

The Ferguson and Krugman Debate: Hubris of Small Differences

In various op-ed pages, the prolific economic historian Niall Ferguson and Nobel-prize winning economist-cum-columnist Paul Krugman are having a heated discussion. Their egos make them exaggerate what appear to be relatively minor differences, which are largely a question of emphasis.

At stake is one of the most important prices in the world—the price that the US government pays to borrow money. Despite claims of the demise of the US in general and the dollar in particular, US Treasury yields are still the benchmark for great swathes of the world's commerce and investment in a way that Chinese, eurozone, and Japanese rates do not come anywhere close to.

When serious people give serious thought to complex issues, they often look at similar variables. Differences more often lie with the coefficients, if you will, that are attributed to the variables. Ferguson and Krugman identify the same factors that influence US interest rates. They both look at supply and demand.

Ferguson thinks the main driver is going to be the sheer supply of Treasuries the federal government will issue to finance the large budget deficits for as far as the eye can see. Krugman places more emphasis on lack of private sector demand for capital because businesses are operating at record low capacity and households are de-leveraging and boosting savings.

Ferguson recognizes that the demand for investment capital is presently weak, but does not see fiscal policy as the appropriate tool. The Federal Reserve's massive injections of liquidity have succeeded in averting a Great Depression. Moreover, Ferguson argues that the overly aggressive fiscal policy mitigates some of the monetary stimulus because such large deficits will result in higher interest rates.

Krugman understands perfectly well that running large budget deficits can undermine the credibility of the issuer and to compensate investors will demand a greater risk premium which will force interest rates higher. However, given the magnitude of the financial and economic crisis, and the loss of private spending and investment, officials still risk doing too little rather than too much.

It seems that Ferguson can't quite figure out whether the crisis is a recession as he claimed in the Financial Times on May 30th/31st or a slight depression as he told Barron's on June 1st. The precision and sparsing may give the appearance of profound thought, but the fact of the matter is that there is no agreed upon definition. Indeed, the end of the business cycle in the 19th century and early 20th century was called crisis, panic, and depression, but after the Great Depression, politicians wanted to avoid that term preferring the term "recession".

By playing down the significance of the economic downturn, it is easier for Ferguson to argue that such large fiscal stimulus is really unnecessary. Ferguson accuses the Obama administration of adopting a war budget to fight a recession. An irony here is that part of the growth in the deficit is that the cost of the two wars being fought is being included in the budget.

Krugman by contrast thinks this is a very serious crisis. He believes the unwinding of the unprecedented degree of leverage risks a deep and prolonged retrenchment by both the household and the government. The deficit that worries Ferguson so much is understood by Krugman as offset by the higher savings in the private sector.

The higher savings increase the pool of available investment capital, but businesses do not want to invest with record low levels of capacity utilization. Non-residential investment collapsed at a 40% annualized pace in the first quarter. If households are not consuming as they were and businesses are not investing, how will the economy recover? Krugman says that the government must step into the breach and/or facilitate others to do what is not being done by households and businesses on their own.

If Ferguson can't decide whether this crisis is a recession or depression, Krugman can't quite figure out if this is an American crisis or a global crisis. Ferguson is sure. He is quite explicit. This crisis has the "made in America" stamp on it. Krugman is not sure. Sometimes he seems to appreciate the global nature of the crisis, but he has gone on

ideological rants and blames the crisis on the deregulation that begun, he says by Ronald Reagan (though a non-ideological historian would recognize that deregulation begun by Jimmy Carter and the airlines).

Ferguson proclaims victory because US Treasury yields have been rising since his dispute with Krugman began. Leave aside the fact that US Treasury yields have been rising since bottoming late last year and the increase has accelerated since mid-March, Ferguson's victory dance is premature.

Ultimately, the difference between the two lies in the explanation one offers for the increase in rates. Ferguson wants us to believe that the increase in US interest rates is a function of the massive government borrowing. There are two transmission channels. The first is the sheer supply of new bonds the government has to sell. The second is the inflation expectations that are fanned by the extreme policies and the lack of a credible exit strategy.

Krugman appears thus far to have simply said that Ferguson is wrong, but has not really offered a different explanation. Not to worry, with the help of his fellow Keynesian, Martin Wolf of the Financial Times, we can anticipate a Krugman-like response.

In an op-ed piece in early June, Wolf embraces the increase in yields, not as a sign of reaching the limit of policy action, but rather the very success of policy. The backing up in US rates has not been caused by the deluge of supply and heightened inflation expectations, but by the desired normalization after a dramatic panic.

That yields are rising and the curve steepening is evidence that policy makers have succeeded in addressing the threat of deflation. There is not crowding out of private sector borrowers where the higher interest rates are the result of allocating a scarce resource: capital. The yield on the 10-year Treasury's Inflation Protected Security (TIPS) is near 2%, which is what is understood to be the Fed's medium term target (for core PCE).

Ferguson and Krugman both locate the causes of the crisis with policy integral to markets themselves, like Hyman Miniski would. In a long period of prosperity, rising asset markets themselves can morph into their opposites. Given that countries with a more extensive regulatory regimes have also succumbed to the financial crisis suggests that Ferguson and Krugman exaggerate the significance of regulation, though from different starting points.

Both seem to be somewhat antagonistic toward China. Ferguson, did his part to debase the English language and clear thinking by coining Chimerica (joining the ranks of Chindia and Shangkong), which was supposed to capture the new global condominium. But now he says that union is dissolving in large measure because China is worried over the implications of US fiscal policy.

But there was never the union or marriage that Ferguson claims. Are we really expected to believe that a marriage existing during the recent Bush Administration which identified China as a strategic competitor, rather than a partner, like the Clinton? For his part, Krugman says that Americans themselves will absorb more of the US Treasury supply and asserts that China is not contributing at all. Such a claim cannot be supported by the facts.

US Treasury data is clear. China increased its Treasury holdings \$272 billion in the second half of last year, boosting its holdings by more than a third. It has continued to buy US Treasuries through the first quarter, for which the most recent data covers. In fact, the Chinese tend to be consistent buyers of Treasuries. The last month that it was a net seller was February 2008. The larger point should also be made. Foreign central banks continue to buy US Treasuries and are absorbing some of the supply. The Federal Reserve's custody holdings for foreign central banks has risen by \$215 billion in the first five months of the year. Through in May foreign central banks bought more Treasuries than the Federal Reserve.

Lastly, Ferguson pays some lip-service to the idea of a savings glut and Krugman sees it as appearing at extreme moments, but is arguably a chronic problem of advanced industrial capitalism. Ben Bernanke was writing about surplus savings back in 2002. It is not simply that during the crisis there is a savings glut which needs to be absorbed, but the boom itself was a function of that surplus. The lack of sufficiently profitable investment opportunities leads to what Minsky called "balance sheet-engineering".

The hair-splitting exercise by the historian and the economist may generate much heat but little light. Their difference is primarily one of emphasis coupled with hubris. That which is unsaid and unexplored appears to be a more promising path to explore.

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