Episode 367 – Murphy Takes on Krugman on Recessions, Business Cycles
Guest: Bob Murphy
March 26, 2015

WOODS: I invited you on to talk about whatever you were working on these days, and then my producer pointed out to me that Krugman had a column yesterday, or a blog post, that is, called "Anti-Keynesian Delusions." He's responding to one or two critics of Keynesianism, but they are not really the best critics of Keynesianism, so it's not so difficult for him to respond, but his responses still are not all that good, and I thought, well, you know what? What the heck? Let's take this apart. Let's see what Murphy would say about this column. We will link to the column. So if you would like to follow along to get the most out of this episode, you can do so at tomwoods.com/367, which is the copious show notes page for today's episode. In fact, maybe I can turn things over to you. You've got the piece in front of you?

MURPHY: Yes, I do.

WOODS: So tell me the most—let's just go through it in order, and we don't have to spend an equal amount of time on each thing, but let's go through it in order. What's the first howler you notice?

MURPHY: Sure. The context here is that Krugman, as usual, is surrounded by friggin' idiots, and he can't believe that he's got to deal with these morons in the economic blogosphere, and he's saying how, man, another example of some critic of Keynesianism who doesn't understand even the basics of the theory let alone realizing that, empirically, Keynesianism has just been totally crushing all of its opponents since the crisis began. Specifically, it's this guy David Levine, and I should say, this guy Levine's critique of Keynesianism: it's not phenomenal, and he does say stuff, like they don't even understand math, and things like that. So I understand why a Keynesian would be offended by this piece and think it was lowbrow.

But the thing that jumped out at me is, Krugman contradicts himself in his response right in the beginning. Let me just set the context here. Levine wants to illustrate the flaws of the Keynesian mindset and how you fix a recession. So he imagines it's a simple, little barter economy where one person produces one good, and he trades it to the next guy, and then that guy takes it, and he trades it to somebody else so that they are all swapping direct goods, and there's no money per se. And then one of the guys was going to produce something in the circle of goods traveling around the little four-person economy, and one of the guys' roles was he was supposed to produce something and then get a tattoo, and that's the service he was going to receive. That was his role—his niche in the economy—to make this all work, and so this Levine guy says, but what if all of a sudden he realizes he doesn't want to get a tattoo? And so I just want to build a phone—this guy was a phone builder—and so the critic of Keynesianism is saying, see, here's an example where deficit spending is not going to fix things.

What I noticed is Krugman contradicts himself right away. He points at that, and he says, see, right away this guy doesn't understand the first thing what he's talking about. Because that guy decided he doesn't want a tattoo anymore, and so he's not going to produce the phone, he's pulling himself out of the labor force—well, that's an adverse supply shock, and no Keynesian, Krugman is saying, thinks that government deficit spending can fix a supply shock. If there is a crop failure, no Keynesian thinks that bigger government spending is going to fix that. So this guy doesn't even know what he's talking about. And then Krugman goes on one paragraph later to say, but it's even further than that. As Nick Rowe points out, in this guy's example, phones are actually the medium of exchange. And so therefore, what this guy has modeled is a contractionary monetary policy, and so ha, ha! So, again, he proves the efficacy of a Keynesian solution.

My point, Tom, is right there Krugman just contradicted himself in two paragraphs. He went from saying this is a supply shock, and that's why Keynesian policy wouldn't be applicable, and no Keynesian would be so stupid as to think a stimulus would help, and then in the next paragraph he says, oh, and by the way, this guy is such an idiot he doesn't realize he just modeled a monetary contraction, in which case a Keynesian stimulus *would* help.

I realize I was going back and forth and getting into the nitty-gritty there, but to step back and point it out. The point it Krugman is correct that in general, the Keynesian theory says if there is a supply shock, meaning like technology has changed, or if there is an earthquake and a bunch of workers get killed, the standard Keynesian textbook does not say, oh, the government should just spend a bunch more money, and the economy won't suffer from that.

