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【Book Review】

The Great Recession: Two Authors in Search of the Floor Plan and an Exit

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Paul Krugman. 2012. *End This Depression Now!* New York, W.W. Norton & Company. Pp. xii, 259. ISBN 978 0 393 08877 9 (hardback).

Michael Lewis. 2011. *Boomerang: The Meltdown Tour.* London, Penguin Books. Pp. xxi, 213. ISBN 978 1 846 14484 4 (hardback).

The Great Depression of the 1930s spawned, and continues to spawn, a vast literature aimed at explaining its birth (conventionally dated from the Wall Street Crash of October, 1929) and, perhaps even more importantly, why it lasted so long. The rationale for this obsessive concern amongst economists and commentators is the near-universal belief that it has important lessons to teach; central bankers like Ben Bernanke study the 1930's so avidly in the firm conviction that, whether or not the Depression could have been averted, there is no question but that it was aggravated by policy mistakes that prevented an effective cure from being found far more quickly – hence, to take just one example, the level of criticism aimed at the Federal Reserve for deciding to abandon monetary easing in the early summer of 1930 (Ahamed, 2009, p. 366). The (unverifiable) conviction that a decade of economic misery and political extremism culminating in a world war was (to a large extent, anyway) avoidable, combined with an assumption that all economic downturns are, at root, the same animal, has made it an article of faith that even if the wild horses of the apocalypse will never be candidates for extinction, they can, with experienced handling, be broken in and rendered reasonably tame.

Yet the economic ebbing that was, and in all probability still is, the Great Recession (which first came to the popular notice in the shape of the 'Lehman shock' of September 2008, though the tide had in fact turned as early as December 2007) seems to suggest that, to date, the correct conclusions from past experience have either yet to be drawn or, having been drawn, have simply been ignored this time around. Robert Hetzel, for example, is certain that 'contractionary money policy turned a moderate recession into a severe recession in the summer of 2008...[when] the Fed, along with other central banks, recreated the stop phase of the stop-go monetary era by failing to lower the funds rate in response to sustained weakening in economic activity' (2012, pp. 214, 216). Others, by contrast, are just as certain that the authorities have made a bad situation far worse by their actions rather than their passivity; the levees hastily put together in the aftermath of Lehman to hold back the waters of the downturn in the U.S., Europe and China are seen by alarmists like Peter Schiff (2012) as merely having created the conditions for a second, and much more devastating, crash to come – the 'perfect storm' now being forecast by Dr. Nouriel Roubini for 2013.

Even some of those with a residual belief in the potential efficacy of policy note that the defences erected in 2008 are today much less secure, and that the arms that should be working to reinforce them have grown weary. According to one leading British commentator, Ambrose Evans-Pritchard (2012), even the 'Federal Reserve has drifted into fatalism, seeming to lose confidence in its own ability to shape events, displaying the same lack of "Rooseveltian resolve" as the Fed in the early 1930s…'. On this view, the malaise is set to continue; there is no early end in sight, the world having run out of answers and its will to seek fresh ones becoming ever more enfeebled. The temptation grows to confess that no quick or effective fixes exist, that we are between a rock and a hard place, things having spun beyond our control, and that time will simply have to be allowed to do its work, even if this means that things will get worse, perhaps much worse, before they get better.

All such defeatist talk is but a red rag to the bulldozer that is Professor Paul Krugman, winner of the 2008 Nobel Prize for Economics. For him, there is no question but that the current downturn can be cured, nor any doubt that the process of recovery can be swift and easy – and in *End This Depression Now!* he undertakes to explain, in relatively simple terms accessible to the non-specialist, how all still lies within our power. For someone of his temperament, this inevitably means excoriating those who disagree with him – the contemporary "liquidationist" school of Raghuram Rajan and others, for example, whose work he views as basically an exegesis of the 'infamous passage" in which Joseph Schumpeter argued that economies can only properly recover from depressions of themselves, and that well-meaning efforts to accelerate the process by 'artificial stimulus' are damagingly counterproductive (Krugman, pp. 203-205, quotes at p. 204). Professor Krugman will have no truck whatsoever with the notion of leaving ill alone; the fact that the usual remedies have failed is for him merely a spur to more radical action. Like any summons to arms, his call seeks to sound a bracing and encouraging note. But in what guise will the bold knights who are to come to our rescue appear?

