"Wrong Way" Krugman Flies Again, and Again

The infamous pilot Douglas Corrigan was dubbed "Wrong Way" in 1938, after he filed a flight plan that would have taken him on a transcontinental flight from New York to Long Beach, California. Instead, Wrong Way took a transoceanic flight from New York to Dublin, Ireland.

Corrigan's "Wrong Way" attribution should be applied to the fiscalists led by Nobelist, Princeton professor and hyper-productive *New York Times* columnist Paul Krugman. He argues that the only way to put the major economies around the world back on track is to "stimulate" them via deficit-financed government spending. There is just one problem: Prof. Krugman and his fiscalist followers are selling snake oil. If nothing else, Prof. Krugman's "success" proves the wisdom of advice which management guru Prof. Peter Drucker imparted to me over lunch in 1998: "the key to successful salesmanship is nothing more than repetition enhanced by incremental product improvement."

Statements made by the likes of Nobel laureates carry weight – even if those statements amount to nothing more than factoids. Recall that, according to the *Oxford English Dictionary*, a factoid is "an item of unreliable information that is reported and repeated so often that it becomes accepted as fact." The famous "Dr. Fox Lecture," which was presented at the University of Southern California's Medical School, illustrates just how so-called "experts" can effectively work and influence a crowd. The lecture was presented by Dr. Myron Fox –an advertised heavyweight – to an academic audience. The response to Dr. Fox's lecture was unanimously favorable. Little did the audience know that "Dr. Fox" was an actor who had been cloaked with an impressive fake curriculum vitae and trained to deliver a nonsensical lecture filled with contradictory statements, double-talk and non sequiturs. When the big guns sound off, they are heard.

In the political sphere, the fiscal factoid is catching on. France has just dumped an economically incoherent Nicolas Sarkozy and replaced him with François Hollande, who is the first Socialist to reside in the Élysée Palace since François Mitterrand did 17 years ago. Not surprisingly, President Hollande is proudly flying the fiscal stimulus flag. And that's not all.

Greece has just announced that a government couldn't be cobbled together after the 6 May 2012 elections, and that new elections would be held on 17 June 2012. In the wake of the May elections, the fly in the ointment has been the surge in support for the Coalition of the Radical Left (SYRIZA), which is lead by Alexis Tsipras. Where does SYRIZA stand? A top adviser to Mr. Tsipras, Prof. Euclid Tsakalotos couldn't have been clearer when he recently rejected fiscal austerity and embraced the fiscal factoid. To finance more government spending, he asserted: "We need a central bank that prints money, euro bonds, and a system that transfers money from rich countries to poor countries." It looks like Wrong Way Krugman has found his man in Prof. Tsakalotos. Both should be grounded, pending the completion of a short course on the efficacy of fiscal stimulus programs.

Let's take a closer look at the fiscal *facts* and the effectiveness of the Keynesian fiscal elixir. Nobelist Milton Friedman addressed the issue in a 1999 *Wall Street Journal* column (8 January 1999). Prof. Friedman wrote:

> The Keynesian view is that government deficit spending is cyclically stimulative whether it is financed by borrowing or by newly created money. The monetarist view is that spending financed by newly created money is cyclically stimulative whether the spending is by the government or the private sector. Government spending financed by borrowing may or may not be stimulative depending on how much

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by Steve Hanke

Do Fiscal Stimuli Stimulate? (United States)

	Levels of (as a % of Potential GDP):		Changes in (as a % of Potential GDP):	
	Output Gap	General Government Structural Balance	Output Gap	General Government Structural Balance
2001	-0.4	-0.1		
2002	-1.5	-2.9	-1.1	-2.8
2003	-1.5	-3.7	0.0	-0.8
2004	-0.5	-3.2	1.0	0.5
2005	0.0	-2.3	0.5	0.9
2006	0.3	-2.0	0.3	0.4
2007	0.0	-2.3	-0.2	-0.4
2008	-1.8	-4.7	-1.9	-2.4
2009	-6.0	-6.8	-4.2	-2.0
2010	-4.8	-7.5	1.2	-0.7
2011	-3.7	-8.1	1.1	-0.6
2012	-2.7	-5.7	1.0	2.4
2013	-2.0	-4.4	0.7	1.3
2014	-1.4	-4.3	0.6	0.1
2015	-0.9	-4.8	0.5	-0.5
2016	-0.4	-5.3	0.5	-0.5

Sources: International Monetary Fund, May 2011 and Author's Calculations.
Notes:
1. A positive (negative) change in the output gap implies an economic expansion (contraction).
2. A negative (positive) change in the general government structural balance implies a fiscal stimulus (contraction).
3. The output gap is the difference between the actual level and the trend level of national output.
4. The general government structural balance is the difference between revenue and expenditure in a cyclically normal situation, with the business cycle midway between a boom and a recession.

