Introduction

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ABOUT THE GENERAL THEORY FOR TODAY

In 2011 it was 75 years since the publication of *The General Theory of Employment Interest and Money*. It was published on 4 February 1936 in the middle of the economic depression. Politicians were groping in the dark with rather little help from the economic profession. People were queuing to buy the book as soon as it was released. Expectations were high.

There are many similarities between then and now: unemployment, low growth and mounting public debt. Unfortunately, no new ‘General Theory’ has been advertised, which may be a reason for a re-read and an up-dated reflection on Keynes’s seminal book.

At the brink of the 21st century a number of academic economists were asked which economist they considered had had the largest impact in the 20th century. A majority pointed at Keynes, many with reference to *The General Theory*; but this voting was about the past. Today one hardly sees a reference to Keynes in the most-used macroeconomic textbooks – perhaps a passing remark related to the case of rigid wages in the labour market (which only demonstrates that the author has not read *The General Theory*). That is all. How can that be? Given the number of similarities between the economic crisis of the 1930s and the recent one, we considered this an obvious reason to gather Keynes-scholars from all over the world to discuss and exchange views on the ‘relevance and perspectives’ of *The General Theory* for this century.

Three themes were particularly mentioned in the call for the conference, which took place at Roskilde University in May 2011.

The first theme of the conference was the relevance of *The General Theory* for macroeconomic theory related to societies in which we happen to live today. The participants in the conference were asked to give an assessment of what parts of *The General Theory* they found wanting with respect to bringing Keynes’s ground-breaking macroeconomic contributions up to date. A number of these conference papers are included in this volume.
This theme is introduced by two invited lectures, followed by papers emphasizing a number of distinct characteristics of Keynes’s macroeconomics as opposed to ‘Keynesian’ economics: methodology, the analytical importance of understanding time, uncertainty and dynamics, the principle of effective demand and the importance of finance for real activity and instability.

The second theme concentrated on recent economic development and the role of Keynes’s macroeconomic framework, characterized by capturing the economy as a whole. The economic crises in the US and Europe were high on the agenda. How could the crises be understood through the theoretical lenses set up and discussed under theme one? In addition, contributors were asked to give an assessment of economic policies pursued in Western countries to overcome the crises. Many high quality papers were presented during the conference, but due to narrow limits on the number of chapters within this volume of conference proceedings, we were forced to be very selective in our choice of papers analyzing the actual economic situation and decided to focus on the neglected importance of the balance of payments within a monetary union.

The third theme, which will be given a separate conference volume, is teaching the economics of Keynes. This theme is considered very important, because the original contributions from The General Theory are no longer present in the syllabuses which are taught in most universities. In many ways, it can be questioned if these original elements contained in the General Theory and described in theme one have ever been a true part of the syllabus in macroeconomics, even in the 1950s and 1960s. During the conference it was made clear that so-called Keynesian economics, as we knew it from Paul Samuelson’s textbook Economics, first published in 1948, is not really the economics of The General Theory. The methodology, the emphasis on equilibrium and the role of inflexibility of prices and wages in explaining unemployment are features which Samuelson, together with many other neoclassical synthesizers, developed in the 1950s and 1960s with inspiration from Hicks’s ISLM diagram. This macroeconomic teaching was easy to undertake in the classroom and to use for constructing the new macroeconometric models that for a while dominated the macroeconomic debate and were at that time mainstream macroeconomics – as long as it lasted. In the 1980s this approach in macroeconomics was swept aside by the claim that it was not ‘scientific’, because a rigorous microeconomic foundation was lacking and the theory of expectations was ad hoc – not grounded in rational choice theory. This is, in fact, where the teaching in macroeconomics stands today. Only textbooks assuming general equilibrium and using the microeconomic foundation of rational choice theory are widely available. This version of macroeconomics is of
little help in understanding the present economic crisis: what caused it, why is it dragging on, and how to get out of it. These are questions which cannot be answered within a general equilibrium model, where crises are caused by exogenous shocks and the macroeconomy is self-adjusting. This teaching situation is, of course, especially embarrassing for those macroeconomists who think that Keynes and *The General Theory* have an important insight and could give students a better understanding of the world in which they live.

