Paper inspired by my participation in a conference focusing on John Maynard Keynes (1919), 'The Economic Consequences of the Peace', University of Brighton, September 2012[1]

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The Economic Consequences of the European Debt crises: Lessons from History (and Keynes)

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Keynes's critique of the Peace Treaty for today

Keynes was not concerned with the possible re-establishing of the gold standard in his critique of the Versailles Treaty in *The Economic Consequences of the Peace* (ECP), (CWK (1919), vol. II). His focus point was the prospects for growth in *Europe as a whole*. The execution of the war reparations imposed on Germany would, according to Keynes, choke the German economy and by that destabilize the entire European economic region to the disadvantage of all nations, including the victorious ones. To pay the war debt Germany would be forced to create a trade surplus at the expense of its own population's starvation as it expanded its exports and reduced imports to obtain the necessary foreign exchange. But a German trade surplus would be harmful to the industries of other European countries. They would experience a fall in output and rising unemployment even though their government might receive some war reparations from Germany. The distinctive feature of Keynes's theoretical framework is to see Europe as an economic unity. On top of that he calculated that the magnitude of the demanded war reparations was out of proportion with the real and direct damages caused by the war. Especially the French exaggerated their claims, which he found immoral.

Hence, the Treaty was to the interest neither of Europe as a whole, nor to the interest of any of the participating countries (in a little longer perspective), and furthermore it showed absolutely no solidarity with the people in the devastated Continental countries, who had suffered the most during and after the war.

When reading the ECP I cannot free myself from being reminded of the present situation in Europe, especially inside the euro-zone. The consequences of the Maastricht Treaty, which forms the institutional and legal framework of the

[1] It is pleasure for me to express my gratitude to those of the participants in the conference which made a number of valuable suggestions for clarifications and sharpening of the arguments.

Economic and Monetary Union (EMU) have been devastating. Southern Europe (and some other periphery countries) has within the last 4-5 years experienced a social and economic catastrophe. Unemployment rates have risen steeply and have reached a level unseen since the 2nd world war. Poverty has re-emerged to an extent beyond the imagination of the fathers of the European post-war welfare states. This unhappy situation has caught the whole of Europe in a political deadlock. Due to the requirements of the Stability Pact (and today of the Fiscal Compact) politicians of the participating countries have put themselves in a straightjacket. Although all countries have a considerable unemployment they are forced to attempt to reduce the public sector budget deficit in the middle of the economic crisis in order to comply. The negative impact of these budget cuts is further reinforced by the coinciding fiscal contraction in several European countries.

Some of the arguments why the EMU has aggravated the economic development to such an extent will be explained below. My conclusion is that the negative consequences of the EMU are apparently so damaging for Europe, that I will – like Keynes did with the Peace Treaty - without hesitation recommend a full-scale revision and partly dissolution of the Maastricht Treaty (Jespersen, 2003). Furthermore, it should be acknowledged that the information about the working of the EMU and the impact on the European economies, which I am presenting here, is already for long known to most economists in and outside Brussels and to (some of) the influential politicians.

Taking this extraordinary situation into consideration, with desperate economic conditions for millions of European inhabitants and no realistic hope of improvement if no political initiatives are taken in the near future, I think Keynes's concluding words most relevant:

> *I appeal, therefore, beyond [the] politicians to the <u>intelligence</u> of France[2] to that element in the French[1] mind which delights to see things as they are and to draw the consequences; and also to that idealism which is the child of humanity and good sense.* (CWK, II: xxii)

Will history repeat itself?

The lesson from the past is tough but undeniable: All currency unions that were not anchored in state-like political structures were wrecked sooner or later, and usually sooner rather than later. This has been the outcome when the economic developments of participating countries begin to drift apart and the internal contradictions between the different countries tighten. The weaker countries experience that rising balance of payments deficits caused the rate of interest to rise and jobs in the export industries to vanish. The pressure on these deficit countries to abandon the common currency and to gain at least some freedom in pursuing its own exchange rate and monetary policy

[2] Instead of France one should, with relevance for today, read Europe.

is enforced. The longer the deficit countries stay within the monetary union and have to accept growing foreign indebtedness, the more they feel that the monetary union represents a straitjacket, which eventually will develop into a financial crisis. A prolonged period with a deficit on the current account is usually characterized by a continuous loss of jobs and rising unemployment. Purchasing power leaks out of deficit countries and into surplus countries. Therefore, surplus countries do not see any reason to accept changes within the monetary union. They are quite happy with the currency arrangement and do not see any urgent reason to change the rules of the game. But this attitude of complacency disregard the mutual dependency which is a part of a monetary union, where the balance of payments surplus of one (or more) countries must out of the necessity imposed by bookkeeping identities be equivalent to one or more member countries' balance of payments deficit.

