

Working Paper

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The Eurozone: Similitudes and differences with Keynes's Plan²

Abstract

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² This paper is a slightly revised version of the paper that was presented at the International Research Workshop 'Full Employment in Europe: With or Without the Euro?', organized by Jean-François Ponsot and Mario Seccareccia, and held in Grenoble, May 15-16, 2014. It was co-sponsored by the Institute for New Economic Thinking and the Centre de Recherches en économie de Grenoble.

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Summary

The eurozone is often considered to be the brainchild of Robert Mundell, who has often bragged about his paternity. In reality, the Eurozone setup, most specifically the TARGET2 settlement system, has several characteristics that look alike the plan for an international currency union that Keynes proposed in the early 1940s. The main objective of the paper is to show the similitudes and the differences between the Eurozone currency union and Keynes' Plan. The paper will also discuss some of the confusions that have arisen from the analysis of the TARGET2 system and the decision of the German constitutional court; and it will deal with the question of whether or not the European financial crisis of the GIIPS countries was akin to a balance-of-payments crisis as argued by some authors and denied by others.

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Introduction

The intellectual paternity of the euro and of the Eurozone is often attributed to Robert Mundell, who designed the concept of optimal currency zones. The creation of the idea of optimal currency areas is indeed one of the two reasons why the Nobel prize committee chose Mundell as a recipient of their prize. Jean-Claude Trichet, the former president of the European Central Bank ‘said quite explicitly that [Mundell] was the father of the euro’ while Mundell himself has often bragged about the influence that his ideas on the possibility and advantages of currency unions have had on the creation of the Eurozone (Vane and Mulhearn 2006, p. 100). Indeed, at least before 2010, most of the discussions by mainstream economists about the prospective success of the Eurozone and the likely defects of a common euro currency were conducted around the notion of optimal currency areas and whether a set of European countries could be said to constitute such an optimal currency area. As Mundell himself said, ‘the optimum currency area argument has been used both for and against the creation of the euro’ (Vane and Mulhearn, 2006, p. 98). Thus a majority of mainstream authors would implicitly claim that the Eurozone is the brainchild of Mundell, although they would dispute whether it was an appropriate decision to implement it in the case of a large set of diverse European countries, whether or not all of them had managed to fulfill the (in)famous Maastricht criteria.

The intent of the present paper is to look at the Eurozone setup from a different angle. As I was writing the international economy chapter of my book on post-Keynesian economics (Lavoie 2014: ch. 7) in the Spring of 2013, discussing the Eurozone setup, in particular the TARGET2 clearing and settlement system that I had previously described in a previous paper first written in 2011 (Lavoie 2013), as well as the plan for an international clearing agency that Keynes had put forward in the early 1940s as an alternative to the abandoned gold exchange standard, I was struck by the resemblances between Keynes’s Plan and the Eurozone setup. I quickly discovered that this was not such an original insight, as I later became aware of a paper that Sergio Cesaratto had written at about the same time and which was published at the end of 2013. Cesaratto (2013) also underlines the similarities between the main features of TARGET2 and Keynes’s Plan, devoted to the creation of an international currency union based on an

international clearing agency. Indeed, writing the chapter, I also discovered that there exists a private clearing and settlement arrangement between a number of countries that has several similarities with the main plank of Keynes's Plan.

It thus seems to me that, willingly or unwillingly, it may be more appropriate to say that the euro is the brainchild of Keynes, rather than the brainchild of Mundell. However the Eurozone has some features that were not found in Keynes's Plan, and reciprocally, Keynes's Plan had some features that are absent from the Eurozone setup. The examination of the similarities and differences between these two institutional constructions may thus help us understand why the Eurozone setup eventually turned out to be such a disastrous experiment, one that a number of economists believe should be aborted to avoid a prolonged period of stagnation and hardship, recognizing that it is most unlikely that the setup will be modified in any substantial way.

The rest of the paper will go as follows. First, we shall recall the main elements of Keynes's Plan. Second, we outline the main features of the TARGET2 clearing and settlement system, showing how it closely resembles Keynes's Plan. Third, we go through some of the arguments that have been advanced regarding the Eurozone crisis as they are related to the clearing and settlement system and to the rules that govern the European Central Bank (ECB), wondering whether it is akin to a balance-of-payment crisis or whether it results from a defective setup.

