Paul Krugman, May 10th , 2010, The New York Times

Shock and Uh?

OK, big plan from Europe. What will it do? What won't it do? Some initial thoughts, probably a bit heavy on jargon (I don't have the time to do a full translation into English.)

So, let's consider a generic cohesion country - call it Speece, or Grain. It had 7 fat years after the creation of the euro, experiencing large capital inflows and relatively high inflation. Now the bubble has burst, government revenue has collapsed, and pain looms.

What the country must do, regardless of how it's accomplished, is achieve relative deflation - reduce its costs and prices compared with Germany and France, regaining competitiveness. With German inflation low, this means an extended period of deflation, with high costs in employment and output. It also means fiscal difficulties, requiring spending cuts and tax increases that deepen the slump.

The immediate crisis risk is that of a self-fulfilling loss of confidence by bond investors, who fear default and therefore demand interest rates so high that they force default, even if the country is willing and able to endure a lot of pain. Hence the loan guarantees: by providing money at not-so-punitive rates, the idea is to buy time for adjustment.

By itself, however, this wasn't enough for Greece: people looked at the program, saw that it would probably lead to rising, not falling, debt as a percentage of GDP, and concluded that it wasn't any kind of solution. And the crisis rolled on, with contagion to Portugal and Spain.

Now comes yesterday's announcements. Announcement #1, from the EU ministers, basically offered a larger version of the failing Greek plan. This, by itself, wouldn't do much for Greece. Arguably, it might help Portugal and especially Spain, which are not in quite as bad shape and might (just possibly) be able and willing to endure years of deflation and fiscal austerity as long as they can avoid speculative attack. But that's kind of a marginal thing. When the first announcement came, my reaction was to say that the EU was making the classic mistake, treating a solvency problem as if it were a liquidity problem.

Announcement #2, from the ECB, changes things somewhat. It now seems that Trichet has been dragged kicking and screaming into becoming at least a semi-Bernanke, engaging in much more expansionary policies than before. (Yes, the ECB says that they're only liquidity operations, and will be sterilized, yada yada - we can only hope that they don't really mean it.)

A more expansionary monetary policy could make a real difference - especially if the ECB ends up accepting somewhat higher inflation. Suppose that Speece or Grain need to get relative prices down 15 percent over the next five years. If the eurozone has 1 percent inflation, that's 10 percent deflation in the periphery. If the eurozone has 3 percent inflation, all you need is stable prices. Also, a stronger overall eurozone economy means higher GDP and hence higher revenue, making the fiscal slog less grim.

So there's something substantive here; it's not just a matter of buying time during which nothing good will happen.

That said, I wonder about magnitudes. I'm sure that the ECB has no intention, even now, of letting inflation rise 200 basis points (even though it should welcome that development.) And Greece, still the epicenter of the crisis, doesn't gain much from the credit lines. So does a drop of more than 500 basis points in the yield on Greek 10-years make sense? I don't think so.

The good news here is that for the first time in this crisis, European policy makers have gotten ahead of the curve, acting more strongly than almost anyone expected. That's a shock, and it has awed the markets. But I still don't think it's nearly enough.