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CAN THE EUROPEAN MONETARY UNION GET OUT OF THE LABYRINTH?

1. Introduction

The Eurozone was hit by the world economic crisis of 2008 more severely than any other part of the world and now risks falling back into recession. In this paper I will argue that the reason for its poor performance is that under a fixed exchange-rate régime — of which a Monetary Union is an extreme version — monetary policy is effective in recovering equilibrium only after money shocks. In the face of real shocks, like the ones produced by the world recession of 2008–2010, either some kind of exchange rate flexibility or public measures able to correct the effects of the shocks without leading to recession are required to correct the asymmetries that inevitably appear among the countries and the areas of the Union.

European Union policy laid down by the Maastricht Treaty did not provide any degree of flexibility to face real crisis. Maastricht regulations reinforced the characteristics of a Monetary Union conceived to act in a world where real shocks would not occur. The Treaty was based on a model of “new” classical macroeconomic theory, that markets are rational and self-correcting ¹.

¹ This view was proved to be incorrect by the worldwide recession after the monetary crisis starting in the second half of 2007, but this did not change the project underpinning European Union.
The European Monetary Union (EMU) was regarded as a first step towards European Union (EU) and policy-makers believed it would lead to the elimination of imbalance among European countries. When this did not occur, because the world had moved on from a financial crisis to real side shocks, European policy-makers did not change their view, and are still expecting that the situation will return to “normal”: a world without real shocks. This however is not happening, and their stubborn convictions are putting at risk the entire EU architecture and further worsening imbalances between European countries.

In what follows I review the traditional theory of the effects of external imbalances on internal balance. I first consider the 1940s “Keynes Plan” drafted to rebuild the international monetary order brought down by the collapse of the “gold standard” in the 1930s. In Section Two I examine the theory of “optimum currency areas” and approaches of various schools of macroeconomic thought, and compare these with today’s European project. In Section Three this theory is used to examine the present-day situation of European Member States (MS) faced with a régime of fixed exchange rates among themselves and flexible exchange rates towards the rest of the world. The conclusion is that it makes for the worst possible world for some MS and places strain onto the entire euro area as long as real shocks occur. This situation will prevail unless the world economy returns to the way it was when the European economic project was originally conceived. Unless this past situation returns, weaker Eurozone MS risk remaining in depression, and depression is likely to spread to the rest of the area through contagion, both real and financial. Section Four discusses the possibility that the strategy of “fiscal consolidation”, currently being followed by European policy-makers, might work and restore full equilibrium (domestic plus external equilibria) in the Eurozone. The conclusion is that it is very unlikely to be effective. The last
section draws some conclusions and provides indications useful for future research.

2. The Traditional Theory of International Macroeconomic Re-adjustment and the European Policy Project

2.1. The “Keynes Plan” for an International Clearing Union

The Great Depression of the 1930s inspired the Keynesian revolution in macroeconomic theory, which became the study of how first best equilibrium conditions could be reached, by way of State intervention where markets were failing to produce them. Keynes indicated full employment as the equilibrium to aim at domestically and current account balance as the external equilibrium. He showed how economies can reach internal equilibrium in the *General Theory of Employment, Interest and Money* (Keynes, 1936) by replacing an expansionist ratio between effective (aggregate) demand and aggregate supply at the domestic level for a contractionist ratio. His next aim was to find out how to co-ordinate the action of domestic policy-makers at the international level, so as to reach international equilibrium without forcing any country to abandon domestic equilibrium. The result was the so-called “Keynes Plan”.

The Keynes Plan was drawn up over a period of more than three years, and appeared in several versions (see Keynes, *Collected Papers*, Vols. XXIII, XXIV and XXV). All versions however aimed to provide for a symmetrical adjustment rule for imbalances in the balance of payments. Keynes believed that the main asymmetry that had led to the collapse of the gold standard was that under the rules fixed by that exchange rate régime, adjustment was “compulsory for the debtors and
voluntary for the creditors”\(^2\). Keynes believed that the custom of many creditor countries of sterilizing their surpluses, neither spending in buying goods from debtor countries or lending surplus to debtor countries, had been the cause of the collapse of the gold standard. His plan aimed at a Clearing Union, and its depositors were to be national central banks. The Clearing Union was to have all the characteristics of a national central bank, especially the function of issuing international money termed “bancor”. “Bancor” was to be used only to pay debts of the countries running current account deficits, and would not be convertible into gold or any currency used to build up international reserves. The aim of the Clearing Union for Keynes would be to clear international accounts, and its responses to current account imbalances were to be decisive. It would have three possible courses of action: (1) Provide cheap overdraft facilities to debtor countries. (2) Prevent creditor countries from sterilizing their surpluses, by charging them high and rising interest rates on credits occasionally kept in their accounts for long periods. (3) Exert a pressure on debtor countries to clear their external balance, by raising interest rates on overdrafts for excessive and long-lasting debt positions \(^3\). The Clearing Union would thus have pushed countries to restore external equilibria without hampering internal equilibrium, contrary to the indication of the “quantity theory of money” that external imbalances could be solved by reducing domestic wages and prices. In this way, international competitiveness would be restored in countries facing current account deficits.

\(^2\) This point is discussed in detail by Skidelsky and Joshi (2010).

\(^3\) A final indication was that persistently debtor countries would be under pressure to devalue their currency and persistently creditor countries under pressure to revalue, again with the aim of clearing international accounts.