So Krugman is right, and he was saying this guy's little fable of a four-person barter economy is a supply shock, and therefore, he is an idiot for thinking that somehow hurts Keynesianism. But then Krugman, thinking he's going to hit the guy with an uppercut, goes and says, oh, by the way, we could also explain this situation, as Nick Rowe has pointed out, as a monetary demand shock, in which case the Keynesian prescription *would* apply, and it would fix things. The point of the problem is it was a barter economy. Krugman can't have it both ways. Is it a supply shock or is it a demand shock? And so he wants to try to have it both ways and say, oh, it's a supply shock so this guy is an idiot for thinking it's applicable, and then he comes right back and says, oh, and by the way, it's actually a demand shock, in which case, we're right. So no matter what, he's right. Go figure.

WOODS: Right, okay, I see that. He's got a link to this babysitting co-op thing. Do we want to talk about that? Or do we want to skip that or save that for another time? Because it's a longstanding Krugman model.

MURPHY: Maybe we could just spend like two sentences on it.

WOODS: Okay, he says, "If you want a simple, homely example of how demand shocks can happen and cause unemployment, there is the babysitting co-op." Did you ever write anything in response to that?

MURPHY: I don't think that I did.

WOODS: Do you have any strong feelings about it?

MURPHY: Well, just to make the point that they are assuming prices aren't flexible, and that's what drives the whole result. I think that somebody—unfortunately, I should have looked this up. Somebody did—one of our guys—I don't know if it was David Gordon or Jeff Herbener—somebody did find something like a little more of the actual history of the real scenario that gave more nuance.

WOODS: All right, I will track that down and put that on the show notes page, because we want to instead focus most of our attention on his claims about what actually happened to the economy in 2008. He says we did not have a supply shock, because he says, "Production capacity was unimpaired." I mean, obviously, because we had just as many buildings, just as much building material. We had all the same stuff. What we had instead was a demand shock. You've written quite a bit on this, and in fact, you even got Krugman's attention. He wrote about you in a column. And even though he thinks your theory, the Austrian business cycle theory, is totally wrong and crazy, he paid you at least the compliment of saying that you laid out the most plausible exposition of it he'd ever seen. That's something.

MURPHY: Yeah, exactly, and so what I think here is that the substantive point for Austrians to really pay attention to is in Krugman's response to this guy Levine again. Levine is not particularly relevant here. The issue is that Krugman thinks that the Keynesians have a monopoly on any sort of explanation of the business cycle that involves changes in, let's call it, aggregate spending, because he is combating what would be called Real Business Cycle theorists. So Krugman is not attacking a straw man. There really are some economists out of the Chicago School tradition who think that the Federal Reserve can't affect the economy. They think it's all rational expectations, and I am exaggerating a little bit, but Krugman is attacking a valid target there. There are people that think that. But the irony is, Krugman believes that only Keynesians can have a feather in their cap by thinking that the central bank influences the business cycle. So just to give you an example, Tom, yes, I wrote a piece that people think of as my sushi article; it was called "The Importance of Capital Theory," and I was showing a little example of an island economy where the islanders are making sushi, and then this foreigner shows up, and he gets them to stop maintaining the infrastructure, the capital structure in their economy and to have an unsustainable expansion by trying to build boats with nets and so on, and it looks good for a while, so it's like an unsustainable boon because it seems like they are having their sushi plus they are doing other things too, and so it's great, but then because they weren't engaging in normal maintenance, it all falls apart, and their standard of living plummets. I have very specific numbers in there, so it's a concrete, actual example that you can think through to the foundation and really see how you could have an unsustainable boom and the story needs to rely on the physical capital structure of the economy.

