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Going forward from B to A? Proposals for the Eurozone crisis

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Working Paper No. 866

Going Forward from B to A? Proposals for the Eurozone Crisis

by

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ABSTRACT

After reviewing the main determinants of the current eurozone crisis, this paper discusses the feasibility of introducing fiscal currencies as a way to restore fiscal space in peripheral countries, like Greece, that have so far adopted austerity measures in order to abide by their commitments to eurozone institutions and the International Monetary Fund. We show that the introduction of fiscal currencies would speed up the recovery, without violating the rules of eurozone treaties. At the same time, these processes could help transition the euro from its current status as the single currency to the status of “common clearing currency,” along the lines proposed by John Maynard Keynes at Bretton Woods as a system of international monetary payments. Eurozone countries could therefore move from “Plan B,” aimed at addressing member-state domestic problems, to a “Plan A” for a better European monetary system.

Keywords: Euro; Fiscal Currencies; Austerity; Current Account Imbalances; Clearing Union

JEL Classifications: E02, E12, E42, F45

1. INTRODUCTION

An increasing number of economists and commentators believe that the current (spring 2016) economic policy path that some eurozone countries are following will undermine the rules of the European Monetary Union (EMU) originally put in place in the Maastricht Treaty in 1992 (subsequently modified in 2007 by the Lisbon Treaty, and in 2011 with the “Sixpack”) and eventually lead to either the collapse of the European cohesion or a period of prolonged stagnation.

The rules of the EMU structure were based on two assumptions, both of which have proven to be untenable. The first was the belief in a smooth transition from simple agreements among different national states to a federation, creating the “United States of Europe,”¹ which would not only complete the institution of a common market, but also share the same constitution, thereby ensuring common rights for the “European citizen,” with a common foreign policy, an integrated fiscal system, and a common currency. Had this belief been realized and accomplished smoothly with the approval of the population of each member state, then the currently missing institutional mechanism of a unified fiscal structure large enough to be an automatic stabilizer facilitating federal fiscal transfers to member states at times of need would have made the eurozone sustainable. This process was, however, stopped by the ill-conceived proposal for a European Constitution, which, albeit ratified by several member states, was rejected by the French and Dutch voters in 2005, *de facto* halting any further attempts to put the United States of Europe project on strong foundations.

The second assumption inspiring the logic of the Maastricht Treaty, and its subsequent modifications, was based on the ordo-liberal economic dogma that prevailed then and continues to this day, mainly by Germany’s dictum. It asserts that markets: would self-adjust towards full employment; the central bank would be independent from governments and be concerned only with price stability; and national governments would be responsible for fiscal policy subject to the Treaties’ guidelines; guarantee property rights; and smooth the functioning of markets irrespective of the asymmetries in their real economies. This (German) logic inspired the

¹ The “Ventotene Manifesto” is believed to be one of the major sources of inspiration for a plan towards a federation of European countries; see Spinelli and Rossi (1941).

structure of the ECB, avoiding the possibility of acting as lender of last resort to governments when needed; it also inspired the limits to government deficits and debts codified in the Maastricht Treaty, which were made even more stringent in the Sixpack.

In the public debate that ended with the signing of the treaties, it became clear that the adoption of a single currency would mean the renunciation of domestic authorities having any role in the formulation of monetary and exchange-rate policies. This, in the face of asymmetric shocks, would imply divergence and crisis handling among member states in accordance with their underlying real economies. To spur growth in regions lagging behind, a system of fiscal transfers—the Structural Funds and the Cohesion Fund—was therefore established. Moreover, some provisions were later included in the treaties to force countries to take corrective actions, reversing their surplus positions whenever their current account balance exceeded a given threshold relative to their GDP. The mechanism of fiscal transfers, however, is insufficiently funded to act as an automatic stabilizer at the level experienced in the US (with a sufficiently large federal budget in the order of 15 percent), while the requirement for surplus-reversing—introduced only in 2011 as part of the “Macroeconomic Imbalance Procedure”—has not been applied thus far, given the large external surpluses of Germany and other countries of the European North.

The euro’s faulty architecture was thus well-known before its implementation started (Papadimitriou and Wray 2010, 2012).² In a prescient contribution, Godley (1992) wrote:

[...]if all these functions are renounced by individual governments they simply have to be taken on by some other authority. The incredible lacuna in the Maastricht programme is that, while it contains a blueprint for the establishment and *modus operandi* of an independent central bank, there is no blueprint whatever of the analogue, in Community terms, of a central government.

