THE FATAL FLAW IN THE DESIGN OF THE EURO

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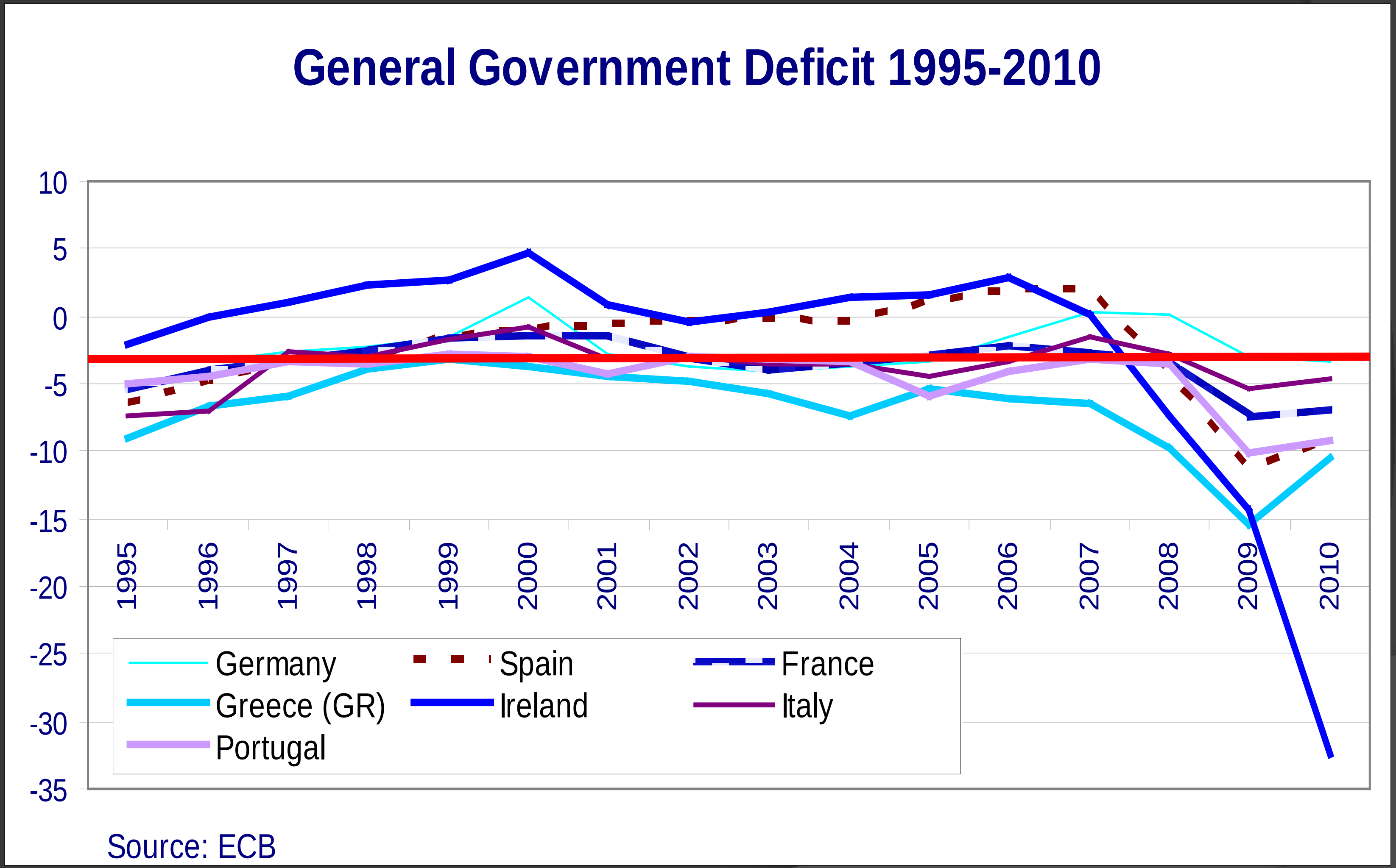
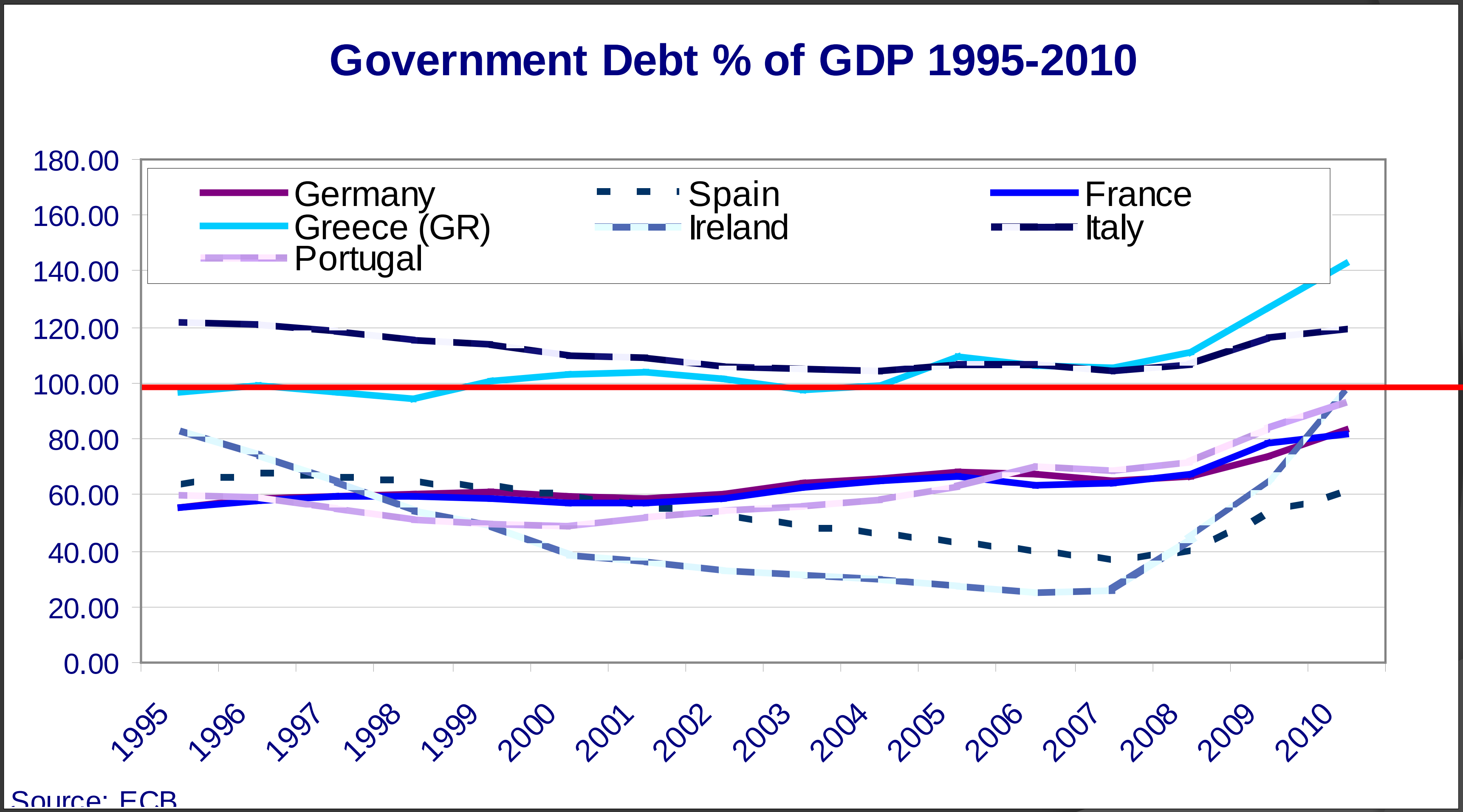
The Eurozone Crisis

- 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

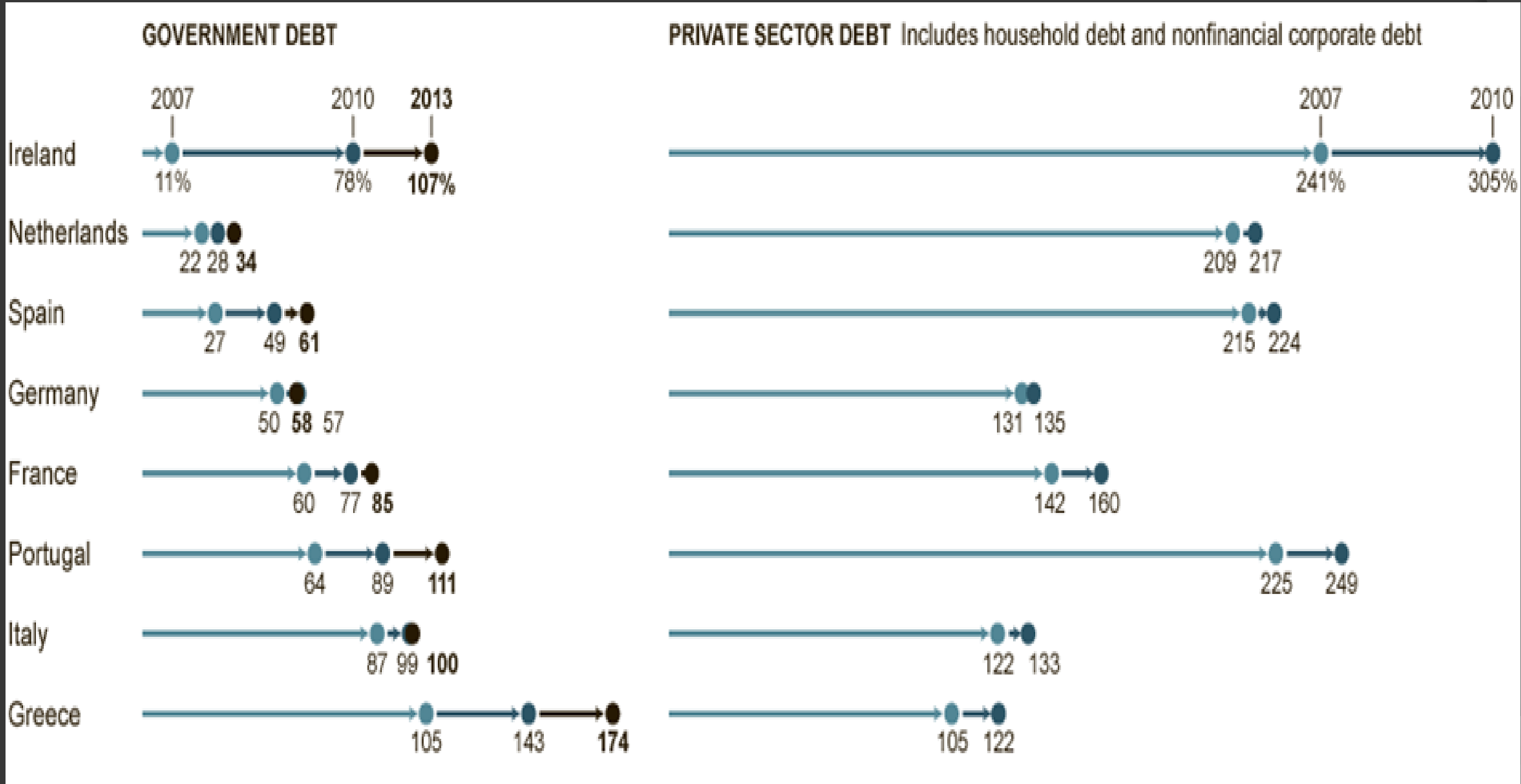
Deficits not “out of control” before crisis



Debt ratios not rising before crisis



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.

