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Keynes and the International Clearing Union: A Possible Model for Eurozone Reform?

Abstract

Economic and monetary union in Europe, as currently constituted, has a number of structural weaknesses. Large, persistent international payments imbalances necessitate deficit nations to deflate their economies or squeeze social wages in order to restore competitiveness. Surplus nations accrue reserves, with little pressure to maintain related contribution to spending power in the real economy. The asymmetric treatment of credit and debit nations reduces aggregate demand in the Eurozone. This paper examines a solution, first proposed by Keynes, whereby symmetrical treatment of balance of payments transactions may promote economic growth and higher levels of employment. It outlines the key features of the system and highlights the relevance of the solution to the issues faced by the Eurozone.

Introduction

The 2008 international financial crisis, which was triggered by problems related to sub-prime housing loans and securitisation via collateralized loan obligations and credit default swops, led to a deep economic recession across most of the industrialized world. Subsequent actions, undertaken in order to prevent the onset of a worsening economic depression, have contributed towards sovereign debt problems for certain Eurozone member states, and a general worsening of budgetary positions for the remainder. These events have highlighted not only the fragility of the European banking system, but additionally the flaws in design of the particular form of economic and monetary union (EMU) established amongst a number of

European Union (EU) member states. The tensions caused by the financial crisis have not *caused* these problems, however, but rather *magnified* or highlighted the existence of pre-existing weaknesses which have long been recognised by a selection of the academic commentators who have written on this topic over the past two decades (Eichengreen, 1992; de Grauwe and Vanhaverbeke, 1993; Burkett et al, 1996; Arestis and Sawyer, 2000). Moreover, it is not only the design of EMU and the rules established to limit participation to suitable candidate nations, which have been found to be at fault, but also the economic architecture introduced in an attempt to sustain this new arrangement (Degryse, 2012, p. 6).

The response to these problems has been three-fold. Firstly, the EU member states have sought to provide emergency loans, to assist EMU members in immediate and pressing difficulties, to prevent nations being forced to leave the single currency or, indeed, for EMU to disintegrate. This has been called the "kicking the can down the road" approach, as it does not solve fundamental problems, but might create the time and space for this to occur. Financial assistance has evolved into a more substantive European stability mechanism (ESM), providing financial loans subject to the implementation of austerity measures, combining reforms in national labour and/or social policy, intended to reduce public expenditure.[1] This 'fiscal compact' is the second aspect (Degryse, 2012). The third element is the ongoing negotiation of a tighter set of budgetary rules, tightening the former stability and growth pact (SGP), by having more restrictive limits on budget deficits and stricter enforcement of any breaches of these new rules (EU Commission, 2011).[2]

This response is, at best, likely to be a temporary relief for Eurozone members, as it does not address some of the fundamental issues inherent within any fixed (or single) currency

[1] http://www.efsf.europa.eu/about/index.htm;
http://ec.europa.eu/economy_finance/eu_borrower/efsm/index_en.htm
[2] http://ec.europa.eu/economy_finance/publications/giovannini/giovannini081100en.pdf

arrangement. In the absence of much stronger variants of fiscal federalism, the stabilisation of the single currency zone is problematic, given the persistence of asymmetric shocks (Bayoumi and Eichengreen, 1993; de Grauwe and Vanhaverbeke, 1993, p. 112-125). Moreover, the policy reforms fail to deal with large, persistent payments imbalances between participating member states, nor the resultant increased demand for international reserves, which has the unfortunate consequence of reducing Eurozone aggregate demand (Stiglitz and Greenwald, 2010, p. 12). The adoption of a single currency precludes the use of the exchange rate as an ameliorating instrument. Thus shifts in international competitiveness are more difficult to resolve, except through deficit nations adopting general deflationary measures and/or policies aimed at reducing real or social wages (Keynes, 1980, p. 29). Little commensurate pressure is exerted upon surplus nations to seek a balance to their international payments account. Indeed, the policy responses to the current Eurozone difficulties reflects this asymmetric treatment of credit and debit nations, with the burden of resolution firmly placed upon those nations already struggling with public debt and international competitiveness problems.

There is, however, an alternative approach, that could be adapted to the Eurozone, and which would promote an agenda favouring employment and growth, rather than fiscal retrenchment and deflation. It would promote social cohesion and solidarity between member states, by imposing symmetrical responsibilities upon surplus as well as deficit nations. It would resolve many of the fundamental structural weaknesses with the current form of EMU, and thereby enhance the medium term sustainability of the Eurozone. This approach is not new. It was first proposed by John Maynard Keynes in 1942, and designed to share the burden of adjustment between debtor and creditor nations, rather than simply the former. This would promote Eurozone balance without forcing ultimately unsustainable deflation upon weaker

member states. Yet, surprisingly, the Keynes Plan seems to have been overlooked by Europe's policy-makers when seeking creative options to resolve current economic problems besetting the single currency. This paper seeks to outline the key features of this approach, identify where these may be relevant to the current difficulties facing the Eurozone, and indicate how this innovation could contribute towards the resolution of identified structural weaknesses.

Excessive Reserves and Macroeconomic Consequences

There are multiple motivations for holding international reserves and these do not necessarily remain constant over time. Volatility and perceptions of risk tends to influence precautionary savings in the form of reserves. Other reasons include high levels of natural resource (especially oil) price volatility and/or policy responses to the perceived fragility of the international economic system. Substantial reserves allow policy-makers more flexibility in responding to periods of economic turbulence. China and Russia were better able to sustain the strengths of their economies and, particularly in the former case, launch a sizeable Keynesian stimulus package in response to the recent financial crisis, due to the previous build-up of reserves (Stiglitz and Greenwald, 2010, p. 8). This might be considered as a case of macro-precautionary motives, albeit that sometimes the trade policies of both of these nations appears to be more inspired by mercantilism. Indeed, Bibow (2010, p. 2) suggests that unregulated global finance has encouraged the growth of defensive macroeconomic policies, and that this faultline in global financial architecture is unlikely to be rectified without further intervention.

