; the financial and political perspective that countries have sinned, so now they must suffer. But the actual problem has never been the level of debt itself, but fiscal and labor market disintegration. For countries with their own currencies, devaluation may be a logical option; others have to face a long period of high unemployment before wages are pushed

down. Yet reverting to using domestic currencies is unadvisable; instead, the euro should be saved. Punishment for the false belief in fiscal irresponsibility is also not the proper response.

From the perspective of seeing all possible solutions, Krugman disagrees with the view that the economy will heal itself. The author suggests taking inspiration and ideas from the Great Depression and starting to build a more sustainable economy. The setback was too severe for actors to 'wait for things to get better' because damage is cumulative, and future prospects are degraded. First of all, the government should spend money on areas where private sector investment is below full capacity, even by reversing budget cuts or enhancing safety nets. Another solution is the more intense intervention of the Fed into whatever is needed for the market to recover. The third option is to reduce the burden of the housing debt. Robert Hall's research on wartime spending and GDP growth indicates that spending can indeed drive growth. Nakamura and Steinsson found that outcomes can even exceed investment. IMF research into 173 countries shows that austerity measures are followed by economic contractions and higher levels of unemployment.

Krugman provides the explanation, or rather the motivation, for policymakers to do away with austerity measures and start boosting the economy: he states that voters do care about the economy. So doing whatever it takes to end the depression will be a good fillip for political leadership. In closing, the author argues that the only thing that is blocking recovery from the depression is intellectual clarity and political will.