Another bank bailout

By Paul Krugman
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Oh, wow — another bank bailout, this time in Spain. Who could have predicted that?

The answer, of course, is everybody. In fact, the whole story is starting to feel like a comedy routine: yet again the economy slides, unemployment soars, banks get into trouble, governments rush to the rescue — but somehow it's only the banks that get rescued, not the unemployed.

Just to be clear, Spanish banks did indeed need a bailout. Spain was clearly on the edge of a "doom loop" — a well-understood process in which concern about banks' solvency forces the banks to sell assets, which drives down the prices of those assets, which makes people even more worried about solvency. Governments can stop such doom loops with an infusion of cash; in this case, however, the Spanish government's own solvency is in question, so the cash had to come from a broader European fund.

So there's nothing necessarily wrong with this latest bailout (although a lot depends on the details). What's striking, however, is that even as European leaders were putting together this rescue, they were signaling strongly that they have no intention of changing the policies that have left almost a quarter of Spain's workers — and more than half its young people — jobless.

Most notably, last week the European Central Bank declined to cut interest rates. This decision was widely expected, but that shouldn't blind us to the fact that it was deeply bizarre. Unemployment in the euro area has soared, and all indications are that the Continent is entering a new recession. Meanwhile, inflation is slowing, and market expectations of future inflation have plunged. By any of the usual rules of monetary policy, the situation calls for aggressive rate cuts. But the central bank won't move.

And that doesn't even take into account the growing risk of a euro crackup. For years Spain and other troubled European nations have been told that they can only recover through a combination of fiscal austerity and "internal devaluation," which basically means cutting wages. It's now completely clear that this strategy can't work unless there is strong growth and, yes, a moderate amount of inflation in the European "core," mainly Germany — which supplies an extra reason to keep interest rates low and print lots of money. But the central bank won't move.

Meanwhile, senior officials are asserting that austerity and internal devaluation really would work if only people truly believed in their necessity.

Consider, for example, what Jörg Asmussen, the German representative on the European Central Bank's executive board, just said in Latvia, which has become the poster child for supposedly successful austerity. (It used to be Ireland, but the Irish economy keeps refusing to recover). "The key difference between, say, Latvia and Greece," Mr. Asmussen said, "lies in the degree of national ownership of the adjustment program — not only by national policy-makers but also by the population itself."

Call it the Darth Vader approach to economic policy; Mr. Asmussen is in effect telling the Greeks, "I find your lack of faith disturbing."

Oh, and that Latvian success consists of one year of pretty good growth following a Depression-level economic decline over the previous three years. True, 5.5 percent growth is a lot better than nothing. But it's worth noting that America's economy grew almost

twice that fast — 10.9 percent! — in 1934, as it rebounded from the worst of the Great Depression. Yet the Depression was far from over.

Put all of this together and you get a picture of a European policy elite always ready to spring into action to defend the banks, but otherwise completely unwilling to admit that its policies are failing the people the economy is supposed to serve.

Still, are we much better? America's near-term outlook isn't quite as dire as Europe's, but the Federal Reserve's own forecasts predict low inflation and very high unemployment for years to come — precisely the conditions under which the Fed should be leaping into action to boost the economy. But the Fed won't move.

What explains this trans-Atlantic paralysis in the face of an ongoing human and economic disaster? Politics is surely part of it — whatever they may say, Fed officials are clearly intimidated by warnings that any expansionary policy will be seen as coming to the rescue of President Obama. So, too, is a mentality that sees economic pain as somehow redeeming, a mentality that a British journalist once dubbed "sado-monetarism."

Whatever the deep roots of this paralysis, it's becoming increasingly clear that it will take utter catastrophe to get any real policy action that goes beyond bank bailouts. But don't despair: at the rate things are going, especially in Europe, utter catastrophe may be just around the corner.