



## Episode 417: Paul Krugman's Three Huge Errors

Guest: Bob Murphy

**WOODS:** It's always fun to talk about Paul Krugman. People enjoy that, for some reason, because you can learn economics sometimes by thinking the opposite of what he thinks. So the next best thing to being right all the time is being wrong all the time, reliably wrong. Now I suppose he's not wrong literally all the time, but in major things he has been wrong. And in particular, in his analysis of the situation that we've faced since 2008, he has been, as you sometimes put it, "running victory laps," saying that the traditional Keynesian model has come out smelling like roses; that we, the Keynesians have been "right about everything" — those are his words — whereas everybody else has been "wrong about everything" — those are also his words. Typical subtle Paul Krugman.

Now, you've written an article, which I'm going to link to on today's show notes page, [TomWoods.com/417](http://TomWoods.com/417), called "Paul Krugman: Three Wrongs Don't Make a Right" and the subtitle is, "The empirical failures of Krugman's macroeconomic model." I'd like to go through these three items and talk to you about them, and let's bear in mind that some of this stuff can be a little technical, so we want to explain it for the reasonably educated laymen. But let's maybe take it down a notch even from there, so that everybody can understand Krugman's mistakes. So let's talk first about this zero lower bound issue and a liquidity trap — I think we've talked about that on the show before, but it was quite some time ago.

**MURPHY:** Sure, and I think before we get into that again, just to justify why are we doing this; what's the point; I thought you Austrians didn't care about predictions; as you mentioned, Tom, Krugman — for those who read him regularly will know — that since 2009, this constant mantra coming from him has been, hey, this isn't ideology; this isn't about my personal preferences; this is just science, folks. We had models; we made predictions. The austerians, or even the Austrians — sometimes he would explicitly label the Austrian School, single them out — they made specific predictions about what would happen, and we won; they were totally wrong. This is science; I can't believe in this day and age that people are still listening to these clowns who got everything wrong about what would happen with the U.S. economy. Right, so he has said some version of that easily a hundred times since 2009, so that was why I felt I should write this article that we're going to discuss, Tom.

**WOODS:** Let me tell you that I want to actually read for the listeners the last two paragraphs of your first section. I won't read them now; they won't make any sense,

but after you've gone through, I want to give them — because these are just crushing paragraphs. The one that starts, "I realize some readers may think I'm nitpicking here" — this is just utterly crushing and devastating. So therefore, let me read it and glory in it after you've done all the hard work of setting them up. Fair enough?

**MURPHY:** Sure, sure thing.

**WOODS:** All right, so go ahead.

**MURPHY:** Okay, so again, just for your listeners, there's three main sections of sort of macroeconomic issues that I'm going to be hitting Krugman on and show that he made very wrong empirical predictions that were falsified by the data, to use this sort of Popperian language that he would use to say why he's more scientific.

This first one is this issue of the so-called zero lower bound. Very quickly, it is true that Krugman, at least according to his public proclamations in the textbook theory that he espouses, is not always in favor of deficit spending, even if there's a recession — that, strictly speaking, his new Keynesian approach says it's always better to have the Fed step in first and use monetary policy to try to address a recession — which in their view is going to be a short fall in aggregate demand, that people aren't spending enough, whether on consumption or investment. He says the first line of attack that the authorities will do is the central bank should cut nominal interest rates, because that will lower interest rates, will cause people to go spend more and invest more.

Okay, so you don't need deficit spending in terms of pump priming Keynesianism, but the reason you did need it in this crisis, Krugman said, is that the Fed ran out of ammunition, in terms of conventional monetary policy. They cut short-term nominal interest rates all the way down to basically zero, and we were still stuck in a really bad recession. And so that's why, Krugman says, we now have the case for the federal government to run a budget deficit, to boost spending that way.

