Austerity's grim legacy

By Paul Krugman
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When economic crisis struck in 2008, policy makers by and large did the right thing. The Federal Reserve and other central banks realized that supporting the financial system took priority over conventional notions of monetary prudence. The Obama administration and its counterparts realized that in a slumping economy budget deficits were helpful, not harmful. And the money-printing and borrowing worked: A repeat of the Great Depression, which seemed all too possible at the time, was avoided.

Then it all went wrong. And the consequences of the wrong turn we took look worse now than the harshest critics of conventional wisdom ever imagined.

For those who don't remember (it's hard to believe how long this has gone on): In 2010, more or less suddenly, the policy elite on both sides of the Atlantic decided to stop worrying about unemployment and start worrying about budget deficits instead.

This shift wasn't driven by evidence or careful analysis. In fact, it was very much at odds with basic economics. Yet ominous talk about the dangers of deficits became something everyone said because everyone else was saying it, and dissenters were no longer considered respectable — which is why I began describing those parroting the orthodoxy of the moment as Very Serious People.

Some of us tried in vain to point out that deficit fetishism was both wrongheaded and destructive, that there was no good evidence that government debt was a problem for major economies, while there was plenty of evidence that cutting spending in a depressed economy would deepen the depression.

And we were vindicated by events. More than four and a half years have passed since Alan Simpson and Erskine Bowles warned of a fiscal crisis within two years; U.S. borrowing costs remain at historic lows. Meanwhile, the austerity policies that were put into place in 2010 and after had exactly the depressing effects textbook economics predicted; the confidence fairy never did put in an appearance.

Yet there's growing evidence that we critics actually underestimated just how destructive the turn to austerity would be. Specifically, it now looks as if austerity policies didn't just impose short-term losses of jobs and output, but they also crippled long-run growth.

The idea that policies that depress the economy in the short run also inflict lasting damage is generally referred to as "hysteresis." It's an idea with an impressive pedigree: The case for hysteresis was made in a well-known 1986 paper by Olivier Blanchard, who later became the chief economist at the International Monetary Fund, and Lawrence Summers, who served as a top official in both the Clinton and the Obama administrations. But I think everyone was hesitant to apply the idea to the Great Recession, for fear of seeming excessively alarmist.

At this point, however, the evidence practically screams hysteresis. Even countries that seem to have largely recovered from the crisis, like the United States, are far poorer than precrisis projections suggested they would be at this point. And a new paper by Mr. Summers and Antonio Fatás, in addition to supporting other economists' conclusion that the crisis seems to have done enormous long-run damage, shows that the downgrading of nations' long-run prospects is strongly correlated with the amount of austerity they imposed.

What this suggests is that the turn to austerity had truly catastrophic effects, going far beyond the jobs and income lost in the first few years. In fact, the long-run damage suggested by the Fatás-Summers estimates is easily big enough to make austerity a self-defeating policy even in purely fiscal terms: Governments that slashed spending in the face of depression hurt their economies, and hence their future tax receipts, so much that even their debt will end up higher than it would have been without the cuts.

And the bitter irony of the story is that this catastrophic policy was undertaken in the name of long-run responsibility, that those who protested against the wrong turn were dismissed as feckless.

There are a few obvious lessons from this debacle. “All the important people say so” is not, it turns out, a good way to decide on policy; groupthink is no substitute for clear analysis. Also, calling for sacrifice (by other people, of course) doesn’t mean you’re tough-minded.

But will these lessons sink in? Past economic troubles, like the stagflation of the 1970s, led to widespread reconsideration of economic orthodoxy. But one striking aspect of the past few years has been how few people are willing to admit having been wrong about anything. It seems all too possible that the Very Serious People who cheered on disastrous policies will learn nothing from the experience. And that is, in its own way, as scary as the economic outlook.