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Contra Krugman: Smashing the Errors of America's Most Famous Keynesian

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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

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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.

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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.)

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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.

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Even so, does this mean the plan was a success? Hardly. This is because aggregate measures of gross output are bogus when they include government expenditures. Even though purists can (rightfully) point out all sorts of methodological problems, it sort of makes sense to add up how much a family spends on rent, dining out, clothing, and other items, in order to measure the family’s total “consumption” over the year. The justification for adding up expenditures to get a gauge of total production is that a household will spend its limited dollars only on things that are more valuable than the dollar bills needed to purchase the items. So if a man spends \$10,000 on a car, it sort of makes sense (though not really) to say he is consuming ten times as much as someone who buys a \$1,000 computer. Correspondingly, we can justifiably claim that the car manufacturer and computer company together must have produced \$11,000 worth of goods.

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But what happens when the government spends \$10 million on refurbishing an airport? Does that mean the community in question is now that much richer, as if a thousand new cars had appeared from heaven? Of course not. Politicians and bureaucrats don't have the incentive to economize on their spending, to make sure every dollar counts. On the contrary, President-elect Obama has specifically said that state and local governments need to "use it or lose it" when it comes to possible stimulus aid. They are going to throw those billions at anything that moves.

In the final analysis, even if a government "stimulus" plan managed to bring down unemployment, it wouldn't represent a true economic recovery. To the extent that the newly hired laborers – such as the construction workers fixing up the airports – seem genuinely richer, it would only be at the expense of taxpayers, whose share of the federal debt had increased.

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Although a bit crude, it may clarify things to imagine three groups in the economy: 1. the taxpayers 2. the unemployed 3. the capitalists What Krugman wants to do is have the capitalists give (say) \$750 billion of their wealth right now to the unemployed. The unemployed are definitely fond of this plan. But why would the capitalists do it? It seems as if they're out \$750 billion, doesn't it?

Ah, the capitalists go along because the government promises that over the coming years, it will force the taxpayers to fork over the equivalent of (say) \$800 billion of their wealth to the capitalists.¹ Say what you will about this game, but it has not made all three groups richer.

Notice that the capitalists and the unemployed can refuse to go along with the stimulus plan. But the taxpayers have no choice; armed men ultimately throw them in jail if they refuse to play along.

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In conclusion, Paul Krugman reverses cause and effect in his analysis, and he also fails to note the difference between private and government expenditures. But hey, at least he provided me with an hour's worth of employment.

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Now things are already starting to look a little shaky for Dr. Krugman and his Keynesian allies. They have been backed into a corner, having to explain away (at least) nine historical episodes that contradict their theories. Sure, maybe one, two, three, even four of those examples really are irrelevant; but all nine? At what point should we start to question the basic Keynesian premise, namely that having politicians borrow and spend a bunch of money is a way to help the economy?

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Do you notice the pattern? The anti-Keynesians point to actual success stories as evidence of the potency of their policies. The Keynesians, in contrast, point to awful economies and claim that they'd be even worse were it not for the Keynesian "medicine." As a last point, you might be thinking, "What about World War II? Isn't that a great example of the Keynesian multiplier at work?" Well, Robert Barro ran the numbers and said no, it wasn't. And in his response, did Paul Krugman challenge the math? Nope, Krugman said that only a "bonehead" would have thought World War II would show the power of the multiplier. So we can't use that as an example to justify the Keynesian models.

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was not merely Christina Romer who famously predicted that unemployment without the stimulus wouldn't rise as much as it in fact did with stimulus. It was also Mark Zandi (whom Krugman later credited for his wonderfully accurate Keynesian models) who predicted in November 2008 that real GDP without stimulus would fall by 2.2 percent in 2009. Then, with the Obama stimulus, the economy in fact fell by 2.6 percent that year. As far as the free-market fundamentalists dominating the political scene "more thoroughly than ever," I suppose Krugman is right, in the sense that two French poodles could dominate a pit bull more than one French poodle could. But as the Fed discloses its cumulative \$9 trillion in backdoor loans, as the FBI raids hedge funds, and as federal spending as a share of the economy is at its highest level since World War II, I hardly think that DC is being overrun by laissez-faire shock troops.

