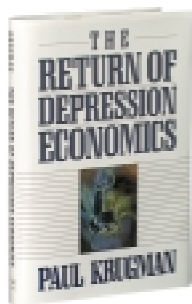


Paul Krugman

The Return of Depression Economics

Norton, New York, 1999, xiv + 176 pp., $23.95 (cloth).

THIS READABLE little volume is directed primarily to a lay audience rather than to professional economists. It describes in nontechnical language some of the burning issues in economics, including the causes of the Mexican, Asian, and Brazilian crises; the reasons for Japan's economic stagnation; and the effects of globalization.

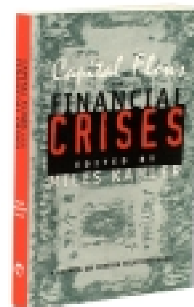
When the book was written, it seemed that financial turbulence and the weakness of economic activity in Asia might drag down the world economy. Paul Krugman argues that the economic policies governments adopted to address such issues have been seriously misguided, as they were in the 1930s, when actions by central banks and governments helped precipitate the Great Depression. He maintains that raising interest rates in the wake of the Mexican, Asian, and Brazilian currency crises was a mistake; that Japan should deliberately try to engineer inflation to escape stagnation; and that emerging market countries would be well advised to institute capital controls in order to insulate themselves from changes in sentiment by international investors. Thus, the problems visited on the world economy are, in Krugman's view, similar to those of the 1930s, and we can apply the policy lessons from that period—hence the term "depression economics."

Although the book remains interesting and relevant, the situation of the Asian crisis countries has improved markedly since it was written. As confidence has returned, interest rates have been allowed to decline, while exchange rates have appreciated. Prospects for growth have improved sharply in a number of these countries, as well as in Brazil, which, after an initial depreciation, saw a strengthening of its currency. These developments make it less easy to argue that the confidence-building measures Krugman decries were a mistake or that the world is in danger of returning to the 1930s. Indeed, one of the objectives of the policies of the 1930s was the creation of financial autarky. Instituting capital controls now would represent a step backward and is unlikely to be effective in the current environment, in which investors have much greater flexibility to take positions in various currencies using innovative financial instruments and in response to instantly available information.

The book does, however, argue convincingly that the crises of the 1990s were not limited to weak economies that had poor policies. Krugman shows how international investors, sometimes operating on little information, were responsible for increased volatility and indiscriminate punishment of emerging market countries through a withdrawal of capital. Some financial institutions—including, but not limited to, hedge funds—have been subject to less than adequate official supervision and reporting requirements. Emerging market governments have exacerbated the problem by giving inadequate and conflicting information about their policies, providing perverse incentives for capital inflows (such as official guarantees and discouragement of direct investment), and borrowing short term, making themselves vulnerable to shifts in investor sentiment. The official response has been to try to make international capital markets work better, not to follow Krugman in trying to insulate emerging markets from them. Consistent with this response, the international financial system is being reformed to increase transparency and the availability of data, improve supervision of financial institutions in both developing and advanced countries, and institute prudent international borrowing policies.

Though the extremes of "irrational exuberance" and gloom and doom need to be avoided, it is to be hoped that the current efforts to make the system work better will enable the world to avoid a return to depression economics. Fearing the worst is not always the road to better policies. But Krugman is, as always, a stimulating antidote to economic orthodoxy and "business as usual."

Paul R. Masson



Miles Kahler (editor)

Capital Flows and Financial Crises

Cornell University Press, Ithaca, New York, 1998, xi + 268 pp., $49.95 (cloth), $19.95 (paper).

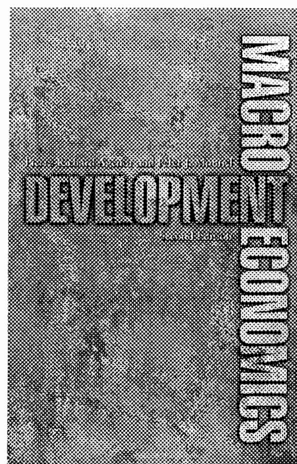
THE EMERGING market crisis that unfolded in the summer of 1997 has catapulted the debate on capital inflows into emerging markets—and the accompanying boom-and-bust cycles—to the center of policy discussions. *Capital Flows and Financial Crises* examines the patterns of private capital flows into emerging markets from a historical perspective, evaluates governments' policy responses to the problems associated with cross-border flows, and suggests policies that balance the risks and benefits of financial integration.

