

Miscellany 54: Review of Paul Krugman's *The Return of Depression Economics and the Crisis of 2008* (W. W. Norton, 2009, 1999)

Copyright © 2009 Joseph George Caldwell. All rights reserved.
Posted at Internet website <http://www.foundationwebsite.org>.
May be copied or reposted for non-commercial use, with attribution to author and website. (18 December 2010; updated 19 Dec. 2010)

Contents

Miscellany: Commentary on Recent Events and Reading 1
Review of Paul Krugman's *The Return of Depression Economics and the Crisis of 2008* (W. W. Norton, 2009, 1999) 1

Miscellany: Commentary on Recent Events and Reading

Review of Paul Krugman's *The Return of Depression Economics and the Crisis of 2008* (W. W. Norton, 2009, 1999)

On my way to Honduras a few weeks ago, I bought a copy of Paul Krugman's book, *The Return of Depression Economics and the Crisis of 2008* (W. W. Norton, 2009, 1999). The book provides some insight into the reasons for the recent financial crisis. Rather than focusing on the US experience in the crisis, it describes a number of cases in which countries have suffered financial problems, at various points in time. Krugman describes the evolution of the environment and conditions that led to the financial crisis, but he does not explain how bankers and financial experts took advantage of those conditions to cause the crisis and profit from it. If you are looking for a detailed discussion of the recent crisis from mainly from the US perspective, with much more detailed description of specific factors and root causes

contributing to the collapse, a more useful book is *Freefall: America, Free Markets, and the Sinking of the World Economy* by Joseph E. Stiglitz (W. W. Norton, 2010). I will review that at a later date.

Both books are written by authors who obviously accept the principle of growth-based economics: that economies should grow. The fact that large numbers of human beings and industrial activity is destroying the biosphere is never mentioned by either author. The value of economic growth is never questioned, and its role in destroying the biosphere is never addressed.

Krugman makes several points about economics, and relates to these during his discussion. He makes the point is that a country's balance of payments always balances. He states, "As a sheer matter of accounting, the balance of payments always balances: that is, every purchase that a country makes from foreigners must be matched by a sale of equal value. (Economics students know that there is a small technical qualification to this statement involving unrequited transfers; never mind.) If a country is running a deficit on its *current* account – buying more goods than it sells – it must correspondingly be running an equal surplus on its *capital* account – selling more *assets* than it buys. And the converse is equally true: a country that runs a surplus on capital account must run a deficit on current account."

Unfortunately, Krugman identifies key economic principles without making full use of them. Consider the case of the point just made, that the value of the purchases and sales made by a country will (eventually) balance. If the value of the purchases and sales does not match as measured by the currency exchange rate at a certain point in time, future purchases and sales must bring the time average of the purchases and sales into line, or the currency exchange rate must change (i.e., one of the two currencies must be devalued relative to the other). There are,

however, other possibilities. One is that the country with the surplus may simply “sit” on it, i.e., retain it as foreign-currency reserves (for use, e.g., in a future emergency). If the surplus is never spent, it is as if it does not exist – the effect is the same as if the surplus had been part of the payment for the goods, or if the surplus was still sitting in the central bank of the trade-deficit country.

In the case of the current financial crisis, for example, because of its free-trade policies over the last half-century, the US government has brought about the systematic destruction of its manufacturing sector, first in basic industries such as ceramics, shoes, and textiles, then in steel, and finally in high-tech sectors such as automobiles and consumer electronics (cameras, televisions, microwaves, refrigerators, video recorders, computers, cell phones, communications). The problem that arises is that the consumer goods have to come from somewhere, and so America’s consumer goods are now manufactured in Japan, China, India, Mexico and many other places. These goods have to be paid for. For a while, the US produced some things that other countries wanted, such as very large Boeing aircraft and sophisticated military weapon systems. For a while, the sale of these goods offset the cost of the consumer goods. Eventually, however, almost everything that the US made that other countries wanted was made in other countries. The US had evolved to a “service” economy, but, unfortunately, the other countries did not need or could not use these services (such as financial services, or services that must be produced locally, such as retail sales). The US wants Chinese manufactured goods, but has little that the Chinese or other nations want to trade in return for them.

