Paul Krugman - New York Times Blog

February 25, 2013, 9:30 am

A Tale of Two Adjustments

A commenter on my last euro post asks a good question: didn't Germany once have a problem of excessive unit labor costs, which it cured with a protracted squeeze? And in that case, why is it so terrible if Spain is asked to do the same thing?

The answer is basically quantitative. I'd make three points:

1. Thanks to the giant housing bubble, Spanish costs got much further out of line than Germany's ever did, so the required adjustment is much bigger.

2. Germany got to do its adjustment in the face of a relatively strong European economy; Spain is being asked to adjust in the face of a depressed Europe sliding back into recession.

3. In part because of this difference in overall macro conditions, but also because Germany doesn't have a housing boom and is actually engaging in a bit of austerity on its own, the burden of adjustment this time around is falling much more on deflation by the overvalued country.

Here's a figure that illustrates that point. According to Eurostat data, German unit labor costs peaked in 2003, Spanish costs in 2009. So here's what the adjustments looked like in each episode, with blue lines representing the earlier case and red lines the later:

You can see just how much harsher Spain's adjustment is, and how much less help it's getting from rising wages in the rest of the eurozone. Basically, Germany is refusing to do for Spain what Spain did for Germany in the past.

And the result of all that is incredibly high unemployment.

February 24, 2013, 9:41 am108 Comments

Euro Delusions

I've been browsing through the collected speeches of Olli Rehn, the vice-president of the European Commission, who has emerged as the face of denialism when it comes to the effects of austerity. What I wanted to do is pinpoint what, exactly, he and those who share his position see as the evidence that their view is right. And I think it's two things.

First, they look at the decline in interest spreads against Germany for troubled countries:

I see these moves as indicators of the effects of ECB policies — the LTRO program at the end of 2011, and the signaled willingness to buy sovereign debt beginning last summer. But they see it as proof that the confidence fairy has arrived.

Second, they see adjustment in unit labor costs:

I see that too — but it looks as if only a fraction of the needed adjustment has taken place, with years to go.

So basically they have seized on the ECB's success at stabilizing debt markets — which from the De Grauwe point of view, which I share, is a demonstration that extreme austerity was unnecessary and unwise — as a vindication of austerity; and they have taken the slow progress of grinding deflation as a sign that all will be well.

Oh, by the way — for those following it, De Grauwe got his austerity measures here.

Debt, Spreads, and Mysterious Omissions

Binyamin Applebaum reports on a new paper by Greenlaw et al alleging that bad things will happen to America, because debt over 80 percent of GDP leads to high interest rates, and is skeptical – but not skeptical enough. I found the paper amazing, and not in a good way.

As Applebaum says, Japan poses a big problem for this kind of analysis. So the question is whether Japan is a special case. The argument that it isn't revolves around the suggestion that what really matters is borrowing in your own currency – in which case the US and the UK are, in terms of borrowing costs, like Japan rather than Greece. That's certainly what the De Grauwe (pdf) analysis suggests.

Even the quickest look at the data suggests that there's something to this argument; for example, taking data from the paper itself, and dividing the countries into euro and non-euro, we get a scatterplot like this:

It's not just Japan, off at the far right, that looks different; Canada, the UK and the US, the three red squares along the middle bottom, also seem to have borrowing costs well below what euro-area experience might have suggested.

Furthermore, the experience since mid-2012, in which the ECB drove spreads down sharply after it signaled its willingness to head off self-fulfilling liquidity crises — which can't happen to countries with their own currencies – also suggests that the own-currency issue is crucial.

So how do Greenlaw et al respond to this issue? Well, they don't – not at all. They don't even cite De Grauwe. So as far as I can tell this paper isn't helpful at all; it ignores the key question in the whole debate.

February 23, 2013, 11:38 am

Little Statesmen and Philosophers

So, people want me to comment on the Moody’s downgrade of Britain. No real news there. As a guide to the future, ratings agency judgments are literally worse than useless; remember, US bond yields actually fell after the 2011 S&P downgrade. Still, it’s kind of a poke in the eye for Cameron/Osborne, who are subjecting their country to pointless austerity because confidence!

