21/2/2010 Herald Tribune February 1

The making of a euromess

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Lately, financial news has been dominated by reports from Greece and other nations on the European periphery. And rightly so.

But I've been troubled by reporting that focuses almost exclusively on European debts and deficits, conveying the impression that it's all about government profligacy — and feeding into the narrative of America's deficit hawks, who want to slash spending even in the face of mass unemployment, and hold Greece up as an object lesson of what will happen if we Americans don't.

For the truth is that lack of fiscal discipline isn't the whole, or even the main, source of Europe's troubles — not even in Greece, whose government was indeed irresponsible (and hid its irresponsibility with creative accounting).

So, the real story behind the euromess lies not in the profligacy of politicians but in the arrogance of elites — specifically, the policy elites who pushed Europe into adopting a single currency well before the Continent was ready for such an experiment.

Consider the case of Spain, which on the eve of the crisis appeared to be a model fiscal citizen. Its debts were low — 43 percent of G.D.P. in 2007, compared with 66 percent in Germany. It was running budget surpluses. And it had exemplary bank regulation.

But with its warm weather and beaches, Spain was also the Florida of Europe — and like Florida, it experienced a huge housing boom. The financing for this boom came largely from outside the country: There were giant inflows of capital from the rest of Europe, Germany in particular.

The result was rapid growth combined with significant inflation: Between 2000 and 2008, the prices of goods and services produced in Spain rose by 35 percent, compared with a rise of only 10 percent in Germany. Thanks to rising costs, Spanish exports became increasingly uncompetitive, but job growth stayed strong thanks to the housing boom.

Then the bubble burst. Spanish unemployment soared, and the budget went into deep deficit. But the flood of red ink — which was caused partly by the way the slump depressed revenues and partly by emergency spending to limit the slump's human costs — was a result, not a cause, of Spain's problems.

> **Europe is in trouble because policy elites pushed the Continent into adopting a single currency before it was ready.**

And there's not much that Spain's government can do to make things better. The nation's core economic problem is that costs and prices have gotten out of line with those in the rest of Europe. If Spain still had its old currency, the peseta, it could remedy that problem quickly through devaluation — by, say, reducing the value of a peseta by 20 percent against other European currencies. But Spain no longer has its own money, which means that it can regain competitiveness only through a slow, grinding process of deflation.

Now, if Spain were an American state rather than a European country, things wouldn't be so bad. For one thing, costs and prices wouldn't have gotten so far out of line: Florida, which among other things was freely able to attract workers from other states and keep labor costs down, never experienced anything like Spain's relative inflation. For another, Spain would be receiving a lot of automatic support in the crisis: Florida's housing boom has gone bust, but Washington keeps sending the Social Security and Medicare checks.

But Spain isn't an American state, and as a result it's in deep trouble. Greece, of course, is in even deeper trouble, because the Greeks, unlike the Spaniards, actually were fiscally irresponsible. Greece, however, has a small economy, whose troubles matter mainly because they're spilling over to much bigger economies, like Spain's. So the inflexibility of the euro, not deficit spending, lies at the heart of the crisis.

None of this should come as a big surprise. Long before the euro came into being, economists warned that Europe wasn't ready for a single currency. But these warnings were ignored, and the crisis came.

Now what? A breakup of the euro is very nearly unthinkable, as a sheer matter of practicality. As Berkeley's Barry Eichengreen puts it, an attempt to reintroduce a national currency would trigger "the mother of all financial crises." So the only way out is forward: To make the euro work, Europe needs to move much further toward political union, so that European nations start to function more like American states.

But that's not going to happen anytime soon. What we'll probably see over the next few years is a painful process of muddling through: bailouts accompanied by demands for savage austerity, all against a background of very high unemployment, perpetuated by the grinding deflation I already mentioned.

It's an ugly picture. But it's important to understand the nature of Europe's fatal flaw. Yes, some governments were irresponsible; but the fundamental problem was hubris, the arrogant belief that Europe could make a single currency work despite strong reasons to believe that it wasn't ready.