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Building new economic-monetary institutions in the EMU as a response to the financial crisis: A Keynesian perspective

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On March 18, 2013, the German Friedrich-Ebert-Foundation organised a conference in Berlin on 'How to tame the monster' (of financial markets). At this conference, Klaus Regling, managing director of the European Stability Mechanism (ESM) mocked economic textbooks, in particular 'American' textbooks where, he said, 'you never shall find any hint that wages might fall'. His mockery reveals one of the great errors of classical economic theory, that is the notion according to which an economy in crisis will find back to equilibrium if only wages fall enough. The fallacy lies in concluding from the movement of a single wage to the movement of the wage level. If all wages fall, the wage level decreases and so does the price level. This well-known process of deflation increases the real burden of debts. It is an illusion to believe a government might reduce its debt burden by organising a deflationary process. This does not only hold in the 'special case' of Greece, which has been conceded by Klaus Regling, but it is a general principle.

To understand this principle we have to clarify the so-called 'stock-flow-problem' in monetary economics, that is the relation of monetary flows (income flows) and monetary stocks (assets and liabilities) in an economy. For that purpose we have to take a Keynesian perspective.

This paper draws on an early, tentative analysis of John Maynard Keynes, his famous 'Economic Consequences of the Peace' of 1920[1]. Nearly a century on, Keynes' book still provides useful insights into economic problems and policy options of today since it is focussed on two distinct deficiencies of the time, excessive external government debt and external (macro-economic) imbalances. Keynes' proposals are taken as a benchmark to assess new economic-monetary institutions established by the European Council in response to the financial crisis. The European Stability Mechanism (ESM) which was concluded in autumn 2012 is a permanent facility to take on joint liability for the debts of member states. In addition, the European Council concluded the introduction of a European banking supervision in December 2012. On first sight, this institution may be interpreted as an alternative way to overcome the rise of joint liability for national public debts.

The paper is organised as follows: To begin with, Keynes' diagnosis and the remedies he proposes are briefly described: first, to settle inter-Ally indebtedness; second, to issue an international loan to cover current-account deficits. Then, monetary relations are highlighted in a Keynesian perspective: the specific uncertainty enshrined in monetary relations and the role of expectations. Turning to the rescue measures taken by the European Council (and implemented by the 'Troika'), these are assessed as short-run solutions in a Keynesian perspective. Finally, the long-term problem is addressed which requires a clearing of bank balance sheets and the conditions of establishing a banking union are discussed.

1. Keynes' tentative judgments

After World War I, the Treaty of Versailles had left unsettled the economic imbalances in Europe. Keynes complained in his book particularly the economic irrationality of claims that were laid down in the Treaty to fulfill French demands vis-à-vis Germany and which concerned the issues of reparation, iron and coal, and tariffs (p244ff). In addition, he pointed at two more subtle problems which, as long as they remained unresolved, would inhibit the post-war economic development in Europe. These were monetary issues which concerned the relationships between the Allies themselves. First, Keynes suggested that the inter-Ally indebtedness should be settled. He calculated a sum of (brut) nearly 4 billion BP of debt that had been incurred for the purposes of the war between the governments of the Allied and

[1] A former version of this paper was presented at the 16th SCEME Seminar in Economic Methodology, Tilton House, Sussex, UK, 12 – 13 September, 2012

associated countries. The main lender was the United States, demanding a sum of (net) 1.9 billion BP. Appealing to the generosity of the United States, Keynes proposed "the entire cancellation of Inter-Ally indebtedness" (p253). He rejected controversies as to relative sacrifice, naming them "very barren and very foolish also" (p257). Instead, he suggested to assess his proposal (of debt cancellation) in terms of "the future relations between the parties to the late war" (p259). His reasoning is composed of basic arguments which we find later to become central axioms in Keynes' monetary theory. First, he points at the uncertainty of monetary relations, and particularly so of debt relations between governments. He explicitly rejects a banker's view on government credit relations:

> Bankers are used to this system, and believe it to be a necessary part of the permanent order of society. They are disposed to believe, therefore, by analogy with it, that a comparable system between Governments, on a far vaster and definitely oppressive scale, represented by no real assets, and less closely associated with the property system, is natural and reasonable and in conformity with human nature.
>
> I doubt this view of the world. Even capitalism at home, which engages many local sympathies, which plays a real part in the daily process of production, and upon the security of which the present organization of society largely depends, is not very safe. But however this may be, will the discontented peoples of Europe be willing for a generation to come so to order their lives that an appreciable part of their daily produce may be available to meet a foreign payment, the reason of which…does not spring compellingly from their sense of justice or duty? (p263f)

Thus, referring to a lack of legitimacy, Keynes doubts whether the tributes in question will be paid for more than a very few years.

