

## Genetski Critiques Krugman

Economics Professor Paul Krugman recently wrote an extensive letter to President Obama offering advice on what to do about the economy <http://www.truthout.org/011709Z> . Krugman is a Keynesian economist. The framework he uses is entirely different from the classical framework. Keynesian economists have tremendous faith in and admiration of government. They often blame people and companies for economic problems and view government as the solution to those problems.

Classical economists tend to believe that people and businesses create wealth and that most economic problems are caused by misguided government policies. Understanding the positions of each of these schools of thought helps to understand how economists can come to such different conclusions about the source of our problems and the recommended solutions. It's particularly important to be aware of Krugman's reasoning since many of the President Obama's advisors as well as Fed Chairman Bernanke have a similar framework. Following are the relevant sections of Krugman's letter along with my critique of what he has to say.

**Krugman:** *Remember the economic boom of 1984, which let Ronald Reagan run on the slogan "It's morning again in America"? Well, Reagan had absolutely nothing to do with that boom. It was, instead, the work of Paul Volcker, whom Jimmy Carter appointed as chairman of the Federal Reserve Board in 1979 (and who's now the head of your economic advisory panel). First Volcker broke the back of inflation, at the cost of a recession that probably doomed Carter's re-election chances in 1980. Then Volcker engineered an economic bounce-back. In effect, Reagan dressed up in a flight suit and pretended to be a hotshot economic pilot, but Volcker was the guy who actually flew the plane and landed it safely.*

**Genetski:** When President Reagan took office productivity had stopped increasing, unemployment was over 7%, inflation was 12% a year, and mortgage rates were 15%. Reagan was a classical economist. His economic program consisted of four things—slow monetary growth to contain inflation, cut tax rates and regulations to improve productivity, reduce government spending and rebuild the nation's military.

Reagan understood that monetary policy affects spending and inflation. By supporting the Fed's efforts to slow the growth in the money supply, Reagan was able to reduce dramatically reduce inflation and interest rates.

Productivity and real growth are different matters. Prior to the Reagan years, US productivity was worse than at any time in the past 50 years. With lower tax rates and deregulation, productivity improved dramatically. After adjusting for the impact of the business cycle, productivity growth increased from 0.7% to 2.0%. In spite of a buildup in military spending that helped bring about an end to the Soviet Union, Reagan made significant progress in containing the growth in government. In the five years prior to Reagan, real government spending increased by an annual average of 4½% while the economy grew by only 2% a year. By the time Reagan left office, the pattern was reversed. The five-year average annual growth in real government spending was just under 3% while real growth in the economy averaged 4%.

Reagan laid out his economic objectives, what he intended to do and what he hoped to accomplish. He not only carried out his plans, but he achieved his objectives. Unlike Krugman, Reagan understood that it would take more than monetary policy to produce a healthy recovery.

**Krugman:** *Compare the situation right now with the one back in the 1980s, when Volcker turned the economy around. All the Fed had to do back then was print a bunch of dollars (OK, it actually credited the money to the accounts of private banks, but it amounts to the same thing) and then use those dollars to buy up U.S. government debt. This drove interest rates down: When Volcker decided that the economy needed a pick-me-up, he was quickly able to drive the interest rate on Treasury bills from 13 percent down to eight percent. Lower interest rates on government debt, in turn, quickly drove down rates on mortgages and business borrowing. People started spending again, and within a few months the economy had gone from slump to boom. Economists call this process - from the Fed's decision to print more money to the resulting pickup in spending, jobs and incomes - the "monetary transmission mechanism." And in the 1980s that mechanism worked just fine.*

*This time, however, the transmission mechanism is broken.*

*First of all, while the Fed can still print money, it can't drive interest rates down. Why? Because those interest rates are already about as low as they can go.*

**Genetski:** Krugman relies on interest rates as a guide to monetary policy. Milton Friedman effectively showed that the Federal Reserve made this same type of mistake in the early 1930s when it allowed the money supply to fall by a third. In spite of a collapse in spending and prices, the Fed insisted that with interest rates at zero there was plenty of money in the system. Eventually, the Fed discovered its mistake. It began to aggressively increase bank reserves. Before long, the money supply and spending increased rapidly. Unfortunately, neither the Fed nor Krugman appear to have learned the lesson from the 1930s—it can be destructive to focus on interest rates as a guide to monetary policy.

**Krugman:** *Ben Bernanke and his colleagues are trying everything they can think of to unfreeze the credit markets....*

**Genetski:** They should think a bit harder. The Fed has been draining bank reserves from the system for much of the past four years. By focusing on interest rates, Krugman makes the same mistake as Bernanke.

