



Comment

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It is a great honor for me to comment on the presentation that Paul Krugman has just delivered to us. But this is also an intimidating challenge. How can I, with all my limitations, comment the ideas of one of the most brilliant and influential economists of the world today?

This is not the first time that I find myself in such a difficult situation. I faced similar problems when I met Paul Krugman for the first time, in 1976. At that time he was only 23 years old and he was still a PhD student in MIT. But I soon concluded that, in spite of the differences in our ages, in our institutional positions and in our familiarity with Portuguese economic problems, he was far better than me in analyzing those problems and in making proposals for their solution.

The presentation that he has delivered to us today is an excellent example of the relevance and quality of his work in dealing with the most important real world issues, instead of being directed, like that of many others, to theories, based on unrealistic assumptions and faulty models.

I believe that economic theories are closely influenced by the ideological preferences of those that originate them or agree with them. In my view, the starting assumptions of the theories of those that Paul Krugman classifies as freshwater economists are chosen not for their realism and relevance but with two other objectives. The first is to show, under the veil of scientific reasoning, that most of the State interventions in the economy are ineffectual or produce negative economic results, and that consequently market mechanisms must be free of government interferences. The second objective is to build models based on assumptions that make it possible to use of sophisticated mathematical method that bring academic prestige, even if they do not contribute at all to useful interpretations of real world economic phenomena and actual economic behavior.

The freshwater economists can of course accuse the saltwater ones, in the opposite camp of the economic debate, of similar ideological bias. But I am of the opinion that there is a big difference between the two: the later ones are more committed to realism, while the former persist in their fanciful hypotheses, even after the facts of the real world, and in particular the crises of 2008-2009, show clearly how wrong they have been.

My worries about the present state of economic theories come more from their impact on economic policy makers than from their intrinsic validity. In the beginning of the present economic crisis in industrialized countries, Governments and Central Banks reacted by adopting expansionary monetary and fiscal policies. During an initial period, many of us believed that Keynesianism had returned. But that period turned out to be very short. By 2010, most governments, and to a smaller extent some Central Banks, were back to conservative policies of demand restrictions, dominated much more by the objective of avoiding inflation than by that of stimulating the recovery. I refrain from commenting the debates in the United States, about which Paul Krugman has written so much. But I cannot hide my alarm about what is being done in the Europe. We are all aware that macro-economic policies in Euro area countries are to a large extent dictated by Germany. The leading German economists and policy makers are strongly influenced by the freshwater thinking in the USA. But to that influence they add their own reasons for adopting policies of demand restriction. The first of these reasons is their obsession with inflation, which is even stronger than that of the conservatives in the United States. Because of that obsession, they tend to oppose any fiscal and monetary policies that might involve risks, however slight, of pushing inflation above very low levels. The second reason is the moralist belief that fiscal sins have to be punished by fiscal expiation, i.e. by austerity, whatever its economic and social consequences may be.

I am of the opinion that countries like Portugal, Greece and Ireland can not escape severe restrictive fiscal policies, given the excessive weight of their foreign and public debts and their unsustainable external disequilibria.

But, within the constraints of the European Monetary Union, the adjustments in those countries would be less painful if two conditions were met. The first relates to the amount of external assistance provided by countries with large current account surpluses. If Portugal received more assistance, although with appropriate conditionality, the contraction of its economy would be less deep, because there would be more time to wait for the results of the improved competitiveness that structural measures are expected to produce. Those who propose harsh fiscal austerity argue that it will bring back the trust of private economic agents, and will therefore encourage them to invest more and consume more. However, the experience of the last two years has proved abundantly that this argument is a fallacy. The rating agencies downgrade the debt of countries with large fiscal and external disequilibria. But when these disequilibria begin to be corrected by austerity policies which depress growth, they downgrade it again, this time because the expected improvement of confidence does not materialize and economic growth turns out to be unsatisfactory. The second – and more important – of the conditions that I mentioned above, is that the solution of the difficulties in indebted countries should require more expansionary domestic demand policies in those which have external surpluses. The international payments system should recover the arguments of Keynes, in the Bretton Woods negotiations, in favor of symmetric adjustments not only in countries with deficits but also in those which have surpluses. Unfortunately such a change does not appear to be likely in the near future, despite the existing dangerous problem of big payments disequilibria on a world scale. Germany should reduce its large current account surplus-which in recent years has fluctuated between 5 and 6 percent of GDP – by stimulating its domestic demand and thus increasing the exports of other Euro area countries. But what we are seeing is that, in spite of brilliant performance of its exports, the rate of increase German domestic demand is projected to fall from an estimated 2,5% in 2011 to around 1,5% in 2012. The fiscal policy is a major contributor to this containment of domestic demand. According to recent forecasts of the European Commission, the cyclically adjusted public deficit in Germany is projected to fall from 1.3% of GDP in 2011, to 0.7% in 2012 and to 0.4% in 2013. And Germany has not only introduced in its constitution the principle of practically forbidding fiscal deficits in the future, but also has led other Euro area countries to accept the a similar rule, imposed by the Intergovernmental Treaty, which was signed two weeks ago. The policies advocated by distinguished German economists and by the German Authorities might result in the elimination of deficits, both external and fiscal, in the more indebted countries of the Euro area, but at the cost of economic and social disasters. The surplus in Germany would end up by being also cut, since its exports would be negatively affected. But the new equilibrium would be reached at income levels which would be significantly lower across Europe than those which would be achievable with more expansionary macro-economic policies.

I would very much like to see in the near future the weakening of the influence not only of freshwater economists but also of their conservative European followers. But I fear that this will not happen until we find ourselves in a more calamitous situation than at present. My only hope is that the ideas of Paul Krugman will soon have more influence in policy makers than at present seems to be the case.

