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Book Review

The Return of Depression Economics and the Crisis of 2008 by Paul Krugman, New York: Norton, 2009, 191 pp.

Paul Krugman, winner of the 2008 Alfred Nobel Prize in Economics, has produced several bestsellers on a wide ranging set of economics issues. Albeit highly controversial, his famous works include strategic trade policy (Krugman, 1986), the fall and rise of development economics (Krugman, 1994a), an attempt to throw cold water on the growth experience of East Asia by equating East Asian growth with Stalinist Russia and hence, attributing it to perspiration rather than inspiration (Krugman, 1994b), and economic geography (Krugman, 1995). In this more recent book Krugman discusses the causes of the 2008 global financial crisis by drawing on a series of financial crises in history. Despite their dissimilarities, Krugman argues that the immediate causes of the financial crises are fundamentally identical. It is worth reviewing this book because of the importance of the issues examined, as well as the authority the author carries.

The book is organized into ten chapters with a separate introduction, which states its aims as being to explain how the 2008 crisis happened, how its victims can recover and how such a crisis can be avoided in future. The first chapter puts into perspective postulations and predictions by eminent economists such as Lucas and Bernanke, that the world had learnt so much that major crises were no longer possible. Chapter two discusses problems that caused the Latin American crisis, which were ignored. Japan's rigid interventionist state framework is presented in chapter three as the cause of its long slump. The East Asian financial crisis of 1997-1998 is examined in chapter four, followed by a discussion of contradictory exchange rate and other financial policies in chapter five. The role of hedge funds is screened in chapter six. Greenspan's policies are critically evaluated in chapter seven, while chapter eight offers a brief assessment of banking history and bank regulation. Chapter nine explains the causes of the 2008 global financial crisis, arguing that it is arguably the most severe with all the eruptions happening at the same time. Chapter ten discusses the return of depression economics.

Krugman offers a masterful account of the causes of the 2008 crisis, drawing from the issues Keynes (1936) had first discussed and explaining how the bubble economy grew in the United States on the back of rising property prices over more than a decade. This trend had deceived economic agents – both the benign and the conniving – into dragging initially the merchant, then the investment and subsequently the commercial banks to participate in fragile sub-prime housing stocks. In the process he discusses how the nature of relationships between the financial firms and the rating firms overwhelmingly tilted to support inflated expectations of unworthy stocks. The proliferation of such badly rated and untenable financial instruments asymmetrically against the real economy complicated the capacity to detect *ex post* and cure the real economy, to deflate the bubble while minimizing the damage being done to the real economy.

Krugman also expertly dismisses in the book the claim of crony capitalism having derailed the Asian economies in the 1997-1998 Asian financial crisis. Indeed, cronyism had existed in the East Asian economies over many decades of rapid growth. However, the original credit for this goes to Akyuz (2002), Stiglitz (2003) and other experts (see Jomo, 2000; Rasiah, 2000) who not only identified the exposure the countries were subjecting themselves to through liberalization but also noted the asymmetries small countries face in such transactions. In addition, Singh and Zammit (2006) had argued that there was no evidence of the performance of such 'crony-based' firms being lower than those of the so called Anglo-Saxon firms of the United States. Also, Krugman's position in the book is in stark contrast to his earlier claim that the East Asian economies had grown through perspiration rather than inspiration and in the process equating them to Stalinist Russia (see Krugman, 1994b). Some elements of this appear tautological in his critique of the Japanese stagnation in chapter three.

I would like to address five issues that I believe the book could have covered better. The first relates to a lack of discussion on the interface between the real economy and the financial economy in East Asian and Latin American countries. Whereas the East Asian economies enjoyed carefully crafted industrial policies with superb macro-micro coordination to insulate firms from destabilizing externally arising crises, most Latin American economies lacked such coordination to drive technological catch up in high tech firms. Hence, whereas a massive number of Latin American firms folded under the siege of liberalizing currents each time there was either deregulation of tariffs or exchange rate devaluations, firms in East Asia enjoyed safety insulations to avoid such destabilizing crises. The exceptions include Embraer and

Petrobrass in Brazil, both of which managed to achieve comparable success through internalizing strategies that helped these firms overcome the daunting currents of competition. These firms are worth discussing as their paths are different from those taken by successful Korean and Taiwanese firms.

