Keynes's Plan, the Eurozone and its crisis: is it a balance-of-payment crisis?

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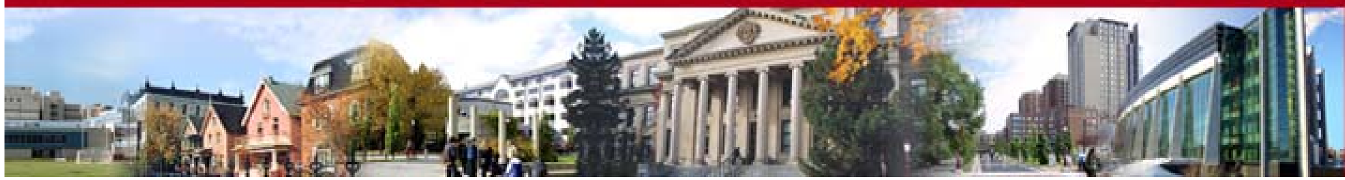

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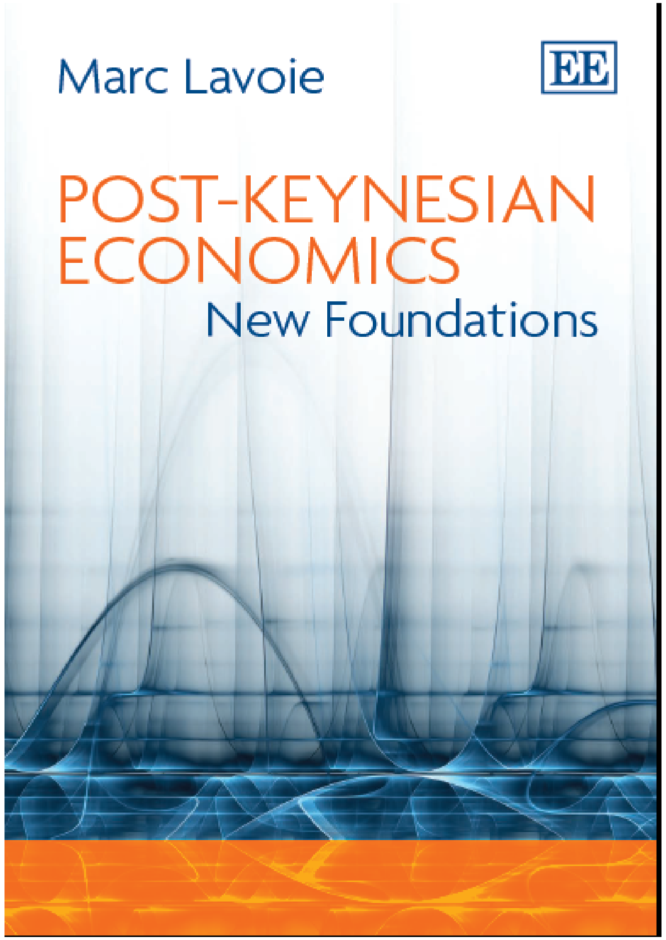

Keynes’s Plan and the euro

- The eurozone TARGET2 system (Lavoie 2011 WP; Lavoie 2013 JEI)
- Similitudes between TARGET2 system and Keynes’s Plan of 1941-42 (that goes back to 1930!) for an international clearing agency (Lavoie, chapter on open-economy macroeconomics, written in 2013; and Cesaratto 2013, EJEEP-Intervention; Zezza and Valdecantos, yesterday).
- But 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.

Burden of adjustment on who?

- Keynes 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 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).

Keynes's Plan in eight points

- All international transactions must first go through the relevant national central banks.
- All international transactions then clear through the clearing accounts that these central banks hold at the International Clearing Bank (ICB).
- Each central bank must be ready to sell its own currency against credit at its clearing account at the International Clearing Bank.
- The clearing accounts are expressed in an international bank-money, the *bancor* .
- The Plan is based on a fixed exchange rate system.
- Each national central bank is allocated a corridor for debits or credits.
- When outside the corridor for a certain amount of time, the debit countries are *entitled* to depreciate their currency. Creditor countries may also be *required* to appreciate their currency.
- Central banks with credit balances and debit balances must pay interest on them.

Keynes's Plan when Spain imports goods from Germany

Sandanter (SB)		Banco de Espagña (BdE)		Deutsche Bank (DB)		Bundesbank (Buba)		International Clearing Bank (ICB)	
Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability	Asset	Liability
	Deposit importer −1660 ESP Advance from BdE +1660 ESP	Advance to SB +1660 ESP	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

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

Sandanter (SB)		Banco de Espagña (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

Was the euro crisis a balance of payments crisis?