The problem that has arisen now is that China is sitting on a trillion dollars of trade surplus. What is going to happen? As long as China does nothing with these dollars, nothing happens. It may

continue to do this for a while, since it needs the massive consumer market of the US to continue to purchase its goods – that “looks better” to its citizens than simply destroying their output in order to keep them working. But if it decides to spend the surplus outside the country, all hell breaks loose. To paraphrase Ross Perot, you are going to hear a “giant sucking sound” of China (or some other country, if China spends the dollars there) buying up US capital assets. There have already been rumblings of Chinese takeovers (see, e.g., the November 13-19, 2010, issue of *The Economist* magazine, with the cover feature article, “Buying up the world: The coming wave of Chinese takeovers.”). Mainly, China will buy US industries and financial organizations. But, subject to US government approval, it can purchase anything it wants. For example, with a trillion dollars, you could give \$200,000 to each of five million illegal-alien Chinese, with which they could all purchase homes in the US.

The preceding example is an example of how Krugman describes an economic principle, but then does not fully explain how it relates to the current financial crisis. His book does not investigate the root causes of the financial crisis. He provides a superficial description of what happened and how it happened, with little discussion of why it happened. It is as if someone reported that someone was injured in a car crash because his car slid off the highway. That is not enough information to satisfy. There are all sorts of questions that need to be answered, such as was the weather bad; was it night-time; was there an equipment failure, such as faulty headlights or brakes; was alcohol involved; was another automobile involved; did the car slide into a ditch or hit a tree; was there no guard-rail; was the car speeding; did the driver have a heart attack; was the driver distracted by others in the car, or by making a call on a cell-phone; was the driver underage or visually impaired; was the driver licensed; was the driver an illegal alien? Krugman describes the financial environment that enabled the crisis to

evolve, but he does not describe why this environment was set up in the first place. While the financial industry took advantage of this environment, it was the government that knowingly set it up. The country had been through the Great Depression, which had been caused essentially by the same factors as the current Great Recession. Why did the government willfully allow some of the same factors to work again to cause the Great Recession? Krugman does not explore these reasons. Government actions, such as spending, could have been conducted in a fashion to make the recession far less severe. Much of the government spending was wasted on things that had little or no effect on improving economy, such as bailing out failed banks and financial firms. The government had the knowledge and first-hand experience to have spent the money much more effectively. Instead, it took advantage of the crisis simply to transfer most of the so-called “stimulus” money to banks and financial firms in ways that had little effect on improving the situation. It told the citizens that it was using the taxpayer money to stimulate the economy and then knowingly used very little of it to do so. It created a massive fraud on the middle class, for the benefit of the wealthy bankers and financiers who caused the crisis in the first place. Why did it do this? Krugman does not investigate why. The Great Recession was knowingly caused by government actions and deliberate inactions. Why did this happen? Krugman does not explain why.

With this brief summary of my overall reaction to Krugman’s book, I will now discuss a few other aspects of it.

Krugman accepts that the large swings (booms and busts) of the business cycle, and the growth of an economy, can be regulated according to the principles of John Maynard Keynes, i.e., by means of (“macroeconomic”) monetary policy actions by the central bank and fiscal policy actions by the government. One method for encouraging the growth of an economy is to lower the

interest rate (or “discount rate”) that the central bank (in the case of the US, the Federal Reserve) charges commercial banks for loans (or, more to the point, for the privilege of creating debt-based money and charging interest on it). This approach does not work if the interest rate is already very low (which is one reason why central bankers like to maintain a certain level of inflation). Another principle of Keynesian economics is that economic growth (higher employment, increased production) can be stimulated by government spending, such as on major infrastructure projects (such as the WPA projects of the 1930s). In a recession, if the government does not have surplus funds, then the spending causes or increases government budget deficits. If this (government spending) doesn’t work, or doesn’t work as well as desired, then another option is to increase the availability of money for loans (i.e., to increase liquidity) by whatever means, such as setting aside funds for special-purpose government-backed loans, setting up new banks, or direct government lending (i.e., independent of the banks). If this doesn’t work, then another option is to increase inflation by whatever means: tax cuts; tax “rebates”; tax credits for home purchase or home improvements; tax credits for automobiles; extension of unemployment benefits; grants to states; monetization of the government debt (i.e., buying back bonds by creating new money) -- whatever.

The effectiveness of Keynesian economics depends on the particular situation. In particular, it depends on the relationship of a country’s financial position with respect to other countries, such as whether it is heavily indebted to other countries or has its currency “pegged” to another currency. A very important factor is the confidence of other countries concerning the economic stability of a country. Krugman discusses examples of economic crises in various countries at various times, and why the government responses succeeded or failed. Krugman notes that although a country’s deflating its currency to a modest degree

may make good economic sense, attempting to do so may cause a loss of confidence in international markets, leading to a dramatic fall in the value of the currency. In addition, currency speculators (such as George Soros) can cause spectacular currency collapses, wresting control for orderly change from central bankers.

