THREE WRONGS DO NOT MAKE A RIGHT

Kenneth Rogoff, Harvard University, October 7, 2013 THE FINANCIAL TIMES

Paul Krugman has posted an interesting and concrete analytical comment (Phantom Crises") in reply to my October 3 op-ed in the *Financial Times* "Britain should not take its credit status for granted". Prof Krugman explained why he never felt any need to temper his famously strong advice to the UK government to massively raise borrowing, even though he simultaneously believed (and widely opined) that the Eurozone might very well soon blow up.

I should also thank Simon Wren-Lewis for his response: he recognised that my op-ed clearly was not intended as a piece of advocacy to justify the UK's exact policy trajectory. In fact, I point to several areas where it could have been significantly improved, for example, greater infrastructure spending. I am, however, arguing that the insurance elements of the problem need to figure more prominently in the discussion.

Prof Krugman's comment, using a simplified version of the canonical modern IS-LM macroeconomic model, shows that even if a euro collapse would have led to a run on sterling, the result would be depreciation of the pound and a rise in demand for British traded goods. At the same time, he argues that even if this built-in automatic stabilizer were not enough to prevent a "squeeze" on long-term bonds, the Bank of England could just print money and buy them up en masse thanks to the liquidity trap. (Prof Wren-Lewis, who Prof Krugman cites, also makes this point.) Thus there was in fact no need to reconcile his debt management advice with his euro red alert.

I beg to differ.

True, Prof Krugman's analysis seems perfectly correct, given its assumptions and simplifications. This is especially clear from a somewhat more detailed analytical note that he published last year, and refers to again in his comment. Prof Krugman has stripped the argument down to its bare analytical essentials with his signature elegance, and I agree that very likely something quite similar could be demonstrated in a more fully fleshed-out "New Open Economy Macroeconomics" model. The analysis is completely internally consistent within its own universe. The question I would pose is whether the model is consistent with the universe the UK would live in after a euro breakup. Rather, I think the model is missing some absolutely essential elements to capture the problems the UK would have faced.

The key proposition is that after after a euro calamity, any resulting run on the pound would lead only to a rise in demand for British goods, shifting the IS curve outwards and to the right.