The second issue refers to Krugman's paradoxical and somewhat tautological attempt to explain economic stagnation in Japan since 1980. He correctly observed that the Asian financial crisis cannot simply be explained by cronyism, which was already present throughout the rapid growth years. However, he uses this argument along with one regarding rigid governance structures, as the problem that precipitated such a chronic crisis in Japan. In so doing he takes on a typical neoclassical view of the failure of big government. Yet, Japan's rapid ascendance economically cannot be explained without looking at industrial policy (Johnson, 1982). Japan had actually liberalized considerably by 1971 when all foreign ownership controls were removed in the manufacturing sector. I would argue instead that two major drawbacks debilitated Japanese growth. The first was the sudden increase in punitive pressures on Japanese exports which led to the relocation of major Japanese firms into the United States and Europe. Johnson had discussed such pressures from the United States' and European governments emerging since the 1960s, but the imposition of quotas and tariffs began only from the 1980s as the trade surpluses of Japan against these countries began to mount. Also, Japan (and Korea, Taiwan and Singapore) was (were) forced to float the Yen (won, New Taiwan dollar and the Singaporean dollar) following the Plaza Accord in 1985 (see Rasiah, 1988). The massive relocation of Japanese investment to North America and Europe caused serious hollowing out problems in Japan. As with Korea, forced liberalization caused Japan to lose its capacity to undertake the macro-micro coordination necessary to ensure that growth and structural change were continued.

The third issue relates to accusing Mahathir of naively making damaging economic statements at a time when the Ringgit was vulnerable in 1997. While the stock and currency markets responded with a pounding each time Mahathir said something negative in 1997, evidence suggests that the shrewd former Prime Minister of Malaysia may have cleverly taken on such a belligerent approach because the acting Prime Minister then was Anwar Ibrahim. Considered the most industrious Prime Minister of Malaysia, Mahathir may have had political objectives to make those statements as his leadership after the sacking of Anwar transformed dramatically to contain the crisis swiftly. Not only was he correct in calling for the shielding of the economy from external volatilities, he also implemented drastic measures to re-liquefy the economy by directing *Danamodal* (capital-fund) and *Danaharta* (asset-fund) to acquire and sell the rapidly accumulating non-performing loans and forcing interest rates down to small and medium firms (see Jomo, 2000;

Rasiah, 2001). These Keynesian measures may have influenced a departure in the IMF's governance procedures as interest rates were also lowered in Korea, Thailand and Indonesia after that.

Fourth, the attempt to link Marxism with Leninism to explain the malaise that took place under Stalinist Russia robs the book of a crucial issue that the original Marx raised on accumulation and equity. Marx's (1853, 1970) articulation of the dynamism of capitalism in engendering the productive forces has no peers and even Schumpeter conceded subsequently to his influence on his writings. The focus on the real economy, but importantly on technology by Marx struck a chord with the technological catch up experiences of Japan and Korea that took account of the creative destruction effects of competition. In hindsight what happened in the Soviet Union was Lenin's (1965) version of revolution where the vanguard dominated politics, thereby denying freedom of expression to the masses that got worse during Stalin's rule. What is important here is to recognize the problems of capitalist societies that generate serious inequalities. Marx not only rejected the idea of a socialist revolution happening in rural Russia, he had actually addressed a fundamental problem liberation theologians have rightly fought for by seeking a classless alternative (see Freire, 2006). Marx's revolutionary alternatives may have come out seriously short, but unless capitalism pays serious attention to its inherent inability to exacerbate inequalities to provide access to basic needs by the poor, economic growth will remain distanced from economic development. Krugman's glorification of the leadership of Pinochet and Carlos Menem in Chile and Argentina respectively does not take account of the diabolic distribution consequences they brought to their respective countries. Indeed, the speculative bubbles may have been reduced if only the unequal distribution of wealth in the United States had been avoided (see Lim and Lim, 2010). Certainly there would have been less capital-chasing excessive consumption of luxury goods and speculation with the latter causing serious problems to the real economy during times of busts. By avoiding a discussion on this issue, the book failed to offer a significant alternative so as to make the world economy more resilient during such systemic crisis.

Finally, indeed the book seeks to offer useful alternatives to prevent the future occurrence of such crisis but does little to justify this claim. If the range of assessments is to be synthesized into a body of lessons, countries seeking to avoid such a crisis will not only face confusion from the tautological presentation, they will also not be able to address collective action issues that are essential to coordinating the critical micro-macro interactions that require inductive assessments from an evolutionary perspective (see Nelson, 2008). In addition, the book appears excellent in analyzing the causes of the United States-led global financial crisis of 2008, but offers little that countries can use to avoid or insulate themselves from future crises. Others have attempted better alternatives that appear worthy of consideration by the global financial governance bodies such as the IMF (see Akyuz, 2010).

While the book is interesting as it brings to the fore past crises, and makes an attempt to capture the similarities and differences behind the more fundamental causes and discusses a number of critical issues that interested persons must read, I believe some of its arguments could have been strengthened if only its presentation had steered clear of ideological shortcomings and with the right sort of evidence. It is important that I put these arguments and evidence on record for interested readers to view even if Krugman may actually reject them.

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