



**Centre of Full Employment and Equity**

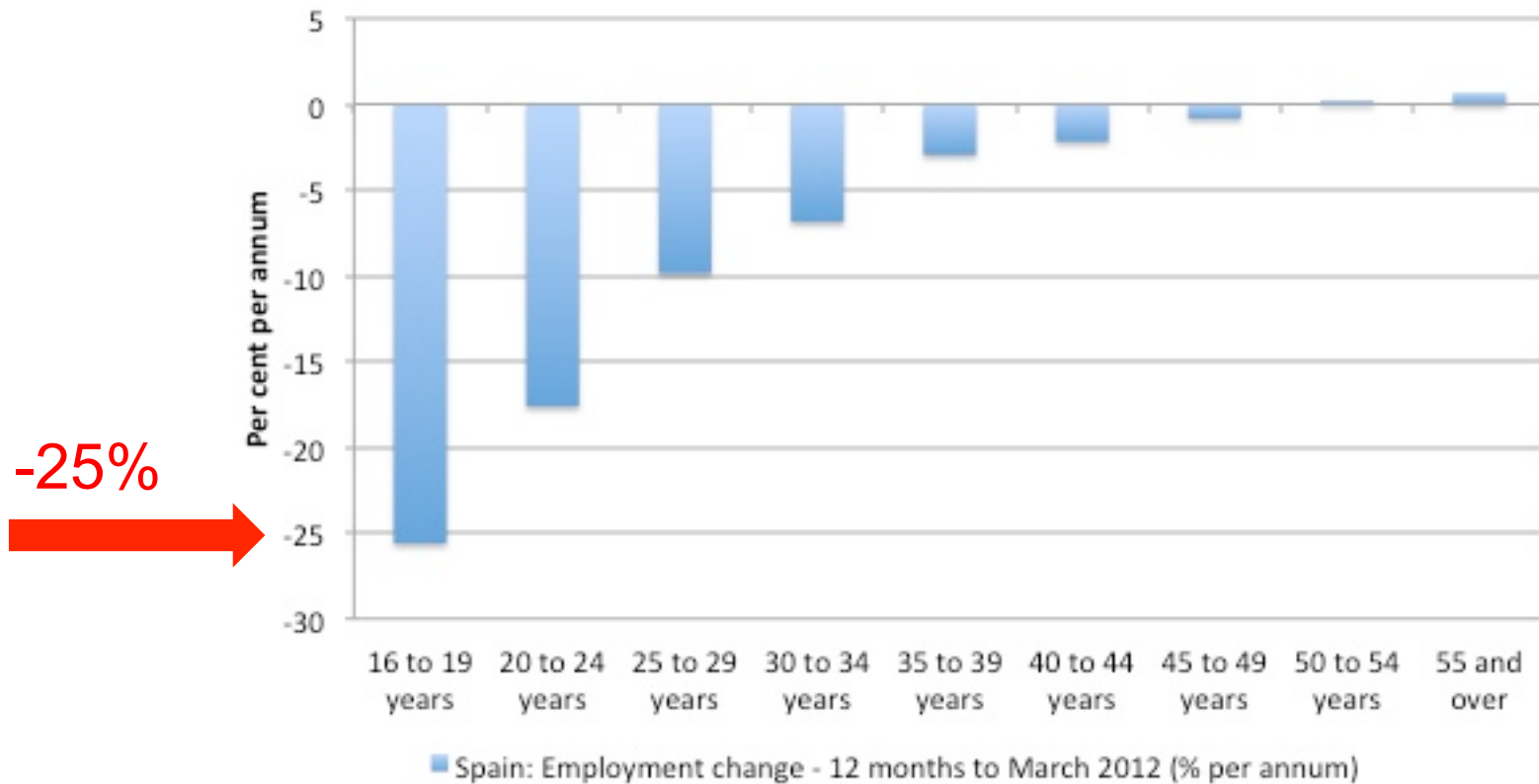


**Centre of Full Employment and Equity**

## The Eurocrisis – facts and fiction

Professor William Mitchell  
Centre of Full Employment and Equity  
University of Newcastle  
Australia