Not, for Professor Krugman, as central bankers, even though he is happy to concede that such champions still have a role to play (p. 217). For he is not a market monetarist, one for whom quantitative easing *á l'outrance* will save the day. Such tactics, he accepts, work well enough with run-of-the-mill recessions, but their limitations are cruelly exposed when an economy is ensnared, as at present, in a liquidity trap (pp. 31-34). So while the Federal Reserve does still have work to do, the real burden has now been shifted onto the shoulders of the Federal Government which, availing itself of the playbook of John Maynard Keynes, must spend whatever sums of money it takes to replace the loss of demand in the private sector and so kick-start a recovery. All the evidence, Professor Krugman claims, confirms that 'changes in government spending move output and employment in the same direction: spend more, and both real GDP and employment will rise; spend less, and both real GDP and employment will fall' (p. 212). For a self-confessed 'sorta-kinda New Keynesian...[who] often turn[s] to Old Keynesian ideas...', a saltwater pragmatist - in his own eyes at least (p. 104) - nothing could be simpler or more obvious. Government funding alone can do all that is needful to rebuild demand in the economy by putting money back into the hands of consumers. Opportunities without number exist for federal initiatives here: it can reemploy the teachers and other public employees sacked by states and municipalities in the past few years as they have cut their budgets (pp. 214-215); bring to fruition infrastructure projects, prosaic as well as high-tech (p. 215); offer a program of mass refinancing to those whose are under water with their mortgages (p. 220-221), and so on, *ad paradisum*.

But this wonder-working government largesse - where is it to come from? Professor Krugman does not dwell overlong on specifics here, being far more concerned to extol the virtuous nature of public spending, and too involved in dismantling the arguments of those who disagree with him on the point, to delve into too much detail. Tax increases, except for the ultra-wealthy perhaps, would not appear to be on the agenda; apart from their adverse impact on demand, they are not politically realistic given the current attitude of U.S. voters. That leaves only borrowing – which, for Professor Krugman himself, is not really a problem. Yet, as he freely acknowledges, debt is the subject which dominates thinking everywhere today, and it is the ground on which the battle of economic ideas will be fought to its conclusion. What he has to say on the subject, then, is key to whether his cry for action will be heeded.

First and last, he must, of course, avoid at all costs having the placard of irresponsible spendthrift hung around his neck. So he is quick to fend it off with a rhetorical question; shouldn't we, he asks, 'be concerned about the burden of debt we're leaving for the future?' The answer is more rhetorical still; not a definite "Maybe", but a 'definite "Yes, but."'

> Yes, debt we run up now, as we try to cope with the aftermath of a financial crisis, will place a burden on the future. But the burden is a lot smaller than the heated rhetoric of deficit hawks suggests.
>
> The key thing to bear in mind is that the $5 trillion or so in debt America has run up since the crisis began, and the trillions more we'll surely run up before this economic siege is over, won't have to be paid off quickly, or indeed at all (p. 141)

Good news indeed, but persistent devils remain to be exorcised from the detail, where we find that two important preconditions must be satisfied before entry into the Promised Land is ours. Firstly there will need to be a return to growth, which will bring down the ratio of debt to GDP to an acceptable level; and. in the second place, enough inflation must be engineered over time to erode the value of the debt, again to render it serviceable – Professor Krugman is certain that the inflation target should be raised above the current 2% p.a., though his preferred figure varies (on p. 217 it is 3–4%, while on pp. 162–163 we advance to 4–5%). All which begs the questions, 'Why not 6% or higher?', 'Are lenders really so blind as not to notice they will be short-changed?', and 'Will they not rush for the inflation-proof bonds whose existence Professor Krugman notes?'. Nonetheless, providing his two prerequisites are satisfied, Professor Krugman is confident that all shall be well and all manner of things shall be well. There is no gainsaying that it is a beguiling vision of the future – but can it realistically be brought to pass that easily? Is debt, on which the world careered to the brink of the abyss, capable of being harnessed to the process of recovery simply by the power of our faith in its beneficent possibilities?