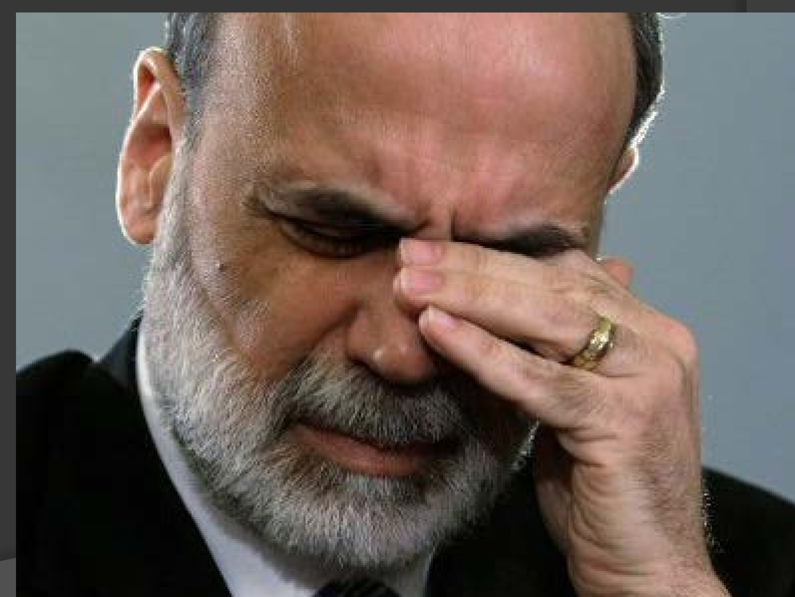
Sources: International Monetary Fund; European Central Bank (via Rebecca Wilder)

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. [W]e simply use the computer to mark up the size of the account.



St. Louis Fed

"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."

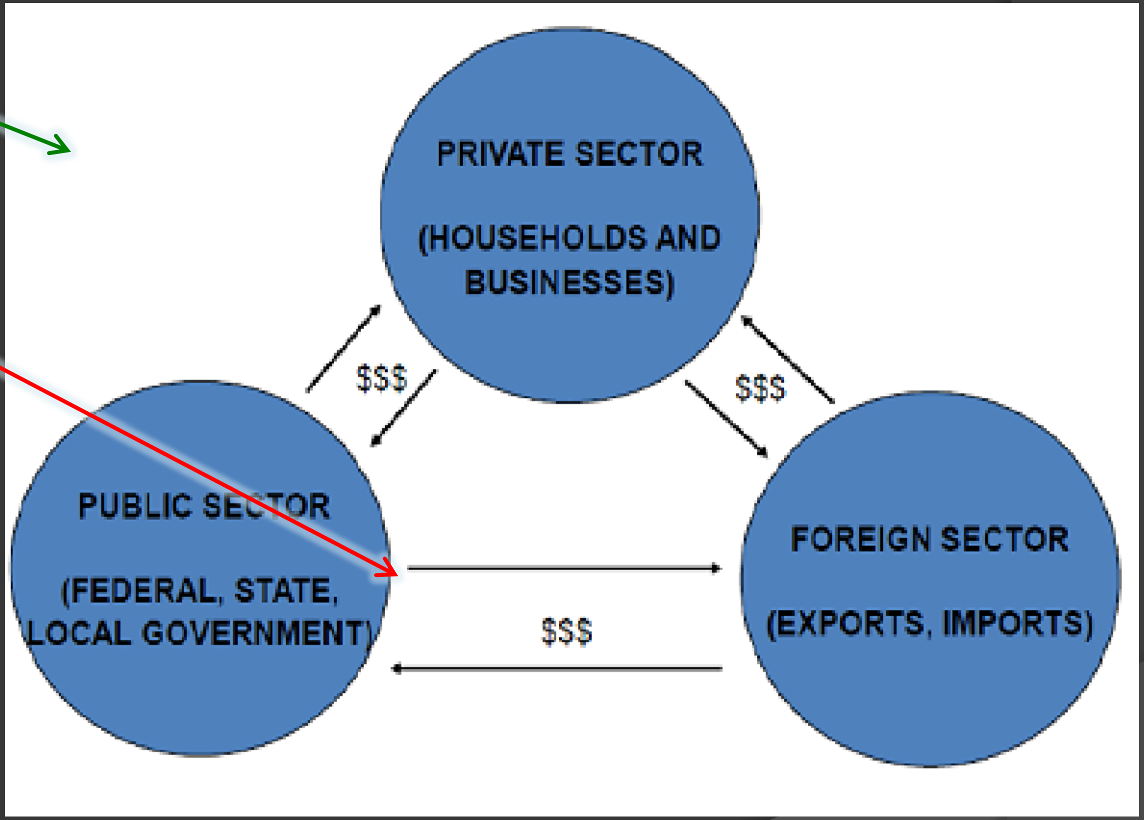
Sovereign government can NEVER run out of Dollars; It can NEVER be forced to default; It can NEVER be forced to miss a payment; It is NEVER subject to whims of "bond vigilantes".

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

Godley's 3 Sector Balance

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 = Public Sector + Current Account

Private Sector	=	Public Sector	+	Current Account
Surplus		**Deficit**		**Surplus**
(S – I)		(G – T)		(X – M)

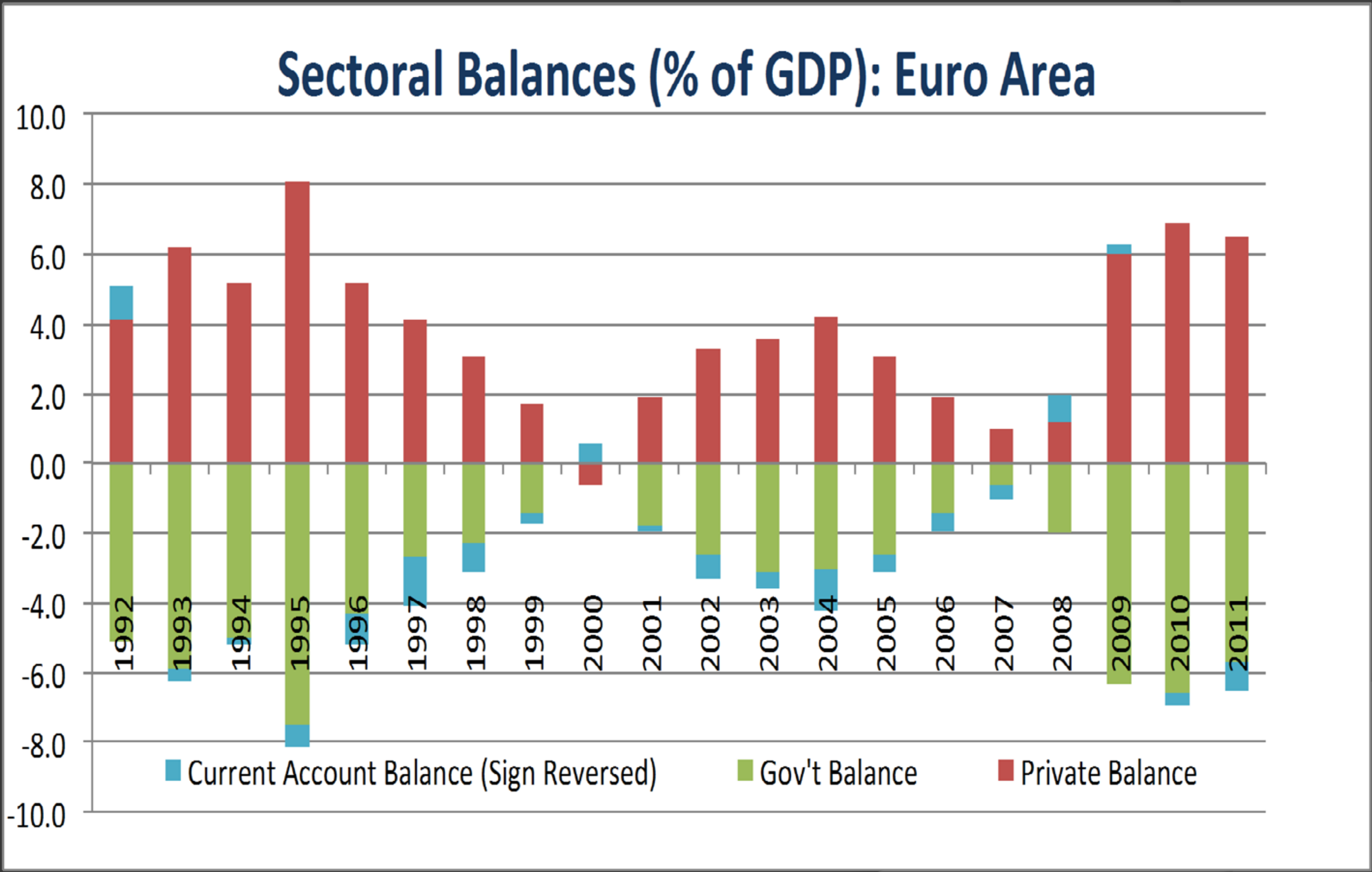
What if the CA is *Not* in Surplus?

- 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 <u>must</u> run even bigger budget deficits (as % of GDP) in order to keep the private sector in surplus


Sectoral Balances (% of GDP): Euro Area
10.0
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
-6.0
-8.0
-10.0
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Current Account Balance (Sign Reversed)
Gov't Balance
Private Balance