At this stage we feel tempted to quote directly from Keynes, who anticipated this situation of difficulties with teaching new ideas. He was in his time up against what he called Ricardian Theory. It was represented in Cambridge by the only professor in economics, Arthur Cecil Pigou, who had just published his view of macroeconomics in the book *Unemployment* (1933). Keynes asked, in *The General Theory*, how it could be that:

\[\text{Ricardo conquered England as completely as the Holy Inquisition conquered Spain} \ldots \text{The completeness of the Ricardian victory is something of a curiosity and a mystery. It must have been due to a complex of suitabilities in the doctrine to the environment into which it was projected. That it reached conclusions quite different from what the ordinary uninstructed person would expect, added, I suppose, to its intellectual prestige. That its teaching, translated into practice, was austere and often unpalatable, lent it virtue. (Keynes, 1936: 32–3)}\]

**VOLUME 1: RELEVANCE AND PRACTICES**

There were three invited speakers at the conference, who each initiated one of the themes: Volume 1: Mark Hayes (theory), James Galbraith (practices) and Volume 2: Marc Lavoie (teaching).

**Relevance for Today**

Mark Hayes gave the opening lecture on *The General Theory: a neglected work*?! Reading his chapter, it becomes evident that it is the exclamation mark which the speaker put emphasis on. According to his reading, *The General Theory* today is a neglected work. He poses the question: how to change that situation in an environment where scholars have stopped reading the classics. The knowledge of Keynes’s economics is today for most economists at best second hand, through the work of Keynes-scholars, but quite often neoclassical textbooks are the main source of knowledge about the economics of Keynes.

Mark Hayes argues that to change the neoclassical dominance you have to attack the citadel which they have created through their main gateway.
Keynes held the same opinion; therefore he addressed *The General Theory* to ‘my fellow economists’. He thought that by persuasion and reasoning and references to the real world he would be able to change the macroeconomic understanding. A modern reader of *The General Theory* should keep in mind that the book was written for a very specific audience, which had been brought up in the tradition of Marshall. Keynes added arguments related to the *economy as a whole*. The main novelty is that expectations related to the economy as a whole have to be uncertain. No one knows the future with certainty. The macroeconomic system is characterized by imperfect information. Equilibrium is established when nobody has an economic incentive to change his or her behaviour. Unemployment is not caused by rigid wages or prices, but by lack of incentives to increase production, in the short run due to lack of effective demand, and in the longer run due to lack of knowledge of the future. If the neoclassical economists can understand these simple conclusions, the chasm between the neoclassical economists and post-Keynesian economists could perhaps be reduced, to the benefit of both parties.

James Galbraith, giving the second invited lecture, was asked to focus on the present economic and political situation in US and Europe. He was less optimistic about the possibilities for the economics of Keynes to make any impact on the real understanding of the macroeconomic dynamics and by that on economic policy with regard to reducing unemployment. Initially he takes issue with Paul Krugman’s (2009) statement that ‘Economists got it so wrong’,1 Galbraith responded rhetorically, ‘which economists?’, because he could mention a number of outstanding economists who had explicitly warned, or according to his reading would have warned, against the development in the financial markets and on the balance of payments for years: Keynes, Wynne Godley, Hyman Minsky and Galbraith père. They had all worked on the implications of increasingly complex market systems: ‘Complexity defeats the market’. In this situation, deregulation, especially of the financial markets, is asking for instability. If you add reduced social control, which opened a way for corporate and financial fraud in many layers of society, you have the recipe for increased inequality and credit expansion without limit.

James Galbraith concludes that economic arguments (and theory) cannot be separated from society and the political environment at large. Although a new US administration took office in 2009, the economic thinking is quite similar to the previous one. It was still ‘False Keynesianism’ (at best) that dominated macroeconomic policy, without any real change in the structures of the financial sector. At the end of the chapter he sets out a list of seven points which should be taken into consideration before one can claim that one is dealing with a realistic theory of
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macroeconomics as a necessary background for changing the macroeconomic development. It is not lack of economic insight but lack of political will that prevents a reduction in unemployment.