That the sum of surpluses is equal to the sum of deficits is not a theoretical conclusion, which can be disputed, since we are dealing with a simple bookkeeping relationship. The Euro-zone has by and large an equilibrium on the current account with other countries due to its floating Euro-exchange rate. In the present case, therefore, one has to be aware that the mounting current account surpluses in Northern Europe, primarily represented by the German surplus (roughly equivalent to the entire EU budget), as a matter of accounting have to be matched by corresponding deficits in Southern Europe. Against this background of mutual dependence it hardly makes sense to ask EMU-countries to put their national current account into balance, because one country cannot reduce its balance of payments deficit without, at least, one surplus country agreeing to reduce its surplus.

To make a monetary union function, it is a requirement that the economic structures and the priorities in the overall policy are quite similar among the participating countries. A harmonious development within the EMU must in particular imply that surplus countries are willing to reduce their surplus – and even for a period of time to accept a balance of payments deficit, which is a necessity for the Southern countries to get rid of at least parts of the foreign debt. So the question to be posed with regard to the future of the EMU is: Will Germany, the Netherlands, Austria and Finland be prepared to go into balance of payments deficits for a number of years? If not something else has to give and history will most likely repeat itself.

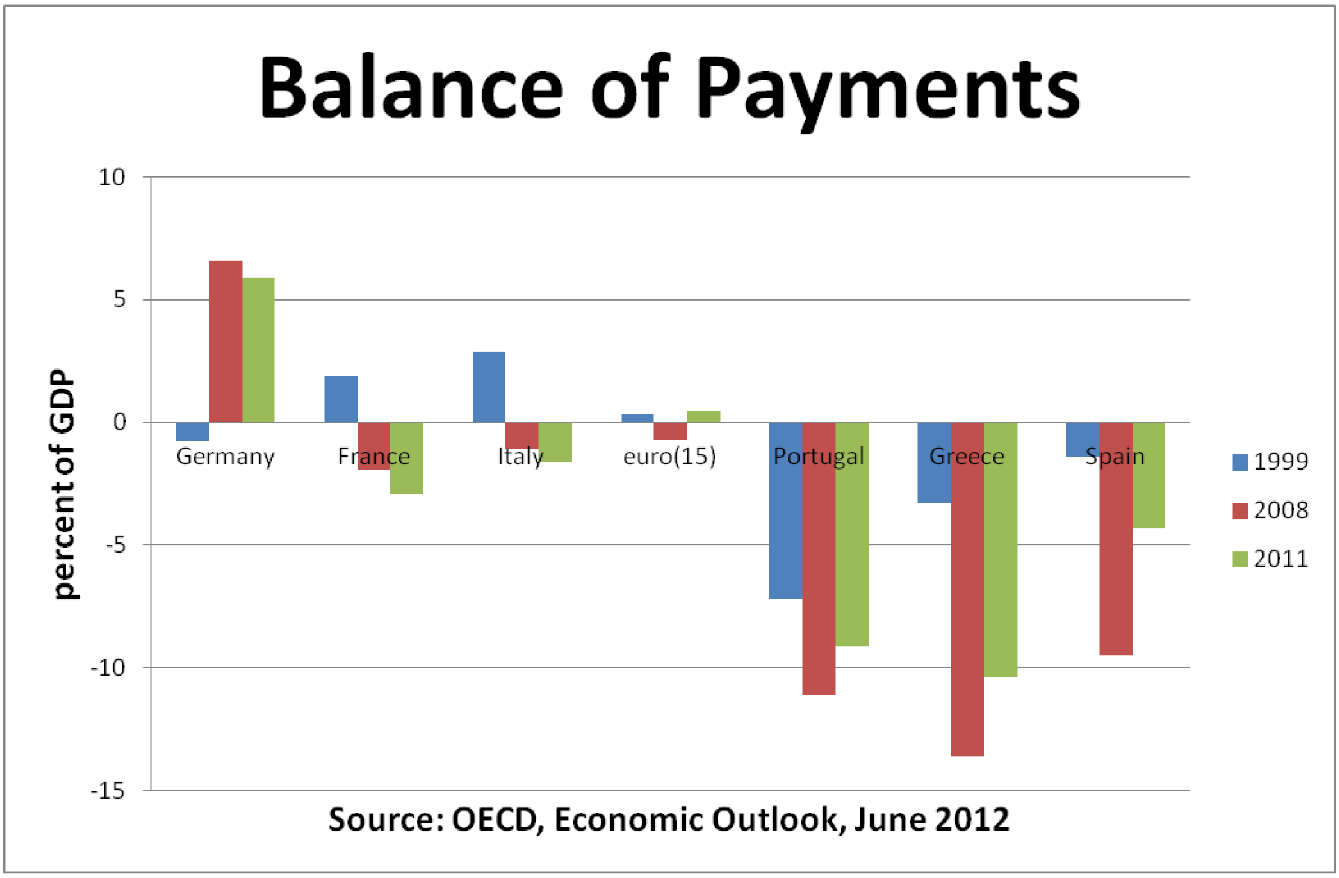
Too little focus on balance of payments disequilibria