A second example may derive from the export-led growth model, utilised by, amongst others, East Asia, Japan, China and Germany (Stiglitz and Greenwald, 2010, p. 10). Structural surpluses ensure that other nations endure persistent deficits, given that global trade must balance. If surplus nations seek to maintain their current account positions, this makes it more difficult for deficit countries to return to balance. This may be reinforced by the combination of neoclassical orthodox hegemony and successive World Trade Organisation rounds, which have made industrial policy more difficult and hence less attractive. This, in turn, places more emphasis upon exchange rate policy or else attempts to reduce wages or the social wage in order to improve international competitiveness. By facilitating increased net exports, these policies promote trade surpluses, which magnify external imbalances (IMF, 2002, pp. 65-6; Bibow, 2010, p. 8; Stiglitz and Greenwald, 2010, p. 8, 11)

To place the issue in context, the reserves held by monetary authorities access the globe more than quadrupled over the decade before the recent international financial crisis, rising from less than $2 trillion in 1999 to more than $8 trillion in 2009, with developing economies accounting for more than two thirds of that increase. This figure is equivalent to in excess of 12 per cent of world output at market exchange rates (Costabile, 2010, p. 7; Stiglitz and Greenwald, 2010, p. 8). Leaving these balances idle creates an opportunity cost, since these funds could have been invested in productive activity. Hence, the world economy is poorer and with a slower potential growth trajectory as a result (Stiglitz and Greenwald, 2010, p. 8). This is a large proportion of potential demand to be withdrawn from the global economy, and hence current arrangements may arguably produce a ‘chronically unstable global macroeconomic situation with a strong deflationary bias’ (Stiglitz and Greenwald, 2010, p. 12).

These factors have particular resonance for nations sharing a single currency, where exchange rate policy is no longer available, and where the current approach is to utilise a combination of deflation and social wage reductions to restore competitiveness in deficit nations. Surplus nations such as Germany, which currently has amongst the largest trade surpluses in the world, appear determined to persist with export-led growth model(s). This insures that other Eurozone members will find it more difficult to improve their own trade balances without more drastic action than might otherwise be needed. Moreover, although German reserves, built up through this trade policy, are being utilised to provide temporary loans to those EU member states suffering fiscal distress, this provides only temporary relief, whilst loans are accompanied by demands for quite severe fiscal tightening. The persistence of trade surpluses, and the lack of pressure upon governments to take corrective action, creates further problems for nations posting trade deficits. There is a need, therefore, to examine more fundamental reforms to the global (or regional) financial architecture; the most important proposals having been made by Keynes (1980).

The Keynes Plan

The Keynes Plan for an International Clearing Union (ICU) originated during discussions about the suitability of international economic foundations capable of promoting reconstruction and economic prosperity in the aftermath of the Second World War. The proposals were developed through a number of drafts, which are outlined in Keynes (1980), and cumulated in a UK government white paper in 1942. They were not ultimately adopted in full, although elements were included in the establishment of the IMF and the Bretton Woods international system of monetary arrangements (Skidelsky, 2000; Steil, 2013).

As befits his broader focus upon inadequate effective demand and under-employment of resources, Keynes proposed a form of international monetary system which combined the benefits of fixed exchange rates (less uncertainty leading to increased investment, trade and economic growth) with an attempt to secure an expansionist and not contractionist pressure on world trade and international balances (Keynes, 1980, p. 77, 143). In the same way that a withdrawal from the circular flow of income, in a particular country, reduces aggregate demand and thereby potentially results in under-employment equilibria, he registered concern over the inability for an international payments system to prevent excess reserves from withdrawing money from the global economy (Keynes, 1980, p. 74-5). If unwarranted by reasonable risk assessment, the build-up of excessive reserves equates to hoarding (Keynes, 1980, p. 273). If surpluses were to remain unused, as would be the case in mercantilist strategy, the result would be a sub-optimal level of aggregate demand, insufficient to maintain full employment.

Attempts made by deficit nations to restore balance, would exacerbate this problem, through deflation and other adjustment programmes (Piffaretti, 2009b, p. 47). Domestic deflation and devaluation, both of which seek to reduce the international price of exports relative to imports, with the elasticities of demand for imported and exported goods and services determining whether a modest or very large correction would be required to restore balance (Keynes, 1980, p. 29). Deflation will reduce the demand for imports, as a result of declining wages (or the social wage, via reductions in welfare expenditure) and/or increasing unemployment, whilst devaluation makes exports cheaper overseas and encourages import-substitution at home.

The Keynes Plan, therefore, sought to devise an international monetary structure which would dissuade (or prevent) nations from pursuing mercantilism and thereby facilitate national aggregate demand management to secure full employment (Bibow, 2010, p. 26). Moreover, if all nations were to maintain their expenditure levels sufficient to secure full employment, this, in turn, should reduce the probability of individual nations suffering persistent balance of payments problems (Kalecki, 1946, p. 323-7). Net foreign expenditure would be financed through international long term lending; the latter to be facilitated through the establishment of an international clearing union, similar to Keynes' proposals, combined with an international investment office. Hence, 'the plan aims at the substitution of an expansionist, in place of a contractionist, pressure on world trade' (Keynes, 1942; Keynes, 1980, p. 46-8, 74-5).

