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KEYNES FOR TODAY

A Barbarous Relic: The Economic Consequences of the Euro

MATTHIAS MATTHIJS

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The main argument the author makes is that the euro shows striking similarities to the workings of the interwar monetary system. In an important sense, the euro suffers all the disadvantages of the interwar gold standard, without enjoying any of the advantages.

> *There are few Englishmen who do not rejoice at the breaking of our gold fetters. We feel that we have at last a free hand to do what is sensible. The romantic phase is over, and we can begin to discuss realistically what is for the best.*
>
> —Keynes, *"The End of the Gold Standard,"* September 27, 1931.

After more than thirty years of ignominious interment in the political-economic wilderness of the advanced industrial world, "the master" triumphantly returned with the collapse of Lehman Brothers in September 2008.[1] The ideas of John Maynard Keynes, arguably the most influential economist of the twentieth century, would once again capture the imagination of the world's economic elites as the global financial crisis dominated the political agenda in the autumn of 2008 and spring of 2009 and the specter of an imminent slide into depression spooked national capitals. Robert Lucas, the father of the rational expectations school at the University of Chicago, who made his career in opposition to Keynes's ideas, had stated as late as 2003 that "the central problem of depression-prevention [had] been solved."[2] By 2009, even Lucas had to admit that "everyone is a Keynesian in a foxhole," even though he was quick to add that the situation called for a "Friedman-esque" lender of last resort rather than a "Keynesian" fine-tuner.[3]

The Keynesian moment would prove to be rather short-lived, however.[4] By the Toronto summit of the G-20 in June 2010, a wide schism over

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economic policy had surfaced across the Atlantic, with Britain's David Cameron and Germany's Angela Merkel openly opposing U.S. President Barack Obama's administration's support for further fiscal stimulus. Austerity would become the new watchword in both the UK and continental Europe, as a banking crisis morphed into (and was repackaged as) a crisis of "sovereign debt."[5] Not long after, the Obama administration's warnings against any premature fiscal tightening were spurned by the tea party assault on Congress in the autumn of 2010, and even the U.S. economy would gradually be forced onto a more austere path. The speed with which this volte-face took place has been most consequential in the eurozone periphery, where EU-imposed austerity policies have led to a steep fall in gross domestic product, especially in Greece, and levels of unemployment reminiscent of the 1930s.[6]

The hasty abandonment of Keynesian ideas in the eurozone is particularly striking, since there are multiple applications and numerous lessons from Keynes's long intellectual oeuvre that apply to the crisis, many of which have been pointed out in both academic scholarship and the popular media over the past few years. For example, Jesper Jespersen has applied Keynes's critique of the Treaty of Versailles (published in *The Economic Consequences of the Peace*) to the euro crisis and has called for a full-scale revision and partial dissolution of the Maastricht Treaty.[7] Henry Farrell and John Quiggin argued for a "hard Keynesianism" in the eurozone; in other words, for spending against the wind, with fiscal expansions during crises combined with budgetary discipline in times of growth.[8] Robert Skidelsky and Michael Kennedy also echoed Keynes when they wrote that "the boom, not the slump, is the right time for austerity at the Treasury."[9] They contrasted the Osborne-Trichet doctrine, which posits that private spending is depressed because of debt sustainability fears, with Keynes's ideas about the importance of generating enough aggregate demand during crises. The Greek economist Yanis Varoufakis, who would go on to become his country's finance minister in 2015, wrote in 2012 that Keynes's central insight, the fragility of business sentiment ("animal spirits" in chapter 12 of the *General Theory*) and the central importance of uncertainty, were at the heart of the euro crisis.[10]

The main argument I want to make in this article is that the euro, despite some significant differences from the gold standard, nonetheless shows striking similarities with the workings of the interwar monetary system. In some sense, the euro suffers all the *dis*advantages of the interwar gold standard, without enjoying any of the advantages. This is the case especially from the point of view of the politics of adjustment during balance-of-payments crises (core vs. periphery), its inherently deflationary bias, against which Keynes warned, and the strong ideological commitment from Europe's political and financial elites to the gold standard/euro. I will heavily draw on Keynes's writings on "Inflation and Deflation" and the "Return to Gold" (including "The Economic Consequences of Mr. Churchill") from his collected *Essays of Persuasion*.