> private spending is crowded out by government spending. Either outcome is possible, depending on conditions.
>
> It is not easy to distinguish between these views on the basis of empirical evidence, because fiscal stimulus generally is accompanied by monetary stimulus. The relevant evidence is provided by those rare occasions when fiscal and monetary policy go in different directions.

To test whether the Keynesian or monetarist view was supported by the empirical evidence, Prof. Friedman recounted two episodes in which fiscal and monetary policies moved in different directions. The first was the Japanese experience during the early 1990s. In an attempt to restart the Japanese economy, repeated fiscal stimuli were applied. But monetary policy remained "tight," and the economy remained in the doldrums.

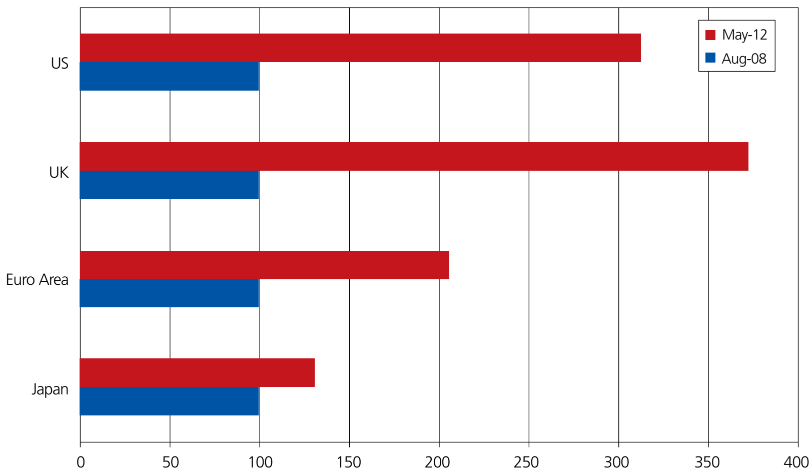
Prof. Friedman's second example was the U.S. experience during the 1990s. When President Clinton entered office, the structural fiscal deficit was 5.3% of potential GDP. In the ensuing eight years, President Clinton squeezed out the fiscal deficits and left office in 2000, with the government's accounts showing a structural surplus of 1.5%. Ironically, the two years in which fiscalist Prof. Lawrence Summers was President Clinton's Secretary of the Treasury (1999-2000), the U.S. registered a structural surplus of 0.9% and 1.5% of GDP. Those years were marked by "tight" fiscal and "loose" monetary policies, and the economy was in an expansionary phase. Note that Prof. Summers has clearly had a sip of snake oil since his heady days of 1999-2000.

Prof. Friedman concluded with the following remark: "Some years back, I tried to collect all the episodes I could find in which monetary policy and fiscal policy went in opposite direction. As in these two episodes, monetary policy uniformly dominated fiscal policies."

We can further demonstrate the existence of the fiscal factoid by comparing changes in the output gaps and general government structural balances. In the accompanying table, the first column records the output gap. When the gap is positive (negative), actual output is above (below) the economy's potential. The second column in the table is the general government's structural balance. When it is negative (positive), a fiscal deficit (surplus) exists. The third and fourth columns record the changes in the output gap and general government structural balance, respectively. A positive (negative) change in the output gap implies an economic expansion (contraction), and a negative (positive) change in the general government structural balance implies a fiscal stimulus (consolidation).

