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BOOK REVIEW

End This Depression Now!

Paul Krugman
New York and London: W.W.Norton & Co., 2012, 272pp, £14.99 (hbk)
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This is a tremendous book, albeit one with flaws, which deserves to be widely read in academia, in the policy world, and by anyone worried about the plight of the international economy.

Paul Krugman is a Nobel Prize winning economist whose name will be recognised by many even if they don't know much about his earlier work. Long before the publication of this new book, he had an enviable reputation as a commentator and pundit on both sides of the Atlantic. Here he lays out his thoughts on what went wrong in the financial crisis of 2008 and what now needs to be done to restore economic growth and reduce unemployment. The focus is on the US economy but his analysis of how modern economies work is of much more general applicability and there is sufficient reference to events in Britain and Europe to keep the non-US reader happy.

Krugman unashamedly sets out to reach a non-technical audience. His intention in doing so is to appeal over the heads of the elite who dominate economic policy making to try to shape wider opinion and political debate. His writing style is lucid and at times there are even touches of humour – this is a 200-page book you can plough through in not much more than one sitting. There are, for example, absolutely no traditional academic references. But that does not mean the content is anything less than rigorous. Krugman draws on ideas and evidence from many of the economics profession's leading players. Sometimes he backs what they have to say; other times he trashes them comprehensively.

Underpinning the whole book is Krugman's essentially Keynesian view of the way that economies operate. The problem the US and European economies now face is one of depression, he argues, not unlike the 1930s in its basic features though thankfully not quite as severe. There is deficient demand for goods and services, and for the labour to produce them. The need is to stimulate demand, but since monetary policy has been pushed to its limits and still hasn't triggered a revival, the way forward lies with expansionary fiscal policy – i.e. more public spending.

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Krugman explains very eloquently how one person's spending is another's income, and how the dynamics of economies as a whole are therefore not the same as the dynamics of individual households. Inject more spending, and incomes and tax revenues will rise. Economic growth, and a modicum of inflation perhaps, is his solution to budget deficits.

Economists from outside the Keynesian tradition will hate this analysis. Indeed, they probably won't even listen. Krugman is correct to point out that economists and policy makers who believe in the merits of self-regulating free markets often do so in an almost religious fashion, in the face of historical evidence or logic. Frankly, anyone who has kept an eye on the dynamics of real economies over the last thirty years or so, or who has some knowledge of the 1930s depression, should need no convincing of the correctness of the Keynesian perspective. But as Krugman points out, the ideological and institutional links between the highest echelons of finance, academia and government often obscure the reality. We already know how to avoid prolonged economic depressions. We just need to get on with the job.

Yet Krugman's commentary also has shortcomings. This is perhaps clearest in his analysis of the roots of the financial crisis. His perspective is actually markedly conventional: that there was excessive lending in the US housing market, leading to an unsustainable house price bubble and to a private-sector debt crisis. This in turn brought the banking system to the point of collapse when the bubble burst, slashing consumer spending and private sector investment, and generating public sector budget deficits as revenue fell and the economy contracted.

So far so good perhaps, but Krugman never asks why the US economy (or the UK economy for that matter) had become so dependent on debt in the years that led up to the financial crisis. The fact is that the US and UK economies had become so reliant on private sector debt to fuel spending and economic growth because both economies were running thunderous trade deficits with the rest of the world. In essence, both the US and the UK were consuming more than they were producing. Imports of goods and services plugged the gap, and continuing spending – beyond the level financed by incomes – was supported by rising debt. What happened in 2008 (or a little earlier in the US) was that the ability of consumers to take on and service more debt hit the buffers.

Krugman's proposed stimulus to economies through higher public spending would therefore only address part of the problem. It would raise spending, incomes, employment and tax receipts – potentially no mean achievement. But in an economy that trades heavily with the rest of the world a proportion of any additional spending inevitably leaks into higher imports. In the absence of fiscal expansion elsewhere around the globe to provide an equivalent boost to exports, the consequence would be further growth in the trade deficit. This in turn would have to be financed by further borrowing.

Krugman argues that there is little practical constraint on the capacity of the US and UK governments to borrow at present. The evidence – particularly interest rates on government bonds – suggests he is right. He also argues that it is entirely incorrect to read across from the troubled Eurozone economies to countries like the US and UK that have their own currencies. In this too he is correct.

Yet it is worth asking how durable a public-sector led recovery in jobs and growth would be if the fundamental trading imbalances in the world economy are not addressed. Or to put it another way, how long will China be willing to lend to the US to finance US consumption?

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I had thought that Krugman would have got to grips with the need to address trading imbalances. The world's creditor nations – China above all but also Germany and several oil producers – need to expand domestic consumption and imports. Rising exports to these economies from countries like the US and UK would enable spending and job growth to be rooted in rising incomes rather than rising debt. China's absurdly low exchange rate, which results in the destruction of industry in so much of the West, and the inflexibilities of the Eurozone, which currently entrench German competitiveness, are at least as much the cause of economic crisis as the hubris of the banking system.

Yet I was shocked to discover how little attention Krugman devotes to these underlying problems. China receives but three mentions in the whole book – and the US-China trade imbalances only one mention, virtually in passing, towards the end of the second-to-last chapter.

So read this book, and learn from it. But it is not the last word in how to solve the current economic crisis.

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