The ICU proposal sought to establish an international system of payments which facilitated global full employment. The proposal had six main elements, namely:

- Establishment of a currency union, based on international bank money
- Creation of a closed payments system, enabling central banks to regulate the flow of international payments
- Restrictions upon speculative and other short term flows of capital
- The need for symmetric not asymmetric rebalancing
- Ensuring that international reserves are limited and re-circulated
- Ability to readjust fixed exchange rate values to reflect changes in efficiency wages

'Bancor' Currency Union

The ICU would utilise a form of international bank money ('bancor'), which would be fixed, at least nominally in terms of gold, with national currencies within the ICU, and thereby fixed in relation to one another. The purpose of the new currency would be to settle international balances between participating member states, through accounts maintained by national central banks. Those nations with a surplus on their balance of payments account, with respect to other ICU participants, would accrue a credit account, whereas those with a balance of payments deficit would generate a debit account. Bancor would not necessarily be utilised for all transactions between individual businesses or banks, but rather would be the sole means of settling the *final outstanding balances* between the central banks of each participating nation.

The supply of bancor was to be perfectly elastic up to the maximum set for each country (Meltzer, 1983, p. 17). Moreover, there would be one-way convertability only, from gold or national currencies to bancor (Keynes, 1942; 1980, p. 95, 140). Thus, bancor reserves never leave the system, thereby negating the possibility of a run on the currency (Arestis, 1999, p. 7). Furthermore, one of the main design features of the bancor system was the attempt to avoid the accumulation of inactive balances held in individual national reserves. Bancor was, therefore, meant to be a means of payment but not a store of value (Meltzer, 1983, p. 17).

Creation of a Closed Payments System

The purpose of the ICU would be to extend the banking principle that exists within any closed system, namely that the sum of credits and debits (assets and liabilities) must balance (Keynes, 1980, p. 44, 72, 201). If credits are not permitted to exit the system, then the ICU will form the equivalent of its own circular flow of income, with demand maintained by

preventing withdrawals. This would require that the provision of foreign exchange would be located solely within the central bank of each participating nation. Where requested by individuals or businesses, other domestic banks would be required to apply to the central banks for release of these funds. This could operate through intermediaries, through a system of licences, but the settlement of ultimate outstanding balances would occur between central banks, which would have unqualified control over outward transactions of national citizens (Keynes, 1980, p. 33-4, 125). The focal position of central banks within the ICU proposal largely reflected the position pertaining in the UK at the time Keynes was drafting the ICU proposals, although it would require a significant reversal of contemporary reality, where international financial markets operate without this restraint.

Capital Controls

A closed payments system would require the reintroduction of capital controls, to prevent unregulated flows from undermining the ICU system. Indeed, Keynes (1980, p. 30-1, 52, 65, 86-7, 129-30, 148-50, 185-6) argued that 'nothing is more certain' than the need for 'central control of capital movements, both inward and outward' to be a 'permanent feature of the post war system', requiring 'exchange control for *all* transactions'. Payments arising from trade would be automatically permitted, and capital flows financing fixed investment would be treated more favourably than speculative capital flows, which would be prohibited (Keynes, 1980, p. 52-3, 87, 212-3; Riese, 2008, p. 39). Hence, an ICU would eliminate what may be regarded as the 'wasteful' foreign exchange activities of multinational banks, thereby curbing speculation and reducing the volatility in currencies that hamper economic activity in the real economy (D'Arista (2003, p. 737).

Melitz (1983, p. 23) argued that Keynes became convinced that no international monetary system was capable of achieving internal and external stability, high employment and economic freedom, and therefore he chose to sacrifice freedom through the introduction of a permanent system of exchange controls. The combination of fixed but adjustable exchange rates, capital controls and multilateral clearing, was intended to smooth the trade cycle and facilitate the expansion of trade, thereby setting the foundations for the maintenance of an expansionist not contractionist global economy. With idle balances being put to productive use, an ICU, protected by capital controls, could facilitate a higher level of international effective demand without inflationary consequences (Keynes, 1980, p. 155). Higher international aggregate demand should further ease the pressure on deficit nations, thereby reducing tensions in the international payments system. Capital controls would, moreover, facilitate domestic macroeconomic management (Meltzer, 1983, p. 14-15).

Symmetric Rebalancing

Given that the sum of the worldwide balance of payments must be zero, such that the sum of all surpluses must equal the sum of all deficits within a set period of time, surpluses cannot exist without an equivalent deficit occurring elsewhere in the world. Therefore, if the latter are a problem, the former must be a significant contributor to this problem occurring and persisting. This should imply that both surplus and deficit countries should be treated equally, in seeking to eliminate such trade imbalances, but this is not typically the case. Deficit countries endure compulsion to reduce trade imbalances, whilst surplus countries do not. Moreover, since problems with debtor countries can only occur, according to Keynes, if creditor countries are not making full use of the purchasing power derived from their trade

surplus, surplus countries are guilty of exporting deflationary consequences to other nations (Keynes, 1980; Richardson, 1985, p. 24; Stiglitz and Greenwald, 2006, p. 11; 2010, p. 6-7).

The ICU therefore sought to prevent *systematic* disequilibria by creating a system of incentives and penalties, to be imposed on both deficit and surplus countries, meant to discourage disequilibria (Costabile, 2010, p. 18-19; Keynes, 1980, p. 78-81). In this endeavour, the ICU would mimic the actions of national central banks, in pursuing international 'symmetric rebalancing', and thereby achieving simultaneous debtor and creditor adjustment (Piffaretti, 2009b, p. 46).