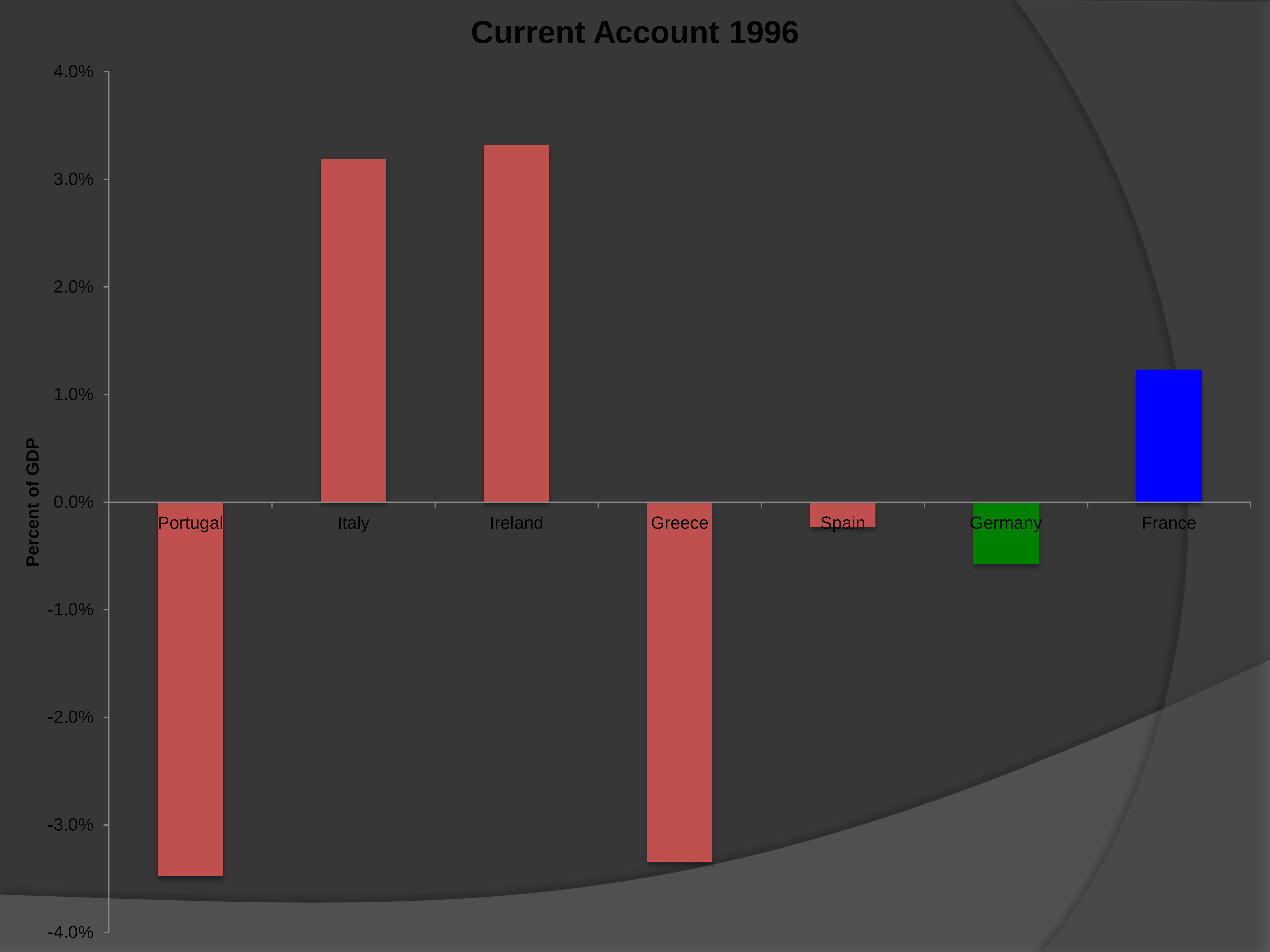
Within EZ Current Account Balances

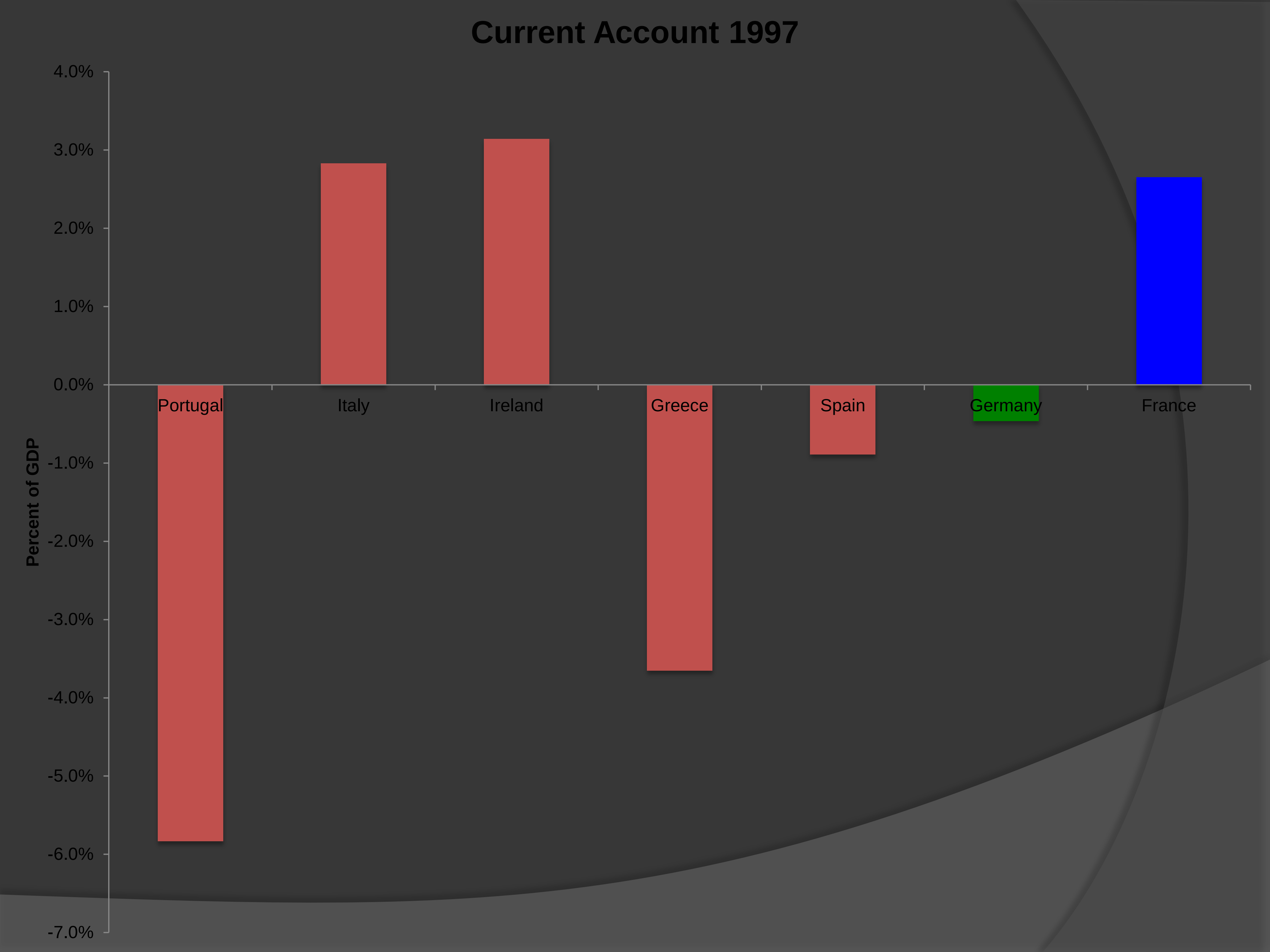
CA Deficit (2012Q1, Millions of €)

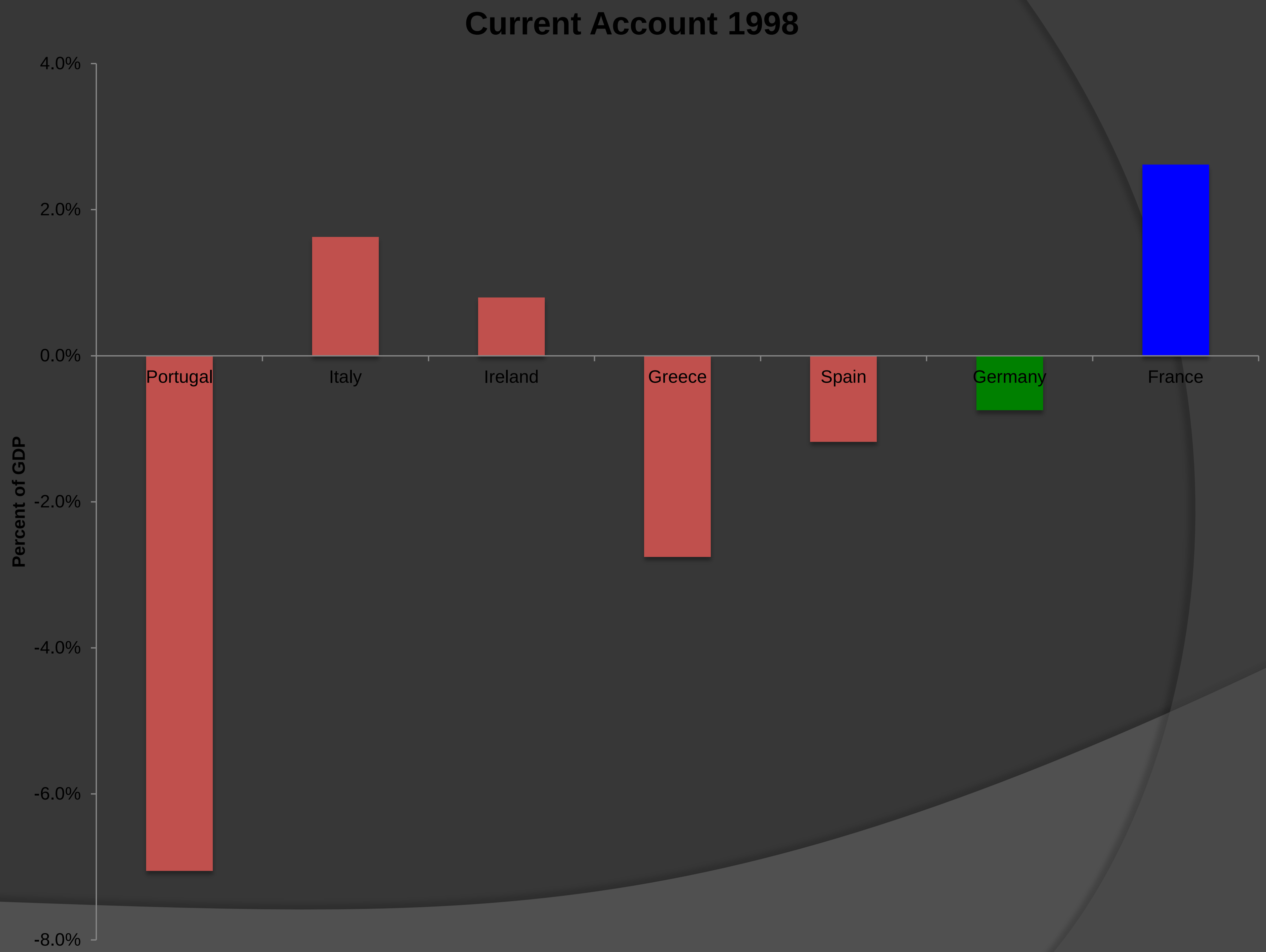
Belgium	-1,422
Estonia	-86
Ireland	-1,045
Greece	-4,721
Spain	-14,444
France	-9,626
Italy	-13,067
Cyprus	-718
Malta	-54
Portugal	-1,264
Slovenia	-77
Finland	-1,191
AVERAGE	**-3,976**