And so Krugman responded to that, yes, and he did pay me a good compliment, saying this is the best exposition of this viewpoint that I've seen, but he came back and said, but what's the empirical evidence that that's actually what was going on in the 2008 crisis? And in his response Krugman actually said if the Austrians are right, how we can have all of this data and evidence showing that central banks can affect the timing of recessions, which is hilarious. That's the Austrian story, so the complex interaction here is—I think it was Roger Garrison who summed it up—saying that the Austrian theory of the business cycle in the tradition of Mises and Hayek is that the monetary influences can—they do affect things, but the effects end up being real. So there are monetary causes, but the effects really are real in that sense, so it kind of combines the best of both camps.

There are plenty of empirical pieces of data to show that the Krugman approach was wrong, and so I could just summarize them really quickly here. So what I mean—Krugman coming into this, so I think this was maybe like 2009, perhaps 2010, he was complaining about the economists who were blaming things on a sectoral rebalance, because Krugman thought, no, the reason we're in this recession is because there's a shortfall in aggregate demand, and in particular he was saying a lot of these economists think there is a rebalancing and people need to get out of housing and into other areas, and that's just not true, and he pointed to the latest BLS dataset, the Bureau of Labor and Statistics, to say look, the states that had the biggest decline in home prices, we would expect them to have the really high unemployment rates, right? But we don't see that.

This is Krugman's argument, but I went through and showed that Krugman wasn't really looking at the right time. He was just looking at the most recent time, and if you started from the beginning of the recession to that point, actually it did line up very well that the states that had the biggest drop in their housing price index had the biggest increase in unemployment, right? And there are other examples like that where, I, for example, took the data and looked at in terms of breaking it up into a sectoral approach or stages of production, and it lined up beautifully with the Austrian story that the drop in employment in industries that were further away from retail was much bigger, and it just lined up in lockstep. It was almost too good to be true in terms of a textbook exposition of the Austrian theory of the business cycle, and so with each of these things, and that's in the article that I sent to you, Tom, if people want to look and see the details. It wasn't that I came up with these criteria. I took articles from Krugman when he thought he was blowing up the sectoral rebalancing approach, and I just show that he didn't do it right, and so the very tests that he himself brought up to show why it was about aggregate demand and not about a sectoral reshifting—I just went and showed him, no, that on your own terms, it actually supports the rebalancing story.

WOODS: I want to look at the article once again. It's called "Anti-Keynesian Delusions," and just to give you more ammunition so that we can continue talking about the Austrian theory of the business cycle. He's quoting a guy named Chris Sims, who says—he's being sarcastic here—he says, "Who I think got some kind of prize for statistical work on economic fluctuation,"—this is the Nobel Prize—and he quotes—this is Sims speaking—"The effects of monetary policy identified this way were quite plausible. A monetary contraction raised interest rates, reduced output and investment, reduced the money stock, and slowly decreased prices. This pattern of results turned out to be robust in a great deal of subsequent research by others that considered data from other countries and time periods and used a variety of other approaches." So he's pointing this out to say that monetary contractions do great damage in all these different ways, and that's why we need some way to counter this. What's wrong with that way of looking at it?

MURPHY: Well, again, that could have been—suppose that Mark Thornton was trying to write and submit an article on Austrian business cycle theory and get it into a mainstream journal and he did an econometric assessment with all the bells and whistles, literally, verbatim what you just read to me, Tom, could have come from Mark Thornton's abstract explaining why the data support Austrian business cycle theory. And so Krugman thinks that he's blowing up all non-Keynesians, but really, that type of evidence just attacks the really strict, dogmatic Real Business Cycle theorists who think that even wild swings—so just to give an idea, these people would say in the extreme case, no, prices are perfectly flexible, and it's all about technology, and so if the Fed cuts the money supply in half next year, prices would just all get cut in half. It's not like there's fewer tractors or less farmland or that computer programmers suddenly forget their job and their skills, and so why would we expect real GDP to do anything—so they had a little blip. So Krugman thinks he's blowing up that kind of mindset, and he is, but that's hardly the Austrian story. The Austrian story, again, it kind of blends the monetary and the real if that's the way you want to think about it, but they are saying the reason, empirically we see that pattern that Sims has documented is not because the central bank just contracts the money supply and raises interest rates in a vacuum, it's because that's always coming on the tail end of a prior expansionary phase where they had pushed down interest rates artificially low and flooded the economy with more money.

