

2014

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The Economies of Balkan and Eastern Europe Countries in the Changed World (EBEEC 2013)

## Keynes and the Eurozone's Crisis: Towards a Fiscal Union?

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### Abstract

The majority of the peripheral member states of the Eurozone Portugal, Italy, Spain, and Greece have experienced financial crises. Until now, the European leaders attempted to solve the crises mainly through austerity measures. For them, either it is an ideological or a political matter; the answers have identified with the free market beliefs. In this paper, we will argue that until now all the solutions that have been agreed on the European level do not help to solve the root causes of the Greek financial problem. The national governments of the European Union do not follow any of the Keynesian ideas to overcome the crisis. The European leaders seem to have forgotten their role to act as a policy makers. Under these conditions, even if the Greek financial problem can be moderated, it cannot be solved. The above observation is highly significant for the future of the European Union because every currency union in order to survive needs a mechanism of fiscal transfers. This mechanism does not exist in the Eurozone. Thus, this crisis will continue to affect the performance and function of the EU.

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Selection and peer-review under responsibility of Kavala Institute of Technology, Department of Accountancy, Greece

Keywords: Political Economy; Greek Crisis; Eurozone; Keynes.

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### 1. Introduction

The European leaders attempted to solve the European crisis mainly through austerity measures. For them, either it is an ideological or a political matter; the answers have identified with the free market beliefs. This *laissez faire* approach has generated severe social, political, and economic phenomena within the member states. The effective demand in each peripheral economy shrunk, creating waves of pessimism and unemployment. How has the

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European Union (EU) responded to the severe crisis? As the Greek case shows, the solutions to overcome the crisis have nothing to do with the most important problems that the member states confront.

This paper argues that even though the last four years many things have changed in the field of European economic governance, the most important flaws today remain unsolved. In this regard, the ideas of John Maynard Keynes are needed to be remembered. Almost all the efforts of European leaders to resolve the Eurozone's crisis are not related to the development of effective policies for the weak peripheral member states. The EU does not follow any of the Keynesian ideas in order to overcome the crisis. Thus, the political economy of austerity does not provide an adequate solution for the peripheral member states like Greece. A new approach for the European economic governance is needed.

This paper is organized as follows. In the first section, the main theoretical arguments of John Maynard Keynes will be presented. It will then proceed with the analysis of the main vulnerabilities and the main gaps that can be identified at the European level. The third section will examine the most important events of what we call Greek story. Finally, it will conclude with policy proposals according to Keynesian rationale.

## 2. The Keynesian rationale

The global financial crisis suggests that government intervention may be necessary as the market players cannot form correct perceptions about the direction of the economy. In this regard, Keynes has an unambiguous role to play. In his writings, Keynes has already provided the missing theoretical link that connects diagnosis and treatment (Skidelsky 2010). Keynes based his arguments on two important variables namely employment and economic growth. At the core of his theory one can make notice of the uncertainty about the future (Keynes 1921). Uncertainty is not only the main reason for the instability of the economies but also hinders the recovery from financial crises.

Keynes also believed that a great economic recession was always possible in a self-regulating market system. The states should take the role for implementing a concrete and deliberate management of the economy when the global demand shrinks. Many times during the financial crises, even if the interest rate (cost of borrowing money) is very low for various reasons this may not lead the economy to recovery and then the intervention of the state in financing new investments is necessary (Keynes 1982). The states should intervene through the expansion of fiscal policies in order to maintain the appropriate effective demand in the economy. This kind of 'socialization' of investments could stabilize the economy. The states should also take the role of investors by creating various compromises and cooperation mechanisms between public and private parties to ensure full employment (Keynes 2001). As he states: "It is the policy of an autonomous rate of interest, unimpeded by international preoccupations, and of a national investment programme directed to an optimum level of domestic employment which is twice blessed in the sense that it helps ourselves and our neighbours at the same time. And it is the simultaneous pursuit of these policies by all countries together which is capable of restoring economic health and strength internationally" (Keynes 2001: 366).

