Smashing the Errors of America's Most Famous Keynesian

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Foreword By Ron Paul **Preface By** Tom Woods

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FOREWORD

If there was a more prolific defender of the free market after the 2008 financial crisis than Bob Murphy, I don't know who it was.

During those crucial months, in which so many erstwhile supporters of the market economy defected to the Establishment, Bob refused to allow the conventional wisdom – namely, that the crisis showed capitalism and "deregulation" didn't work – to go unchallenged. Day after day he wrote articles and blog posts striking down common fallacies and providing the libertarian world with the intellectual ammunition to respond to a veritable avalanche of myth-making and error.

Of course, by virtue of his positions as a *New York Times* columnist and honorary chief Keynesian of the United States, Paul Krugman was responsible for much of the error Bob had to refute.

The scope of this book, however, extends well beyond the financial crisis. It covers stimulus spending, austerity, business cycles, financial reform, the Great Depression, debt, trade, climate change, employment and wages, monetary policy, the minimum wage, Obamacare, and more.

I've been delighted to speak at numerous events alongside Bob over the years, and I'm just as delighted to introduce this masterful collection to you. He is a tremendous asset to the liberty movement, and you will be glad to get to know his work.

Ron Paul

Lake Jackson, Texas

November 2017

PREFACE

Paul Krugman – "Nobel Prize winner, newspaper columnist, and destroyer of nations," as our podcast intro puts it – is the face of American Keynesianism. Whether his colleagues like it or not, it is Krugman who has become the chief spokesman for the Keynesian worldview before the American public.

That's why, in September 2015, Bob Murphy and I launched the weekly podcast Contra Krugman. Every week we refute one of Krugman's newspaper columns. Check it out at ContraKrugman.com.

Libertarians have rarely been much for strategy. Bob and I have smacked our heads more than once at critics who wonder why we give Krugman the time of day.

Gee, maybe because he has millions of readers, and fills their heads with destructive nonsense week after week?

No matter what Bob and I do, those millions will continue to be exposed to Krugman's ideas on a regular basis. How is the world a better place if his inanities go unanswered?

Meanwhile – and here's the real point – while dismantling Krugman we can be teaching economics to the general public. We can expose generic Republicans to the specific free-market tradition known as the Austrian School – that venerable pedigree that boasts Carl Menger, Eugen von Böhm-Bawerk, Ludwig von Mises, F.A. Hayek, and Murray N. Rothbard. More people need to know about the Austrian School if future calamities are to be avoided. Such folks are unlikely to encounter the Austrian perspective in the pages of *National Review* or the *Weekly Standard*.

The podcast itself was my idea, but the brains of the

operation are all Bob's. Bob became the undisputed master in this area: with an uncanny ability to recall Krugman's columns and blog posts from years past, he catches the *New York Times* columnist in contradictions – or Kontradictions, Bob's special term for Krugman's habit of not quite contradicting himself, and giving himself just enough rhetorical wiggle room for a convoluted defense if he were ever called on it.

This book is a collection of many of Bob's critiques of Paul Krugman over the years. We're grateful to the Foundation for Economic Education (FEE), mises.org, mises.ca, and Liberty Fund for allowing these columns to be reproduced here.

The cumulative effect of this book is not only to reinforce how confused and downright wrong Krugman has been over the years, but also to remind the reader of just what a talented economist Bob Murphy is. Krugman – and, more importantly, the school of economic ideas he represents – is decimated.

Bob's online articles contained many references with embedded hyperlinks. We decided it would be too clunky to put them in this book as text, so we omitted them (with a few exceptions). At times Bob will say things like 'here and here' where he is clearly hyperlinking to a source. For those readers who wish to read the link, it's easy enough for you to simply Google the title of the chapter to find the original version online, where you can then find the link.

You will become more knowledgeable, a better economic thinker, and a more formidable debater after reading this book. If a book can deliver those three things, it gives you more than your money's worth.

As you're about to discover, this one does.

Tom Woods

Harmony, Florida

November 2017

PART I

STIMULUS

1

Does "Depression Economics" Change the Rules?

Wily competitors have known for ages that if you can't win the game, you can simply change the rules. Now, during normal economic times, if somebody recommended that the government borrow a trillion dollars and spend it on anything that moves, most economists (as well as common sense) would say, "That's nuts." So one would think that *especially* in the middle of a severe recession, in which the American public has to recover from misguided overconsumption (fueled by Fed policies), such massive deficit spending would be all the more ludicrous.