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example, Fed economists and Ben Bernanke himself denied that there was a housing bubble. Barney Frank – hardly a Jedi Knight of libertarianism – infamously defended the solvency of Fannie and Freddie up until their seizures. And let us not forget Paul Krugman himself, who – it must be admitted – did indeed recognize the housing bubble before many others did. But, ironically, he praised Greenspan for creating it. Many people have pointed to Krugman's 2002 call for Greenspan to create a housing boom, but not as many saw Krugman endorse it after the fact, as this October 2006 exchange with one of his readers illustrates:

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PAUL KRUGMAN: As Paul McCulley of PIMCO remarked when the tech boom crashed, Greenspan needed to create a housing bubble to replace the technology bubble. So within limits he may have done the right thing. But by late 2004 he should have seen the danger signs and warned against what was happening; such a warning could have taken the place of rising interest rates. He didn't, and he left a terrible mess for Ben Bernanke.

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In sum, regarding the worldviews of Ron Paul versus Paul Krugman, here's what we can say: Ron Paul thought it was a terrible mistake for Greenspan to fuel the housing bubble, for government agencies to encourage banks to lower their lending standards, and then for the Treasury (as well as the Fed) to bail out the big banks from their mistakes. Krugman, in contrast, recommended that Greenspan blow up the housing bubble, and his only criticism was that Greenspan began raising interest rates to quell it, rather than simply jawboning the speculators. Krugman continues to downplay any role that the government had in encouraging reckless lending. Further, Krugman was in favor of bailing out the banks, who he thinks acted recklessly.

So if we are going to look at the current, dismal economy and blame somebody's policies for it, surely we can acquit Ron Paul. That doesn't by itself prove that Ron Paul's views are correct, but it certainly casts doubt on Krugman's constant claims that he himself has been a beacon of clarity over the years with his accurate Keynesian modeling.

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“But c’mon,” the perplexed reader might object, “surely Krugman isn’t that crazy! Why does he think those charts vindicate Zandi’s Keynesian forecast?” The explanation is that Krugman is looking at the change in the growth rate of the economy (i.e., the second derivative of GDP), rather than the change in GDP itself. Because Krugman “knows,” deep in his bones, that additional government spending boosted GDP relative to what it otherwise would have been, he looks at the above charts and “sees” the vindication of his theory.

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Specifically, the economy shrank at a horrible clip in the first quarter of 2009, but things had improved markedly by the next quarter. Things got even better by the third quarter of 2009, when the economy actually started expanding again. Krugman credits this sharp turnaround to the massive stimulus that kicked in precisely during these quarters, as Zandi’s original chart predicted. Now it’s true, even on Krugman’s own terms, his story doesn’t quite work because the economy improved even more by the 4th quarter of 2009, even if we are looking at the “increase in the increase.” In other words, if we look at the second chart, we can see that the rate of actual GDP growth in the 3rd quarter was about 2.5 percentage points higher than the rate in the 2nd quarter, yet the rate of growth in the 4th quarter was about 3.5 percentage points higher than it was in the 3rd quarter.

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This is a problem for Krugman, because Zandi’s model had predicted that the stimulus package’s boost to GDP growth should have fallen by more than 1.5 percentage points, going from 3rd quarter to 4th quarter (as the first chart shows). It would have been far better for Krugman if the chart of actual GDP growth showed a huge bump in the 3rd quarter rather than the 4th. But hey, Krugman says, we’ve got inventory adjustments that can mess up the precise timing, and of course economies are very complex. The basic pattern still holds up, he thinks, because we saw economic growth pick up generally in the period when the stimulus really kicked in, and we saw economic growth taper off generally in the period when the stimulus began to fade.

