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Book Review: COVID-19 Pandemic and the Return of Depression Economics: The Return of Depression Economics and the Crisis of 2008, Paul Krugman (W.W. Norton & Company, 1st Edition (2009), Pages: 191).

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COVID-19 outbreak started towards the end of 2019 in Wuhan, China, and emerged as a significant threat to human life and social order. The virus spread across over 200 countries infecting over 100 million people while causing nearly two million fatalities so far. This pandemic disturbed society due to loss of lives, long-lasting social distancing, lockdowns, and curfews in 2020, and the same continued to some extent even in 2021. The governments were compelled to adopt unprecedented socio-economic policies notwithstanding the enormous pressures created by increased government spending and contracted revenues. The importance of recognizing public health as a national economic priority was emphasized, supporting the movement for welfare economics rather than for laissez-faire economics.

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The COVID-19 pandemic had substantially contracted the world economic activity in 2020, creating a massive slump in aggregate demand and investment while creating a noteworthy increase in unemployment and poverty, especially in developing and frontier markets. This global economic recession is expected to continue for another two to three years, even for advanced economies. Fortunately, the COVID-19 outbreak so far did not evolve into a full-scale financial crisis, probably owing to the various initiatives taken promptly by economic policymakers and financial regulators for sustaining aggregate demand, easing out the credit, and the facilities provided to the borrowers to cope up with their debt repayments. Nevertheless, the financial risks have heightened than ever before, substantially lowering the asset quality in the financial system. Therefore, the possibilities of a prevailing liquidity crisis transforming into a solvency crisis have not yet faded entirely away.

In this context, a decade-old book becomes worthy of reading. ‘The Return of Depression Economics and the Crisis of 2008’, published in 2009 by Paul Krugman, the 2008 Nobel Prize Laureate in Economics, is a profound analytical illustration of a series of global economic disturbances entangled primarily with financial crises. To a large extent, this book resembles his earlier publication, ‘The Return of Depression Economics’, published in 1999, mainly focusing on the Asian financial crisis. The book published in 2009 mainly focuses on the global financial crisis of 2008. The crisis of 2008 hit the world economy approximately ten years after the Asian financial crisis. Surprisingly, approximately after ten years after the global financial crisis of 2008, the COVID-19 outbreak hit the world economy in 2020, creating another catastrophic economic disturbance. Even though the current disturbance did not stem from a financial crisis, the consequences resemble a great deal. Therefore, Krugman’s emphasis on interventionist macroeconomic regime and policy suggestions made during the previous two financial crises seems remarkably valid concerning the economic recession created by the COVID-19 pandemic as well. The reviewer used the academic approach in reviewing this book as employed by Gamage (2021a), Peiris et al. (2021), and Gamage (2021b).

The book starts with a soft opening and encapsulates valuable interpretations on why past financial crises happened and why most of the remedies did not work in each case. Finally, it shows how naively the policymakers ignored the lessons from those and Japan’s real estate bubble to let the greatest financial crisis ever since the 1930s happened in the US. Further, he recommends a set of proposals by which the financial crisis of 2008 can be reversed before it leads to another depression.

In general, there are three things, if not many, common to all recent crises. First, easy credit has pushed borrowers and borrowing nations into trouble where banks and alike have played a central role in boosting bubbles. Second, expectations and herd behaviour of the majority have caused “irrational exuberance”, as Alan Greenspan termed it, which builds upon itself and induces crises through unnecessarily heating and suddenly freezing the system even when fundamentals remain substantially unaltered. Finally, during each crisis, something big enough has stepped in to instill normalcy by liquidizing the frozen economy and building up confidence. For instance, World War II in the great depression, America in the Mexican and Argentinean crises, IMF in the Asian financial crisis, and massive government spending in Japan’s bubble have played a vital role in respective recent crises. It does not necessarily mean that these mechanisms eradicated the crises with the best possible solution, but they effectively reverse the crises. One thing unique, among some other things, in the crisis of 2008 is that it is not confined to a particular country or region as it happened in most cases. Despite having a different cause, the crisis of 2008 resembles, in this aspect, the economic recession instilled by the COVID-19 pandemic.

The grossly unregulated shadow banking system had expanded well beyond viable limits and boomed too big in magnitude relative to the regulated banking system and the real economy. Moreover, repeal of the Glass-Steagall Act exposed regulated banks also to risk by allowing commercial banks to create and hold risky financial products ‘off-balance sheet’, though Krugman is not keen on this. For example, Krugman does not point his finger, in any manner, at the wrong signal transmitted to the market when the regulated commercial banking system was deregulated when, in fact, the unregulated shadow banking system should have been brought under regulatory control instead.

Complex financial innovations spread the risk across the world. With booming financial markets and ever-rising real estate prices, the growth rates portrayed a wrong picture for the investors providing positive feedback that further aggravated the boom while deceiving regulators that prevented or delayed needed actions. Thus, it is not surprising to see those who could have prevented the crisis happened to enjoy the illusion of prosperity. Monetary experts had enough room to charge their weapons by increasing interest rates and extending regulations to avoid the recession. If they did so, depression economics would not have been required. Finally, however, prices plunged substantially, intensifying doubts in investors about recovery in the foreseeable future, confidence collapsed, panics were too broad and self-fulfilling, policymakers did not have their weapons ready, and the crisis happened in the financial economy and then rapidly hit the real economy. Sins of laissez-faire economics became obvious and surpassed the virtues thereof.

Drawing upon his expertise in crises and depression economics, Krugman prescribes four main remedies to cure the crisis. First, capitalize the banking system so that the capital markets are unfrozen. Second, create a fiscal stimulus by expanding public expenditure on infrastructure development and directly financing the non-financial sector. Third, initiate a global rescue operation oriented to developing countries. Finally, tighten the regulation on the financial system as a whole to prevent a crisis happening again. Unarguably, these prescriptions eased out of the crisis of 2008. Importantly, what the economies across the globe are doing recently amidst the COVID-19 pandemic is not dissimilar to these policy prescriptions.

However, Krugman is not very specific about the magnitude of the stimulus package needed to cure the crisis in his text, possibly because it is better to err by doing too much than doing too little. With several trillions of dollars in the shadow banking system, can several hundred billions of stimuli create the required level of liquidity and confidence? Moreover, he is less explicit in this book about the morals hazards that could have prevailed within the shadow banking system; about the failure of prudential regulations to evolve as rapidly as the evolution of shadow banking system and financial innovations; about the failure of credit rating agencies to effectively assess the risk and appropriately rate complex financial products; about the failure of auditors, and prevailing accounting and financial standards to effectively capture the effect of ‘off-balance sheet’ operations of commercial banks; and about the political mechanisms that might have curtailed much of the informed actions of policymakers. All of these might have fueled the crisis other than just Alan Greenspan’s failure to use standard economic tools in time. Moreover, Krugman does not comment on the plummeting dollar since 2002, reaching historically low levels in 2008, which on one hand heavily affected the countries, including the largest economies, that relied too much on exports to the US and the countries that had extensive dollar reserves and, on the other hand, contributed, in part, to bring the crisis out of US.

Overall, the book is thought-provoking mainly due to its relevance, richness of ideas, and inclusion of a broad range of crises and interpretations that cannot be found easily in one book. Furthermore, it is written in easy-to-understand comprehension, free of technical jargon so that it is accessible to a wide array of audiences. Therefore, the book is worthy of reading even today amidst the economic recession instilled by the COVID-19 pandemic.

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