The Northern European countries have, since the EMU was launched in 1999, focused on an economic development with price and money wage stability at the centre of national economic policy. In fact, until 2008, German economic performance was considered disappointing. Her exports did well, but domestic demand, especially private consumption, lagged, leading to poor real economic growth. This was a deliberate prioritization by a German government that preferred cost stability at the expense of growth. Conversely, the countries of Southern Europe were more interested in supporting real growth in an attempt to catch up with the richer countries in the northern part of the region. This catching up policy had the consequence of a faster cost development and rather sluggish structural reforms in Southern European countries. In these countries unit labour costs rose 2-3 percentage points quicker per annum than in Northern Europe. Such a difference does not play any role in a single year; but when it continues year after year for more than 10 years, the difference in cost *levels* becomes significant. Today it is 20-30 per cent more expensive to produce similar goods in the Southern compared with the Northern parts of the EMU. Such a difference cannot avoid being reflected in growing surpluses and deficits in foreign trade in goods and services.

Throughout the entire time the Euro has been in existence, the Southern European countries have run larger and larger current account deficits, with the consequence of an accelerating foreign debt. The external debt of the South has grown year by year. This growing imbalance was in the beginning considered temporary and of minor importance, because these deficit and surplus countries had a *common* currency. Economists and politicians were misled by a wrong analogy comparing the situations of sovereign states with regions inside a national state. It was not understood that the easiness (or rather the difficulties) of borrowing abroad do not depend on sharing the same currency, but sharing a mutual responsibility for economic development. At the end of the day, it is the federal government of the US, which has the economic responsibility of the economic performance of the different states. If the Californian state government goes bust, Washington will step in – for sure not unconditionally, but the Federal Government will stabilize the Californian economy and make it possible for profitable Californian firms to able to borrow in dollars at a reasonable rate of interest. In this case it makes sense to have a common currency. They have a shared political responsibility, a shared cultural back ground, a shared language and a highly integrated labour market. Contrary to the states of the US, countries within the EMU are in principle politically sovereign. They do not share political or economic mutual responsibility. Their labour markets remain highly fragmented, geographically, linguistically, legally and culturally - just to get north and south to integrate within Italy seems still to be a problem after 150 years of political unification. Within the EMU there is no institution, which secures automatic convergence of the balance of payments imbalance. On the contrary, the shared monetary and exchange rate policies make the countries drift even further away from each other. The rate of interest and the Euro-exchange rate are too low for some countries and too high for others, because it is set to match the 'average' country which does not exist.

But as long as the overall economic development in the EU showed positive growth rates of 2-3 percent in most countries and falling unemployment, politicians (and most economists) were willing to ignore these underlying growing cost imbalances. Equally surprising was that the often very fearful financial markets continued to provide loans to Southern Europe on terms which did not differ much from the rate of interest in Northern Europe. Right up until 2007, the rate of interest paid by debtors in Greece was only ½ percentage point higher than the rate on a comparable German loan. In retrospect, it can be seen that the financial markets (and rating agencies) were, to say the least, incompetent in their judgement on country risks. Anyone with an insight into macroeconomics could already at that time see that the balance of payments situation was fundamentally untenable, cf. figure 1. Here it is seen how imbalances grew from the start of EMU in 1999 until 2008 in the North (represented by Germany) and in the South (Spain, Portugal and Greece). And still worse, these Southern countries, although in a deep recession, are still running a deficit at the balance of payments, making them even more dependent on foreign borrowing. Foreign indebtedness continues to grow year by year; this has already caused Greece, Portugal (and Ireland) to demand financial help from the EFSF. These loans carry a relatively high rate of interest (between 5 and 6 percent p.a.) and very, very hard conditions on public finances. I will return to these conditions, which seem to be misplaced as long as the major problem is lack of foreign competitiveness rather than public overspending.

Figure 1 Balance of Payments surpluses and deficits



Note: The balance of payments for the Euro-zone as a whole comes close to zero

Balance of payments, unemployment and budget deficits

The EMU countries with the largest balance of payments deficit were hardest hit by the financial crisis, which developed starting in 2008. They had to depend on foreign borrowing. When the international capital markets dried up in the wake of the Lehman Brothers' collapse, these countries stood with an acute financial problem. Interest rates soared, especially for those countries that had the highest private foreign debt and also the weakest private banks (and other financial institutions): Ireland, Greece, Portugal and Spain.

In these countries the national governments had to support the financial sector to such an extent that it became a debt burden by itself on public finances. Later the public debt grew as a consequence of rising unemployment. As a consequence the weaker Southern European countries found themselves in a double debt squeeze: foreign and public debt. The true understanding of this development requires that the proper causality is unveiled. There are of course several causes; but instabilities of the private sector real investment (housing bubbles) and financial sector excess lending seem to be dominant. It quickly became apparent that it was countries with large current account deficits that were most vulnerable. They had to varying degrees based growth in the national economy on domestic private demand, particularly in a fiercely overheated construction sector, which collapsed when interest rates began to rise and credit was rationed.