Each national central bank would be allocated an index-quota equal to the sum of its imports and exports, averaged over the previous five years and would be entitled to overdraw its clearing account by up to the value of its index account. If a deficit remained above one quarter of the index value for more than a year, the 'deficiency bank' would be allowed to borrow from the clearing account of a bank running a surplus, whilst the deficit nation would be entitled to devalue its exchange rate by up to 5 per cent per year. If the deficit exceeded half the index quota, this devaluation would be *required*, whilst outward movements of capital would be prohibited without the express permission of the governors of the central bank itself.

Meanwhile, surplus banks would be encouraged or (if the surplus balance exceeded 50 per cent of the index quota), required to introduce corrective measures, involving currency appreciation, to the maximum of 5 per cent per annum, or easing the restrictions upon the outward flow of capital. At the year end, surplus balances still exceeding the value of the index quota would be transferred to the reserve fund of the central bank. In addition, surplus

nations would be caused to transfer into the central bank's reserve fund 5 per cent of the annual excess above one quarter of its index quota, and 10 per cent above half the quota figure (Keynes, 1980, p. 35-7). In essence, this imposed the equivalent of a rate of interest upon credit balances, in the attempt to provide a deterrent against the development of a persistent surplus position. In later drafts, this element was reluctantly dropped albeit that this element of the proposal may have particular relevance to the circumstances facing the Eurozone (Keynes, 1980, p. 96).

Utilisation of Reserves to Promote Investment

Given that idle balances represent unused purchasing power, the ICU determined to prevent their build-up and ensure that such credit balances were recycled and utilised if holders were unwilling to do this themselves. Keynes expected that the threat of lost potential purchasing power would ensure that surplus nations used their otherwise idle balances to create productive capacity abroad - through FDI or through allowing the ICU to loan the funds to deficit nations. Or, alternatively, they would prevent accumulation of idle balances in the first place, by boosting domestic demand. The point of the 'use it or lose it' clause was to prevent creditor nations from remaining passive and placing all adjustment burdens upon deficit nations (Keynes, 1980, p. 49, 117).

Nevertheless, in the absence of creditor nation action, the ICU retained the ability to make use of any credit balances that surplus nations choose to remain idle, and recycle them through offering loans to deficit nations, thereby maintaining a sufficient level of effective demand adequate to maintain full employment within the clearing union (Riese, 2008, p. 39). Hoarding would not be permitted. Moreover, there would be no cost to surplus nations, since

they had chosen not to use these resources themselves, and hence the ICU could invest these idle balances in much the same way as a domestic bank with savings accounts (Keynes, 1980, p. 113). Thus, Kalecki and Schumacher (1943) believed that the combination of an ICU and institutional investment office should be sufficient to provide sufficient short- and long-term lending to prevent unsustainable foreign exchange problems.

Exchange Rate Adjustment

Whilst the ICU was conceived as supporting a fixed exchange rate system, it is important to note that Keynes did not view this fix as unalterable (Keynes, 1942). Devaluation would, therefore, be permitted if efficiency wages increased relative to wages abroad (Meltzer, 1983, p. 19; Keynes, 1980, p. 274).

Issues Arising from the Keynes Plan

Many of the initial reactions to the Keynes Plan are documented elsewhere (de Vegh, 1943; Horsefield, 1969; Keynes, 1980; Riese, 2008). However, there were a number of issues, arising out of the Plan, identified as potentially problematic for the adoption and operation of the scheme.

The first relates to relations between ICU participants and non-members. Given that the ICU was devised as a means of resolving problems for the global economy, it would operate more smoothly if all nation states participated. However, this was always going to be unlikely. Consequently, the ICU would have to accommodate trade between member and non-member states. If non-ICU nations wish to trade with ICU member states – and there is a presumption

that they would if they had an existing trade surplus with these nations – then they would need to establish an account with the Clearing Bank. Ultimate balances would be cleared between central banks of member and non-member states alike, through Clearing Bank accounts (Keynes, 1980, pp. 61-2). Nations generating a trade surplus with the ICU would hold a credit balance, and those with a trade deficit, a debit account, which they would have to settle through transfer of foreign exchange or other assets (Keynes, 1980, p. 176, 223).

There is a question as to whether non-member states would wish to trade with the ICU, since they would be subject to the same rules as members but without influence. The significance of this relationship can be noted from the latest trade balances between Eurozone (and, more widely, EU) member states and the rest of the world (see Table 1). However, withdrawing from trade relationships with ICU member states would be damaging to non-participants. Nations running a trade deficit with ICU members could not maintain an overdraft facility, and hence would have to settle their accounts into the Clearing Bank using any previous bancor credits or utilising other financial securities. For nations running a surplus, if they chose to retain credit balances unused, there would be little practical difference, albeit that these would have to be held in bancor, rather than their own currencies, except that excess reserves would be recycled and used within the clearing union, thereby maintaining potential purchasing power in those nations buying exported goods from surplus nations. If, however, the surplus nations chose to use these balances themselves, they would be restricted to occur within the ICU and not withdrawn from the clearing union (Keynes, 1980, p. 83, 112, 122).