So this zero lower bound, even though it's kind of just an interesting curiosity to perhaps other schools of thought, in the Keynesian model, it makes a huge difference — or it's a very significant thing — because that's the critical barrier showing why there was allegedly a case for fiscal stimulus. Because in normal times, as long as that interest rate has room to be reduced, then there's no argument for fiscal stimulus, even in terms of Paul Krugman's model.

**WOODS:** All right, so how did things turn out in a such a way that Krugman's analysis comes up short?

**MURPHY:** Okay, so after having put so much weight on this zero lower bound in the article — there's quotes of him being pretty flippant with Gary Becker and other pretty big guns in the economics profession, saying I can't believe these idiots don't see the reason we've got to use fiscal policy is because of the zero lower bound. So he really rested his case on it.

And it turned out, we saw earlier in 2015, there were sustained negative nominal short-term rates across Europe. And so what that means — and it's kind of paradoxical at first — but what was happening was people were so panicked, and just the inconveniences of holding large amounts of cash that, actually, people were keeping their money on deposit, or they were buying bonds that had a negative nominal yield.

And so that opens up the door to say, holy cow, this huge plank in Krugman's argument for fiscal stimulus just went out the window. And so what he came out with was just to say — so this is the first time he acknowledged it in his blog — he said, "We now know that interest rates can in fact go negative. Those of us who dismissed the possibility by saying that people could simply hold currency were clearly too casual about it. But how low?" And then he goes on and looks at estimates of people, saying, well, how low can these negative interest rates go beyond the zero lower bound? And then he just comes back and ends that article, where he says, "And I am pinching myself at the realization that this seemingly whimsical and arcane discussion is turning out to have real policy significance."

Okay, so this is the huge plank in his argument; it went out the window, and he's saying he's "pinching himself," because, hey everyone, isn't this fun? Look, economics actually affects the real world. When you'd think he'd be a little bit more sober about, oh my gosh, let's do damage control here; let's run through and see how much did my confident assertion that the zero lower bound was a barrier — what impact does that have on people, because I've been wrong for years now on this point.

**WOODS:** Right, and you actually say here, "The foundation for the Keynesian case for fiscal stimulus rests on an assumption that interest rates can't go negative. Then they do go negative, and Krugman" — and then here's your edit; you could insert an editorial comment here: instead of saying well, gee, maybe I'd better retreat for a little while and think this over — "is pinching himself that he gets to live in such exciting times." Now, do I have permission to read your last two paragraphs of this section?

**MURPHY:** (laughing) Sure thing, Tom.

**WOODS:** All right, I just love this. "I realize some readers may think I'm nitpicking here, because (thus far) it seems that maybe central banks can push interest rates only 50 basis points or so beneath the zero bound."

A basis point is 1/100th of a percent.

"Yet, in practice, that result would still be quite significant, if we are operating in the Keynesian framework. It's hard to come up with a precise estimate, but using the Taylor Principle reverse, and then invoking Okun's Law, a typical Keynesian might agree that the Fed pushing rates down to -0.5 percent, rather than stopping at 0 percent, would have reduced unemployment during the height of the recession by 0.5 percentage points.

"That might not sound like a lot, but it corresponds to about 780,000 workers. For some perspective, in February 2013, Krugman estimated that the budget sequester would cost about 700,000 jobs, and classified it as a 'fiscal doomsday machine' and 'one of the worst policy ideas in our nation's history.'"

Those are his words.

"So if my estimate is in the right ballpark, then on his own terms, Krugman should admit that his blunder — in thinking the Fed couldn't push nominal interest rates below 0 percent — is one of the worst mistakes by an economist in U.S. history. If he believes his own model and rhetoric, Krugman should be doing a lot more than pinching himself."

That's great, Bob. May you live long and prosper and write more paragraphs like those. All right, let's move on to the next thing. This is an area that I think is may be easier for the casual student to understand: the subject of fiscal stimulus and so-called budget austerity. Talk about that.