A second, related argument which Keynes will also elaborate later on as a central axiom of his monetary theory concerns the question of how to evaluate monetary assets and liabilities. In his book, he directs the reader's interest to this question by asking him for "his view as to the future place in the world's progress of the vast paper entanglements which are our legacy from war finance both at home and abroad." (p262) He first provides a tentative, emotional answer that reads like a doomsday forecast:

> The war has ended with every one owing every one else immense sums of money…The whole position is in the highest degree artificial, misleading, and vexatious. We shall never be able to move again, unless we can free our limbs from these paper shackles. A general bonfire is so great a necessity that unless we can make of it an orderly and good-tempered affair in which no serious injustice is done to any one, it will, when it comes at last, grow into a conflagration that may destroy much else as well. (p262f)

Nonetheless, only a few lines later Keynes formulates the conditions on which an international system of government indebtedness may survive and actually had survived during the nineteenth century. These conditions form the basic criteria for the evaluation of solvency of a sovereign debtor. In Keynes' own words:

> (But) the system is fragile; and it has only survived because its burden on the paying countries has not so far been oppressive, because this burden is represented by real assets and is bound up with the property system generally, and because the sums already lent are not unduly large in relation to those which it is still hoped to borrow. (p263)

It is the third condition which is of principal importance in Keynes' monetary theory. Generally, this condition points at the fact that the money value of assets and liabilities depends on expectations of future payments. These are, albeit in various degrees, expectations on uncertain payments. In the special case of government indebtedness, the borrower's expectation on payments he will receive in the future determines his propensity to serve the debt. In the case of a government's internal debt, this raises the question of redistribution. Keynes actually proposes a capital levy (p263). But in the case of external debt, a peculiar problem arises. Since governments are sovereign debtors, no external power can enforce the lender's claims. So, the money value of an 'excessive' external debt is highly uncertain. In a democratic society, it depends on the willingness of the people, as Keynes pointed out, if the government may actually serve this debt.

Monetary theory has formalized the 'solvency condition' of a sovereign debtor. Referring to the debt crisis of emerging economies during the 1980s, Niehans assumed that the economic rationale for a government owing debt to external lenders is to service its debt so long as the net value of payments is positive (Niehans, 1986). That is to say, the net amount of borrowing which may be expected in the future should exceed the amount of interest payments on the existing debt. Writing δ for the growth rate of debt, $\Delta D / D$, the condition in any given period t is

$$c(t) = (\delta - i) D(t) > 0;$$

for c(t): cash flow expected in period t.

We may call this the sufficient condition of a sovereign debtor's solvency.

If, in a long-term perspective, the present value of expected cash flows was negative, how could the solvency of the debtor, that is to say the debtor's propensity to serve the debt be re-established? It is evident from the equation that the only way out is to devalue the stock of the debt, D. A reduced money value of D diminishes the amount of interest payments and so, with given expected flows of new lending which depend on the real economy, the present value of expected cash flows switches into a positive value, that is an asset. So, Keynes' tentative judgment on debt cancellation is based on a fundamental economic rationale, given the uncertainty of money values.

Keynes made a second financial proposal, in order to stimulate the economic activity of "all the belligerent countries of continental Europe, allied and ex-enemy alike" (p268). Based on his diagnosis of immediate liquidity requirements which resulted from external imbalances and non-contractible currencies after World War I Keynes suggested to issue an international loan providing foreign purchasing credits of BP 200million and, in addition, a guarantee fund of an equal amount. This proposal, again, was addressed to the United States (and, as far as the guarantee fund was concerned, to the League of Nations). Although Keynes expressed his utmost pessimism whether the US were inclined "to entangle herself further in the affairs of Europe" and prepared "to postpone her own capital developments and raise her own cost of living in order that Europe might continue for another year or two the practices, the policy, and the men of the past nine months", he plainly expressed his hope that America would "contribute to the process of building up the good forces of Europe" (p266f). Keynes did not elaborate in detail a scheme for the loan but he emphasized that the loan had to be given priority over all other government indebtedness and that "the borrowing countries should be required to place their customs duties on a gold basis and to pledge such receipts to its service." (p269) In addition, the lending countries should be entitled to supervise expenditure out of the loan. Later on in history, we shall find such conditionality as practice of the IMF.

