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When crisis strikes

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Not that long ago, European economists used to mock their American counterparts for having questioned the wisdom of Europe's march to monetary union. "On the whole," declared an article published just this past January, "the euro has, thus far, gone much better than many U.S. economists had predicted."

Oops. The article summarized the euro-skeptics' views as having been: "It can't happen, it's a bad idea, it won't last." Well, it did happen, but right now it seems to have been a bad idea for exactly the reasons the skeptics cited. And as for whether it will last — suddenly, that's looking like an open question.

To understand the euro-mess you need to see past the headlines. Right now everyone is focused on public debt, which can make it seem as if this is a simple story of governments that couldn't control their spending. But that's only part of the story for Greece, much less for Portugal, and not at all the story for Spain.

The fact is that three years ago none of the countries now in or near crisis seemed to be in deep fiscal trouble. Even Greece's 2007 budget deficit was no higher, as a share of G.D.P., than the deficits the United States ran in the mid-1980s, while Spain actually ran a surplus. And all of the countries were attracting large inflows of foreign capital, largely because markets believed that membership in the euro zone made Greek, Portuguese and Spanish bonds safe investments.

Then came the global financial crisis. Those inflows of capital dried up; revenues plunged and deficits soared; and membership in the euro, which had encouraged markets to love the crisis countries not wisely but too well, turned into a trap.

What's the nature of the trap? During the years of easy money, wages and prices in the crisis countries rose much faster than in the rest of Europe. Now that the money is no longer rolling in, those countries need to get costs back in line. But that's a much harder thing to do now than it was when each European nation had its own currency. Back then, costs could be brought in line by adjusting exchange rates — e.g., Greece could cut its wages relative to German wages simply by reducing the value of the drachma in terms of Deutsche marks. Now that Greece and Germany share the same currency, however, the only way to reduce Greek relative costs is through some combination of German inflation and Greek deflation. And since Germany won't accept inflation, deflation it is.

The problem is that deflation — falling wages and prices — is a deeply painful process. It invariably involves a prolonged slump with high unemployment. And it also aggravates debt problems, both public and private, because incomes fall while the debt burden doesn't.

Hence the crisis. Greece's fiscal woes would be serious but probably manageable if the Greek economy's prospects for the next few years looked moderately favorable. But they don't. Last week, when it downgraded Greek debt, Standard & Poor's suggested that the euro value of Greek G.D.P. may not return to its 2008 level until 2017, meaning that Greece has no hope of growing out of its troubles.

All this is exactly what the euro-skeptics feared. Giving up the ability to adjust exchange rates, they warned, would invite future crises. And it has.

So what will happen to the euro? Until recently, most analysts, myself included, considered a euro breakup basically impossible, since any government that even hinted that it was considering leaving the euro would be inviting a catastrophic run on its banks. But if the crisis countries are forced into default, they'll probably face severe bank runs anyway, forcing them into emergency measures like temporary restrictions on bank withdrawals. This would open the door to euro exit.

So is the euro itself in danger? In a word, yes. If European leaders don't start acting much more forcefully, providing Greece with enough help to avoid the worst, a chain reaction that starts with a Greek default and ends up wreaking much wider havoc looks all too possible.

Meanwhile, what are the lessons for the rest of us?

America's deficit hawks are already trying to appropriate the European crisis, presenting it as an object lesson in the evils of government red ink. What the crisis really demonstrates, however, is the dangers of putting yourself in a policy straitjacket. When they joined the euro, the governments of Greece, Portugal and Spain denied themselves the ability to do some bad things, like printing too much money; but they also denied themselves the ability to respond flexibly to events.

And when crisis strikes, governments need to be able to act. That's what the architects of the euro forgot — and the rest of us need to remember.