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Comment Paul Krugman

Human beings—even economists—are not natural statisticians. Our views tend to be driven by the most arresting anecdote rather than the best *t*-statistic. And this creates a bias toward neophilia: man bites dog is more interesting than dog bites man, so when it happens there is a strong temptation to quickly adopt a revisionist theory that says that dogs are more likely to be bitten than to bite.

What Robert Gordon is saying here is that this is more or less what happened in the aftermath of the ERM breakup. In 1992 many Europeans believed that devaluation would be a disappointment, perhaps even a disaster; when it did not lead to massive inflation in the depreciating countries, and when the United Kingdom in particular did rather well in the years following, a number of people were inclined to stand that orthodoxy on its head, to claim not just that the costs of exiting the ERM were less than some had thought but that they were less than anyone had thought. This view, which Gordon calls the conventional wisdom (I guess it depends which convention you attend), is the subject of his paper.

What he finds is that the successes of the "leavers," of those countries that chose not to do whatever was necessary to stay in the ERM, are not that obvious when you actually look at the numbers. The leavers achieved a bit better unemployment performance than the stayers but did so at the price of somewhat higher inflation. There is no sign of a free lunch, and certainly not the huge bonus some have claimed. All in all, European experience is more or less what you might have expected from textbook macroeconomics—specifically, the Gordon macroeconomics text or my own international text with Obstfeld.

I have a few quibbles about the methodology by which Gordon arrives at this conclusion, but I doubt that they would change the basic picture. So perhaps my main complaint about the paper is the way it portrays the debate.

In Europe, at least, the battle lines in 1992—or for that matter today—were not between IS-LM-Phillips curve modelers, on one side, and "free lunchers," on the other; they were between ISLMic economists and what

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we might call Maastricht monetarists, who believed that currency depreciation would be quickly dissipated in inflation and would actually raise unemployment because of the loss of credibility. I happen to have been in Sweden in the interregnum between the devaluation of sterling and that of the kronor and had the opportunity to meet with the then finance minister. Her view, shared by many other Europeans, was that letting the kronor float would mean a replay of the mid-1980s, a runaway surge in prices followed by a severe slump. As someone who believed in my own textbook, I was way out on the left in the European debate. And from my point of view, the failure of the supposed terrible consequences of depreciation to emerge validates my view. (Yes, I am aware that this is an illustration of the Frankel theory of modern econometrics cited at the beginning of the paper.)

Let me turn briefly to some technical quibbles. I am a bit unhappy with the use of effective exchange rate indexes in this paper. The reason is that the ratio of effective exchange rates need not track the actual bilateral exchange rate between two countries. Consider, for example, an imaginary world in which there are only three countries: Germany, Luxembourg, and the United States, and imagine that each country has an effective exchange rate based on trade shares. Germany will then carry considerable weight in the Luxembourgeois index, but Luxembourg will not count much in Germany's. Now suppose that both European currencies depreciate against the dollar, by exactly the same amount. Well, Germany's effective rate—which basically only considers the dollar—will depreciate by more than Luxembourg's, even though their bilateral rate has not changed. I think there is a bit of that sort of illusion going on in Gordon's data, though it probably does not much alter the conclusions.

An even more trivial quibble involves measuring unemployment rates with index numbers. Is an increase in the German rate from 2 to 3 really equivalent to an increase in the Spanish rate from 12 to 18?

A more fundamental issue is that of reversed causation. A determined defender of devaluation might argue that since all European governments were reluctant to devalue and did so only under duress, almost by definition the leavers were economies in trouble—more trouble, on average, than the stayers. So one might have expected the leavers to have had worse performance than the stayers, even if the exchange rate regime were irrelevant. The fact that the leavers actually did about as well or even a bit better than the stayers, then, represents a success! (This Frankel method of econometrics is a wonderful thing if you use it cleverly.)

The answer to that sort of problem is, of course, econometrics—which is what Gordon does, to very good effect, in the later sections of the paper. As Gordon suggests, these results seem "to ratify old verities in international macroeconomics" rather than some new free lunch interpretation.

But in Europe itself, there has been a widespread rejection of precisely those old verities—which would seem to suggest that monetary union is a project of questionable virtue, likely to prove more costly than EMU rhetoric allows. If the old verities remain true, then Europe may have just made a rather serious mistake.