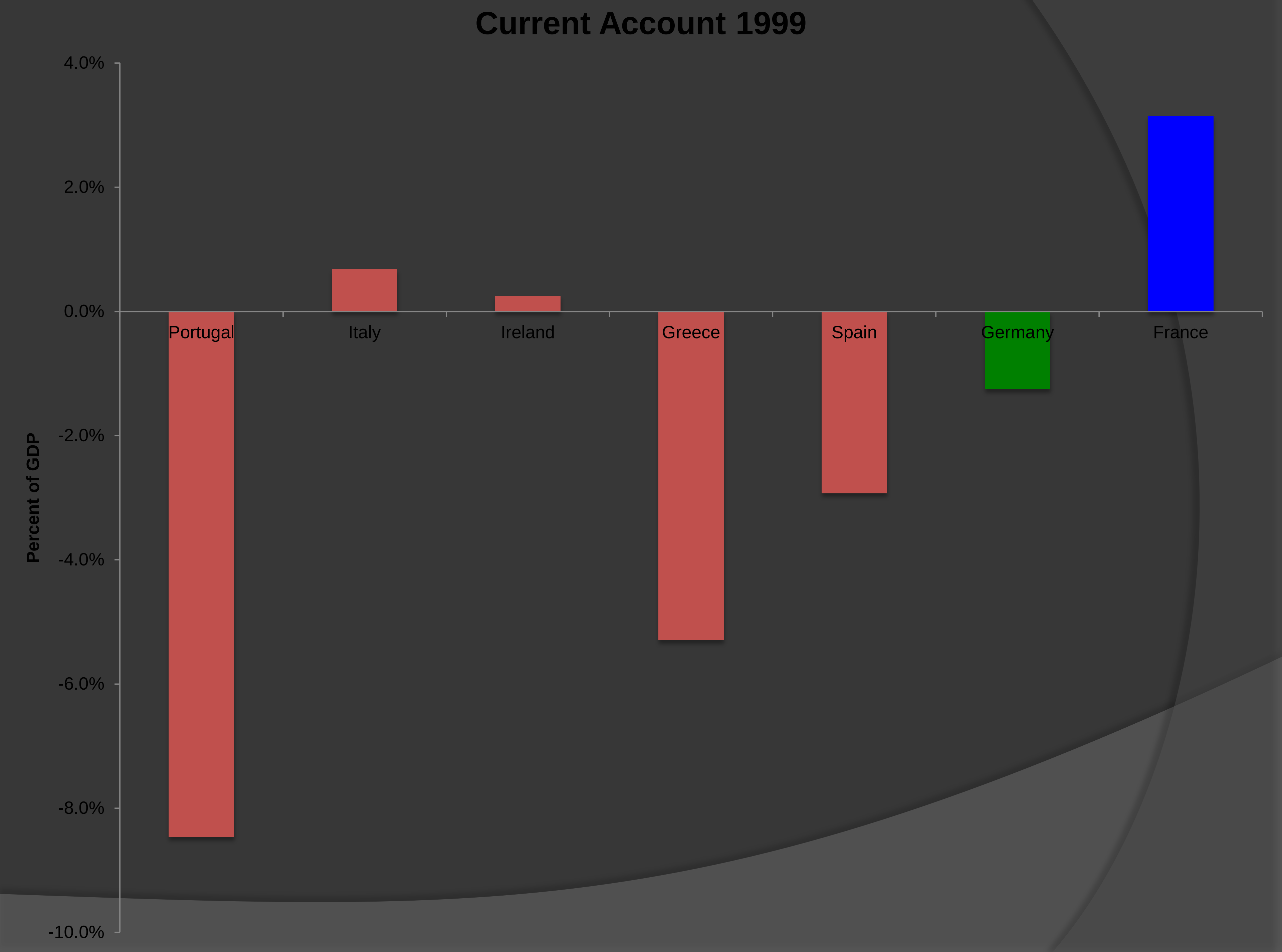
CA Surplus (2012Q1, Millions of €)

Germany	+41,068
Netherlands	+17,454
Austria	+3,210
Slovakia	+648
AVERAGE	**+12,659**

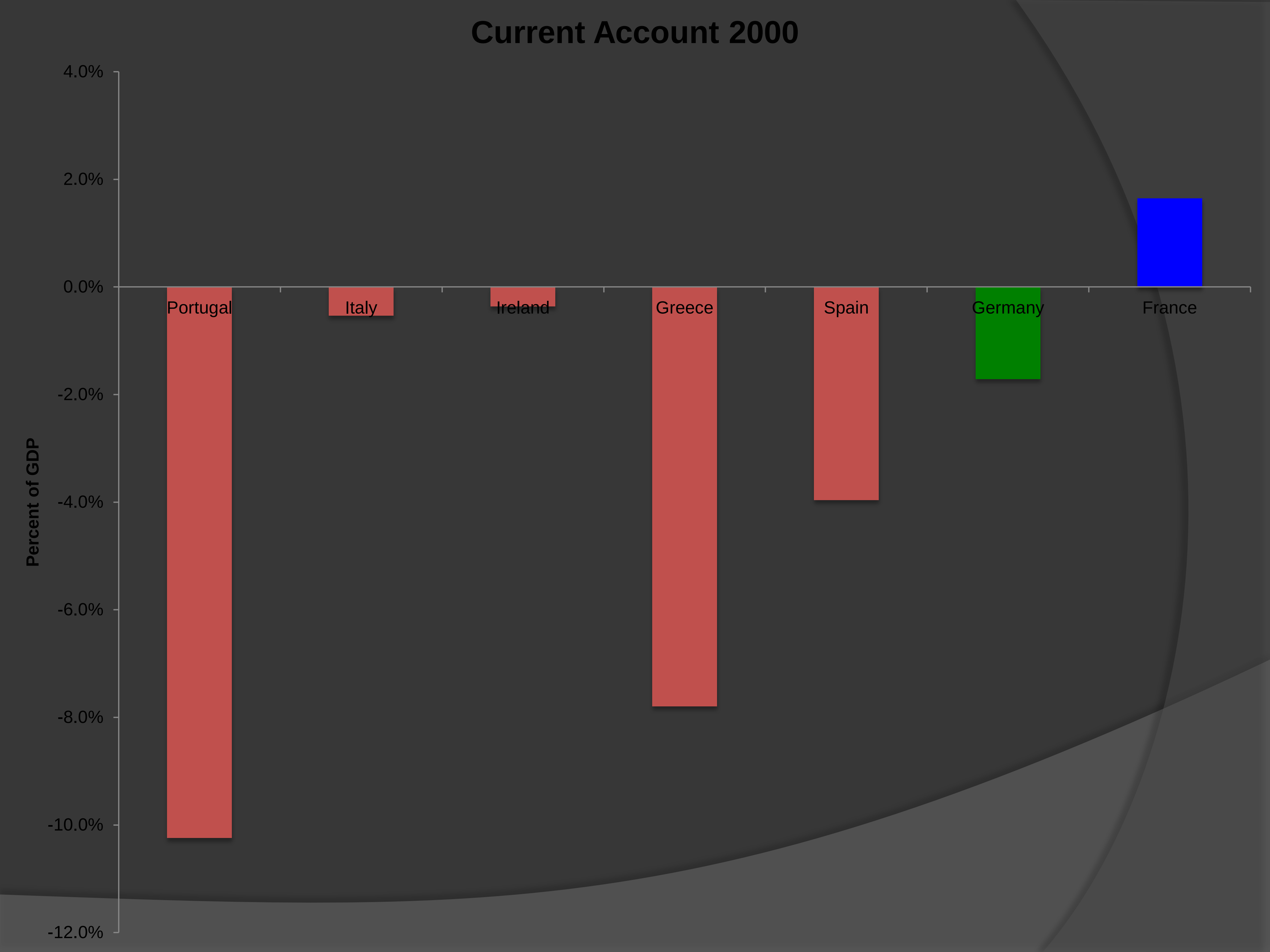

Current Account 1996
Percent of GDP
4.0%
3.0%
2.0%
1.0%
0.0%
-1.0%
-2.0%
-3.0%
-4.0%
Portugal
Italy
Ireland
Greece
Spain
Germany
France

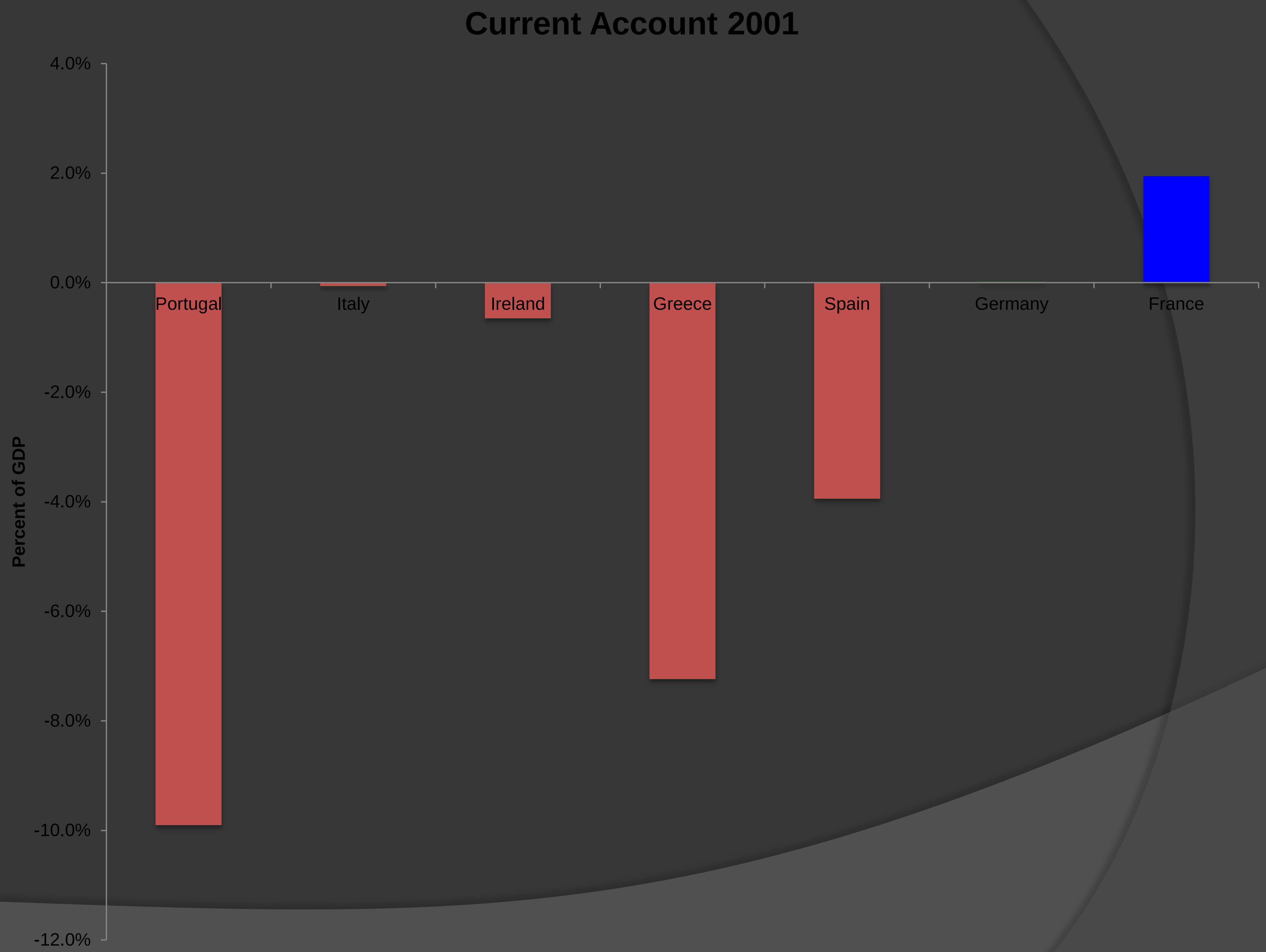

Current Account 1997
Percent of GDP
4.0%
3.0%
2.0%
1.0%
0.0%
-1.0%
-2.0%
-3.0%
-4.0%
-5.0%
-6.0%
-7.0%
Portugal
Italy
Ireland
Greece
Spain
Germany
France


