BOOKS & ARTS

Old lessons for a new economics

Nobel prizewinner Paul Krugman's updated analysis of past economic crises teaches us that recovery now will require more than a new set of rules, explains **Bill Emmott**.

The Return of Depression Economics and the Crisis of 2008
by Paul Krugman
Penguin/W. W. Norton: 2008.
256 pp/224 pp. £9.99 (pbk)/$24.95 (hbk)

An often-told story about a politician — whose name varies according to the nationality of the teller — has him declaiming loudly that he is a man who sticks to his principles. But, he adds after a coy hesitation, if you don't like those principles, I have some others I could try.

That, essentially, is what Paul Krugman, a professor of economics at Princeton University and the 2008 Nobel prizewinner for his discipline, says is happening to economics. Rules that had become commandments — thou shalt not run a big budget deficit, nor allow the money supply to grow excessively, nor take private firms into public ownership — are being thrown away amid the worst economic downturn since the early 1980s, and possibly since 1945.

Krugman does not decry this abandonment of principles. On the contrary, he argues that it hasn't happened fast enough. For these were not laws of economics but rather creatures of circumstance that were misunderstood or misused. For more than three decades, the world's industrialized economies suffered from inflation and were preoccupied by trying to control or even defeat it. High public borrowing and rapid monetary expansion are dangerous only when they cause or contribute to inflation, which they did during the 1970s and 1980s, by adding further to demand at a time when too much money was already chasing too few goods and services.

That is not, however, the situation now. Rather than excessive demand and inflexible supply, developed economies are facing inadequate demand. That problem occurred during the Great Depression of the 1930s, and it is what Krugman means by 'depression economics'.

It is the topic that made John Maynard Keynes the most famous economist of the 1930s, with his book *The General Theory of Employment, Interest and Money* (1936). This work provided the theoretical framework for the use of public borrowing and spending to counter the insufficiency of private demand during depressions, although the practice of that policy in the United States, in the form of President Franklin D. Roosevelt's New Deal, was already under way by then. The Keynesian idea was that fiscal policy could be used to fine-tune the economy, ensuring that there would be full employment at all times. It was the misuse of that notion in the 1970s that helped to entrench inflation, which in turn made the need to restrict budget deficits seem like a fixed principle.

Old tricks: President Roosevelt saw spending as the economy's saviour in 1938.

GRANGER COLLECTION/TOPFOTO

One of Keynes's most famous off-the-cuff remarks, which some say is apocryphal, was made when he was challenged over an apparent change of position. He is supposed to have said: "When the facts change, I change my mind. What do you do, sir?" That point is made here by Krugman, a long-time fan of Keynes. Minds should change when the facts change. Facts did change during several of the financial crises of the 1990s — in Japan, Mexico, east Asia, Brazil and elsewhere — when depressionary tendencies were seen, yet minds still stuck wrongly to the old orthodoxies.

This rigidity of thinking, when combined with a desire to believe that deregulated financial markets would be capable of learning from their own mistakes, has led to the current global economic crisis.

The Return of Depression Economics and the Crisis of 2008 is a fine piece of popular writing. Krugman avoids jargon and technicalities without leaving the already-informed reader either bored or annoyed, using homely examples to describe economic issues. For example, he makes good use of a story of how a babysitting cooperative on Washington's Capitol Hill created its own depression. The cooperative worked by giving coupons to those who babysat, which they could then use to buy babysitting services from other members; the depression occurred when too many members began to hoard coupons for later use, so that demand fell well below supply.

That, more or less, is what is happening now. Shocked by the collapse of banks on both sides of the Atlantic, households and companies are increasing their savings and paying off their debts to protect themselves against harder economic times. Individually sensible, such action to save more is collectively disastrous: what Keynes called "the paradox of thrift". Demand is slumping, production lines are being halted, people are losing their jobs and so demand is likely to fall further. At such times when people are scared of debt, they will not borrow even if the cost of money falls virtually to zero: a 'liquidity trap'.