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The main difference between the euro and the gold standard—the existence of the European Central Bank (ECB) as a lender of last resort (even allowing for all-out quantitative easing since early 2015)—cannot by itself correct for the euro's deflationary bias in the absence of fiscal demand stimulus. After five years of crisis, it is clear that the euro finds itself stuck in a "liquidity trap," that other celebrated Keynesian invention. Only the return of some sort of appropriate macroeconomic policy mix—combining monetary with fiscal expansion—can return the eurozone to growth. Of the many lessons in Keynes's writings for today's euro predicament, I will show the gold standard analogy to be the most salient for the fraught politics of adjustment that characterize Europe's ongoing debt crisis. It should be noted that when Keynes observed that "the boom, not the slump, was the right time for austerity," he was talking in the specific historical context of the interwar gold standard.[11]

The paper proceeds as follows. In the next section, I will revisit Keynes's ideas on inflation, deflation, and devaluation and briefly explain his thinking on the merits of the gold standard. The following section will make the case for seeing the euro as a modern-day equivalent of the interwar gold standard, most powerfully so in times of crisis and uncertainty. The next section will further analyze the toxic politics of asymmetric economic adjustment in the eurozone, while the succeeding section will analyze the Keynesian liquidity trap in which the Europeans found themselves starting in 2013. The final section concludes.

REVISITING KEYNES'S VIEWS ON INFLATION, DEFLATION, DEVALUATION, AND THE GOLD STANDARD

In 1923, Keynes focused his writings on the "Social Consequences of Changes in the Value of Money."[12] He worried that unexpected changes in the value of money would adversely affect the distribution of income and the level of production. His most famous dictum on inflation versus deflation was his mantra that "Inflation [was] unjust and Deflation [was] inexpedient."[13] Inflation—a general increase in the overall price level—arbitrarily redistributed money from creditor (the "investor class") to debtor (the "business class"), but also, if relatively high, led to the systematic erosion of the purchasing power of the worker (the "earner"). Inflation, if you had too much of it, would overstimulate industrial activity, and the business class would benefit disproportionately. Generally speaking, the business class would purchase inputs long before they sold their output, resulting in even further gains. The investor, by contrast, would lose from rising prices. Too high inflation was therefore undesirable, even though for Keynes, compared to deflation it was undoubtedly the lesser of two evils.

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Keynes thought deflation to be a lot more problematic than being a mere injustice to the borrower, or the business class, as it would be harder for them to pay back their debts in the future. As Keynes put it: "a *general* fear of falling prices may inhibit the productive process altogether . . . . The *fact* of falling prices injures entrepreneurs; consequently, the *fear* of falling prices causes them to protect themselves by curtailing their operations."[14] Deflation—an overall decrease in the price level—would bring the whole economy to a standstill, directly causing poverty and unemployment for the earning classes. Most entrepreneurs would restrict production in an effort to avoid losses, and the knock-on effect on the firm's employment would be negative, with disastrous consequences for the economy as a whole. Keynes himself also thought that "it [was] worse, in an impoverished world, to provoke unemployment than to disappoint the rentier."[15]

As Chancellor of the Exchequer Winston Churchill and Bank of England Governor Montagu Norman were gearing up for the pound sterling's restoration to the gold standard at prewar parity in 1925, Keynes weighed the relative merits of deflation versus devaluation, as well as the stability of prices (in terms of national purchasing power) versus the stability of exchange (i.e., in terms of the currency of certain foreign countries).[16] For Keynes, the case against *deflation* was simple. First, deflation did serious damage to business and social stability, as it transferred money from "traders, manufacturers, and farmers, to lenders, *from the active to the inactive*" (emphasis added).[17] Second, Keynes believed deflation, even if it was desirable, to be impossible to work to a sufficient degree in order to restore the pound to its prewar parity. As he put it, "the burden which it would throw on the taxpayer would be insupportable."[18]