**MURPHY:** Sure thing, and yeah, you're right. If some people were getting confused in the last section, this one's straightforward. This is easy to understand, and you can see just the silliness and shamelessness of Krugman's rhetorical moves on this particular topic.

So what Krugman was arguing for years was that, hey guys, this stimulus — the so-called Obama stimulus package that passed in early 2009 — that wasn't big enough. So that's the reason we're still stuck in this recession or depression, as he sometimes called it, because the Republicans and so on — Ron Paul scared people and all these austerians — and so the deficit was just too small, but at least it prevented the Great Depression, a replay of the '30s. But now, guys, now that the recovery is here — and it's very tepid, don't get me wrong — we cannot cut spending and return to austerity policies too soon, because that's the mistake they made in the '30s; that's the mistake they're making in Europe. And so if the U.S. goes along with the sequester, in particular — which again, he called a "fiscal doomsday machine" — then, things are going to be awful. I mean, there's all kinds of quotations that I linked to of him saying that.

And then, in particular, what was hilarious was — remember the Fed now starts another round of QE right at the time when this so-called sequester is kicking in, where all these automatic spending cuts go on and so forth, because the budget had passed. And so in April 2013, Krugman actually said — I'm paraphrasing here, but this is a fair representation of what he said — he said, right now in April 2013, we're getting a good test to see these two things put together, with the Fed inflating while Congress is cutting spending, and, sorry guys, it's not looking too good for you, those who thought that just monetary policy could just carry the day. And he's saying, because the economy's turning down — so this is as of April 2013 — he says, it's a good test of it.

Well, the economy then actually did okay in 2013, according to standard measures. And so then in January 2014, as you can imagine, all these market monetarist guys, like Scott Sumner, are running victory laps, like whoa, whoa, whoa, back in April 2013, Krugman said it's a good test of monetary versus fiscal, and clearly we won. So whoo hoo, we're right; it's okay if Congress cuts spending. It's not going to cause the economy to fall off a cliff.

So then in January 2014, Krugman's complaining about those guys, saying, I can't believe they're saying that 2013 was a test of monetary versus fiscal policy. Clearly, there's 19 things going on in an economy; you can never have a really controlled experiment like that. Other things offset the spending cuts. Right, so he was complaining and saying, why are they calling it a test of the two camps, when, when he thought he was winning few months earlier, he said, this is a good test of these two theories. So I mean, it's just crystal clear what he did there

**WOODS:** So he himself says, this is a good test. And then when he fails the test, he says this is a terrible test; why would you think this is a good test? Is that a fair summary?

**MURPHY:** Yeah, and again, there's quotes and links in the article. I know people are going to say, oh, come on; you guys have to be exaggerating a little.

**WOODS:** Yeah, right, he couldn't possibly have said it this way. But if you've read Krugman for any length of time, you know that that *is* how he speaks.

**MURPHY:** It was exactly that blatant. Now somebody else, he was quoting somebody like Mike Konczal, I think — I don't know how you pronounce the guy's name — but in April 2013, it was this other Keynesian guy who said, right now, we have a good test. And Krugman linked to him and said, as Konczal says, right now's a good test of these — so I mean, he's grabbing somebody else's test; Krugman was endorsing it when it looked like they were winning. And then when it blew up in his face, and Scott Sumner was running around linking to that April 2013 piece saying, hey, we won the test that he just set up for us, then Krugman was complaining and saying, oh, come on, guys; that wasn't a good test; I can't believe you're saying that.

**WOODS:** Yeah, that one — that's pretty hard to slither out of, I would say.

**MURPHY:** So then he does a similar thing — even, perhaps, more shocking — in 2014. So then 2014 ends up — again, this is — and I know your listeners might be surprised by this — for a while, I was rolling my eyes at the claims of, oh, come on, this isn't austerity with sequester — but in terms of — go look at federal spending and things like that — it actually is kind of flat. So it zoomed way up when Obama first came in, but I understand how, if you always think the government should be spending more money, you would be horrified at the so-called restraint the last few years. So it's actually probably better than a lot of your listeners are imagining. It's not just cuts in the rate of growth; it actually was pretty flat for a while there, especially if you

include state spending, looking at like total government spending and not just the federal level.