# Spain - employment growth - last 12 months ...



# Spain – 71.5 per cent of active teenagers - idle

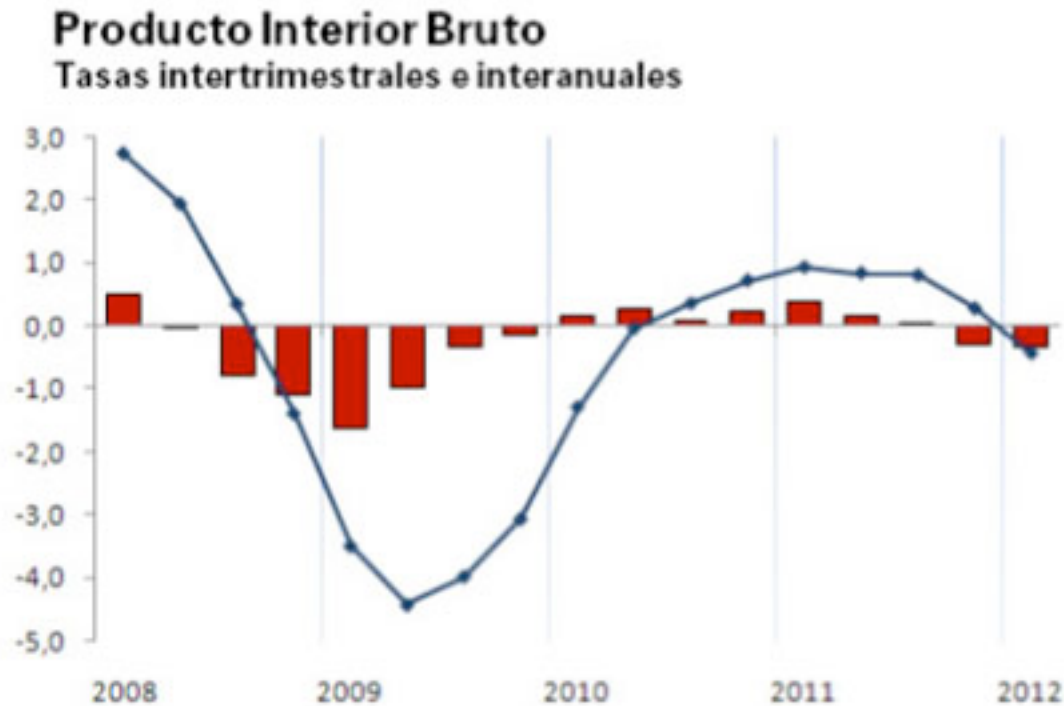


Spain: Labour Force summary, March quarter 2012, by Age group

	Employment	Unemployment	Unemployment Rate (%)
Total	17,433.2	5,639.5	24.4
16 to 19 years	85.5	214.1	71.5
20 to 24 years	765.0	707.7	48.1
25 to 54 years	14,181.1	4,243.6	23.0
55 and over	2,401.6	474.2	16.5