Keynes's Plan

Keynes, as early as 1930, already argued that an ideal international monetary system should incorporate the existence of what he called a Supernational Bank. Such a super central bank would have as assets gold, government securities and advances to national central banks; the liabilities of the Supernational Bank would be the deposits of national central banks at the Supernational Bank, in other words the reserves of these central banks, which Keynes called the Supernational Bank-money. All international exchanges would have to go through the Supernational Bank, with payment in the Supernational Bank-money. In the view of Keynes (1930: 399), 'the ideal arrangement would surely be to set a Supernational Bank to which the Central Banks of the world would stand in much

the same relation as their own member banks stand to them'. At the time, the objective of the creation of such a Supernational Bank seems to have been the relative stability of prices.

When, ten years later Keynes was asked to devise the currency arrangements that could be put in place at the end of the war, the purpose of setting up some supernational banking institution had completely changed. In September 1941, he argued that 'it is characteristic of a freely convertible international standard that it throws the main burden of adjustment on the country which is in the *debtor* position on the international balance of payments, -- that is on the country which is (in this context) by hypothesis the *weaker* and above all the *smaller* in comparison with the other side of the scales which (for this purpose) is the rest of the world' (Keynes 1980: 27). Keynes rightly pointed out that while debtor countries must pursue some downward adjustment because they will eventually run out of foreign reserves, there is no such compulsion for creditor countries to pursue an upward adjustment. Thus, Keynes argued that 'the object of the new system must be to require the chief initiative from the creditor countries, whilst maintaining enough discipline in the debtor country' (Keynes 1980: 30).

The austerity policies proposed by mainstream economists and the European Commission as a solution to the Eurozone crisis exemplify the main drawback of current fixed exchange rate regimes, be they of the standard sort or currency unions such as the Eurozone: the burden of adjustment falls on the country that is running a current account deficit or a balance-of-payment deficit. The alternative to the Bretton Woods system that Keynes put forward in the five drafts of his Plan for an International Currency Union, which he wrote between September 1941 and August 1942, was precisely based on the opposite principle: it is the country running the current account surplus that ought to defend the parity of the exchange rate. In other words, Keynes wanted the burden of adjustment to fall mostly, or at least equally, on the creditor, and not on the debtor. As was pointed out earlier, the reason for which the creditor – the country running a current account surplus – ought to provide support for exchange rate parity is that it is much easier to stop a currency from appreciating than it is to stop it from depreciating. In the former case, the central bank can buy foreign exchange without limit by issuing its own

money. The country running a surplus can sell unlimited amounts of its own currency and thus preserve an exchange rate peg. By contrast, the debtor with a current account deficit, or more precisely with a balance-of-payments deficit, will eventually run out of foreign exchange reserves. Keynes wanted a system where international disequilibria would be resolved by expanding exports and imports, not by restricting imports through austerity policies, because Keynes thought that in general countries possessed the productive capacity to produce more. He aimed at ‘the substitution of an expansionist, in place of a contractionist, pressure on world trade’ (Keynes 1980: 46).

As pointed out by Keynes in several of his drafts, the idea underlying the Currency Union and its International Clearing Bank (ICB) is simple, ‘namely to generalise the essential principle of banking, as it is exhibited within any closed system. The principle is the necessary equality of credits and debits, of assets and liabilities. If no credits can be removed from outside the banking system but only transferred within it, the Bank itself can never be in difficulties’ (Keynes 1980: 72; cf. 112 and 171). Paul Davidson (1982: 223), who has been a long-time advocate of such a plan, or more precisely of a slightly modified version of it, concurs with Keynes, claiming that the Plan is to have ‘a *closed*, double-entry book-keeping clearing institution to keep the payments score among the various trading regions plus some mutually agreed upon rules’.

