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The Hole in Europe's Bucket

By PAUL KRUGMAN

If it weren't so tragic, the current European crisis would be funny, in a gallows-humor sort of way. For as one rescue plan after another falls flat, Europe's Very Serious People — who are, if such a thing is possible, even more pompous and self-regarding than their American counterparts — just keep looking more and more ridiculous.

I'll get to the tragedy in a minute. First, let's talk about the pratfalls, which have lately had me humming the old children's song "There's a Hole in My Bucket."

For those not familiar with the song, it concerns a lazy farmer who complains about said hole and is told by his wife to fix it. Each action she suggests, however, turns out to require a prior action, and, eventually, she tells him to draw some water from the well. "But there's a hole in my bucket, dear Liza, dear Liza."

What does this have to do with Europe? Well, at this point, Greece, where the crisis began, is no more than a grim sideshow. The clear and present danger comes instead from a sort of bank run on Italy, the euro area's third-largest economy. Investors, fearing a possible default, are demanding high interest rates on Italian debt. And these high interest rates, by raising the burden of debt service, make default more likely.

It's a vicious circle, with fears of default threatening to become a self-fulfilling prophecy. To save the euro, this threat must be contained. But how? The answer has to involve creating a fund that can, if necessary, lend Italy (and Spain, which is also under threat) enough money that it doesn't need to borrow at those high rates. Such a fund probably wouldn't have to be used, since its mere existence should put an end to the cycle of fear. But the potential for really large-scale lending, certainly more than a trillion euros' worth, has to be there.

And here's the problem: All the various proposals for creating such a fund ultimately require backing from major European governments, whose promises to investors must be credible for the plan to work. Yet Italy is one of those major governments; it can't achieve a rescue by lending money to itself. And France, the euro area's second-biggest economy, has been looking shaky lately, raising fears that creation of a large rescue fund, by in effect adding to French debt, could simply have the effect of adding France to the list of crisis countries. There's a hole in the bucket, dear Liza, dear Liza.

You see what I mean about the situation being funny in a gallows-humor fashion? What makes the story really painful is the fact that none of this had to happen.

Think about countries like Britain, Japan and the United States, which have large debts and deficits yet remain able to borrow at low interest rates. What's their secret? The answer, in large part, is that they retain their own currencies, and investors know that in a pinch they could finance their deficits by printing more of those currencies. If the European Central Bank were to similarly stand behind European debts, the crisis would ease dramatically.

Wouldn't that cause inflation? Probably not: whatever the likes of Ron Paul may believe, money creation isn't inflationary in a depressed economy. Furthermore, Europe actually needs modestly higher overall inflation: too low an overall inflation rate would condemn southern Europe to years of grinding deflation, virtually guaranteeing both continued high unemployment and a string of defaults.

But such action, we keep being told, is off the table. The statutes under which the central bank was established supposedly prohibit this kind of thing, although one suspects that clever lawyers could find a way to make it happen. The broader problem, however, is that the whole euro system was designed to fight the last economic war. It's a Maginot Line built to prevent a replay of the 1970s, which is worse than useless when the real danger is a replay of the 1930s.

And this turn of events is, as I said, tragic.

The story of postwar Europe is deeply inspiring. Out of the ruins of war, Europeans built a system of peace and democracy, constructing along the way societies that, while imperfect — what society isn't? — are arguably the most decent in human history.

Yet that achievement is under threat because the European elite, in its arrogance, locked the Continent into a monetary system that recreated the rigidities of the gold standard, and — like the gold standard in the 1930s — has turned into a deadly trap.

Now maybe European leaders will come up with a truly credible rescue plan. I hope so, but I don't expect it.

The bitter truth is that it's looking more and more as if the euro system is doomed. And the even more bitter truth is that given the way that system has been performing, Europe might be better off if it collapses sooner rather than later.