The paper is structured as follows. In the next section, we briefly review the historical evolution of the imbalances that led to the prolonged stagnation of the eurozone periphery and the outright

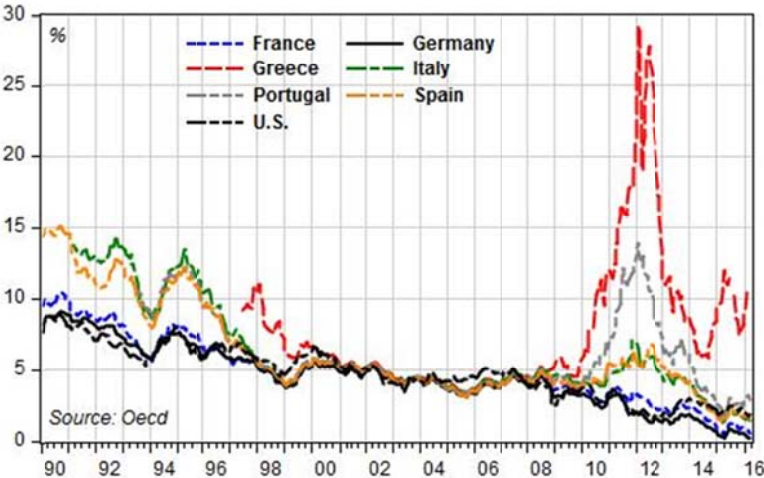
² On the other hand, there was a hope that countries not satisfying the requirements for an optimal currency area would converge to such requirements once the common currency had been adopted; see Frankel and Rose (1998), among others.

crisis (which dominated in Greece) that has stimulated a debate on how to reform the eurozone institutions—a plan commonly referred to as “Plan A,” or “Plan B”—focusing instead on implementing domestic policies that do not necessarily terminate the current eurozone agreements. There is also the option of which countries in deep crisis, such as Greece, may very well choose to abandon the euro, possibly precipitating the collapse of the eurozone monetary system. In this paper, we will not investigate this possibility. Instead, in the third section, we present a proposal, based on Papadimitriou (2016) and Papadimitriou, Nikiforos, and Zezza (2014, 2015a, 2016), for the introduction of a domestic fiscal currency compatible with keeping the euro as legal currency. In the fourth section, we discuss how some simple changes in the functioning of the ECB Target2 system may lead the way to a more sustainable monetary architecture; in the final section, we offer our conclusions.

2. THE RISE AND FALL OF THE EUROZONE PERIPHERY

The adoption of the euro as a common currency afforded some benefits to the eurozone (EZ) member states of the periphery but concurrently its faulty design planted the seeds of the current crisis and exacerbated the already unsustainable trajectories.

Figure 1. Long-term interest rates



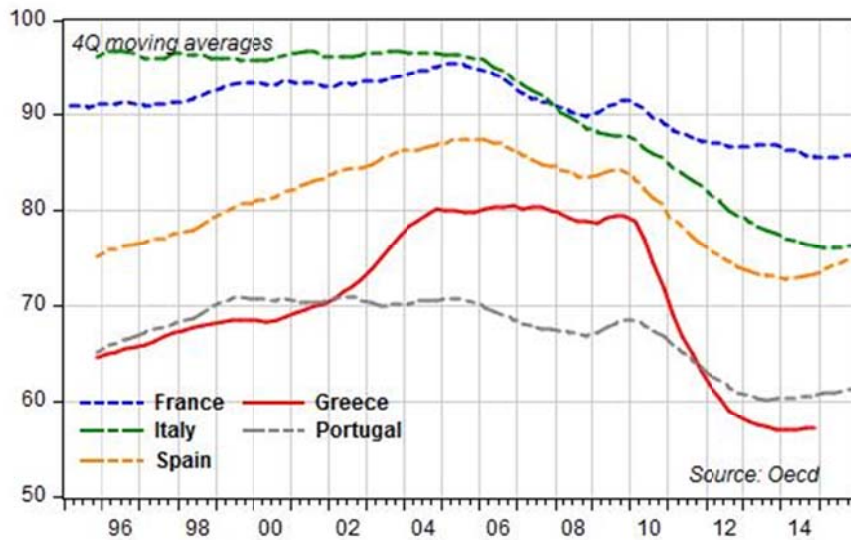
The adoption of the single currency, accompanied by a single monetary policy, had two major implications:

- a) Domestic banks could obtain reserves from the ECB at the same discount rate. This meant a significant reduction in the interest rates of the EZ member states in the periphery (figure 1), reducing the cost of borrowing to firms and households, converging with the already-low interest rates of the core EZ member states, such as Germany. As figure 1 shows, the decline in interest rates was similar to the United States, a consequence of the decline in inflation worldwide; and

- b) The single currency eliminated the possibility of exchange-rate adjustments. The value of the euro against the US dollar or other currencies depended on the overall price competitiveness of the area.³ This implied that even small differences in inflation among EZ countries built up on relative prices, making the euro a strong currency for countries with higher inflation above the EZ average, such as Italy or Greece, and a weak currency for countries with inflation below the EZ average, such as Germany. To phrase the process differently, Germany and other low-inflation countries would have seen their exchange rate appreciate had they kept their domestic currency, while Italy, Spain, or Greece would have depreciated their domestic currency as long as their inflation rates remained above those of Germany.

