# Notes on the Euro Crisis and the Global Fiscal Crisis

by Keith Rankin, 29 May 2012

There are two economic crises in the world at present.

The smaller but most serious is the Eurozone crisis. Commonly portrayed as a crisis of government debt, the Eurozone crisis is in fact an internal trade crisis within the Eurozone. Countries for which the Euro is undervalued are running substantial trade surpluses (mainly in northern Europe), whereas countries for which the Euro is an overvalued currency (mainly in southern Europe) are running balance of trade deficits. In addition, there are substantial flows of interest income from southern to northern Europe, meaning that the Eurozone countries' current accounts are even more unbalanced than the trade balances.

There is no easy solution, because two of the three ways countries can deal with persistent trade deficits – currency depreciation and import controls – are prevented. (The European Union has import controls with respect to the rest of the world, but not with respect to member countries.)

The other traditional solution to persistent trade imbalances is to have deflation in the (southern) trade deficit countries and inflation in the (northern) surplus countries. Indeed, the purpose of the austerity measures associated with the bail-out arrangements is to create deflation in the southern countries. (Austerity means to give priority to saving and debt-repayment, rather than spending.)

In practice it is very difficult – and quite cruel – to impose deflationary solutions on other countries. Attempts to create deflation tend to create economic depressions. They certainly do not create business confidence, although, if successful, any resulting increased export competitiveness from lower wages may restore confidence in the tradable sector. ('Competitiveness' is a kind of absolute advantage concept that determines trade flows in a real-world economy with unemployment.)

The problem in Europe requires, under this rebalancing mechanism, the surplus countries to be trying to create inflation. But they are not doing this, partly due to their cultural frugality, partly due to the memory of the large inflations briefly experienced by Germany and a few others in the 1920s, and partly due to the confusion arising from the second crisis, the global fiscal crisis.

The global fiscal crisis is the problem of rising government debt in almost every country, and is revealed by the huge government deficits seen since the 2008 global financial crisis. This problem is present in the Eurozone as a whole, but is not as bad as in many countries outside of the Eurozone. In many countries, government debt appears to be structural rather than cyclical.

As we can see from the inter-sectoral balances of most countries, and the world as a whole, the problem of excessive public deficits can just as easily be understood as the problem of excessive private surpluses. The two go together – just like the head-sides and the tail-sides of coins – because the sum of the public and private balances must equal zero. The surplus of one sector is balanced by an equal deficit in the other sector.

The global fiscal crisis could be caused: by people not paying enough tax, by greedy governments trying to spend much more than they did before the crisis, or by an austere private sector with nobody but governments to lend their savings to. While the first two of these causes are part of the story in some countries, the overwhelming evidence is that the fiscal crisis is caused by unusually high levels of private austerity, across the whole world.

While there are technical solutions to these problems, in the end they are largely a result of collective private behaviour, which in turn result from the increased fears of households and

businesses everywhere. Thus, in northern Europe, private households and businesses are afraid to spend; yet the Eurozone cannot be saved in its present form unless they do spend, especially by buying goods and services from the Eurozone countries with the biggest external debts.

If governments also (as well as private parties) become afraid to spend – and that is what is now happening – then private incomes start to fall dramatically, and an economic depression is the result. We need to remember that the spending of one party (household, firm or government) becomes the income of another party.

The world only got out of the Great Depression of the 1930s when households and governments started spending again, creating business confidence. This happened in different countries at different times, following currency depreciations, expanded welfare schemes, temporary import controls (eg the UK), and an increased willingness of governments to borrow to spend on big projects (eg USA, through the 'New Deal').

An interesting example of such 'public works' spending in the USA was the Golden Gate Bridge in San Francisco. (You may have seen on the TV news the story of the 75th anniversary of this bridge.) This was actually financed by one very rich California banker lending the money to the municipal authority that had already planned the bridge. Construction began early in 1933 in the middle of the Depression in the USA, thanks to the existence of a 'shovel-ready' project, to the willingness of a local government authority to run a huge deficit, and to the willingness of a publicly-spirited multi-millionaire citizen to take up that investment opportunity.

The global fiscal crisis can be sorted by governments (local and national) borrowing more (not less). The resulting spending can lead to a revival of business confidence. When businesses are confident – and the banks share that confidence – then the period of private austerity comes to an end. The resulting income earned by the spending of governments and the investment spending of newly confident businesses generates a growth of government tax revenue that out-paces the extra government borrowing. Reduced private surpluses are balanced by reduced public-sector deficits.

The Eurozone crisis, however, is in large part a political crisis that requires a political solution. One solution would be to make the Eurozone into a single country (also called a 'fiscal union') – the United States of Europe – with subsidies payable to the poor regions. Germany already pays subsidies to its poorer provinces. One big problem would be that, if decision-making was dominated by Germany, then this new country could be seen as Great Germany. The European nations fought great wars in the 20th century in order to not become part of a Great Germany!

Another solution would be to create two Euros – a southern Euro (with a fiscal union centred on Italy) – and a northern Euro (with a fiscal union centred on Germany) – within the European Union (EU). It is likely that some countries at present in the Eurozone (eg France) would go back to their own currency. Thus France could operate within the EU in much the same way as the Great Britain does today.

It is important to appreciate that all of these big problems do have workable solutions. If we look back into history we see solutions that seem obvious to us today, but which were very difficult for the people living in those times to see clearly.

------------------------------------------