The third depression

Paul Krugman

Recessions are common; depressions are rare. As far as I can tell, there were only two eras in economic history that were widely described as "depressions" at the time: the years of deflation and instability that followed the Panic of 1873 and the years of mass unemployment that followed the financial crisis of 1929-31.

Neither the Long Depression of the 19th century nor the Great Depression of the 20th was an era of nonstop decline — on the contrary, both included periods when the economy grew. But these episodes of improvement were never enough to undo the damage from the initial slump, and were followed by relapses.

We are now, I fear, in the early stages of a third depression. It will probably look more like the Long Depression than the much more severe Great Depression. But the cost — to the world economy and, above all, to the millions of lives blighted by the absence of jobs — will nonetheless be immense.

And this third depression will be primarily a failure of policy. Around the world — most recently at last weekend's deeply discouraging G-20 meeting — governments are obsessing about inflation when the real threat is deflation, preaching the need for belt-tightening when the real problem is inadequate spending.

In 2008 and 2009, it seemed as if we might have learned from history. Unlike their predecessors, who raised interest rates in the face of financial crisis, the current leaders of the Federal Reserve and the European Central Bank slashed rates and moved to support credit markets. Unlike governments of the past, which tried to balance budgets in the face of a plunging economy, today's governments allowed deficits to rise. And better policies helped the world avoid complete collapse: The recession brought on by the financial crisis arguably ended last summer.

But future historians will tell us that this wasn't the end of the third depression, just as the business upturn that began in 1933 wasn't the end of the Great Depression. After all, unemployment — especially long-term unemployment — remains at levels that would have been considered catastrophic not long ago, and shows no sign of coming down rapidly. And both the United States and Europe are well on their way toward Japan-style deflationary traps.

In the face of this grim picture, you might have expected policy makers to realize that they haven't yet done enough to promote recovery. But no: Over the last few months there has been a stunning resurgence of hard-money and balanced-budget orthodoxy.

As far as rhetoric is concerned, the revival of the old-time religion is most evident in Europe, where officials seem to be getting their talking points from the collected speeches of Herbert Hoover, up to and including the claim that raising taxes and cutting spending will actually expand the economy, by improving business confidence. As a practical matter, however, America isn't doing much better. The Fed seems aware of the deflationary risks — but what it proposes to do about these risks is, well, nothing. The Obama administration understands the dangers of premature fiscal austerity — but because Republicans and conservative Democrats in Congress won't authorize additional aid to state governments, that austerity is coming anyway, in the form of budget cuts at the state and local levels.

Why the wrong turn in policy? The hard-liners often invoke the troubles facing Greece and other nations around the edges of Europe to justify their actions. And it's true that bond investors have turned on governments with intractable deficits. But there is no evidence that short-run fiscal austerity in the face of a depressed economy reassures investors. On the contrary: Greece has agreed to harsh austerity, only to find its risk spreads growing ever wider; Ireland has imposed savage cuts in public spending, only to be treated by the markets as a worse risk than Spain, which has been far more reluctant to take the hard-liners' medicine.

There was the Long Depression, then the Great Depression, and now we are in the early stages of a third depression.

It's almost as if the financial markets understand what policy makers seemingly don't: that while long-term fiscal responsibility is important, slashing spending in the midst of a depression, which deepens that depression and paves the way for deflation, is actually self-defeating.

So I don't think this is really about Greece, or indeed about any realistic appreciation of the tradeoffs between deficits and jobs. It is, instead, the victory of an orthodoxy that has little to do with rational analysis, whose main tenet is that imposing suffering on other people is how you show leadership in tough times.

And who will pay the price for this triumph of orthodoxy? The answer is, tens of millions of unemployed workers, many of whom will go jobless for years, and some of whom will never work again.