Current Account 1998
Percent of GDP
4.0%
2.0%
0.0%
-2.0%
-4.0%
-6.0%
-8.0%
Portugal
Italy
Ireland
Greece
Spain
Germany
France

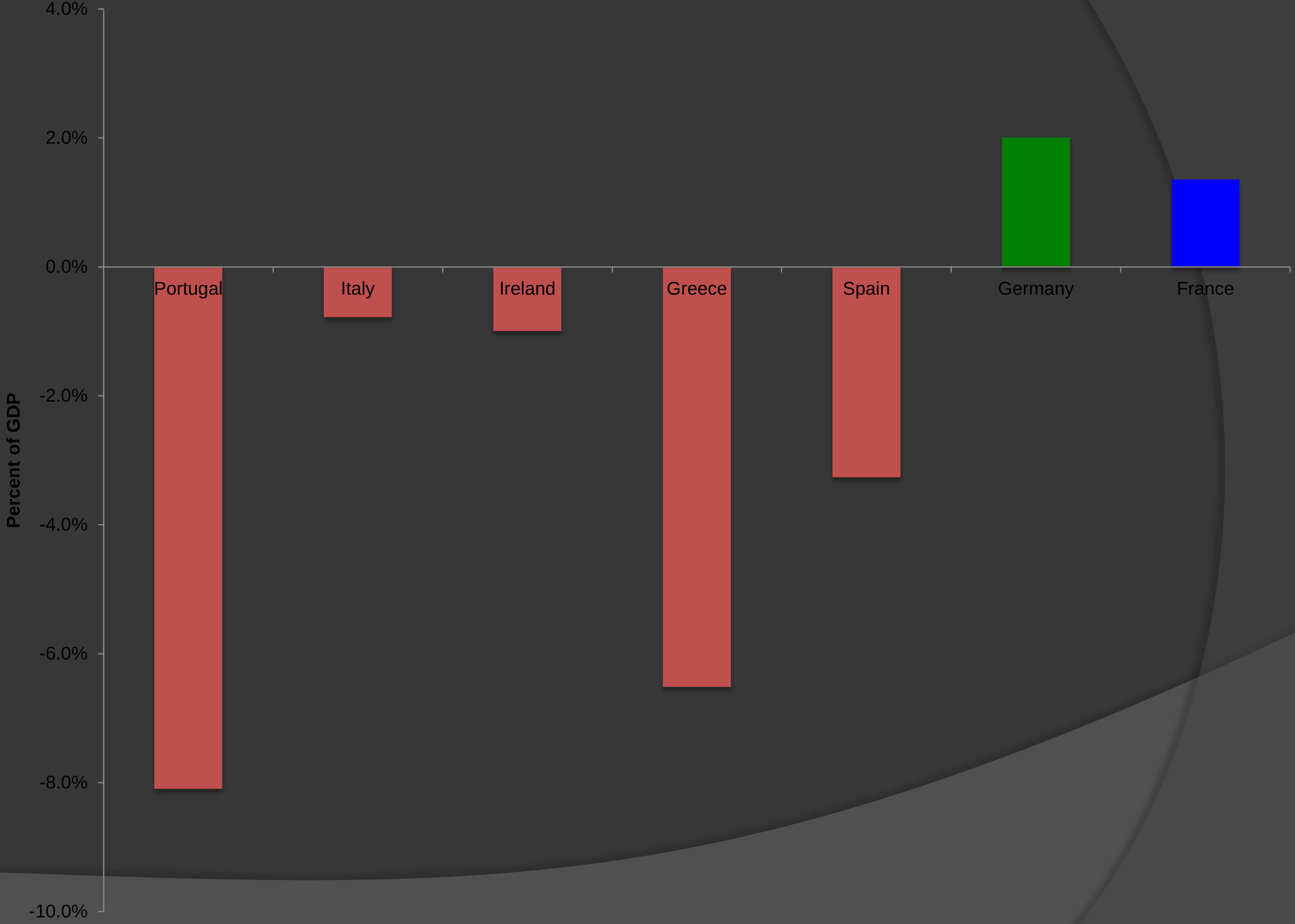


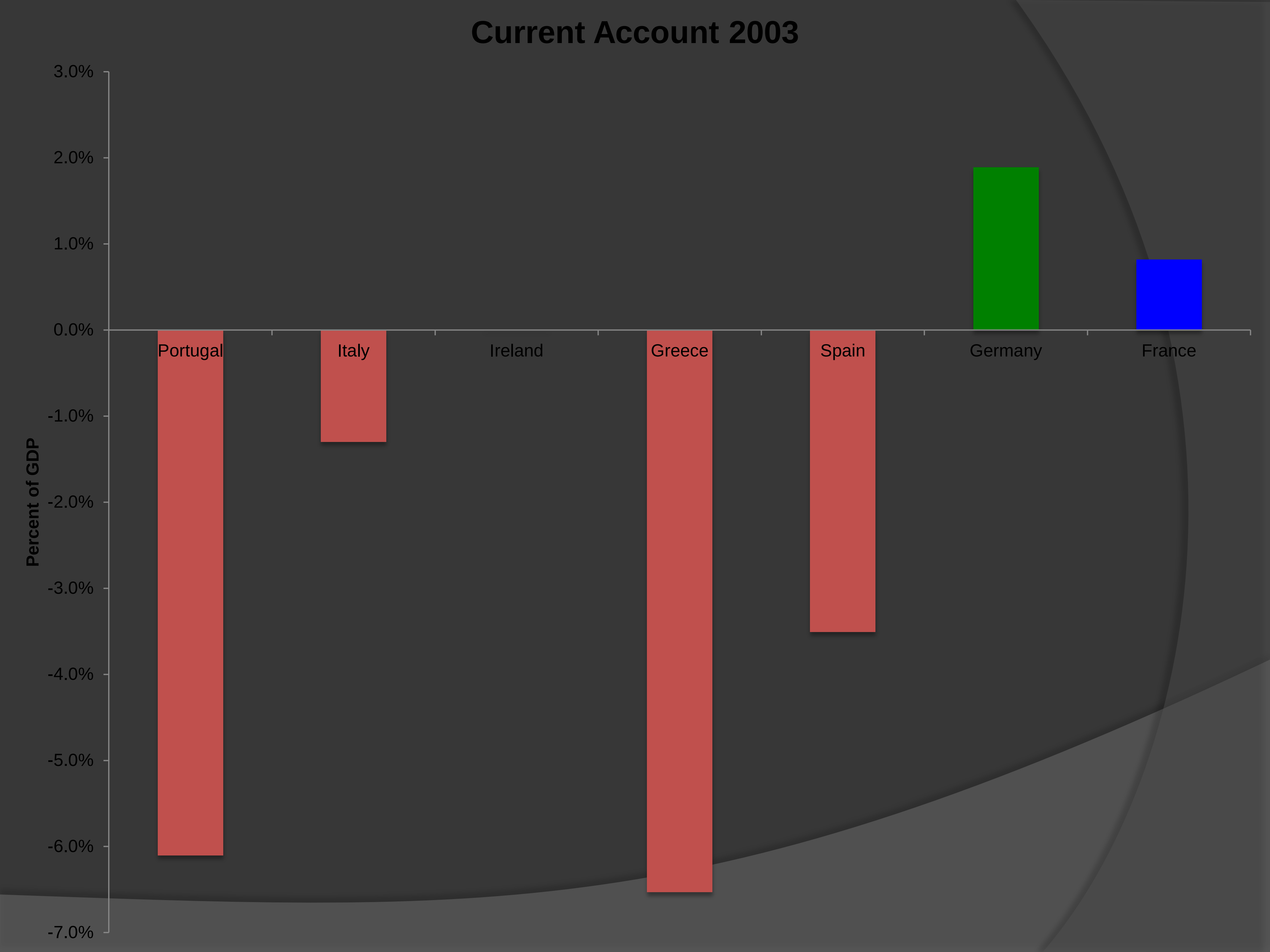
Current Account 1999
Percent of GDP
4.0%
2.0%
0.0%
-2.0%
-4.0%
-6.0%
-8.0%
-10.0%
Portugal
Italy
Ireland
Greece
Spain
Germany
France

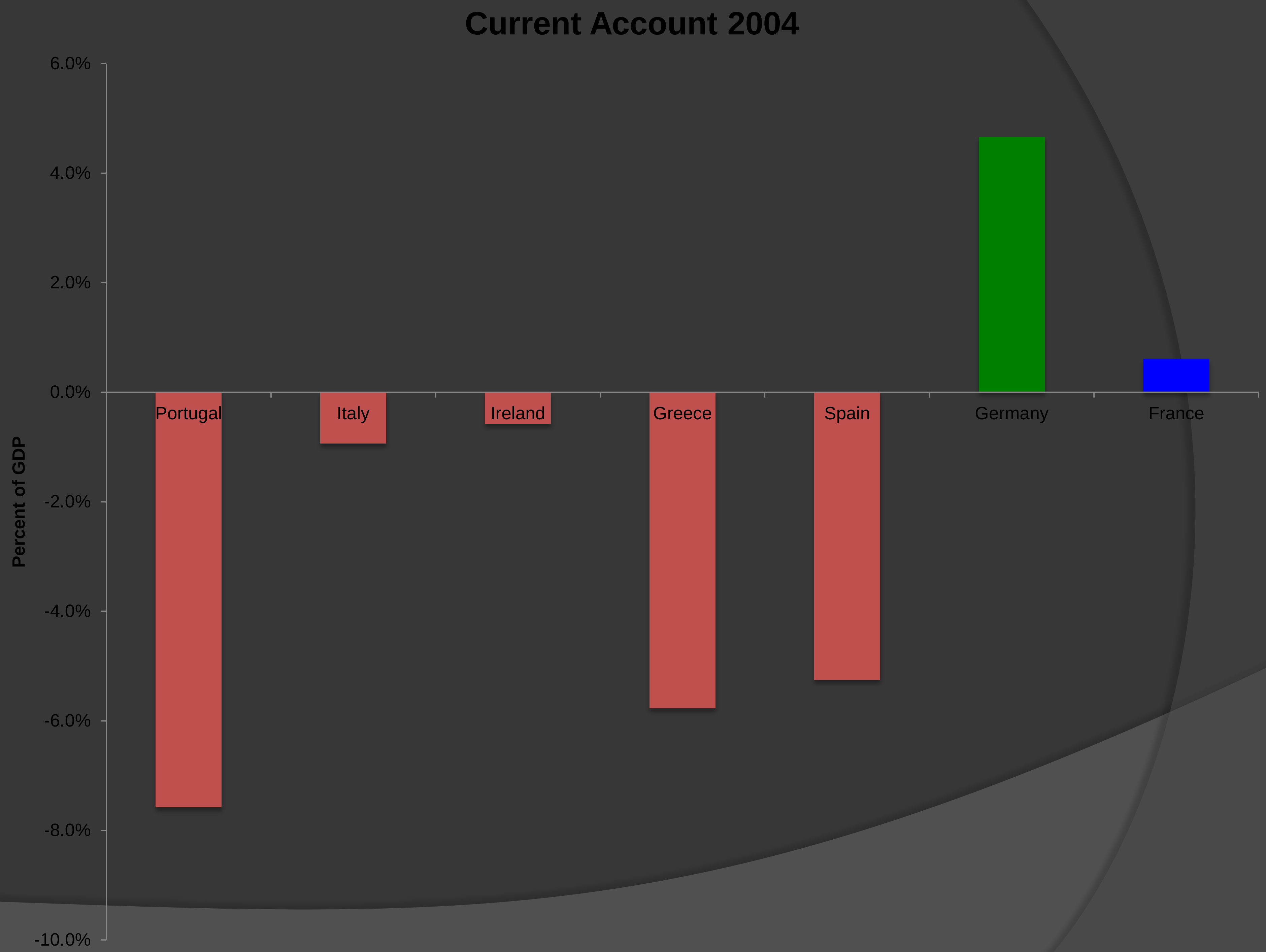

Current Account 2000
Percent of GDP
4.0%
2.0%
0.0%
-2.0%
-4.0%
-6.0%
-8.0%
-10.0%
-12.0%
Portugal
Italy
Ireland
Greece
Spain
Germany
France