Based on this Keynesian perspective, the crisis is a result of the investment volatility. If the state does not take action to stabilize the total expenditure that it is needed to stabilize the economy then the market economy becomes unstable as investments are affected by the uncertain expectations about future developments. In good times, the states should maintain budget surpluses but during financial turmoil should intervene to market economy by creating deficits in order to give the necessary impetus for growth.

Speculation, the activity of forecasting the psychology of the market is growing as the organization of investment markets is improving. Keynes (2001: 187) believes that "Americans are apt to be unduly interested in discovering what average opinion believes average opinion to be; and this national weakness finds its nemesis in the stock market". The functioning of securities markets coincides with a "beauty contest" where the prize is awarded to that competent obtaining the most average preferences. In this way, Keynes (2001: 188) states

"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of *laissez-faire* capitalism".

### 3. The main vulnerabilities at the European level

The European crisis is not like a ‘Black Swan’ which unexpectedly spread its negative consequences throughout the world. This means that the European storm did not erupt so unpredictably. In the Eurozone, as in any monetary union with fixed exchange rates and single currency, there are significant trade and capital imbalances among the member states. These imbalances may persist for many years, creating an explosive mixture of conditions in the absence of appropriate institutions that could mitigate their impact. Thus, the most significant vulnerability of the Eurozone is rather the lack of a European mechanism of fiscal transfers, in order to alleviate the huge trade and growth gaps for the majority of the peripheral countries. The EU’s mechanism for managing the economic gaps through macroeconomic coordination is weak and ineffective and the peripheral indebted member states have fewer options for stocking growth (EUCE 2012). In Bretton Woods, Keynes tried to solve the same problem by making a proposal for the creation of a global currency, the creation of an international monetary union and all the necessary institutions.

Even though, the proposals for the establishment of such institutions have been done many years ago, in the Eurozone there is no a formal or informal mechanism for recycling imbalances yet. For example, Eichengreen (1991) proposed a system of budgetary transfers for a possible injection of liquidity from other countries. This calls for a system of redistributive policies which also requires a central fiscal authority (Dibooglu and Horvath 1997). In this regard, there is a need for an economic institution that could organise not only the monetary but also the budgetary and fiscal policies in the Eurozone (Verdun 2007). Varoufakis (2012) believes that, this kind of recycling of budget surpluses can take either the form of standard transfer of money or investments in production activities in the deficient areas. But how big is the problem today? As figure 1 demonstrates, within the Eurozone there are huge current account imbalances. In this way, Europe suffers from a kind of trade or capital disequilibrium which is similar to the disequilibrium between the US and China (Buzgalo 2011). The table 1 shows that, this policy has also created huge external debts for peripheral counties which they have limited their capacity to repay their debts. The conclusion is uncontested. Only the peripheral countries with large current account deficits were affected by the crisis (Gros 2013).

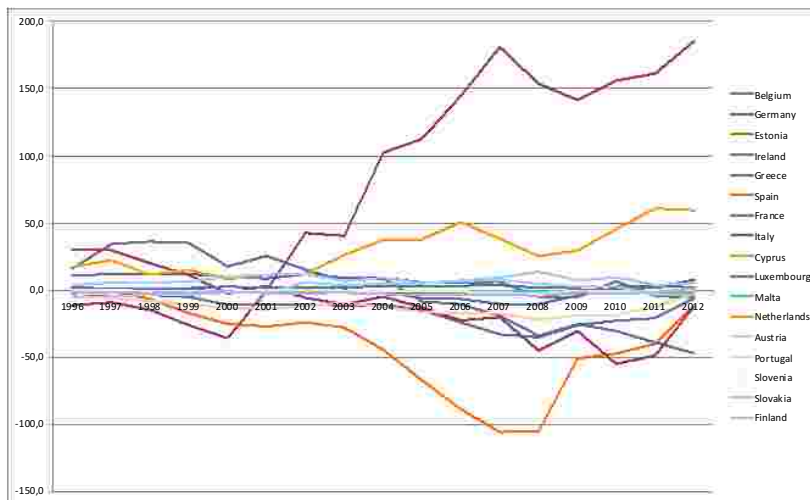


Fig 1. Current Account Imbalances within the Eurozone

Source: (Eurostat, 2013)

The most disappointing of all is the fact that there is a strong political unwillingness from many European countries to prevent these imbalances and thus, the main problem within the Eurozone remains. Darvas et al. (2013: 2) state “Europe’s pre-crisis growth performance was disappointing enough, but the performance since the onset of the crisis has been even more dismal”.