**Krugman:** *If banks need federal funds to survive, provide them - but demand that the banks do their part by lending those funds out to the rest of the economy.... Conservatives will accuse you of nationalizing the financial system, and some will call you a Marxist. (It happens to me all the time.) And the truth is that you will, in a way, be engaging in temporary nationalization. But that's OK: In the long run we don't want the government running financial institutions, but for now we need to do whatever it takes to get credit flowing again.*

**Genetski:** Interesting. Socialism admittedly doesn't work in the long-run, but somehow it's expected to work in the short-run. Having politicians dictate the flow of credit is neither necessary nor productive. The money will get into the system. All the Fed has to do is purchase debt and penalize banks for keeping deposits at the Fed. Banks will then either loan or invest the funds and the money will get into the economy. More importantly, the market (as opposed to politicians) will be able to allocate the funds to their most efficient uses. Krugman can't cite any examples of success with government allocating credit. It will end badly, as the recent experience with Fannie and Freddie suggests.

**Krugman:** *When the economy is deeply depressed, you have to put normal concerns about budget deficits aside; FDR never managed to do that. As a result, he was too cautious: The boost he gave the economy between 1933 and 1936 was enough to get unemployment down, but not back to pre-Depression levels. And in 1937 he let the deficit worriers get to him: Even though the economy was still weak, he let himself be talked into slashing spending while raising taxes. This led to a severe recession that undid much of the progress the economy had made to*

*that point. It took the giant public works project known as World War II - a project that finally silenced the penny pinchers - to bring the Depression to an end.*

**Genetski:** It's important to remember that when government borrows to spend money it takes the funds from one group and gives it to another. Shifting spending from some people to others doesn't stimulate spending, it reallocates it. There has never been a shred of evidence that government spending boosts the economy unless the spending is accompanied by an increase in the money supply. In 1921 and 1922 government spending was cut by more than 50%. In spite of the cuts, the economy emerged from a recession and began an economic recovery. From 1929 to 1932, government spending rose by 50%. This did nothing to prevent the Depression. The economy did not begin to show signs of recovery until 1933, a year when government spending actually fell. The recovery from 1933-36 was accompanied by both an increase in money and an increase in government spending so it cannot be used as an example of the power of fiscal stimulus. Other than the anomaly of World War II, when the nation was fighting for its survival, there has never been a case where government spending has boosted the economy without the aid of an increase in money.

**Krugman:** *Do the math: You probably have to spend \$800 billion a year to achieve a full economic recovery. Anything less than \$500 billion a year will be much too little to produce an economic turnaround.... As much as possible, you should spend on things of lasting value, things that, like roads and bridges, will make us a richer nation. Upgrade the infrastructure behind the Internet; upgrade the electrical grid; improve information technology in the health care sector, a crucial part of any health care reform. Provide aid to state and local governments, to prevent them from cutting investment spending at precisely the wrong moment. And remember, as you do this, that all this spending does double duty: It serves the future, but it also helps in the present, by providing jobs and income to offset the slump.*

**Genetski:** There is a wide range of research that shows that government spending tends to be about half as efficient as spending in the private sector. This is why productivity growth was almost three times faster under Reagan than under Carter. The great Scottish economist Adam Smith put it best: *The statesman who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted to no council and senate whatsoever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumptions enough to fancy himself fit to exercise it.*

**Krugman:** *Even if you do all this, however, it won't be enough to offset the awesome slump in private spending. So yes, it also makes sense to cut taxes on a temporary basis. The tax cuts should go primarily to lower- and middle-income Americans - again, both because that's the fair thing to do, and because they're more likely to spend their windfall than the affluent.*

**Genetski:** When I was in graduate school one of my many Keynesian professors noted that classical economists had all the evidence, but Keynesians had the right theory. With respect to evidence, nothing has changed. The \$170 billion stimulus in the spring of 2008 is simply the latest example of how ineffective these programs are. Since government doesn't have any money, it has to borrow the money to send tax rebates to lower and middle income groups. When government borrows funds it takes spending power away from those who buy its bonds. Shifting spending from one group to another doesn't stimulate anything, except perhaps more articles by Krugman about how well it should work.

The remainder of Krugman's article is simply a wide-ranging wish list of everything he would like to see. Unfortunately, if President Obama chooses to move policies in the direction Krugman suggests, the deterioration in productivity will be such that government will not be able to meet its current obligations, no less Krugman's wish list.