
November 28, 2010

The Spanish Prisoner

By PAUL KRUGMAN

The best thing about the Irish right now is that there are so few of them. By itself, Ireland can’t do all that much damage to Europe’s prospects. The same can be said of Greece and of Portugal, which is widely regarded as the next potential domino.

But then there’s Spain. The others are tapas; Spain is the main course.

What’s striking about Spain, from an American perspective, is how much its economic story resembles our own. Like America, Spain experienced a huge property bubble, accompanied by a huge rise in private-sector debt. Like America, Spain fell into recession when that bubble burst, and has experienced a surge in unemployment. And like America, Spain has seen its budget deficit balloon thanks to plunging revenues and recession-related costs.

But unlike America, Spain is on the edge of a debt crisis. The U.S. government is having no trouble financing its deficit, with interest rates on long-term federal debt under 3 percent. Spain, by contrast, has seen its borrowing cost shoot up in recent weeks, reflecting growing fears of a possible future default.

Why is Spain in so much trouble? In a word, it’s the euro.

Spain was among the most enthusiastic adopters of the euro back in 1999, when the currency was introduced. And for a while things seemed to go swimmingly: European funds poured into Spain, powering private-sector spending, and the Spanish economy experienced rapid growth.

Through the good years, by the way, the Spanish government appeared to be a model of both fiscal and financial responsibility: unlike Greece, it ran budget surpluses, and unlike Ireland, it tried hard (though with only partial success) to regulate its banks. At the end of 2007 Spain's public debt, as a share of the economy, was only about half as high as Germany's, and even now its banks are in nowhere near as bad shape as Ireland's.

But problems were developing under the surface. During the boom, prices and wages rose more rapidly in Spain than in the rest of Europe, helping to feed a large trade deficit. And when the bubble burst, Spanish industry was left with costs that made it uncompetitive with other nations.

Now what? If Spain still had its own currency, like the United States — or like Britain, which shares some of the same characteristics — it could have let that currency fall, making its industry competitive again. But with Spain on the euro, that option isn't available. Instead, Spain must achieve "internal devaluation": it must cut wages and prices until its costs are back in line with its neighbors.

And internal devaluation is an ugly affair. For one thing, it's slow: it normally take years of high unemployment to push wages down. Beyond that, falling wages mean falling incomes, while debt stays the same. So internal devaluation worsens the private sector's debt problems.

What all this means for Spain is very poor economic prospects over the next few years. America's recovery has been disappointing, especially in terms of jobs — but at least we've seen some growth, with real G.D.P. more or less back to its pre-crisis peak, and we can reasonably expect future growth to help bring our deficit under control. Spain, on the other hand, hasn't recovered at all. And the lack of recovery translates into fears about Spain's fiscal future.

Should Spain try to break out of this trap by leaving the euro, and re-establishing its own currency?

Will it? The answer to both questions is, probably not. Spain would be better off now if it had never adopted the euro — but trying to leave would create a huge banking crisis, as depositors raced to move their money elsewhere. Unless there's a catastrophic bank crisis anyway — which seems plausible for Greece and increasingly possible in Ireland, but unlikely though not impossible for Spain — it's hard to see any Spanish government taking the risk of "de-euroizing."

So Spain is in effect a prisoner of the euro, leaving it with no good options.

The good news about America is that we aren't in that kind of trap: we still have our own currency, with all the flexibility that implies. By the way, so does Britain, whose deficits and debt are comparable to Spain's, but which investors don't see as a default risk.

The bad news about America is that a powerful political faction is trying to shackle the Federal Reserve, in effect removing the one big advantage we have over the suffering Spaniards. Republican attacks on the Fed — demands that it stop trying to promote economic recovery and focus instead on keeping the dollar strong and fighting the imaginary risks of inflation — amount to a demand that we voluntarily put ourselves in the Spanish prison.

Let's hope that the Fed doesn't listen. Things in America are bad, but they could be much worse. And if the hard-money faction gets its way, they will be.