Youth unemployment (16 to 24 years) = 52 per cent

# Spanish real GDP growth (%)



Red bars – quarterly; Blue line - annualised

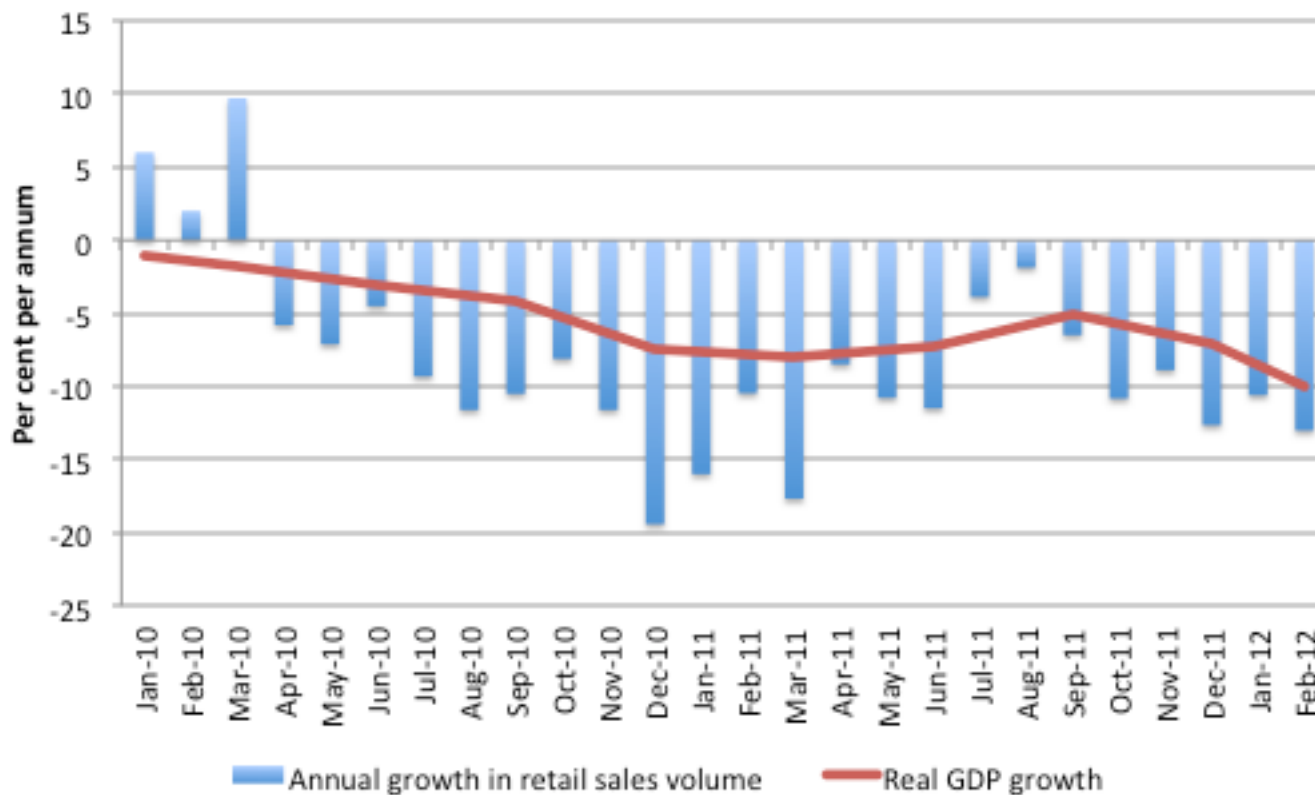
# Greece – unemployment by age



**Table 3: Unemployment rate by age groups: January 2007-2012**

Age Group	January					
	2007	2008	2009	2010	2011	2012
15-24 years old	25,3	22,6	25,6	31,0	37,1	50,8
25-34 »	11,7	10,9	11,5	14,0	20,9	28,7
35-44 »	6,9	5,9	6,9	9,0	12,2	17,9
45-54 »	4,6	4,3	5,3	7,4	10,2	15,6
55-64 »	3,3	3,2	3,9	5,3	7,0	11,3
65-74 »	1,5	0,9	1,0	1,5	2,0	4,2
<b>Total</b>	<b>8,8</b>	<b>7,8</b>	<b>8,7</b>	<b>10,8</b>	<b>14,8</b>	<b>21,8</b>

# Greece – retail sales volume drops 13 per cent



12 months to February 2012

# Eurostat front page – May 1, 2012



€	30.04.2012	Household saving rate up to 13.7% in the euro area and to 11.8% in the EU27
€	30.04.2012	Business investment rate down to 20.7% in the euro area and to 20.2% in the EU27

No Ricardians in sight - to be explained



# Thieves!



ILO Social Unrest Index rising where employment is falling

# Outline of talk

- General observations about crisis.
- What is a monetary system?
  - Convertible currency, fixed exchange rates
  - Fiat currency, non-convertible
  - Fixed exchange rate, foreign currency – Eurozone
- Brief history of Eurozone:
  - Optimal currency area
  - Not a true fiscal federation
  - Stability and Growth Pact
- Period of “stability” – German austerity!

# Outline of talk

- Period of crisis – Flawed design exposed.
- Policy response:
  - Austerity?
  - Bailout?
  - Fiscal Compact?
- Policy options:
  - Tightening fiscal rules versus creation of true supra-national fiscal capacity
  - Default and exit?