- **NO**: Randall Wray and myself: how is this possible with the TARGET2 system and its unlimited debits?

- **YES**: Cesaratto (2013), although his own explanations, as I read them, seem to show that it was not;

- **YES**: Sinn and Wollmershäuser (2012), but their explanation is based on a loanable funds theory, as well demonstrated by Febrero and Unó (2013). Sinn even claimed at some point that the Target2 system was taking money and credit out of Germany, hurting German firms!

Not an exchange crisis, then something else

- Cesaratto (2013: 364) recalls and translates Simonazzi and Vianello (1999): ‘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’.
- Also, 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’.

So, what is the problem?

- 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 initial critics were perhaps Wynne Godley (1992) and Alain Parguez (1999), who were quite prescient about the flaws of the Eurozone setup.
- They both argued that the eurozone would eventually impart a deflationary bias and that it would increase financial instability.

A flawed setup of the eurozone

- No fiscal transfers (equalization payments)
- No functional finance from a central government (expansionary fiscal policies in times of recession)
- Near impossibility for individual countries to launch stimulus programs (Maastricht, Stability and Growth Pact, Fiscal Compact)
- Restraining guidelines and procedures of the ECB

Restraining ECB guidelines

- **Rules**
  - ECB forbidden to make advances to governments
  - ECB forbidden to purchase government debt on primary markets
- **Beliefs**
  - That lending to banks is good enough to insure the stability of the financial system
  - That it is wrong to purchase government debt on secondary markets
  - That the no-bailout clause (article 125) also applies to the ECB

Conclusion I

- 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 government securities.
  - The moment Draghi promised to do anything that was needed, interest rates of the GIIPS started to drop, as pointed out by Gennaro Zezza yesterday.

Conclusion II

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

A Postcript I

- This paper has just been published in the *Journal of International Political Economy*.
- Sergio Cesaratto has written a comment on it, that will be published in the next issue.
- Cesaratto reiterates his 2013 position that the eurozone crisis is a balance-of-payments crisis.

A Postscript II

- Cesaratto and I agree on nearly everything, except for his insistence that the Eurozone crisis should be considered as a balance-of-payment problem.
- Our theoretical framework is similar, for instance our views about the functioning of TARGET2 and our views about endogenous money and credit and the irrelevance of the loanable funds approach are identical.
- Also we both agree that the Eurozone setup is deficient in many respects.
  - When describing the Eurozone, Cesaratto (2013) uses the words ‘flawed currency union’ no less than nine times. I myself refer to the flaws of the Eurozone setup eight times

A Postscript III

- The point I have often tried to get across is that outflows are not limited by the amount of foreign reserves in the Eurozone context, in contrast to a country on a fixed or managed exchange rate regime.
- If a Eurozone country is running a current account deficit that banks from other Eurozone members decline to finance, or if it is subjected to capital outflows, then all that happens is that the national central bank of that country will be accumulating TARGET2 debit balances at the ECB.
- There is no legal limit to these debit balances.

Postscript IV

- The national central bank with the debit balances, which pay interest at the target interest rate, has as a counterpart in its assets the advances that it must make to its national commercial banks at that same target interest rate.
- And the commercial banks can obtain central bank advances as long as they show proper collateral.
- Why would the size of current account deficits or TARGET2 debit balances worry speculators?
- There might be a problem with the quality of the loans that have been granted by the banks, or with the size of the government debt, but that as such has nothing directly to do with a balance-of-payment problem (putting aside the possibility of a 'twin deficit')

Does Frenkel endorse the balance-of-payments cause of the euro crisis?

- Cesaratto (2015) enlists Roberto Frenkel (2012) among the economists who support his ‘balance-of-payment’ interpretation of the crisis.
- I got quite a different impression when I got to read his paper.

Roberto Frenkel's 2012 view

- …Public debts in the Euro Zone economies do have a specific liquidity risk of default similar to that of public debts in emerging market economies issued in foreign currency. *This is so because governments in the Euro Zone do not have a (highly credible) lender of last resort able to dissipate this risk…*. In the Euro Zone economies' crises …the main source of negative feedback effects in the second phase of the cycle is the evolution of public debt ratios and sovereign risk premiums, throughout their effects on the portfolio decisions of the private sector. *These effects would not occur if the Euro Zone governments had a credible lender of last resort*…. [Vicious public debt ratios and risk premiums] *could have been stopped by the operation of the ECB as a credible lender of last resort of the Euro Zone governments*, in the same way as did the central banks in US, UK and Japan after the financial crises burst in these countries. (Frenkel 2012: 9 and 13, my italics).