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To sum up: Even if we restrict ourselves to the evidence Krugman himself provides in their defense, it's not clear that we should acquit the Keynesian models of murdering the economy. If we had reason to suppose that the economy's awful performance in the first quarter of 2009 was an indication of how it would have proceeded in the absence of stimulus, then Krugman's story broadly makes sense. On the other hand, what if the critics of stimulus are right? Then their story too fits the very facts that Krugman offers. Specifically, when news of the stimulus first hit, the economy fell horribly, and then only really recovered as the stimulus faded away.

If Krugman's two charts were the only information we had available, it would be hard to judge between the two rival interpretations. Yet there is one more thing we can do to test the validity of Zandi's Keynesian forecasting model. Rather than simply looking at how much Zandi thought the stimulus would boost GDP growth in each quarter, let's also take into account what Zandi forecasted as the original level of GDP, without the stimulus. Once we incorporate this crucial element, we see that the claimed success of Zandi's forecasting falls away completely, and the critics of Keynesianism emerge victorious. Looking at Levels, Not Just Changes If we want to figure out what Zandi's model projected for 2009 in the absence of stimulus, we can simply go to his November 3, 2008 paper on the financial crisis, presumably written as a recommendation for the newly elected

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If we want the specific predictions on unemployment, we can look at Table 2 (page 21) to see that with no stimulus, unemployment would top out at 8.94 percent in October 2009.¹ But with the stimulus, unemployment would top out at 7.71 percent in the same month. So how did Zandi's projections hold up? In fairness, we should point out that the actual Obama stimulus package was not as potent (in Keynesian terms) as the hypothetical \$300 billion package that Zandi simulated for his November 2008 paper. However, the CBO analysis (see page 3 of this pdf) of the actual Obama stimulus scored it as having about a \$250 billion increase in the federal budget deficit in calendar year 2009, which isn't as much as Zandi's hypothetical \$300 billion stimulus but is nonetheless fairly sizable.² If the actual numbers fell in between the two extremes of Zandi's projections – one set of numbers for the no-stimulus case, and the other for his hypothetical \$300-billion-stimulus case – then we could give Zandi the benefit of the doubt, because the actual Obama stimulus was not as good from a Keynesian perspective. Fortunately, we don't have to make such a judgment call. In reality, the actual unemployment rate hit 10.1 percent in October 2009, which was not only higher than Zandi's prediction in the stimulus case, but was more than a full point higher than Zandi's do-nothing scenario. Turning to GDP performance, it's even worse. Zandi had forecast a slight 0.3 percent drop in real GDP if the government wisely implemented his suggested stimulus. Zandi had warned that if the government did nothing, then 2009 GDP might fall a “stunning” 2.2 percent in a single year – the horrors!

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Well, with the actual Obama stimulus that passed early in the year, real GDP in 2009 fell 2.6 percent compared to the previous year, i.e., a worse decline than Zandi's projection for a no-stimulus scenario. We are not picking on Zandi here; his projections were in line with what other forecasters (themselves relying on Keynesian models) projected at the time. Indeed, the incoming Obama team famously made the same mistake, by predicting that unemployment without the stimulus would peak at a lower level than what the actual unemployment rate hit with the stimulus. (To his credit, Krugman's analysis at the time was much better than his peers'.)

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A few points jump out: The government in Belgium consistently spent less than the French. The government deficit in Belgium was consistently smaller than in France. The Belgian government cut spending far more sharply from 2009 to 2010 than did the French government, even though 2010 is when the "no government" condition began.

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So once again, we see that actual history is the exact opposite of how Krugman tries to spin it to his readers. Had we not first looked at the GDP data, and seen only the spending and deficit charts, which country – Belgium or France – more closely followed Krugman's policy recommendations? Their moves were similar – it's not as if one of the countries went on the gold standard and balanced the budget – but the French government clearly spent and borrowed more, throughout every stage of the crisis and (tepid) recovery, and moreover their move to so-called "austerity" occurred a year after the Belgian rollback. Even now, with its government safely in existence again, the Belgian government cut spending (as a share of the economy) from 55.1% in 2012 to 54.7% in 2013. This doesn't seem to faze Krugman in the slightest, as he praises the success of the Belgian economy in recent times. Yet had Belgium's economy fallen off a cliff last year, we can be quite sure Krugman would have blamed this Neanderthal decision to pull back stimulus

