Myths of austerity

By Paul Krugman
July 2, 2010 – *The New York Times*

When I was young and naïve, I believed that important people took positions based on careful consideration of the options. Now I know better. Much of what Serious People believe rests on prejudices, not analysis. And these prejudices are subject to fads and fashions.

Which brings me to the subject of today's column. For the last few months, I and others have watched, with amazement and horror, the emergence of a consensus in policy circles in favor of immediate fiscal austerity. That is, somehow it has become conventional wisdom that now is the time to slash spending, despite the fact that the world's major economies remain deeply depressed.

This conventional wisdom isn't based on either evidence or careful analysis. Instead, it rests on what we might charitably call sheer speculation, and less charitably call figments of the policy elite's imagination — specifically, on belief in what I've come to think of as the invisible bond vigilante and the confidence fairy.

Bond vigilantes are investors who pull the plug on governments they perceive as unable or unwilling to pay their debts. Now there's no question that countries can suffer crises of confidence (see Greece, debt of). But what the advocates of austerity claim is that (a) the bond vigilantes are about to attack America, and (b) spending anything more on stimulus will set them off.

What reason do we have to believe that any of this is true? Yes, America has long-run budget problems, but what we do on stimulus over the next couple of years has almost no bearing on our ability to deal with these long-run problems. As Douglas Elmendorf, the director of the Congressional Budget Office, recently put it, "There is no intrinsic contradiction between providing additional fiscal stimulus today, while the unemployment rate is high and many factories and offices are underused, and imposing fiscal restraint several years from now, when output and employment will probably be close to their potential."

Nonetheless, every few months we're told that the bond vigilantes have arrived, and we must impose austerity now now now to appease them. Three months ago, a slight uptick in long-term interest rates was greeted with near hysteria: "Debt Fears Send Rates Up," was the headline at The Wall Street Journal, although there was no actual evidence of such fears, and Alan Greenspan pronounced the rise a "canary in the mine."

Since then, long-term rates have plunged again. Far from fleeing U.S. government debt, investors evidently see it as their safest bet in a stumbling economy. Yet the advocates of austerity still assure us that bond vigilantes will attack any day now if we don't slash spending immediately.

But don't worry: spending cuts may hurt, but the confidence fairy will take away the pain. "The idea that austerity measures could trigger stagnation is incorrect," declared Jean-Claude Trichet, the president of the European Central Bank, in a recent interview. Why? Because "confidence-inspiring policies will foster and not hamper economic recovery."

What's the evidence for the belief that fiscal contraction is actually expansionary, because it improves confidence? (By the way, this is precisely the doctrine expounded by Herbert Hoover in 1932.) Well, there have been historical cases of spending cuts and tax increases followed by economic growth. But as far as I can tell, every one of those examples proves, on closer examination, to be a case in which the negative effects of austerity were offset by other factors, factors not likely to be relevant today. For example, Ireland's era of austerity-with-growth in the 1980s depended on a drastic move from trade deficit to trade surplus, which isn't a strategy everyone can pursue at the same time.

And current examples of austerity are anything but encouraging. Ireland has been a good soldier in this crisis, grimly implementing savage spending cuts. Its reward has been a Depression-level slump — and financial markets continue to treat it as a serious default risk. Other good soldiers, like Latvia and Estonia, have done even worse — and all three nations have, believe it or not, had worse slumps in output and employment than Iceland, which was forced by the sheer scale of its financial crisis to adopt less orthodox policies.

So the next time you hear serious-sounding people explaining the need for fiscal austerity, try to parse their argument. Almost surely, you'll discover that what sounds like hardheaded realism actually rests on a foundation of fantasy, on the belief that invisible vigilantes will punish us if we're bad and the confidence fairy will reward us if we're good. And real-world policy — policy that will blight the lives of millions of working families — is being built on that foundation.