Voodoo Economics

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Is Paul Krugman a Voodoo Economist? Readers ask me if Paul Krugman could be correct that deficits don't matter and that neither does printing endless reams of money with which to purchase the Treasury's debt instruments that finance the deficits.

If people at home and abroad who hold dollars and dollar denominated financial instruments do not care that trillions of new dollars are being created in order to cover the large gaps between revenues and expenditures in Washington's annual budgets and to support "banks too big to fail," that is, if these dollar holders do not see the value of their dollars diluted by the new dollars, which are appearing in greater quantities than new goods and services, Krugman is right.

The problem for Krugman is that the likelihood of such indifference goes against supply and demand. Economists believe, including Krugman, that if supply increases faster than demand, price drops. So, if there is anything at all to economics, an excess supply of dollars must cause the dollar's value to drop.

A drop in the dollar's value can occur in one of two ways. The way most people think of is via monetary inflation. Too many dollars chasing too few goods drives up prices, and each dollar buys less and is thus devalued. However, in our current situation, the excess dollars are in the banks. As the banks are not lending, the excess dollars are not getting into the money supply or prices. The banks are keeping large reserves in order to meet demands that can arise from their uncovered derivative bets, and the banks are using some of the money that the Federal Reserve is making available to them to speculate on stock market futures, thus pushing stock prices to unrealistic levels.

The other way through which the dollar can lose value is via its exchange rate to other currencies. Foreign holders of dollars, watching five years of dollar creation in order to finance federal budget deficits and seeing no end, can come to the conclusion that their dollar holdings are being diluted. If they make this decision, they will decide to get out of dollars or to reduce their exposure to the US dollar.

When they sell dollars in the currency market, the value of the dollar in terms of other currencies will fall. As the US is now an import-dependent country, domestic US prices will rise as a result of dollar devaluation in the currency market. The appearance of

domestic inflation on top of the dollar's falling exchange value would, if economics is correct, cause a greater haste on the part of dollar holders to get out of dollars.

In other words, once it begins there is a downward spiral.

Apparently, Krugman believes that the dollar is so unique and so wonderful, like America, that its value cannot be harmed by abuse.

The question whether federal budget deficits matter or don't matter is a different question. It depends on the cause of the deficit. Some readers have poked fun at Krugman and at me, saying that Krugman sounds like a voodoo supply-side economist

from the Reagan era claiming that "deficits don't matter." In other words, Krugman and I are peas in a pod.

These comments illustrate the power of the presstitute media to instill misunderstanding. Here we are three decades after Reagan and vast numbers of literate Americans have no idea what Reaganomics was.

Supply-side economics is not about deficits. Its novel feature is elucidation of the impact of fiscal policy on aggregate supply. For Keynesian demand-side economists, who dominated US economic policy until the Reagan era, fiscal policy can only impact aggregate demand. If government gives people a tax cut, they spend more money and raise aggregate demand, thus boosting employment. If people are hit with a tax hike, they have less money to spend, and inflation falls.

What supply-side economists said is that some kinds of fiscal policy, such as changes in marginal tax rates (the tax rates on additions to income), change incentives and, therefore, increases or decreases aggregate supply. (In Keynesian economics, supply is a passive responder to aggregate demand.)

Marginal tax rates are the rates that apply to additions to income. In a progressive income tax system, the rates rise with income. Marginal tax rates determine the price of leisure in terms of income foregone by not working. Marginal tax rates also determine the price of current consumption in terms of future income foregone by not saving and investing the money. The higher the tax rate on additions to income, the cheaper are leisure and current consumption in terms of foregone present and future income. The lower the tax rate on additions to income, the more expensive are leisure and current consumption. In other words, high tax rates discourage labor supply, the supply of savings, and the growth of GDP.

Supply-side economics was an important contribution to economics. In the 12th edition of his famous textbook, Paul Samuelson, the doyen of economics before his death, acknowledged the correctness of the supply-side point.

Are deficits important? As I said, it depends on their cause. The so-called "Reagan deficits" were really Federal Reserve chairman Paul Volcker's deficits, because Volcker, mired in Keynesian thinking, could not understand the supply-side policy. The Treasury met with Volcker regularly. We tried to help Volcker understand the new policy, but Volcker could only think of tax cuts as a stimulus to demand, which was the way his economic advisory board also thought of tax cuts.

