

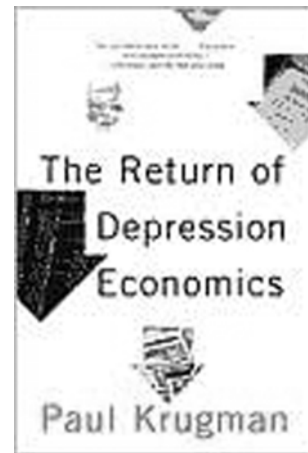
The Return of Depression Economics: and the Crisis of 2008 by Paul Krugman

by John Howard Brown

Biography: John Howard Brown, PhD, is associate professor of economics in Georgia Southern University's College of Business Administration. He is Interim Director of the School of Economic Development and teaches principles of economics, Industrial Organization, Law and Economics and Microeconomic theory in the School of Economic Development. Dr. Brown may be reached by email at jbrown@georgiasouthern.edu



Economists fall into two broad categories regarding the role of government in the economy, interventionists and anti-interventionists. Anti-interventionists advocate carefully circumscribing the role of government, usually limited to a minimal law enforcement role. Interventionists suggest a larger role for government to improve the performance of the economy. One of the characteristics shared by these disparate groups (besides an acceptance of markets as the best method for making most decisions) is a tendency towards hubristic over-confidence in their position. Prior to 1929, the anti-interventionists ruled the roost. From the 1930s to the 1970s interventionism was dominant, then the Reagan revolution restored the dominance of the anti-interventionists. It appears that current circumstances will result in renewed dominance by interventionists.



Paul Krugman, the 2008 Nobel Laureate in Economics, has probably been best known outside of the economics profession as an outspokenly liberal columnist for the New York Times. This surely identifies him as an arch-interventionist.

This book represents an extended argument for such interventionism. Krugman wrote the first edition as a response to the various economic crises less developed countries experienced in the 1990s and before. It is freshly revised and updated to reflect the (disastrous) experience of the past several years. The book proceeds as a series of case studies of the financial crises that have overtaken many countries over the past several decades. The common thread in these events is borrowed money.

The Cover Story

Title and author: *The Return of Depression Economics: and the Crisis of 2008* by Paul Krugman

Number of Pages: 191

Area of Business: General/Economic Conditions

Readability: High

Time needed to read: 4–8 hours

Why I should read this book: It will aid readers in understanding the current financial crisis.

Overall Rating: 4 Bulbs

Borrowing and credit underpins the modern economy. A complex web of institutions has evolved to channel resources (money) from those who do not currently need to use them (savers) to those who do (borrowers). The chief institutions in this process are banks. Banks perform an exceedingly valuable service to the economy by gathering deposits and performing credit evaluations. However, banks have an Achilles heel since they promise depositors instant access to their funds but they never have sufficient funds available to pay all depositors at once. (The money has largely been loaned out.) As long as everyone doesn't ask for their money at the same time, everyone's money is safe. If all the depositors demand their money at once, the bank inevitably fails. What is worse, a failed bank drags its customers down in its wake. Businesses must pay off their loans prematurely, and likely will reduce production in response.

This flaw has been recognized in most countries for seventy years and ameliorated by providing deposit insurance. If depositors don't fear for their money, the infamous bank run will not occur. Why then does borrowed money lie behind the various crises discussed in this book? There are two reasons. First, the deposit insurance guarantees do not extend across international borders. If borrowers in one country default, their foreign lenders may be unable to reclaim their loans. Second, the costs attendant on deposit insurance and regulation causes some firms that function as banks to operate without a safety net, as it were.

In normal times, this doesn't matter. However, panics by definition are not normal. Instead, a pervasive loss of faith causes the credit system to freeze up. Lack of confidence begets lack of confidence, firms reduce their investment and their hiring so that panic spreads like ripples around a thrown stone so that the entire economy contracts.

There is also a well developed play book for coping with panics. In addition to deposit insurance, central banks can reduce interest rates to encourage more borrowing and provide reserves to banks threatened by runs. The real question is what to do when the playbook fails. The technical term for this is liquidity trap, a situation where faith in the credit system and economic activity are so reduced, that these conventional remedies fail. Under these extreme circumstances, government can step in with spending to bolster the economy. This was the course of action proposed by John Maynard Keynes during the Great Depression of the 1930's, hence the book's title.

Krugman's argument is that the financial crisis that the US has been experiencing since 2006 has driven the economy to the point where massive government intervention is the only tool left right the ship. Since this book went to press some six to eight weeks ago, the economic situation has, if anything, become even more grave. Thus Professor Krugman's book is a timely and well argued contribution to public debate.