Three wrongs don’t make a right

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.
Three wrongs don’t make a right | The A-List

http://blogs.ft.com/the-a-list/2013/10/07/three-wrongs-dont-make...  10/8/2013
Three wrongs don’t make a right | The A-List
Three wrongs don’t make a right | The A-List