The Eurozone crisis:

Looking through the financial fog with Keynesian glasses

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It is easy to become confused about what is really happening to the European economies. The media are totally focused on financial surface phenomena. Attention is given only to the developments in the financial markets, in particular the growing difficulties of the so called PIIGS countries (Portugal, Ireland, Italy, Greece and Spain) for keeping on financing their government spending by increasing debt — as reflected by increasing spreads in interest rates (e.g. compared with German rates).

However, looking just below the surface one discovers that the Eurozone is suffering from a kind of disequilibrium that is similar to the type of imbalance existing in the trade relationship between the US and China.

The origin of the US-China imbalance can be found in the huge expansion of credit and debt in the US (a Minsky-type process), which financed a large consumption and import boom — including a boom in imports from China in particular. The vast import boom caused in turn a large US trade deficit and a growing external debt. External debts cannot grow indefinitely; at some point markets judge them unsustainable.

With a de facto fixed exchange rate between the dollar and the yuan, the only way available for the economy to stop the unsustainable growth of debt is through recession, which was induced by a financial panic. When the process of credit and debt expansion reaches what is believed to be an unsustainable level, the markets panic.

There is also a fixed exchange rate regime within the Eurozone, a common currency. There was also a wide Minsky process of credit and debt expansion in the EU. As in the US, the lending boom financed a large expansion of consumption. Wide availability of credit generated in PIIGS a large debt-financed increase in consumption (both public and private), with growing imports and large trade deficits as a consequence.[1] In the last several years, current account deficits for PIIGS were often at levels which within a flexible exchange regime would have caused large depreciations (see Table 1). Germany, on the other hand, had during these same years large current account surpluses.

[1] As in the case of the US "toxic asset" bubble, the European lending boom also had an important element of fraud. This must be the case when a creditor lends to a borrower knowing that s/he is insolvent. In that case, the idea behind the loan must be to take over the property of the debtor, or that the State (i.e., the EU) will step in. Several books document "debt-pushing" and other criminal activities within the wide global financial underground (see e.g., J. Stiglitz, *Globalization and Its Discontents;* J. Henry, *The Blood Bankers: Tales from the Underground Global Economy*; J. Perkins, *Confessions of an Economic Hit Man*).

Table 1
Germany and PIIGS: Current account balance (% of GDP)

	2005	2006	2007	2008	2009	2010
Germany	5.0	6.3	7.5	6.3	5.7	5.7
Greece	-7.5	-11.1	-14.3	-14.8	-11.0	-10.6
Ireland	3.5	-3.5	-5.3	-5.8	-2.8	-0.5
Italy	-1.7	-2.6	-2.4	-2.9	-1.9	-3.5
Portugal	-10.4	-10.7	-10.1	-12.6	-10.9	-10.4
Spain	-7.4	-9.0	-10.0	-9.7	-5.1	-4.6

Source: World dataBank

As we implicitly did in the case of the US-China relationship, we can for simplicity assume, as an approximation, that there is a situation of bilateral trade between Germany and PIIGS, in which German exports are PIIGS imports and vice-versa. Credit expansion in the Eurozone generated a demand expansion in PIIGS. The expansion of demand included the expansion of the demand for imports. The import demand expansion in PIIGS allowed for rapid growth of German exports. On the other hand, German aggregate demand (and in particular, import demand), was severely constrained by a strict wage restraint policy.[2] As a result, Germany's trade surpluses increased. Export-oriented growth, based on stagnating domestic demand and wages, also implied for Germany deteriorating overall wage-shares and income distribution.[3]

The demand generating function of PIIGS, and their role of absorbing growing German exports, resembles the US demand creating and export absorbing role *vis-à-vis* China. Only that in the European case it is the richer country, Germany, which applies a policy of export oriented growth dependent on external demand growth, and based on wage and domestic demand restraint, with the same negative effects on functional and personal income distribution.

PIIGS's role of demand creators within the Eurozone, that is, their role of permanent net importers, resulted in their rapid accumulation of huge external debts. As shown in Table

[2] The German wage restraint policy, a kind of "structural undervaluation policy" can thus be compared with the Chinese policy of own currency undervaluation.

[3] "As measured by commonly used indices, inequality and poverty increased considerably between 2000 and 2006. For example, the ratio between the 90 percent and the 10 percent quantile increased from roughly 3.3 in 2000 to 3.9 in 2006, while the Gini increased from .26 to .30." (p.3 in M. Biewen and A. Juhasz, "Understanding Rising Income Inequality in Germany," IZA Discussion Paper No. 5062, July 2010). The wage share decreased in Germany from 71.4% in 1980-85 to 66.2% in 2008-09 (Table 2 in ILO, *Global Wage Report 2010/11*).

