Paroling the Spanish prisoner

By Paul Krugman
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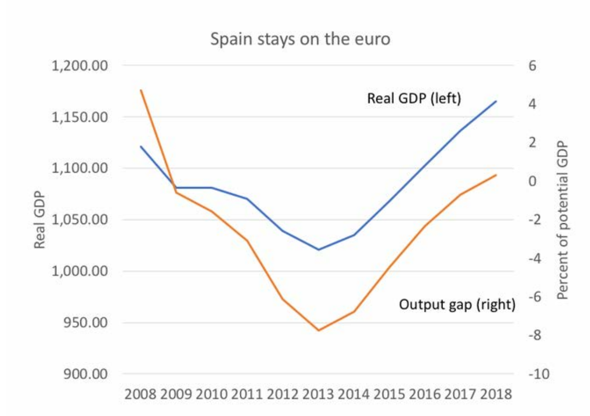
Yesterday I was the keynote speaker – actually keynote have-a-chat-with-Anil Kashyap – at the U.S. Monetary Policy Forum – which was both interesting, I thought, and something of an emotional vacation. What I mean by that was that I got to have an extended policy discussion without once mentioning the name T****.

Anyway, one of the issues that came up was the recovery in Europe, which is real and in some ways a bigger story for the world economy than the continuation of the Obama expansion here. An obvious question, which Anil raised, was whether this recovery calls for a reconsideration by Euroskeptics like myself. And my answer is no and yes: No, the economics of the euro look about as bad as we expected. Yes, we underestimated the political cohesion of the single currency, the willingness of political elites to suffer enormous economic pain in order to stay in the monetary union.

I think I can illustrate all of these points with the case of Spain, which is in some ways at the heart of the euro story. During the good years money poured into Spain, fueling a huge housing bubble. This fed inflation that made Spanish industry uncompetitive, leading to a huge trade deficit. When the music stopped, Spain saw unemployment soar; it then went into a painful process of "internal devaluation," slowly squeezing down unit labor costs while costs in northern Europe gradually rose. And eventually this worked: Spain resumed fairly rapid growth, boosted by surging exports of autos and other manufactured goods.

So does this story vindicate the euro? Hardly. Here's a chart, using data from the IMF's World Economic Outlook database. The blue line shows Spain's real G.D.P. (left scale). As you can see, there was a terrible slump from 2008 to 2013, but since then Spain has been growing strongly. In the long run, then, the Spanish economy is not dead.



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But the cost along the way was immense. The red line shows the IMF's estimate of Spain's "output gap" – the difference, in percentage points, between what it could have been producing consistent with stable inflation and what it actually produced. My guess is that this output gap is understated: the methods organizations like the IMF use to estimate potential G.D.P. tend to interpret any sustained slump as a decline in potential, even if it's really just the result of inadequate demand. (This was, by the way, a point I made at some length in my 1998 Brookings Paper on the liquidity trap – see pp. 168 and following.)

But even if we take the IMF estimate at face value, it says that over the period 2008-2018 Spain suffered an enormous cumulative loss of output it could have produced: 33 percent of potential G.D.P. That's as if the U.S. were forced to pay a price of more than $6 trillion to, say, remain on the gold standard. Not all of this loss can be attributed to the necessity of achieving competitiveness through relative deflation rather than simply devaluing, but surely much of it can.

So the economics of the euro have been as bad as critics warned they would. Spain in effect spent years as the economic prisoner of the single currency, and the fact that it eventually received parole doesn't change that fact. Remarkably, however, Spain stayed the course, paid the price, and is now more or less back to where it needs to be. So the politics of the euro have been far more robust than us Anglo-Americans could have imagined.