THE FATAL FLAW IN THE DESIGN OF THE EURO

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The Eurozone Crisis

- The financial crisis was driven by an out-of-control financial sector and excess private debt has morphed into an alleged sovereign debt crisis.
  - Some countries currently called irresponsible were the role models of fiscal discipline.
    - Ireland and Spain

- Real problem: excessive private sector debt; lax lending by banks
- Real problem: EMU was designed to fail as nongovt deficits (external & internal) create budget deficits
Deficits not “out of control” before crisis

General Government Deficit 1995-2010

Source: ECB
Debt ratios not rising before crisis

**Government Debt % of GDP 1995-2010**

- Germany
- Greece (GR)
- France
- Spain
- Ireland
- Portugal

Source: ECB
Net debt as % of GDP

Note: Government figures are I.M.F. calculations of net debt of general governments, after subtracting monetary assets held by governments.

Sources: International Monetary Fund; European Central Bank (via Rebecca Wilder)
Modern Money Theory

- Govt-issued sovereign currency
- Floating exchange rate → policy space
- Govt spends by crediting reserves; taxes by debiting reserves
- CB sets overnight rate target
  - CB adds/drains reserves as needed to hit target
- Sovereign Govt cannot run out of its own money; finance never scarce
- The real constraint is full employment
Chairman Bernanke: Keystrokes

- As Chairman Bernanke explained on 60 Minutes in 2009:
  - (PELLEY): Is that tax money that the Fed is spending?
  - (BERNANKE): It’s not tax money. We simply use the computer to mark up the size of the account.
"As the sole manufacturer of dollars, whose debt is denominated in dollars, the U.S. government can never become insolvent, i.e., unable to pay its bills. In this sense, the government is not dependent on credit markets to remain operational. Moreover, there will always be a market for U.S. government debt at home because the U.S. government has the only means of creating risk-free dollar-denominated assets."

Sovereign government can NEVER run out of Dollars; It can NEVER be forced to default; It can NEVER be forced to miss a payment; It is NEVER subject to whims of “bond vigilantes”.
Accounting for Govt Deficit

- Govt purchases goods and services and makes transfers by crediting accts
- Nongovt pays taxes leading to debit of accts
- G>T → Govt Deficit → Nongovt Surplus
- Surplus = accumulation of claims on Govt, or Net Financial Saving
- Govt debt = Nongovt net financial wealth
He understood that **Private** sector could only net save if these sectors (on balance) spent more than their income.
“Without an expansionary fiscal policy, real output cannot grow for long.”

~ Wynne Godley, 2000
The Private Sector Cannot Create Its Own *Net* Financial Assets

- Assets and liabilities cancel each other out
  - Loans create deposits
- Net financial assets must come from *outside* the domestic private sector

- Private Sector Surplus = Public Sector Deficit + Current Account Surplus
  - \((S - I)\) = \((G - T)\) + \((X - M)\)
What if the CA is *Not* in Surplus?

- Can the private sector still achieve a surplus?

- Yes, but only if the government deficit is **bigger** than the current account deficit

  EX: \(1\% = 4\% - 3\%\)

- This means that countries with current account deficits **must** run even bigger budget deficits (as % of GDP) in order to keep the private sector in surplus
## Within EZ Current Account Balances

### CA Deficit (2012Q1, Millions of €)

<table>
<thead>
<tr>
<th>Country</th>
<th>Deficit (Millions of €)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>-1,422</td>
</tr>
<tr>
<td>Estonia</td>
<td>-86</td>
</tr>
<tr>
<td>Ireland</td>
<td>-1,045</td>
</tr>
<tr>
<td>Greece</td>
<td>-4,721</td>
</tr>
<tr>
<td>Spain</td>
<td>-14,444</td>
</tr>
<tr>
<td>France</td>
<td>-9,626</td>
</tr>
<tr>
<td>Italy</td>
<td>-13,067</td>
</tr>
<tr>
<td>Cyprus</td>
<td>-718</td>
</tr>
<tr>
<td>Malta</td>
<td>-54</td>
</tr>
<tr>
<td>Portugal</td>
<td>-1,264</td>
</tr>
<tr>
<td>Slovenia</td>
<td>-77</td>
</tr>
<tr>
<td>Finland</td>
<td>-1,191</td>
</tr>
<tr>
<td><strong>AVERAGE</strong></td>
<td><strong>-3,976</strong></td>
</tr>
</tbody>
</table>

### CA Surplus (2012Q1, Millions of €)

<table>
<thead>
<tr>
<th>Country</th>
<th>Surplus (Millions of €)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>+41,068</td>
</tr>
<tr>
<td>Netherlands</td>
<td>+17,454</td>
</tr>
<tr>
<td>Austria</td>
<td>+3,210</td>
</tr>
<tr>
<td>Slovakia</td>
<td>+648</td>
</tr>
<tr>
<td><strong>AVERAGE</strong></td>
<td><strong>+12,659</strong></td>
</tr>
</tbody>
</table>
Current Account 2000

Portugal, Italy, Ireland, Greece, Spain, Germany, France

Percent of GDP

Portugal: -12.0%
Italy: -10.0%
Ireland: -8.0%
Greece: -6.0%
Spain: -4.0%
Germany: 2.0%
France: 4.0%
Current Account 2003

Percent of GDP

Portugal: -7.0%
Italy: -6.0%
Ireland: -5.0%
Greece: -4.0%
Spain: -3.0%
Germany: 2.0%
France: 1.0%
Current Account 2006

Portugal, Italy, Ireland, Greece, Spain, Germany, France

Percent of GDP

Portugal: -14.0%
Italy: -12.0%
Ireland: -10.0%
Greece: -8.0%
Spain: -6.0%
Germany: 6.0%
France: 0.0%

Percent of GDP
Current Account 2008

Percent of GDP

Portugal Italy Ireland Greece Spain Germany France

-20.0% -15.0% -10.0% -5.0% 0.0% 5.0% 10.0%
Current Account 2010

Percent of GDP

Portugal
Italy
Ireland
Greece
Spain
Germany
France

-12.0%
-10.0%
-8.0%
-6.0%
-4.0%
-2.0%
0.0%
2.0%
4.0%
6.0%
8.0%
Current Account 2011

Who won?
What Happened in Greece?
“[T]he power to issue its own money, to make drafts on its own central bank, is the main thing which defines national independence. If a country gives up or loses this power, it acquires the status of a local authority or colony.”

~Wynne Godley, 1992
Thanks to Stephanie Kelton for providing some of the slides.