Ah, enter the wily academics. According to our most recent Nobel laureate, Paul Krugman, we are now in a period of "depression economics," where the standard rules don't apply. In particular, the argument goes, when there are *idle resources* lying around, the traditional economic problem of scarcity disappears. The government can prime the pump by throwing borrowed money around, and this can only boost total output, because employed workers produce more than unemployed workers.

In the present article I will pick apart this reasoning and show that the standard rules still apply. It's wasteful for the government to commandeer resources from the private sector during good times, and it's even more harmful when the government kicks the economy during a recession.

The Argument From Idle Resources

First let's make sure we fairly present the argument in favor of massive government "stimulus." Although Krugman has said equivalent things over the last few months, Mark Thoma actually provides the most succinct statement I have seen of the position. I ask the reader to forgive the following lengthy quotation, but this issue is crucial and we really need to understand the Krugman/Thoma point:

> Let me explain through an example why I don't think these objections [of crowding out and job destruction from higher taxes or borrowing] do not [sic] apply to depression economies.
>
> Imagine a town with a widget factory that provides employment for workers in the town. There is full employment so that everyone who wants a job at the going

rate of compensation has one, save for the unavoidable frictional unemployment as people voluntarily change occupations, move, etc.

The town also has infrastructure needs; in particular there is a bridge that is essential to commerce that can no longer support the weight of loaded trucks, and this is forcing trucks headed to and from market to take a much longer, much more expensive route.

If the government tries to build a new bridge or fix the old one, and there is full employment, it will be forced to bid those resources away from other uses. There is no labor or other resources sitting around idle waiting for something to do, so if the government wants to employ the labor, raw materials, and equipment to repair the bridge, it will have to bid these resources away from other uses. A crane working on the bridge cannot be building a new factory at the same time, labor to build the bridge must be bid away from the widget factory, and so on. In such a case, we will see substantial crowding out…

It is correct to say that government spending crowds out private investment in this case, and that all government spending can do is change the mix of jobs; it can't change the number. In the example above labor moved from widgets to bridges, but there was no change in the overall quantity of labor.

But let's change the situation. Suppose that for some reason…a recession hits and the demand for widgets falls nationally. Because of this, a large number of workers are laid off. They would work at pretty much any wage, and they have looked and looked, but there's nothing available for them.

In this case, government spending does not crowd out private investment – and it creates jobs; it doesn't just change the mix. Let's suppose, to make it easy, that…the number of laid off workers is just the number needed to build a new bridge (if not, then adjust the list of projects and add more or less until there is a match).

When the government steps in and hires workers to build the bridge, it doesn't take the workers away from other employment. This is a recession, firms aren't building new factories, new buildings aren't needed, or not needed to the same degree as at full employment, and there are cranes sitting in the yard waiting for something to do. **Resources, like labor, are no longer fully employed, and putting them to work does not mean having less of something else. In depression economies – when there are idle resources that are involuntarily unemployed – crowding out is not the problem…**

When we talk about crowding out, we mean that government spending, by using the crane, labor, etc., to build the bridge, displaces private investment. If we believe that private investment is more productive than government investment (which isn't completely clear for a bridge if the bridge is essential infrastructure), then future growth will be lower because of the lower level of private sector investment.

But in depression economies, things are different. The choice is not between a new bridge and a new factory, the choice is between a bridge and no bridge (you could try to induce the private sector to build a factory through tax incentives or other means, but good luck with that in a depression). [Emphasis added]

After that lengthy quotation, we have a solid grasp of the Krugmanite point: putting unemployed resources to work can only help, since prodding workers into producing even items of dubious value is better than letting them sit around watching *Let's Make a Deal.*

Unfortunately, there are several fatal flaws with this perspective, which we now explain.

Government "Smart" Stimulus Can't Target Only Idle Resources

Even on its own terms, Thoma's scenario fails because it is unrealistic. It is absurd to think that the government could come up with spending programs that would draw only on unemployed resources. Keynesian "macro" thinking ignores the complex capital structure of an economy. To build a bridge (as in Thoma's example) requires a lot more than cranes and generic laborers. For example, gasoline will be burned in order to transport the newly employed workers to and from the work site. Nails, screws, steel, lumber, and other resources will be channeled into the new bridge, and at least some of these inputs will be diverted away from other private-sector uses, rather than simply leaving a state of idleness.

Within the broad category of "labor" we find a similar situation, once we actually contemplate doing this project for real. If the city of Houston wants to build a new bridge, is it really the case that every last person even remotely involved with the project, will come from the ranks of the unemployed *who are within commuting distance of the Houston bridge site?* Surely the project will draw on engineers, construction foremen, and other skilled workers who were still gainfully employed even amidst the recession, and who therefore will not be able to work on as many private-sector projects as they otherwise would have.