Keynes was convinced that the restoration of the gold standard would not bring about stability in Britain's internal prices and could only guarantee stability of external exchanges if all other countries restored the gold standard at the same time, which he thought unlikely to happen. He saw the coalition in favor of the return to gold as a joining of arms between conservatism and skepticism, as the advocates for the gold standard did not believe any government to be competent enough to properly manage a currency. He also thought there to be a fair dose of superstition involved, "for gold still enjoy[ed] the prestige of its smell and colour."[19] In *The Economic Consequences of Mr. Churchill*, Keynes emphasized that he was not against a return to the gold standard per se. He was mainly arguing "against having restored gold in conditions which required a substantial readjustment of all our money values."[20] He worried about the social impact of the inevitable deflationary consequences of the gold standard's reintroduction. He questioned "how far public opinion will allow such a policy to go."[21] Britain's General Strike of 1926 amply proved his point less than one year after the return to gold.[22]

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SEEING THE EURO AS A MODERN VERSION OF THE INTERWAR GOLD STANDARD

Lawrence Broz and Jeffry Frieden have noted that "[exchange rate] regime decisions involve trade-offs with domestic distributional and electoral implications: thus, selecting an exchange rate regime is as much a political decision as an economic one."[23] It would be no different for the eurozone. The institutional design that was chosen in the early 1990s was not a mere technocratic one but one that would have far-reaching political implications.[24] These implications are considerable for *internal* adjustments, however; Europe's Economic and Monetary Union's (EMU) *external* adjustments are rather straightforward. If one considers the eurozone to be a single country that is integrated economically and politically, then it has a flexible exchange rate regime, given that the euro's value vis-à-vis the U.S. dollar, the Japanese yen, or the British pound is determined by market forces. Any external adjustment in the case of a eurozone imbalance with the rest of the world could take place via an appreciation or a depreciation of the euro. Given that the eurozone was broadly in balance with the rest of the world by 2010, external adjustment with the rest of the world economy was not the problem.[25]

The real issue for the eurozone is one of intra-EMU adjustment, where current-account imbalances between, for example, Italy and France or Spain and Germany, have to be settled by internal or domestic adjustments. Adjustment could in theory happen through inflation in surplus countries or deflation in deficit countries, or a combination of the two. However, given the ECB's commitment to low inflation and a one-size-fits-all interest rate policy, the burden of adjustment was on the deficit country alone to deflate by using fiscal levers, that is, spending and wage cuts combined with tax increases. This fundamental asymmetry was also present in the gold exchange standard, under which surplus countries could shift the burden of adjustment to countries in deficit, forcing them to adopt severe measures of austerity, with disastrous political consequences for interwar Europe during the 1930s.[26]

A number of academic and nonacademic observers have made the explicit link between the EMU and either the pre-1913 gold standard or the interwar gold exchange standard, some of them pointing out the differences while others mainly see the resemblances. Barry Eichengreen argues that even though there are similarities between the euro and the gold exchange standard, in that both systems acted as constraints on reflationary actions, these did not mean that the euro's fate would be similar to that of the gold standard.[27] He sees four differences between the euro in 2012 and the gold exchange standard in the 1930s: the existence of a single central bank to coordinate monetary action as opposed to multiple ones; the presence of much more generous welfare states in today's eurozone economies compared to

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the situation in the 1930s; better conditions for a cooperative response at the European level under the euro; and the fact that a disintegration of the euro would be a lot more disruptive than the abandonment of the gold exchange standard proved to be during the Great Depression.[28]

In a National Bureau of Economic Research (NBER) working paper, Eichengreen and Peter Temin pointed out another analogy between the euro and the gold exchange standard, that is, the need for international coordination. They lamented that the eurozone's various mechanisms for such intra-EMU coordination—the Stability and Growth Pact, the Excessive Deficit Procedure, and the Broad Economic Policy Guidelines—have been honored mainly in their breach. In their paper, Eichengreen and Temin make a strong case for flexible exchange rate regimes, noting that fixed exchange rates might "facilitate business and communication in good times but intensify problems when times are bad."[29]