Current Account 2001
Percent of GDP
4.0%
2.0%
0.0%
-2.0%
-4.0%
-6.0%
-8.0%
-10.0%
-12.0%
Portugal
Italy
Ireland
Greece
Spain
Germany
France

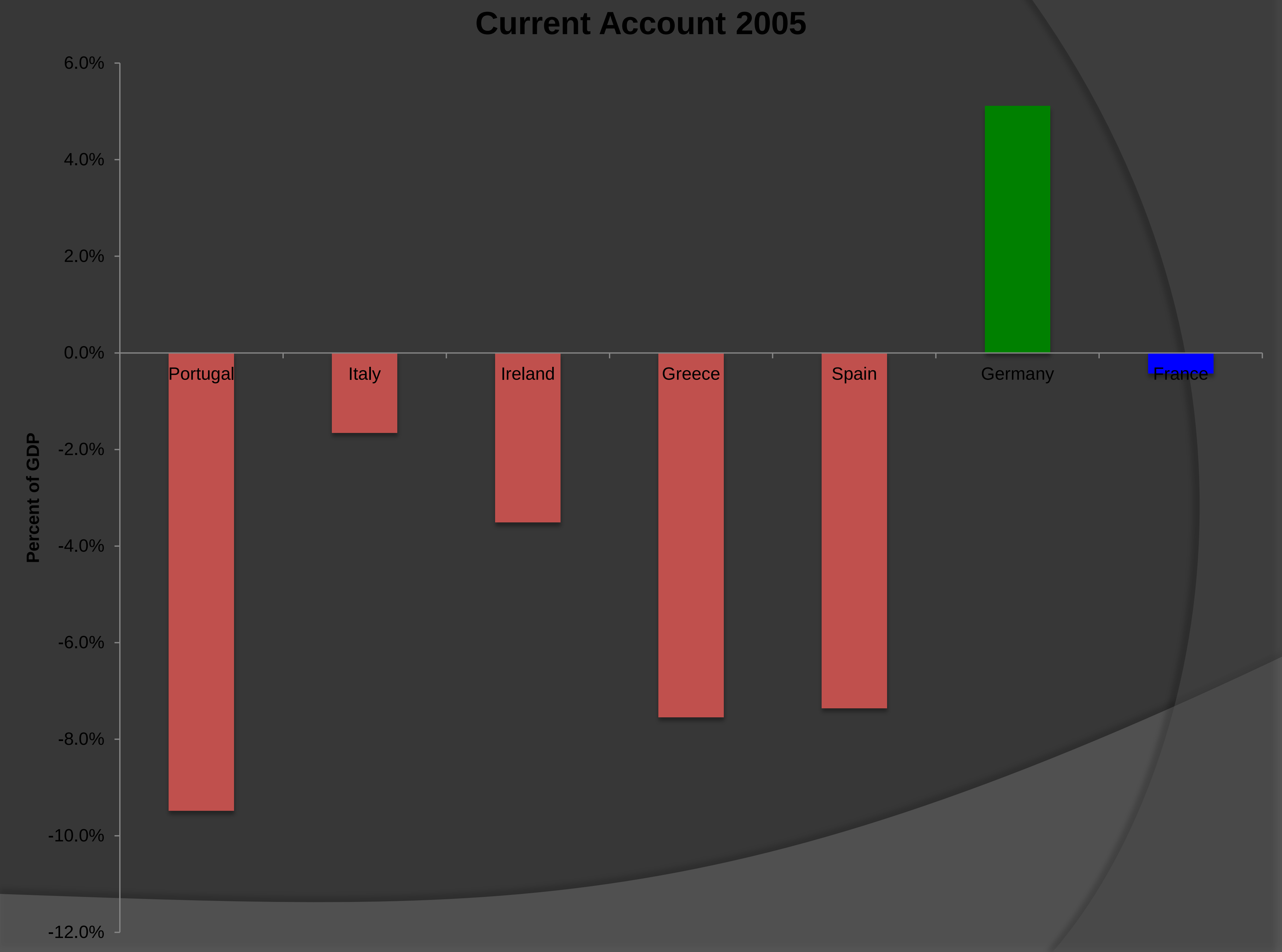
Current Account 2002



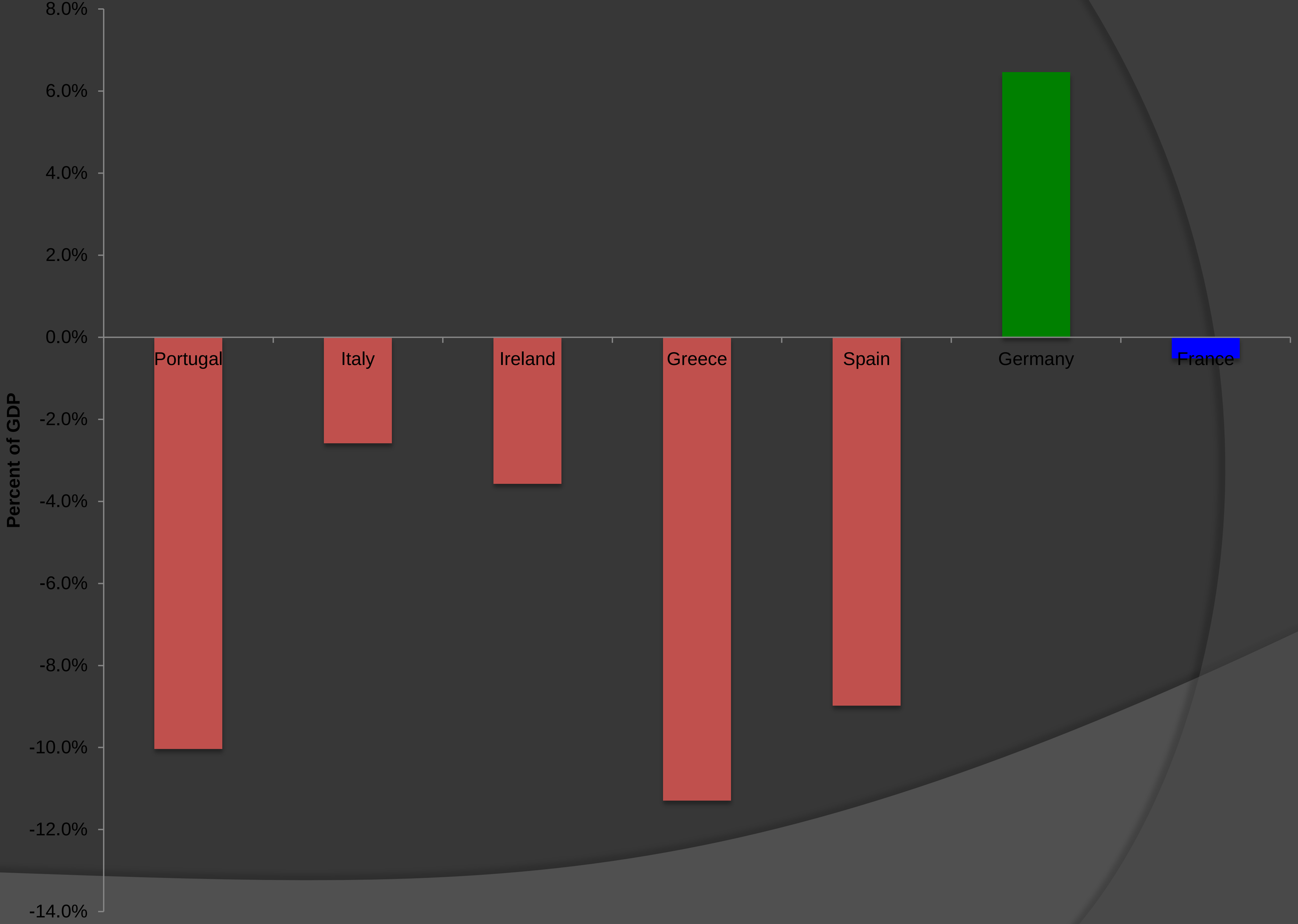

Current Account 2003
Percent of GDP
3.0%
2.0%
1.0%
0.0%
-1.0%
-2.0%
-3.0%
-4.0%
-5.0%
-6.0%
-7.0%
Portugal
Italy
Ireland
Greece
Spain
Germany
France