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Many economists who currently support large minimum wage hikes claim that the best research now shows that such an increase would not cause significant drops in employment. However, their conclusion relies on a dubious reading of the literature. Dozens of recent empirical studies show significant employment reductions from minimum wage hikes, with some of these analyses using the newer “case study” approach, as opposed to the traditional regression analysis. Furthermore, serious methodological criticisms have been leveled against even the best of the studies used to justify increases in the minimum wage. Finally, even on their own terms, the studies purporting to show that the minimum wage is benign can justify only modest hikes: these studies’ own results are consistent with the claim that aggressive minimum wage hikes will cause many unskilled workers to lose jobs.

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Notwithstanding the apparent strength of the Card-Krueger (1994) result, a more recent paper casts significant doubt on its wider relevance. Hoffman and Trace (2009) realized that a later episode would effectively provide a mirror-image case study.⁸ Specifically, between 1996 and 1997, the federal minimum wage was raised 90 cents (in two steps), from \$4.25 to \$5.15. Because New Jersey had already raised its own minimum wage to \$5.05 back in 1992, this federal hike corresponded to an increase of 90 cents in Pennsylvania but only 10 cents in New Jersey. Hoffman and Trace analyzed whether this much larger effective raise in the minimum wage in Pennsylvania affected relevant employment growth compared to that in New Jersey. Looking at employment data from the Current Population Survey (not merely fast food workers) in 1995 and then in 1998, Hoffman and Trace found a negative employment effect in Pennsylvania among those workers that economic theory would predict to suffer, while Pennsylvania workers unlikely to be affected (because they were highly skilled and already were paid more than the new minimum wage) actually saw slightly higher employment growth. To be sure, Hoffman and Trace (2009) isn’t exactly the opposite of Card and Krueger (1994); one difference is that this study relies on statewide data rather than Card and Krueger’s approach of using county-level data. Nonetheless, their study should give serious pause to anyone who thinks that the 1994 Card and Krueger study was a dagger to the heart of the traditional empirical findings.

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Of course he wouldn't. He would rightfully argue that if we're going to judge whether Barack Obama is presiding over the growth in Big Government, we should look at the spending that is actually under Obama's control, i.e., federal spending. When we do that, we find that from the 4th quarter of 2008 through the 3rd quarter of 2010, federal spending as a share of GDP grew about 3.4 percentage points (from 22.1 percent to 25.5 percent). In contrast, the statistic Krugman looks at – total government spending at the federal, state, and local levels – only grew about 2.7 percentage points (from 33.4 percent to 36.1 percent) in the same period. Another way to see just how unusual the growth in federal spending under Obama has been is to chart the 12-month growth rate of federal spending:

So when Krugman asks, "Where is this myth of a surge in spending under Obama coming from?" we can offer him a straightforward reply: well, Dr. Krugman, in Obama's first year in office, federal-government expenditures grew at the fastest rate in 17 years, far higher than in the first Bush administration, when you were railing against the Republican president for starting two wars without paying for them.

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have done my best to paraphrase what I understand to be Krugman's and Cowen's points. I must confess that even while typing out the above, the non sequitur in each objection jumped out at me. For Krugman, his argument relies on a static conception of income and spending. Just using that accounting tautology – without indexing for time – Krugman could also argue that real income can never change in an economy, even if the government announced that the most productive 10% of workers in every firm would be shot. (After all, total income would still equal total spending.) As for Cowen, he seems to be assuming that "real income" is equivalent to "real consumption." I don't know what to say except, "No, it isn't." If a worker gets a job in a silver mine and gets paid in ounces of silver that he stores in his basement, he can have very high "real wages" even if his consumption is very low. In fairness, Cowen fired off the above on his blog, not in a refereed journal article; I would hate to see a collection of the dumbest things I've ever said on my blog. So let's assume that he meant to say that ABCT makes us expect real consumption (not income) to fall during the boom period. Cowen's point is that this doesn't match with the data. During the boom, we see increased investment in new (and more "roundabout" in Austrian lingo) projects, and we see workers getting paid more and hence buying more consumer goods. But shouldn't this be impossible, Cowen asks, if, as the Austrians claim, during the boom, resources are pulled away from consumption goods (like iPhones) and instead are devoted to the production of investment goods (like tractor trailers)? In the next section we'll see what Cowen is overlooking.