So anyway, while this is all happening — things that Krugman is saying, you know, his "fiscal doomsday machine"; this is the worst policy idea ever, blah, blah blah — the economy, according to conventional metrics — I mean, it's sluggish, but the recovery just keeps improving. The official employment rate keeps going up; GDP keeps going up. And yeah, there are issues with those things, but that's not the way Krugman can argue with it. He has to make fun of the shadow stats, you know, conspiracy theories and stuff. So according to Krugman's own metrics that he uses, the economy inexplicably kept getting better, even when they were cutting spending or holding spending constant, which he said was going to be a disaster and cause a double dip and so on.

And so, by the end of 2014, he really couldn't keep that up. He knew, I can't keep saying how the spending restraint's going to be disastrous. And so he totally flipped, and he started praising the Obama recovery. And he used it as a way to mock all those conservative Republicans who gave such dire warnings about Obamacare and how that was going to ruin the economy, because Obama was some crypto-Marxist/Muslim/atheist.

And I'm not exaggerating. Those are the terms Krugman uses to show how silly the opponents of Obama are, and how paranoid, nutjob, and contradictory they are, that they can simultaneously accuse him of being a Muslim and an atheist. So Krugman often uses that kind of phrase to label conservative Republican critics.

So again, just to back up and give you the big picture, Krugman for years was warning spending cuts while we are still in a weak economy is going to lead to disaster; we got the spending cuts and restraints; he said, "This is a fiscal doomsday machine" that we've just unleashed. He wasn't making a warning that this is the way policy might go. When the sequester went through, he said, "This is a fiscal doomsday machine." It's in operation. Then when the economy kept getting better, he finally said, okay, this Obama recovery proves the Republican critics didn't know what they were talking about. They kept warning us about how bad the economy would be, and employers wouldn't hire anybody because of Obamacare. Haha, you idiots, once again, their model's totally wrong; I can't believe people are still listening to them. That is the rhetorical move he tried to take.

**WOODS:** Let's move into the third one, because this one is the one that surprised me the most: the area of price inflation. Because here is where he feels, I'm sure, that there's no way anyone can say anything against him. His position is completely unimpeachable, that he was telling everybody that there would not be appreciable price inflation, and there has not been. So therefore, he was clearly right.

**MURPHY:** Right, this is my favorite one. So for those of your listeners who don't know — I don't want anyone to go Googling and be surprised and think I withheld something. Let me disclose, I was wrong on this issue. I foolishly made a bet with my friend, David

R. Henderson, another free market guy. He was worried about the Fed's policies, but he thought I was being premature in my warnings, so we both had a bet. He posted it on EconLog, and I did it on my blog, so it was public knowledge. And I said that I thought CPI was going to rise by 10% year over year, and we had some framework of like three years – I don't remember the exact details. And it didn't happen, so I paid him, and I lost the bet.

So Krugman and Brad DeLong and guys like that were just laughing themselves silly, saying, ha ha, these idiot Austrians warning about hyperinflation, and they're totally wrong, and yet they keep the same model. And as you say, Tom, the way Krugman very cleverly phrased this particular aspect of the issue over the years was to say, here's a clear cut example of models making two divergent predictions. We said price inflation would be modest, because the aggregate demand is so weak, and we're in a demand side recession. We're up again in a liquidity trap. Whereas, these conservative right-wingers were worried about hyperinflation, because, look at all the money the Fed's dumping in. They were wrong; we were right; therefore, if you're a scientist or care about empiricism, you should agree with our policy conclusions.