TABLE 1 TO GO HERE

A second, related point concerns the position of surplus nations within the ICU. As a voluntary system, from which nations can decline to participate or withdraw subject to one year's notice (and leaving any credit balances within the clearing union), surplus nations will necessarily require benefits of some kind to outweigh the costs related to the restrictions upon behaviour that the ICU would impose (Riddle, 1943, p. 15). The most powerful argument relates to disquiet concerning the stability and long term sustainability of present international payments arrangements. Historical evidence would seem to suggest that disproportionate loading of adjustment costs upon deficit nations has been a fundamental flaw in previous fixed currency systems (Keynes, 1980, p. 27). Thus, surplus nations (i.e. Germany, Czech Republic) cannot continue to prosper, in the long term, by causing their trading partners (i.e. Greece, Italy, Spain, Portugal) to respond through deflation. Reduced demand, in deficit nations, reduces the exports of surplus nations unless they respond through their own internal deflation, thereby initiating a further beggar-thy-neighbour deflationary spiral. The ICU would provide a longer term sustainable solution to this dilemma for surplus nations (Keynes, 1980, p. 276).

Surplus nations may, furthermore, benefit through any promotion of deeper economic integration, especially in relation to the completion of the single market, arising from the introduction of the ICU programme (Keynes, 1980, p. 121). In addition, the ability of the ICU to prevent deflation and reductions in social wages across a large swathe of the Eurozone – undertaken in order to promote international competitiveness (due, in no small part, to persistent trade imbalances) – would promote the social solidarity across the EU which seems rather lacking at present.

A third issue is related to the first, in that nations are reluctant to surrender sovereignty in economic matters. Keynes (1942) dismissed this as necessitating no greater loss than might occur under a standard commercial treaty. However, his claim would appear to be a little disingenuous, as commercial contracts do not restrict what one party can do with the proceeds of the activity, in the way that the ICU would impose upon creditor nations. Indeed, he acknowledged that the post-war world would require a "greater surrender of sovereign rights" than had been accepted to that point (Keynes, 1980, p. 57). Instead, he argued that the discipline inherent within the ICU system would be advantageous, since it encouraged nation states to reject "indiscipline, disorder and bad neighbourliness" which had so often operated to the general disadvantage of all nations concerned (Keynes, 1980, p. 57-8). It, furthermore, implied the creation of a new instrument of economic leadership and economic governance, which could assist in the promotion of global economic development and macroeconomic management (de Vegh, 1943, p. 544, 547; Keynes, 1980, p. 58-60, 90-2, 131-3).

A fourth issue arising from the ICU proposal, and one that Keynes identified as perhaps the most difficult issue to resolve, relates to the demarcation of rules and discretion in the design of the system (Keynes, 1980, p. 73, 116-7). In his early drafts of the Plan, Keynes erred on the side of designing a rule-based system, capable of restraining economic indiscipline, whereas in later drafts, he softened this stance, due to peer feedback, in order to allow greater discretion for government policy to adapt to circumstances and take whatever measures were necessary at the time Keynes, 1980, p. 48, 78). He noted the theoretical preference for rules, but that discretion is probably necessary to make the system work more effectively in practice (Keynes, 1980, p. 97, 116). Indeed, he remained essentially undecided about the balance between rule and discretion, concluding that it might be finally determined after the scheme had been enacted for an initial experimental period of a few years (Keynes, 1980, p. 117).

In terms of the choice of a supranational body which has the strength and authority to be able to manage an international monetary system, Davidson has suggested two alternatives. In the first, a closed, double-entry bookkeeping clearing institution might be sufficient to keep track of net international payment positions between participating trading nations, and monitor compliance with the mutually agreed rules intended to solve problems of persistent trade and payments imbalances (Davidson, 2009, p. 136-142). His second suggestion would be to utilise the format of a central bank, similar to the current European Central Bank (ECB), in order to take advantage of the acceptance and credibility associated with an existing format, albeit that it would have to embrace rather different objectives (Davidson, 1992, p. 8). At the minimum, this would require the ECB to enshrine payments balance as a core part of its mandate, but, additionally, to seek to operate the ICU to secure and maintain full employment within the Euro-ICU zone (Davidson, 1992; Arestis, 1999, p. 9). This would necessitate a radical reform in ECB structure, strategic objectives and its willingness to use a broader use of differential policy tools, before it would be an acceptable conduit.

A final issue concerns potential inflationary effects arising from the operation of the ICU. For example, Meltzer (1983, p. 19) claims that Keynes was aware of the possible inflationary bias of his scheme, due to an excess supply of money, but that this flaw was not addressed. He suggests that this may have been because the scheme was unlikely to be accepted by the American negotiators at the Bretton Woods summit. The argument is advanced that the ICU provides surplus nations with an incentive to expand their economy, rather than allow build-up of surpluses triggering an exchange rate appreciation. If the economy was already operating at full employment, this would be inflationary. Similarly, persistent deficit nations would be expected to devalue, which would improve the competitiveness of their exports but

also provide an expansionary effect. In combination, these two measures would provide a stimulus to economic activity across the ICU. If economies were already operating at full employment levels, then this would be inflationary.

This critique ignores the basic starting point which led to the development of the Keynes Plan in the first place, namely that the operation of the current international payments system – through asymmetric treatment of deficit and surplus nations, alongside the amassing of idle reserves – has a profound *deflationary* effect upon the global economy (Keynes, 1980, p. 46-8, 60, 74-7, 112-3). The ICU was *supposed* to reverse this effect, thereby providing better global balance. Moreover, it would do so with no burden placed upon surplus nations (Keynes, 1980, p. 112, 115). If this analysis is correct, then it is likely that the global economy would 'run hotter', with less wasted resources, and the varied evidence arising from Phillips Curve, NAIRU and other policy trade-off analysis, would indicate that inflationary pressures may arise at slightly less than full employment equilibrium. Nevertheless, even if this analysis is correct, this is more of a problem for the correct use of macroeconomic policy tools, rather than a justification to reject the ICU system.