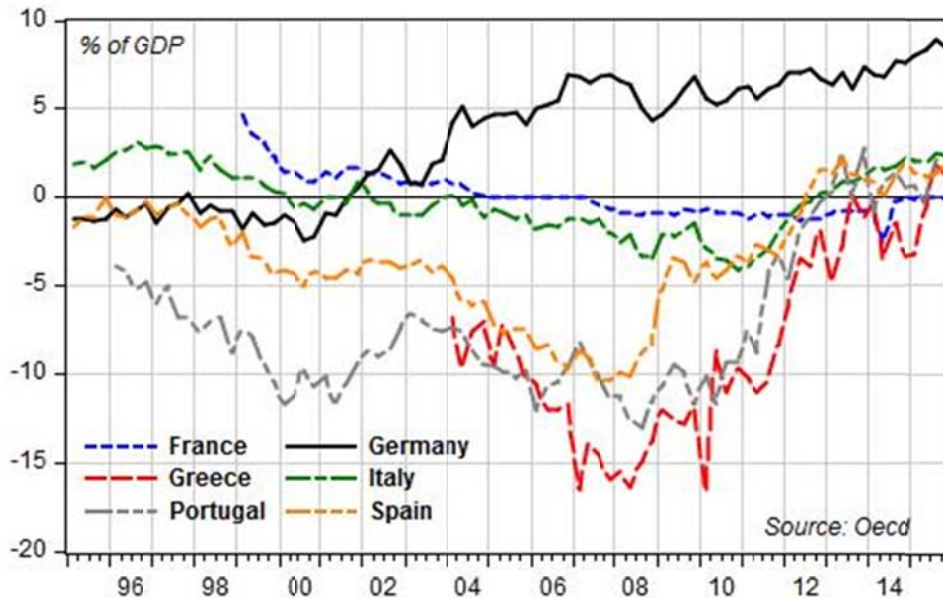
³ As well as on financial markets, but figure 1 shows that long-term interest rates in the EZ converged to those in the US when the euro was introduced, so that financial speculation on exchange-rate markets did not appear to have played a major role in the 2000–07 period.

Figure 2. GDP per capita (Germany = 100)



The former process allowed some countries in the EZ periphery—notably Greece, Ireland, and Spain—to achieve higher rates of growth in their real per capita GDP in the 2000–07 period, closing the gap with Germany (figure 2). In some cases, such growth rates undoubtedly were achieved through private-sector borrowing, helping generate asset inflation in the housing sector; this was the case for Ireland, Spain, and—to a lesser extent—Greece. In the same 2000–06 period, Germany was considered to be the “sick man of Europe,” experiencing low growth rates. While the introduction of labor market reforms helped to lower the unemployment rate, contributed to a strong wage moderation (Engbom, Detragiache, and Raei 2015), and augmented price competitiveness, they failed to stimulate domestic demand.

Figure 3. Current account balances



The combined processes—faster growth and reduced price competitiveness in the periphery relative to the core—had a strong impact on current account balances relative to GDP, which turned negative for surplus countries, like France and Italy, and deteriorated further the deficit ridden countries, like Greece and Portugal (figure 3). Greece and Portugal, in particular, adopted the euro with a large current account deficit relative to GDP, implying an unsustainable future increase in their net foreign debt position. The impact of relatively faster growth and decreasing price competitiveness on their trade made matters worse.

The growing trade imbalances were and still are even more evident when we focus on the trade of the periphery with the core. In figures 4a–4e, we report bilateral trade in goods, scaled to the GDP of Germany. The adoption of the euro turned the balance of trade for France, Italy, and Portugal into a trade deficit, and increased further the trade deficit for Spain and Greece. Such trade imbalances were obviously funded via an accumulation of private debt in the periphery, mirrored as credit in the core countries. As long as countries kept growing, however, such debts were not considered a major problem, especially since the financial markets were expecting the ECB to intervene should a crisis happen, even against its mandate of such intervention.

