

## **THE EURO CRISIS: A story of multiple structural imbalances**

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### **Executive Summary**

Several design failures of the European Union and especially the Currency Union have been evaluated and investigated as causes of the crisis. The lack of a banking union has been identified as one fundamental flaw. However, the financial aspects are only one side of the developments leading up to the Euro crisis. Structural imbalances on the real side, between imports and exports, but also between net lending/net borrowing imbalances within countries have played a substantial role in the development of the crisis and have made many Southern economies but also those in Central Europe vulnerable such that the financial crisis was able to develop into the greatest recession since World War II. In the following research the financial and real inter-linkages between the institutional sectors as well as distributional developments within the European Union, following Goodwin (1967), will be investigated in order to get a better understanding on the process leading up to the crisis.

Furthermore the research project seeks to analyse long-run patterns of demand for the Euro zone. To this end and following Barbosa-Filho et al. (2008), the National Income Accounts' separation of the economy into the institutional sectors Business, Households, Government, and Foreign will be used. Given this dissection, total aggregate demand can be decomposed into the difference of expenditure (injections) over saving (leakages) of each sector. The relevance of such net injections – also called net borrowing flows – and the adding-up constraint that they are subject to has been pointed out originally by Godley and Cripps (1983). This constraint goes back to Keynes (1936) who stated that national income has to equal national output (an idea going back to the American Institutionalists and ultimately to the Venetian merchants of the 12<sup>th</sup> century). At the aggregated macro-level such net borrowing flows can be employed in answering questions of economic structure and causality: Using the adding-up constraint one can investigate how economic activity of which sector leads the other sectors', which sectors are actively pursuing net borrowing and which ones are playing the accommodating part, and whether one sector's net borrowing is sustainable over time.

In a related research project, Barbosa-Filho et al. (2008) used a simple, statistical apparatus to gain some important insight into the working of the US economy. Using correlation between net borrowing flows and simple lead-lag analyses, they demonstrate how the countercyclical spending of the government is a necessary and functional one which cannot easily be dismantled, that consumption smoothing is not the reality for US consumers, and that twin-deficits are more likely to occur between household spending and external deficits than fiscal and external. Also they illustrate how household spending leads the end of a recovery of the economy after a recession. A similar analysis on sectoral net lending's influence and reaction to output growth will be done for the countries of the European Union. Thereby we can assess the importance of counter-cyclical government spending as well as open economy doctrines like the Ricardian Equivalence, the structural gap models or the twin-deficit hypothesis and whether there is empirical evidence supporting them.

## References

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