2. The stock-flow problem in monetary economics

Regarding the methodological aspects, Keynes based his conclusions on the assumption that the value of money contracts (stocks) depends on the expectations of future payments (income flows). If it turns out that these expectations have changed – or if they were false from the beginning – this requires a re-valuation of money stocks. Otherwise, false trading in the capital market would result which may lead to severe distortions in the overall economy. Let me give two examples to demonstrate the conclusion of this analysis. The first example is the story of a young couple of investment bankers in the City of London who had just bought a fashionable apartment in the City when the financial crisis broke out. Both of them were sacked, losing their joint income and, in particular, bonus claims and being confronted with a credit contract of several million pounds that had to be served. Since the value of the pledge had deteriorated substantially as a consequence of the crisis, their financial situation had become unbearable. Should the bank keep this credit at par value in its books and, accordingly, demand that the couple would service and redeem the difference between the nominal value of the credit and the (reduced) value of the pledge? If the bank does not re-negotiate with the couple on their credit on realistic assumptions concerning their future payments and, accordingly, write off the credit, its balance sheet will disclose false numbers on the bank's future income (the value of its assets). In the course of a financial crisis, when such cases become ubiquitous, the bank will loose credibility and reputation.

The second example is the case of Greece. When Greece entered the EMU in 2002, its debt ratio was relatively high, indicating an inflation-ridden past. Unlike Italy, which also had gained access to the monetary union with relatively high debt levels, Greece did not manage to reduce its debt burden during EMU-membership. When the financial crisis swapped into the EMU, the Greek government disclosed a budget deficit of more than 12 percent of GDP and a corresponding debt ratio of above 110 percent (figures for 2009). According to the criteria of the Stability and Growth Pact, these figures were clearly excessive. Although the actual size of the deficit was the result of the crisis and the then prime minister Papandreou promised to reduce the budget deficit substantially in 2010, thereby giving up any flexibility to combat the consequences of the crisis in his country, the perception of excessive deficits had changed expectations in financial markets. In early 2010, Greece, like Portugal and Ireland, experienced a dramatic rise in the spreads of government bonds. The market for Greek government bonds dried up totally. So, the Greek government's solvency was put into question and the European partners, in particular the partners in the euro zone had to assist Greece that could not regain a sustainable budget on its own. Since then, several rescue packages were tailored in order to avoid a Greek insolvency which was expected to induce uncontrollable contagion effects all over the euro zone. Meanwhile, the Greek debt ratio has risen to more than 150 percent of GDP and the economic crisis in Greece has deepened, triggering off a government crisis. The Papandreou government was replaced in 2011 by a temporary 'technical' government led by Lucas Papademos. After two elections in spring 2012 a new coalition government was formed that tries to renegotiate on the rescue programmes and conditionality.

In order to assess these programmes we should clarify the concept of solvency. Let me refer to the criteria to evaluate the sustainability of a budget. We know from the literature that to gain evidence on the sustainability of a budget we have to look on the relation of monetary stocks (in this case the size of government debt) and monetary flows (i.e. net income flows). The budget balance,

$$(1) \qquad BB = G - T + iD = \Delta D;$$

is composed of the primary deficit - that is government expenditure, G, minus tax revenue, T - and interest payments on the existing debt D, iD. How to finance this budget? Excluding monetisation of the debt as well as the option of privatising public assets, a deficit has to be financed on the capital market by issuing bonds. So, each year's deficit increases the existing stock of the public debt. To receive a sustainable budget, the growth of debt must be restricted. Since each additional euro of debt creates interest payments, the critical question is if future budgets can bear the increase of interest payments. In particular, if additional interest payments would be financed by issuing new bonds, the growth of debt gained momentum. We may consider the components of the growth of debt as being the criteria to evaluate the sustainability of a budget.

$$(2) \qquad \Delta D / D = (G - T + iD) / D = (G - T) / D + i = \alpha (Y / D) + i;$$
$$\text{for } \alpha = (G - T) / Y;$$

The growth rate of debt has as components the primary deficit ratio α, that is the relation of the primary deficit to GDP or income, Y; the debt ratio, D / Y; and the rate of interest, i. Where are the limits to the growth of public debt? In order to define these limits, let us now compare the growth of debt to the growth of income. The reason is that in a growing economy public debt may grow without increasing the debt 'burden' (Domar, 1944). With growing income the government may dispose of additional tax receipts to finance the additional interest payments due for an increasing debt. So, in a dynamic setting it is the debt ratio which seems to be an adequate indicator of sustainability. Control of the debt ratio requires that the growth rate of debt does not surmount the growth rate of income. Taking r as the growth rate of income, this condition is:

$$(3) \qquad \alpha (Y / D) + i < r;$$

or

(3a) $\alpha < (r - i) (D / Y)$;