In addition to previous crises, the papers discuss Thailand and, to some extent, Korea, but do not cover Russia's default in August 1998 or Brazil's devaluation in January 1999. Perspectives on crises have changed since mid-1997, but Kahler, in an insightful overview, does an excellent job of tying the contributors' extant views together.

In their chapter, "Contending with Capital Flows: What Is Different About the 1990s?" Barry Eichengreen and Albert Fishlow note that large-scale foreign lending followed by a debt crisis has been the norm in the present century, which has seen three notable external debt crises—in the 1930s, the 1980s, and the 1990s. What distinguish the three episodes are mainly the method of finance and the policy responses to them. The authors point out that capital-importing countries raised funding primarily through bond financing in the 1920s, bank lending to governments in the 1970s, and equity financing in the early 1990s. Borrowers' policy responses to crises ranged from import substitution in the 1930s—because export markets had collapsed—to a fiscal response in the 1980s and a greater monetary adjustment in the 1990s, when the crises were driven largely by the private sector. The subsequent Russian and Brazilian episodes challenge some of these observations and perhaps show greater parallels with the 1980s.

In a chapter on government policy, Sylvia Maxfield writes perceptively about how investors make investment decisions and how the composition of investors influences policy options. She finds that capital flows to emerging markets are generally not sensitive to information about changes in the host country's economic policy or its prospects for political stability, but are sensitive to yield differentials; that is, "push" factors from industrial countries dominate "pull" factors from the host countries. She notes that hedge funds—which have short time horizons but a greater appreciation of host country fundamentals than mutual funds, focus on price rather than yield, and emphasize capital gains over accrual of interest and dividends—seek to differentiate fundamentals from market momentum. Banks are pushed largely by global liquidity conditions fueling lending booms, as occurred in Asia in the 1990s. Capital from bank lending is withdrawn subsequent to a crisis or a tightening of global liquidity but rarely, if ever, as a disciplining device. Maxfield's empirical results establish the domination of push factors on capital flows characterized by a preference for yield, and the only relevant policy variables seem to be exchange and interest rates. She observes that mutual funds are the key source of unstable capital inflows, which are least responsive to good domestic policy, and that greater investment by insurance and pension funds may increase the stability of flows.

The aim of international public policy is to avoid financial crises as well as to ameliorate them if they strike. Jeffrey Sachs discusses alternative approaches for dealing with financial crises, reflecting the view that events other than poor domestic policies play a disproportionately large role in emerging market crises. One policy lesson he draws is that strictly pegged exchange rates raise the risk of financial crisis and should be used sparingly. While that is true in some cases, he argues less persuasively that self-fulfilling panics are easier to handle under floating exchange rate regimes, and some of his examples are flawed. He makes a strong case for an international bankruptcy framework similar to U.S. corporate bankruptcy, a theme with which Sachs has been widely associated.



Development Macroeconomics

Second Edition

Pierre-Richard Agénor and Peter J. Montiel

Development Macroeconomics was hailed on its publication in 1996 for providing a clear, rigorous, and long-needed synthesis of recent work in the field. This revised edition brings that achievement up to date. Here Pierre-Richard Agénor and Peter Montiel review and assess the burgeoning research done in the past two decades, paying special attention in this new edition to issues that have recently gained in importance among developing countries, such as the interaction between macroeconomic policies and long-term growth, the political economy of macroeconomic reform, the management of capital inflows, and currency crises.

This is a crucial book for anyone who wants to understand this rapidly changing field.

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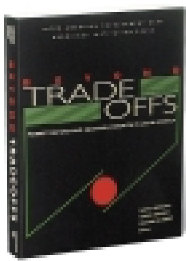
Other chapters discuss alternative policy options in dealing with capital inflows and the dilemmas they pose, as well as patterns of capital flows from Latin America, Asia, and Eastern Europe. Given that recent market dynamics have depended crucially on such capital market aspects as banks' internal risk-management practices, the book would have benefited from a capital markets perspective on financial crises. Although its focus is primarily macroeconomic, the book offers a wealth of theory and facts that will be important for anyone interested in understanding cross-border capital flows.

Subir Lall



Nancy Birdsall, Carol Graham, and Richard H. Sabot (editors)

Beyond Tradeoffs

Market Reform and Equitable Growth in Latin America

Brookings Institution Press and Inter-American Development Bank, Washington, 1998, v + 367 pp., $22.95 (paper).