Table 1. Gross External Debt and Exports Ratios (Billion real US\$, 2005=100)

Year	Portugal			Ireland			Italy			Greece			Spain			Euro area		
	Gross external debt	Exports	External debt/ Exports	Gross external debt	Exports	External debt/ Exports	Gross external debt	Exports	External debt/ Exports	Gross external debt	Exports	External debt/ Exports	Gross external debt	Exports	External debt/ Exports	Gross external debt	Exports	External debt/ Exports
2003	287	48	5.9	780	139	5.6	1,543	393	3.9	217	39	5.6	1,041	247	4.2		3,198	
2004	321	55	5.8	1,087	158	6.9	1,703	451	3.8	262	50	5.2	1,277	280	4.6		3,703	
2005	302	54	5.6	1,336	163	8.2	1,676	462	3.6	263	52	5.1	1,350	291	4.6		3,861	
2006	369	61	6.0	1,708	171	10.0	2,042	501	4.1	319	54	5.9	1,748	317	5.5	11,081	4,210	2.6
2007	455	72	6.4	2,133	196	10.9	2,398	577	4.2	427	63	6.8	2,166	369	5.9	13,837	4,848	2.9
2008	446	77	5.8	2,169	202	10.8	2,205	609	3.6	465	73	6.3	2,142	395	5.4	13,984	5,261	2.7
2009	501	62	8.1	2,176	184	11.8	2,327	458	5.1	536	54	9.9	2,309	321	7.2	13,657	4,153	3.3
2010	478	65	7.3	2,082	188	11.1	2,201	494	4.5	491	54	9.0	2,087	340	6.1	13,303	4,487	3.0

Source: (World Bank, 2012)

#### 4. The Greek story

In 2007, the Commission decided to stop the excessive deficit procedure for Greece, a policy option that was in contrast to the current financial turmoil (European Commission 2007). Around the same time, many in Greece could not have predicted the impact of the global crisis. The Greek minister of economic affairs Alogoskoufis (2009) stated that Greece was fortunately not affected by the global economic crisis as other countries. The same argument was pointed out by the Greek Prime Minister Konstantinos Karamanlis, who at the end of 2008 was forced by the economic conditions to admit that the big problem for Greece is that the global crisis will have a negative impact on the level of government debt (Eleytherotipia 2008). For this end, in January 2009 it was published an “Updated Stability and Growth Programme 2008-2011” (Ministry of Economics 2009). However, the European Council warned Greece that the new stability program was unrealistic (Council of the EU 2009). But even then, no one could predict how the global financial crisis and the debt crisis in Greece were associated with the systemic European economic governance crisis.

Shortly before the October elections in Greece, the main dispute between the two political parties PASOK and ND had begun. However, the main arguments of the political campaign of the later Prime Minister George Papandreou had nothing to do with an organized exit strategy from the crisis. Instead, Papandreou’s speeches mainly focused on the various political and economic scandals and the unreliability of the opponent party. During this period, PASOK’s main arguments were based on the economic policy of populism. Papandreou was promising income support, market revitalization, employment boosting and fiscal discipline. All those were based on his populist slogan “there is money” (PASOK 2009).

The new government appeared not to have been aware of the severity of the Greek financial problem. For this reason, it developed no exit strategy from the crisis and very quickly the financial markets closed for Greece. Only in early 2010 the new government began to take some budgetary measures. However, these attempts were rather spasmodic movements of the Greek political leadership which was paying very quickly for the error of populist announcements of the Greek Prime Minister. These inadequate and delayed measures clearly showed that the lack of an exit strategy from the crisis was the main problem of the leadership of PASOK. At the same time, the financial markets were fully aware of the structural problems of the Greek economy and did not believe that Greece could overcome the crisis easily. This also appears from the figure 2.

