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SPONSORED BY**January 5, 2009****OP-ED COLUMNIST**

Fighting Off Depression

By [PAUL KRUGMAN](#)

“If we don’t act swiftly and boldly,” declared President-elect Barack Obama in his latest weekly address, “we could see a much deeper economic downturn that could lead to double-digit unemployment.” If you ask me, he was understating the case.

The fact is that recent economic numbers have been terrifying, not just in the United States but around the world. Manufacturing, in particular, is plunging everywhere. Banks aren’t lending; businesses and consumers aren’t spending. Let’s not mince words: This looks an awful lot like the beginning of a second Great Depression.

So will we “act swiftly and boldly” enough to stop that from happening? We’ll soon find out.

We weren’t supposed to find ourselves in this situation. For many years most economists believed that preventing another Great Depression would be easy. In 2003, Robert Lucas of the University of Chicago, in his presidential address to the American Economic Association, declared that the “central problem of depression-prevention has been solved, for all practical purposes, and has in fact been solved for many decades.”

Milton Friedman, in particular, persuaded many economists that the Federal Reserve could have stopped the Depression in its tracks simply by providing banks with more liquidity, which would have prevented a sharp fall in the money supply. Ben Bernanke, the Federal Reserve chairman, famously apologized to Friedman on his institution’s behalf: “You’re right. We did it. We’re very sorry. But thanks to you, we won’t do it again.”

It turns out, however, that preventing depressions isn’t that easy after all. Under Mr. Bernanke’s leadership, the Fed has been supplying liquidity like an engine crew trying to put out a five-alarm fire, and the money supply has been rising rapidly. Yet credit remains scarce, and the economy is still in free fall.

Friedman’s claim that monetary policy could have prevented the Great Depression was an attempt to refute the analysis of John Maynard Keynes, who argued that monetary policy is ineffective under depression conditions and that fiscal policy — large-scale deficit spending by the government — is needed to fight mass unemployment. The failure of monetary policy in the current crisis shows that Keynes had it right the first time. And Keynesian thinking lies behind Mr. Obama’s plans to rescue the economy.

But these plans may turn out to be a hard sell.

News reports say that Democrats hope to pass an economic plan with broad bipartisan support. Good luck with that.

In reality, the political posturing has already started, with Republican leaders setting up roadblocks to stimulus legislation while posing as the champions of careful Congressional deliberation — which is pretty rich considering their party's behavior over the past eight years.

More broadly, after decades of declaring that government is the problem, not the solution, not to mention reviling both Keynesian economics and the New Deal, most Republicans aren't going to accept the need for a big-spending, F.D.R.-type solution to the economic crisis.

The biggest problem facing the Obama plan, however, is likely to be the demand of many politicians for proof that the benefits of the proposed public spending justify its costs — a burden of proof never imposed on proposals for tax cuts.

This is a problem with which Keynes was familiar: giving money away, he pointed out, tends to be met with fewer objections than plans for public investment “which, because they are not wholly wasteful, tend to be judged on strict ‘business’ principles.” What gets lost in such discussions is the key argument for economic stimulus — namely, that under current conditions, a surge in public spending would employ Americans who would otherwise be unemployed and money that would otherwise be sitting idle, and put both to work producing something useful.

All of this leaves me concerned about the prospects for the Obama plan. I'm sure that Congress will pass a stimulus plan, but I worry that the plan may be delayed and/or downsized. And Mr. Obama is right: We really do need swift, bold action.

Here's my nightmare scenario: It takes Congress months to pass a stimulus plan, and the legislation that actually emerges is too cautious. As a result, the economy plunges for most of 2009, and when the plan finally starts to kick in, it's only enough to slow the descent, not stop it. Meanwhile, deflation is setting in, while businesses and consumers start to base their spending plans on the expectation of a permanently depressed economy — well, you can see where this is going.

So this is our moment of truth. Will we in fact do what's necessary to prevent Great Depression II?

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