

Op-Ed Columnist

The Big Fail

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It's that time again: the annual meeting of the American Economic Association and affiliates, a sort of medieval fair that serves as a marketplace for bodies (newly minted Ph.D.'s in search of jobs), books and ideas. And this year, as in past meetings, there is one theme dominating discussion: the ongoing economic crisis.

This isn't how things were supposed to be. If you had polled the economists attending this meeting three years ago, most of them would surely have predicted that by now we'd be talking about how the great slump ended, not why it still continues.

So what went wrong? The answer, mainly, is the triumph of bad ideas.

It's tempting to argue that the economic failures of recent years prove that economists don't have the answers. But the truth is actually worse: in reality, standard economics offered good answers, but political leaders — and all too many economists — chose to forget or ignore what they should have known.

The story, at this point, is fairly straightforward. The financial crisis led, through several channels, to a sharp fall in private spending: residential investment plunged as the housing bubble burst; consumers began saving more as the illusory wealth created by the bubble vanished, while the mortgage debt remained. And this fall in private spending led, inevitably, to a global recession.

For an economy is not like a household. A family can decide to spend less and try to earn more. But in the economy as a whole, spending and earning go together: my spending is your income; your spending is my income. If everyone tries to slash spending at the same time, incomes will fall — and unemployment will soar.

So what can be done? A smaller financial shock, like the dot-com bust at the end of the 1990s, can be met by cutting interest rates. But the crisis of 2008 was far bigger, and even cutting rates all the way to zero wasn't nearly enough.

At that point governments needed to step in, spending to support their economies while the private sector regained its balance. And to some extent that did happen: revenue dropped sharply in the slump, but spending actually rose as programs like unemployment insurance expanded and temporary economic stimulus went into effect. Budget deficits rose, but this was actually a good thing, probably the most important reason we didn't have a full replay of the Great Depression.

But it all went wrong in 2010. The crisis in Greece was taken, wrongly, as a sign that all governments had better slash spending and deficits right away. Austerity became the order of the day, and supposed experts who should have known better cheered the process on, while the warnings of some (but not enough) economists that austerity would derail recovery were ignored. For example, the president of the European Central Bank confidently asserted that "the idea that austerity measures could trigger stagnation is incorrect."

Well, someone was incorrect, all right.

Of the papers presented at this meeting, probably the biggest flash came from one by Olivier Blanchard and Daniel Leigh of the International Monetary Fund. Formally, the paper represents the views only of the authors; but Mr. Blanchard, the I.M.F.'s chief economist, isn't an ordinary researcher, and the paper has been widely taken as a sign that the fund has had a major rethinking of economic policy.

For what the paper concludes is not just that austerity has a depressing effect on weak economies, but that the adverse effect is much stronger than previously believed. The premature turn to austerity, it turns out, was a terrible mistake.

I've seen some reporting describing the paper as an admission from the I.M.F. that it doesn't know what it's doing. That misses the point; the fund was actually less enthusiastic about austerity than other major players. To the extent that it says it was wrong, it's also saying that everyone else (except those skeptical economists) was even more wrong. And it deserves credit for being willing to rethink its position in the light of evidence.

The really bad news is how few other players are doing the same. European leaders, having created Depression-level suffering in debtor countries without restoring financial confidence, still insist that the answer is even more pain. The current British government, which killed a promising recovery by turning to austerity, completely refuses to consider the possibility that it made a mistake.

And here in America, Republicans insist that they'll use a confrontation over the debt ceiling — a deeply illegitimate action in itself — to demand spending cuts that would drive us back into recession.

The truth is that we've just experienced a colossal failure of economic policy — and far too many of those responsible for that failure both retain power and refuse to learn from experience.

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