Public sector budget deficits, where do they come from?

The balance of payments deficits and surpluses within the EMU add up to zero; but nearly all EMU-countries have a deficit on the public sector budget. How can that be? There are two different kinds of macroeconomic imbalances marring the EMU-countries: 1. different cost-levels and 2. lack of effective demand. The latter had not developed as a uniform problem until the outbreak of the economic crisis in 2008. The main reason for today's government budget deficit can be attributed to the significant imbalance in the private sector between savings and real investment in all EMU-countries. When private savings exceed private real investments there is a drag on effective demand and unemployment increases. In a closed economy, the real activity will go on falling until savings and real investments match each other. A public deficit can counterweigh the lack of private real investment. In modern welfare states the so-called automatic stabilizers will ensure increased public social expenditures during a recession. The smaller the size of the automatic stabilizers is the deeper the fall in private income and employment will be. Increased public real investment can also fill in part of the lacking private investments. At the end of the adjustment process, a private financial surplus has to match exactly public sector deficit[3]. Hence, the cause of public deficit will usually be found in the private sector imbalance and increased unemployment. Those EMU countries, which have experienced a particularly large deterioration in government budgets, have, without exception, also had the largest increase in unemployment. This increase can be attributed to a collapse in private investments and partly to large current account deficits[4].

When these causal relationships are recognized, it is also easier to understand why a one-sided focus on public sector budget deficits, particularly in Southern Europe, will not be able to overcome the economic crisis. Public savings will primarily have the effect of raising unemployment further. Higher unemployment is a burden on social spending and reduces tax revenues. The automatic budget stabilizers have a size of approximate ½ percent of GDP for each percentage point increase in unemployment. This means that every time the unemployment rate rises by one

[3] This book-keeping identity counts for a closed economy without foreign trade. In this case a surplus in the private sector is by definition equal to a similar deficit in the public sector - this cannot be discussed. If foreign trade is integrated into the accounting identity, the private sector's savings surplus may be used to finance net exports abroad - ie. a balance of payments surplus. The point is that the sum of the public sector deficit and balance of payment surplus adds up to a ***financial surplus*** in the private sector, ie. financial saving in excess of real private investment. This is the situation in Northern Europe. In these countries, the saving surplus in the private sector is so large that it not only can cover the public sector deficit, but also the current account deficit in Southern Europe.

[4] Greece, however, is somewhat of an exception, because there was a significant deficit in public finances even before the financial and economic crisis manifested itself in 2008.

percentage point, public net-spending goes up by ½ percent of GDP. In Spain, unemployment has increased by 14 percentage points since 2007, cf. figure 2, which explains approximate 7 percent of the deterioration of the Spanish public sector budget.

If the ambition of the policy recommendations of the EU-Commission were to get rid of unemployment, budget deficit and current account deficit (in the south), it would, of course, be necessarily to analyse these three imbalances of each EMU-country as a part of an integrated euro-zone model. It is the private over-saving i.e. the lack of private real investment, which is the main cause of unemployment and thus budget deficits. Real investment is held back by weak effective demand in all the EMU-countries[5], by the banking sector's lack of equity capital caused by bad loans, and finally in the South by the loss of competitiveness. The three conditions have jointly depressed European economic prospects and overburdened public budgets, resulting in a public debt crisis.

Once the macroeconomic imbalances have grown so large, as it is the case today, with unemployment exceeding 25 percent in some countries, a foreign debt of more than 100 percent of GDP and continued large current account deficits, there is no easy or quick way out. Any suggested solution requires an insight into the causes of the crisis and political ability (and will) to act, both at the national and the European level, to change direction away from the abyss. The one-sided focus on reducing the public deficit and public debt ratios contained in the Fiscal Compact seems only to have reinforced the European crisis by increasing the macroeconomic imbalances within and among the EMU-countries, see IMF (2013).

[5] Due to high trade integration the economic development in the euro-zone is dependent on effective in all countries. The mutual interdependence is quite high, which means the restrictive fiscal policy in one country has a negative spill-over effect on other EMU-countries.