A GROWING BODY of research has been chiseling away at one of the shibboleths of the economics profession: the presumed trade-off between equity and efficiency. Confronted with this trade-off, policymakers were viewed as facing the difficult choice of promoting either growth and efficiency or a more equitable distribution of income. This new research has demonstrated, however, that well-crafted policies can both spur growth and improve income distribution.

Beyond Tradeoffs, which includes contributions from some of the leading thinkers on growth and equity in Latin America, is an important addition to this new body of research. Furthermore, by venturing into specific policy areas (such as agriculture and water supply) often overlooked by generalists, the individual essays delve into the nitty-gritty of implementing equity-enhancing policies and are therefore valuable reading for those desiring some familiarity with these issues.

One of the book's strengths is its organization. The beginning chapters are general surveys that explore the relationship between economic growth and equity. They are followed by essays that address equity and efficiency by sector and a concluding chapter on the political economy of institutional reform. Among the most innovative of the general essays is the one by Michael Gavin and Ricardo Hausmann, which explores the connection between economic volatility and income inequality. Another strength of the volume is that it provides examples of reforms that have succeeded in increasing both equity and efficiency. These serve as valuable lessons for reformers eager to learn from the successes of others.

What makes the book especially interesting reading is that the authors often do not shy away from provocative conclusions. For example, Birdsall, Graham, and Sabot offer an optimistic assessment of the future of equity-enhancing reforms in Latin America, citing, among other reasons, the positive effects of the political mobilization of the poor. While I share their optimism to a degree, it struck me that the evidence presented also provides plenty of ammunition for a less cheerful assessment. Indeed, a major contribution of the book—one I wish had been given more prominence in the opening chapter—is to show that policies that might be perceived as "pro-poor" are, in fact, counterproductive—for example, excessively expansionary macroeconomic policies, restrictive labor laws, unreformed pay-as-you-go pension systems, and generalized subsidies. Unfortunately, the current state of policy debate in some Latin American countries reveals that these lessons of the past have not been fully absorbed.

The sectoral issues addressed in individual chapters, which include education and health, the labor market, the financial sector, and pensions, reinforce the notion that implementing equity-enhancing reforms has been difficult in practice and that some major stumbling blocks remain. In the excellent essay by Birdsall and Juan Luis Londoño on health and education reform, one is struck by the paucity of examples of equity-enhancing reforms, despite widespread recognition that they can spur growth. On labor markets, René Cortázar, Nora Lustig, and Sabot observe that reform has been slow and many reform proposals "timid." On agriculture, Michael R. Carter and Jonathan Coles note that, because of the many underlying market imperfections, simply removing subsidies and other market distortions is not enough to secure equity-enhancing agricultural growth.

In sum, this book makes for worthwhile reading for those interested in the equity aspects of public policy, both in Latin America and in developing countries in general.

Benedict Clements

Credits

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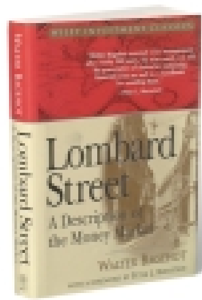


Walter Bagehot

Lombard Street

A Description of the Money Market

Wiley, New York, 1999, x + 359 pp., $34.95 (cloth), $19.95 (paper).

IN THE Glorious Year 1688, the father of the poet Alexander Pope retired from the linen trade in London. Settling in Binfield in Windsor Forest, he took with him a strongbox containing £20,000 in gold coin, from which he paid household expenses for the rest of his life. Bagehot deplored this do-it-yourself retirement plan. It was all very well for an individual to retire, but it was unconscionable for money to indulge in "idle luxury." In the early years of the reign of William III, a mass of gold and silver lay "hidden in secret draws and behind wainscots" wanting opportunity for investment in the "rough and vulgar structure of English commerce." The opportunity came only later, when Lombard Street (where London's banking houses were concentrated) became the great intermediary between lender and borrower by managing money because "money will not manage itself."

John Wiley and Sons, in its Wiley Investment Classics series, has usefully reprinted (in delightfully antique typeface) Walter Bagehot's *Lombard Street: A Description of the Money Market* (copyright 1873). Bagehot (1826–77) has been described as Victorian England's most versatile genius and is regarded as the most influential journalist of the mid-Victorian period. Graduating with honors from University College, London, he followed a career in banking, at the same time making a name for himself with his literary essays. For 17 years he was editor and chief feature writer of *The Economist*, founded in 1843 by his father-in-law, James Wilson. Because of Bagehot's profound understanding and articulation of the world of finance, William Gladstone referred to him as "Permanent Chancellor of the Exchequer."