Harold James argues that there is a certain appeal to comparing the euro with the pre-1913 gold standard. This comes from the fact that there is more pressure on deficit countries to adjust through austerity than for surplus countries to adjust by stimulating demand. However, he also believes that euro pessimists were too quick to claim that the adjustment process was politically unsustainable, since they were missing the very real possibilities that the gold standard afforded individual countries, compared to the eurozone's institutional setup.[30] James suggests that the national banks of individual eurozone members should be able to have more leeway in setting their own domestic interest rates, as was the case during the classical gold standard, which would go a long way toward stabilizing the single currency. Writing on the "Economists' Forum" of the *Financial Times*, Edward Gottesman also makes the explicit comparison, referring to the euro as the "21st century gold standard." Gottesman is convinced that adjustment by (external) exchange rate devaluation would be a lot quicker than through internal devaluation, which would be slower and much more uneven.[31]

David Marsh, in a recent book on the history of the euro, stated that Giscard d'Estaing, who was president of France from 1974 to 1981, believed that "the road to European money was part of a journey that had been abandoned when the Gold Standard ended."[32] Marsh also detected a similar line of thinking in Helmut Schmidt, the German chancellor from 1974 to 1982, who also saw the need for a return to the stability of the prewar gold standard.[33] Finally, Harris Dellas and George Tavlas, in a working paper for the Bank of Greece, contend that the Greek sovereign debt crisis happened exactly because of the *absence* of an adjustment mechanism like the one that existed under the classical gold standard. For them, if the euro had actually worked like the gold standard, countries with excessive current account deficits would have experienced an outflow of gold, higher interest rates, lower money and credit growth, and much more automatic adjustments in wages and prices.[34]

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Of course, the gold standard analogy with today's eurozone is far from perfect. There are some notable differences, as other authors have pointed out. First and foremost, there is the ECB, which can print its own gold, as it were, even though it has shown its reluctance to do so throughout the crisis and only started all-out quantitative easing in March 2015, even though still constrained by its own "capital key." Second, it is far from clear that leaving the eurozone would bring similar quick economic benefits to say, Greece in 2015, as it brought to the United Kingdom when it chose to abandon the gold standard in 1931. That, of course, might prove not to be a big enough deterrent if the economic situation does not get better in the medium term, as the victory of radical left party Syriza in Greece in January 2015 underlined. Third, automatic fiscal stabilizers are a lot more advanced today in Europe than they were during the interwar period, and welfare states are more generous and better developed, meaning that economies could more likely sustain longer periods of deflation today than they could eighty years ago. Also, the classical gold standard in fact did have an automatic adjustment mechanism, with surplus countries experiencing an inflow of gold and therefore inflationary pressures, while deficit countries saw an outflow of gold and thus automatic deflation. One of the problems, however, of the interwar gold exchange standard is that those automatic adjustment mechanisms no longer functioned when countries resorted to beggar-thy-neighbor policies and trade protectionism.

If one focuses purely on the adjustment mechanism of balance-of-payments imbalances in today's eurozone, then a convincing case can be made that it does indeed function like the gold exchange standard. Just like in the 1930s, the main obsession of EU policymakers during the eurozone crisis was to tame inflation, while in fact the real danger was deflation. Eichengreen observed the following about the ideational consensus during the 1930s: "There is no little irony in the fact that inflation was the dominant fear in the depths of the Great Depression, when deflation was the real and present danger. Precisely because this fear seems so misplaced, its pervasiveness cannot be overemphasized."[35] Keynes would not have disagreed.