What is particularly ironic in this discussion of idle resources is that it is the pro-stimulus Keynesians who ought to be very fastidious in their recommendations for government spending projects. After all, if the whole point is to draw down resources that have been thrown out of work, then care should be taken to tailor the stimulus package for the resources in question. Is it really the case, for example, that bridges and roads require labor and other inputs in the same proportions as housing construction and finance? Does the construction of a new sewer system require the services of investment bankers and roof layers in such combinations that local government spending can perfectly offset the bursting of the housing bubble?

Even though their position would require it, in practice (of course) the Keynesians are not concerned a whit for the specific projects to be funded. To reason in this way misses the point, they say. (Notice that "the point" changes from argument to argument.) Lest the reader accuse me of unfairness, here's Paul Krugman on the matter:

> The key thing, when you're in a situation like this, is realizing that normal rules don't apply. Ordinarily we'd welcome an increase in private saving; right now we're living in a world subject to the "paradox of thrift," in which private virtue is public vice. **Normally we want to be careful that public funds are spent wisely; right now the crucial thing is that they be spent fast.** (John Maynard Keynes once suggested burying bottles of cash in coal mines and letting the private sector dig them up – not as a real proposal, but as a way of emphasizing the priority of supporting demand.) [Emphasis added]

Why Are Resources Idle in the First Place?

Although a serious objection, the above considerations really just argue that it would be difficult *in practice* for Thoma to tailor a stimulus package suiting his specifications. But even if we conceded that the government could spend money in a way that only involved unemployed resources, the measure would nevertheless be harmful and would make the country poorer.

To see why, we need to understand what is causing so many resources to be unemployed in the first place. According to the Austrian theory of the business cycle, the housing and stock market booms were fueled by Alan Greenspan's decision to slash interest rates in an effort to provide a "soft landing" after the dot-com crash and 9/11 attacks. This artificial stimulus goaded entrepreneurs into starting numerous projects that were unsustainable.

In short, people in the private sector made decisions as if there were far more real resources at their disposal to "fund" the projects to completion. When reality set in, many of the projects had to be abandoned, meaning that the workers and other resources involved had to be laid off. (See *Human Action*, chapter 20, for Mises's analogy of the master homebuilder being misled by an erroneous resource inventory, and why workers would be unemployed once he discovers his error.)

Once people in the private sector realized they had made horrible decisions during the boom years, they needed to stop business as usual and figure out how to make the best of a bad situation. Homeowners who had skimped on their savings for years (relying on booming house prices) had to slash spending to compensate for years of overconsumption, while entrepreneurs needed to decide which activities were likely to be profitable going forward, in light of the new information.

What had to happen is that workers and other resources that had been misallocated into housing construction and Wall Street investment banks needed to be moved into other sectors. To repeat, this was and is a fantastically complex reshuffling, because even something as simple as producing a pencil requires the contributions of thousands of workers all over the world.

It's not a simple matter of moving unemployed builders and hedge-fund managers into "booming" sectors X, Y, and Z, because (as we've seen above) these newly employed workers will require complementary tools and resources that were not laid off to the same extent. So the issue is, what is the best new outlet for all of these laid-off workers, such that – *all things considered* – the final mix of output goods best satisfies consumer desires? How can we be sure that channeling them into occupation X won't actually do more harm than good?

In practice, the people in a market economy solve this fantastically complex problem by making profit-and-loss calculations, which in turn rely on *market prices*. For example, it is clear that a former Wall Street quant isn't doing anybody a service by cranking out models that give mortgage-backed securities a gold star for safety. But what should this PhD do now? Should he go into academia and teach thermodynamics (which may very well have been the subject of his dissertation)? Or is his impressive education really a complete waste, and he would – at this point, given the economic realities – provide the most service by working the register at Walmart?

Nobody knows the answer to this question. What happens during the recovery process is that the unemployed whiz kid initially looks for a job paying his former salary. As the months pass, he realizes that this is unrealistic, and he begins lowering his minimum price. Eventually, he finds an employer with compatible desires, and the two agree to a mutually beneficial arrangement.

As my simple story illustrates, the period of "idle unemployment" serves a real function in a market economy. It is true that such periods of massive discoordination are almost always the fault of government interference, but whatever the initial cause, there is no denying that the discoordination is *real*. Writers such as Krugman and Thoma act as if recessions are caused by massive bouts of irrational consumer anxiety, and that all problems can be patched up by a simple boost of "aggregate demand."