WOODS: Okay, that was my impression, that he's coming to the story really at the tail end leaving out the plot, the characters, the development of the plot. He's coming on the last 10 minutes and saying, oh, my gosh, look at all these things that are happening. Now what do we do?

MURPHY: Yeah, exactly, and so it's the standard Austrian story here that they are saying if you don't like the depression, then thing to do is to stop having the prior, artificial expansion, the unsustainable boom period. That's ultimately the way you fix it, and if instead, when you just notice all of a sudden, well, geez for some reason, aggregate demand fell off a cliff, and all of these firms are laying workers off, but I don't understand why. It's not like we ran out of steel. What the heck is going on? We still have crops pop out of the ground. I don't get it. I guess we should just flood the economy with more money and that will fix it. That's the crude Keynesian analysis of the situation and solution. Whereas, the Austrians are saying, why is it that all of a sudden the economy fell off a cliff like that? It's not that the central bank just for no reason decided to jack up interest rates. They did it because prices were rising too rapidly or there are other things going on, and so that's the Austrian solution. They see what it was—the real forces that were set into motion, and so if the Austrians are right, if there really was this prior period of an unsustainable boom, well, then that really is an adverse supply shock, so again, it comes back to the crude Keynesian model where they just look at things like the aggregate capital stock.

That's why the Krugmans can say, geez, the U.S. economy as of 2008 was not in any sense poorer than it was in 2007, so why wouldn't potential GDP have just kept rising? (He doesn't use the phrase "potential GDP" in his blog post, but he does elsewhere.) So that's the way to see the distinction between the Austrians and Keynesians on this: the Austrians would say, no, the way the officially measured, real GDP was increasing from 2003, 2004, 2005, 2006, 2007—that was unsustainable because the economy's capital structure was getting knocked all out of whack. It was not mutually compatible. It was not sustainable, and therefore, there had to be a drop off in measured real GDP just because the structure of the pipeline was getting all screwed up. So finished TVs and houses and cars couldn't have kept shooting out of the end of the pipeline in a predictable, rising fashion because it's not just a simple matter of, well, gee, how many workers do we have? How much capital do we have? How much land do we have? That didn't go down in 2008. Why would output go down?

And it's because the Keynesians ignore all of the complex subtleties of the capital structure. Just to give a simple example: If all of a sudden one year—total investment didn't go down, but instead people invested in just increasing the quantity of screwdrivers. So there was the same amount of hundreds of billions of new investment, but the economy did nothing except produce a bunch of new screwdrivers, and that's all capital goods. That's all net investment. That's great. Obviously, the next year, the economy is going to fall off a cliff because now they are going to have a bunch of screwdrivers—no new screws, and you know, all of the factories and stuff that needed other kinds of maintenance, that didn't get done. Instead, all the resources got pumped into making millions of new screwdrivers. Well, clearly, people would not be able to go to work and keep doing what they were doing the next year once they hit that wall—that real, physical wall, and yet, in terms of the aggregates, that wouldn't necessarily show up. And people would be scratching their heads saying, geez, I don't get it: investment was robust last year; how come all of a sudden it seems like we have this adverse supply? Well, it can't be supply. Let's just have deficit spending. That's the only way to fix this.

