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Confusion in Euroland

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There is a widespread failure to understand the nature of the crisis in Europe. Contrary to all the finger wagging, the central problem is not profligate spending by debtor-nation governments, but the very setup of the European Monetary Union (EMU). The story about fiscal excess simply doesn't apply to countries like Ireland or Spain, and even in the case of Greece it is either overblown or misses the crucial facts. The figure below, which breaks down the public and private debt ratios of some key EMU nations, shows that a significant rise in government debt ratios was caused by the 2007 global financial crisis. Precrisis, only Greece and Italy significantly exceeded the 60 percent Maastricht limit for government debt. But if you look at private debt, almost all of these countries had precrisis ratios above 100 percent of GDP—half had ratios above 200 percent. Calling this a "sovereign debt crisis" misses the point.

There was something else going on here; something that has been in the works for the past 40 years: a general trend in the West of rising debt-to-GDP ratios. While government debt is part of this trend, it is dwarfed by the rise in private debt. Taking the West as a whole, government debt grew from 40 percent of GDP in 1980 to 90 percent today, while private debt grew from over 100 percent to roughly 230 percent of GDP. This explosion in private debt is largely a function of the "financialization" of the economy and the rise of managed money—a huge increase in financial assets (the flip side of this private debt) under professional management. This is not a Mediterranean phenomenon. Greece's post crisis debt ratio (private plus sovereign) of 250 percent of GDP pales in comparison to the nearly 500 percent US ratio.

Government spending did not cause this crisis, and fiscal austerity for the periphery will not solve it. To see why, we need only look at the balance sheets. One of the other unacknowledged reasons for the growth in debt-to-GDP ratios in the developed world as a whole was the rise of current account surpluses in Brazil, Russia, India, and China—the BRICs. These BRIC surpluses have been matched by current account deficits in the developed West. Likewise, current account deficits in Greece and the rest of Europe are the mirror image of current account surpluses in Germany. Any attempt at debt resolution must take these balances into account.

In the eurozone, the only way to pursue austerity while avoiding a crippling slowdown—which would cause a rise in private sector indebtedness—is to facilitate a corresponding reduction in current account deficits in the periphery. But this will only be possible if Germany reduces its external surplus. We cannot sensibly lecture Greece about reducing its debt ratios without asking Germany to move toward a current account deficit.

So far, political authorities have refused to consider expansionary policies for creditor nations like Germany. With a common currency, this leaves deflation on the periphery as the only means to restore competitive balance. But deflation itself imposes huge costs on debtor nations. It increases the value of their nominally denominated debts, making default, and an EMU breakup, more likely. Until policymakers see these facts clearly, no amount of austerity will prevent the collapse of the European project in its present form.

A more detailed discussion of this topic can be found at www.levyinstitute.org/pubs/wp_693.pdf.

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Net Debt as a Percentage of GDP

Note: Government figures are IMF calculations of net debt of general governments, after subtracting monetary assets held by governments. *Sources:* International Monetary Fund; European Central Bank (via Rebecca Wilder)