Teodoro Dario Togati’s chapter makes a criticism of Keynes’s *General Theory* based on the distinction between what he calls a modernist approach and his preferred ‘post-modernism’. He characterizes the former as a ‘static approach’, by which he means something different from the economists’ usual meaning: he means an approach that does not take into account the two-way interaction between private agents and policymakers. He calls the latter ‘interactionism’, which comes close to the term ‘reflexivity’ used by other authors – for instance, George Soros. He doubts that Keynes (or post-Keynesian economists for that matter) could win the argument of today unless these insights from post- and neo-modernism are incorporated into macroeconomic analysis.

Reason and references to empirical results are, according to the author, not really appropriate remedies to persuade the audience. The post-modern approach considers all theory as a kind of social construction: if people believe that the theory is the true explanation, then contrary to science it becomes the true argument of today. Ricardo conquered the economic teaching in the 19th century by incomprehensible arguments and recommendation of austerity policy – a combination of metaphysics and bad conscience due to indulgence. Ricardian economists of today argue in favour of austerity policy with reference to the superiority of the market mechanism, to politicians’ self-seeking behaviour and to common sense that one should not live beyond one’s own means. This is the plausible story of today’s individualism, which has become the mainstream argument taught in economics classes and subscribed to by most economists.

The challenge of Keynes’s macroeconomics is to construct a story where the fundamental insight from *The General Theory* is combined with the individualistic political arguments. Post-Keynesian economists should search for a microeconomic story which people of the 21st century will subscribe to. The New Classical story of rational economic man has fallen out of fashion in the wake of the financial crisis, increasing inequality and fraud. The author concludes the chapter by suggesting that the neo-modernist microeconomic foundation of Keynes’s macroeconomics could be an elaborated theory of ‘interactionism’ or ‘reflexivity’, which people might find convincing for their daily life.

Relevance for Macro Methodology

Keynes began studying philosophy and mathematics in 1902 at the University of Cambridge. He could not have studied economics proper,
because that study was not established until 1903: we cannot know if he would have chosen economics. His chosen subjects of study do signal his interest in society and in methodology.

There are three papers on macro methodology, which take their departure from Keynes’s own struggles with the question, how to understand macroeconomics as different from aggregated microeconomics.

Michael Lainé’s chapter is entitled ‘Keynes on Method: Is Economics a Moral Science?’ If we accept the hypothesis that macroeconomics is a social science, what Keynes called a moral science, we have a scientific problem. Social science, in contrast to natural sciences, does not have a specific purpose. There is no specific outcome that is the preferred one; value judgments are all over the place within and outside the social sciences. Further, we cannot know what people think or how they behave individually. The author is primarily taking issue with the claim that positivism could be helpful in this matter.

If the topic is (hardly) observable then positivism is of no use. Hence, using a number of arguments taken from Keynes, he is sceptical towards Friedman’s claim that the quality of an economic theory lies in its ability to predict. He is equally sceptical towards Popper’s method of falsification. If one cannot measure the relevant variables and, furthermore, one cannot put into a formal equation the relevant relationship, then empirical testing falls apart. On the other hand, the lack of any correspondence to the real world opens a gateway for all (even post-modern) arguments. Most post-Keynesian economists endorse a realist epistemology, but the author is somewhat sceptical towards critical realism in its more simplistic form. If in the spirit of Keynes the ethical and unknowable aspects of macroeconomics became more explicit however, then an elaborated form of critical realism might ‘constitute a sound basis upon which to build a genuinely Keynesian theoretical framework’.