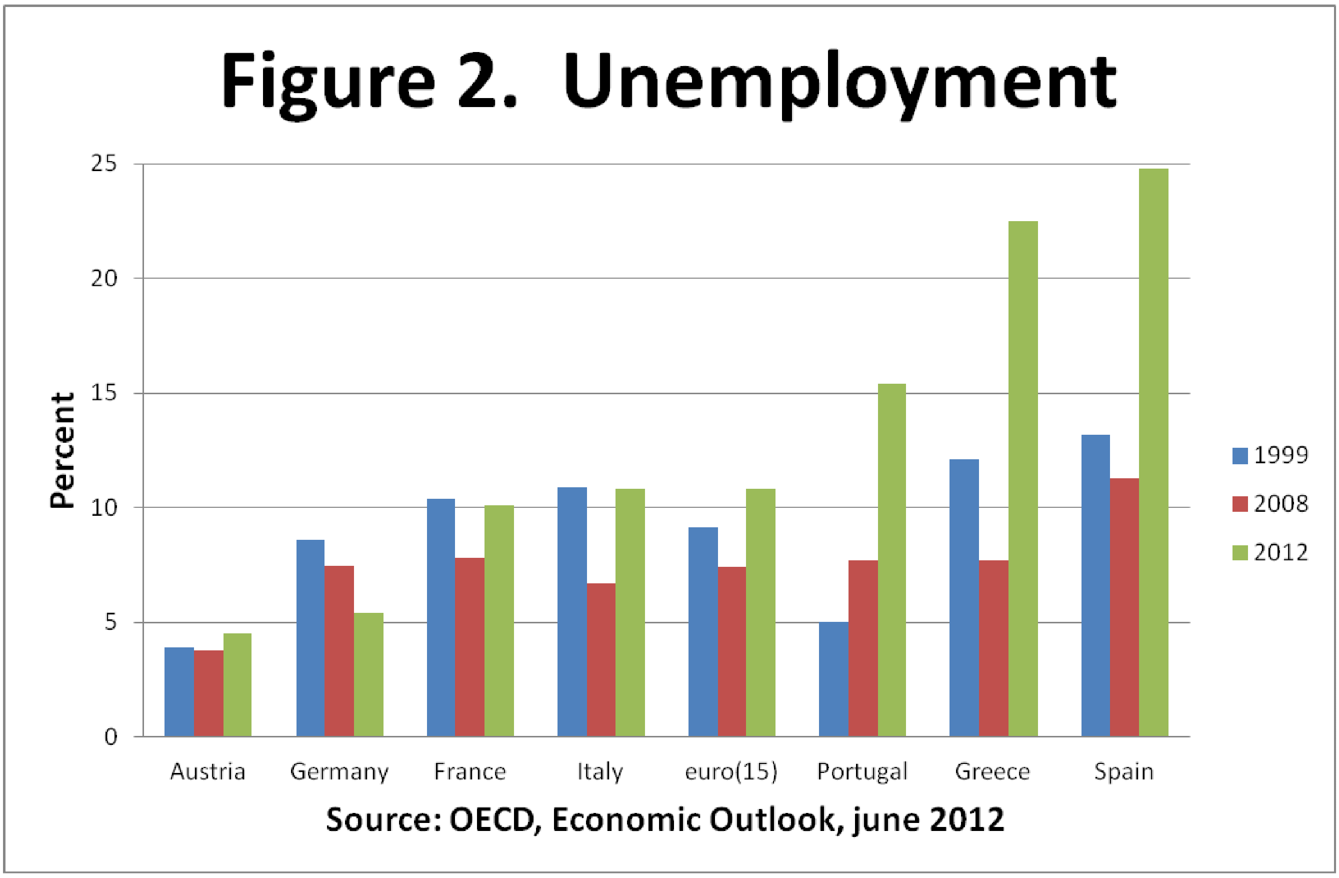


Figure 2. Unemployment

Source: OECD, Economic Outlook, june 2012

Possible options for the future

The two charts above illustrate the core of EMU countries' overall balance problems. They have a common currency but are evolving in a macroeconomic sense in increasingly different directions, a situation which cannot be sustained in the longer run.

1. Business as usual; muddling through

Business as usual means one-sided focus on public sector deficit. Hence, the Fiscal Compact, which is just a tightened version of the Stability Pact, may reduce the budget deficit, but it will increase unemployment and lower growth prospects, which would obstruct the revitalization of the private investment and make no contribution to an improvement of the competitive position in Southern Europe. In contrast, the continued public spending cuts which are demanded by Brussels because the 3-per-cent-of-GDP rule is violated will weaken the business cycle even further. In fact, any fixed limit on the size of the budget deficit is a cause of instability in itself. There is a risk that such a rule weakens the workings of the automatic stabilizers. This, therefore, easily leads to erroneous policies when a fixed target for the government budget balance is set independently of the general macroeconomic development. The target should, of course, differ from country to country in recognition of their different political and economic structures (and welfare states). Further the budget limit should be corrected in cases, like the recent one, for extraordinary high unemployment or low private investment (savings surplus in the private sector). A uniform and fixed budget limit in all countries has a destabilizing effect, because it may force countries to undertake counter-cyclical fiscal policies. Even more paradoxically, there are no breaks on booming economies built into the Stability Pact. The Spanish and Irish governments could fuel an already overheated economy in the years before 2008, because they had a surplus on their public sector budgets. This over expansionary policy caused instability. In fact, the surpluses in these countries were too small. However Brussels did not (and could not) intervene, although it was obvious that the macroeconomic imbalances (mainly the balance of payments) were unsustainable, because the private sectors in these countries had a large savings deficit.

