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Euro gave a false sense of security

By Paul Krugman

Things are terrible here in Lisbon, Portugal, as unemployment soars past 13 percent. Things are even worse in Greece, Ireland and arguably in Spain, and Europe as a whole appears to be sliding back into recession.

Why has Europe become the sick man of the world economy? Everyone knows the answer.

Unfortunately, most of what people know isn't true-and false stories about European woes are warping our economic discourse.

Read an opinion piece about Europe-or, all too often, a supposedly factual news report-and you'll probably encounter one of two stories, which I think of as the GOP narrative and the German narrative. Neither story fits the facts.

The Republican story - it's one of the central themes of Mitt Romney's campaign - is that Europe is in trouble because it has done too much to help the poor and unlucky, that we're watching the death throes of the welfare state.

This story is, by the way, a perennial right-wing favorite: Back in 1991, when Sweden was suffering from a banking crisis brought on by deregulation (sound familiar?), the **Cato Institute** published a triumphant report on how this proved the failure of the whole welfare state model.

Did I mention that Sweden, which still has a generous welfare state, is a star performer, with economic growth faster than that of any other wealthy nation? But let's do this systematically. Look at the 15 European nations using the euro (leaving Malta and Cyprus aside), and rank them by the percentage of GDP they spent on social programs before the crisis. Do the troubled GIPSI nations (Greece, Ireland, Portugal, Spain, Italy) stand out for having unusually large welfare states? No, they don't; only Italy was in the top five, and even so its welfare state was smaller than Germany's.

So excessively large welfare states didn't cause the troubles.

Next up, the German story, which is that it's all about fiscal irresponsibility. This story seems to fit Greece, but nobody else. Italy ran deficits in the years before the crisis, but they were only slightly larger than Germany's (Italy's large debt is a legacy from irresponsible policies many years ago). Portugal's deficits were significantly smaller, while Spain and Ireland ran surpluses.

Oh, and countries that aren't on the euro seem able to run large deficits and carry large debts without facing any crises. Britain and the United States can borrow long-term at interest rates of around 2 percent; Japan, which is far more deeply in debt than any country in Europe, Greece included, pays only 1 percent.

In other words, the Hellenization of our economic discourse, in which we're all just a year or two of deficits from becoming another Greece, is completely off base.

So what does ail Europe? The truth is that the story is mostly monetary. By introducing a single currency without the institutions needed to make that currency work, Europe effectively reinvented the defects of the gold standard-defects that played a role in causing and perpetuating the Depression.

More specifically, the creation of the euro fostered a false sense of security among private investors, unleashing huge, unsustainable flows of capital into nations all around Europe's periphery. As a consequence of these inflows, costs and prices rose, manufacturing became uncompetitive, and nations that had roughly balanced trade in 1999 began running large trade deficits instead. Then the music stopped.

If the peripheral nations still had their currencies, they could and would use devaluation to restore competitiveness. But they don't, which means they are in for a long period of mass unemployment and slow, grinding deflation. Their crises are mainly a byproduct of this sad prospect, because depressed economies lead to budget deficits and deflation magnifies the burden of debt.

Now, understanding the nature of Europe's troubles offers only limited benefits to the Europeans themselves.

The afflicted nations, in particular, have nothing but bad choices: Either they suffer the pains of deflation or they take the drastic step of leaving the euro, which won't be politically feasible until or unless all else fails (a point Greece seems to be approaching). Germany could help by reversing its own austerity policies and accepting higher inflation, but it won't.

For the rest of us, however, getting Europe right makes a huge difference, because false stories about Europe are being used to push policies that would be cruel, destructive or both. The next time you hear people invoking the European example to demand that we destroy our social safety net or slash spending in the face of a deeply depressed economy, here's what you need to know: They have no idea what they're talking about.