All five drafts of Keynes’s Plan propose the same setup (Keynes 1980: 33-195). They differ only in the limits being imposed on debtors or creditors, on the consequences of prolonged surpluses or deficits, and on how credit and debit balances would be remunerated or paid for. The main features of Keynes’s Plan are the following. First, all international transactions must first go through the relevant national central banks.³ From Keynes’s (1980: 212) standpoint, the advantage of such a procedure is that it facilitates the imposition of capital controls and increases the likelihood of getting rid of currency speculation. Second, all international transactions then clear through the clearing

³ Note that since 2002 there exists an special private international institution, the CLS Bank, that acts as a clearinghouse that settles foreign exchange transactions occurring in a dozen of major currencies. As in Keynes’s Plan, all payments first have to go through the central banks of the countries so involved. The purpose of this private international clearing bank is however different from that of Keynes: it is there only to avoid the so-called ‘principal Herstatt risk’, that is, the risk that a bank could have provided the sold currency without having received the bought currency. The CLS Bank is a pure financial intermediary.

accounts that these central banks hold at the International Clearing Bank (ICB). Third, each central bank must be ready to sell its own currency against credit at its clearing account at the International Clearing Bank. Fourth, the clearing accounts are expressed in an international bank-money, similar to the Supernational Bank-money of the *Treatise*, which Keynes started to call the *bancor* in the third draft of his Plan.⁴ Fourth, the Plan is based on a fixed exchange rate system, each foreign currency being expressed as a fixed value of the *bancor*. The parities would first be set in accordance with the existing exchange rates, exactly as when the conversion rates towards the euro were decided in January 1999, and would then be modified, according to circumstances, by following pre-established rules. Fifth, each national central bank, based on the past value of its international transactions in goods and services, is allocated a corridor within which its debit or credit position at the International Clearing bank should remain.

National central banks that are in a debit position, thus being forced to take advances from International Clearing Bank, are being charged a low rate of interest set by the latter. In later drafts, the interest rate being charged is higher on the debits that exceed that allowable by the corridor. When outside the corridor for a certain amount of time, the debit countries are *entitled* to depreciate their currency. Keynes slightly changed his mind about national central banks that are in a credit position. In the earlier drafts, credit balances carried no interest payment, and the surpluses could be confiscated by the International Clearing Bank. In the later drafts, central banks with credit balances had to pay an interest charge similar to that of central banks with debit balances. Both schemes were designed to encourage creditors to expand their economic activity and thus avoid future charges. Creditor countries may also be *required* to appreciate their currency.

How does the system work? Take the example of a Spanish importer of German cars, before the introduction of the euro. The Spanish importer would have paid for the cars in pesetas, from his or her account at a Spanish bank (say Santander); the payment would go through the Banco de España (BdE), which would be debited at the International Clearing Bank (ICB) in *bancor* units. The Bundesbank (Buba) would then

⁴ This was no doubt a contraction of the word 'bank' and of the French word 'or' which means gold, since Keynes presumed that the value of the *bancor* would be fixed in terms of gold.

be granted a credit in bancor at the ICB, and would credit in marks the account of the bank of the car exporter, say the Deutsche Bank, who would then credit the account of the exporter. This process is shown in Table 1.

TABLE 1

TARGET2 as a European version of Keynes's Plan

The TARGET2 clearing and settlement system that has been put in place in the Eurozone has several similarities with Keynes's Plan. In a sense this is not surprising since the Eurozone is a peculiar instance of a fixed exchange rate. Of course, things are simplified in the case of the Eurozone since Keynes's equivalent of the bancor is also the currency used for private transactions – the euro. While there is much talk about the ECB and its decisions to set the target interest rate and to provide various special lending facilities to the banks, most of the actual operations occur through the national central banks of the countries that are part of the Eurozone. When it comes to monetary transactions involving banking systems located in different countries of the eurozone, the ECB operates in a way that is very similar to Keynes's International Clearing Bank (or for that matter, Davidson's International Clearing Agency): the ECB lets national central banks accumulate surpluses or overdrafts on their accounts at the ECB. This can be shown with the following example.

Suppose again that some Spanish company imports cars from Germany and makes its payment through its Spanish bank, Santander (SB). The payment goes through TARGET2, and ends up as a credit on the account of the German exporting firm, at its German bank, here the Deutsche Bank (DB). At this stage, the Spanish bank has a debit position at the Banco de España (BdE), while the German bank has a credit position at the Bundesbank (Buba). Furthermore, the Bundesbank debits the account of the Banco de España. All this occurs smoothly as national central banks of the Eurozone provide unlimited and uncollateralized lines of credit to each other. All these debit and credit accounts are recorded in the first row of Table 2. However, by the end of the day, national central banks must also settle with each other. All the debits and credits are netted on the books of the ECB, where each national central bank then acquires a net position vis-à-vis

the rest of the European System of Central Banks (ESCB). This is shown in the second row of Table 2. Moreover, as one would expect within the confines of a theory of endogenous money and the reflux principle, the Deutsche Bank will most probably use its positive clearing balances (or reserves) to reduce its overdraft position *vis-à-vis* the Bundesbank.⁵ This is also shown in the second row of the table.⁶

