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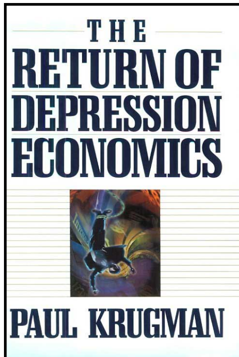

The Return of Depression Economics

by Paul Krugman
W.W. Norton © 1999
176 pages

Focus

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Take-Aways

- The world economy will not enter a 1930's style depression in the near future.
- Be alert for dark forces — namely panic attacks in international financial markets.
- For the first time since WWII, failures on the demand side of the economy have become the greatest hazard to prosperity.
- An economic slump is characterized by excess supply, relative to demand.
- Recessions are normally caused by the public trying to accumulate cash and can usually be cured by printing money.
- Be cautious of sudden apparent recoveries following economic recessions.
- Capitalism has redeveloped a romantic hero: the independent entrepreneur.
- Asian economies did not perform well in "total factor productivity" even during the miracle years. They were growing from perspiration rather than inspiration.
- The Thai government's most critical fiscal crisis mistake was being indecisive.
- Southeast Asian countries are strongly tied together in the minds of investors. Negative perceptions regarding one country have a negative impact on all countries.

Rating (10 is best)

Overall	Applicability	Innovation	Style
9	7	9	10

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Relevance

What You Will Learn

In this Abstract, you will learn: 1) The roles that consumer demand and productivity growth play in sustainable prosperity; 2) The recession-fighting ability of specific economic policy tools; and 3) The power of investor perceptions, panic and negative feedback loops to bring down otherwise well-behaved economies.

Recommendation

Economic scholar Paul R. Krugman investigates the forces that drive economic growth and recession, and makes sense of several complicated issues. His ability to maintain the essence of a topic while simplifying complex economics with examples and analogies is a hallmark of his work. Despite the gloomy title, the book is not depressing because, Krugman concludes, another Great Depression is not looming in our future. Capitalism has, overall, provided the foundation for prosperity in advanced and developing economies alike. Indeed, the information age has introduced entrepreneurs who have generated wealth while becoming romantic heroes for succeeding in spite of giant corporations. However, Krugman stays alert for dark forces, warning us against panic attacks in the international financial markets, where multiplying negative feedback can overwhelm the effects of monetary policy. *getAbstract.com* recommends Krugman's in-depth analysis to anyone with an interest in world economics and financial markets.

Abstract

The Need to Want More

The world economy will not enter a depression reminiscent of the 1930's in the near future. However, a large part of the world must become sensitive to the forces of depression economics. For the first time since WWII, failures on the demand side of the economy including insufficient private spending have become the greatest hazard to prosperity for many economies.

"Economics inevitably takes place in a political context."

The Success and Romance of Capitalism

The return of depression economics does not signal the failure of capitalism. In fact, depression economics has returned in the midst of the triumph of capitalism. The former Soviet Union — once the financier of worldwide socialist movements — has lost its ability to support other nations. Russia's economy is in a miserable state. In addition, Hong Kong's capitalist system, virtually untouched despite its return to China in 1997, shows the world that the free market is too valuable to destroy, even in the eyes of the People's Republic.

Not only has capitalism brought economic success and prosperity to many nations, it has even redeveloped a romantic hero. After Henry Ford, the economy was dominated by giant corporations, run not by romantic innovators but by bureaucrats who might just as well have been government officials. However, the information age now has created a renaissance of independent entrepreneurs whose heroic tales are chronicled in business magazines.

"While China might have occupied Hong Kong, ideologically Hong Kong had conquered China."

The Mechanics of an Economic Slump

An economic slump is characterized by excess supply, relative to demand. There are more workers than jobs and more production capacity than demand. It is not hard to

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"As late as the early 1990s, China's transformation had failed fully to register with the chattering classes — China was thought of, if at all, as a subsidiary player, perhaps part of an emerging yen bloc."

imagine how demand for some goods may decrease while demand for others increases due to shifts in preferences or costs, but it is less obvious why the overall demand for all goods might decrease. Since the real economy is very complex, this is best explained by a simple analogy.