While Krugman lauds the ability of Keynesian actions to reduce unemployment and stimulate economic growth, he does not discuss the fact that in the recent Great Recession, most of the government spending was knowingly done in ways that were not effective in reducing unemployment or increasing lending. Instead, most of the money was used to bail out financial firms, with very little used to provide for additional lending to reduce unemployment. The financial firms that caused the financial crisis could have – and should have, under our supposed capitalist system – been allowed to fail, and others created in their place. The liquidity crisis could have been solved instantly simply through direct lending from the government. Why did the government deliberately create the conditions that led to the crisis, and then take advantage of the crisis to line the pockets of the very people who caused it? Why did the government create a sense of urgency that immediate action was necessary, and then use most of the funds to bail out the firms that caused it, and very little to resolve the crisis? Krugman does not explore these issues.

One point that Krugman makes is that the policies that countries adopt for themselves (such as Keynesian economics) are often not at all the policies that they prescribe for others. In the case of developing countries that encounter financial problems, for example, the US and IMF often impose (in exchange for loans) austerity programs that involve raising interest rates and cutting government spending (to lower government-budget deficits) – exactly the reverse of what Keynesian economics prescribes.

The reason for this is that the best policy from the point of view of the lending party (e.g., US or the IMF) may not be the best policy from the point of view of the borrowing party. The lending party is concerned with risk of default, and has a strong interest in the financial integrity of the borrower, no matter how much pain and suffering financial austerity measures may cause to the borrower-country's citizens.

Krugman discusses what is referred to in economics as the "impossible" trinity, viz., that it is impossible to have all three of the following at the same time: a fixed exchange rate; free capital movement (i.e., absence of capital controls); and an independent monetary policy. Each of these three policies has advantages and disadvantages, but most of today's economists favor a floating exchange rate (to maximize total economic growth), in which case capital flows freely and the country has more control over its monetary policy.

Krugman also discusses the concept of an optimal currency area (without naming it as such).

The fact is, Krugman discusses the numerous macroscopic policy tools that countries have to control economic activity. He makes the point that these tools are effective, but he does not make it clear why, despite the availability of these tools and the knowledge (from experience) that they work, they were not used to avoid the recent financial crisis.

Krugman discusses principal reasons for the recent financial crisis, including the government's covering the losses of derivatives traders (such as Long Term Capital Management and banks and insurance companies who issued large credit default swaps) and lax housing-lending standards caused by moral hazard (lenders being able to pass the mortgages on to others, such as Fannie Mae, Freddie Mac, or securitization of subprime

mortgages (collateralized debt obligations, or CDOs)). He identifies a major reason for the crisis as the shadow (or parallel) banking system, in which a large amount of banking – largely unregulated and uninsured – is done by firms that are not classified as commercial banks (since they don't accept deposits).

Commercial banks accept deposits; investment banks do not. Under the Glass-Steagall Act passed during the Great Depression, commercial banks could provide government insurance to their depositors, in exchange for tight regulation. The tight regulation was imposed because if the insurance premiums were unable to cover the losses of a bank failure, then taxpayer money would be used to cover the losses, and it is important to minimize the risk to the taxpayer money (through regulation and monitoring). The Glass-Steagall Act was repealed in 1999, allowing commercial banks to do investment banking. The tremendous disadvantage of this change for the US taxpayer was that the government wasted taxpayer money to bail out banks that had failed because of their investment banking, when all that was insured were depositors of commercial banking.

The shadow banking system involved the use of “auction-rate” securities and other financial arrangements to enable commercial lending, while avoiding the regulation of traditional (insured, regulated) commercial banks. When the housing market crashed, the shadow banking system collapsed. The major problem that arose was that the government decided to cover the losses incurred by firms engaged in shadow banking, even though their operations were not insured by the government and, absent regulation, were subject to greater risk of failure. This included the bailout – using taxpayer funds – of large financial firms such as Bear Stearns and AIG. The government claimed that if it did not do so, the financial crisis would have been even worse. In its response to the financial crisis, the government used taxpayer money to cover the massive losses of financial firms that were not

insured and not regulated. [In the case of AIG, it even paid off claims even though no loss had been incurred!]

