Paul Krugman - New York Times Blog

July 16, 2013, 9:33 am

The Paradox of Flexibility

Bruce Bartlett's latest has some interesting history from the 1930s that just so happens to bear on my mild chiding of Noah Smith (Smith has an answer that, frankly, I don't understand — but he's been such a good guy over time that I'm just going to let this one drop). Anyway, Bartlett focuses largely on the malign influence of Henry Hazlitt, who was among other things writing many editorials for the New York Times, always insisting that the answer to the Great Depression was to encourage big cuts in wages.

Hazlitt remains, by the way, a popular figure on the right. Once I was walking down the street near Capitol Hill and a man in a suit yelled at me, "Read Henry Hazlitt and learn some economics!" And Hazlitt's continuing popularity should serve as some kind of lesson to those of us, like me or Matt O'Brien, who marvel at the continuing influence of inflation fearmongers; they've been wrong about everything for 5 years, so why do they still get treated as authority figures? Well, Hazlitt has been wrong about everything for more than 80 years, and is still regarded as a guru. Bad ideas, it appears, are extremely robust in the face of contrary evidence.

The thing is, by the time Hazlitt was penning those editorials demanding wage cuts, Keynes and Fisher had already said everything that needed to be said. Keynes in 1930:

> [I]f a particular producer or a particular country cuts wages, then, so long as others do not follow suit, that producer or that country is able to get more of what trade is going. But if wages are cut all round, the purchasing power of the community as a whole is reduced by the same amount as the reduction of costs; and, again, no one is further forward.

And Fisher pointed out in 1933 that a general fall in wages and prices actually makes things worse, by making debtors poorer in real terms; true, creditors are made richer, but because debtors are more likely to cut spending than creditors are to increase it, the overall effect is to deepen the depression.

One implication of all this is what Gauti Eggerstsson and I (pdf) call the paradox of flexibility: making it easier for wages to fall, as Hazlitt demanded then and his modern acolytes demand now, doesn't just redistribute income away from workers to the wealthy (funny how that happens); it actually worsens the economy as a whole.

One thing Noah Smith did get right, by the way, is his suggestion that Japanese wages are less sticky than in other advanced countries. There's a fair bit of evidence to that effect, above all the fact that Japan is pretty much unique in having gone into actual deflation. The point, however, is that this is not a good thing in a country that is in a liquidity trap and suffering from a debt overhang: when it comes to wage and price flexibility, the situation in the economy has developed not necessarily to Japan's advantage.

One place Bartlett goes a bit wrong, I'd argue, is in continuing to preach the Friedman line that all this could have been avoided if only the Fed had done its job; that’s a view that, I’d argue,has taken a real beating from recent events. But that’s going to have to wait for a later post.