There is no limit to the debit position that a national central bank can incur on the books of the ECB; that is, its liabilities with respect to the rest of the Eurosystem are not limited. They can be carried indefinitely. There is no time prescribed for the settlement of the TARGET2 balances. Additionally, national central banks in debit are charged the main official rate, which is also the rate gained by those with claims on the Eurosystem. Thus these imbalances could go on forever, as (coming back to the example) Santander would be taking advances from the Banco de España at 1.5 per cent (if this is the main refinancing rate), while the Banco de España would be accumulating liabilities within the Eurosystem at the same pace, also at 1.5 per cent interest rate.

TABLE 2

In the example of Table 2, we assumed that German banks would not provide overnight lending or longer-term lending to Spanish banks. But if they were to do so, as they did before 2007, the current account deficit of Spain would be compensated by a financial account surplus. There would be no increase in the balance sheet of the ECB. But if the overnight market within the Eurozone is partially frozen, as was the case starting in the summer of 2007, then the second row of Table 2 is indeed the most likely result of imbalances in current accounts. Similar changes to the balance sheet of the ECB will also occur if economic agents lose confidence in the Spanish banking system and

⁵ This was interpreted by a well-known German economist as meaning that the increase in the debit position of GIPS countries at the ECB implied a reduction in the credits that the Bundesbank was granting to German banks, thus implying some crowding out of credit expansion in Germany (Sinn and Wollmershäuser 2012). Needless to say, this interpretation was the result of a highly confused understanding of monetary economics and of the implications of endogenous money, as shown by Bindseil and Krönig (2011: 23-4).

⁶ This was shown in Lavoie (2013). Bindseil and König (2011), Cesaratto (2013) and Febrero and Uxó (2013) also has a clear exposition of this process.

decide to move their funds to German banks. Again, balance sheets will get modified as shown in the second row of Table 2.

There are thus great similarities between Keynes's Plan and the functioning of the payment system in the Eurozone, since both setups envisage an international clearing bank that grants advances to deficit countries. Obviously, Table 1 and the second row of Table 2 are nearly identical. Both setups are based on a closed banking system, where the debits are by necessity equal to the credits at the supranational bank. Indeed, TARGET2 is less constraining than Keynes's Plan, since TARGET2 has no limits as to the size of the advances that can be taken by national central banks from the European Central Bank, which acts here as the international clearing agency, whereas Keynes's Plan imposed a ceiling on the amounts that could be normally borrowed by the national central banks from the International Clearing Bank, in addition to imposing limits on the length of time during which the ceiling could be exceeded.

Still, despite the nice features of the TARGET2 setup, which fulfill the conditions for an elastic supply of credit and money, or perhaps because of them, some countries of the Eurozone have been embroiled in an extraordinary and devastating financial and economic crisis since 2010. How can this be so? The next section tries to provide some answers to this question and to provide an assessment of the kind of crisis encountered by the GIIPS countries.

A balance-of-payment crisis?

What has been shown above demonstrates that financial imbalances within the Eurozone ought not to be a problem, besides the obvious fact that a trade deficit has a negative impact on economic activity. A current account deficit of Spain or Italy with respect to the rest of the Eurozone is no more meaningful than the current account deficit of the Mezzogiorno relative to northern Italy. This point was made by Tom Palley when the debate about the relevance of a currency union was raging:

As part of a common currency area, country economies will take on a position similar to that of individual states in the US economy. These states can run either balance of payments deficits or surpluses with other states, but

this poses no problem since all use a common currency. The only effect (which is never officially recorded) is that residents of deficit states either run down their existing asset holdings or build up obligations to residents of surplus states. An analogous situation would apply for EMU member countries. (Palley 1997: 153)