To try to reassure the sceptical, Professor Krugman cites the evidence of history, specifically the tale of U.S. government debt from 1945 through the 1970s (pp. 141–142). Yet the greenest neophyte in the stock market has read the small print warning that past performance is no sure guide to the future; that which is now hidden may resolve itself into sunlit uplands, a jungle replete with every variety of venomous creature, or any terrain in-between. Given the inherent unpredictability of the next decade and more, Professor Krugman recognizes the advisability of having a second line of defence. So, shifting his ground, he enjoins trust and patience on those 'worried about the long-term budget picture.' In return for their forbearance, they shall have the action against indebtedness that they crave, but 'economic logic would seem to suggest that austerity should wait – that there should be plans for longer-term cuts in spending and tax hikes, but that these cuts and hikes should not take effect until the economy was stronger' (p. 194). Those desperate to shed the kilos now must continue awhile with the feast of debt – but they can also gnaw on plans and promises in the interim, safe in the knowledge that, appearances notwithstanding, Professor Krugman is really, in his heart, sound on debt.

But the hesitant may have still other doubts that need assuaging before they irrevocably commit themselves, and they will not rest content with academic answers to what are far from academic questions. Are there genuinely no risks to the prescription being proffered here? Is inflation really as easily and precisely controllable as the temperature of bathwater? What if those in receipt of government money use it to pay down debt rather than jack up demand? What if, despite all assurances, growth does not come roaring back, perhaps because of adverse developments elsewhere in the world? In essence, then, they are asking whether this glassblower understands his material and craft well enough to create a crystal ball with reliably predictive powers, and their right to pose the question is surely undeniable – for if Professor Krugman has in fact misread the fundamentals of the crisis, then may not the incurring of yet more debt lead even the U.S. to wake one day and find itself confronting the brave new world of sovereign default? Cue *Boomerang: The Meltdown Tour*.

This, the latest offering from Michael Lewis, is another variation on themes that he has made his own; the hidden workings of the world of high finance, their malign influence on the 'real' economy, and the laughable absurdity of what unfolded once the doors of the merchant banks were closed, dealing began in one of the most predatory card games in the world, and the line between illusion and reality dissolved. Having begun the story at company level by laying bare the sordid inner machinations of Salomon Brothers in the late '80's (*Liar's Poker*), expanded it to the plane of the nation state by chronicling the foulness that permeated the sub-prime phenomenon in the U.S. (*The Big Short*), in *Boomerang* Lewis turns to consider the global consequences of all this putrefaction, which he feels constitutes the ongoing 'Act II of the financial crisis' (p. 213). As ever, there is humour aplenty in his descriptions of the absurd unreality of what passed for received wisdom prior to 2008, but the laughter rings increasingly hollow now that the stakes have been raised so high.

Boomerang opens with Lewis' account of two conversations (one in late 2008, the other in mid-2011) he had with Kyle Bass, the hedge fund manager who rose to prominence by predicting and profiting from the onset of the Great Recession. In 2008 he had already moved on to forecasting that the crisis was about to metastasize, to the point that not just banks but the governments that had stood behind them would lose all financial credibility. By 2011 that was about to come to pass in Greece, but for Bass the countries about which he believed investors should really be worried were France, Japan and, yes, the U.S. (p. xvii). His view was unrelievedly bleak; the events that would bring sovereign collapse to pass had already been set in train, and their progress could no longer be arrested by human agency - only the manner and timing of the denouement were still in doubt. It was partly to test this assertion that Lewis embarked a 'meltdown tour' of Iceland, Greece, Ireland and Germany, before landing up in California to try to establish whether the boomerang of debt launched into the air by the U.S. would indeed arc back with a vengeance to scythe its economy down.

Much of the story Lewis chooses to tell concerns the different ways in which his four chosen countries responded to 'the eruption of cheap and indiscriminate lending between 2002 and 2008' (p. 145). Icelandic males decided *en masse* on a bizarre change of career; from fishermen they transformed themselves overnight into investment bankers and, regardless of their almost complete lack of the experience or aptitude needed for this new role, proceeded to behave like denizens of Wall Street. What was little short of an act of mass insanity ended in the bust of 2008, at which point 'Iceland's 300,000 citizens found that they bore some kind of responsibility for $100 billion in banking losses...[and also had] tens of billions of dollars in personal losses from their own bizarre foreign-currency speculation, and even more from the 85 percent collapse in the Icelandic stock market...[all of which was] so ridiculously out of proportion that, within weeks of the collapse, a third of the population told pollsters that they were considering emigration' (pp. 3-4).

