Review Essay

POST-MODERN ECONOMICS: THE RETURN OF DEPRESSION ECONOMICS. BY PAUL KRUGMAN. NEW YORK: W.W. NORTON AND COMPANY, 1999

Paul Krugman is a Keynesian, and I do not mean New Keynesian either. He is a devout Keynesian of the most paleo variety. To understand this fact is to understand his latest spin on world economic events, The Return of Depression Economics. In this relatively brief and breezy work, Krugman uses Keynes's General Theory to explain the recent financial crises of Latin America and Asia. Consequently, in his tale of economic recessions, all of the usual Keynesian suspects appear: the abuse of aggregates, the liquidity trap, crabby dismissals of "orthodox views of economic policy," chronically unstable financial markets ruled by animal spirits, and monetary inflation as the wonder sedative for an economy plagued by panic attacks.

While damning the free market with the faintest of praise, Krugman's book provides us with an excellent example of why it is so important to get the analysis right before prescribing policy solutions for an economic problem. In Krugman's case, bad analysis leads to bad policy recommendations.

Krugman's main analytical model is a quintessential example of his strengths, such as they are, and weaknesses. While attempting to explain the workings of the economy in simple terms that the general population can readily understand, he hitches his analytical wagon to an article using a baby-sitting co-op in 1970s Georgetown as a model for the macroeconomy.[1] As a result, Krugman makes fundamental errors regarding how the economy works. In an attempt to efficiently ration baby-sitting services among the members, the baby-sitting co-op issued coupons. Each member family paid a baby-sitting ticket whenever they used the co-op and received a ticket whenever they baby-sat for one of the other members of the co-op. Purposely leaving out the details, Krugman tells the reader that members of the co-op suddenly increased their demand to hold baby-sitting tickets. Consequently, there was not enough aggregate baby-sitting demand for the services of those members in the co-op who were looking to baby-sit in order to increase their ticket incomes. In other words, Krugman explains, the baby-sitting co-op went into a recession.

[1]Joan and Richard Sweeney, "Monetary Theory and the Great Capital Hill Baby-sitting Co-op Crisis," Journal of Money, Banking, and Credit (1977), pp. 86-89. Incidentally, although Krugman gives the article a date of 1978, Richard Sweeney's vita lists the date as 1977.

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The attraction of this model is its seductive simplicity. Krugman is often quite good at taking issues and problems the general reader finds unmanageably complex and explaining them in ways simple to understand. While this is, of course, a virtue, it is only a virtue if his explanation accurately reflects reality. The chief responsibility of the economist is to get the analysis straight. For this, the baby-sitting model will not do.

The fundamental error of this model is that it only has one good: baby-sitting. This leads the reader to think of economic output as if all goods produced in the economy are homogenous units making up one aggregate. The lesson of the model is that if a recession occurs, it must be that there is not enough demand for this homogenous output. In the baby-sitting model, the problem is that members demanded to hold too many tickets. For the economy as a whole, as Krugman views it, "a recession is normally a matter of the public as a whole trying to accumulate cash" (p. 11). People decrease spending in order to increase their cash balances. The supply of goods not demanded sits idle, and unemployment results.

In reality, of course, the plethora of goods bought and sold in the world economy are heterogeneous. What causes a recession is not too little "aggregate demand" or "too much capacity" due to overinvestment. Recessions are a product of malinvestment, resulting from government intervention in credit markets. If the government increases the money supply through credit expansion by artificially lowering interest rates, an incentive is created for entrepreneurs to invest in too much production of some higher order goods and not enough production of other lower order goods. It is not that too much investment is occurring in every sector of the economy, rather, investment that is occurring is being directed toward producing the wrong things, from the point of view of the people who make up society.

A very telling characteristic of Krugman's analysis is that he argues that recessions will persist until aggregate demand picks up due to monetary inflation. Again Krugman, alluding to both the baby-sitting co-op and the economy, states that the recession "can normally be cured simply by issuing more coupons" (p. 11). The immediate question that should come to mind is why the surplus was not eliminated by a fall in the price of baby-sitting. We do not know. Krugman does not even bring it up! The model assumes that the prices are fixed at a one-ticket-to-one-night-of-baby-sitting ratio. This lulls the reader, and it seems Krugman himself, into forgetting that prices will adjust downward to eliminate any surplus due to a drop in demand. It is curious, to say the least, that in a book with the word economics in the title, the author does not get around to discussing even the mere possibility of a price decrease in the face of a surplus until page 155, that is, until the reader has read 92 percent of the text.

Nevertheless, this is the story that Krugman tells regarding the world's recent financial crises. In his view, the Asian and Latin American financial breakdowns were simply a problem of not enough demand. Krugman does not explain why aggregate demand decreased, except by claiming that a lack of investor confidence in those

economies fed on itself, creating full-fledged panic. Evidently, that is what we get for allowing the animal spirits to roam free in the market.

Of course, to paint such a threatening picture of the free market, Krugman must make it an easy target. He begins with cogent arguments that should have led him down a better path. Krugman rightly notes the positive effects of decreasing tariffs and regulation in Third World countries and he correctly sees increased capital accumulation and technology as key determinants of the economic development that has occurred in Latin American and Asia. He also seems skeptical of government's ability to manage an economy, particularly due to the amount of corruption that takes place in any country where the state calls the economic shots. He even implies that capital accumulation itself is not enough; it must be invested where it will make a profit. Unfortunately, he does not follow his logic to the conclusion that private-property rights and the profit and loss system of the free market are necessary for efficient investment.