WOODS: Bob, I wonder if I can ask you a question that's not really directly related to this column except that it touches on Austrian business cycle theory. A few episodes ago, I don't remember the number offhand; I will link to it on the show notes page. I talked to Joe Salerno, and we apparently generated some controversy, and I am not trying to drag you into this, Bob, but I do want to get your thoughts about a question that was raised by people who may not agree with Joe. When you have a situation in which total spending declines because of an increase in the demand to hold money—it could be, you know, people suddenly are very uncertain about the future, and they had rather just hold onto some cash and just wait it out and see what the future holds—this pushes prices down, but not instantly and uniformly, and it takes a while, and in the meantime, you get prices that are stuck for various reasons, and this leads to discoordination and layoffs and so on and so forth. And Joe's view is that entrepreneurs can figure this out. They can see their way through it. That some price stickiness exists because that's what the market wants. That's what the consuming public actually wants. They prefer some price stickiness, and so on. So he is saying entrepreneurs can navigate their way through this. But the objection is: if entrepreneurs can navigate their way through that, why can't they navigate their way through the Federal Reserve artificially pushing interest rates low? Why does that send them into a tailspin? But they can deal with faulty price signals?

MURPHY: Okay, yeah, that's a great question. As far as the targeting of nominal GDP, and I did listen to that episode, and I liked what you had to say there. One sort of nitpicky point, and this isn't Joe's fault because he's got to just take the discussion as it stands and try to show, you know, make an immanent critique, but it's not total spending, right? Nominal GDP only looks at spending on final goods and services not adjusted for changes in the price level. Otherwise, it would be real GDP. So even there, these models and everything—we start talking about this abstract fairyland and not the real world. So that's just one thing, that when people are thinking of it as total spending and M times V, it actually isn't, right? And it's not Joe's fault. This is the way the market monetarist guys talk about it, and so does that have a direct policy implication? Well, conceivably it could if the public for some reason started spending a lot more on intermediate goods and less on final goods. Then it would show up as a huge collapse in nominal GDP. So, anyway, put that aside.

It's frustrating dealing with these simplistic models of the economy that proponents don't even follow through to their logical conclusion, but as far as your more fundamental point there, Tom, I think it is correct to look at why are we saying that there is something qualitatively different about the monetary good such that changes in demand that impinge on that therefore invite a special role for the central bank to come in, or let's say just experts in Washington to come in and fix things, but we would never talk like that, at least as free-market economists, for anything else. If the public all of a sudden decided, you know what? I want to shift my investment, my portfolio, I want to get out of stocks, and I want to get more into bonds, or I want to get out of stocks and get more into real estate, and there were big shifts in that for some reason, the population in the aggregate had net changes in the composition of their portfolio holdings, that would certainly show up in big changes in relative prices, and so forth, but no free-market economist would say, well, I don't know: there could be problems there because there is different price elasticities and so on in these different industries and these different asset classes, and so maybe the SEC should come in and lay down some regulations to make sure we don't fall into a recession. Nobody would think like that, but why is it then when people say, you know what? I am very uncertain about the future. I want to hold less of certain other things, and I want to bulk up on my cash holdings, all of a sudden, holy cow! We better have a central bank come in and do x, y, and z, otherwise, you are going to be stuck in a recession for five year.

So, again, it's just the idea. In other words, I am not saying that there couldn't be problems, but the idea that the way we're going to fix that is to have a central bank do these policies, to me, that seems crazy. Why would we think that would ever be a good idea to add that as just an extra layer of uncertainty and things entrepreneurs have to deal with? As far as, again, the classic, sort of rational expectations objection to Austrian business cycle theory that, you know, isn't even directly connected to market monetarism—just in general, a lot of people say, you Austrians like entrepreneurs in general. Why can't they just offset what the central bank does? Well, there's two things. One, that's just an extra layer of things they have to deal with. So other things equal, let's say, you know, would it be good if Martians showed up and started jamming our radio frequencies, and I said, no, that would probably be bad.