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Note too that this aspect of the story answers Cowen's objection: people consume more during the boom – i.e., the villagers eat more sushi per day – even while new, unsustainable investment projects are started. (In our sushi economy, the unsustainable project was looking for gasoline for the newfangled outboard motor.) Cowen is right that a sustainable lengthening of the capital structure initially requires a reduction in consumption; what happens is investors abstain and plow their savings into the new projects. But during a central-bank-induced boom, there hasn't been real savings to fund the new investments. That's why the boom is unsustainable, but it also explains why consumption increases at the same time. It's true that this is impossible in the long run, but in the short run it is possible to increase investment in new projects, and to increase consumption at the same time. What you do is neglect maintenance on critical intermediate goods, just as our islanders were able to pull off the feat for a few months. A modern economy is very complex, and it can take a few years for an unsustainable structure to become recognized as such.

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In the real world, this also happens: during the recession following the artificial boom period, resources need to get rearranged; certain projects need to be abandoned (like hunting for gasoline in the sushi economy); and critical intermediate goods (like boats and nets) need to be replenished since they were ignored during the boom. It takes time for all of the million-and-one different types of materials, tools, and equipment to be furnished in order to resume normal growth. During that transition, the contribution of the labor of some people is so low that it's not worth it to hire them (especially with minimum-wage laws and other regulations).

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The elementary flaw in Krugman's objection is that he is ignoring the time structure of production. When workers get laid off in the industries that produce investment goods, they can't simply switch over to cranking out TVs and steak dinners. This is because the production of TVs and steak dinners relies on capital goods that must have already been produced. In our sushi economy, the unemployed islanders couldn't jump into sushi rolling, because there weren't yet enough fish being produced. And they couldn't jump into fish production, because there weren't enough boats and nets to make their efforts worthwhile. And finally, they couldn't jump into boat and net production, because there were already enough islanders working in that area to restore the fleet and collection of nets back to their long-run sustainable level. People in grad school would sometimes ask me why I bothered with an "obsolete" school of thought. I didn't bother citing subjectivism, monetary theory, or even entrepreneurship, though those are all areas where the Austrian school is superior to the neoclassical mainstream. Nope, I would always say, "Their capital theory and business-cycle theory are the best I have found." Our current economic crisis – and the fact that Nobel laureates don't even understand what is happening – shows that I chose wisely.

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There is one more contradiction we should mention. The essence of the paradox of thrift and the liquidity trap is the insight that businesses won't expand operations if there is no demand for their product. But if Krugman and other pump-primers can see that the interruption in spending is only temporary, then so can the business owners involved. And to the extent that it is not temporary – for example, homebuilders are seeing much lower sales, and this isn't simply due to irrational hoarding – then government spending to “fill the gap” only screws things up even more.

For long-run sustainable output, businesses

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Now when the Federal Reserve artificially reduces interest rates below their free-market level, it sends a false message to entrepreneurs. Firms begin expanding as if consumers have increased their savings, but in fact consumers have reduced their savings (due to the lower interest rates). Businesses that churn out durable goods, such as furnaces, cargo ships, and, yes, houses will find business booming, because these sectors respond positively to low interest rates.

On the other hand, other sectors don't need to contract, because (unlike the scenario of genuine savings) nobody is cutting back on consumption. This is precisely why the Fed-induced boom is unsustainable – real resources have not been released from consumer sectors in order to fuel the expansion of the capital sectors. Because modern economies are so complex, the charade can continue for a few years, with entrepreneurs cutting corners and “consuming capital” (i.e., postponing necessary replacement and maintenance on equipment) while both investment and consumer goods keep flowing out of the pipeline at increased rates. But the music eventually stops, since (after all) the Fed's printing of green pieces of paper doesn't really make a country wealthier. When the Fed “cuts interest rates” it isn't really creating more capital for businesses to borrow; it is instead distorting the signal that the market interest rate was trying to convey.