Krugman makes his case for government intervention in typical Keynesian fashion by stating that the free market can simply just go bad. He cites examples such as Brazil, Argentina, Thailand, and South Korea who decreased regulations and tariffs and privatized industry and subsequently reaped economic growth. Then in this more laissez-faire environment, a crisis occurred. It is clear to Krugman that the free market cannot be left on its own to persistently increase wealth and incomes. Rather, the moral of the story is that the free market, while providing a certain level of prosperity, repeatedly becomes unstable due to the volatile behavior of speculators, leading to oscillations in confidence. As Krugman puts it, "the world is lurching from crisis to crisis, all of them crucially involving the problem of generating sufficient demand" (p. 156).

This brand of depression economics suffers from at least two fundamental errors. In the first place, it completely misconstrues the very reason for economic activity. The economic problem that man has worked at solving throughout history has never been insufficient demand. It is, in fact, just the opposite. Men must make economic choices for the very reason that goods are scarce. That is, the supply of goods freely available from nature is less than the demand for them. Consequently, in order to survive and prosper, humans must make choices and direct the scarce factors of production toward their most highly valued use. The fundamental economic problem always has been and will continue to be scarcity.

Second, Krugman's characterization of the economies of Asia and Latin America before the crisis overlooks the very catalyst that sowed the seeds for the panic: government inflation. While it is true that the countries he cited were making progress in freeing their economies, they were still intervening in the economy via their central banks. Preceding their respective economic crises, all of the countries cited by Krugman set themselves up for trouble ahead, not by freeing their economies, but by rapidly increasing the supply of money. From 1985 to 1990, Japan inflated its money supply at an annual rate of 10.5 percent. From 1991 through 1995, South Korea increased its money supply at an annual rate of 17.3

percent. From 1992 through 1996, the annual rate of inflation for Indonesia was 30.6 percent, while that for Thailand was 13.8 percent. Krugman neglects to mention these facts; it is as if he views inflation as standard operating procedure in the free market.

Not surprisingly, Krugman's faulty analysis leads to faulty policy conclusions. Following his mentor, Krugman recommends hefty monetary inflation as the cure for financial crises. He points to World War II as the cure for the Great Depression and to post-World War II central bank money manipulation (what he calls the "Keynesian Compact") as the key to financial stability.

Dismissing what he takes for Austrian business cycle theory with the pejorative "hangover theory," Krugman advocates massive inflation in Asia and Latin America to solve their economic ills.[2] He definitely does not think that the free market should be allowed to liquidate losses. As Krugman argues, "There is no good reason...why misguided investments in the past should leave perfectly good workers unemployed, perfectly useful factories idle" (p. 160). He repeatedly calls for increases in the money supply instead of recognizing that inflation is what created the mess in the first place.

The problem is even worse in Japan, in Krugman's eyes, because it has fallen into the old liquidity trap. Normal credit expansion through artificially lowered interest rates will not do the monetary trick, because the Japanese want to hoard cash. The solution, according to Krugman, is for the government to print up and spend Yen until the Japanese citizen forms inflationary expectations. Once this occurs, the Japanese will decrease their demand to hold money, because they will be expecting its value to decrease. For other Asian countries where the crisis is particularly acute, Krugman advocates capital controls in order to forestall the next level of panic in the financial markets. Krugman, like Keynes, thinks we can save some semblance of the free market with the right amount of intervention.

Austrian theory has shown that the problem of recession is not "idle capacity" per se and that increasing the money supply in order to put such idle capacity back to work will fail to solve the problem. In fact, increasing the money supply via credit expansion only exacerbates the malinvestment. New funds that are borrowed will be used by businesses to produce even more higher order goods and the economy is knocked even further out of balance. Additionally, some of the capital goods that are malinvested during the inflationary boom are nonconvertible. They are only suitable for use in producing a particular good. If investment in that good proves to be a bust, that nonconvertible capital is completely wasted. It cannot be recovered, and increasing the money supply will not make it more suitable for alternative production. The only way to replace lost capital stock is through saving, not inflation. The solution is to free the market, giving entrepreneurs the

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[2]Although he never identifies the "hangover theory" as Austrian as he has done elsewhere, he is really criticizing Schumpeter, whom he mentions by name, having apparently never read Mises.

incentive to save again and invest in those lines of production most in demand by the public.

Ironically, after Krugman vows to the reader that he, objective social scientist that he is, will resist the "inclination to moralize"; he concludes by faulting the advocates of the free market for pride and prejudice. Krugman argues that pride in a free market is "a luxury none of us can afford in a world that has turned out to pose unsuspected risks" (p. 166). He accuses economists who recommend allowing the market to freely liquidate unprofitable investments after an inflationary boom of suffering from a prejudicial attachment to "orthodox" theories and he ends his work with a subtle gibe at those who maintain that unemployment persists during a bust because interventionist measures hinder the price adjustment process.

Krugman closes with a revealing statement, "the only important structural obstacles to world prosperity are obsolete doctrines that clutter the minds of men." Here Krugman implies that he does not really believe in economic truth. In his mind, economic laws that were once perfectly valid are now "obsolete." Supply and demand theory may have been true before 1936, but now we need to make way once again for the "new economics," what Krugman calls "depression economics."

What counts, of course, is not whether an economic theory is old or new, but whether or not is it true. Krugman's depression economics might make for good reading for today's postmodernist who is bored with the notion that there is still an inverse relationship between price and quantity demanded, ceteris paribus. Those economists who still believe in economic laws, however, will remain less than pixilated. Moreover, if those individuals who are actually experiencing the crises he writes about follow his prescriptions, they will have every right to remain depressed.

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