Figure 4a. France. Bilateral trade in goods with Germany

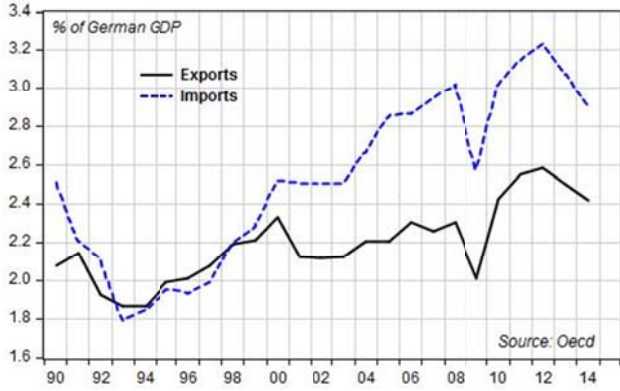


Figure 4b. Italy. Bilateral trade in goods with Germany

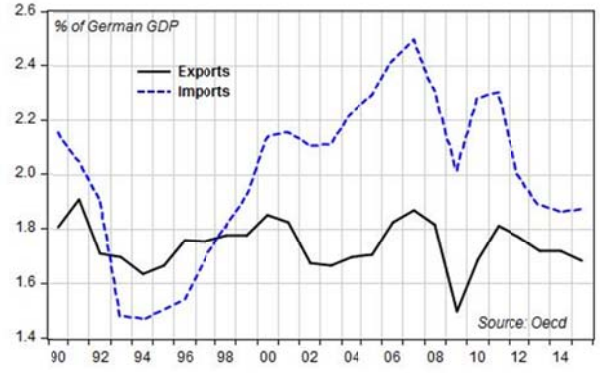


Figure 4c. Spain. Bilateral trade in goods with Germany

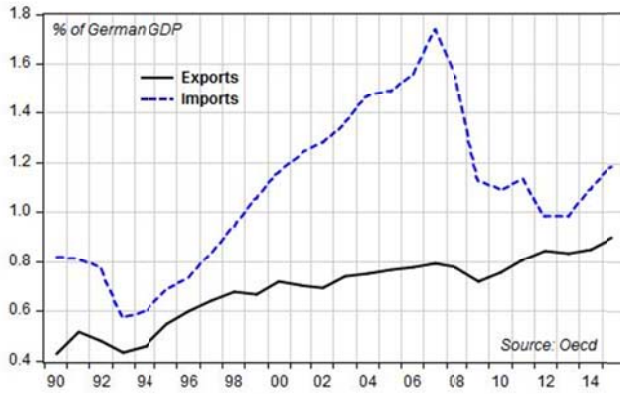


Figure 4d. Portugal. Bilateral trade in goods with Germany

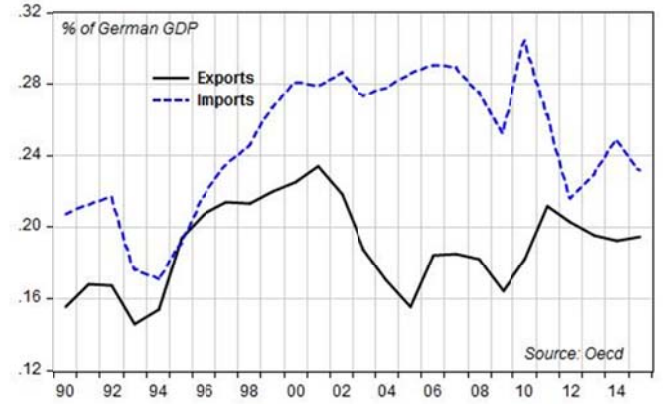
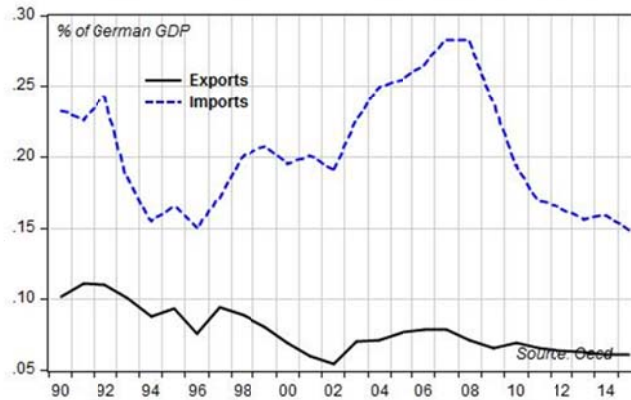


Figure 4e. Greece. Bilateral trade in goods with Germany



When the Great Recession hit in 2007–08, popping the bubbles in the housing markets in the US, Spain, Ireland, and Greece, it disrupted the stability of European banks' balance sheets, which were loaded with toxic US financial assets. This revealed the fragility of growth in many EZ countries, which required governments to come to the rescue of a collapsing financial system. At the same time, the recession lowered the actual and prospective income of the overborrowed households and firms, negatively affecting domestic demand with implications of higher unemployment. In these countries, the private sector started to deleverage and many loans became non-performing, putting further stress on the banks' balance sheets. In all EZ countries, the recession inflicted the standard impact on public finances (i.e., a reduction in tax receipts, and larger welfare payments in the face of rising unemployment). In some countries (i.e., Ireland), the government chose to bailout banks in trouble, transforming large portions of private debt into public debt.