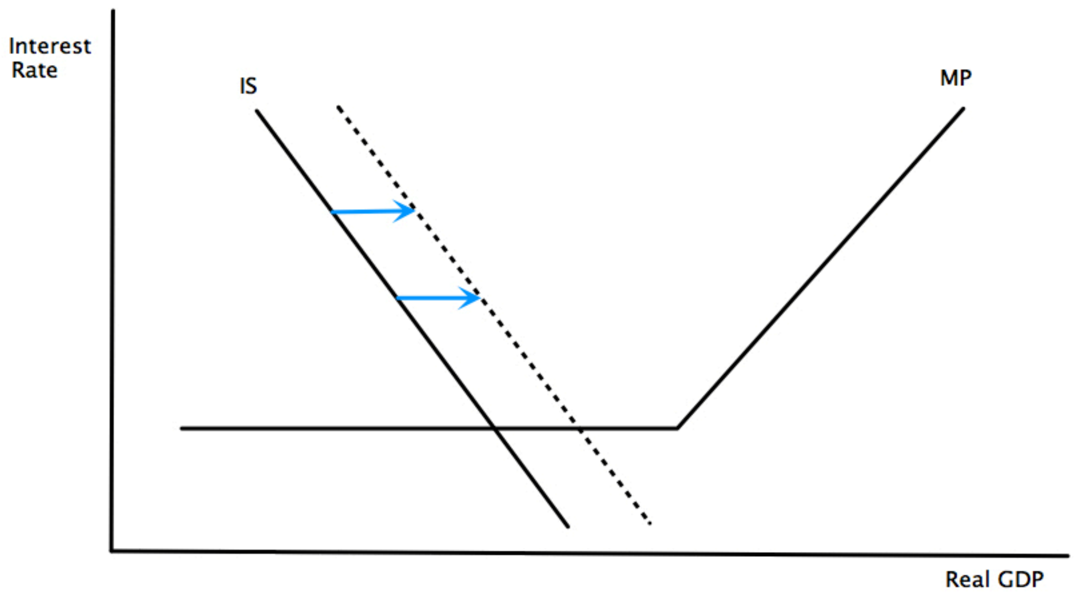
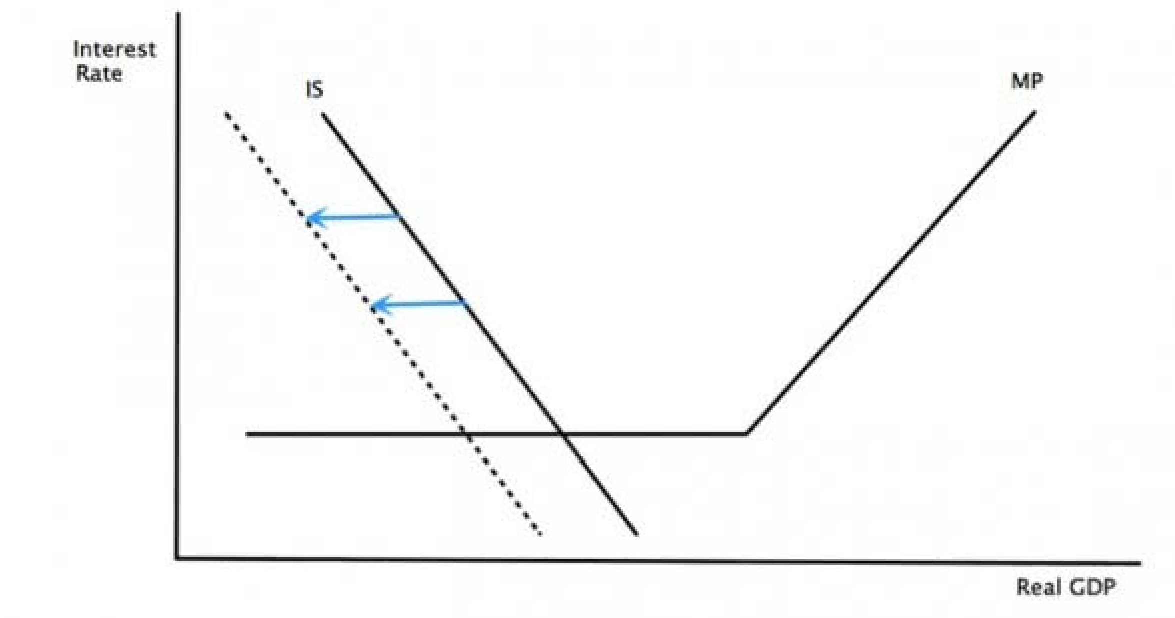


Figure 1: Krugman's model of UK economy response to a euro breakup: upward shift in aggregate demand curve (IS) due to exchange rate depreciation, output rises

That doesn't quite have the ring of common sense, so what is missing? Well, first, a collapse in demand in the UK's major trading partner would lead to a downward shift in demand for British goods, tending to shift the IS curve inwards not outwards. Second, the euro might well fall even more than the pound, further aggravating this effect. (Even though the overall trade-weighted pound might still fall, it is not clear how much stimulus this would really give. After the crisis, the pound in fact fell by roughly 25%, a massive stimulus most "debt panglossians" gloss over, and it did not help UK exports all that much in the short run.)

And this is not all. UK banks would get hammered if a disorderly euro-breakup led to a wave of defaults, particularly on Irish debt. This would surely reduce the availability of credit, another reason why the IS curve would shift inwards. Fourth, the uncertainty entailed by a euro breakup would likely freeze up business investment. Yes, that's right, this is another reason why the IS curve would shift in. Fifth, there would almost certainly be a giant negative wealth effect on demand as the stock market crashed, with housing prices likely to follow.



More likely UK economy response after a euro breakup: downward shift in aggregate demand curve (IS) as (1) exports to Eurozone falter, (2) stock market collapses (3) uncertainty lowers investment, (4) banking crisis reduces lending. Output falls.