So, in a macroeconomic equilibrium, if the rate of interest equals the rate of income growth, the primary budget has to be balanced. If, on the other hand, the rate of interest is higher than the rate of income growth, a compensating primary surplus is necessary to avoid an increase in the debt ratio. The amount of the required surplus depends on the size of the debt. A debt ratio above 100 percent, the case of Greece, works as a multiplier.

Although the relation between the primary budget balance and the debt burden indicates the limits of public debt in the long run, it may be taken as a solvency condition for the government (so Paul De Grauwe in a recent paper: De Grauwe, 2011). The reason is that the interest rate is a measure of the confidence of investors, reflecting their long-term expectations. To cope with deteriorating expectations, a primary budget surplus is required. We may call this condition a necessary condition of solvency. The government must be in a position to convince investors that the required primary budget surplus to service the debt is feasible. But here lies a dilemma, as the Greek example demonstrates. In principle, there are three options to resolve this dilemma. First, long-term sustainability requires a reduction of the primary budget deficit. So, the government has to reform its tax system, particularly by increasing the fiscal drag on higher incomes and, on the other hand, cut public expenditure. But even if it is successful in undertaking these measures the results will not immediately show up in the budget criteria. Rather, the immediate income effects of its measures will reduce tax revenues and so increase the primary deficit. In addition, if the budget deficit cannot be brought down financial markets may further increase the risk premium on government bonds and thus aggravate the task of consolidation. The problem is that financial markets' expectations (as well as the regulations of the Stability and Growth Pact) are fixed on criteria that are not under control of the government in the short run. Under these conditions, as the Greek experience has demonstrated, if the budget is perceived of being unsustainable, an austerity programme of the government cannot turn investors' expectations. The second option is to reduce the interest burden by providing official credits at low interest rates and so to provide some temporary relief for the government. This strategy may complement an austerity programme but it is only successful if the government is capable of achieving the required primary surplus in time, that is to say before the official credits expire. Otherwise, the problem of insolvency is passed into the future. The third option is to cut the debt and so immediately reduce the debt burden leaving the country on its own to provide sustainable budgets in the future.

In the case of Greece, all three options have been applied. So far, however, their combination was unfortunate, giving more weight to flow-solutions rather than stock-solutions. Eventually, the severe social cost of flow-solutions and the resulting threat to the stability of the political system have become evident. The lesson is that the treatment of the solvency problems of the Greek government shifted the issue more and more into inter-government indebtedness. At present, the situation is very similar to one for which Keynes had proposed debt cancellation. The demand for Eurobonds which became prevalent in the political debate may be regarded as an attempt to circumvent the necessary steps. So, what reason have politicians for their reluctance?

3. Short-run solutions: Variations of an international loan

Keynes had proposed an international loan as a short-run solution to provide liquidity in international trade and so to stimulate the real economy. Within the euro-zone, trade is not restricted by the lack of a convertible currency. Trade deficits are balanced by euro liabilities. This, nonetheless, discloses an aspect of the current crisis since the European banks have substantially reduced their mutual liabilities by replacing their credits vis-á-vis other banks by central bank money. So, the accumulated trade deficits within the euro-zone are now accounted as balances within the Eurosystem (“target balances”). It has been argued that these target balances are kind of an international loan since the central banks of surplus-countries like Germany are crediting the central banks of deficit countries like Portugal (so, in Germany, particularly Hans-Werner Sinn; see EEAG, 2012). However, as soon as the European banks will have re-established their mutual trust these accumulated target balances will be reduced again. This process of ‘normalisation’ has started in 2012.

Rather, the European Council established several forms of an international loan since 2010 in order to avoid or postpone the insolvency of governments with excessive debt burdens. The basic reason for this strategy was to preserve the functioning of the financial sector, disguised as a strategy of securing the euro. After bilateral credits to Greece in 2010, the crediting strategy was soon institutionalised as a temporary European Financial Stability Facility (EFSF) which – together with the IMF - provided funds to Portugal and Ireland, only to be replaced by a permanent fund, the European Stability Mechanism (ESM) which was enacted on September 27, 2012. The volume of the ESM was enlarged and the conditions on which it provides credits were released in important aspects before its enactment.