In Greece, when the George Papandreou government took office in 2009, both the public deficit and debt were higher than reported by the previous government, triggering an adverse reaction from the EZ institutions, and concurrently the financial markets, precipitating the country's sovereign debt crisis. An obvious option for Papandreou would have been to either insist on a debt write-down supported by the IMF or to abandon the euro and redenominate all debt obligations under Greek law in a new national currency. This possible option, along with the possibility of an outright default—understood by the players in the financial markets—caused prices of Greek bonds to collapse precipitously and interest rates to rise to unprecedented levels (figure 1). Papandreou chose instead to accept an agreement with eurozone institutions and the IMF to obtain new liquidity—albeit, as it turned out, at insufficient level—on the condition of implementing fiscal austerity and structural labor market reforms (including severe wage and pensions cuts).

The outcome of the Greek crisis gave a clear signal to financial markets that the ECB would not act as lender of last resort should a member state of the EZ run into peril. The consequence of this was the recognition that the euro had the status of a foreign currency when repaying debt held by non-residents.⁴ The other implication was that governments in the EZ, having lost their

⁴ See Cesaratto (2013) for a discussion.

monetary sovereignty, could default, and this prospect generated the large spread in interest rates of other EZ countries, as reported in figure 1.

The implementation of fiscal austerity was backed by theories suggesting that the fiscal multiplier was small, or even negative,⁵ so that reductions in public expenditure—believed to be more effective than increases in taxation—would not result in large drops in GDP. After a few years of austerity in the EZ periphery countries, fiscal multipliers proved to be much larger (especially during a recession), to the consternation of IMF chief economists and others who willingly or unwillingly admitted it (Blanchard and Leigh 2013). Notwithstanding the discrediting of the “expansive austerity” theory, fiscal austerity and labor market reforms are still the TINA (There Is No Alternative) recommendation for countries like Greece. In currently ongoing negotiations (April 2016) the IMF is demanding the implementation of further cuts in pension payments and other public expenses, including precautionary austerity, should the Greek government fail to meet the agreed-upon primary budget surplus 2–3 years from now.

Once it is recognized that the problem of the eurozone periphery is not the size of public debts and deficits per se, but rather the size of private and public debt held abroad (on the asset side of the balance sheet of financial institutions in creditor countries), fiscal austerity, together with labor market reforms that cut nominal wages substantially, is thought to be an effective short-term instrument to make such debt sustainable, thereby increasing price competitiveness. Theory suggests in concert with this comes increased profitability, thus making the policy of austerity an effective—albeit painful—long-term solution.

Fiscal austerity, through its strong effects on domestic demand, reduces imports, especially in countries like Greece that do not have much space for import substitution. If this policy helps improve the trade balance in the short term and thus guarantee a net influx of euro reserves to service foreign debt—even at the cost of rising unemployment and a private sector in misery—so be it.

⁵ See Zezza (2012) for a discussion, and Gechert and Will (2012) for a meta-analysis of estimates of multipliers.

Theory does suggest that the fall in nominal wages may translate into increased price competitiveness, which, if effective on trade, may reverse a current account deficit into a surplus. It also suggests that labor market reforms with the potential effect of increased profitability will in turn translate into higher investment, stimulating economic growth.

Looking at the experience of Greece, where nominal wages have fallen by 22 percent between 2009 and 2015, and by 27 percent in real terms, only part of the fall in wages has translated into lower prices, and lower prices have improved trade only for the tourism sector. At the same time, along with fiscal austerity, lower real wages have contributed to keeping domestic demand very low, and thus an increase in uncertainty regarding the future profitability of private investment.

The effectiveness of austerity as a tool for achieving growth through increases in net exports is obviously diminished when all countries in a trade agreement—as it is the case for the eurozone—pursue the same strategy. If wages and prices are falling among all trade partners, nobody is getting a relative advantage. This constitutes a race to the bottom that nobody wins (Papadimitriou and Wray 2010, 2012). It is not surprising, therefore, that the improvement in trade of many EZ countries is with trade partners outside the eurozone.

At the time of writing, it seems that fiscal austerity and more labor market reform will continue to be the only policy option administered by eurozone institutions (and the IMF) to the EZ periphery countries. We believe that if this continues, the improvement in current accounts will not be sufficient to offset the negative impact of austerity, and unless the balance sheets of the entire EZ financial sector are very significantly strengthened, the area will experience modest growth rates or stagnation for many years to come.

In the face of the possibility of prolonged stagnation, the major concern of EZ institutions seems to be the strengthening of the asset side of the balance sheet of the EZ banks, and the introduction of alternative monetary policy (quantitative easing or QE) increasing the commitment of individual countries to the euro.

The evidence of the above can be drawn from the plan to “rescue Greece” as it has been implemented. As documented in Papadimitriou, Nikiforos, and Zezza (2015), the sum of 200 billion euro in loans made to the Greek government between 2010 and 2014 was used to decrease Greek public debt held abroad by private investors by 104 billion euro, support (recapitalization) to the Greek financial sector by about 60 billion euro, and pay interest on debt outstanding of about 52 billion euro. While the EZ media has presented the support to Greece as a transfer from the eurozone taxpayer to the lazy Greeks, reality has been quite different. There have been no net fund transfers⁶ for purposes of employment growth or to stimulate investment. While the Greek public debt outstanding in 2010 had mainly been issued under domestic legislation—and could therefore be redenominated in case of a euro-exit—almost all of it now has been reissued under foreign law, which renders such redenomination impossible.