# Special type of crisis – balance sheet recession



- The world is trapped in a **balance-sheet** crisis which is a special type of recession.
- It originates in the financial sector and then spills over to the real (production) sector.
- The proximate cause – the collapse of spending as a result of excessive private debt.
- Deeper cause – go back two decades or so.

# Why?



- The global crisis has arisen because over the last 2-3 decades most Western governments have succumbed to the neo-liberalism.
- Policy developments allowed the destructive dynamics of the capitalist system to create an economic structure that was ultimately unsustainable.
  - Budget austerity (surpluses are good mantra)
  - Deregulation of labour and financial markets
  - Massive redistribution of income – private credit-led growth
- It was only a matter of time before the system imploded.

# Full employment era ...

- Post-WWII commitment to full employment.
- The post-WWII social and economic settlement was strongly mediated through public institutions.
- Fiscal policy, wage setting, Welfare State.
- Budget deficits were the norm as private sector saved.

# The origins of the crisis ...

- The neo-liberal era begins – around mid-1970s.
- Promotion of the idea that private markets self-regulate and deliver optimal outcomes – wealth maximisation.
- Features:
  - Abandoned government commitment to full employment.
  - Accelerated deregulation of labour market and financial markets.
  - Massive growth of financial sector.
  - Privatisation – loss of training capacity in public sector.
  - “Individual” promoted - “collective” eschewed.

# The neo-liberal era ...



- The **fetish against budget deficits** began ....
- Inflation became the priority evil and unemployment became an instrument rather than a target of policy.
- Governments extolled the virtues of budget surpluses.
- The myths about the operations of the monetary economy were pervasive.
- The corporate (financial) elites consolidated their power.
- Major shifts in national income distribution to profits.
- Consumption driven by credit not real wages growth.



# Enter the European eccentricity

- However, the Europeans put their own particular “stamp” on the dominant neo-liberal ideology.
- The European Monetary Union (EMU) accompanied by the Stability and Growth Pact (SGP) – is an even more rigid and damaging neo-liberal construction.
- It is the **existence of the Euro** that has made the crisis worse in the Eurozone than elsewhere.
- It is the Euro that is the problem.

# Monetary systems

- A monetary system refers to how the currency is issued and the constraints that are imposed on governments.
- Gold standard – fixed exchange rates, convertibility – up to 1971 (Bretton Woods).
- **Fiat currency systems** – such as US, Japan, Australia etc.
- European Monetary Union (EMU) – an eccentric, ideologically-driven hybrid of both.

# Fiat monetary systems

- Government **issues its own currency** – as a monopolist.
- The currency has no intrinsic value – cf. to commodity money (gold, silver).
- The imposition of taxes in that currency unit provide an incentive for us to use the currency.
- The **central bank** (part of government) sets the short-term interest rate – and the term structure follows.
- The currency **floats on international markets** which means that the government can concentrate on domestic policy – not compromised by need to maintain parity.

# Implications of a fiat currency ...

- Government spending is never revenue dependent .
- Government budgets are not like household budgets – the government never needs to finance its spending.
- The government cannot run out of money!
- This is not the same thing as saying the government should spend infinitely.
- How much should government spend?

**SPENDING = INCOME = OUTPUT**  
**which leads to EMPLOYMENT**

# Non-government spending gaps

- Non-government sector typically desires to save over the business cycle.
- This **unspent income** amounts to a deficiency of non-government spending relative to the demand (spending) needed to maintain full capacity (full employment).
- Non-government **spending gaps** can **only** be filled by the government net spending – that is, budget deficits.
- Government deficits (surpluses) = non-government surpluses (deficits).

# Choices for a government in a fiat currency



- The national government always has a choice:
  - maintain full employment by ensuring there is no spending gap – that is run budget deficits commensurate with non-government surpluses;

OR

- maintain some slack in the economy (persistent unemployment and underemployment) which means that the government deficit will be somewhat smaller and perhaps even, for a time, a budget surplus will be possible (if private credit growth).
- **Bad** versus **good** deficits – automatic stabilisers.

# Government chooses the unemployment rate...



- The unemployment rate is always a **choice** of government.
- Remember basic macroeconomic rule:

SPENDING = INCOME  EMPLOYMENT.

