No fairy, no cry

By Paul Krugman
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Republicans preached fiscal austerity when the economy needed stimulus, and have turned to fiscal profligacy now that it doesn't. If this surprises you, either you've been completely oblivious to the reality of the modern GOP for the past decade, or you're a reflexive centrist – which is pretty much the same thing.

But how bad a thing is this fiscal profligacy? It's not good – it means higher debt, which will in turn reduce the "fiscal space" for responding to the next crisis. It will also crowd out investment, hurting long-run growth. But I've been seeing some people suggesting that rising deficits are going to hurt the economy in the short run, perhaps even cause a recession. Will they?

Well, much as I'd like to believe this proposition for political reasons, it doesn't make sense. The same analysis that told us that austerity was a bad thing in the depths of the slump says that deficit spending now won't be contractionary. The cases aren't symmetric – this deficit will do much less good than austerity did harm. But still, we should be consistent.

Remember, the direct effect of fiscal policy is to change overall spending in the economy: a fiscal expansion means more spending, a fiscal contraction means less spending. When the economy is depressed, as it was for years after the financial crisis, the number of jobs is constrained by the overall level of spending. And because the Fed had limited influence – short-term interest rates, which the Fed controls, were already zero – fiscal contraction translated into major job loss.

True, advocates of austerity tried to claim otherwise; for a while, a lot of policymakers bought into the doctrine of "expansionary austerity," in which slashing government spending in a depressed economy would somehow lead to a big rise in private spending. But this doctrine, as I wrote at the time, depended on belief in the "confidence fairy" – belief that somehow consumers and investors would be so reassured by the government's willingness to inflict pain that the economy would surge.

But if we didn't believe that the confidence fairy would come to rescue us then, we shouldn't believe that it will desert us now. What the GOP has done is hugely irresponsible, but don't expect that to have much effect on private-sector spending.

But what about interest rates? Won't this ill-timed stimulus drive them up? Yes, a bit – but it's important to understand why.

As I said, the Fed sets short-term interest rates; and longer-term interest rates are mostly driven by expectations about future short rates, that is, by expectations about future Fed policy.

So why will the blowup in the deficit cause the Fed to raise rates? Precisely because it will tend to make the economy grow faster in the short run, raising the perceived risk of inflation, and the Fed will raise rates to head that risk off. You may think the Fed is over-worried on that front, but still, that's how it will work.

And what that means is that you shouldn't worry about higher interest rates causing a recession – rates will be going up only to the extent that the Fed believes this fiscal blowout will cause economic expansion.

Now, the Fed's role will limit the expansionary effects of the deficit. The Fed couldn't offset the effects of austerity policies in 2010-2013 by cutting rates, but it can and will offset the effects of unwarranted stimulus now by raising rates. But it will limit the magnitude of the expansionary effect, not turn it into contraction.

OK, there's one slight wild card here: if there was a bubble in asset prices, the prospect of Fed rate hikes could be the pinprick that bursts the bubble. But we don't know that, and even if it turns out to be the story, the bubble would have burst eventually regardless.

Bottom line: the G.O.P.'s fiscal behavior has been hypocritical, irresponsible, and reprehensible. But it won't cause a recession.