Relevance to the EU in 2013

Having outlined the fundamental elements of the Keynes Plan, the relevance to the difficulties faced by the Eurozone, in 2013, should be obvious to the reader. The current asymmetry of economic development, within the Eurozone, and the resulting internal imbalances, threaten to undermine the solidarity that underpins the European project (Bibow, 2007, p. 31). The experience of previous fixed exchange rate regimes would suggest that

loading the burden of adjustment upon weaker (deficit) nations, such as Greece or Portugal as at present, exacerbates tensions and facilitates political or popular opposition. Moreover, reliance upon export-led growth, to compensate for inadequate domestic levels of aggregate demand, relies upon external economies continuing to accept symmetrical trade deficits. Neither of these factors is likely to persist in the long term, and the Eurozone is not currently constructed to contribute towards the unwinding of imbalances, and thereby reducing the threat to its sustainability (Bibow, 2007, p. 34).

Were an ICU reform to be introduced, the asymmetric nature of the current Eurozone rescue plans, which dampen demand in already struggling member states and provide only temporary relief, could be exchanged for a system which would automatically ensure a *symmetric* rebalancing of the Eurozone. There would be fewer macro-precautionary reasons for holding idle reserves, with consequent loss of potential purchasing power within the Eurozone, as an ICU would facilitate a more expansive European economy, with fewer inherent trade-related tensions and lower perceptions of risks associated with deflationary policies necessitated by trade imbalances. Creditor nations would be encouraged to either increase the economic activity in their own economies, and thereby suck in more imports and thereby reduce excess surplus balances or, if already at or near full employment, to spend these reserves in debtor nations, through direct investment (FDI) or the provision of foreign aid. Otherwise, the ICU would ensure that excess credit balances would be utilised, perhaps through a European Investment Foundation, as suggested by Arestis (1999, p. 9-10). Whatever the method chosen, the result should be the union experiencing a higher level of aggregate demand, as resources are not withdrawn as the result of a build-up of reserves or deflation imposed upon deficit nations, and thereby growth should rise and unemployment fall across participating member states.

One advantage that the EU has, over supporters of the original Keynes Plan in the 1940s, is that part of the infrastructure necessary for the operation of the scheme is already in place. The ECB already exists as an accepted supranational economic authority, and as such, this could form the basis for the clearing agency proposed by Keynes to manage the clearing union.

The adoption of an ICU would, however, not be without significant difficulties. The first of these relates to the current state of the international finance system. Compared to the more managed economies characterising the period in which Keynes developed his ideas, contemporary central banks are far less in control of the creation of credit and the establishment of interest rates (Arestis, 1999, p. 9). Liberalisation and the subsequent internationalisation of financial markets have combined to weaken the control of central banks. Nevertheless, the necessity to regulate financial capital has been amply demonstrated by the recent global financial crisis. Writing in advance of this event, Cartapanis and Herland (2002, p. 273-4) were already observing that 'rarely in the course of history has the international markets experienced such violent adjustments' as had been experienced in the previous decade. Indeed, the IMF has documented 124 systemic banking crises since the demise of Bretton Woods (Laeven and Valencia, 2008, p. 5). One significant factor underpinning this increase in financial volatility has been the liberalisation of capital movements (Cartapanis and Herland, 2002, p. 274). Consequently, re-regulation of international financial capital movements would appear overdue. This, however, is problematic due to the hegemonic dominance of neo-classical orthodoxy, which does not seem to have been as fatally wounded by the crisis as might have been anticipated.

Capital restrictions would additionally, at least superficially, appear to conflict with the 'four freedoms' enshrined in the Treaty of Rome; one of which being the freedom of movement of capital. The clearing union would have, at its heart, restrictions upon the convertibility of currencies into bancor and the regulation of the supranational clearing agency authority of all capital movements not related directly to trade or long term productive investment. This would necessarily constrain the freedom of movement of capital. However, the EU has never been absolutist in its adherence to these principles, when they conflict with other objectives. For example, current discussions regarding the advisability of introducing a form of Tobin tax (1978), to prevent short term speculative financial transactions from undermining economic stability, would imply that the principle of freedom of movement of capital is not sacrosanct. Moreover, the ICU proposal would encourage the expansion of international trade in goods and services, alongside long term productive investment, so it would only be short term capital movements which would be severely curtailed. This would not hamper the completion of the European single internal market and, indeed, may facilitate its progress.

Fundamental change of theoretical underpinning for the ECB would, moreover, be required in addition to a radical revision of its objectives. Thus, the narrow focus upon low inflation would need to be superseded by the task of managing the clearing union and, as a consequence, to prioritise the facilitation of full employment across the union. This is incompatible with a theoretical adherence to economic orthodoxy, with a neo-liberal flavour, and hence the ECB and its officers would need to accept the tenants of Keynesian theory. This will prove problematic, given the dominance of orthodox economic perspectives in the finance sector and, albeit to a lesser extent, to academia; the two areas from which potential ECB officials might be drawn. Nevertheless, given the importance of the new institution for

the success of the new policy orientation, sufficient candidates could be found amongst the minority heterodox economist communities.