Still, the Eurozone countries that ran into problems with the financial markets were precisely those countries, with the exception of Ireland, that had current account deficits (and so did France, but this seemed to leave financial markets totally indifferent). One may thus start to wonder whether it is correct to affirm that financial balances as such ought not to be a problem within the Eurozone. Cesaratto (2013: 363) points out that ‘the need to finance a CA [current account] deficit with foreign currencies seems to disappear in a CU [currency union]’. But, he asks, ‘does the foreign constraint evaporate with it, or does it reappear in a different form?’ Cesaratto is of the opinion that there can be some form of a balance-of-payment crisis in a currency union, and that the financial crisis of the Eurozone was indeed such a balance-of-payment crisis.⁷ He objects to the views of Randall Wray according to which the Eurozone crisis was not a balance-of-payment crisis. Cesaratto is adamant that the GIIPS crisis had the standard characteristics of a balance-of-payment crisis, and that austerity policies are being imposed by surplus countries as a means to generate future current account surpluses so as to insure that the external debt of GIIPS countries can be serviced and even be reduced (Cesaratto 2013: 378).

However, his own description of the unfolding events leaves the uncommitted reader, such as myself, with the impression that the Eurozone crisis was instead mainly the consequence of an initial banking problem, which transformed itself into a public debt problem, caused both by the world slowdown in economic activity and by the national states deciding to bail-out their banking system. Indeed, Cesaratto (2013: 374) himself concedes that one can view the TARGET2 balances as means to *create* the equivalent of the lost foreign exchange reserves for countries within the Eurozone which are suffering

⁷ Krugman (2014, p. 7) has also recently argued that ‘the crisis in the European periphery ... is arguably best viewed largely as a balance of payments crisis rather than a sovereign debt crisis’.

from a crisis of confidence. Cesaratto (2013: 378) further concedes that TARGET2 balances can be interpreted as the current account surplus recycling device that Keynes had envisaged in his Plan, and hence that these compensating balances can be created ‘ad libitum’, as he says himself, although he adds that ‘there are of course limits to what Minsky defined as Ponzi finance’.

There is also a mainstream view according to which the GIIPS crisis is a form of balance-of-payment crisis. Sinn and Wollmershäuser (2012) argue along these lines, pointing out that the Eurozone is a variant of a fixed-exchange rate regime. As is well explained and criticized by Febrero and Unó (2013), this mainstream view is based on a loanable funds approach and the belief in the maintenance of the *rules of the game*, according to which countries that are running current account deficits ought to see their money supply reduced, as would presumably be the case under a pure gold exchange standard with the price-specie flow mechanism, thus creating price deflation and the conditions required for a return to a current account balance, while countries with a current account surplus ought to have an expansion of the money supply. Thus, for Sinn and Wollmershäuser, the TARGET2 mechanism is the problem, as it stops the *rules of the game* from operating, since, in their view, credit is being expanded in the deficit countries while it is being contracted in the surplus countries, in particular in Germany. But it is precisely the operation of the *rules of the game* that Keynes was trying to undermine with his Plan for an international currency union. The Plan and TARGET2 allow international payments to keep on going despite large shocks. As Bindseil and Winkler (2012: 37) argue, ‘the unlimited and unconditional character of TARGET2 balances is at the very heart of monetary union. The ability of banks to transfer deposits across national central banks *constitutes* the genuine single currency’.

If we accept that the Eurozone crisis is not truly a balance-of-payment crisis, what is it? What is the flaw within the Eurozone setup that has led to such disastrous results despite the presence of the well-designed TARGET2 system that we examined in the previous section? Cesaratto attributes to Wray the opinion that the main flaw is the absence of a proper bank default resolution mechanism. The flaw is made worse by the absence of a common banking surveillance mechanism within the Eurozone. Reading

Cesaratto, he seems to put some emphasis on the absence of an inter-regional redistributive mechanism as can be found in a genuine federal state, that is, the lack of important fiscal transfers from a central government that would help the weaker countries to support negative shocks to their economy, and hence, in the view of Cesaratto (2013: 365), allow them to ‘relax the foreign constraint’. The problem would be that there are no federal transfer payments from the surplus to the deficit countries to help compensate the negative impact of trade deficits on GDP and budget balances. While these may certainly be important factors, it seems to me that the true problem lies elsewhere, in the setup and the self-imposed constraints of the European Central Bank.