Anna Carabelli follows the same line of reasoning in her chapter ‘A new methodological approach to economic theory’, that Keynes’s macroeconomics requires a special methodology. Her claim is that *The General Theory* can be read as a manual in macroeconomic methodology rather than in macroeconomic theory. That is her conclusion ‘from 30 years research on Keynes’. She goes all the way back to *A Treatise on Probability* (Keynes 1921), which she considers Keynes’s ‘essay on method’. In that book Keynes spelled out principles of rational individual behaviour under the conditions of uncertainty. To Keynes, economics was a ‘branch of logic’, a way to establish consistent arguments which create probable relationships between uncertain (partly unknowable) expectations and human actions. This kind of reasoning has to be open-ended at the individual level and at the social level. Even more difficulties arise
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when the aim of the activity is not measurable, for instance utility, goodness, beauty and love, which were Keynes’s focal points in his early writings as well as in his later essays.

The complexity of the methodology increases when the focus shifts from individual behaviour to society as a whole. This is what Keynes struggles with in his major books. Procedures to make a consistent reasoning within an interdependent system are extremely demanding. Already in the introduction to *Cambridge Economic Handbooks* (1922/23) (reprinted in CWK) he listed five logical fallacies which should be avoided. The best known fallacy in macroeconomics is the ‘fallacy of composition’ between individual activities and the outcome for the economy as a whole (for instance, the ‘paradox of savings’). The chapter concludes with a call to ‘post-Keynesian economists to be less reluctant to investigate the potential of Keynes’s economic method as a tool to develop a complexity approach to economics’.

Macroeconomics is a dynamic subject. It evolves through time. Any relevant macroeconomic method has to incorporate aspects of time. Mogens Ove Madsen’s chapter ‘Keynes’s early cognition of the concept of time’ takes issue with Keynes’s awareness of the importance of time in the understanding of social phenomena. Keynes studied philosophy and was taught by G.E. Moore and J.M.E. McTaggart. It is well known from the Keynes biographies that Keynes was, especially in the early Cambridge years, a student of Moore. This is evident in his attempts to break away from the Victorian social norms and conventions and his firm contact with the Bloomsbury group for many years. But the author’s claim is that with regard to a number of more abstract philosophical issues Keynes might have been influenced more than is usually acknowledged by ideas put forward by McTaggart.

The teaching of McTaggart especially brought Keynes a vital introduction to an ontological difference between two theories of time. The same fundamental difference is known from contemporary philosophical discussions. One view is the dynamic approach according to which the essential notions are past, present and future. In this view, time is seen ‘from the inside’. Secondly, there is the static view of time where time is understood as a set of instants (or durations) ordered by the before-after relation. Keynes’s early paper on the concept of time is about the awareness of change, and change requires that at least one aspect differs with respect to what is happening, i.e. whether the event is future, present or past. The idea of adequately incorporating aspects of time as ‘economic theory in time’ in contrast to ‘economic theory out of time’ was after Keynes followed in the works of, for example, Joan Robinson, Nicholas Kaldor, G.L.S. Shackle, Nicholas Georgescu-Roegen and John Hicks. This effort
to use a dynamic concept of time can still seek inspiration, as Keynes did, from the current philosophical debate on time.

RELEVANCE FOR MACRO THEORY

In a condensed form one can say that it is the explicit treatment of uncertainty which separates Keynes’s macroeconomics from neoclassical economics. It is a necessary aspect if one has the aspiration of explaining real world economics. That is a part of the methodology and the analytical outcome of *The General Theory*. Four chapters take up the role of uncertainty for modern financial macroeconomic theory. This is done with inspiration from *The General Theory* as well as *A Treatise on Money* (TM) (Keynes 1930). It was in TM that Keynes made an elaborate presentation of his new theory of liquidity preference, which cannot be understood without an explicit treatment of uncertainty.

The first chapter of this section is Stefan Voss’s ‘*When Keynes and Minsky meet Mandelbrot...*’. This chapter gives an overview of how the phenomenon of uncertainty has been treated by a few leading macroeconomists. The distinction between uncertainty and risk is quite often referred back to Chicago economist Frank Knight (1885–1972) rather than Keynes. This is unfortunate, because Knight only relates uncertainty to individual experiment and, according to the author, claimed that at the macro level uncertainty could be treated as risk due to the law of large numbers. Here, Knight and Keynes separate: in Keynes’s 1937 paper ‘The General Theory of Employment’ especially, it becomes clear that macroeconomics cannot be understood without taking uncertainty, which cannot be calculated by any mathematical method, seriously at the macro level.

