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Euro Zone Death Trip

By PAUL KRUGMAN

Is it possible to be both terrified and bored? That's how I feel about the negotiations now under way over how to respond to Europe's economic crisis, and I suspect other observers share the sentiment.

On one side, Europe's situation is really, really scary: with countries that account for a third of the euro area's economy now under speculative attack, the single currency's very existence is being threatened — and a euro collapse could inflict vast damage on the world.

On the other side, European policy makers seem set to deliver more of the same. They'll probably find a way to provide more credit to countries in trouble, which may or may not stave off imminent disaster. But they don't seem at all ready to acknowledge a crucial fact — namely, that without more expansionary fiscal and monetary policies in Europe's stronger economies, all of their rescue attempts will fail.

The story so far: The introduction of the euro in 1999 led to a vast boom in lending to Europe's peripheral economies, because investors believed (wrongly) that the shared currency made Greek or Spanish debt just as safe as German debt. Contrary to what you often hear, this lending boom wasn't mostly financing profligate government spending — Spain and Ireland actually ran budget surpluses on the eve of the crisis, and had low levels of debt. Instead, the inflows of money mainly fueled huge booms in private spending, especially on housing.

But when the lending boom abruptly ended, the result was both an economic and a fiscal crisis. Savage recessions drove down tax receipts, pushing budgets deep into the red; meanwhile, the cost of bank bailouts led to a sudden increase in public debt. And one result was a collapse of investor confidence in the peripheral nations' bonds.

So now what? Europe's answer has been to demand harsh fiscal austerity, especially sharp cuts in public spending, from troubled debtors, meanwhile providing stopgap financing until private-investor confidence returns. Can this strategy work?

Not for Greece, which actually was fiscally profligate during the good years, and owes more than it can plausibly repay. Probably not for Ireland and Portugal, which for different reasons also have heavy debt burdens. But given a favorable external environment — specifically, a strong overall European economy with moderate inflation — Spain, which even now has relatively low debt, and Italy, which has a high level of debt but surprisingly small deficits, could possibly pull it off.

Unfortunately, European policy makers seem determined to deny those debtors the environment they need.

Think of it this way: private demand in the debtor countries has plunged with the end of the debt-financed boom. Meanwhile, public-sector spending is also being sharply reduced by austerity programs. So where are jobs and growth supposed to come from? The answer has to be exports, mainly to other European countries.

But exports can't boom if creditor countries are also implementing austerity policies, quite possibly pushing Europe as a whole back into recession.

Also, the debtor nations need to cut prices and costs relative to creditor countries like Germany, which wouldn't be too hard if Germany had 3 or 4 percent inflation, allowing the debtors to gain ground simply by having low or zero inflation. But the European Central Bank has a deflationary bias — it made a terrible mistake by raising interest rates in 2008 just as the financial crisis was gathering strength, and showed that it has learned nothing by repeating that mistake this year.

As a result, the market now expects very low inflation in Germany — around 1 percent over the next five years — which implies significant deflation in the debtor nations. This will both deepen their slumps and increase the real burden of their debts, more or less ensuring that all rescue efforts will fail.

And I see no sign at all that European policy elites are ready to rethink their hard-money-and-austerity dogma.

Part of the problem may be that those policy elites have a selective historical memory. They love to talk about the German inflation of the early 1920s — a story that, as it happens, has no bearing on our current situation. Yet they almost never talk about a much more relevant example: the policies of Heinrich Brüning, Germany's chancellor from 1930 to 1932, whose insistence on balancing budgets and preserving the gold standard made the Great Depression even worse in Germany than in the rest of Europe — setting the stage for you-know-what.

Now, I don't expect anything that bad to happen in 21st-century Europe. But there is a very wide gap between what the euro needs to survive and what European leaders are willing to do, or even talk about doing. And given that gap, it's hard to find reasons for optimism.