You'd say, oh! I thought you said the free market could handle stuff like that. Now, you're a socialist? So that would be silly. Beyond that, it's when the central bank comes in and does those things—look, if they are buying mortgage-backed securities, there's nothing people in the private sector can do to offset that. That's real. That's a real thing, and so if they are doing things like that, if the central bank is giving out loans at 2% interest rates, why would anybody go borrow from somebody at 3%? You see what I mean? Even if everybody were perfectly rational and can see the future, you can't completely offset a central bank that has a monopoly on the money supply dumping more money in and taking certain groups to get it first. There's nothing you can do to offset that. So it's not merely an issue of bad expectations, but again, certainly it hurts things. It makes it harder for entrepreneurs to predict the future when you've got a central bank making all kinds of decisions on the fly.

WOODS: I want to close, Bob, by reading just the concluding paragraph, which is just one sentence of this Krugman blog post we've been talking about because I want you to comment on Krugman as a scholar and Krugman as a human being even. The point of his blog post is to say, "Our opponents have no arguments. They have no leg to stand on. They don't have the empirical evidence. They don't have the theory. They have nothing." So he says at the end, "To understand why anti-Keynesian delusions persist then, we need to other social sciences and try to make sense of the sociological forces that keep these delusions alive." Comment on that.

MURPHY: Well, again, that's a classic move just to say not only are my opponents idiots, but they are also evil or literally crazy, and you know, we tried to explain it away, so it's just moving it on to a different terrain so we don't really have to take their arguments very seriously. It takes a lot of gumption for him to say that because, again, his trump card through all this is to say, hey, our predictions have come through with flying colors. Your guys' models blew up. I realize we're running out of time. At some point, I am going to write a systematic analysis of that just to show Krugman has been wrong time and again throughout this crisis. Just the most recent example, when the so-called fiscal austerity of the U.S. budget sequester went into effect, Krugman was saying this was one of the worst things in legislative history and was making all sorts of predictions and saying this is going to be the test to see whether the people who think the Fed can offset this collapse in aggregate spending are right. And early on, when the sequester first went through, and the economic data didn't look so good, Krugman was claiming victory.

Then by the end of the year, it turned around, and market monetarists were running around giving each other high fives, and Krugman actually said, oh, come on, you can't just look at one example of this, and so he actually moved on then to say the U.S. doesn't count because that's just one country. You've got to look at Europe to see the effects of fiscal austerity. So, yeah, when you're allowed to say, if I am right, then it's a feather in my cap, but if I am wrong, well, then I am just going to say, well, that's just one outlier—the U.S. economy being the outlier here. So, again, he's been wrong on many things throughout this, but that never counts. It's always he shifts the terrain. He moves the goalposts. It's more merely that he's being classless to say, my opponents are driven by some other forces. They are just getting paid by big companies under the table for their position, but beyond that, he's not right when he says the empirical records supports him, and these guys are all delusional.

WOODS: That is one of the aspects of your own work that I appreciate that I point out to other people that I wish I could emulate more, and I am trying is that when you criticize somebody, you generally don't say, well, this guy is obviously in the pay of the Fed or the pay of the big corporations or whatever. You just say, these are the mistakes being made, and then you say, now, it's true this person can say this or can say that, or this or that may be somewhat of a difficulty for our position, but there are these offsetting factors. You conduct yourself in a way that really is a model for us all, even when your own opponents are engaged in all kinds of vicious name calling, you don't descend to that, and I wish I had that kind of self-control. As I say, I am trying, and I try to take the high road, and sometimes I succeed, and other times I look back at things I wrote and said, and I just put my head in hands and say, oh, no, no, why didn't I have somebody stopping me? So you're a great examples to us, and I appreciate your time with us today as always, Bob. Thank you.

MURPHY: Thanks for the kind words, and beyond just your not having to lament it later if you feel squeamish about it, but also, it is more persuasive because, yes, it is funny, and don't get me wrong, I love reading it when somebody really blows up somebody else and does things that geez, I wouldn't have written that, but I am glad he did, ha ha! But if you're trying to persuade people who don't already agree with you, then you can come up like a jerk.

WOODS: Right, I know. I need to remember that. All right, thanks again, Bob. Talk to you soon.

MURPHY: All right, thanks Tom.