Without going into the details, there are important differences to the Keynes proposal. Keynes demanded priority for the international loan and he demanded a pledge on the borrower's revenues. By contrast, priority for ESM credits was discussed but generally rejected[2]. And the European rescue programmes are provided without pledges – the only exception being Finland which demands securities by the borrowing government for its contributions to the fund. Instead, the contemporary credit strategies of the European Council rely on fiscal discipline. That is to say, credit programmes are enacted on the condition that the borrowing countries conduct fiscal consolidation programmes which require deep cuts into public budgets also in the short run and put fiscal sovereignty into question. The obsession with fiscal discipline may be explained by the Treaty which does not allow bail-out strategies among member countries. But it has become evident in the receiving countries, particularly so in Greece and Portugal, that the resulting austerity policies had damaging deflationary effects on the economy and, accordingly, detrimental effects on the consolidation of public budgets.

It is also evident that the credit potential of the ESM was exhausted if big debtor countries like Spain or Italy would demand programme credits. So, new institutions providing bail-out solutions have been called for, particularly Eurobonds. This instrument has been discussed for long in better times as being a measure to improve liquidity in the European capital market. Meanwhile, with excessive public debt in the euro zone, it counts as a remedy to pool liabilities. By issuing bonds backed by joint liability, all euro zone governments would enjoy low interest rates to finance their budget deficits. Again, no pledges would be provided for governments taking risks for other countries (an exemption being the debt-redemption fund proposed by the German Council of Economic Experts; see its Annual Report, 2012). However, instead of introducing Eurobonds the European Council trusts that more fiscal discipline would work as a counter-balance. The German government in particular vetoes Eurobonds until more control on fiscal discipline has been enshrined into the Treaty.

The upshot is that international loans which have been provided as 'rescue programmes' so far were not credible. This situation changed when Mario Draghi, President of the ECB, announced in September 2012 that the ECB was prepared to buy short-term government bonds of programme countries in unlimited amounts if necessary to stabilise the euro. This programme of 'Outright Monetary Transactions' (OMT), being part of the ECB's unconventional monetary policy, was perceived as an advice to reduce the risk of government

[2] The ESM statutes do not require Preferred Creditor Status except for loans to support macroeconomic adjustment programmes, article 16.

insolvency for euro zone members. Its implementation will bring governments back to a situation as if they had their own currency. Although expectations in financial markets were stabilised, there is now no clear distinction between monetary policy and fiscal policy. Rather, responsibilities are blurred. The only caveat is that the OMT programme concerns short-term operations and thus is restricted to improve the liquidity of public budgets.

4. Long-run solutions: Clearing bank balance sheets

Whereas the political debate has been concentrated on forms of an international loan to be provided for governments with excessive debt burdens, the real (long-term) problems lie within the financial sector. Monetary stocks of banks and their investors have not yet been adjusted to the changed financial risks. Indeed, taking decisions in the European Council to mitigate the effects of excessive government debt during the crisis, politicians were strongly motivated to avoid government insolvencies in order to rescue European banks. So, the main task of clearing bank balance sheets to overcome the crisis (Mervyn King in a speech delivered on June 16, 2012) is not yet resolved. Evidently, the re-valuation of money stocks, if it is to be conducted in an orderly manner, is not feasible but in the long run. Thus, without a solution to the valuation of money stocks, the crisis will endure. This view is backed by the IMF which in its latest report on the global financial stability points at the risk that the crisis in Europe might become “mired in a more chronic phase” (IMF, 2013). One important reason for that risk is seen in an unresolved balance sheet repair in peripheral European banks.

The present performance of the European financial sector corresponds to typical patterns of financial crises. As Jorda, Schularick and Taylor have shown in a recent paper (2011), recessions following a financial crisis have deflationary tendencies that are considerably more pronounced than in the case of “normal” recessions. In particular, there is “a strongly negative impact on loan growth” (p.343). Evidently, the reduction of their loan portfolios is the main strategy of banks to re-establish capital adequacy in their balance sheets. On the other hand, they are more reluctant to make losses evident by adjusting asset prices. So, while Jorda et al. conclude that loans and securitized assets follow different cycles and have different predictive values, the real consequence is that the recovery of the economy will be postponed. Also, the real burden of debt is growing during a deflation, thus aggravating the problem. Private households as well as private enterprise have to reduce their debts in order to maintain credibility. So, private saving is increasing during the crisis although interest rates are low. With the changed behaviour of private aggregate demand, the risk rises that the economy may fall into the trap of a general depression. More and more economists recognize that Europe – as well as the US – comes close to a constellation where Japan found itself during the decade after 1990 (so Richard Koo in an interview in April 2012).