Consequently, Volcker viewed "Reaganomics" as wildly inflationary (the inflation rate was double-digit prior to Reagan). He thought he would be blamed by Reagan for the higher inflation that Volcker thought would result from what Volcker mistook to be a Keynesian stimulus policy. To protect himself and the Federal Reserve from blame, Volcker dramatically reduced the growth of the money supply prior to the tax cuts going into effect. Volcker reasoned that if the growth of the money supply was reduced, monetary policy could not be blamed for the inflation that he thought would be caused by Reagan's fiscal policy.

The reduction in money growth caused a recession. As the OMB budget projection did not anticipate the sudden collapse of inflation, nominal GNP and thus tax revenues collapsed below projection. This was the main cause of the "Reagan deficits."

As the Reagan deficits resulted from the unanticipated collapse of inflation and thus nominal tax base, they were not a problem. Deficits that result from inflation's collapse cannot cause inflation or dollar devaluation in currency markets.

In the post-war US (post WW II), most federal budget deficits or the worst ones resulted from the Federal Reserve causing a recession in order to reduce the inflation that Keynesian demand management produced. The high tax rates of the post-war era discouraged and reduced the response of supply to the stimulated aggregate demand.

Consequently, in place of output rises, prices rose. This was the problem that supply-side economics addressed. The problem had worsened with time and became known as worsening "Phillips curve" trade-offs between inflation and employment. In the Carter years the problem was termed "stagflation" and the "malaise" of the American economy. It gave hope to the Soviet government that the US economy was also afflicted with troubles.

It would be interesting to know what Krugman's response was to the "Reagan deficits."

Like Robert Parry now into his fourth decade of his war against Reagan, Krugman does not like Reagan. I wouldn't be surprised if Krugman wrote that the "Reagan deficits" were the end of the world. Krugman is a Democrat, not a Republican, so are Reagan's deficits bad, but not Obama's? Other economists seem to have the same problem.

Perhaps I am being unfair to Krugman. More likely, the truth is that Krugman, being an old-fashioned liberal, saw the income distribution aspects of high marginal tax rates as more important than the relative price or incentive aspects that affected inflation, employment, and economic growth. Krugman probably saw supply-side economics as threatening the arrangement of the income distribution without realizing that stagflation–the problem that supply-side economists addressed–was far more harmful to the working class than to the rich.

Krugman has a social conscience for which I respect him. I am confident that he would agree with me that economists who lack a social conscience do more harm than good. In my opinion, for what it is worth, Krugman does not understand or realize the way in which jobs offshoring has changed the US economy, the position of US workers and employees, and the efficacy of economic policy.

As I have often explained, when US corporations pursue higher profits at the expense of US labor by offshoring the jobs that produce the goods and services that they sell to Americans, they separate the US labor force from the incomes associated with the production of the goods and services that they consume. Eventually, this destroys the consumer market. According to the Census Bureau, American median family income is 9% less than a dozen years ago. This means that what once was spending power of American consumers is now the paper wealth of the mega-rich.

Keynesian stimulus policy works when the jobs from which people have been laid off still exist. By boosting aggregate demand for goods and services, the stimulus puts people back to work. But if the jobs have been moved offshore and the factories closed, the jobs no longer exist. No stimulus policy can put the unemployed into jobs that no longer exist.

Krugman has not come to terms with this basic fact. Nor have the majority of economists. Economists assumed that new and better jobs would take the place of the offshored ones. However, as I am forever pointing out, there is no sign of these jobs in the employment data.

Most economists believe that jobs offshoring is free trade and that free trade is beneficial, which simply demonstrates their confusion. Jobs offshoring is based on the pursuit of absolute advantage, the antithesis of comparative advantage that is the basis of free trade.

As I have said before, many economists are bought and paid for. I do not think that Krugman is one of the whores. In my opinion, Krugman, whatever his contribution to economics might be, simply does not understand how First World labor has been disadvantaged by Wall Street and US transnational corporations. The upward redistribution of real income is not solely the result of reductions in tax rates. The larger impact results from the offshore relocation of labor to low wage countries and from the deregulation of the financial sector. Labor arbitrage has converted American wages into corporate profits.

In my opinion US marginal tax rates were appropriate where Reagan left them. Their further reduction by Bush/Cheney and Obama are not necessary policy adjustments but rewards to the mega-rich who underwrite political careers and provide grants to economics departments and think tanks.

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