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In a simple mainstream model, where we have one giant production function $Y=F(K,L)$, and in which there is a “stock” of capital and a certain “amount” of homogeneous laborers, you won’t pick up such fine nuances. In that world, especially if we assume that prices are “sticky,” it might be true that massive government deficit spending – or money drops from the Fed – could boost “aggregate demand” and restore full employment. But in the real world, if consumers want to spend their money on software, but the unemployed workers are coming from construction, this Keynesian solution isn’t going to work. Hopefully the reader can now see the apparent power of Sumner’s statistics. If the recession were about real resource misallocation – as opposed to a nominal spending shortfall – we would expect the unemployment rate to vary according to the fortunes of the housing sector. In other words, if Kling and the Austrians were right, we would have expected the drop in home construction to match up closely with the rising unemployment rate as those laid-off workers tried to find something

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Here’s the crucial portion of Sumner’s blog post: “So housing starts fall by 1.3 million over 27 months, and unemployment hardly changes. Looks like those construction workers found other jobs...” There’s just one problem with Sumner’s argument: housing starts are not synonymous with construction jobs. In fact, from January 2006 to April 2008 – the period when Sumner thinks construction workers must have been laid off in droves because housing starts fell by more than half – US construction employment only fell from 7.6 million to 7.3 million. Here’s a graph showing housing construction (blue) versus the national unemployment rate (red):

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There is nothing embarrassing in the above chart for the Austrian (or Klingian) theory. As the housing boom intensified, sucking more and more workers into construction, the national unemployment rate steadily fell. Then, as the housing boom tapered off, extra workers stopped getting siphoned into the housing sector, and the national unemployment rate bottomed out. Finally, as construction employment began falling, the national unemployment rate began rising.

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So what is wrong with Sumner's approach? Well, part of the problem is encapsulated in Kling's critique – Sumner isn't viewing the economy as a complex capital structure, with various lines of interlocking production processes that have to "mesh" in order for the finished output to keep popping out of the terminal. Rather, Sumner and his Keynesian allies are thinking of the economy as a bunch of masseuses or stand-up comedians, in which there are not dedicated capital goods that must augment the laborers in each field. In their world, when consumer spending switches (or freezes up altogether), the production structure just turns on a dime; there's no "memory" in the capital stock of what the patterns of output were before the sudden disruption.

But in the real world, and particularly in the housing sector, time and capital structure are crucial. In the years leading up to 2006, housing starts steadily expanded. Now if they had simply leveled off in January 2006 – so that (annualized) housing starts every month thereafter remained at the permanently high plateau of 2.3 million – construction employment would have continued rising after that date.

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The reason is that there's more to the construction sector than simply starting new houses. That fact alone buys us another few months, as a look at housing completions shows. But more important, construction workers are needed to maintain an existing stock of housing. In other words, if the builders had kept constructing new homes at an annualized rate of 2.3 million from January 2006 onward, and if families moved in to them as in normal times, total construction employment would have needed to rise above its January 2006 level. Those workers were needed to keep cranking out the brand new houses, and it would have taken new workers (siphoned from elsewhere in the economy) to, say, add a new deck in the backyard or build a shopping mall down the street from a new housing development. I am an economist, not an expert in housing

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Before closing, I want to remind Arnold Kling and other sympathizers with the Austrian reallocation story that the economy is suffering from more than the housing bust. If the government had done nothing, then there would have been a bad recession in 2007-2008. But it would be long gone by now. Home prices and the stock market would have crashed, but unemployment would now be at regular levels. Instead, we suffered a string of interventions in the market, including TARP, backdoor Fed bailouts of more than \$1 trillion, a "stimulus" package of more than \$700 billion, extensions of unemployment benefits, a massive overhaul of health insurance, stop-and-go bans on offshore drilling, and the EPA's unilaterally announcing it would regulate carbon emissions.