In addition, there is no consideration of comparative cost levels, imbalances of payments or foreign debt in the Fiscal Compact. Hence, business as usual causes increased imbalances among the EMU-countries, increased instability and at the end an unavoidable break-up of (parts) of the monetary union. That could be a deliberate German strategy, because the German government never aspired to a monetary Union of seventeen (or even more) members. At the end, the German government might get its will concerning the EMU’s size so it comes close to what in theory is called an optimal currency area. Whether this area will contain France is difficult to say in practice.

2. A (more) federal Euro-zone: a political illusion

That the Fiscal Compact does not offer a solution to the Euro crisis has, fortunately, been understood by an increasing number of professional economists, when reality is difficult to deny. Mainstream economic theory has moved in the direction of recommending much stronger coordination of fiscal policy within the EMU to counteract the tendency towards dissolution. The argument is that Brussels must be given more power to ensure that individual countries conform to the average of a number of macroeconomic variables in the EMU-countries. Unfortunately, one might fear that Brussels will primarily be concerned with the size of the budget deficits, but a part of the federal structure may entitle Brussels to give a helping hand to member countries which have run into trouble beyond their command. In that respect larger structural and cohesion funds and increased lending capacity of the European Investment Bank could be useful. These proposals are referred to as project-related financial policy, which to some extent can be a substitute for the lacking private investments. This kind of suggestion is part of the 'stimulus package' launched by French President Francois Hollande, and to a small extent they have been adopted at the EU summit held in June 2012.

Eurobonds have been suggested as part of a more centralized decision-making structure and a federalist structure. This proposal would imply that public deficits in all member states could be financed by bonds issued on behalf of, and guaranteed by, the EMU-countries as a whole but can be used by individual countries to cover (part of) the public debt if approved by Brussels. Eurobonds are anathema to surplus countries, especially Germany. She will experience higher borrowing costs together with a commitment to share part of the risk related to the Southern European countries. Yet federalism as conceived within the EMU does not go that far. In fact, 'federalism' seems mainly to be just a euphemism for a stronger enforcement of the requirements stated within the Fiscal Compact. If that is correct interpretation, then 'federalism' is even less a solution than just doing 'business as usual', where member countries more often than not were exempt from the penalties related to the Stability Pact.

3. Increased national flexibility, more regulated financial markets and back to basics – (a Keynes-inspired solution)

It remains to be discussed whether it was too early or utterly misguided and therefore a failure to establish a common currency among 12 (later 17) countries within the EU? Economic theory operates, as mentioned, with an analytical concept of an 'optimal currency area'. This theory, first presented by Robert Mundell back in 1961, discusses the requirements which have to be fulfilled before the establishment of a common currency gives more benefits to member countries than costs. This was obviously not the case with regard to the 12 countries which included countries as different as Greece and Germany. They all fulfilled, according to the official statistics, the convergence criteria, which, we can see now, were much too lenient to make a sustainable decision on admission. Subsequently, it has in any case been found that even though the originally 12 EMU countries, which subsequently grew to 17 countries, were declared for convergence in 1999[6], they have ever since been going in opposite directions from each other measured by relevant macroeconomic parameters. In addition, it has to be remembered that during the last 2 years an EMU (crisis) summit has been held every 3 months; but the decisions at these summits have not been sufficient to curb the trend towards disintegration. The participants do not really seem to have understood that member countries have to experience parallel developments, especially with regard to competitiveness and unemployment. If they do not, there will be an increasing demand from the countries left behind for greater flexibility and a more national orientation in economic.

As mentioned in the introduction, monetary unions have been tried out many times in history, but without success as soon as the internal tension has reached a

[6] All the 15 'old' EU countries could have been a member of EMU in 1999, but the UK, Sweden and Denmark chose to remain outside, although they fulfilled the convergence criteria. These three countries had concerns about whether the common currency would be a beneficial institution for Europe and in particular for the individual countries.

certain degree. The Latin Union was dissolved in 1914, leaving France, Belgium and Switzerland with their own currencies, but still carrying the name of ‘Franc’. The gold standard was dissolved during the 1930s. Here Britain took the lead in 1931 followed by the Scandinavian countries and the Netherlands quite quickly thereafter. Looking at history one could ask the question whether or not it was a disaster for the countries to leave a monetary union. It is of course difficult to give a clear answer: it depends on what socio-economic parameters are paramount. If the emphasis is on a reduction of unemployment, then the lessons of the 1930s would be that the dissolution gave more leeway for nations to pursue a more expansionary economic policy, whereby unemployment started to fall. But the evolution on the international financial markets was rather chaotic. Each country tried, through currency depreciation, to obtain an improved competitive position, which developed into a state of competing devaluations and increasing tariffs, which no country could win.