The Greeks, 'once the lights went out and they were alone in the dark with a pile of money' chose their character-defining route to Armageddon by allowing their government to turn the public sector, already a byword for inefficiency and corruption, into a machine for waste that is perhaps unrivalled in that part of Europe which did not disappear behind the Iron Curtain after 1945; its staggering generosity in terms of salaries, age of retirement and pensions has today made the country an object of vilification throughout much of northern Europe, and Lewis can find space for only a few of the most egregious examples of its failings (pp. 44-45). Even worse, though, is the atmosphere of corruption that pervades the entire system, for as Lewis remarks, 'Where waste ends and theft begins almost doesn't matter; the one masks and thus enables the other' (p. 45).

Temptation Irish-style took the guise of a real estate boom. Once it got into full swing, 'Ireland was building as many new houses a year as the United Kingdom, which had fifteen times as many people to house...and Irish home prices implied an economic growth rate that would leave Ireland, in twenty-five years, three times as rich as the United States.' Irish banks lent to property developers with an abandon perhaps even greater than their counterparts in Spain, incurring 'debts they could never repay, of something like 100 billion euros' (p. 115), money that was ploughed into the construction of dwellings that are completely unsaleable for the simple reason that 'There aren't enough people in Ireland to fill the new houses; there were never enough people in Ireland to fill the new houses...[while] people from outside Ireland, even those with a genetic link to the place, have no interest in owning houses in Ireland' (pp. 121-122).

Lastly, the Germans. But surely this must be some kind of mistake, for are not the Germans the very models of prudence and self-discipline, totally averse to risk and speculation? Inside their own borders, Lewis argues, this is entirely true. But let them loose across those frontiers, he says, and it is a very different story, as the behaviour of German banks prior to 2008 showed all too clearly.

> They lent money to American subprime borrowers, to Irish real estate barons, to Icelandic banking tycoons, to do things that no German ever would do. The German losses are still being toted up, but at last count they stand at $21 billion to Icelandic banks, $100 billion to Irish banks, $60 billion in various U.S. subprime-backed bonds, and some yet to be determined amount in Greek bonds. The only financial disaster in the last decade German bankers appear to have missed was investing with Bernie Madoff...' (p. 146).

Undeniably absurd and deeply comic as this catalogue of ineptitude may be, it has an importance for our current predicament that is not easily underestimated, because it bears directly and acutely on the subjects of debt and attitudes to it. The deluge of credit between 2002 and 2008 created a world so illusory, so detached from fundamentals, that the inevitable return to reality could not be anything other than a searing experience. Prior to the onset of the Great Recession, debt appeared to hold no dangers, most clearly of all in the property market;

in an era of ever rising prices, it made nothing but 'sense' to lend and borrow. Creditors felt secure since, in the event of a default, repossession and resale would preserve and probably enhance their capital. Debtors matched them in believing themselves to be immune from disaster, and fell for the lure of the easy money on offer through home ownership. While today, with the advantage of hindsight, it appears both astonishing and ludicrous, people did not, generally speaking, anticipate a crash. As Lewis notes, only 15 or so brave souls were prepared to bet against sub-prime on a large scale, and they had to endure a profoundly bleak sense of solitude before their insight was eventually vindicated to the tune of billions of dollars; they had 'the strange and isolating sensation of being the sane man in an insane world and, when they talked about their experience, sounded as a person might if he had sat alone and in silence in a small boat and watched the Titanic steam into the iceberg' (pp. ix-x, quote at p. x).