The euro–gold standard comparison is compelling for four main reasons. First of all, just like under the gold exchange standard, the eurozone today has only one adjustment mechanism, deflation, given that: (a) external devaluation vis-à-vis other eurozone members is impossible; (b) inflation is kept in check by the ECB while demand stimulus is hard under a regime of strengthened fiscal rules; and (c) default is the option of last resort, given the structural power of institutional investors and the importance of international financial markets for the liquidity of sovereign bond markets.[36] Second, just like the gold exchange standard, the eurozone has led to the formation of a relatively well-off and advanced core and a lagging, much poorer periphery. The crisis has only widened this gap. The asymmetry stems from the fact that the core countries can force all of the adjustment exclusively onto the peripheral countries. Third, the ideological commitment of Europe's elite

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to the euro is just as strong as the financial and political elite's commitment to the sacredness of the gold standard in the 1920s and early 1930s. Fourth, the Fiscal Compact, which replaced the SGP and was signed in March 2012, committed the eurozone economies to balanced budgets and limited the scope for temporary deviations and calls for automatic correction mechanisms. This (German) commitment to fiscal rectitude is reminiscent of U.S. President Herbert Hoover's obsession with balancing the budget, and his Treasury secretary Andrew Mellon's view on how best to recover from the Great Crash in 1929.

Just as the gold exchange standard, as Eichengreen argues in *Golden Fetters*, contributed to the length and depth of the Great Depression, so did the institutional design of the euro and the EU's response to the sovereign debt crisis in 2010 lead to a worsening of the debt problem and a deepening of the recession in the periphery due to a collapse in economic growth triggered by draconian measures of austerity.

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THE POLITICS OF ASYMMETRIC ADJUSTMENT IN THE EUROZONE

So, what precisely does the political economy of adjustment look like in a multistate currency union? A useful way to approach the issue is to differentiate between the method of adjustment a government will embrace in the face of a crisis, and which socioeconomic groups—domestic or international—will suffer the main burden of adjustment. There are four main possible policy responses or shock absorbers during a crisis. The method of adjustment can either be mainly internal (fiscal austerity or demand stimulus) or external (devaluation or external debt default); while the burden of adjustment can either fall broadly on debtors or creditors (national or foreign) or on workers or owners of capital, or both. As we will see, the institutional design of the euro reduced the menu of choice for member states to just one option.

The first potential national policy choice—*austerity*—usually involves a combination of public spending cuts and tax increases on the fiscal side and interest rate increases on the monetary side. Austerity is transmitted into the macroeconomy mostly via internal channels; that is, by affecting domestic economic activity in the short term and lowering wages and prices in the medium term. The adjustment burden in the case of austerity falls on both debtors, who see the real value of the debts they owe increase, and on domestic workers, who tend to have relatively little savings and might suffer either through lower nominal wages (and fixed rent or mortgage payments), cuts in benefits, less generous government services, or higher unemployment. Creditors and capital owners, on the other hand, will see the real value of their savings, and outstanding loans increase and will generally be less negatively affected.

The second possible policy choice—*demand stimulus*—is the other internal method of adjustment. Demand stimulus usually entails direct increases in government spending and cuts in taxes on the fiscal side, or interest rate cuts on the monetary side. Demand stimulus normally has the short-to-medium-term effect of stimulating domestic economic activity by pushing up aggregate demand and raising prices and nominal wages in the medium term. In this case, the burden of adjustment will fall disproportionately on creditors and capital owners, who will experience a drop in the real value of their capital and savings, and a lower nominal return. Debtors and workers are likely to benefit, through either a lowering of the real value of their outstanding loans, higher nominal wages, lower unemployment, or better employment prospects.

Devaluation boosts exports and makes domestic firms more competitive with foreign firms but lowers the purchasing power of workers and pensioners, whose nominal incomes are fixed. The latter bear the brunt of the adjustment since devaluation usually goes hand in hand with higher prices of imported goods and services. Debtors who have outstanding loans in foreign currencies will also be significantly worse off. However, devaluation is more complicated, since workers in export industries will likely keep their jobs and might even see wages increase, and therefore stand to benefit from devaluation. And obviously capital owners will also see their purchasing power damaged by devaluation, unless they have invested most of their capital abroad. So, devaluation tends to hit debtors and workers but also harms capital owners, depending on their consumption and investment patterns. It is probably the response that spreads the burden of adjustment the most equally across society.