Based on these experiences Keynes suggested in 1942 that after the war more orderly conditions should characterize international currency and capital markets. His proposal was in a number of respects followed in 1944 when the Bretton Woods agreement between 44 participating countries was signed. The participating countries accepted to keep exchange rates fixed, but adjustable in accordance with mutually accepted principles. This meant that countries which were lagging behind due to high costs (or other foreign-trade-impeding conditions) were allowed to change their exchange rate. Keynes had originally suggested that countries running a current account surplus should revalue their currency according to specific principles, and if they reused to revalue, they should pay a certain ‘surplus-tax’ to the International Monetary Fund (IMF). This arrangement would have given the surplus countries an incentive to expand their domestic economies and to import more from abroad, thus re-establishing a better balance between surplus and deficit countries. The US having, at that time, a huge surplus could, of course, not accept this part of Keynes’s international currency plan.

But Keynes was successful in persuading the Americans to accept an international ban on speculative capital flows. Keynes had experienced the negative consequences in the 1930s, where massive speculation against the British pound had forced the British government to undertake a restrictive policy to protect its currency against these speculative flows. Such financial flows are disruptive both when they flow in and out of the country, because they come and go too quickly and create tensions in the currency and financial markets which disturb domestic economic development.

The Bretton Woods system worked quite well the first 20-25 years after the war, when Western Europe and the US experienced the fastest growth in GDP ever seen before (and after). But after a while, the system started to be undermined. The US experienced rising inflation, which prevented the dollar from keeping its position of an unchallenged anchor of the international monetary system. In addition, financial capital found ways to circumvent the ban on speculative transactions. A Euro-dollar market, based in London, was starting to build up. As a consequence, in 1971 President Nixon decided to release the Federal Reserve System from having to defend a fixed gold value and fixed exchange rates in general by setting the dollar exchange rate free to float. This decision shocked the international markets, but after a short time it became evident that the greater flexibility also had some advantages with regard to loosening the ties between the US, Western Europe and Japan. On the other hand, the value of the dollar became quite unstable, which had a destabilizing effect on the current account of the U.S. balance of payments.

After the abandonment of the Bretton Woods agreement the EU countries should have thought deeply about what kind of future exchange rate system they would prefer. They should have asked themselves whether or not we are ready to share a common currency. Politically it was tempting to get rid of the frequent currency crises; but the theory of an optimal currency area did tell quite another story (Mundell, 1961). Furthermore, the experience from the gold standard and Bretton Woods agreement would have suggested caution. The EU countries were still very different with regard to economic structures and aspirations. It was obvious that not even 'the nine' countries which formed the EU in 1973 came close to an optimal currency area. The step taken in 1991 when the Maastricht Treaty was signed and the monetary union agreed upon was beyond economic rationality. Most serious economists knew this, but no one dared at that time, when German unification was just about to take place, to challenge the politically grounded idea of a common European currency.

Today in the middle of the economic crisis it has been demonstrated that the design of the EMU was flawed from the very beginning. Now, the pro-Euro argument runs that the Euro is a reality which we have to learn to live with and to adapt to. That conclusion is only valid if the participating countries are willing to pay the price of living with a malfunctioning EMU. But no one seems willing to pay this high price of failed political aspirations. The question being discussed every three months at the EU summits is how to minimize these costs for the victorious countries, while the population of the loosing countries is paying a rising social and economic toll.

I shall make no secret of the fact that to me the present situation within the EMU is quite similar to the one described by Keynes in ECP. The defeated countries do not have the economic, social or political capacity to pay back the mounting (and still rising) foreign debt. It is difficult to see how a continuing increase in unemployment, balance of payments deficits and mounting foreign and public debt can go on. Something has to give, sooner rather than later: either Germany has to be less restrictive in her attitude to setting up a scheme for mutual support or the Southern countries will be forced to leave one by one.

History does not necessarily repeat itself.

The *raison d'être* of history is to prevent the repetition of failures. The constructive example is, of course, the international arrangement after the 2nd world war. Keynes had at this time one of the upper hands at the table of negotiation. He (and the Americans) could draw on the lessons from 1919: make the economy of the defeated enemy start to grow as soon and as quickly as possible. Two elements were crucial: Firstly, give (West) Germany an undervalued currency and, secondly give generous foreign support (Marshall Aid) and postpone paying the war-damage debt. Within a few years (West) Germany could rejoin the economic fabric of Europe, further supported by the establishment of the Coal and Steel Union (which became the European Common Market in 1957). The German economy was so successful that the currency (D-mark) started to revalue against the other European currencies to prevent the surplus on the German balance of payments growing beyond limits.

Hence, within the perspectives of ECP and the experience from the second half of the 20th century, what are the options for the EMU-countries?

1. reintroduce an undervalued currency in the 'defeated' countries
2. 'Forgive war-debt' (or parts of it). It was perceived to be in mutual political interest to set up the EMU in the 1990s, although it was also known that it would create very unequally shared consequences (gainers and losers would emerge according to the theory of non-optimal currency area)
3. Offer a generous 'Marshall-Plan' to those countries who are willing to undergo needed structural reforms (tax administration, labour market reforms and some kind of currency and banking control.