So when, and to all intents and purposes entirely out of the blue, Lehman arrived to make the recession a reality for the vast majority, the unmasking proved an enormous shock, one that turned the world upside down practically overnight. And in the course of that sudden, brief somersault, people lost their stomach for borrowing; debt (in any form) became toxic, and its hidden dangers, loss of assets and autonomy, blotted out any thought that it could ever again be benign. And the Lehman shock has been very slow to fade; the near-instantaneous, terrifying realization that debt could indeed destroy and that no asset was truly safe (for even gold was ultimately to be viewed as just another casino commodity) radically damaged confidence in the future. The age of austerity began to show itself first at the popular level, in the domestic economy of everyman and everywoman, where caution, retrenchment, and the preservation of financial independence became the new watchwords. And sadly for Keynsians like Professor Krugman, these watchwords hold good for people as voters as well as consumers.

Much of the story of 2008 and its causes as told by Michael Lewis is one that Professor Krugman is prepared to accept, but only intellectually, in strictly economic terms, those of a 'bubble' and the consequent collapse of consumer demand. He himself argues (p. 51) that people's thinking is often a prisoner of their language – and, specifically, of their choice of the wrong metaphors. But he proceeds to fall into exactly the same trap when, in seeking to convince us (pp. 22-23) that what happened to the economy in 2008 was 'a relatively minor malfunction' he talks of "magneto trouble" and a 'bubble'. Are such metaphors anything like adequate to capture the full reality of what people experienced in that tumultuous year? For when, in life, a bubble bursts, this constitutes a single, sharply-defined event that deprives the world of a little iridescence and leaves it with the faintest sensation of dampness. The analogy does nothing approaching justice to what people in general went through during and after the sub-prime phenomenon; for non-economists, what happened was far more akin to the creation and detonation of a complex arrangement of maliciously contrived booby-trapped explosive devices. Some of these have already been tripped by particular events, but there is a feeling that there are others still out there with fuses of varying length in the process of burning. If so, defusing them is bound to be a long drawn-out process, and one fraught with danger – a fact that has been very widely, if sometimes only subconsciously, accepted. On this view, promises of a quick and easy fix through increased debt are not simply an impossible sell to an audience that has recently tumbled out of one world of debt-illusion with bruises to show for it so painful that wild horses will not drag it into another; they also fail to address the nagging unease that there is more, and unavoidable, pain to come. On this supposition, the most urgent task is not to begin rebuilding the damage already done by excessive debt, but to sandbag the premises against explosions to come. And since the mother of all possible bombs is sovereign default in the U.S., voters there need to be very sure that they are not being asked to bring it upon themselves by throwing good money after bad.

That this is the chief obstacle to the acceptance of his proposals Professor Krugman half-recognizes – witness his promise to row back on U.S. debt once the crisis is past. Whether he proffers this out of genuine regard for principle or as a tactic to persuade does not matter, for either way the premise that underlies it is still that excessive sovereign debt can indeed be dangerous. Faced with the prospect that this perception amongst ordinary, sensible folk will thwart his drive for Keynesian reflation, Professor Krugman does his best to evade the problem. The easiest escape route is via ad hominem arguments; opposition to his program thus becomes the work of evil Republicans, out to sabotage a recovery for their own selfish ends with their 'Big Lie' (pp. 64-66). But even Professor Krugman cannot deny that doubters exist on his own side of the fence, as his account (p. 192) of the way that the debate slipped from his control under the Obama administration shows:

> ...it became all the fashion for respectable people to issue apocalyptic warnings about imminent disaster if we didn't move immediately to cut the deficit. Erskine Bowles, the co-chairman – the Democratic co-chairman! – of a panel that was supposed to deliver a plan for long-term deficit reduction, testified to Congress in March 2011, a few months after the panel failed to reach agreement, and warned about a debt crisis any day now...

Clearly, then, Professor Krugman needs to offer reassurance about the deficit, and fast. He can point to the dangers of trying to reduce it too quickly, and indeed makes great play with the self-defeating program of the 'Austerians' in the Eurozone, and possibly in the U.K. too, who are doing just this and seem to be finding that debt-deflation is an invitation to the vortex. But this is really beside the point, because proving the Austerians wrong does not automatically make Professor Krugman right; cutting the deficit too fast may indeed be counterproductive, but one alternative is to slow the process or simply keep the deficit at current levels. Yet what Professor Krugman advocates is increasing it, and very sizeably so. The onus is thus on him to provide guarantees that disaster does not lie that way either, and he offers Americans not one, but two.