Lombard Street, a compilation of articles that appeared in *The Economist*, is in fact a pamphleteering tract arguing for greater reserves to be held in the Bank of England and for expansive lending as the proper way to deal with financial crisis. Bagehot was the inventor of crisis management and an advocate of the lender-of-last-resort function. "A panic, in a word, is a species of neuralgia, and according to the rules of science you must not starve it. The holders of the cash reserve must be ready . . . to advance it most freely for the liabilities of others."

But the book transcends pamphleteering, describing the mechanics of the "constant and chronic borrowing" of the money market and outlining the theory of central banking and exchange control. The analysis of the position and government of the Bank of England, the fruit of close and direct observation, is extraordinarily informative. The chapter on the Exchequer and the money market, presenting an early analysis of the relation of fiscal to monetary policy, offers the Chancellor of the Exchequer a generous dollop of advice on how to go about his business. It is as amusing and as relevant today as it was the day it was written.

Other passages are less relevant, dealing, as they do, with obsolete controversies and ideas that have long since become part of received wisdom. Why on earth, then, should one read this 127-year-old book? The answer is simple: for pure pleasure. Bagehot wrote brilliantly. He named his book *Lombard Street* and not "Money Market," or some such abstraction, to show he wished to deal with concrete realities. "A notion prevails that the Money Market is something so impalpable that it can only be spoken of in very abstract words, and that therefore books on it must always be exceedingly difficult. But I maintain that the Money Market is as concrete and real as anything else; that it can be described in as plain words; that it is the writer's fault if what he says is not clear." The result, filled with anecdote and humor, is a delight to read—the dismal science without the tears. "But never was a book written with less eye on examination candidates," wrote J.M. Keynes in a perceptive review of Bagehot's works in 1915, adding that ". . . it is not necessary to understand it much in order to enjoy it a great deal."

But Bagehot makes it easy to understand and enjoy. He is at his psychological best in peopling the Bank of England, the Exchequer, the counting and discount houses of Dickensian London, and the byways of Lombard Street with real businessmen, financiers, and politicians. You owe it to yourself to read (reread) this classic.

David D. Driscoll

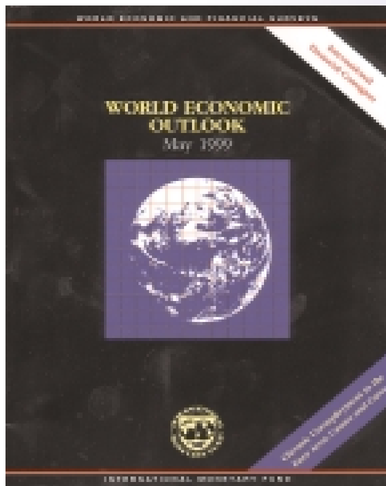
ADDENDUM

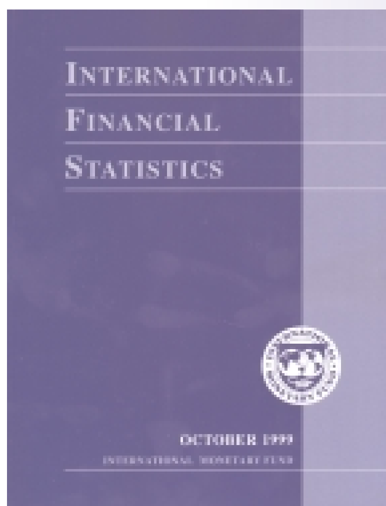
Owing to space limitations, the following entries were not included in the "Suggestions for further reading" that accompanied Dale F. Gray and Mark R. Stone's article, "Corporate Balance Sheets and Macroeconomic Policy," on page 59 of our September 1999 issue:

Stijn Claessens, Simeon Djankov, and Giovanni Ferri, 1999, "Corporate Distress in East Asia: Assessing the Impact of Interest and Exchange Rate Shocks," Emerging Markets Quarterly, *Vol. 3 (Summer).*

Stijn Claessens, Simeon Djankov, and Larry Lang, 1998, "Corporate Growth, Financing, and Risks in the Decade before East Asia's Financial Crisis," World Bank Policy Research Working Paper No. 2017 (November).

Tools of the Trade





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