Fundamental uncertainty is explaining why the macroeconomic system must be non-ergodic, which means that the future is not predictable in statistical terms. Time is not a linear function and not reversible, because the flow of events is not homogenous and not stable. This conclusion is further enforced by Hyman Minsky’s ‘Financial Instability Hypothesis’, which explains why modern macroeconomic system is inherently unstable in a way Keynes only hinted at in Chapter 12 of *GT*.

These theoretical considerations are empirically substantiated by Benoit Mandelbrot, who concludes his investigation the following way:

I [Mandelbrot] analyzed more than a century of data on U.S. cotton prices and studied the way they had varied daily, monthly, and yearly. The results were clear and irrefutable. Far away from being well-behaved and normal as the standard theory then predicted, cotton prices jumped wildly around. Their
variance, rather than holding steady as expected, gyrated a hundred-fold and never settled down to a constant value. In the world of financial theory that was a bombshell . . . (Mandelbrot 2008: 95)

Later Mandelbrot extended his research to stocks and currencies and found the same results (Mandelbrot 2008: 96–97). So, there is empirical evidence that market processes are not following any normal distribution and that they are non-ergodic. Unfortunately, the risk models of modern financial theory assume that market processes are ergodic, where uncertainty is reduced to quantifiable risk. The chapter concludes with a plea never to lose sight of the role of uncertainty in macroeconomic analysis.

The importance of getting uncertainty right for the understanding of macroeconomics is further discussed by Jesper Jespersen in ‘Keynes’s General Theory after 75 years’. His focus is the ‘principle of effective demand’, which is widely considered the analytically distinct novelty of The General Theory. But from his point of view, emphasis on demand has caused a barrier to communicating Keynes’s fundamental new insight of how production and employment are determined. It is important instead to stress the word effective, which really is a modifier. According to the author’s interpretation, effective means all relevant matters which have an influence on the entrepreneurs’ decision on how much to produce and how many people to employ in the coming period. Keynes had no objection to the assumption that entrepreneurs try to maximize profit given the available information. Here the concept of ‘rational beliefs’ developed in A Treatise of Probability becomes relevant. Entrepreneurs have to establish rational beliefs on the firm’s future sales dependent on expectations of aggregate demand. Each firm has a market share which is relatively stable from one period to the next. Further, production has to be profitable, which is a necessary but not sufficient condition for producing anything. In addition, access to credit has become demonstrably important. If you cannot get extra credit/finance it is difficult to expand production at the micro level and impossible at the macro level. Hence, effective demand cannot be understood at the macro level independently of uncertain expectations, expected profits, and available credit as well as the more traditional factors of production, qualified labour and real capital.

Hence, the principle of effective demand encompasses a broad-ranging set of arguments which have relevance for entrepreneurs’ production and employment decisions. The decision process is based on rational beliefs and influenced by a variety of relevant demand and supply factors where the information is in a varying degree uncertain.

A casual reading of The General Theory could leave the impression that
finance and credit is not that important for the macroeconomic develop-
ment. If anything the current economic crisis has demonstrated the rel-
evance of the financial instability hypothesis (FIH) and the importance
of availability of credit. Elisabetta De Antoni has made a reassessment of
these claims in her chapter ‘The General Theory after the Sub-Prime Crisis:
A Minskyan Perspective’. Minsky’s analysis of the dynamics of the finan-
cial sector and its impact on the real economy is an important supplement
to analysis within The General Theory. Minsky’s FIH is an important extra
argument for the inherent trade cycle discussed by Keynes in Chapter 22.
The trade cycle is unavoidable especially when the psychology for bankers
(and other financial actors) is understood. In fact one could argue that
the FIH could rather easily be integrated into Keynes’s theory of liquidity
preference. It is in this perspective naïve to believe that a modern macro-
economic system ever could get rid of trade cycles. Keynes was struggling
with a theoretical explanation of persistent unemployment of 10 percent or
even more, which in fact is the same magnitude of unemployment which
has characterized European economies since the early 1980s. Right now
the rate of unemployment is close to 11 percent and the average has been
around 9 percent for several decades.