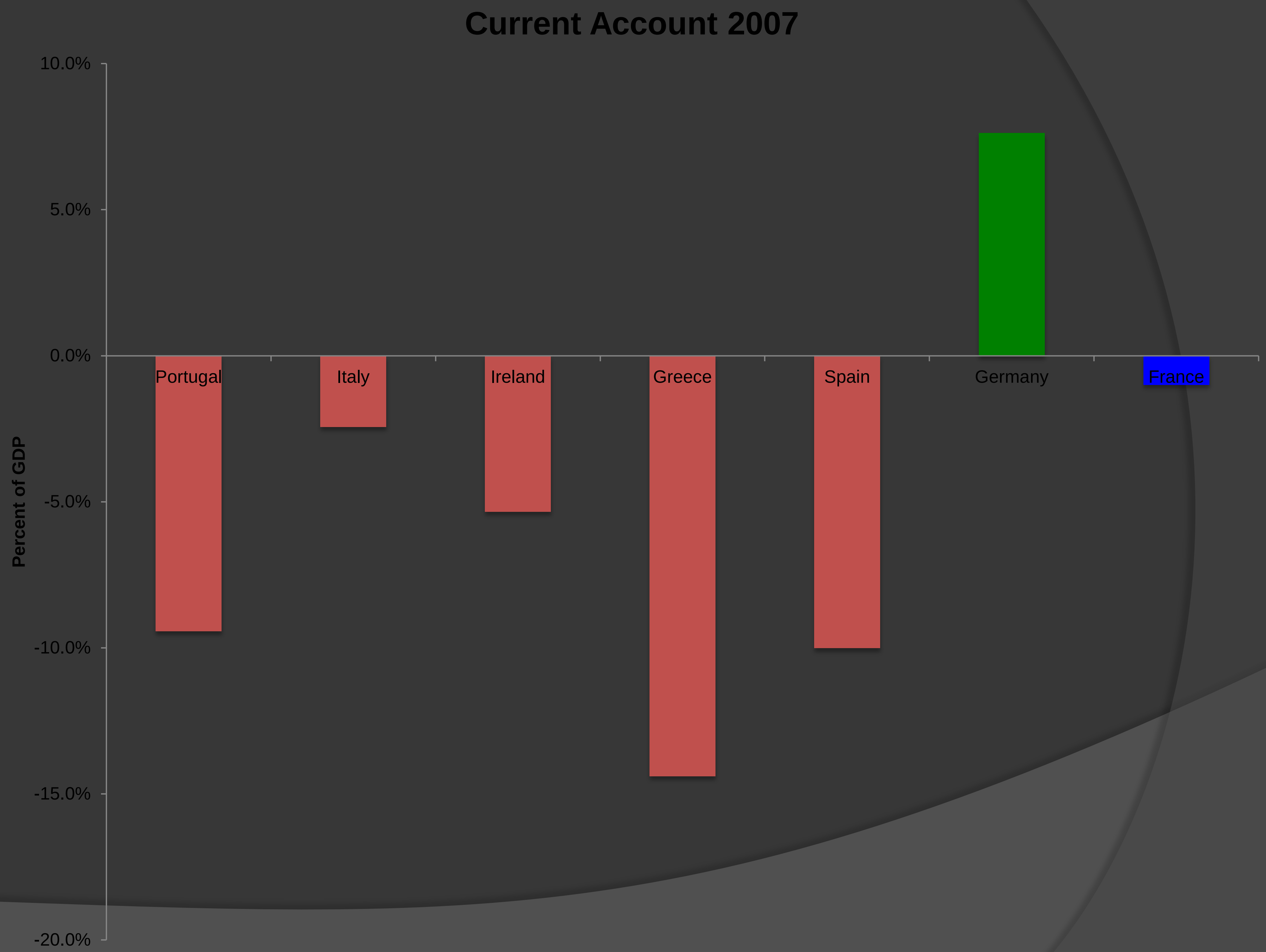


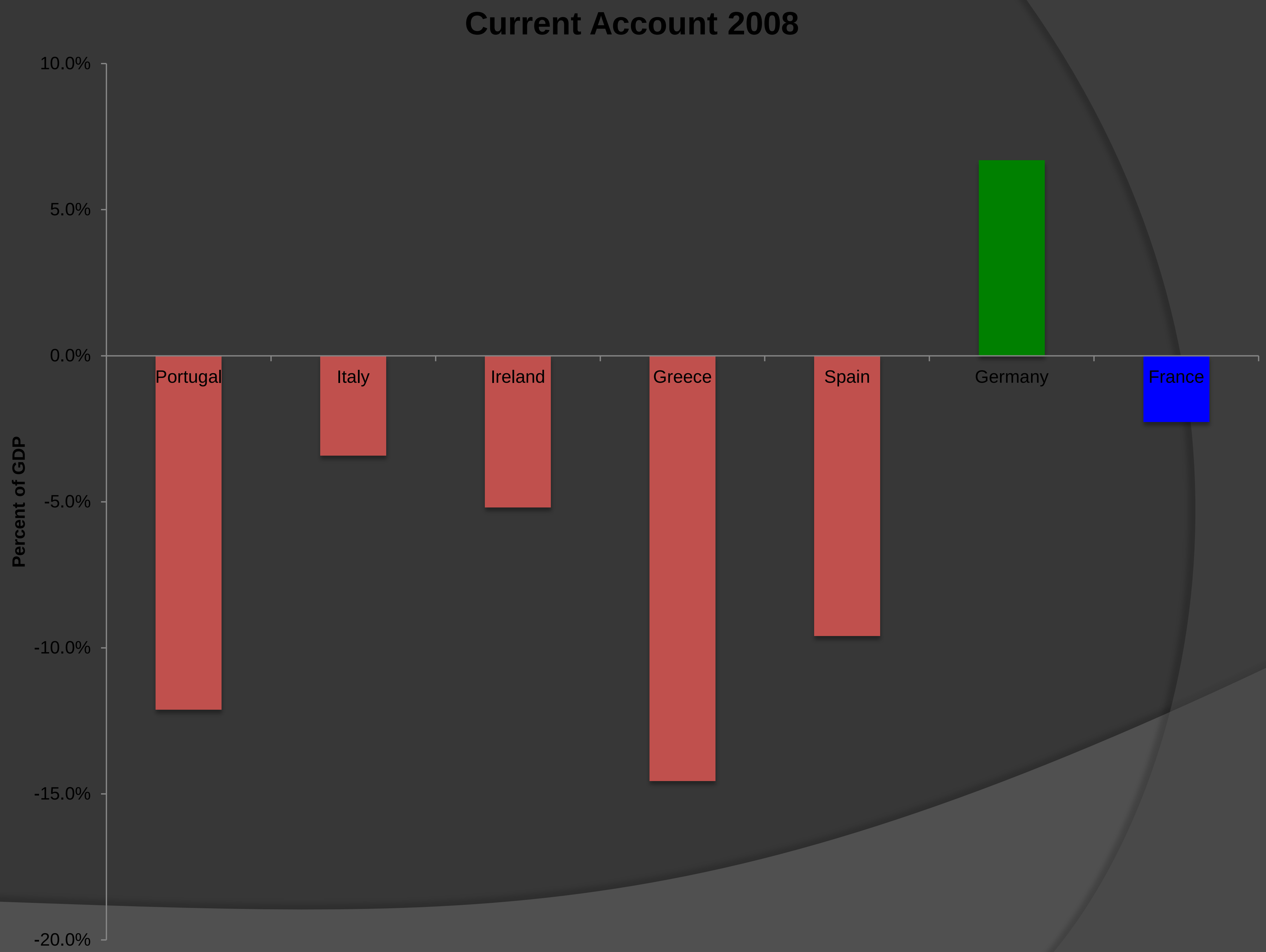
Current Account 2004
Percent of GDP
6.0%
4.0%
2.0%
0.0%
-2.0%
-4.0%
-6.0%
-8.0%
-10.0%
Portugal
Italy
Ireland
Greece
Spain
Germany
France

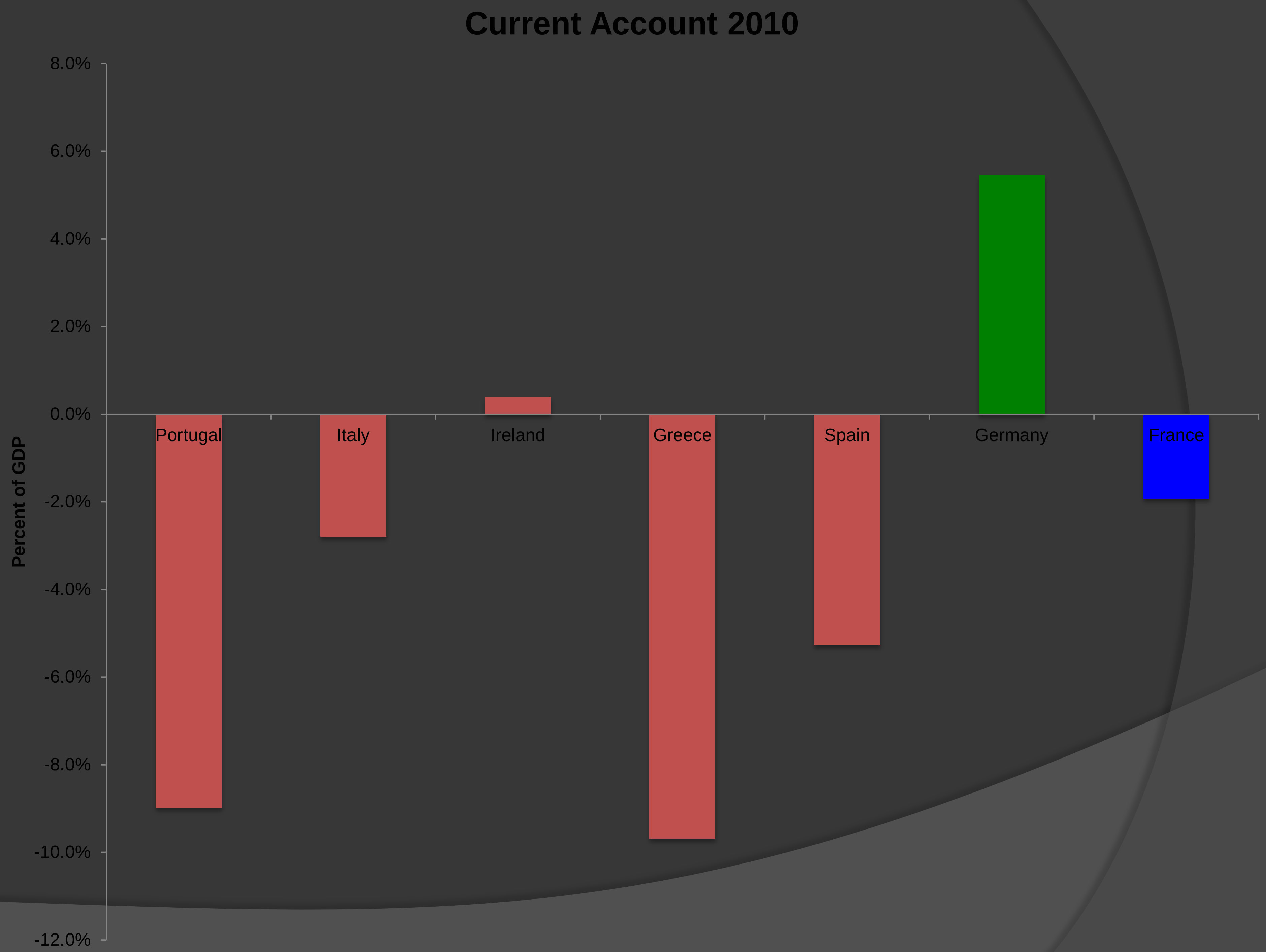

Current Account 2005
6.0%
4.0%
2.0%
0.0%
-2.0%
-4.0%
-6.0%
-8.0%
-10.0%
-12.0%
Percent of GDP
Portugal
Italy
Ireland
Greece
Spain
Germany
France

Current Account 2006




Current Account 2007
10.0%
5.0%
0.0%
-5.0%
-10.0%
-15.0%
-20.0%
Percent of GDP
Portugal
Italy
Ireland
Greece
Spain
Germany
France


Current Account 2008
10.0%
5.0%
0.0%
-5.0%
-10.0%
-15.0%
-20.0%
Percent of GDP
Portugal
Italy
Ireland
Greece
Spain
Germany
France


