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Erin Go Broke

By PAUL KRUGMAN

“What,” asked my interlocutor, “is the worst-case outlook for the world economy?” It wasn’t until the next day that I came up with the right answer: America could turn Irish.

What’s so bad about that? Well, the Irish government now predicts that this year G.D.P. will fall more than 10 percent from its peak, crossing the line that is sometimes used to distinguish between a recession and a depression.

But there’s more to it than that: to satisfy nervous lenders, Ireland is being forced to raise taxes and slash government spending in the face of an economic slump — policies that will further deepen the slump.

And it’s that closing off of policy options that I’m afraid might happen to the rest of us. The slogan “Erin go bragh,” usually translated as “Ireland forever,” is traditionally used as a declaration of Irish identity. But it could also, I fear, be read as a prediction for the world economy.

How did Ireland get into its current bind? By being just like us, only more so. Like its near-namesake Iceland, Ireland jumped with both feet into the brave new world of unsupervised global markets. Last year the Heritage Foundation declared Ireland the third freest economy in the world, behind only Hong Kong and Singapore.

One part of the Irish economy that became especially free was the banking sector, which used its freedom to finance a monstrous housing bubble. Ireland became in effect a cool, snake-free version of coastal Florida.

Then the bubble burst. The collapse of construction sent the economy into a tailspin, while plunging home prices left many people owing more than their houses were worth. The result, as in the United States, has been a rising tide of defaults and heavy losses for the banks.

And the troubles of the banks are largely responsible for putting the Irish government in a policy straitjacket.

On the eve of the crisis Ireland seemed to be in good shape, fiscally speaking, with a balanced budget and a low level of public debt. But the government’s revenue — which had become strongly dependent on the housing boom — collapsed along with the bubble.

Even more important, the Irish government found itself having to take responsibility for the mistakes of private bankers. Last September Ireland moved to shore up confidence in its banks by offering a government guarantee on their liabilities — thereby putting taxpayers on the hook for potential losses of more than twice the country's G.D.P., equivalent to $30 trillion for the United States.

The combination of deficits and exposure to bank losses raised doubts about Ireland's long-run solvency, reflected in a rising risk premium on Irish debt and warnings about possible downgrades from ratings agencies.

Hence the harsh new policies. Earlier this month the Irish government simultaneously announced a plan to purchase many of the banks' bad assets — putting taxpayers even further on the hook — while raising taxes and cutting spending, to reassure lenders.

Is Ireland's government doing the right thing? As I read the debate among Irish experts, there's widespread criticism of the bank plan, with many of the country's leading economists calling for temporary nationalization instead. (Ireland has already nationalized one major bank.) The arguments of these Irish economists are very similar to those of a number of American economists, myself included, about how to deal with our own banking mess.

But there isn't much disagreement about the need for fiscal austerity. As far as responding to the recession goes, Ireland appears to be really, truly without options, other than to hope for an export-led recovery if and when the rest of the world bounces back.

So what does all this say about those of us who aren't Irish?

For now, the United States isn't confined by an Irish-type fiscal straitjacket: the financial markets still consider U.S. government debt safer than anything else.

But we can't assume that this will always be true. Unfortunately, we didn't save for a rainy day: thanks to tax cuts and the war in Iraq, America came out of the "Bush boom" with a higher ratio of government debt to G.D.P. than it had going in. And if we push that ratio another 30 or 40 points higher — not out of the question if economic policy is mishandled over the next few years — we might start facing our own problems with the bond market.

Not to put too fine a point on it, that's one reason I'm so concerned about the Obama administration's bank plan. If, as some of us fear, taxpayer funds end up providing windfalls to financial operators instead of fixing what needs to be fixed, we might not have the money to go back and do it right.

And the lesson of Ireland is that you really, really don't want to put yourself in a position where you have to punish your economy in order to save your banks.