The main flaw of the Eurozone

When the Eurozone was created, there was a belief among the supporters of an independent ECB, nourished by reliance on the efficient-market hypothesis and the assumption that markets are self-righting, that with the strictures and obligations of the Maastricht Treaty, Eurozone countries would never run into any sort of financial trouble. This was not the view held by some more critical economists. Cesaratto (2013: 364) recalls and translates the very prescient comments made by Simonazzi and Vianello (1999) on the prospects of the Eurozone: ‘Monetary unification eliminates one of the two causes of interest rate spreads, that is, the exchange rate risk, but not the other, linked to trustworthiness of debtors.... Financial speculation, unable to target exchange rates, concentrates on the sovereign bond market, determining a fall in bond prices, making servicing of debt unsustainable and exposing the country to a risk of insolvency’.

Similarly, Palley (1997: 155) pointed out that ‘individual governments will no longer be subject to the threat of an exchange rate crisis’. However, he adds, ‘financial capital may still be able to discipline governments through the bond market. Thus if financial capital dislikes the stance of national fiscal policy, there could be a sell-off of government bonds and a shift into bonds of other countries’. These capital movements, within the euro currency union, are even more likely in a country which is not part of a currency union since, in the former case, domestic investors can store their funds in another country while keeping them in the same currency, thus being able to threaten their government without encountering an additional exchange risk.

As was pointed out by a representative of the ECB, ‘the euro area is in fact the only area of the world where monetary and fiscal institutions are completely separate, in which the fiscal authority cannot count on the monetary authority, not only to prevent a solvency problem, but also a liquidity problem’ (Bini Smaghi 2011: 3). By both design and convention, the ECB and its national central banks did not act as a purchaser of last resort for sovereign securities, or rather did not do so until it was too late and until interest rates of several Eurozone countries escalated to unsustainable levels, driven up by the feverish sentiments of speculators and the fears caused by a sovereign debt no longer deemed default-free (Bell 2003: 82). The convention held by the creators of the Eurozone, as Sawyer (2001: 188) points out, was that interest rates are set by a ‘loanable funds consideration’, so that ‘there must be limits on the borrowing of each government, as “excessive” borrowing by one government in euros would bid up the interest rate paid by other governments, also borrowing in euros’. To avoid distortions in the financial markets, it was thus decided that it was best for the ECB not to purchase any sovereign debt at all.

A number of post-Keynesian authors were quite critical of the Eurozone setup and how the ECB and national central banks were being constrained in their ability to sustain the prices of government securities. The most explicit critics were perhaps Wynne Godley and Alain Parguez, who were quite prescient about the flaws of the Eurozone setup and their damning consequences, although it took nearly ten years for these flaws to become obvious. Their statements speak for themselves.

It needs to be emphasized at the start that the establishment of a single currency in the EC would indeed bring to an end the sovereignty of its component nations and their power to take independent actions on major issues . . . The power to issue its own money, to make drafts on its own central bank, is the main thing that defines national independence. If a country gives up or loses this power, it acquires the status of a local authority or colony. Local authorities and regions obviously cannot devalue. But they also lose the power to finance deficits through money creation while other

methods of raising finance are subject to central regulation. Nor can they change interest rates. (Godley 1992: 3)

Member states will have to be granted credit by private banks . . . Their ability to borrow will depend on the ability and willingness of private banks to finance government expenditures . . . A credit-worthy state should pledge to balance its budget, to get to a zero ex post deficit, so as to protect the banks against the risk of accumulating public debt. Government bonds will no longer be liquid assets . . . The fate of the euro will depend upon the fiscal austerity rules. States could not be granted credits by private banks if they do not meet the constraint of running a balanced budget or a fiscal surplus. To comply with this constraint, states will have to slash their social expenditures because they are the most adverse to the brutal instincts of financial investors . . . Contrary to the hopes of its architects, the Euro will increase financial instability in the world economy. By exporting its self-imposed deflation, Europe will, like in the early 1930s, accelerate the pace of the world crisis. (Parguez 1999: 73–4)

Besides a system of equalization payments, the Eurozone setup should have incorporated a central government that can pursue expansionary fiscal policies, targeting in particular the countries that are most hurt by a recession. With the present setup, individual countries are prevented from doing so on their own, first because they might be punished by financial markets while the central bank stands still, and second because the various European treaties – starting with Maastricht in 1992, moving on to the Stability and Growth Pact, and culminating in the 2012 Fiscal Compact – forbid large fiscal deficits. A number of heterodox economists, with Keynesian leanings, would agree with the above.