The author takes issue at this point with Chapter 12 in The General
Theory, asking if the organization of the financial sector with ample room
for financial speculation adds to the persistent deficient effective demand.
If the capitalist system has developed into a full flush casino which is
soaking up a substantial amount of available credit and where the trend of
asset prices is derailed from the fundamentals, then a case for persistent
underemployment is at hand. The author concludes that the organization
of national and international financial markets allows the predominance
of speculation over entrepreneurship. For these reasons the macroeco-
nomic system, not only the trade cycle, has an inherent element of macro-
 instability in the short run but even more importantly in the long run.
Only an open-system analysis could make this fact comprehensible for the
politicians.

Private banks did not play a significant role in The General Theory. This
is discussed and expanded by Noemi Levy-Orlik in her chapter ‘Keynes’s
Views in Financing Economic Growth: The Role of Capital Markets in
the Process of Funding’. The author outlines three important aspects of
banking and finance in modern growth societies, where the stock of real
capital and the flow of output are constantly growing except for periods
of economic crisis. In The General Theory Keynes focused on the low
level of real investment. One of the great novelties was his demonstration
that ‘investment creates its own savings’. Hence, the key to prosperity is
private investment. For that reason he made a thorough discussion of
the determinants of the rate of interest and of entrepreneurs’ long-term expectations. The author acknowledges the importance of Keynes’s arguments but wants to put more emphasis on the role of the banking system as the provider of the credit which is a necessity for production plans to be realized. Growth in GDP requires a continuous expansion of bank credit. Hence, the functioning of the banking system is important for any expansionary economic policy to be successful. The author recommends that the theory of endogenous money supply, the monetary circuit and the working of the inter-bank market get a more prominent position within Post Keynesian macroeconomics in the future.

RELEVANCE FOR MACRO POLITICS

The final two chapters are directed towards economic policy in the Euro area. Making a macroeconomic analysis of the economy as a whole today means looking at the European economy as a whole. This statement is obvious with regard to trade and capital flows; but when it comes to economic policies each country is treated as a separate entity. Especially within the European Monetary Union this partial approach hardly makes sense. One could say that an analytical fallacy of composition is committed at the European level. This is the common theme of both papers, that macroeconomic imbalances in one country cannot be corrected independently of the development in the other 16 Euro zone countries. But the Stability and Growth Pact only focuses on the imbalance of the public sector, independently of the corresponding imbalances within the private sector and the balance of payments. As we know from the national accounting principles, these imbalances are linked. The correction of the public sector deficit in any country has an impact on the current account and by that on the other member countries’ macroeconomic performance, which will to some extent create a backfire. In some way one could read these two chapters as a modern response to Keynes’s ‘Notes on Mercantilism’ in Chapter 23 of The General Theory.

Gregor Semieniuk, Till van Treeck and Achim Truger ask the question ‘Nothing Learned from the Crisis? Some remarks on the Stability Programmes 2011–2014 of the Euro Area Governments’. What governments could have learned is that member countries within the Euro area are more closely interrelated than previously realized. Within orthodox theory of ‘optimum currency areas’ the importance of balance of payments imbalances within a common currency area is hardly mentioned. The theoretical and practical focus has been solely on the public sector deficit. Hence, balance of payments deficits and surpluses were allowed to
build up within the Euro area without anyone taking serious notice. This imbalance is a mirror image of the sum of the private and public sector financial deficit/surplus. Not even the financial markets reacted to balance of payments deficits of more than 10 percent of GDP in some countries. Until 2007 the margin of the rate of interest on Greek government bonds compared to German bonds was less than 0.5 percent.