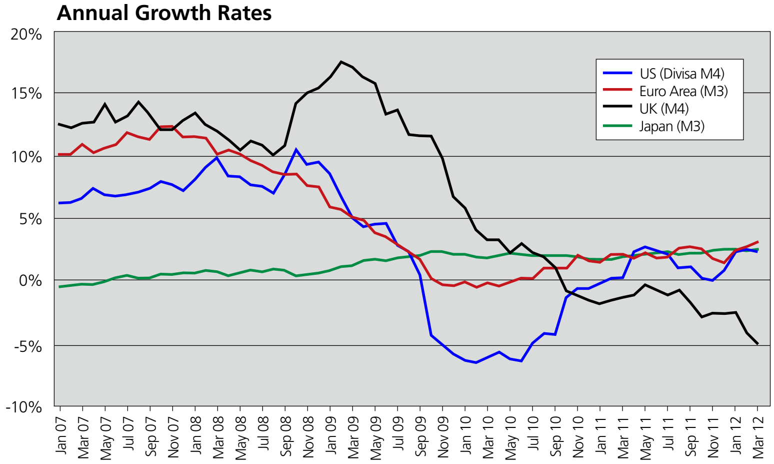
If the fiscalists are correct, we should observe an inverse relationship between changes in the rate of growth in output (the third column of the table) and the budget balance (the fourth column of the table). From 2001 through 2016, as projected by the International Monetary Fund, the U.S. economy does not behave in the way that Prof. Krugman and other Keynesians have asserted and proselytized. Indeed, the number of years in which the economy responds to fiscal policy in an anti-Keynesian fashion is more than double those in which the economy follows the Keynesian dogma.

Size of Central Banks' Balance Sheets
Index (August 2008=100)



Sources: Federal Reserve Board, Bank of England, European Central Bank, Bank of Japan and Author's Calculations.

Broad Money Growth
Annual Growth Rates



Sources: Center for Financial Stability, Bank of England, European Central Bank and Bank of Japan.

As it turns out, there is plenty of austerity out there. But, in general, it's not fiscal austerity, with real cuts in government spending, as the fiscalists claim – a cut is when you have spent $1 billion last year and will spend $900 million this year. Never mind. As Prof. Friedman taught us, money matters. And when we look at money, we see two pictures. One is the size of the central banks' balance sheets. They have exploded since the Lehman bankruptcy of September 2008 (see the accompanying chart). If you just focused on those balance sheets and the associated growth in high-powered money, you would conclude – as many have done – that we are facing a wall of money and liquidity and that hyperinflation is just around the corner. But that would be a wrongheaded conclusion.

The second picture, one that plots the course of broad money (derivative measures of high-powered money), shows very subdued growth in the money supply (see the accompanying chart). Indeed, in the United Kingdom, broad money is contracting. No wonder the U.K. economy is mired in a double dip recession. It has little, if anything, to do with the Cameron government's alleged fiscal austerity, but everything to do with the U.K.'s money and banking policies. Note that I include the word "banking." Most economists nowadays might find this strange since their models don't even include banks.

In the wake of the financial crisis that has engulfed us, the chattering classes have embraced a wrongheaded set of policies to make banks "safe." One who led the charge was Britain's former Prime Minister Gordon Brown. In the prologue to his book *Beyond the Crash*, he glorifies the moment when he underlined twice "Recapitalize NOW." It turns out that Mr. Brown attracted many like-minded souls, including his successor, David Cameron, as well as the central bankers who endorsed Basel III, which mandates higher capital-asset ratios for banks.

In response to Basel III, banks have shrunk their loan books and dramatically increased their cash and government securities positions (both of these "risk free" assets are not covered by the capital requirements imposed by Basel III and related capital mandates). This explains, in large part, why the explosion in high-powered money has not flowed through to broad money measures and why we have not bounced back from the crisis induced slump that our friendly central bankers pushed us into.

We are in deep trouble – trouble that has nothing to do with alleged fiscal austerity. Today, the source of our economic malfunction resides with government-mandated bank regulations that have thrown a monkey wrench into the banking system. Wrong Way Krugman and his followers should abandon the fiscal factoid and keep their eyes on what matters – money. They can start by contemplating the monetary contraction in Greece: in the last year, broad money (M3) contracted by 17.1%.

References:

Donald H. Naftulin, M.D., John E. Ware, Jr., and Frank A. Donnelly. "The Doctor Fox Lecture: A Paradigm of Educational Seduction." *Journal of Medical Education*, Vol. 48, 1973, pp. 630-635.

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