Of the clauses of the QE program that the ECB has been implementing since 2015 (and more particularly as detailed in the treaty establishing the European Stability Mechanism for long-term bonds issued after 2013), the covenant of the Collective Action Clause now allows a minority of bond holders to veto an offer from the issuer to change the terms of the contract (as would be the case if a country chose to exit the euro and redenominate its existing debt in a new currency).

More importantly, the QE program (started in 2015) has introduced risk-sharing clauses, entailing that—should a country exit the euro or default on its debt obligations—the full value in euro of such debt would be guaranteed by its domestic central bank. Thus, the public debt of countries like Italy, for instance, that has been issued mainly under domestic legislation (and could therefore be redenominated) now will be obliged to extinguish its debt in a currency, the euro, which will become a foreign currency should it choose to exit the EZ.

⁶ We are not denying that European funds have been used for employment programs by the Greek government but these are not included in the rescue packages since the financial obligations more than exceeded the liquidity made available by the “rescue” packages.

3. FISCAL CURRENCIES TO REFLATE THE EUROZONE PERIPHERY

As discussed above, the major concern of EZ institutions seems to be strengthening the asset side of the balance sheet of EZ banks, and this in turn requires each EZ country to be able to honor its debt—both private and public—in euro. From a macroeconomic perspective, this goal requires countries to run a current account surplus. Any alternative domestic policy compatible with eurozone treaties—so called “Plan B” policies—therefore must comply with this requirement to be politically feasible.

Our proposal for Greece, presented in Papadimitriou, Nikiforos, and Zezza (2014, 2016) and built on the work of Mayer (2012), is based on introducing a fiscal currency, which for Greece we labelled “geuro” following Mayer (2012). It would be issued in a similar fashion as the Swiss WIR (Papadimitriou 2016) and would not become the new domestic legal tender, but be accepted at par for internal transactions and tax payments to central and local governments.⁷

Several proposals⁸ have been advanced for introducing an alternative currency in Greece, with many differences, mainly relating to the convertibility of the new currency in euro, and on how the new currency should be issued. We propose that the geuro would be in electronic form, issued to increase government expenditure for direct job creation and for additional transfers to partially recover the cuts to pensions implemented in Greece, or to fund programs alleviating poverty. Geuro would be accepted for all tax payments, up to a limit of 20 percent, while the remaining tax obligations would be paid in euro. The government would not guarantee the convertibility of geuro, but since it will be ready to accept it as tax payments at par with the euro, this should sustain the value of the new currency, as long as the amount of new currency in circulation is not “excessive.” As such, the geuro would quickly become a close substitute for the euro in settling payments among private agents, and there is no obvious reason for prices in geuro to differ from prices in euro, as long as the government keeps the credibility of the program.

⁷ We will not attempt here a survey of the literature on parallel currencies. For a proposed taxonomy, see Hileman (2013). See Meyer (2015) for an interesting analysis on how to reintroduce domestic currencies while keeping the euro as a parallel currency. See Theret and Kalinowsky (2012) for a different proposal of a fiscal currency.

⁸ We will not discuss alternative proposals here. See our survey in Papadimitriou et al. (2014). See also Andresen and Parentau (2015) and Harvey (2015).

The amount of geuro to be issued would be fixed subject to the following two constraints:

1. The increase in domestic demand, and therefore imports, that has to be expected from this fiscal stimulus should not generate a current account deficit; and
2. The relation between geuro issued through additional expenditure and geuro retrieved as tax receipts should not compromise the government targets on the fiscal deficit in euro, which have been established in the negotiations with the eurozone institutions and the IMF.

Our estimates of the impact of such a proposal, based on simulations of the Levy Institute's Model for Greece (LIMG), show that a moderate fiscal expansion, financed by issuing geuro, would increase the growth rate in real GDP considerably, while keeping the current account in a surplus. The government would keep a surplus in euro, while generating a deficit in geuro. It is expected that the amount of additional expenditure in geuro would exceed tax receipts in geuro, at least for the first years of the program, to stimulate growth.

There is no reason why the introduction of a fiscal currency, which is not considered legal tender, should be opposed by the current eurozone partners under the Treaties, as long as it does not compromise existing obligations that, as we have argued, are mainly related to the ability of governments to meet the deficit and debt targets in euro under the agreements detailed in the Memoranda of Understanding.

