The New York Times

December 29, 2011

Keynes Was Right

By PAUL KRUGMAN

"The boom, not the slump, is the right time for austerity at the Treasury." So declared John Maynard Keynes in 1937, even as F.D.R. was about to prove him right by trying to balance the budget too soon, sending the United States economy — which had been steadily recovering up to that point — into a severe recession. Slashing government spending in a depressed economy depresses the economy further; austerity should wait until a strong recovery is well under way.

Unfortunately, in late 2010 and early 2011, politicians and policy makers in much of the Western world believed that they knew better, that we should focus on deficits, not jobs, even though our economies had barely begun to recover from the slump that followed the financial crisis. And by acting on that anti-Keynesian belief, they ended up proving Keynes right all over again.

In declaring Keynesian economics vindicated I am, of course, at odds with conventional wisdom. In Washington, in particular, the failure of the Obama stimulus package to produce an employment boom is generally seen as having proved that government spending can't create jobs. But those of us who did the math realized, right from the beginning, that the Recovery and Reinvestment Act of 2009 (more than a third of which, by the way, took the relatively ineffective form of tax cuts) was much too small given the depth of the slump. And we also predicted the resulting political backlash.

So the real test of Keynesian economics hasn't come from the half-hearted efforts of the U.S. federal government to boost the economy, which were largely offset by cuts at the state and local levels. It has, instead, come from European nations like Greece and Ireland that had to impose savage fiscal austerity as a condition for receiving emergency loans — and have suffered Depression-level economic slumps, with real G.D.P. in both countries down by double digits.

This wasn't supposed to happen, according to the ideology that dominates much of our political discourse. In March 2011, the Republican staff of Congress's Joint Economic Committee released a report titled "Spend Less, Owe Less, Grow the Economy." It ridiculed concerns that cutting spending in a slump would worsen that slump, arguing that spending cuts would improve consumer and business confidence, and that this might well lead to faster, not slower, growth.

They should have known better even at the time: the alleged historical examples of "expansionary austerity" they used to make their case had already been thoroughly debunked. And there was also the embarrassing fact that many on the right had prematurely declared Ireland a success story, demonstrating the virtues of spending cuts, in mid-2010, only to see the Irish slump deepen and whatever confidence investors might have felt evaporate.

Amazingly, by the way, it happened all over again this year. There were widespread proclamations that Ireland had turned the corner, proving that austerity works — and then the numbers came in, and they were as dismal as before.

Yet the insistence on immediate spending cuts continued to dominate the political landscape, with malign effects on the U.S. economy. True, there weren't major new austerity measures at the federal level, but there was a lot of "passive" austerity as the Obama stimulus faded out and cash-strapped state and local governments continued to cut.

Now, you could argue that Greece and Ireland had no choice about imposing austerity, or, at any rate, no choices other than defaulting on their debts and leaving the euro. But another lesson of 2011 was that America did and does have a choice; Washington may be obsessed with the deficit, but financial markets are, if anything, signaling that we should borrow more.

Again, this wasn't supposed to happen. We entered 2011 amid dire warnings about a Greek-style debt crisis that would happen as soon as the Federal Reserve stopped buying bonds, or the rating agencies ended our triple-A status, or the superdupercommittee failed to reach a deal, or something. But the Fed ended its bond-purchase program in June; Standard & Poor's downgraded America in August; the supercommittee deadlocked in November; and U.S. borrowing costs just kept falling. In fact, at this point, inflation-protected U.S. bonds pay negative interest: investors are willing to pay America to hold their money.

The bottom line is that 2011 was a year in which our political elite obsessed over short-term deficits that aren't actually a problem and, in the process, made the real problem — a depressed economy and mass unemployment — worse.

The good news, such as it is, is that President Obama has finally gone back to fighting against premature austerity — and he seems to be winning the political battle. And one of these years we might actually end up taking Keynes's advice, which is every bit as valid now as it was 75 years ago.