A baby-sitting co-op was organized for 150 couples who have young children. In the beginning, a certain number of coupons were evenly distributed amongst the parents. After that, parents used a coupon to pay for baby-sitting services when they went out and they earned a coupon when they provided this service for another couple in the co-op. After a certain time, members began to sense that there was a shortage of coupons in circulation. As a result, members became anxious to baby-sit in order to earn more coupons. At the same time, few members wanted to spend their coupons. As a result, opportunities to earn coupons diminished and the co-op entered a recession.

"But who can now use the words of socialism with a straight face? As a member of the baby boomer generation, I can remember when the idea of revolution, of brave men pushing history forward, had a certain glamour. Now it is a sick joke."

The baby-sitting slump occurred due to a lack of effective demand, not due to poor quality baby-sitting, a change in baby-sitting technology, particular values or corruption. The problem had two basic solutions. The first was to require each couple to go out at least twice a month. The second, preferred by economists, was to increase the supply of baby-sitting coupons. Increasing the supply had magical results. Couples were more willing to go out and the co-op generated more opportunities to baby-sit to earn more coupons. As a result the gross baby-sitting product (the number of baby sittings and parent outings) soared and the co-op enjoyed a high standard of living. The lesson: recessions are normally caused by the public as a whole trying to accumulate cash and can usually be cured by printing money.

Accelerator Principle

Be cautious of sudden apparent recoveries following economic recessions. The Accelerator Principle explains why, in most cases, a sudden partial recovery immediately follows even the worst recessions. Again, an analogy offers the best explanation. Consider a line of cars, equally spaced, going 60 mph. The front car reaches a patch of road that requires it to suddenly reduce its speed by half. A series of reactions from the cars behind follows. However, the necessary reactions are not all the same. They become more dramatic down the line.

"For the first time since 1917, we live in a world in which property rights and free markets are viewed as fundamental principles, not grudging expedients; where the unpleasant aspects of a market system — inequality, unemployment, injustice — are accepted as facts of life."

The first car immediately slows from 60 to 30 mph. It takes a moment, however, for the second car to notice that the first car has slowed, which reduces the distance between the two cars and forces the second car to reduce its speed even more, to compensate for its slower reaction time. The second car reduces its speed to 20 mph. Now the third car, which takes a moment to notice that the second car has reduced its speed, must also reduce its speed, but it must do so to an even greater degree than the second car. And so on. Once the cars have all reduced their speed, they are soon able to increase their speed to that of the lead car, 30 mph.

This speed reduction of all cars to 30 mph is analogous to the partial recovery of an economy after an initial slump. Regardless of the cause, the economy suddenly slows down. Demand drops. Businesses are surprised. Inventories pile up. Companies cut production and lay off workers. Incomes drop. Demand drops further. This is a circular pattern. However, production and demand eventually reach a new equilibrium, leading to a partial recovery, even if the slowdown's original cause has not been cured. This quick partial recovery is due to the accelerator effect, and does not signal that the original problem is cured.

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The Asian Miracle

During the third quarter of this century, the countries collectively known as the 'Third World' were considered economically backward, poor and hopeless. These countries were trapped in a pattern of exporting low-valued agricultural products and raw materials. Then, some combination of globalization factors that are still not fully understood, such as reduced tariffs, improved telecommunications and less costly air transport, changed everything. Suddenly a number of industries found that cheap labor offered them an adequate competitive advantage to break into world markets. This export-led economic growth resulted in very measurable standard-of-living benefits for many people. However, the sudden increase in Asian economic growth was not created by foreign aid or by the benign policies of national governments. Rather, it grew from the rather selfish motivations of local entrepreneurs and multinational corporations who profitted from the opportunities offered by cheap labor.

"When the debt crisis struck in 1982, many in the United States had feared that the result would be a radicalization of Mexican politics, that anti-American forces — perhaps even Communists — would rise in the resulting chaos. Instead, pro-American, free-market types had miraculously come to power, and offered to take down all the old barriers."

Really a Miracle? The Importance of Total Factor Productivity

Even during the miracle years, Asian economies did not perform well by one measure: total factor productivity. This is a ratio of an economy's total output (measured by metrics such as GDP) to an economy's total input (index of labor and capital). The input measure includes capital, which is not part of common labor productivity measures. This is important since productivity can be increased by improving the efficiency of equipment, not just by providing labor with more equipment. In other words, this measure captures technological improvements. In Asian economies (somewhat like the Soviet economy that preceded them), even though apparent economic growth came from the massive labor mobilization and huge investments, total factor productivity growth was very slow. These economies were growing from perspiration not inspiration, and that type of growth is not sustainable.