The first is that sovereign default simply cannot, or at least will not, happen in the land of the free. 'So is the United States a default risk, or likely to be seen as one any time soon? History suggests not…' (p. 139). We are not talking about Greece, after all – and indeed Professor Krugman is most concerned that we should not 'Hellenize' the story of Europe (p. 187), let alone that of the U.S. Greece, he assures us, is sui *generis* (not least, perhaps, because his crusade for public spending would suffer irreparable damage by being associated with the kind of profligacy that brought Greece to its present pass). No-one in Europe can be permitted to take a seat in the same boat. But sovereign default sometimes arrives as single spies rather than in the battalions that marched into Greece. It can begin at regional level or even lower, rather than as a full-blown national repudiation of debt. That may well now be happening in Europe, with Valencia the first brick to detach itself from the Spanish wall, and Sicily the first from the Italian one. And in the U.S.? Well, as Michael Lewis notes, the equivalent phenomenon may have already begun to play out at state level in California (pp. 172-178, 188-191) and in municipalities there like San Jose (pp. 191-199) and Vallejo (pp. 199-203) – a list we can now update to include Stockton and San Bernadino. Are these but the first dominoes to fall? If that is at least a possibility, then U.S. sovereign default is perhaps not quite so unthinkable after all, and Professor Krugman is in need of a fall-back position. It comes in the form of an assertion that, even if a default were to happen, it would be no catastrophe, for the difficulties involved could be simply sidestepped.

> Governments depend on being able to roll over most of…[their] debt, in effect selling new bonds to pay off old ones. If for some reason investors should refuse to buy new bonds, even a basically sovereign government could be forced into default.
>
> Could this happen to the United States? Actually, no – because the Federal Reserve could and would step in and buy federal debt, in effect printing money to buy federal bills… (p. 183).

But this is a technical solution only. Its effects on inflation, and on relationships with bondholders like the People's Republic of China, will not be airbrushed from the record as easily as they are here – international creditors and their contracts cannot be treated quite so cavalierly as Professor Krugman believes is possible in the domestic economy, where there is apparently:

> …an alternative or, better yet, complementary road to recovery: just reduce the debt directly. Debt, after all, isn't a physical object – it's a contract, something written on paper and enforced by the government. So why not rewrite the contracts?
>
> And don't say that contracts are sacred, never to be renegotiated. Orderly bankruptcy, which reduces debts when they simply cannot be paid, is a long-established part of our economic system… (pp. 126-127).

It is a long-established part of the international system too, but that does not of itself make it any the more advisable. It is not that the U.S., if menaced by default, will necessarily find itself playing host to a troika as the Irish or the Greeks have done in the recent past. But other ways may be found to inflict international humiliation and loss of autonomy on a country; it would be foolhardy to wave away the dangers of offending a creditor nation like China. And this is another thing of which voters are not unaware; they know from the experience of their own lives that the consequences of excessive debt leading to default are serious, and proof of this is still present to their eyes in communities where foreclosure is not yet a thing of the past. Nor is there any great willingness to follow Professor Krugman in distinguishing between the public and private spheres, between the vice of personal debt and the virtue of the sovereign variety. Truth here is indivisible for the majority, which means that Keynesian reflation is close to an impossible sell to those who have returned not long since from a near-debt experience and who have not the least appetite for a close encounter of a second kind. This, then, is the giant and immovable rock that awaits Professor Krugman's ship at the bottom of the slipway.

He knows it is there, but emotionally he cannot afford to recognise or sympathize with the quality of the reconnection with reality brought about by the Lehman shock, since this spells doom for his advocacy of a vast expansion of public debt today; the consumers who experienced that shock are also voters, and for them the toxicity of debt is still a reality. He can try to overcome their reluctance by stoking the fires of public anger over unemployment, writing with all that he can command in the way of eloquence about the wasteful, bitter reality facing those who have little prospect of finding work (e.g. pp. 6-12). But for the foreseeable future, fear and the memory of a chastening will trump anger, and there will be no broad constituency of voters demanding a massive campaign of federal spending – which means that for those seeking public office, advocating that path is seen as leading only to electoral annihilation. The voters and politicians whom Professor Krugman needs to turn his vision into reality are, therefore, as much a figment of the imagination as the illusions of prosperity that seduced the world between 2002 and 2008.

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