- If private spending is weak then governments have to spend to ensure there is adequate economic growth.



# Maastricht Treaty – February 7, 1992

- Agreement to enter a “convergence process” - harsh.
- Two requirements for entry (SGP):
  - a public debt to GDP ratio below 60 per cent, or converging towards it, and
  - a budget deficit below 3 per cent of GDP.
- Highly arbitrary without any solid theoretical foundation or internal consistency.
- Consistent with dominant neo-liberal orthodoxy - inflation control the macroeconomic policy priority and primacy of monetary policy over fiscal policy.

# European monetary union

- Member states agreed to use a **foreign currency** – the Euro.
- Ceded monetary policy to the unelected, unaccountable **European Central Bank** – legally separated national central banks from government.
- Agreed to the **SGP** which stifled their capacity to defend their economies when aggregate demand fell.
- Abandoned their exchange rate float and accepted a **fixed exchange rate** – so domestic economy has to make the adjustment to trade imbalances.

# No supra-national fiscal capacity

- The design of the union was driven by claims that the new “region” would comprise an Optimal Currency Area (OCA).
- But the conditions required were never met (nor could exist):
  - Resource mobility
  - Similar productivity
  - Common fiscal entity
- The failure to create a “Federal” fiscal capacity was a major flaw – ideological and dysfunctional.

# So-called period of “stability”

- Germany imposed harsh domestic conditions – Hartz reforms to overcome loss of exchange rate flexibility.
- Low interest rates in peripheral states (“one size fits all”) reduced private borrowing costs.
- German investors headed south looking for returns given the domestic austerity imposed in their own country.
- Ireland, Spain boomed – but it was illusory.
- German exports boomed – but on the back of the spending in the south – given mostly intra-Eurozone trade.

- The growth strategy predicated on the acceleration of private debt was unsustainable.
- Eventually the precariousness of the private balance sheets becomes the problem and households (and firms) then seek to reduce debt levels and that impacts negatively on aggregate demand (spending) which, in turn, stifles economic growth.

# US housing market collapse

- The collapse sent a large negative aggregate demand shock through the world as housing markets collapsed in many nations.
- The correct response to a **balance sheet recession** was for governments to expand deficits to meet the loss of private spending and to insulate the real economy from the financial sector collapse.
- Budget deficits also rose due to **automatic stabilisers**.
- The scale of the collapse in demand exposed the design flaws in the EMU.

# Why is the world still in a mess?

- In most nations, the fiscal interventions were not sufficient and were withdrawn too early.
- Reliance on monetary policy to stimulate demand was flawed – ideological.
- A balance sheet recession requires a long slow period of private sector de-leveraging which has to be supported by fiscal stimulus.
- In Europe, the rising deficits challenged the whole logic of a system that was designed for austerity.

# The Troika policy response

- Without a “federal” fiscal capacity, the Troika (EU/ECB/IMF) imposed fiscal austerity.
- **Pro-cyclical** fiscal policy – anathema of sound macroeconomic management.
- Based on the myth of a “fiscal contraction expansion” – Ricardian Equivalence!.
- Failed to understand that:
  - Households will not consume if threatened with loss of pay and rising unemployment.
  - Firms will not invest when consumers are not spending.



# Fiscal austerity?

- Absolute madness – creates a vicious circle of declining growth, rising unemployment, falling tax revenue, rising deficits and so on.
- Budget deficits are **endogenous** – the automatic stabilisers.
- The imposition of fiscal austerity and tightening SGP rules is a self-defeating strategy.
- Budget deficits are rising – **bad** deficits!

# Fiscal austerity?

- The only way out of a balance sheet recession is to stimulate growth and maintain stimulus until the private sector balance sheets have been repaired.
- You cannot reduce public and private debt simultaneously with an external deficit.
- The neo-liberal solution relies on the same logic that created the crisis in the first place.

# Financial market response

- The financial markets soon worked out that the member states were open to default risk.
- That translated into rising “spreads” on the benchmark German bund (10-year government bond).
- Effectively, some member states were unable to fund themselves – Greece first – Spain next!
- Currency-issuing governments do not face this pressure.

