Paul Krugman - New York Times Blog

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Been There, Done That: Monetary and Fiscal Policy Edition

Noah Smith has a nice takedown of Martin Feldstein's latest, which is the claim that the reason a vast expansion of the Fed's balance sheet has produced no inflationary effect at all is the 0.25 percent — that's right, 0.25 percent — rate of interest the Fed is paying on excess reserves.

Even if this were right, wouldn't it suggest that the Fed's expansion poses no inflationary risk? I mean, if all that alleged pressure can be completely contained with a 1/4 percent interest rate, how big a problem can it be?

But it's not right, as Noah shows logically; and of course the example of Japan, which did massive QE without paying interest on reserves, and saw nothing happen, reinforces the point.

The remarkable thing is the desperation with which inflationistas keep conjuring up new explanations for a result –the failure of large increases in the monetary base to have an inflationary impact — that was fully predicted, in advance, by simple economic models. Instead of saying that a simple IS-LM framework, or a New Keynesian analysis along the same general lines, has worked very well — and that whatever other model they were using failed the test — they keep coming up with excuses. It's Obamacare! It's interest on reserves! It's the decline of traditional marriage! OK, they haven't used that last one yet, but give them time.

And let me admit that I'm especially exasperated — actually, about the fiscal as well as monetary arguments — because I went over all this ground fifteen years ago.

Look, please, at my Brookings Paper on the liquidity trap (pdf), especially pp. 155-159. (Those are pages in the volume — the paper isn't that long). You'll find me explaining that once you're up against the zero lower bound:

1. Changes in government spending are still effective, with a multiplier of 1, even with full Ricardian equivalence.

2. Unless you break that equivalence, it doesn't matter how government spending is financed; "helicopter money" makes no difference.

3. Even very large increases in the monetary base will have no effect if seen as temporary.

4. Large increases in the base are likely to show up partly in increased cash holdings, partly in a large rise in excess bank reserves; this rise in excess reserves tells you nothing about whether the problem lies in the banking system, since it will happen even if the banks are perfectly OK.

So you can see why it was so frustrating to see reputable economists get all of these things wrong in the early years of the crisis; and some of them seem determined to keep getting them wrong even

now.

Look, we have a framework here that has been a stunning success in practice. Why won’t you guys admit it?

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