The final policy choice—*default*—signifies that the government chooses not to make good on its promise to pay back its outstanding sovereign debt, either partially or not at all, which will mainly affect the creditors to the government and capital owners. In the case of debt restructuring, the government's creditors could be either domestic citizens or foreign nationals. If foreign nationals hold most of the outstanding debt, the default option becomes considerably more attractive, given that the domestic fallout from default will be relatively contained, passing on the burden of adjustment to foreigners. This final option usually leads to a deep recession caused by massive capital flight, which will affect all socioeconomic groups in society. It is usually considered by far the worst option of all four, and is only ever used as a last resort.

Between 1945 and the mid-1970s—a period of fast growth and falling inequality all over the advanced industrial world—countries could utilize all four economic policy tools, or a combination thereof. What John Ruggie called the "embedded liberal" compromise, which was struck in 1944 at Bretton Woods by Keynes and Harry Dexter White, incorporated the main lessons of the Great Depression and allowed countries to combine internal (full employment) with

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external (balance of payments) equilibrium through a system of fixed exchange rates, capital controls, and domestic discretion over monetary and fiscal policy.[37]

Nixon's closure of the gold window in 1971 heralded the beginning of a new era of flexible exchange rates, deregulation, and rising international capital flows. However, most industrialized countries—including the United States, Japan, and Britain and later the emerging economies of China, India, and Brazil—kept all four policy tools firmly on their menus. While everybody talked the talk of market discipline and strict economic policy rules during the early 1990s, in practice they were all careful to preserve their domestic fiscal and monetary policy levers with a variety of capital controls, exchange rate measures, and downright prohibitions.[38] In other words, they all preserved the main tenets of the embedded liberal compromise.

The exception was continental Europe, where France and Germany, along with other members of the then European Community (EC), gradually surrendered their national economic sovereignty and eventually agreed to tie their economic fate together by creating a single currency—the euro—in the early 1990s. With the euro's adoption, EMU members put in place a forever fixed exchange rate to supplant their national currencies, controlled by an independent central bank focused exclusively on price stability but with no de facto lender-of-last-resort functions or common debt instrument. By doing so, European leaders removed one policy tool, devaluation, from their menus of choice, and made the other, demand stimulus, a lot harder by signing onto a Stability and Growth Pact with strict fiscal rules and a deflationary bias. Given the growing importance of international financial markets and the importance of sovereign credit ratings for the liquidity of most countries' bond markets, default also became a much less appealing option. In effect, this left austerity as the only realistic policy option.[39]

By constructing the euro, European elites disembedded the Bretton Woods compromise from their national politics but without putting in place any supranational fiscal transfer mechanisms to guarantee solidarity in times of stress. During a crisis, international commitments would take precedence over domestic concerns, just as they did during the interwar gold standard.[40] Most advanced industrial countries—from the United States to Britain, and Japan to Brazil—could spread the burden of adjustment over their political economy's different constituencies, making the politics of adjustment during both good times and hard times a lot more sustainable and less overtly redistributive. In the eurozone, this would no longer be the case: deflation would be the only option for deficit countries (Figure 1).

Part of the reason electorates in the eurozone periphery are turning against their political elites is the perception that those elites no longer control their own country's future but instead are being run by Brussels's unelected technocrats. No matter what the outcome of a national election, it is clear that the deflationary course Europe has forced onto their countries since 2010 cannot be changed. This growing awareness of the European Union's negative influence on a country's economy and welfare, as well as the