This is just a sketch, and like Prof Krugman, I welcome further concrete analytical contributions in this area. Let me finally note that Prof Krugman's model attempts to capture risk by incorporating a shock to the risk premium in the "uncovered interest parity condition" which relates UK to world interest rates. (Like other IS-LM and most log-linearized New Open Economy Macroeconomic models, Prof Krugman's does not genuinely incorporate risk, but this is not my central complaint here.)

In the model, pressure on UK rates does indeed drive down the exchange rate, leading to an outward shift of the IS curve, meaning that there is greater demand for output at any given real interest rate. Assuming normal monetary policy (a normal "LM" curve), there is a growth bonanza. But even if we take the example of a different kind of speculative attack, not necessarily motivated by the predicted euro breakup, it is likely that the answers will be quite sensitive to the underlying risk, and that long-term debt sustainability will sometimes come into play.

And what about long-term debt sustainability? Well, the aftermath of a euro breakup is exactly a situation where credibility would be everything. In arguing that the UK can always just print money, Profs Krugman and Simon-Wren Lewis take for granted the credibility of long-term fiscal sustainability and the Bank of England's commitment to maintain low inflation. But, as my op-ed explains, a close look at its credit history, especially from the mid-1930s to the mid-1970s, would suggest that the UK's macro policy credibility is far from bullet proof.

Yes, a country with its own currency has the ability to escape a debt crisis through seignorage and inflation, but this works only insofar as the inflation is not priced in. In reality, having one's own currency is hardly absolute protection against speculative attacks and default, it only morphs their expression. In the 1980s and 1990s, central banks everywhere had to fight hard to bring down long-term interest rates after the high inflation of the 1970s breached the public's trust. This process was very costly. Even in a liquidity trap, the capacity to print money is not an infinitely deep well. In a real attack, it is not just government liabilities but bank liabilities that would come under attack. The UK has short-term external debt over 250 per cent of GDP.

A calamity of the proportions we are talking about here would make it very hard to sustain credibility, and the UK government would have had to call on every ounce of its credibility reserve. Prof Krugman often cites the high debt loads the UK has had in the past as prema facie evidence that those concerned with apparently high debt loads overplay the issue of fiscal sustainability. As my op-ed argues, this is a superficial read of UK debt history.

There is a completely legitimate question of how a country can best enhance credibility when faced with the high risk of an impending external shock, as Wren-Lewis rightly points out. I would put my money on the time-honoured advice that countries with very large budget and current account deficits have more trouble maintaining credibility than countries that don't, although it helps a lot if policymakers have a truly credible plan to rein things in.

Let me hasten to add that in the bottom line of policies, there are significant points of agreement in our analyses (as anyone who has been following what I have actually been saying would know.) Again, high return infrastructure projects pay for themselves in the long run, and are a reasonable risk for the short run. One might make the same remark of effective expenditures aimed at making education more effective at all levels, albeit in practice the politics are particularly complex. Monetary policy should have been even more aggressive after the crisis. I believe debt overhang is a huge problem across the periphery of Europe, and I have long clearly favoured sharply writing down debts, even at the ultimate expense of taxpayers in the core of Europe. But there is the matter of calibration, simply spending huge amounts of money is not always a panacea in an uncertain world, and there has to be a balance between stimulus and stability.

Yes, tens millions of people have been affected by the financial crisis, and by the slow recovery that is unfortunately typical of such crises (as Carmen Reinhart and I showed in our work in our 2009 book *This Time is Different*, and even before that in our January 2009 AEA proceedings paper.) Policymakers could have and should have done better. It is the responsibility of economists to do further research to understand these issues better, and to debate their conclusions in a balanced fashion. But it is dead wrong to tell policymakers that the answers are simple. As one can see from the highly debatable assumptions implicit in Krugman's analytical framework, and from the apparent inconsistencies between his UK debt management advice and eurozone breakup call, they are not simple at all.