Reading the ECP reminds us of the need to be *realistic* and to think of Europe (or at least the Euro-zone) as a whole. Because, if no major political initiative is taken, market forces or national policies will by necessity lead to a new currency agenda in Europe, but in an unpredictable and regretfully chaotic way.

Brussels' vanity and pride

Reading the preface of the French translation of the ECP is revealing (see CWK, II: xix-xxii). Here Keynes lists the two grand errors committed at the Paris conference: 1. demanding the impossible of Germany and 2. forgoing the European economic prosperity by choking the German economy. These failures had as their common root a failure to analyse and understand the European economy *as a whole.*

According to Keynes's analysis, it was almost certain that the Treaty had made Europe unnecessarily unstable. In 1920, when he wrote the French preface, this view had already become a part of public knowledge in Great Britain; but no one knew what to do about it. In France the opinion, especially among the politicians, was still unchanged and 'one hears the weak and empty words *l'execution intégrale du traité de Versailles* (*ibid*: xxi)

The support of the EU institutions is of crucial importance for the successful transformation of the Euro-zone into an optimal currency area with, say, six member-countries. This support can only be obtained if the EU Commission and the dominant EU politicians dare to change their minds.[7]

Fortunately, there are many examples even from recent history that monetary unions have been dissolved in an orderly fashion and with continued mutual respect. For instance the UK and Ireland dissolved their monetary union in 1979, because Ireland wanted to enter the European Monetary System (EMS). When Czechoslovakia was divided in 1992 each country got its own currency without much fuss. If the break-up of a monetary union is undertaken by mutual agreement, problems can be overcome, but of course not without financial pain. The difficulties of the EMU are not the fault of ordinary people, but of over-optimistic politicians. In this case there will be a need for a considerable solidarity from the rich EU countries to support the citizens of the countries which have to leave the EMU after unsuccessfully having fought for several years to conform to the draconian and socially devastating requirements of the Troika (the EU Commission, the ECB and the IMF). These countries should, as described above, be given a supportive hand. Furthermore, it should also be emphasized that withdrawal from the EMU should not imply a farewell to the EU as such. The benefits for all parties of continued participation in the single goods market is not challenged.

Lastly, the entire EU system should reconsider the dogma of free and largely unregulated financial transactions between countries. Keynes was right, speculative financial capital is an impediment on economic policy and by that on the promotion of 'growth, prosperity and sustainable development'. Speculative capital movements force interest rates hither and thither, especially in the weaker countries. Fears of unpredictable reactions in the financial markets almost paralyze European politicians, so that they only dare to suggest policies that conform to market principles.

Concluding reflections on the EU: ‘Peace and democracy’ rather than a common currency

The European economy is in havoc, which damages the harmonious development of Europe. New national tensions are created between countries. Distrust of the sincerity of European solidarity has become a part of the political agenda. The opinion is expressed more and more loudly in the side-corridors of the EU headquarters in Brussels that it is only the rich and the conforming countries which will benefit from further European integration. In reality European integration had already gone too far when the EMU was established. The next question becomes, why do the EU elite and bureaucrats stubbornly reiterate ‘it is not the Euro which is

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[7] In the French preface Keynes makes, therefore, an appeal beyond the French politicians to the *intelligence* of France, to that element in the French mind which delights to see things as they are and to draw the consequences. (CWK, II: xxii).

the problem', when anyone outside Brussels (and Frankfurt) can see that the EMU is falling apart?

This observation brings me once again to the preface of the French translation of ECP:

There is one respect, I venture to say, in which France is now alone and by reason of which she is isolating herself. France is the only country in the world, whose statesmen have not yet begun to tell the truth to their fellow-countrymen, or even perhaps to themselves. (CWK, II: p. xxi)

The plainer it becomes that the treaty is not being executed and cannot be executed, the more, apparently, do French statesmen blind their eyes and muffle their ears and seek to alter facts by denying them. (CWK, II: p. xxii)

I do fear that history is repeating itself; the wisdom of the post-WW2 époque seems to have been lost. Originally the political and economic foundation of the EU was 'peace and democracy'. But, today the project seems to have deteriorated into only economic considerations dominated by the failures of the common currency and uncontrolled financial markets and paralyzed by dogmatic liberal ideology. This constellation of policy failures in combination with the stubborn insistence of Brussels on 'saving the Euro at any price' is putting the entire European project (EU) at risk. Does a distant bell from 1919 ring? Keynes argued at that time that economics should never be a goal by itself, but misguided economics could challenge the European civilisation, as we experience in the Southern European countries these days. Economics is at best an instrument to ensure the primary social goals are met. No one can be in doubt that 'peace and democracy' is much more important than a common European unit of account, which is nothing but a political symbol. Those politicians who claim that the EU will vanish together with a (partial) dissolution of the Euro have not understood what the original European idea meant.

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Together with Dr. Bruno Amoroso he published *L'Europa oltre l'Europa*, by RX-CastelVecchi, Roma, Settembre 2012, info@castelvecchieditore.com

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