But they won’t change course; basically, they can’t, for careerist reasons. And that’s the story of a lot of what’s going on now.

Ralph Waldo Emerson understood this. The original version of his famous quote — I had forgotten this — reads:

> A foolish consistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines.

I don’t know about the divines bit, but the little statesmen thing is completely accurate. Suppose George Osborne were to admit that austerity isn’t working. What, then, would be left of his claim to be qualified to do, well, anything? He has to stick it out until something turns up,no matter how many lives it destroys.

Pretty much the same thing is going on among pundits now stuck in what Jonathan Chait memorably calls the “fever swamp of the center”. Suppose that some pundit who has spent his whole career calling for bipartisanship, a compromise between the extremes of left and right, were to admit the plain fact that Obama is very much a centrist, who is in particular proposing deficit reduction through exactly the kind of mix of tax hikes and spending cuts “centrist” pundits demand — and that the GOP, by contrast, is an extremist organization whose extremism is almost solely responsible for the bitterness of the partisan divide. A pundit making that admission would in effect be saying that everything he has said and done for the past several years was not just useless but harmful, actively misleading readers about the state of the debate. He just can’t do it.

The point is that a large part of the reason we’re locked into such a mess is careerism. And yes, that’s quite vile, if you think about it: politicians and pundits alike letting the world burn — probably unconsciously, but still — because their personal position would be hurt if they admitted to past mistakes.

February 23, 2013, 10:32 am

Austerity Europe

Some readers have been asking me for the data source for Paul De Grauwe’s measure of austerity. I’m working on it. Meanwhile, however — and partly for my own reference — I discovered that I can do a similar exercise over a somewhat longer time horizon, which I’m posting in large part as a note to myself.

Now, measuring austerity is tricky. You can’t just use budget surpluses or deficits, because these are affected by the state of the economy. You can — and I often have — use "cyclically adjusted" budget balances, which are supposed to take account of this effect. This is better; however, these numbers depend on estimates of potential output, which themselves seem to be affected by business cycle developments.

So the best measure, arguably, would look directly at policy changes. And it turns out that the IMF Fiscal Monitor provides us with those estimates, as a share of potential GDP, for selected countries from 2009 to 2012 (Table 15). What I've done is to plot those estimates (horizontal axis) against changes in real GDP from 2008 to 2012 (vertical axis). Here it is:

The implied multiplier is 1.2; the R-squared is 0.84.

In normal life, a result like this would be considered overwhelming confirmation of the proposition that austerity has large negative impacts. Yes, you can concoct elaborate stories about how it could be wrong; but it's really reaching. It seems safe to say that what we have here is a case in which rival theories made different predictions, the predictions of one theory proved completely wrong while those of the other were totally vindicated — but in which adherents of the failed theory, for political and ideological reasons, refuse to accept the facts.

February 22, 2013, 10:14 am

Paul De Grauwe and the Rehn of Terror

Nobody has taught me as much about the euro crisis as Paul De Grauwe, who brought to the fore a crucial point almost everyone was overlooking: the importance of self-fulfilling debt panics in countries that no longer have their own currencies. Now he has a new paper with Yuemei Ji following up on that insight, and offering yet more evidence of the incredible unwisdom of European economic policy.

What De Grauwe and Ji show is that the rush to austerity in Europe largely reflected the surge in sovereign debt spreads after Greece got in trouble; the bigger the spread, the harsher the austerity. But it turned out that the spreads didn't reflect underlying fiscal fundamentals. De Grauwe had already made that point by comparing the UK with Spain; similar fiscal outlooks, wildly different borrowing costs. Now he has another piece of evidence, the spectacular decline in spreads once the ECB signaled its willingness to buy sovereign debt if necessary, thereby removing fears of a self-fulfilling liquidity crisis.

