

MORE KRUGMANOMICS
END THIS DEPRESSION NOW (2012)
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In his new book Paul Krugman writes what governments like to hear, thereby following the legacy of J.M. Keynes. The populist economist tries to give a scientific justification for political measures that seem to violate the reader's common sense. Krugman maintains that when you are overindebted you should increase your debts to get out of debts in the long run, when you save too little you should consume more, and when you have gigantic unsustainable expenditures, in a last effort you should spend even more.

The book could have been much shorter. Krugman's argument boils down to the following: Governments do not spend enough and central banks do not print enough money leading to a lack in aggregate demand. Expansionary fiscal and monetary policies are also the solution Krugman recommends for the crisis in the Eurozone for which he also suggests a political union.

In the context of the crisis of the Eurozone a paradox for Krugman's theory arises. Krugman writes that Germany is doing relatively well compared with the European periphery. At the same time Germany's economic policies during the financial crisis have been less expansionary than the periphery's and the US's. How would Krugman explain this fact? As Krugman often refers to historical examples to prove his theory he should look on his own evidence.

In the course of the book, basically all old Keynesian fallacies are revived. Krugman fails to understand that Western economies

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suffer from a distortion in the structure of production. The cause of the crisis was that the productive structure does not produce the most urgently demanded goods. The restructuring that is underway should be as fast as possible. Expansionary fiscal and monetary policy as recommended by Krugman can and does only prolong the recession.

Even though Krugman sometimes shows ignorance, for instance, when he calls Ron Paul a follower of Joseph Schumpeter, and sometimes oblivion, for instance, when he writes that Alan Greenspan refused to prick the housing bubble and forgets to mention that he himself had recommended its creation, the book can be instructive in several aspects.

First, the book provides an excellent example that with a different theory you get to totally opposed interpretations of past events. For Krugman the reason for the ongoing recession are austerity measures, while for Austrians the recession persists because austerity measures are not sufficient or completely absent. Krugman maintains that we are in crisis because we save too much and do not spend enough. On the contrary, Austrians claim that we are in crisis despite of small austerity efforts. Are we in crisis because of too much or too little austerity? This question can only be decided with the help of the correct theory. History is of no help in answering this question. In fact, it is *a priori* theory that allows us to interpret history adequately.

Second, Krugman gives the reader a lesson in rhetoric. He applies several sophisms to make his points usually using analogies. Thus, he says that a car worth 30,000 € may not work because a battery worth 100 € is broken. His statement is true of course. Small mistakes can have great effects. However, Krugman wants to imply that a little bit of government stimulus can make the economic engine run again. However, the analogy does not work. Rather it is the other way around. A trillion dollar economy may be pushed or remain in a recession due to a relatively small «government stimulus». Krugman just assumes that the problem is too less and not too much government spending.

In another sophism, Krugman attempts to answer the critique that public expenditures do not create additional jobs because they destroy private jobs. In his rebuttal, he states that when private

expenditures increase, the money also comes from somewhere and that is the government. When the government reduces its spending, the private sector can increase its spending. However, private expenditure would not create additional jobs either as simultaneously jobs in the public sector are destroyed. There is a «crowding out» of public sector jobs by the private sector expansion.

Yet, the relevant question is what kind of jobs an economy needs to flourish. Most people would prefer jobs that produce something consumers want. It makes a difference if a person is working for the government or if a person is working in a competitive environment where entrepreneurs try to satisfy consumer wants with better and cheaper products. Furthermore, reduction in government spending may create a multiple of the destroyed public jobs in the private economy by generating incentives to work, invest and accumulate capital. Moreover, increasing public jobs on costs of private jobs is not the same as increasing private jobs on costs of public jobs because public jobs are only possible thanks to private jobs but not the other way around. Thus, Krugman fails to mention that the government sector lives off the private sector. When the government sector grows too big, the private sector may be unable to feed the public sector anymore, leading to a breakdown of the economy. Nothing of this sort happens the other way around. When the private sectors grows bigger and bigger, it produces ever more wealth and the smaller public sector can be fed more easily.

Another sophism employed by Krugman is his already famous analogy of the baby-sitting cooperative. In this cooperative parental couples offer baby-sitting services to each other paying with scrip. When couples start hoarding scrip (because they want to use more services in the future) there is a recession. No one goes to parties anymore, because everyone is hoarding scrip. If no one spends scrip, other couples cannot get new scrip and therefore reduce their demand for services. The demand and supply of baby-sitting services falls. According to Krugman we suffer the same problem today. The solution is that the central baby-sitting cooperative prints more scrip. Otherwise, there is insufficient consumption and therefore insufficient production and employment.

The baby-sitting analogy suffers from many shortcomings. First, there is no price system. Prices cannot adjust to changes in demand. When the demand for baby-sitting services increases, the price of the services cannot increase as the price is fixed at 1 scrip per service. Nor can couples themselves produce alternative ways of payment. Second, there is also a complete lack of capital theory. There is no structure of production. There is only one good that is produced instantaneously. Of course, one cannot understand the phenomenon of malinvestment (i.e. investments in the production of a certain good that should have gone into the production of another good that is more urgently demanded) if there is only one good. Third, during the business cycle there is unemployment not due to a lack of demand, but rather because some projects have shown to be malinvestments. The necessary restructuring takes time, especially if factor markets are inflexible due to government intervention. During the restructuring there can be unemployment of resources. However, there cannot be any restructuring in Krugman's analogy because there is only one industry – namely the baby-sitting service industry. Fourth, Krugman also fails to explain what happens in his model when more scrip is produced than couples want to provide services. Are couples forced to accept them in a form of legal tender? Fifth, Krugman also seems to imply that it is bad when there is less baby-sitting and that a society is better off when people instead of watching their own children, babysit the children of others. Lastly, Krugman's model does not allow for saving and investment leading to sustainable economic growth. The only way to save is to hoard scrip. But hoarding has no effect on relative prices as the price is fixed at 1 scrip per service. In short, Krugman's model cannot explain reality.

Another insight that we can derive from Krugman's book is that «they are all monetarists now.» Milton Friedman is cited approvingly four times in the book. Similar to Krugman and the Keynesians, Friedman also saw an important role for monetary policy in stabilizing the economy. In fact, there are no fundamental differences between monetarists and Keynesians as Krugman himself acknowledges. Krugman makes also reference to a famous argument by Milton Friedman in favor of flexible exchange rates.

Friedman argues that when time has to be changed to improve the use of day light, it is better to introduce a summer/winter time equal for all than for everyone having his own time adjustment to maximize his personal daylight time. Similarly it would be better to adjust all prices at once through a change in the exchange rate, than to adjust all prices on an individual basis. We are confronted with another sophism and false analogy. In order to improve the coordination among people, the time they use should be the same. Prices, however, have to vary relatively to each other to fulfill their function and allow for coordination. Prices have to adapt to different degrees in order to align to preferences. While one and the same time for all people is efficient (at least in the same time zone), one and the same price for all goods is not optimal. The analogy simply does not work. Furthermore the analogy does not take into account the distortions and moral hazard created by the inflation that causes the devaluation of the exchange rate. It also neglects the reform pressure on governments implied by fixed exchange rates with some countries inflating less than others.

In sum, Krugman's book presents typical Keynesian arguments for more government spending and money printing. Krugman's analogies can help to sharpen one's own responses against these arguments. However, the advantages of the book do not prevent the reader from thinking once in a while: End this Nonsense Now.