But the flaws of the Eurozone setup go deeper than this. Various rules, found in the guidelines and procedures of the European Central Bank, and which go as far back as the 1992 Maastricht Treaty, encumber the behaviour of the ECB and of the national central banks. They cannot make advances to national governments and they cannot

purchase government securities on primary markets. This is article 123 of the Treaty of Lisbon, also called the Treaty on the Functioning of the European Union. The same rule can be found again in article 21(1) of the Statute of the European System of Central Banks and of the European Central Bank (protocol 4 of the European Union 2010). The main refinancing (liquidity creating) operations of the ECB and the national central banks occur in the form of reverse transactions (repos), or more simply as collateralized loans. Although the European monetary authorities are allowed to take government securities as collateral when providing liquidity to banks, it can only be done if that debt is highly rated.⁸ Finally, there is the question of outright transactions on secondary markets (which elsewhere are called open market operations), which were deemed to be irregular and exceptional. It was understood that the ECB and the national central banks would not conduct open market operations at all, and hence would not purchase government securities on secondary markets, for instance to assist Eurozone countries that would have difficulties in servicing their debts or financing their deficits.

This convention about the participation of the ECB and the national central banks to the secondary markets in government securities has given rise to an economic and judicial controversy. From an outsider point of view, this is difficult to understand. Article 18 of the Statute of the European System of Central Banks and of the European Central Bank gives it the right to conduct open market operations. Under the title of ‘open market and credit operations’, the article says clearly that ‘in order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may: operate in the financial markets by buying and selling outright (spot and forward) or under repurchase agreements and by lending or borrowing claims and marketable instruments’. Article 18(2) leaves to the ECB the task of establishing principles for the conduct of such transactions.

It has been claimed by a number of economists and the German federal constitutional court that the ECB and the national central banks are being prohibited to assist Eurozone countries attacked by financial markets. What is often invoked is the so-

⁸ When the Eurozone crisis occurred however, the standards had to be modified, for otherwise the whole Eurozone financial system would have collapsed.

called no-bailout clause that is contained in article 125 of the Treaty of Lisbon (European Union 2010). But this no-bailout clause does not apply to the ECB; it applies to *member states of the Union*, who shall not assume the commitments of other member states. The German federal constitutional court invoked instead article 123 of the Treaty of Lisbon to argue that the ECB did not have the right to conduct its Outright Monetary Transactions (OMT) program that was announced in August and September 2012, a program according to which the ECB would make large purchases of government securities on secondary markets whenever a Eurozone would ask for it and would be willing to abide by the conditions set by the ECB. But article 123 only says that ‘overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States’ in favour of central governments ‘shall be prohibited, as shall the purchase directly from them ... of debt instruments’. Article 123 has no reference whatsoever to secondary market purchases, so it is difficult to see where the constitutional challenge is going, besides the claim that OMT operations are akin to fiscal policy.⁹

The Eurozone setup should have incorporated a central bank that holds and purchases large amounts of securities issued by the participating national governments. Palley (1997: 161) wondered ‘which country’s bonds the ECB will purchase’. The answer provided in the three-country stock-flow consistent model of Godley and Lavoie (2007) is that the ECB should be purchasing the bonds of countries running current account deficits or public deficits, so that the ECB would acquire the securities of the countries whose yields are likely to rise and would sell its holdings of securities whose yields are likely to decrease. The convention that the ECB should provide instead advances to commercial banks, acting for them as the lender of last resort, in the hope that the domestic private banks would purchase more of the securities issued by their government, turned out to be insufficient and even totally inept in times of crisis.¹⁰

⁹ Buiter (2008) makes a similar point, arguing as I would that: ‘It is an insignificant minor operational detail, that the ECB cannot buy sovereign debt instruments directly from the governments involved. It can however, buy any amount in the secondary markets’.

¹⁰ Even the long-term refinancing operations (LTRO) were only successful in reducing interest rates on sovereign bonds for a short while.

Thus, as Bindseil and Winkler (2012: 44) remark, ‘while the economic rationale of monetary financing prohibitions is clear, they might under some circumstances contribute to the unfolding of a confidence crisis’. This, as we know, is exactly what happened, until the ECB finally came up with its OMT program, which drove down the interest rates of the GIIPS countries. The belief that the ECB should not ever purchase government securities is now recognized, by the highest authorities at the ECB, to be highly mistaken, as this quote shows:¹¹

Turning to fiscal policy, since 2010 the euro area has suffered from fiscal policy being less available and effective, especially compared with other large advanced economies. This is not so much a consequence of high initial debt ratios – public debt is in aggregate not higher in the euro area than in the US or Japan. *It reflects the fact that the central bank in those countries could act and has acted as a backstop for government funding.* This is an important reason why markets spared their fiscal authorities the loss of confidence that constrained many euro area governments’ market access. This has in turn allowed fiscal consolidation in the US and Japan to be more backloaded. (Draghi, 2014).