On the contrary, the economy's capital structure really *was* thrown into an unsustainable condition during the boom years, and it takes *time* for the mess to be sorted out. When the government runs up a deficit to fund "stimulus" projects, all that really means is that it is forcing taxpayers to pay for projects that they wouldn't buy with their own money. (It is true that a group of private citizens might not have the legal ability to build a new bridge, but that's not essential to Krugman and Thoma's argument. Imagine that Thoma had discussed government funding of a new shopping mall.)

To the extent that some of the drop in demand is due to the general "panic" and flight to liquidity, the politicians aren't helping matters by increasing household indebtedness and throwing money at one-off projects. If a restaurant owner discontinues his expansion because demand has collapsed, how does Thoma's bridge project change things? The restaurant owner isn't going to make a long-term investment based on the business of bridge workers, since they will be out of work once the bridge is finished.

Private investors are fleeing to real goods because they are uncertain, and making trillions of dollars subject to political deals, rather than consumer choice, only increases the uncertainty over future conditions. Pro-stimulus economists can keep bringing up new aspects, but each new consideration just proves how counterproductive their proposals are.

Conclusion

It is difficult to think objectively about "idle resources" when they are workers with families to feed. The reader who is still on the fence should first work through the arguments, pro and con, with other resources. In the comments of a recent blog post, Mario Rizzo relates how in class Milton Friedman used the example of dress shirts on the shelves of department stores. Adopting Krugman's viewpoint, these shirts are "idle" inventory and are clearly being wasted in the sputtering private sector. Clearly the government ought to raise the deficit and spend a few billion dollars buying up these shirts, even if just to use them as rags on construction sites. Some critics might object that this is a "waste" of precious resources, but what good is a shirt on a store shelf?

The above analogy with shirts is not as cute and flippant as it first sounds; the reader should really think through the implications of Friedman's analogy. Every problem with the tongue-in-cheek suggestion regarding dress shirts is (more or less) applicable to unemployed workers. In particular, government shirt buying would lead to too many new shirts being produced, just as government "green jobs" programs will induce workers to quit other lines and go into solar-panel production.

Although Krugman and Thoma have made the only rhetorical move left to salvage their disastrous recommendations, their claim is wrong: the normal rules of scarcity do still apply, even in the middle of a depression. No matter the scenario, government spending channels resources away from the private sector. Even if the project employs workers who were previously unemployed, this still retards the genuine, private-sector recovery from the slump, because that is one less worker available to be hired by an entrepreneur.

If the government wants the economy to recover as quickly as possible, the solution is simple: cut spending, cut taxes, stop inflating the money supply, and stop changing the rules every three days. But this solution won't be adopted, since it doesn't allow the politicians to pose as generous saviors.

January 12, 2009

2

Filling the Holes in Krugman's Analysis

Although many free-market economists were aghast that Paul Krugman won the Nobel (Memorial) Prize in Economics, I have come to realize that he is every bit as brilliant as that august award indicates. For some time now, Krugman has said we are in "depression economics" mode, where the normal rules of scarcity and tradeoffs don't apply. In this universe, it makes sense to have one group of workers dig holes, and another group fill them back up. Sure, when all is said and done, there is nothing tangible to show for this effort, but at least it "creates jobs."

So what I've come to realize is that in these last few months Krugman has implemented his own private-sector stimulus plan. He has been working furiously, cranking out fallacious articles and blog posts, which then provide work for people like Bill Anderson and me, as well as thousands of other bloggers who still can't understand why it's bad for families to save more. A clever chap, this Dr. Krugman, no?

Today my make-work will fill in two holes in a recent Krugman blog post. The first flaw is his belief that output generates employment (rather than vice versa), and the second is his belief that government spending is a measure of real output.

Krugman Thinking Backwards

In his post, Krugman goes through some "stimulus arithmetic" to see how much spending the incoming Obama administration needs to avert a serious recession:

> The starting point for this discussion is Okun's Law, the relationship between changes in real GDP and changes in the unemployment rate. Estimates of the Okun's Law coefficient range from 2 to 3. I'll use 2, which is an optimistic estimate for current purposes: it says that you have to raise real GDP by 2 percent from what it would otherwise have been to reduce the unemployment rate 1 percentage point from what it would otherwise have been. Since GDP is roughly $15 trillion, this means that you have to raise GDP by $300 billion per year to reduce unemployment by 1 percentage point.

We already see the problem. Regardless of whatever correlations Okun may have found, it is quite obvious that to increase *real* output – to crank out more units of goods and services – you must first get more people working to create the products. In other words, higher real GDP is associated with lower unemployment, *because more people are working and thus producing more output*.