This proposal, however, should not be limited to Greece. The introduction of fiscal currencies in other countries, like Italy, would allow them to gain back needed fiscal space and get their economies out of stagnation.⁹

⁹ Similar proposals are being discussed in Italy, based on the government issuing Fiscal Credit Certificates rather than a fiscal currency proper. We evaluated this proposal for Greece in Papadimitriou, Nikiforos, and Zezza (2015). See Bossone and Sylos-Labini (2016) for a recent view.

4. THE EURO AS A COMMON CURRENCY?

As recalled above, a necessary condition for a “Plan B” to be feasible is that it helps a country meet its public and private commitments in euro. In other terms, the success and the acceptability of a “Plan B” on the part of eurozone institutions depends on its prospective capacity to contribute to a reduction in both the public and foreign debt of the country involved.

The introduction of a fiscal currency along the lines illustrated in the previous section, by reducing the budget deficit under the assumption of a multiplier effect, could provide a positive contribution towards the attainment of the first objective. However, it would also run the risk of leading away from the second objective, by possibly amplifying the trade deficit. The fiscal currency, by expanding aggregate demand, could, in fact, produce the undesired side effect of weakening the external position of the country through two different channels. First, to the extent that the increase in aggregate demand should lead, directly or indirectly, to an increase in the demand for imported goods, the budget deficit financed by the fiscal currency would produce a proportionate expansion in the trade deficit. Second, by alleviating deflationary pressures, the expansion of domestic demand would affect the terms of trade, mitigating and possibly offsetting the competitiveness gains pursued by means of austerity measures.

The proposal of a reformed Target2 system sketched out in the present section¹⁰ aims expressly at reducing balance-of-payments disequilibria within the eurozone, and is intended therefore, in this respect, as an ideal complement to the fiscal currency outlined above. Just as the latter addresses the reduction of public debts in euro, the proposal presented here tackles foreign debts by overturning the logic that inspires austerity policies: instead of impinging exclusively on debtor countries to have them reduce their imports, inducing a contraction of intra-European trade and a mercantilist stance of the eurozone towards the rest of the world, it aims at producing an expansionary effect by also involving creditor countries and encouraging them to import more.

¹⁰ See also Fantacci (2014).

The idea that “creditors should not be allowed to remain passive” was at the basis of Keynes’s proposal to reform the international monetary system after World War II. In his view, a surplus country ought to be induced to dispose of its credit, in order to facilitate the repayment of debts by deficit countries and to avoid exacerbating deflationary pressures on international trade, which would eventually damage, by repercussion, the creditor countries as well.

To apply the principle of symmetrical adjustment, Keynes’s plan envisaged the establishment of an international clearing union, which would act as a bank for the settlement of all payments related to international trade, and would finance temporary imbalances simply by crediting the account of the exporting country and debiting the account of the importing country. However, unlike a regular bank, the clearing union would charge a fee not only on debtor countries, but also on creditor countries, since both would be benefiting from the services of the clearing union: the deficit countries, by allowing them to temporarily buy more than they would have otherwise afforded to buy, but also the surplus countries, by allowing them to sell more than they could otherwise have been able to sell. Moreover, the symmetric charges could act as an incentive for all countries to converge towards balanced trade.¹¹

It is interesting to note that Keynes’s (1971: 143) plan explicitly excluded the adoption of austerity measures as a means to restoring external equilibrium:

the measures [...] which the Governing board [of the clearing union] can ask a country to take “to improve its position,” if it has a substantial debit balance, do not include a deflationary policy, enforced by dear money or similar measures, having the effect of causing unemployment; for this would amount to restoring, subject to insufficient safeguards, the evils of the old automatic gold standard.

The principles underlying Keynes’s plan could clearly provide an alternative approach to the balance of payments disequilibria within the eurozone, as described in section 2. Their practical implementation could rely on a clearing system, Target2, which already exists and is managed by

¹¹ Keynes’s proposal was not adopted at the Bretton Woods Conference that defined the postwar global economic order in 1944. Only a few years later, however, it was taken as a model for the creation of the European Payments Union (EPU). From 1950 and 1958, the EPU intermediated 75 percent of the commercial transactions between member countries, contributing significantly to the “economic miracles” of the time, like Italy and Germany, and to the beginning of the process of European integration.

the ECB for the settlement of intra-eurozone financial transactions. Since the outbreak of the current crisis, Target2 has played a crucial role in financing balance of payments disequilibria within the eurozone by creating a form of reserve asset similar to Bancor. However, unlike the clearing union, it is used to finance not only trade deficits, but also, and primarily, capital flight. Moreover, it fails to reabsorb disequilibria given that Target2 balances, unlike Bancor balances, are not subject to quotas or to symmetrical charges on surplus and deficit countries. In fact, only negative Target2 balances are currently charged with the payment of interests to the ECB, which then transfers them to national central banks.

