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The Bleeding Cure

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Doctors used to believe that by draining a patient's blood they could purge the evil "humors" that were thought to cause disease. In reality, of course, all their bloodletting did was make the patient weaker, and more likely to succumb.

Fortunately, physicians no longer believe that bleeding the sick will make them healthy. Unfortunately, many of the makers of economic policy still do. And economic bloodletting isn't just inflicting vast pain; it's starting to undermine our long-run growth prospects.

Some background: For the past year and a half, policy discourse in both Europe and the United States has been dominated by calls for fiscal austerity. By slashing spending and reducing deficits, we were told, nations could restore confidence and drive economic revival.

And the austerity has been real. In Europe, troubled nations like Greece and Ireland have imposed savage cuts, even as stronger nations have imposed milder austerity programs of their own. In the United States, the modest federal stimulus of 2009 has faded out, while state and local governments have slashed their budgets, so that over all we've had a de facto move toward austerity not so different from Europe's.

Strange to say, however, confidence hasn't surged. Somehow, businesses and consumers seem much more concerned about the lack of customers and jobs, respectively, than they are reassured by the fiscal righteousness of their governments. And growth seems to be stalling, while unemployment remains disastrously high on both sides of the Atlantic.

But, say apologists for the bad results so far, shouldn't we be focused on the long run rather than short-run pain? Actually, no: the economy needs real help now, not hypothetical payoffs a decade from now. In any case, evidence is starting to emerge that the economy's "short run" troubles — now in their fourth year, and being made worse by the focus on austerity — are taking a toll on its long-run prospects as well.

Consider, in particular, what is happening to America's manufacturing base. In normal times manufacturing capacity rises 2 or 3 percent every year. But faced with a persistently weak economy, industry has been reducing, not increasing, its productive capacity. At this point, according to Federal Reserve estimates, manufacturing capacity is almost 5 percent lower than it was in December 2007.

What this means is that if and when a real recovery finally gets going, the economy will run into capacity constraints and production bottlenecks much sooner than it should. That is, the weak economy, which is partly the result of budget-cutting, is hurting the future as well as the present.

Furthermore, the decline in manufacturing capacity is probably only the beginning of the bad news. Similar cuts in capacity will probably take place in the service sector — indeed, they may already be taking place. And with long-term unemployment at its highest level since the Great Depression, there is a real risk that many of the unemployed will come to be seen as unemployable.

Oh, and the brunt of those cuts in public spending is falling on education. Somehow, laying off hundreds of thousands of schoolteachers doesn't seem like a good way to win the future.

In fact, when you combine the growing evidence that fiscal austerity is reducing our future prospects with the very low interest rates on U.S. government debt, it's hard to avoid a startling conclusion: budget austerity may well be counterproductive even from a purely fiscal point of view, because lower future growth means lower tax receipts.

What should be happening? The answer is that we need a major push to get the economy moving, not at some future date, but right now. For the time being we need more, not less, government spending, supported by aggressively expansionary policies from the Federal Reserve and its counterparts abroad. And it's not just pointy-headed economists saying this; business leaders like Google's Eric Schmidt are saying the same thing, and the bond market, by buying U.S. debt at such low interest rates, is in effect pleading for a more expansionary policy.

And to be fair, some policy players seem to get it. President Obama's new jobs plan is a step in the right direction, while some board members of the Federal Reserve and the Bank of England — though not, sad to say, the European Central Bank — have been calling for much more growth-oriented policies.

What we really need, however, is to convince a substantial number of people with political power or influence that they've spent the last year and a half going in exactly the wrong direction, and that they need to make a U-turn.

It's not going to be easy. But until that U-turn happens, the bleeding — which is making our economy weaker now, and undermining its future at the same time — will continue.