© 2009 Macmillan Publishers Limited. All rights reserved

What to do? The weakness of this book, an update of a work first published in 1999, is that its emphasis is on the financial crises of the 1990s and not that of today. If Krugman were writing from scratch now, he would surely focus much more on the present day. However, the 11 pages he does devote to solving the current crisis make good sense: government borrowing is vital to substitute for slumping private demand, as Keynes said. At the same time, banks need to be recapitalized and have their bad debts written off to make them capable of lending again; financial regulation must be reformed to make the system more stable and to encourage people to trust it again. All that is fine in principle. But more detail would have helped readers to understand how it might work in practice. ■

Bill Emmott was editor of *The Economist* during 1993–2006, and is the author of *Rivals: How the Power Struggle between China, India and Japan will Shape our Next Decade.*
e-mail: bill@billemmott.com

For more on the credit crunch, see online at www.nature.com/news/specials/recessionwatch.

Investing in the environment

Sustainable Investing: The Art of Long-Term Performance
Edited by Cary Krosinsky and Nick Robins
Earthscan: 2008. 272 pp. £19.99, $38.95

Money can't buy love. But can it buy a more sustainable world? *Sustainable Investing* suggests that it can, yet this book presents only half of the story.

Editors Cary Krosinsky and Nick Robins are industry people: Krosinsky is vice-president of a US environmental research organization and advised on the United Nations' Principles for Responsible Investment as part of its Environment Programme Finance Initiative, and Robins is head of the HSBC Climate Change Centre of Excellence. Together with co-authors from a range of financial organizations, they provide tips on the emerging market of sustainable investing, ranging from equities, bonds, carbon finance, private equity, sustainable real-estate and microfinance. With up to US$5 trillion in sustainable investment funds and a quarter of public equities and bonds incorporating sustainability criteria, the world has never had such green markets.

If you take this book at face value, it certainly pays to be green. Sustainable investing — investing in green technologies, clean-energy sectors or companies that have an integrated environmental approach — has "outperformed not only ethical funds, but mainstream indices as well over a one-, three- and five-year period". Ethical funds, a separate category of responsible investing, are less profitable.

You may be relieved to hear that your clean-energy funds are good financial bets. But Krosinsky and Robins warn us against the 'materiality trap': the tendency of investors to incorporate environmental or social issues only when they are financially attractive. Many chapters focus on this point. Yet the book does not pay enough attention to another trillion-dollar question: how do we measure the effects of investment on the sustainability of our world?

To answer that, we need to know more about the systemic effects of specific investments on specific ecosystem services and societies, both over time and on a cumulative basis. This requires multidisciplinary research. For example, funds such as Jupiter Ecology, Winslow Green Growth, Orange SeNSe or the CalPERS emerging markets fund all invest in green activities and offer strong financial returns. It is less clear if they make measurable reductions in the degradation of various ecosystems. I am not saying they do not — it is just very difficult to tell.

TOMRA SYSTEMS ASA

Green technologies, such as this reverse vending machine that refunds consumers who recycle, represent good investments.

In the financial districts of New York, Hong Kong and the City in London, market intelligence is not set up to convey this kind of knowledge. Research shows that capital markets have difficulty capturing environmental feedback. Most financial-investment decisions are decoupled from on-the-ground effects. The abstraction becomes clear only when there is a visible collapse.

In one chapter, investment managers from the investment banking group Société Générale concur: "In our experience, long-term analysis is almost always sacrificed in favour of short-term profits by both investors and brokers." Sustainable investment can introduce new information, but there is significant bounded rationality. In regular financial investment, "a financial analyst covers a maximum of four to eight stocks and often has as much as 10 or 20 years' experience in doing so. In contrast, many SRI [socially responsible investment] analysts cover up to 50 stocks, with far less experience and an often limited financial background." There is also the inherent danger of market spin in sustainability ratings: "best in class … needs to be complemented by a searching analysis of the sustainability of the 'class' itself". The authors warn that unless this is done, a situation can emerge in which everyone wins, and relative benchmarking ensures that there is always a sector leader, even if neither business model nor behaviour warrant such an outcome.

Sustainable Investing argues for a paradigm shift in financial markets, and suggests that better data and stronger networks will positively affect the effectiveness of managers of sustainable funds. However, this is not an academic book, and the chapters are of uneven quality. Notably absent is any mention of what role scientists could have in this shift — a serious omission.

From a scientific standpoint, managing complex nonlinear change requires flows of robust information that cross spatial and temporal scales, and adaptive governance arising from a mix of legislation and economic incentives. Sustainable investing is only one of many strategies that we can choose, and it should be more tightly coupled with actual impacts.

The recent financial collapse highlighted the need for new forms of financial governance. To take advantage of this opportunity, we need to ask questions that are more

© 2009 Macmillan Publishers Limited. All rights reserved