An outright transformation of Target2 into a European clearing union built upon the blueprint of the Keynes Plan (as envisaged in Amato and Fantacci [2013]) would entail major changes that do not appear to be politically viable, such as the adoption of stringent capital controls and the reintroduction of national currencies. A more modest, yet more realistic, proposal would be simply to introduce symmetric and increasing charges on positive and negative Target2 balances. A similar measure would induce surplus countries to play their part in restoring balance of payments equilibria by adopting expansionary policies (such as tax cuts or wage increases) in an effort to encourage imports. Moreover, the proceeds of the charges could be used to finance investments, possibly through the European Investment Bank or European Investment Fund. The possibility of introducing such charges should fall entirely under the current capacities of the ECB, without representing a form of fiscal transfer between member states and without infringing on other EU regulations.

The introduction of a similar cooperative mechanism of adjustment would reduce the financial imbalances that enhance instability and speculation and give a decisive impetus to the actual circulation of money in the circuits of the real economy. Balanced trade would thus actually operate as a cohesive force for the unification of Europe. The proposed change would not require, but could prepare, a more radical reform of the architecture of the monetary union.

Even if it would not attain the ideal objective of a European clearing union, the introduction of a *principle of symmetry* between creditors and debtors within the eurozone would imply a complementarity between domestic reflation and external balance, offering the compromise of a

pragmatic solution consistent with current European treaties. It is foreseeable, and not merely desirable, that the positive effects of a similar solution would exceed the difficulties of implementation, representing thus an important precedent for the revision of the Treaties and for a more radical reform of the European monetary architecture in the direction of a complementarity between the common currency used as a unit of account within a European clearing union and a multiplicity of national, or even regional, currencies linked by a system of adjustable pegs.

5. CONCLUSIONS

In this paper we have argued that the current rules governing the eurozone are the result of a faulty architecture and an incomplete political process towards greater European integration, which should it have been completed would have instituted a mechanism of automatic stabilizers being channeled through a European Treasury with a sufficient budget, as is the case with the US.

However, be that as it may, we have argued that current account imbalances that were already large for some countries when the euro was introduced were exacerbated by the adoption of the common monetary policy. The remedy took the form of uncoordinated wage policies and public investment cuts, leading to a real appreciation of the exchange rate in the eurozone periphery countries and a real depreciation for countries in the core.

Deficit countries, like Greece, Portugal, and—to a lesser extent—Spain and Italy, saw their net foreign asset position deteriorate, and the need to rescue a collapsing financial system (when the Global Financial Crisis turned into the Great Recession in 2007–08) contributed to the increase in fiscal deficits and debts that are the consequence of the crisis, rather than the primary cause.

The dangerous policy of austerity has been imposed harshly on countries seeking financial support, such as Greece; while the IMF's assessments erroneously projected a modest impact on output and employment, the policy instead delivered the complete opposite outcomes.

Notwithstanding the abysmal results of lost output and employment, the same policy prescription of more austerity continues unabated. To be sure, austerity has succeeded in addressing, at least in the short term, the main problem of countries in the eurozone periphery (namely their current account deficits) by generating a large decrease in imports and a modest increase in exports. A current account surplus is the precondition for a country to be able to pay its foreign debt in euro, which is *de facto* a foreign currency. The continuing austerity solution, however, is likely to generate more stagnation and long-term unemployment, and sooner or later prompt a breakup of the EMU which, if it happens in a disorderly manner, will most likely cause another and larger global financial and economic crisis.

To avoid a disorderly collapse of the eurozone, we have proposed two actions that should be politically, as well as economically, feasible. Countries that need to increase their fiscal space for employment and investment growth, like Greece, can introduce a fiscal currency—which is not legal tender, but used to finance a fiscal stimulus and direct job creation, and can be accepted at par for tax payments obligations. The size of such stimulus should be calibrated in such a manner that it does not cause the current account balance to move into negative territory, thereby enabling countries to keep servicing their foreign debt in euro. Our estimates for the Greek economy show that such policy is feasible, and would be successful in restoring growth and employment. Such fiscal currencies could be issued by all eurozone countries—and even at the regional level—to restore fiscal space without breaking the Treaties, while a much-needed reform of the eurozone monetary system begins to occur.

Moreover, we also suggest a simple measure to restore symmetry in response to eurozone countries with current account imbalances: adopting one of the features of Keynes's Bancor proposal. We propose the introduction of charging interest on Target2 surplus balances, so as to create incentives for countries with large surpluses to expand domestic demand, thus contributing to the recovery of the entire eurozone region.

While undoubtedly the latter proposal will not be supported by countries like Germany, who is currently running large external surpluses and huge Target2 positive balances to the tune of more than 600 billion euro, our former proposal of introducing fiscal currencies should be backed by

countries in the periphery that desperately need to reflate, and from conservative political groups in the core alike fearing that an unresolved and continuing debt crisis may lead to never-ending transfers of liquidity, burdening the national budgets of the countries in peril.

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