There is, however, one final and potentially even more difficult problem for the EU, in adopting an ICU proposal, and that arises from the pre-existing single currency, on to which a clearing union would need to be grafted. Whilst the symmetrical rebalancing facilitated via the ICU should reduce problems arising from large and persistent surpluses and deficits (Keynes, 1980, p. 77), it was envisaged that any remaining fundamental trade imbalances through changes in exchange rates. However, this is not available for a clearing union formed between nations sharing a single currency. Advocates of the ICU therefore have two alternatives – to amend the original Keynes Plan to incorporate the single currency, and create what might be termed an 'ICU-light' version of the scheme, or to advocate a comprehensive implementation of the scheme, based more closely to the original design.

In terms of an 'ICU-light' variant, the Euro could either become the international banking currency or else a separate currency, perhaps named the Eurobancor, could be established. In either case, this could operate much as in the Keynes Plan, with each nation having a clearing account to settle net balances between Eurozone participants, with one-way convertibility of their domestic currencies (in this case, the Euro for each nation) and the clearing account. For those creditor economies, limitations would be placed upon the size of the credit balances in the clearing account, and similarly for deficit nations, and once these were reached, corrective action would be required.

Greater emphasis would be placed upon the automatic stabilisation arising from the operation of the ICU, as surplus nations would be encouraged to reflate their own economies to the

point of full employment and/or use remaining resources for productive investment in deficit nations. It should be noted, however, that FDI may displace as well as supplement existing productive activity in the host nation (Moran et al, 2005). Consequently, in the absence of internal devaluation, whose likely requirement for deficit nations to lower social wages in order to restore competitiveness would be contrary to the essence of the Keynes Plan, this may require repeated FDI transfers from surplus to deficit nations, which may test the solidarity necessary for the success of the scheme. Thus, in the absence of exchange rate modification, the 'ICU-light' approach may require the development of supplementary policy instruments to strengthen the scheme where automatic stabilisation is insufficiently strong.

To take one example, if Germany has a large surplus, and Greece a deficit, with other members of the clearing union, it is not possible to attempt to rectify differentials in international competitiveness through the means of appreciating the German currency relative to Greece, since they both share the Euro. The operation of the ICU would require Germany to use its surplus either to increase domestic activity towards full employment or to use this in the form of overseas investment (or aid) in Greece. This may not be straightforward, however, as German memory of the hyperinflationary episode, in the 1930s, would cause resistance to the former recommendation. Nevertheless, even without occasional exchange rate revaluation, the 'ICU-light' option could still make a useful contribution to the present Eurozone crisis.

It would still require much tighter financial regulation, with central bank control over financial flows limiting the destabilising effect arising from short term speculative flows. Moreover, since surpluses would be built up within the clearing union payments system, and could not be withdrawn from the system, these funds would be made available to finance

productive investment in deficit nations. Additional incentives could be introduced to encourage creditor nations to expand their domestic demand rather than continue to build up surpluses. This could include the requirement to transfer excess account balances into a special holding account in the supranational clearing union institution, which could either pay no interest (hence imposing a real terms cost) or else consider the imposition of a negative interest rate, payable by the creditor nation, upon these excess balances. If this achieved its aim, and surplus nations inflated their economies, this would achieve a form of internal devaluation capable of gradually shifting relative competitive positions, although this would be slower and potentially more disruptive than the exchange rate alternative not available to members of a single currency. The 'ICU-light' version of the Keynes Plan would, therefore, achieve many of the stated goals.

The full variant would, however, be a superior solution, yet, for this to be achieved, there would need to be some form of reintroduction of national currencies in order for the rebalancing to work more effectively. In this scenario, each member of the Eurozone would possess their individual currency, and use the Euro as their international bank currency intended to resolve balance of payments. As credit or debit balances grew, the option of encouraged or enforced currency revaluation and devaluation would be possible, thereby securing a quicker and more effective symmetric rebalancing of the clearing union than could be accomplished through the alternative plethora of incentives, outlined in the previous paragraph. The 'ICU-full' version, therefore, would incorporate all of the main aspects of the original Keynes Plan, namely symmetric rebalancing, a closed system of payments combined with capital controls, and the combination of the bank currency with the retention of national currencies, thereby enabling exchange rate revision to reflect changes in competitiveness.

This would require the EU Commission and Eurozone participants to acknowledge that the present form of EMU is fatally flawed – and neither politicians nor economists appear to welcome having to admit previous mistakes. A new economic framework would be required, placing payments balance at the heart of the new union, and with supranational economic institutions given the mandate to manage the 'ICU-full' scheme. However, once this step has been taken, the future for this alternative vision of a currency union has greater potential for long term sustainability. It would be possible, for example, for shifts in international competitiveness to be swiftly dealt with, in the absence of painful adjustment that stretched internal solidarity. It would also encourage the Eurozone economy to operate closer to full employment, with faster rates of economic growth, which would mark a significant improvement over achievements since the advent of the Euro. Moreover, the creation of a more flexible system, in which the objectives of employment and economic prosperity dominate over financial considerations, might encourage more nations to participate in the system. The UK, for example, would find it easier to consider membership of a clearing union of this type, rather than the current version of EMU.

This is not to suggest that the ICU would prove to be a panacea for all economic problems facing the European economy. However it has the potential to provide a superior alternative to the present solutions (Arestis, 1999, p. 1). Perhaps it might be time for EU economists and policy-makers to dust off their copies of the Keynes Plan and familiarise themselves with the contents – it might prove instructive.