# Things got worse

- Bailouts proposed to keep system afloat - European Financial Stabilisation Fund (EFSF) – basically contributions from governments who also face default risk.
- December EU summit – proposed fiscal union - **The Fiscal Compact** – which was really just a proposal to tightening SGP even more.
- Which will make the crisis worse.

# The role of the ECB

- Implicit fiscal function – the only way the EMU nations are still solvent.
- Lender of last resort to banks and governments.
- Securities Market Program (SMB) - by pass the Lisbon Treaty rule of “no bailouts”.
- Admission of failure in design.
- Massive lending program to private banks.
- US Federal Reserve – currency swap line.

# Future options ...

- Bond markets matter in Eurozone while the ECB allows them to matter.
- Bond markets don't matter elsewhere.
- Austerity begets austerity no matter which monetary system but pushes EMU nations closer to insolvency.
- Only ECB intervention is saving mass insolvency and collapse of monetary system – BUT!
- Two options:
  - Full federal system
  - Return currency sovereignty

## Broader issues ...

- We have to change courses dramatically and reject the IMF-Washington-Frankfurt consensus – that is, reject neo-liberalism.
- National governments must run deficits as a normal consequence of the desire by the private sector to save.
- Fiscal policy has to replace monetary policy as the primary means to stabilise the business cycle.
- Japan proves that rising budget deficits are not a problem – low interest rates, low inflation.

# Solutions – which monetary system

- A fundamental redistribution of national income to workers is required – to allow consumption growth to be funded from real wages rather than credit.
- Major and fundamental financial market reform is required:
  - Banks have to be made to act like banks not casinos.
  - Speculative financial transactions have to be limited to supporting productive ventures.





[Home](#) [About](#) [Contact](#) [Comments policy](#) [Site Map](#) [Music](#)

### Category Archives: *Eurozone*

Commentary on the madness involved in setting up the EMU and how it is dysfunctional

#### **They better keep the vacuum on or else!**

Posted on Thursday, January 12, 2012 by bill

While the Eurozone leaders appear to be obsessed with a relentless series of meetings which discuss largely irrelevant problems that they identify, there is a growing chorus that is highlighting the reality facing the region. It is patently obvious that ... [Read the rest of this entry »](#)

My current state



### January 2012

M T W T F S S

# http://bilbo.economicoutlook.net/blog

#### **Rehn fiddles, while Europe burns**

Posted on Monday, January 9, 2012 by bill

According to the popular legend Nero, Roman Emperor from 54 to 68 and the last in the Julio-Claudian dynasty allegedly "fiddled while Rome burned" (played his lyre and singing) during the fire in 64 which destroyed most of Rome. His ... [Read the rest of this entry »](#)

Posted in Economics, Eurozone | 18 Comments | [Edit](#)

#### **Hungary helps to demonstrate MMT principles**

Posted on Friday, January 6, 2012 by bill

I have received a lot of E-mails overnight about developments in Hungary. The vast majority of these E-mails have suggested that these developments (sharp rise in government bond yields since November) coupled with the fact that the Hungary uses its ... [Read the rest of this entry »](#)

Posted in Economics, Eurozone | 35 Comments | [Edit](#)

#### **The Eurozone failed from day one**

Posted on Wednesday, January 4, 2012 by bill

The current Eurozone crisis is getting worse and has concentrated our minds on the most recent period of European history. As in all these situations where focus is very immediate our memories get a little blurred and we are inclined ... [Read the rest of this entry »](#)

16	17	18	19	20	21	22
23	24	25	26	27	28	29
30	31					

[« Dec](#)

### Categories

- [Admin](#)
- [Britain](#)
- [Climate change](#)
- [Debriefing 101](#)
- [Economics](#)
- [Eurozone](#)
- [Friends like this](#)
- [Guest blogger](#)
- [Hyperinflation](#)
- [Inflation](#)
- [Job Guarantee](#)
- [Labour costs](#)
- [Labour Force](#)
- [Letters to](#)
- [Linux](#)
- [Music](#)
- [National Accounts](#)
- [Permaculture](#)
- [Personal](#)
- [Politics](#)
- [Q&A](#)
- [RBA decisions](#)
- [Saturday quiz](#)
- [Teaching models](#)

**Thank you**