2, until 2010, in the five years since 2005, external debts for PIIGS increased between 50 and 100% — 80% in (unweighted) average.

Table 2
PIIGS: Gross external debt (billion euros)

	2005	2006	2007	2008	2009	2010	2010/ 2005
Greece	263	330	454	505	588	547	2.1
Ireland	1,136	1,763	2,267	2,356	2,385	2,303	2.0
Italy	1,676	2,108	2,549	2,395	2,551	2,435	1.5
Portugal	302	381	484	485	549	529	1.7
Spain	1,350	1,805	2,302	2,327	2,539	2,317	1.7

Source: World dataBank

The repayment capacity or solvency of countries, that is, their ability to pay back their debts, is often measured by the ratio of the external debt to the annual exports of goods and services, because it is the income from exports that must pay for the service of the debt. In the context of the debt crises of developing countries, an empirical standard of risk emerged, of critical debt-to-export ratios in the range of 2-3. Most debt crises episodes happened when that threshold was exceeded.

PIIGS are of course not developing countries, and they are not either totally independent economies, but belong to the common political and economic co-operative framework of the EU and the Eurozone. Debt-to-exports ratios as those shown Table 3, which are several times the empirical benchmark for developing countries, and are also fast growing, are however a symptom of unsustainable tensions.[4] The problem is that within the Eurozone there are no rules about when and how trade imbalances are to be addressed. In fact, the whole constitutive approach of the EU is based on the idea that such a problem does not exist — there is not such a thing as an imbalance or disequilibrium.

Table 3
PIIGS: gross external debt/exports (goods and services) ratios

	2005	2006	2007	2008	2009
Greece	6.0	6.9	8.9	9.0	13.4
Ireland	8.5	12.5	14.9	5.7	16.4
Italy	4.5	5.1	5.7	5.3	7.0
Portugal	7.0	7.6	8.8	8.7	11.7
Spain	5.8	7.0	8.1	8.1	10.3

Source: World dataBank

The whole approach of the Eurozone has been that of *laissez faire*, the neoliberal approach for which markets, left to themselves, constantly find the equilibrium values corresponding to an optimal solution of the resource allocation problem. In the neoclassical Utopia, all you need are free markets and egotistic individuals. There is no unemployment. No debts.

[4] Another common solvency indicator is the debt-to-GDP ratio. In the context of the debt crises of developing countries, external debt-to-GDP ratios above 0.5 were considered critical values above which the risk of payments' crises increased drastically. External debt-to-GDP ratios for PIIGS were in 2010 respectively: 2.4, 15.0, 1.6, 3.0, and 2.2 (source: World dataBank).

The free market belief is even more strongly held in the case of the financial markets, assumed to be of an almost divine omniscience — the "efficient markets hypothesis." Interfering with these omniscient markets is believed to be a kind of sacrilege which is severely punished by the financial gods. As far away from Keynes as can ever be. How is it that such efficient markets become so openly possessed by herd euphoria? How can they become prey to "irrational exuberance"? How can they ignore the warning signals of all unsustainability indicators? How can such efficient markets suddenly enter the depressive mode and collapse? Are manic-depressive markets inhabited by agents with "rational expectations"? Is collective bipolar psychosis rational?

Unfortunately, these problems are not only and not principally problems of economic theory. They are real-world problems, with difficult and even dangerous consequences. The *laissez faire* approach to crisis resolution in the Eurozone will increase unemployment and generate harsh social and political unrest. Nationalism and racism, and the tendency to put the blame for the crisis on foreigners and minorities will also grow. There is already an astonishing tendency in public opinion and the media to adhere to "national character" explanations of the crisis, and to attribute it to the fixed idiosyncrasies of different peoples (Greeks are lazy, Germans always wanted to take over Europe, etc.). Nationalist and xenophobic parties are gaining influence everywhere, including in Greece, where the extreme right-wing party LAOS is now even part of the new government.

As Keynes observed when considering the European problems of the 1930s, it is as a result of naïve and confused thinking that we believe that the best policy for promoting peace is to rely on international fixed exchange rates (or in the present case, on a common currency) and on *laissez faire* in international lending (in our case, unregulated financial markets and a conservative monetary authority).[5] Keynes warns that within such a system, "there is no orthodox means open to the authorities for countering unemployment at home except by struggling for an export surplus … Never in history was there a method of such efficacy for setting each country's advantage at variance with its neighbours' … For it made domestic prosperity dependent on a competitive pursuit of markets … [W]ith the growth of wealth and the diminishing marginal propensity to consume, it has tended to become increasingly internecine."[6]

There are several ideas in Keynes which are still relevant to address the two outstanding components underlying the present European crisis. As in Keynes's times, still today "[t]he outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes."[7]

Central to Keynes thinking in *The General Theory* is the crucial role of investment activity in capitalism. Investment is too important in determining employment and income levels to be allowed to become "the bubble on a whirlpool of speculation. When the capital development of a country becomes the by-product of the activities of a casino, the job is likely to be ill-done."[8] The capital development of Europe is being ill-done indeed by the European branch of the global financial casino.