The Beginning of the Asian Crisis — Thailand

"Only yesterday, it seems, Americans were obsessed with Japan. You couldn't enter an airport bookstore without encountering rows of dust jackets featuring rising suns and samurai warriors."

The crisis was sparked by the devaluation of the Thai baht on July 2, 1997, the day after Hong Kong finally was returned to Chinese rule. Devalulation was precipitated by a decrease in demand for Thai exports and an increase in Japanese competition as the yen depreciated. Most importantly, devaluation resulted from a significant reduction in access to credit from foreign investors due to the unsurprising failure of some earlier speculative investments.

To some extent, this credit reduction became a self-reinforcing process that reduced the flow of new loans, further reducing confidence. This slowdown resulted in an increased demand for foreign currencies and a decreased demand for the baht. This required the Bank of Thailand to purchase bahts to support the currency. Controlling deflation is much more difficult than controlling inflation because the central bank can print local currency to control inflation, but it can not print foreign currency to control deflation. In addition, many banks, finance companies and Thai businesses were highly exposed to exchange slides since they had large debts in dollars.

"Hedge funds don't hedge. Indeed, they do more or less the opposite."

The Thai government's most critical mistake was being indecisive. It was unwilling to let the baht depreciate and also unwilling to take harsh domestic measures. Speculators observing this unwillingness could thus predict that the baht would eventually fall. Therefore, during the period of indecisiveness, they borrowed in baht which required the central bank to buy even more baht to prevent devaluation. This process carried on until the bank's reserves were essentially depleted and, on July 2, the Thai government let the baht go.

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Asian Crisis Contagion

Despite their geographic proximity, the economies of the 'Asian tiger' countries were quite distinct. South Korea, for example, was a relatively distant economy, geographically. In 1996, its GDP was twice as large as Indonesia's and three times as large as Thailand's. Why did the economic crisis spread so quickly and so dramatically throughout all these countries? First, there were some direct linkages between countries — Malaysia is a market for Thai products and vice versa — and they often sold similar products, such as textiles, to third parties. However, all economic analysis indicates that this was not the major force driving the spread of the crisis.

"What nobody realized until it happened was that the competition among hedge funds to exploit ever narrower profit opportunities had created a sort of financial doomsday machine."

More likely, direct financial linkage was the driving force of contagion. 'Emerging market funds' that lumped all of these economies together were a major source of capital flow into the region. This resulted in direct mechanical links among these countries' finances. The association of Asian economies in the psyches of investors was an even greater force. These countries were perceived to share in the 'Asian miracle.' Thus, Southeast Asian countries were strongly tied together in the minds of investors; therefore, negative perceptions about one country had a negative impact on all the related countries.

Panic

Investor panic is a powerful force that can override otherwise sound macroeconomic policy. Panics are so powerful because they can be self-reinforcing and, as a result, can validate themselves. The negative impact moves in a circular pattern, increasing as it goes. This could result in a devastating feedback loop, though it does not necessarily have to do so. Why doesn't any shock to an economic system result in a devastating panic? Again, an analogy is useful. A microphone in an auditorium always creates a feedback loop. The microphone picks up sounds from the speakers and sends the signal back to the speakers to be amplified, and so on. However, this is usually a 'damped' process and so the feedback loop doesn't cause a problem. However, if the room has a significant echo and the gain is turned up too high, the sounds from the speakers that return to the microphone exceed some critical threshold, the feedback loop increases the recycled signal's amplification and the sound system malfunctions.

The key is that the feedback mechanism is always present, but it does not have a destructive effect unless the critical threshold, which is unique to the system, is crossed. It is impossible to identify the critical feedback threshold in an economy, but it is useful to understand the concept. Panic is only dangerous if the threshold is crossed, otherwise its effects are dampened and unimportant.

About The Author

Paul R. Krugman is a professor of economics at the Massachusetts Institute of Technology (MIT) and produced this book in a time of economic crisis, specifically, in Brazil in January 1999. He is a prolific economic scholar. *Fortune* magazine claims that he "writes better than any economist since John Maynard Keynes," and the *Economist* describes him as "probably the most creative economist of his generation."

Buzz-Words

Accelerator principle / **N**egative feedback loop / **T**otal factor productivity

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