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Table 1 – Trade Balance for Eurozone members, January 2014 (€10million)

	Austria	Belgium	Cyprus	Estonia	EU	Finland	France	Germany	Greece	Ireland	Italy	Latvia	Luxem	Malta	Netherlands	Portugal	Slovak Republic	Slovenia	Spain
Austria	0	165.939	-4.85048	-9.78085	2026.3	-32.0466	-258.248	2281.79	-31.3706	22.3367	-40.82	-16.39975	9.7553	-1.92428	561.799	-2.8667	-72.211	-80.281	17.149
Belgium	-135.823	0	-16.62144	-5.1381	-2068.7	-20.576	-3302.21	-1708.39	-129.1432	1602.865	-541.66	-12.3143	-566.896	-7.69678	3865	2.094	21.7785	-25.6306	-168.485
Cyprus	8.95441	12.5936	0	0.20869	467.352	2.08782	48.05643	58.6327	110.069	3.89277	58.1008	4.25412	2.38517	-1.0151	51.7014	2.86268	0.95798	1.6654	32.48198
Estonia	9.88213	18.116	0.03979	0	534.409	7.474	19.2345	137.8026	0.43095	1.52416	39.2025	36.519	0.73692	-0.3516	51.076	1.23861	1.65059	3.41982	4.7939
Euro area	*-2486.26*	*428.7*	*-367.6521*	*-192.419*	*0*	*-676.83*	*-11455.4*	*669*	*-1233.58*	*3127.3*	*-561.9*	*-271.284*	*-768.14*	*-293.91*	*20127.2*	*-1198.76*	*534.22*	*-91.9*	*-271.6*
EU	*-1996.4*	*1549.3*	*-423.7425*	*-328.29*	*8575*	*-908.68*	*-11812*	*6381.7*	*-1350.57*	*2792.23*	*1157.5*	*-458.005*	*-648.7*	*-348.625*	*22981.8*	*-1121.8*	*1079.13*	*103.79*	*183.2*
Finland	0.346	30.088	-1.73044	-13.392	716.56	0	-8.365	282.99	1.7779	31.0524	17.759	-40.1078	5.48736	0.67511	192.878	10.9476	2.4332	0.0043	-31.5385
France	275.065	2331.21	-42.05879	-10.0748	14249	-2.104	0	4666.18	-186.6	330.899	1496.02	-22.8945	9.837	-9.3996	3300.09	210.591	174.305	31.385	1025.31
Germany	-2349.48	1594.03	-47.3561	-108.9301	-2261.1	-383.287	-3599.39	0	-364.974	460.835	-813.93	-95.768	-251.506	4.3585	8932.66	-103.132	299.27	120.985	-797.16
Greece	32.6252	121.0184	-119.4382	0.05983	1393.15	-7.1319	216.6619	381.544	0	30.06784	272.711	-0.36176	14.66114	-11.24946	232.8382	12.8407	12.58704	-8.66352	80.8392
Ireland	-12.3112	-1714.806	-1.74924	-2.53342	-3190.19	-50.1801	-406.874	-331.998	-32.37364	0	-241.967	-2.21889	-3.85427	-1.58503	-234.182	-52.5377	-6.0721	-3.5434	-342.2183
Italy	-35.17	603.48	-55.49157	-16.0375	550.7	-30.419	-834.52	969.09	-243.568	248.0668	0	-63.8244	56.1312	-232.2562	1869.55	-165.007	73.731	-142.788	-8.38
Latvia	15.71572	17.0735	-0.06506	-11.491	415.829	26.3536	6.5695	85.9431	0.1384	3.43248	42.2915	0	0.72525	-0.18034	-20.7489	0.18238	14.47304	3.80033	15.73761
Luxembourg	-23.6456	467.524	-0.78238	-1.08605	543.15	-4.15823	-35.017	286.016	-14.53968	1.63029	-66.1348	-1.14513	0	0.01368	127.4223	-2.78734	-1.66217	-6.4777	-33.2533
Malta	2.87267	3.5138	-0.34956	0.85505	321.073	0.06627	19.8338	-2.6392	7.9239	1.86614	193.3358	0.7496	0.39093	0	21.5816	-0.95457	1.38561	0.56716	20.9475
Netherlands	-440.87	-3477.34	-46.94938	-26.9269	-18835.5	-155.369	-2487.55	-7128.3	-237.7991	79.258	-1448.85	-23.2651	-65.8655	-12.7493	0	-108.067	-4.267	-26.2014	-889.27
Portugal	8.9548	1.481	-1.88512	-0.19418	1188.79	-17.3029	-149.43	159.037	-13.8129	33.9051	182.136	-1.31817	-1.24292	0.32301	172.799	0	5.5222	0.7972	836.04
Slovak Republic	70.074	9.895	-1.34337	-0.66438	-287.26	-4.6453	-108.857	-283.92	-6.55046	2.80475	-41.621	-9.66268	0.31124	-0.11063	27.165	-4.7562	0	62.4216	-43.5122
Slovenia	61.88	37.429	-0.52358	-3.19751	109.77	1.0297	-34.381	-106.18	7.7075	2.20772	200.491	-3.74311	2.85447	-0.287	48.318	0.42025	-27.8788	0	24.6618
Spain	40.375	224.518	-26.56171	4.4132	699.5	19.7337	-534.26	1007.39	-100.7584	274.0875	173.42	-19.78338	18.6815	-20.65497	906.508	-999.64	52.6803	-19.554	0
World	*-1467.5*	*-451.8*	*-564.939*	*-130.55*	*-15108*	*-393.9*	*-10353.9*	*17168*	*-2775.64*	*5012.6*	*3662.7*	*-331.69*	*-852.43*	*-340.317*	*5347.5*	*-1409.79*	*63.73*	*6.92*	*-4402.9*

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