In this constellation, politicians have started to question their protection of the banking sector. Since the severe social costs of postponing clear-cut (stock-) solutions have become visible, doubts arise whether banks are really “too big to fail”. In the public debate, the floor has been opened for proposals which focus on a restructuring of the banking sector as being the core of the problem. The debate focusses on three main issues, (1) a recapitalisation of European banks, (2) a fundamental extension of capital adequacy requirements, and (3) shifting of banking supervision and regulation to the European level. These issues have induced a political discussion on the creation of a banking union. The political charm of a banking union is that it does not require joint liability for government debts in the Union and so spares the painful if not illusionary way to a fiscal union (Fuest, 2012). By contrast, the no-bailout-rule of the Treaty can be revitalized and, apart from fiscal co-ordination, responsibility for the national budget can be left with the national parliament. According to Clemens Fuest (2012), a banking union should have four elements. (1) A European regulation of banks and financial markets that provides high capital adequacy standards; an important rule is that banks are not allowed to hold large amounts of bonds of a single country (particularly their home country) on their investment books. (2) Banking supervision is established on the European level, for instance at the ECB. (3) A European fund to assist destabilized banks and, in case, to enforce insolvency procedures is established. This fund is provided with capital by member states. (4) A European deposit insurance is institutionalized.

Clemens Fuest points at a special advantage of a banking union. Government indebtedness and banking activities are disentangled. So, a sovereign default becomes feasible without endangering the functioning of the banking system. This exerts a strong incentive for governments to achieve fiscal discipline. At the same time, insolvency of a bank is no longer a systemic risk. So, the banks can clear their balance sheets (and they should have to) and the blockade of the real economy is resolved. There may be transition problems since the shifting of existing risks to the European level implies distributional effects. This requires to identify these risks and to take political decisions (Buch and Weigert, 2012).

Against this background, Herman Van Rompuy, President of the European Council, set up a ‘Roadmap for the completion of Economic and Monetary Union’ (President of the European Union, 2012) which was agreed by the European Council on 14 December 2012. As a first step a Single Supervisory Mechanism (SSM) for euro-area banks was adopted, to be conducted by the ECB. Once the European Parliament has approved this mechanism, it will be implemented, but due to a procedural delay not before summer 2014. As soon as it is enacted, the European Stability Mechanism (ESM) will be able to recapitalise banks directly. In addition, the Council intends to establish a “single resolution mechanism for member states participating in the SSM. This mechanism, including appropriate and effective backstop arrangements, will safeguard financial stability if banks fail…The objective is to reach agreement on this mechanism by the summer of 2014.” (European Council, press release of 14/12/2012)

A European banking union according to these schemes would have clear advantages. (1) The vicious circle of bank failures and government indebtedness is interrupted, (2) monetary policy becomes effective again and is not hindered by zombie banks. Even so, enactment of a European banking union will take its time. Meanwhile, one of the unresolved questions remains: How to distribute the debt burden of the past? By counting on austerity and consolidation of public budgets, politicians seem to hope that this burden will melt down when time goes by. That would be a dangerous illusion.

However, the case of Cyprus indicates that a new philosophy evolves among European politicians. Cyprus received a €10bn bail-out in March 2013 on the condition that private lenders had to bear their share of bank losses and the banks involved had to be restructured. The new philosophy is most clearly demonstrated by Jeroen Dijsselbloem, the new euro group president: “Now we are going down the bail-in track, and I’m pretty confident the markets will see this as a sensible, very concentrated and direct approach instead of the more general approach (of) let’s levy everyone to gather the money for the banks. So yes, that is a sort of shift in approach.” (Dijsselbloem, 2013)

5. Conclusion

The evolution of the European debt crisis and the drift of political activities give evidence that a Keynesian approach to the interpretation of the relationship between money stocks and flows is a useful policy guide. Unavoidably, the problem of revaluating monetary assets including government bonds in the banks’ balance sheets came to the forefront in the course of the crisis. The accumulation and shifting around of debt “represented by no real assets” (Keynes, op.cit.) has proved an awkward and costly way to the resolution of the original task of clearing bank balance sheets. By declaring debt cancellation and insolvency of governments and banks as a taboo, politicians not only did delay a crisis resolution but also demonstrated a misconception of the capitalist order.

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