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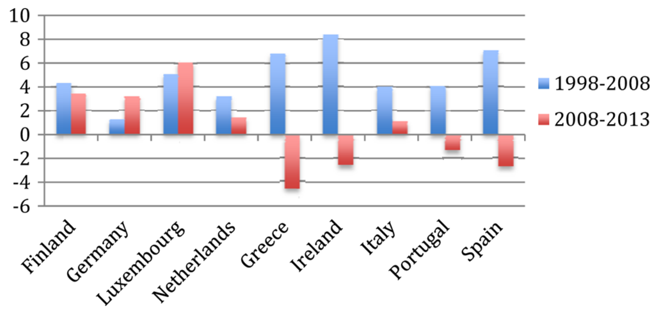

FIGURE 1 Real Wage Growth in Northern Core vs. Southern Periphery (1998–2013).
Note: Measured as (Nominal Wage Growth—Labor Productivity Growth) (period average).
Source: European Commission (2014): *Ameco Database*, available at http://ec.europa.eu/economy_finance/db_indicators/ameco/index_en.htm.

perceived violation of its sovereignty, has rekindled anti-European and anti-euro sentiments across the region.[41]

THE LACK OF A MACROECONOMIC POLICY MIX: FISCAL RULES OVER DISCRETION, ECB AS RELUCTANT LENDER OF LAST RESORT, AND THE KEYNESIAN LIQUIDITY TRAP

With the onset of the European sovereign debt crisis in 2010, there has been a marked shift in the consensus on monetary and fiscal policy in the eurozone. When Greece admitted in the fall of 2009 that its deficits were a lot higher than earlier reported, the main cause of the crisis was believed to be fiscal, and the 2005 reform of the SGP was seen as one of the main culprits for letting the proverbial fiscal cat out of the bag. The argument went that as soon as France and Germany, the two founding members of the EMU, broke the rules and were let off without punishment by the European Commission, it opened the door to other countries that were not in the midst of deep structural reforms to their labor and product markets (as in the case of Germany) to start running excessive deficits. Even though this argument only really holds for Greece—and most notably not in the cases of Ireland and Spain, who were both deeply affected by the crisis—the obsession with fiscal policy changed the consensus from "discretion" to "balanced budget" rules. This result formed one of the main principles of the new Fiscal Compact that was agreed upon by twenty-five of twenty-seven member states in December 2011, and signed in March 2012, which considerably limited temporary deviations due to exceptional circumstances and put in place an automatic correction mechanism.[42]

Since 2010, the policies of the European Central Bank in Frankfurt, which had enjoyed independence just like its German predecessor, the Bundesbank, in which image it was built, have become a lot more active (and therefore political), given that the ECB has started to interpret its mandate much more

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broadly than had originally been envisaged.[43] Given that the impact of its market interventions—from two rounds of longer-term refinancing operations (LTROs) in late 2011 and early 2012, which put significant amounts of liquidity in the European banking system, to ECB President Mario Draghi's statement that he would do "whatever it takes" to save the euro, to the announcement of potentially open-ended outright monetary transactions (OMTs) in early September 2012—have been crucial for the survival of the eurozone, the ECB has gained remarkable political clout in fighting the crisis. Indeed, many financial market participants see it as the only institution capable of effectively taking control of the crisis. However, while the ECB has seen a steep rise in the size of its balance sheet (Figure 2), by itself it has not been able to bring growth back to the eurozone.

In his August 2014 speech at Jackson Hole, Draghi emphasized his concerns about persistently high unemployment and very low inflation. He seemed to subtly suggest that governments should ease off on austerity, especially those countries that have the fiscal space (mainly Germany). "Draghinomics" includes an implicit new deal for the eurozone, by which the ECB will keep doing "whatever it takes," including American-style quantitative easing (QE), which the institution unveiled in January 2015, but only as long as EU member states commit to a temporary short-term fiscal stimulus (or at least a flexible interpretation of the EU's budgetary rules) combined with long-term structural reforms of their labor, product, and services markets.[44]

With deflation taking hold across southern Europe and the eurozone as a whole at risk of entering another recession, there is an increased sense of desperation among both national leaders and EU policymakers that "something needs to be done" to stimulate growth. But here exactly lies the rub. Germany so far has continued to block efforts to reinterpret austerity rules in a flexible manner or to launch any significant infrastructure and investment initiatives.