The government claimed that bailing out banks was necessary to restore liquidity (availability of credit). The bailout did not restore liquidity. Instead, the banks either sat on the bailout funds or used them to pay large bonuses to their employees. Ben Bernanke argued “that monetary policy could be effective, even in a liquidity trap, if one were willing to ‘alter the composition of the central bank’s balance sheet.’ Instead of only holding Treasury bills and loans to conventional banks, the Fed could make loans to other players: investment banks, money-market funds, maybe even nonfinancial businesses. And over the course of 2008 the Fed introduced an alphabet soup of special lending ‘facilities’ to do just that: the TSLF, the PDCF, and so on. In October 2008 the fed announced that it would begin buying commercial paper too, in effect proposing to do the lending the private financial system wouldn’t or couldn’t do.”

Krugman discusses the reason why banks were unwilling to restructure home mortgages, even when foreclosure meant far greater losses for them and for the homeowner. “Between the time it takes to get a foreclosed home back on the market, the legal expenses, the degradation that tends to happen in vacant homes, and so on, creditors seizing a house from the borrower typically get back only part, say half, of the original value of the loan. In that case, you may ask, why not make a deal with the current homeowner to reduce payments and avoid the cost of foreclosure? Well, for one thing, that also costs money, and requires staff. And subprime loans were not, for the most part, made by banks that held on to the loans; they were made by loan originators, who quickly sold the loans to financial institutions, which, in turn, sliced and diced pools of mortgages into collateralized debt obligations (CDOs) sold to investors. The actual management of the loans was left to loan servicers, who

had neither the resources nor, for the most part, the incentive to engage in loan restructuring. And one more thing: the complexity of the financial engineering supporting subprime lending, which left ownership of mortgages dispersed among many investors with claims of varying seniority, created formidable legal obstacles to any kind of debt forgiveness. So restructuring was mostly out, leading to costly foreclosures. And this meant that securities backed by subprime mortgages turned into very bad investments as soon as the housing boom began to falter.”

In its response to the housing bubble, the US government chose to reimburse banks for their losses, and let the individuals lose all of their equity. This action has caused extreme alienation between the US middle class and the government, and between the US middle class and the financial sector.

In summary, Krugman identifies the major reason for the financial collapse on inadequate government regulation of a large part of the *de facto* banking system, viz., the unregulated shadow banking system. He is critical of the repeal of the Glass-Steagall Act, which allowed insured commercial banks to engage in uninsured investment banking. As a remedy for the current crisis, he proposes stronger “Keynesian” stimulus. To avoid or reduce the magnitude of similar crisis in the future, he recommends regulation of *all* commercial banking activity in the future, not just regulation for traditional commercial banks. He argues that the basic principle should be that “anything that has to be rescued during a financial crisis, because it plays a role in the financial mechanism, should be regulated when there isn’t a crisis so that it doesn’t take excessive risk.” Krugman does not impugn the motives of those in the financial industry or in government who worked to reduce banking regulations and thereby create the conditions that enabled the financial crisis, or the motives of those who designed, constructed and implemented the financial instruments that were the direct cause of the crisis (such as credit

default swaps and securitized subprime mortgages). He does not comment on the fact that much of the money the government used to bail out banks and financial firms had relatively little effect on resolving the crisis (reducing unemployment), and could have had a much stronger effect if spent differently, as was done in other countries (such as Britain). While his book provides some insight to the nature of the financial crisis, it does not address the root causes of the problem, viz., the design and implementation of a financial system intended to generate great wealth for the wealthy elite, irrespective of cost to the middle class or to the environment.

Krugman recommends that the stimulus spending by the government should have been much larger than it was. But what is the point to more spending, when most of the money was poorly spent, simply to bail out the financial firms that caused the problem and enable them to pay themselves obscenely large bonuses? Krugman does not say why. Fifty years ago, much of the money spent on the financial sector was used to provide useful services, such as funding and servicing home loans. Local banks earned the interest they received each month, by monitoring the loan carefully and restructuring it if need be. Now, the banks simply charge an origination fee and sell the mortgage to someone else, such as Fannie Mae or Freddie Mac. When problems arise, the local bank is no longer involved. Fannie Mae and Freddie Mac were once government organizations, operated responsibly by civil servants making reasonable salaries. The government decided to “privatize” them, so that the managers could pay themselves millions of dollars in salaries (such as CEO Franklin Raines, who was paid \$20 million in salary and bonuses by Fannie Mae in 2003). The government, such as President Bush, claimed that they were private entities. Yet when the crisis happened, the government bailed them out. It did not take steps to take back the obscene salaries and bonuses paid to managers of the banks and financial firms that caused the problem. It did

not punish these people who had ripped the country off. As it has done many times before, the government socialized the cost and privatized the benefits. Krugman describes this problem, but does not explain why the government did such a thing. He does not discuss that the US is now a fascist dictatorship in which the government serves the wealthy elite, rather than the people.