Conclusion

We have seen that Keynes’s Plan for an international currency union, designed in the early 1940s, displays several similarities with the TARGET2 clearing and settlement system that rules within the Eurozone. In fact, we showed that in some respect, the TARGET2 system offers more flexibility than Keynes’s Plan since the former has no ceiling on the amounts of advances that the central banks of the deficit countries can take from the clearing bank, here the ECB. We have also argued that the Eurozone crisis is not a balance-of-payment crisis, but rather a crisis related to the flawed design of the links between the national governments and the system of central banks, in particular the self-imposed prohibition to hold large amounts of government securities and to intervene on the secondary markets for bonds.

¹¹ The italics are mine.

We conclude the paper by revisiting the major differences between Keynes's Plan and the Eurozone setup. Within Keynes's Plan, the participating central banks could still purchase the securities issued by their government, both in the primary and secondary markets, in contrast to the rules or conventions within the Eurozone. Secondly, in Keynes's Plan, credits held at the International Clearing Bank either carried no interest and could be confiscated or were subjected to an interest charge. By contrast, credits on the Eurosystem benefit from an interest rate equal to the ECB target rate. Keynes wanted that both debtors and especially the creditors partake in the necessary adjustments. Within the Eurozone, the Maastricht spirit is ever more powerful, based on the assumption that external deficits are caused by public deficits or a lack of wage-cost competitiveness and hence that sinners must get punished, through sanctions and austerity policies to be imposed on deficit countries. Meanwhile, no pressure is being exerted on creditor countries to expand their economic activity and imports so as to alleviate the problems of the deficit countries.¹²

There are two other obvious differences between Keynes's Plan and the Eurozone setup. Keynes (1980: 185) thought it evident that there ought to be controls on capital flows, an absolute no-no for Europeans. The other difference is that in Keynes's world, there was a way out of current account deficits: when these deficits were overly large, countries were allowed to devalue their currency. Deprived of their ability to devalue, Eurozone countries in crisis seem to be stuck in a 'low' equilibrium. Indeed, some heterodox economists argue that the structure of the Eurozone could be modified so as to incorporate this features of Keynes's Plan, that is, the obligation to revise the existing parities within the Eurozone, and hence to devalue or revalue all contracts and financial assets held in a given country of the Eurozone (Lordon 2013; Mazier and Valdecantos 2014). But is this just another of the many solutions that appear to be politically impossible?

¹² The European Commission now has a Macroeconomic Imbalance Procedure with an Alert Mechanism Report. While several countries with deficit imbalances have been identified and admonested, large current account surpluses do not seem to be of any real concern to the Commission.

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Table 1 Keynes's Plan when Spain imports goods from Germany

Santander (SB)		Banco de España (BdE)		Deutsche Bank (DB)		Bundesbank (Buba)		International Clearing Bank (ICB)	
Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability
	Deposit importer -1660ESP Advance from BdE +1660ESP	Advance to SB +1660ESP	Advance from ICB +10 bancor	Reserves at Buba +19DM	Deposit exporter +19DM	Credit at ICB +10 bancor	Deposit of BB +19DM	Debit position of BdE +10 bancor	Credit position of Buba +10 bancor

Table 2 The eurozone clearing and settlement system when Spain imports goods from Germany

Santander (SB)		Banco de España (BdE)		Deutsche Bank (DB)		Bundesbank (Buba)		ECB	
Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability
	Deposit importer -10 Advance from BdE +10	Advance to SB +10	Advance from Buba +10	Reserves at BB +10	Deposit exporter +10	Advance to BdE +10	Deposit of DB +10		
	Deposit importer -10 Advance from BdE +10	Advance to SB +10	Due to the eurosystem +10		Deposit exporter +10 Advance from Buba -10	Claims on the eurosystem +10 Advance to DB -10		Debit position of BdE +10	Credit position of Buba +10

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