Meanwhile, all that austerity has taken a terrible toll. De Grauwe and Ji offer us yet another revealing scatterplot, using announced austerity measures in 2011:

But hey, Keynesian economics can't be right, can it?

And they also show that countries pursuing austerity have by and large seen their debt positions worsen:

But take heart. Olli Rehn of the European Commission, last heard declaring that the big problem with austerity isn't that it doesn't work, it's the fact that economists keep publishing studies showing that it doesn't work, says that the only thing we have to fear is fear itself:

Mr. Rehn insisted that Europe's belt-tightening policies were working and would lay the groundwork for a recovery. He said the European economy should expand in 2014, with growth reaching 1.6 percent across the Union and 1.4 percent in the euro area.

"We must stay the course of reform and avoid any loss of momentum, which could undermine the turnaround in confidence that is underway, delaying the needed upswing in growth and job creation," he said in the statement.

Well, that's all right, then.

February 22, 2013, 9:52 am62 Comments

More Swiss Myths

Oh, boy — it turns out that I, too, wasn't nearly hard enough on Holtz-Eakin and Roy's health care op-ed. In praising the allegedly more free-market Swiss system, they declare:

While most Americans view their healthcare system as "free-market," Switzerland actually has the most market-oriented healthcare system in the West. It translates into universal coverage and low entitlement costs. Swiss government entities spent about 3.5 percent of gross domestic product on healthcare in 2010, compared to 8.5 percent in the United States. That's a difference of more than $5 trillion over 10 years: real money, especially relative to our $16 trillion debt.

OK, I don't know what spending by "government entities" means — but the OECD offers standard data on public and private health care expenditure; according to these data, America does indeed have public spending of 8.5 percent of GDP — but the Swiss number is 7.4 percent. This isn't an obscure source, it's where everyone goes for the numbers. Something is very wrong here.

More generally, comparing public spending and calling lower public spending a "saving" is deeply wrong when it comes to health care, where some countries simply pay for health care out of public funds, while others use a combination of regulation and subsidies to achieve similar result, but with lower on-budget outlays. Here's how I do the comparison when I teach it. First, a single payer system:

Here all of the spending shows up in the government budget.

Next, ObamaRomneycare (or, actually, the Swiss system), in which everyone is obliged to buy insurance, but the government subsidizes premiums for lower-income families:

Here only the subsidy component shows up in the government's budget — but the two systems produce pretty much the same results. Oh, and ObamaRomneycare doesn't save money relative to single payer — it just arranges that much of the cost takes the form of premiums rather than taxes.

Look, I know that we're supposed to be celebrating people like Holtz-Eakin and Roy for showing more intellectual flexibility than the rest of their party. But I guess I find it hard to be encouraged when the supposed show of flexibility leads with grossly false and/or misleading numbers.

February 21, 2013, 4:55 pm153 Comments
Swiss Myths

Oh, my. Aaron Carroll is rightly very, very annoyed at Douglas Holtz-Eakin and Arik Roy for saying that Obamacare should be replaced with a free-market system, like Switzerland's. As he points out, the Swiss system is nothing like their description. In particular, they denounce community rating — but Switzerland has community rating!

Actually, though, it's even worse than Carroll lets on, for two reasons.

One is that Obamacare in fact looks a lot like, you guessed it, the Swiss system — so much so that back in 2009 I described it as a plan to Swissfy America. After all the screaming about the awfulness of Obamacare, it's pretty rich to hold up as a role model a very similar system.

But wait, there's more: the Swiss system is more privatized than other European systems — and guess what, it has higher costs, indeed second only to America's:

Maybe Holtz-Eakin doesn't know anything about this — but wasn't Roy supposed to be a conservative expert in this field? Are they really unaware of the basics here? Or do they just expect their readers to be easily fooled?

Web link:

http://krugman.blogs.nytimes.com/2013/02/25/a-tale-of-two-adjustments/?nl=opinion&emc=edit_ty_20130225