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Once we understand gold's historical role as the world's market-based commodity money, we can see why it is the inflation hedge par excellence, and also why people rush into gold when they are fearful. The equilibrium relationships described by Krugman et al., need to be true, other things equal, but they have by no means demonstrated that Bernanke needs to inflate more.

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Notice that federal spending went up throughout the period in question. It's true, in fiscal year (FY) 1933, Hoover had cut the federal budget by \$63 million (1.3%) from the previous year. But fiscal year 1933 didn't start until July 1, 1932, which was two and a half years into the Great Depression. Up until then, Hoover had steadily increased federal spending, just as Krugman would have recommended.

As far as deficits, the federal government actually continued the surpluses it had inherited from the Coolidge years through fiscal year 1930. However, the slight uptick in the surplus as a share of the economy (in FY 1930) is misleading; the actual surplus was about the same in both years (around \$730 million), but the economy had shrunk from 1929 to 1930 and so the surplus was a bigger share. In any event, by the summer after the stock-market crash Hoover's spending – combined with plunging tax receipts – had moved the Coolidge surpluses into Hoover deficits, and by the following year the deficit was 4% of GDP. For comparison, note that in his first term – when he “cut taxes on the rich and started a war” – George Bush's deficits were a maximum of 3.6% of GDP. But I've saved my favorite for last. Look at what the New York Fed did with its discount rate. Immediately following the late October 1929 crash, the NY Fed began slashing rates. It kept periodically cutting until it got to 1.5%, which was the lowest rate in Fed history to that point. Now it's true, in October 1931 the NY Fed abruptly changed course, because the Bank of England the month before had severed the pound's link to gold, and worldwide investors were fearful of a similar move by the US authorities. In order to stem the outflow of gold, the Federal Reserve did indeed find its hand forced and it had to jack up its rates. But the point is that the Fed had implemented record “easy” policies from November 1929 through September 1931, some 22 months after the onset of the Great Depression. That is too long for Krugman's historical narrative to make any sense. As we explained in the beginning of this article, at best Krugman has a 20-month window to work with, since our present-day Keynesian and loose-money policies allegedly nipped the Depression in the bud in that timeframe. To tie up one potential loose end that might trouble the fair-minded reader – is it possible that the Great Depression wasn't so bad in the early years, and only turned into the horrible slump after Hoover cut spending and the Fed raised rates? Well, it's true that things continued getting worse after October 1931, but they had gotten pretty bad leading up to that point, too. The monthly statistics of those days are a bit speculative, but the average annual unemployment rate for calendar year 1930 was 8.9%, while for 1931 it was 15.9%. That means it was very likely the case that unemployment had already broken our current levels by the end of 1930 (in order to make the average for the whole year 8.9%). When we turn from unemployment figures to output statistics, the comparison isn't even close. From 1929 to 1930, real GNP fell 8.6%. Then from 1930 to 1931, it fell another 6.6%, for a total two-year drop of 14.7%. (In contrast, US real GNP was actually higher in 2008 than in 2007, according to the official figures, and it only dropped 2.7% from 2008 to 2009.) So it is clear that the awful Great Depression was in high gear even during the period of rising budget deficits and easy Fed policy; Krugman can't say that the real pain only set in after Hoover cut spending and the Fed raised rates.

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The above excerpt from Rapaport beautifully illustrates my observation that in the social sciences, believing is seeing. After telling us that Hoover was a “virtual dictator” in agriculture and an engineering busybody – whom Roosevelt himself thought would make a great president in 1920 – and that his disastrous decisions in office consisted of tax increases, Rapaport nonetheless describes Hoover as relying on the market.

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As the chart shows, unemployment with the stimulus actually broke 10 percent. In other words, actual unemployment with the stimulus ended up being worse than what the Obama team warned Americans would be the case without the stimulus. In response to this debacle, Keynesians of course have claimed that they just got the baseline wrong. Why, the economy was even worse than they had realized in early 2009, meaning that the stimulus still helped. In policy wonk circles, the Romer/Bernstein stimulus goof has achieved iconic status, epitomizing the non-falsifiable nature of Keynesian economics, even though the Keynesians are the ones who keep claiming they have all of the empirical evidence on their side. Yet we have also seen the mirror image outcome occurring with the so-called “sequester,” in which the U.S. federal government reduced spending (relative to the original baseline) because Congress couldn’t come up with a budget deal.