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[5] *The General Theory of Employment, Interest, and Money*, p. 348.
[6] *General Theory*, p. 348-9.
[7] *General Theory*, p. 372.
[8] *General Theory*, p. 159.

Keynes's alternative to casino capitalism, still relevant today, is the policy of programming investment towards an optimum level of employment, and of a monetary policy unimpeded by international preoccupations.[9] Such a Keynesian investment fund should be created within the EU, with the mandate of organising investment "on long views and on the basis of the general social advantage," taking into account the efficiency of investments.[10] A long view of the social advantage would today in Europe explicitly include also avoiding climate change and environmental degradation.

Such a visionary investment organizing fund should be accompanied by an enlightened monetary policy by the European Central Bank. Monetary policy, if not totally "unimpeded by international preoccupations," should at least not be permanently chained to the vagaries of the financial markets, and the permanent threats of capital flight and speculative attacks. The ECB should announce a monetary expansion plan of several points of Euro-GDP, consistent with the ambitious investment program of the investment programming authority. This should have an immediate effect on economic expectations, shifting upwards Keynes's "marginal efficiency of capital" schedule, and increasing employment and incomes.

The ECB, or a parallel financial authority, should also exert close financial supervision in order to ensure the safety of financial products — financial regulators should be mandated to ascertain the safety and appropriate use of financial instruments and practices. All types of financial institutions (including credit rating agencies) and instruments (including derivatives) should be supervised and regulated. Financial supervision should also prevent financial fraud and illicit flows (such as financial flows related to drug and arms trafficking, tax evasion, and illegal capital flight).

In view of the present severe trade imbalances between debtor and creditor countries, a further urgent remedy is needed, discussed by Keynes in the preparatory work for the IMF. The (common currency) equivalent of a European Clearing Union is necessary, with the function of avoiding large imbalances and unsustainable foreign debt accumulation. A non-recessive system of adjustment should be introduced, which would symmetrically treat surplus and deficit nations. That is, both export and import surplus countries should share in the re-balancing effort.

In the present debt crisis context, the first urgent task of this "European Clearing Union" or financial authority should be to restructure and reduce debts to sustainability levels. The sovereign debt restructuring mechanism should be charged in the first place with checking the legality of debts, securing the elimination of fraudulent and "odious" debts.

As put by Keynes,"[t]he introduction of a substantial Government transfer tax on all [financial] transactions might prove the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprise […]."[11] That is, there is already in Keynes the idea of the so called Tobin tax, as an important policy instrument for reducing volatility and instability in financial markets, increasing economic policy sovereignty, and removing the recessive bias introduced by unregulated financial flows. The revenues of such a tax should contribute to address at the European and global levels "[t]he outstanding faults

[9] *General Theory*, p. 349.
[10] *General Theory*, p. 164.
[11] *General Theory*, p. 160.

of the economic society in which we live, [namely] its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes."[12]

However, "sand in the wheels" of international financial markets in the form of the Keynes-Tobin tax should not substitute for the possibility of introducing different types of controls when capital flows and speculative attacks seem to drive the Eurozone system or particular member economies out of control.

Conclusions

Behind the financial turbulence of the present Eurozone crisis there are real economy imbalances and disequilibria. One important class of imbalances are those related to the trade relationships within the Eurozone. In the context of a common currency zone, deficit countries (PIIGS) accumulated large external debts. Export surplus countries (particularly Germany) followed an export oriented policy, with low wage and demand growth — a kind of "structural undervaluation policy." Within neoliberal *laissez faire*, this is an unstable arrangement, and imbalances tend to be solved by recession. A Keynesian approach to the design of a more stable arrangement would include:

1. An ambitious common investment policy, on long views and on the basis of the general social and ecological advantage.
2. An expansive monetary policy by the ECB, in accord with the common socio-ecological investment strategy.
3. A European Financial Authority in charge of: a) operating a non-recessive system of adjustment, symmetrically treating surplus and deficit nations, b) managing a sovereign debt restructuring mechanism, c) exerting overall financial supervision and fraud prevention, d) introducing capital controls when necessary.
4. A European Fiscal Authority in charge of the introduction and operation of the Keynes-Tobin tax on financial transactions.

These several ideas of Keynes' should be a good starting point to address what he saw (and we still see) as the outstanding faults of the economic system in which we live, namely its failure to provide for full employment, and its arbitrary and inequitable distribution of wealth and incomes. These ideas might also have large popular support, thus being the starting point of a real democratization of the EU.

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[12] *General Theory*, p. 372.