Current Account 2010
Percent of GDP
8.0%
6.0%
4.0%
2.0%
0.0%
-2.0%
-4.0%
-6.0%
-8.0%
-10.0%
-12.0%
Portugal
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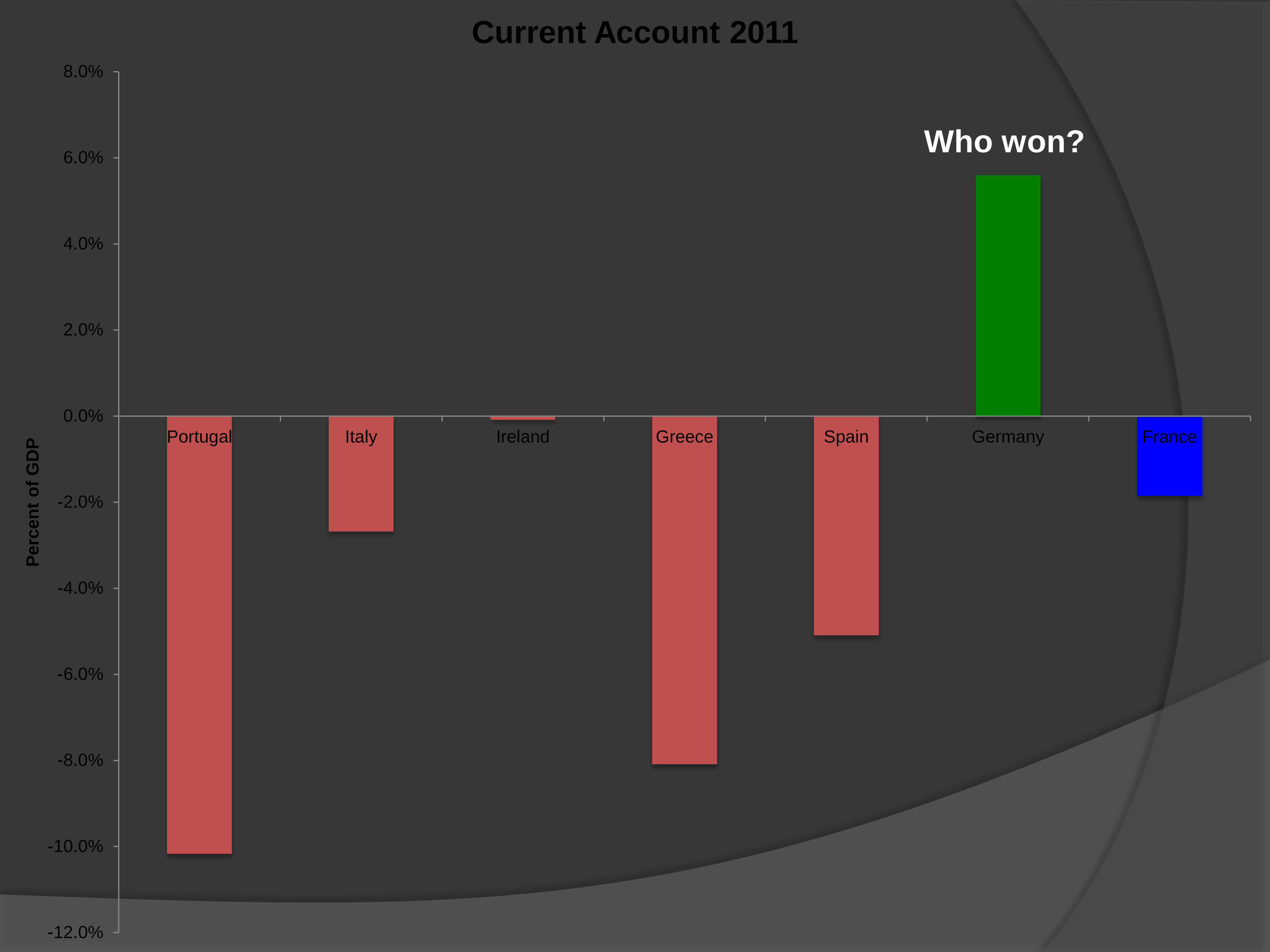
Current Account 2011
Who won?
Percent of GDP
8.0%
6.0%
4.0%
2.0%
0.0%
-2.0%
-4.0%
-6.0%
-8.0%
-10.0%
-12.0%
Portugal
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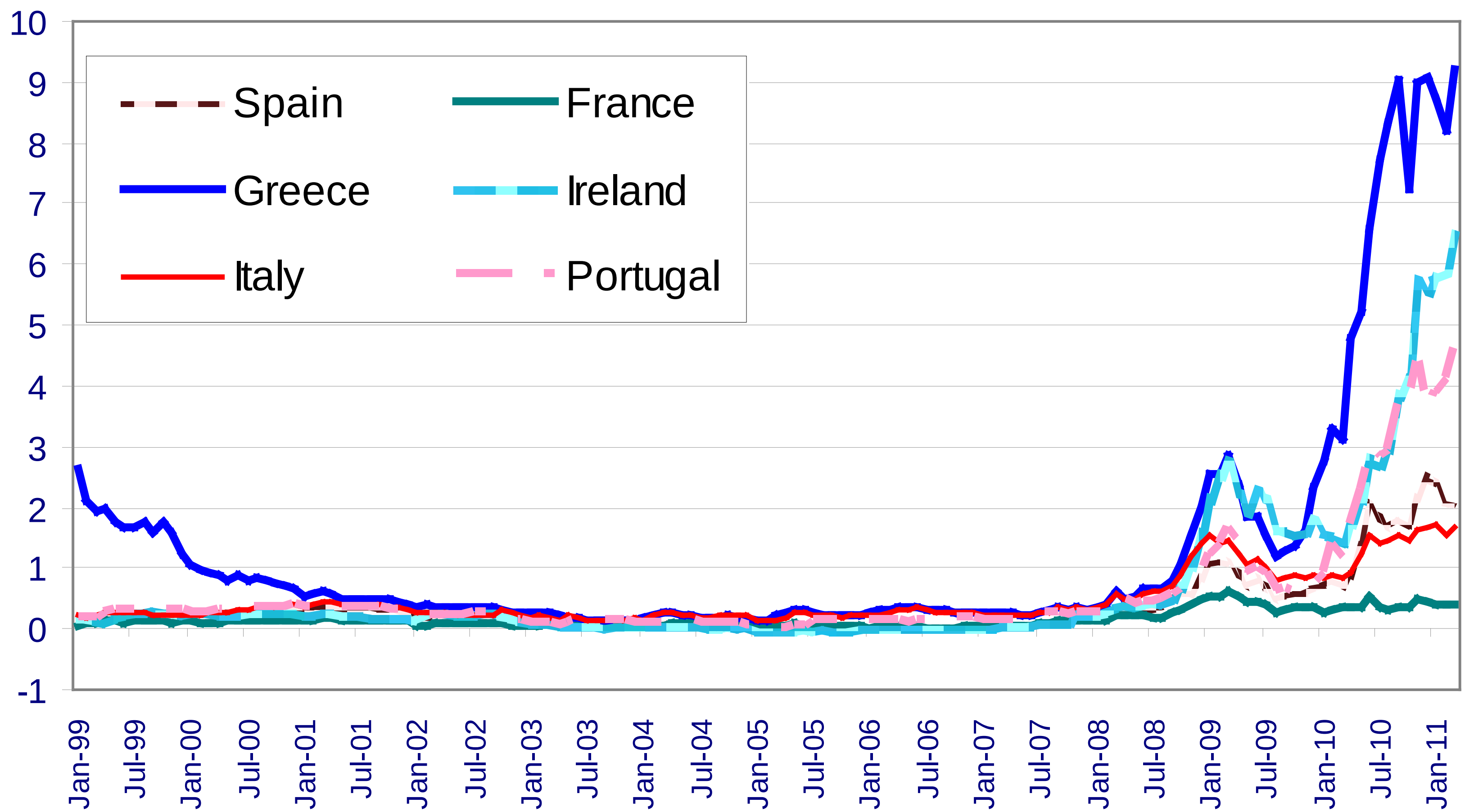
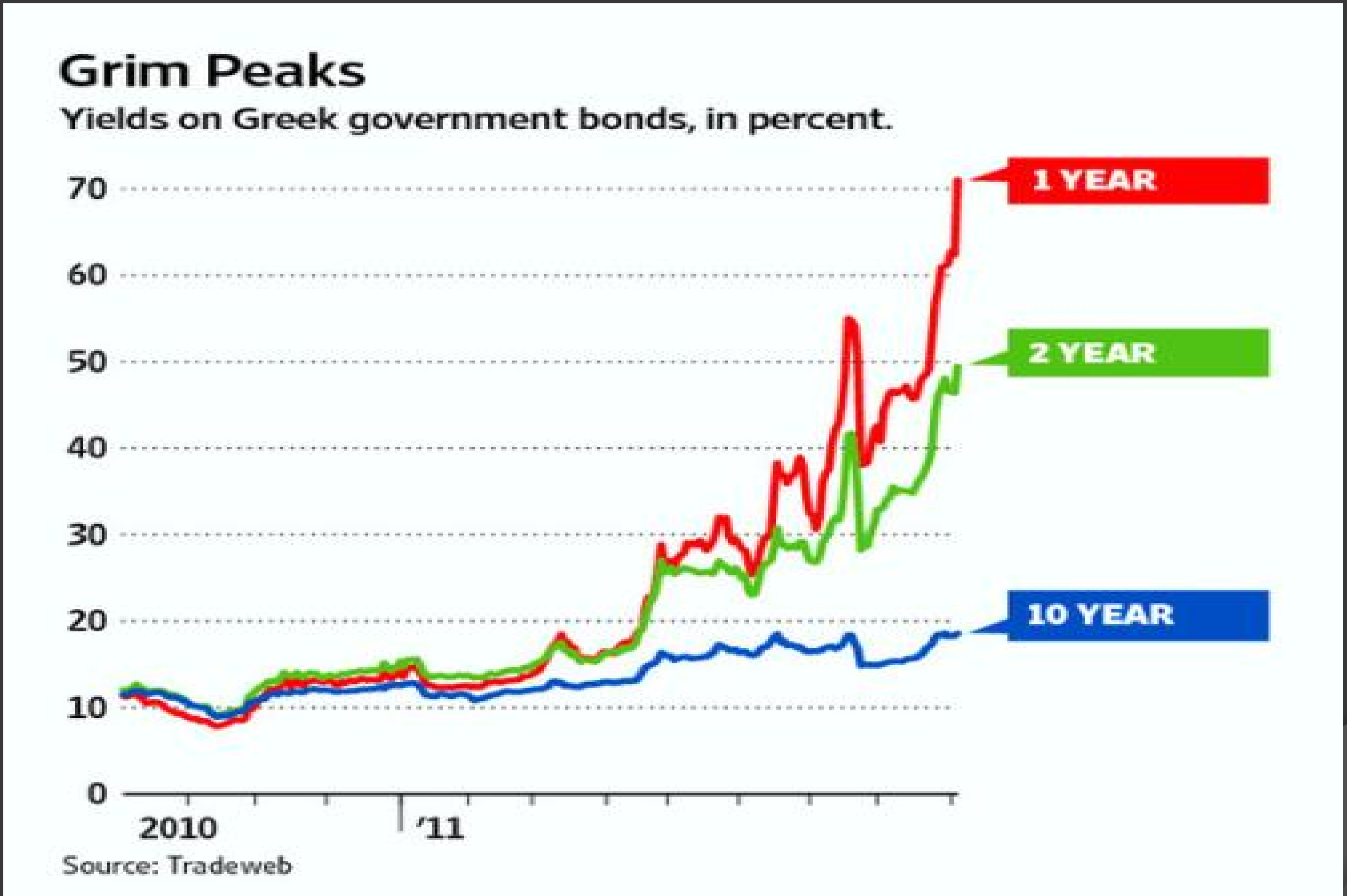
10-year Government Bond Yield Spreads, Monthly Data (German Benchmark) Jan. 1999 - March 2011



Source: Eurostat and Author's Calculations

What Happened in Greece?



Fiscal Space with EMU

"[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.