But that is a very slippery way of framing it, because actually, Krugman's model did not merely predict that there wouldn't be large price inflation. Krugman, the model he was using coming into this thing, said there should be accelerating deflation. In other words, whenever there's high unemployment, and there's slack in the system, price inflation will slow down, and if you're still, even once CPI's flat, if you still have very high unemployment, idle resources, slack labor markets, and so on, we will go negative. And that's what happened actually in Japan. CPI literally fell in Japan over long stretches. And Krugman predicted that in the U.S. He said, "Japan, here we come," back in 2010.

So, yeah, it's a true statement for Krugman to say, we did not predict massive price inflation, but that's very misleading and self-serving. Actually, his model and he himself predicted that prices would plummet. And they didn't. We had modest CPI inflation. We can argue about whether CPI's valid or not if they cook the numbers, but the point is it didn't do what Krugman thought it was going to do.

So in the big picture, at certain points, I was worried about very rapidly rising price inflation; Krugman was worried about very rapidly falling deflation, and what happened was we got modest CPI for the period, according to official numbers. And Krugman's running around, saying how his model passes with flying colors. I mean, you really can't make it up.

**WOODS:** I'm going to steal your text again here. In your conclusion, you say, "Krugman, armed with his Keynesian model, came into the Great Recession thinking that (a) nominal interest rates can't go below 0 percent, (b) total government spending reductions in the United States amid a weak recovery would lead to a double dip, and (c) persistently high unemployment would go hand in hand with accelerating price deflation. Because of these macroeconomic views, Krugman recommended aggressive federal deficit spending.

"As things turned out, Krugman was wrong on each of the above points: we learned (and this surprised me, too) that nominal rates could go persistently negative, that the U.S. budget 'austerity' from 2011 onward coincided with a strengthening recovery, and that consumer prices rose modestly even as unemployment remained high. Krugman was wrong on all of these points, and yet his policy recommendations didn't budge an iota over the years."

People should read your article for themselves at [TomWoods.com/417](http://TomWoods.com/417). Let me say a word about the podcast that you and I had come up with called *Contra Krugman*, where every week we're going to go through Krugman's *New York Times* column and give it a critique. I had initially thought that April would be a good time to do that, and then I made an announcement on my Facebook page – [Facebook.com/ThomasEWoods](https://www.facebook.com/ThomasEWoods) – in which I said, you know, I really have been balancing so many things, with the [RonPaulHomeschool.com](http://RonPaulHomeschool.com) stuff and just everything. And I think I need a little bit more time before I take on a new project. And everybody's saying such wonderful things: oh, you do so much, and we appreciate it. And that's very sweet, and I'm grateful for that. But let's say we won't make a hard and fast announcement of the precise month, but let's just say, the wheels are turning. Bob and I are working on this, and we do plan to launch this thing before long. Do you want to add anything that's as cryptic as that?

**MURPHY:** (laughing) We're really looking forward to it; you guys are going to love it, and you don't want to miss a single episode of it.

**WOODS:** All right, that's really, really good. So if you want to be the first to find out about the launch of that show, which, there's no show like that. There's no podcast like that for anybody, and yet, Krugman needs that. And for anybody inclined to say, why are you giving Krugman all this attention? He doesn't deserve it. Well, it's not because of him as a person, necessarily; it's because of the ideas, which get spread like crazy, and even some people who are on our side would like to know how to respond to these sorts of arguments. But if you want to be the first to know about it, then text the word "liberty" to 33444. First of all, you'll get a free ebook, my book, *14 Hard Questions for Libertarians Answered*, which has some material by Bob Murphy in it, and secondly, you'll be subscribed to my weekly letter, and in that letter, I will announce – before anybody else finds out about it – I'll announce exactly what the deal is with the podcast. So just text the word "liberty" to 33444. Bob, thanks again for being here to help us correct some errors and understand the world better.

**MURPHY:** Thanks for having me, Tom; always fun.