



Krugman Makes Key Misstatements

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In Friday's New York Times, columnist Paul Krugman makes one key misstatement of fact and another misstatement of economic theory.

The misstatement of fact relates to the timing of the government spending in the Obama stimulus package and its effect on growth. Krugman argues, referencing himself and others who argued the stimulus was too small:

Critics in the second camp were particularly worried about what would happen this year, since the stimulus would have its maximum effect on growth in late 2009 then gradually fade out. Last year, many of us were already warning that the economy might stall in the second half of 2010.

In truth, the stimulus was designed to have the maximum effect on growth in the three quarters immediately preceding the 2010 election. Overall, the "low estimate" of the impact on growth in calendar year 2010 is more than 50% greater than in calendar year 2010 than in calendar year 2009. For the "high estimate," the impact on growth in 2010 is more than double the impact in 2009. The effect on the employment rate in the low estimate is more than twice as great in calendar year 2010 as in 2009. It is not until Q4 2010 that the low estimate of the stimulus impact on GDP falls below the 2009 maximum (Q4) and the stimulus contribution to 2010 growth in the "high estimate" never falls below the estimated contribution in Q4 2009.

The initial criticism of stimulus was that so much of the spending was "backloaded" and occurred in 2010 instead of 2009, when it was needed and could have proven catalytic to a private sector recovery. Table

1 of the August 2010 CBO report on the stimulus is provided below. (Also, see Wall Street Journal article "Bulk of Stimulus Spending Yet to Come" from February of this year).

The second misstatement has to do with basic economic theory. Krugman again takes issue with the notion that the German experience could provide useful insights to U.S. policymakers by deliberately misstating the channel through which fiscal consolidation provides benefits today:

Oh, and don't tell me that Germany proves that austerity, not stimulus, is the way to go. Germany actually did quite a lot of stimulus — the austerity is all in the future. Also, it never had a housing bubble that burst. And with all that, German G.D.P. is still further below its precrisis peak than American G.D.P. True, Germany has done better in terms of employment — but that's because strong unions and government policy have prevented American-style mass layoffs.

As explained previously by e21, the focus on the precrisis peak (December 2007) is a deliberate evasion intended to distract from the much faster, 4% German growth of the past twelve months. But more significantly, Krugman contemptuously disregards the effect today of planned cuts to government spending. Cuts to future government spending can generate large increases in household and business spending today by restoring confidence and reducing expectations of future tax increases. This was articulated quite clearly by European Central Bank (ECB) President Jean-Claude Trichet at Jackson Hole.

The same argument was made in an e21 editorial in June:

Fiscal accommodation was first launched more than two years ago. The boost to consumption has long since faded, as private sector expectations of future tax



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increases have caused private sector savings to increase. According to the Federal Reserve, over the past four quarters the government has required an average 9.2% of GDP in debt financing, of which 8.25% of GDP was provided by the private sector and 0.95% from foreigners. The private sector is now saving 8% more than it spends – roughly a 10% of GDP swing from the 2001-2008 average. The current expansion is indeed “fragile” but current data are consistent with the view that it is time to back off of stimulus and increase private sector spending through fiscal consolidation.

We’ll try it one more time: All else equal, an increase in government purchases increases GDP. But all else is not equal. As the years drag on and public debt burdens spiral upwards, the private sector begins to become concerned about fiscal sustainability and the distortionary cost of the taxation necessary to pay for the increase in public expenditure. At this point, households and businesses respond to increases in debt-financed government spending by reducing investment and consumption expenditures. In these cases, “fiscal consolidation” based on large cuts to government spending has proven successful in improving long-run economic performance and boosting short-run private sector spending. Germany succeeded in knowing where to draw the line and was able to capitalize from tax-cut based stimulus, while quickly pivoting to spending cuts to reassure the private sector that the increase in public debt was fleeting.

Krugman is fond of quoting Upton Sinclair’s bon mot about the difficulty of getting a man to understand something when his salary depends on his not understanding it. Ironically, Krugman epitomizes this quip in his unwillingness to confront alternative theories or data that call into question his unflinching advocacy for more and more deficit spending.



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