A highly unrestricted free-market system is bound to have random fluctuations. These fluctuations exhibit highly “autoregressive” macroscopic features, with business “cycles” that span one or two decades. Long ago, the science of economics determined how to moderate the severity of the peaks and valleys of the business cycle, through regulation of the financial industry and macroeconomic policy government interventions. The recent economic recession was the direct result of the government’s choosing not to regulate banking (in particular, the shadow banking industry); to allow massive derivative contracts that could not possibly be paid off, and then cover the losses from these contracts using taxpayer money; and to encourage a housing bubble through extension of mortgages to unqualified people and allowing banks to make the mortgages so complex that foreclosure was the only option in the event of inability of the homeowner to pay. The country had been through the Great Depression and had learned first-hand what to do and not to do to moderate economic recessions. Instead of taking steps to avoid the recent Great Recession and to reduce its severity when it occurred, the government knowingly chose to take actions to cause it, to magnify its severity, and to prolong its duration. What is worse, it conned the public by pretending to be taking steps (Keynesian intervention) to fix things, when in fact it used most of the money to bail out the institutions that had caused the problem in the first place. The main cause of the recession was a government conspiracy to defraud the American people and transfer much of their wealth to bankers and financial firms, under the guise of attempting to fix the problem. In implementing its

goal to generate vast wealth for the wealthy elite who control the country, it caused the middle class great suffering. It has shown the country to be what it is – a fascist dictatorship dedicated to the use of government to generate massive wealth for the wealthy elite. It has caused great antipathy of the middle class for both the government and the wealthy class. Krugman failed to discuss any of these issues. The government's causing and handling of the recent financial crisis will be a major factor in the coming class warfare between the middle class and those who defrauded it: the government and the financial sector.

Is there a lesson to be learned from all of the pain and suffering that the recent financial crisis has wrought on the middle class? Yes, there is. But the main lesson to be learned from the recent Great Recession has nothing to do with economics. During the Great Depression and the half-century that followed, the government learned that Keynesian economics is a useful tool for moderating the business cycle. That lesson had already been learned. The government already knew this, and it successfully applied these principles to moderate the business cycle for decades. Then, to support the greed of bankers and financiers, the government willfully agreed to reduce regulation of the financial industry and permit them to engage in the tremendously risky operations that led, once again, to massive financial collapse. It then decided to cover the uninsured losses of these gamblers with taxpayer money. It deceived the public by telling them that the transfer of massive funds to the banks and finance companies was a Keynesian stimulus necessary to save the economy, knowing full well that most of the expenditure was going for things that had little to do with stimulus (reducing unemployment; increasing availability of loans), such as bailing out firms that had caused the crisis and paying them large salaries.

Because of all of these developments, a lesson has indeed been learned. The lesson that has been learned from the Great Recession is that the government works hand in hand with the banks and financiers to defraud the public. This experience has shown beyond a shadow of a doubt that the US is now a fascist dictatorship in which the government works to generate great wealth for the wealthy elite, regardless of cost to the middle class or to the planet's environment. It is now patently clear that the US government is no longer "of, by and for the people," but "of, by and for the wealthy elite." This episode has created tremendous antipathy of the US middle class against the government and the financial industry. This significant event formally marks the end of the United States as we have known it, and signals the beginning of an era of overt class warfare between the US middle class and its manifest enemies – the government and the finance sector.

Overall, I enjoyed the insight that Krugman presented in his book. It helps one understand the macroeconomic policy actions that the government might have taken to avoid and mitigate the recent financial crisis. It does not explain why the government, knowing the value of these policies, took actions that were quite contrary to them. It decreased regulation of banking. It allowed massive speculation in derivatives, and then used taxpayer money to cover the losses. It pretended to be engaged in applying Keynesian spending, when it knowingly simply gave the stimulus funds to the banks and other firms that had caused the problem. An understanding of these issues is very important, yet Krugman did not address them.

FndID(127)

FndTitle(Miscellany 54: Review of Paul Krugman's The Return of Depression Economics and the Crisis of 2008 (W. W. Norton, 2009, 1999))

FndDescription(Miscellany 54: Review of Paul Krugman's The Return of Depression Economics and the Crisis of 2008 (W. W. Norton, 2009, 1999))

FndKeywords(Paul Krugman; depression economics; 2008 recession; book review)