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As the table shows, we have the mirror image of the stimulus debacle: Actual U.S. GDP growth in both quarters was greater with the sequester than what the Keynesians told us would be the case without the sequester.

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As always, no single outcome “proves” anything in macroeconomics. Krugman and the rest can claim, “Oh, phew, the economy was stronger than we realized back in early 2013. The sequester still hurt, but in absolute terms we’re doing better than we previously would have guessed.” They can also quibble with the actual fate of government spending compared to the specific projections that went into the Macroeconomic Advisers forecast. But especially with the government shutdown in the fall, no Keynesian can possibly claim that 2013 was a case of a boost in “stimulus” spending, and in fact the year was littered with Keynesians constantly warning of the dire effects of “unprecedented austerity.” The 3q growth of 4.1% is completely anomalous for the Keynesian paradigm. The arguments over fiscal policy show the importance of Ludwig von Mises’ stress upon the primacy of theory over empirical “testing.” There are 57 moving parts in macro; a partisan can always explain away the facts, whatever happens. Yet Austrian theory shows why government spending merely transfers resources away from the productive private sector and into the inefficient political realm. We shouldn’t be surprised to see the data easily accord with the Austrian theory.

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Does everyone see Krugman’s Kontortion? He went from saying that the relatively successful French economic growth proved the naysayers were wrong about its tax hikes, to saying that its economy was performing poorly because of austerity. To put it more succinctly: Krugman in late 2013 was saying that the French economy proved that tax hikes weren’t so bad. By July 2014, Krugman was saying that the French economy proved how bad fiscal austerity was.

I know, I know, when it comes to Paul

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First, as I’ve documented before, the Belgian government has persistently spent less money than the French, had lower deficits, and cut spending/deficits much more in 2010. So no matter how you slice it, the Belgians engaged in less of Krugman’s “medicine,” and took it away faster, than the French. Had the Belgium economy crashed in 2011, we can be quite sure Krugman would have blamed their “anarchy” for the irresponsible spending cuts so soon into a fragile economic recovery. Second, what about those alleged sadomasochists warning back in the latter half of 2013 that the French economy would suffer from tax hikes? Krugman said those guys were nuts. (I quoted him above on this.) Well, as of late June 2014 the French statistical bureau reported:

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Krugman et al. can't have it both ways. It can't be the case that the world is (a) full of imbeciles who lose boatloads of their clients' money because they listened to a Chicago School or Austrian economist give advice, while (b) investors aren't influenced by their fears over Obama and Bernanke's policies. Krugman and the other Keynesians need to pick one story and run with it.

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Instead, a "geoengineering" solution could be adopted to keep the earth cool despite increasing concentrations of greenhouse gases in the atmosphere. Perhaps the most fanciful idea is to suspend a hose using helium balloons, in order to pump sulfur dioxide into the stratosphere. This would reflect some of the incoming sunlight and arrest (or even reverse) global warming, just as occurred after the eruption of Mount Pinatubo in 1991. Best of all, this particular approach would only cost about \$250 million total – less than what Al Gore's foundation is spending just to "raise awareness" about climate change.

Naturally, the proponents of massive government interventions into the economy were furious at Levitt and Dubner's claims. Physicist and Clinton administration Department of Energy official Joe Romm got the ball rolling with this fiery post in which he accused the Superfreakonomics writers not merely of being incredibly sloppy in their summary of the climate science but also of consciously distorting the views of the scientists they quoted. Romm's frequent ally in such matters, Paul Krugman, soon followed suit and claimed that the authors horribly mischaracterized the views of leading climate economists in the chapter. Dubner defended himself and coauthor Levitt against Romm's accusations of intentional distortion in this post, as did physicist (and all-around guru) Nathan Myhrvold, one of the primary sources for the chapter.