Under these conditions, a Memorandum of Understanding between the four parties was ratified by Law 3845/2010 on 6 May 2010. This approach greatly differed from previous IMF reform programs because there was actual involvement of the European Commission and the ECB in writing the terms of agreement and in the supervision of the implementation of Greek commitments (Mitsopoulos and Pelagidis 2012). In return for the 110 billion euro package, the Greek side should go in hard austerity measures which in fact could have severe structural implications for Greece to be ignored (Monastiriotes 2011).

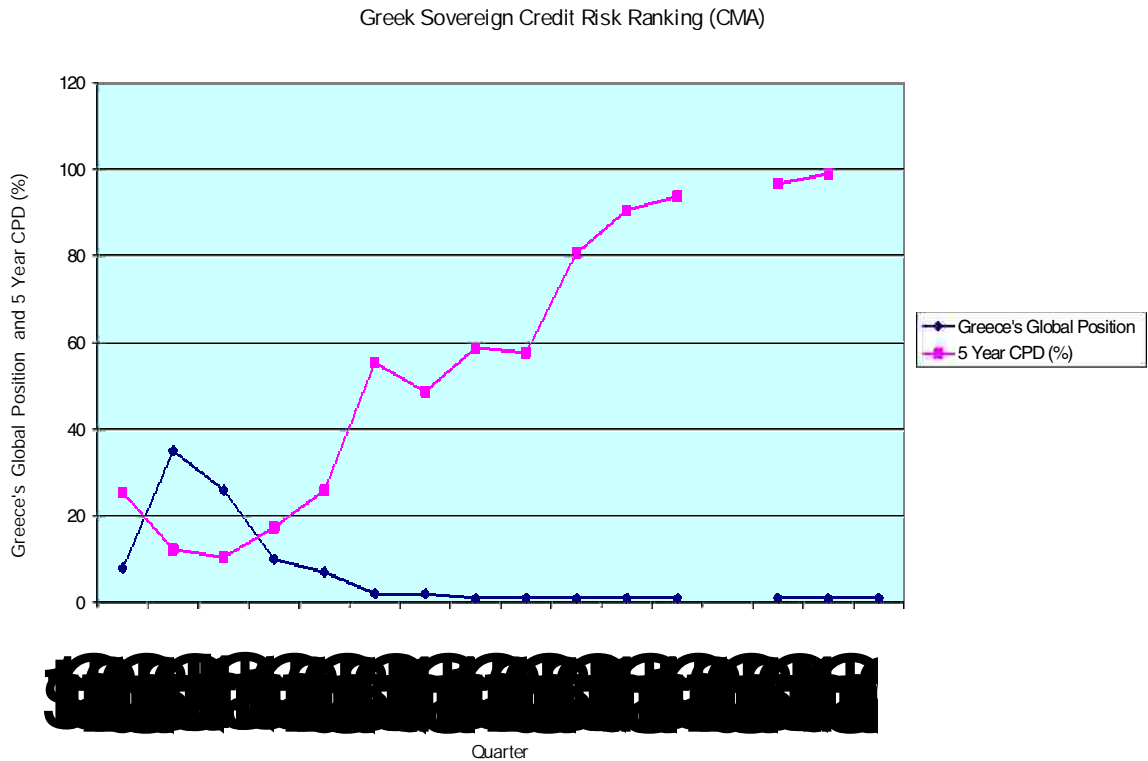


Fig 2. Greek Sovereign Credit Risk Ranking

Source: (CMA, 2013)

The memorandum was ruinous for Greece and its outcome uncertain. First, the creators of the program did not consider the impact that would have the income reduction in effective demand as they miscalculated the fiscal multiplier (Standard & Poor’s 2012). Second, the global financial markets affected the severity of austerity measures in Greece. As De Grauwe and Yuemei (2013: 4) believe “the timing and the intensity of the austerity programmes have been dictated too much by market sentiment instead of being the outcome of rational decision-making process”. Third, the technocrats ignored the role of trade unions, syndicates and various interest groups in the implementation of reforms. Kaplanoglou and Rapanos (2012: 17) state that “more surprising is the degree to which these features seem to have persisted even after Greece was subjected to an ambitious fiscal adjustment programme by the three international organizations”. Fourth, the Greek officials showed reluctance to comply with major institutional reforms (Mitsopoulos and Pelagidis 2012). Fifth, the current demands made by Eurozone officials for austerity and a smaller, more efficient state apparatus could be understandable but they amount to a demand that Greek political culture be dramatically changed in a very short time frame. This it is not an easy task for the Greek and European officials and it seems unlikely to be realized (Sklias and Maris 2013).