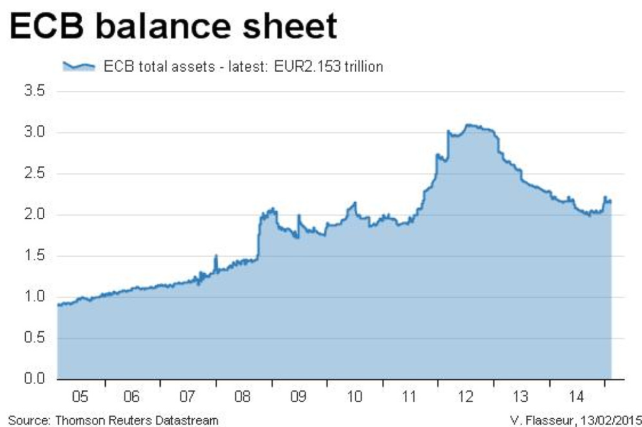

FIGURE 2 ECB Balance Sheet (2005–2015).
Source: Thomson Reuters Datastream.

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As long as there is no real fiscal stimulus, or pickup in aggregate demand, the eurozone periphery will remain stuck in a Keynesian liquidity trap, in a catastrophic equilibrium of high levels of liquidity, low levels of growth, and high levels of unemployment. Even all-out QE by itself is unlikely to fix the monetary transmission mechanism. It can only happen if expectations about the future eurozone economy improve.

The shift in the economic policy consensus in Europe from monetary rule to monetary discretion, and from fiscal discretion to fiscal rule, makes the deflationary straitjacket in which most countries of the European periphery find themselves all the more cumbersome. In the past, even though they had no influence over the monetary policies of the ECB, they at least had some short-term discretion to stimulate their economies by fiscal means, either cutting taxes or increasing spending. Since 2010, with the fiscal consensus in Brussels and Frankfurt shifted to balanced budgets, with strict supranational control of national budgets, those countries are even more stuck with austerity and deflationary policies. A Keynesian response seems firmly off the table for now, even though it would in many ways be the key to recovery.

CONCLUSION: THE EURO TRAPPED IN A FISCAL STRAIGHTJACKET

In this article, I have argued that the euro's institutional design makes it function like the interwar "gold exchange standard" during periods of stress. Just like the gold standard, the euro created a core of surplus countries and a periphery of deficit countries, in which the latter had to sacrifice their internal domestic economic equilibrium in order to restore their external equilibrium, and thus had no choice but to respond to balance-of-payments crises by a series of deflationary spending, price and wage cuts. This was exactly the kind of scenario Keynes most fretted about as he was writing on the relative merits of deflation, inflation, and devaluation in the 1920s. The paper has underscored how the euro's institutional design and the EU's commitment to fiscal rules deepened the recession in the eurozone periphery, as Europe's leaders focused almost exclusively on deflationary austerity measures in response to the crisis.

As Barry Eichengreen argued in *Golden Fetters*, the rigidity of the gold standard contributed to the length and depth of the Great Depression during the 1930s, but it also underscored the incompatibility of the system with legitimate national democratic government in places like Italy, Germany, and Spain. Keynes's worst fear as he was writing *The General Theory* in the 1930s was not only the collapse of capitalism, but also the ultimate failure of democratic government and the system of liberalism in the rest of Western Europe.

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Of course, the eurozone is still far from such a fate. But cracks are appearing on the surface. As I have argued elsewhere,[45] the euro crisis instigated a crisis of democratic government in southern Europe, underlining that, for better or worse, democratic legitimacy still mainly resides within nation states. By taking on the euro, EMU member states gave up their ability to control major economic policy decisions, thereby damaging their domestic political legitimacy, which in turn dogged attempts to enact structural reforms.[46] Evidence of the erosion of national democracy in the eurozone periphery can be seen in the rise of anti-establishment parties and the inability of traditional center-left and center-right parties to form stable governments and implement long-lasting structural reforms.

NOTES

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