This chapter looks at the adjustments of the individual euro-countries which are planned for 2012–14 and challenges the projections, because according to the authors the euro-interdependence has not been taken into account. The programmes concentrate on the adjustment of the public sector, without any consideration of which sectors domestically or abroad are implicitly assumed to take the corresponding adjustment. And what imbalances may that cause? An improved public sector deficit (increased public savings) means by definition a reduction of the private sector’s financial surplus domestically (reduced savings) or abroad (reduced balance of payments deficit). These changes in the private sector financial balance will have further repercussions: attempts to increase private sector indebtedness (which is the case in Southern Europe, the so-called PIGS countries: Portugal, Italy, Greece and Spain) will be difficult to finance. Are the Northern European countries prepared to reduce their current account surpluses? These questions are not addressed within the mutual plan of Stability Programmes for the euro-countries.

Three counterfactual exercises are carried out to demonstrate that the outcome with regard to reduced sector imbalances could easily be less positive if there is some resistance within the private sectors or abroad passively to accept the desired reduction of the public sector deficit. Especially, if the Euro zone as a whole cannot realize a substantial balance of payments surplus, the PIGS cannot improve their national balance of payments as assumed in the Stability Programme, and they will end up with huge – unsustainable – balance of payments and private sector deficits. If the balance of payments between the Euro area and the external world does not improve (which is difficult with a floating euro exchange rate), then the only sustainable adjustment programme within the Euro area is one where the Northern European countries expand their national economies by a more relaxed attitude to the public sector deficit – at least for the time it takes to restart the growth process in the South. According to the calculations this is the only economically viable programme to create stability within the Euro area; but it is hardly politically realistic.

The chapter ‘European Economic Policy and the Problem of Current Account Imbalances: The Case of Germany and Spain’, written by Jorge Uxó, Jesús Paúl and Eladio Febrero focuses on the impact of balance of payments imbalances within the Euro area. They emphasize that this
imbalance is a mutual problem within the European Monetary Union, to a much larger extent than public sector deficits. This interdependency is further enforced by the fact that, since the EMU was established in 1999, there has been, by and large, an external balance. This means that balance of payments deficits and surpluses with the Euro area as a whole have cancelled out. Deficit countries, mainly the PIGS countries plus to a lesser extent Italy and France, have exported jobs to the much more competitive Northern countries (especially Germany) and at the same time indebted themselves to Northern investors. When the crisis broke out in 2008 it was overwhelmingly demonstrated that it does not matter much that South shares the same currency as North, because unemployment and high rates of interest were not shared. Year by year it has been demonstrated by the statistics that South and North deviate more and more with regard to overall macroeconomic imbalances. The root of the imbalance is the balance of payments, which cannot be corrected unilaterally. The situation within the Euro area comes close to the one Keynes feared could be the outcome of the Bretton Woods agreement in 1944: that the US economy would dominate due to a strong competitive position and excess savings. Keynes therefore suggested that surplus countries should pay a penalty on their accumulated foreign assets and hereby give an economic incentive to reduce the surplus.

Using Spain and Germany as illustrative cases, the chapter demonstrates that Spain cannot improve on its current account without Germany accepting a reduced surplus and some weakening of its strong competitive position. Unfortunately, the idea that Germany should have any mutual responsibility for the re-establishment of macroeconomic balance within the Euro area as a whole does not occur in the minds of decision-makers of a surplus country. Deficit countries have to ‘make order in their own house’ but they cannot do that without cooperation from the surplus countries. The claim of the chapter is that the poorest countries within the Euro area cannot grow their way to prosperity at the same level as the Northern countries without being able to increase exports at least as speedily as imports. This is not only a matter of relative competitiveness but also a matter of accepting higher growth rates in the South for a while.

However, it should also be said that Spain might have created some problems of its own by letting the housing bubble grow too high and for too long; but no warning signal was sent from Brussels, because Spain had a surplus on the public sector deficit. In fact, until 2007 Spain was often claimed as a success story within the Euro zone on account of its high growth rates. If anything this demonstrates how badly the euro-institutions are organized. Spain was not really able to break the housing bubble, because monetary policy was directed from Frankfurt with an eye
on the weak German (and French) performance. No consideration was paid to the mounting balance of payments deficit, and capital markets were blind and deaf to the huge indebtedness of the private sector.

If these inherent institutional asymmetries are not corrected, the authors are sceptical with regard to any substantial reduction of the macro-economic imbalances within the Euro area.

NOTES


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