The Greek paradigm affirms that the political and institutional convergence within the Eurozone is much more difficult than the economic one. It seems that all the attempts for modernization and Europeanization not only failed to create a stable political and economic system in Greece but also solidified a mature clientelistic political system as the main characteristic of the Greek polity. Even though, the political parties acknowledged the necessity of reforms and real modernization of the Greek society, at the same time they undermined any effort for reforms and modernization.

## 5. The Keynesian critique

The European leaders, instead of creating effective policies seem to have forgotten their role as policy makers. This does not mean that the solutions proposed already are completely ineffective. Rather, we should ask for the creation of European fiscal transfer mechanisms that can spread the risks and imbalances across the region. The European crisis is identified with creating a European system of fiscal centralization in order to diffuse growth and wealth in a more effective and rational way.

The EU should seek immediate policy responses that can mitigate the destruction of the European periphery. First, the peripheral countries must propose the creation of a Common European System for Taxes by which the various regional risks and asymmetries can be diffused effectively across the regions. This is not to say that the national tax systems should be abolished but rather should have a complementary role in order to diffuse and redistribute the growth across the weakest regions. Thus, the EU's tax policy strategy as it is proposed from the European Commission (2001) should be re-examined. The EU should follow the American paradigm where taxes are imposed both from the federal state, the autonomous states and the local governments.

Second, they must also propose the creation of a European Unemployment Benefit. This potential mechanism could work as one of the main official mechanisms for growth redistribution of the European social policy. The American unemployment benefit is in fact a federal state program which is jointly financed through the federal and the autonomous states. Again this program could complement the unemployment insurance programs in each member states. In this respect, a European Revenue Service should be created, like the Internal Revenue Service in the United States, in order to collect a standard rate of taxes.

Third, the peripheral countries should also claim large European investment projects to be transferred to their periphery. In the United States, this mechanism works very well as the government intervenes in the deficit regions by creating huge military bases and weapon production factories (Varoufakis 2012). The common European investment projects not only can be diversified more efficiently across regions and sectors but can also create the essential mechanism for a balanced development within the Eurozone through the form of productive investments. This is not to say that the role of the European Investment Bank and the Social Cohesion Funds should be ignored.

Fourth, the EU must also ask for the decentralization of European institutions. The European Commission only employs 32.666 people by which the 21.467 work in Brussels, 3.908 in Luxembourg, 3.524 in other European countries and 3.767 in third countries (European Commission 2013). Is there any specific reason for this regional concentration of the EU's institutions? The decentralization of the European institutions can help the peripheral countries to overcome the growing asymmetries within the Eurozone as this decentralization can work as an unofficial mechanism for recycling the imbalances.

Fifth, they must also claim penalties for the intra-European trade particularly for countries with huge surpluses like Germany. This Keynesian argument is very simple in its rationale. If the surpluses of a member state exceed an agreed level of its trade transactions, this country should pay some penalties because these excessive surpluses affect the stability of the EU. Then the collected taxes can be invested in the deficit member states by creating a virtual mechanism of automatic stabilizers that can also spread the risks of asymmetries within the Eurozone.

## 6. Conclusion

The EU confronts several challenges that must be tackled. The last five years any proposals for fiscal policy options that could compensate overheating in the indebted peripheral countries failed. In this way, the solutions that have been agreed on the European level do not help to solve the causes of the Greek financial problem. The European leaders seem to have forgotten to act as a policy makers and do not follow any of the Keynesian ideas. Even if the Greek financial problem can be moderated, it cannot be solved.

A new approach for the European economic governance is needed. Undoubtedly, Keynes has an unambiguous role to play. The above observation is highly significant for the future of the Eurozone because every currency union in order to survive needs a rational system of fiscal centralization. This mechanism does not exist in the Eurozone and in this way the crisis will continue to affect the performance of the EU.



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