

*“The Financial and Monetary Crisis:
Rethinking Economic Policies and Redefining the
Architecture and Governance of International Finance”*

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How long will the Keynes's moment be?

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Abstract: The Great Recession has produced a comeback of the name of Keynes on media, as well as the implementation of policies with a Keynesian ‘taste’, ranging from unlimited liquidity provision to fiscal packages of unusual size. Does this mean the New Neo-Classical synthesis is in retreat? From what can be so far observed in the U.S and Europe, there only seems to be a pendulum swing, from ‘freshwater’ to ‘saltwater’ economics: partial acceptance of ‘Keynes-flavored’ policies as a ‘quick fix’ made necessary by the consequences of a (rare) tsunami.

Indeed, policy makers are not signaling a change in paradigm. They continue to believe in the disciplining power of monetary policy and are sending conflicting signals on the power of fiscal policy. Recent ‘non-standard responses’ are seen as exceptions that will soon end with a timely ‘exit-strategy’ and a return to ‘discipline’.

Yet, both the ‘quick fix’ and the rules of ‘discipline’ approach are extraneous to Keynes. His legacy is the description of a market system that oscillates within bounds, constantly underperforming. Full employment and price stability are pursued with structural, not cyclical, policies.

A true return of Keynesianism begins by reading Keynes as a ‘classic author’ who can still enlighten the present debate by challenging major claims of policy-making, including: the alleged benefits of price and wage adjustments, of net exports, of private and public savings; the necessity of curbing booms; and the ineffectiveness of fiscal policy.

OUTLINE SUMMARY

(NOT TO BE QUOTED WITHOUT PERMISSION)

1. THE GREAT RECESSION AND QUICK-FIX KEYNESIANISM

The extent of the impact of what is now labeled the 'Great Recession' has abruptly ended the Great Moderation and brought a comeback of the name of Keynes. In 2009, books by Lord Skidelsky, Peter Clarke and Paul Davidson have brought to the public's attention how the legacy of Keynes is relevant to understand and address today problems.

Many professional mainstream economists find this 'return of Keynesianism' annoying, if not irritating. Mankiw, for example, in an unfair review to Skidelsky's book, argued that Keynes 'left us with more hard questions than compelling answers.' After all, it is all in neoclassical microeconomics and in its byproduct, macroeconomics with 'Keynesian results', also known as New Neo-Classical synthesis.

Indeed, the 'Keynesian arm' of today's mainstream macroeconomics consensus provides a foundation on how to employ short-run policies in dealing with the urgent and politically pressing emergency of a crisis that has created huge output and job losses.

This is the 'return to Keynesianism' that we all have seen last year in the U.S. and Europe, following an economic crisis that trailed (*and not inevitably*) a banking crisis, a banking crisis that trailed (*and not inevitably*) a financial crisis that, on its turn, had trailed (*and not inevitably*) a liquidity crisis. Central banks have adopted an allegedly Keynes-flavored policy of providing liquidity almost without limits (i.e., significantly broadening the required collateral) to meet banks' needs at a near zero rate. Governments have agreed on considerable fiscal packages in a scale that had not been seen for a long time. Even the limited and uneven fiscal efforts in Europe one could not realistically imagine or expect, on the basis of conventional wisdom, only two years ago.

Yet, such emergency measures do not so far hint at a fundamental change in paradigm, but rather only seem to reflect a drifting towards 'saltwater economics', i.e., a modified version of macroeconomics (largely developed by economists based in the US's coastal universities) based on micro-foundations that allow for a number of imperfections leading to skepticism about the efficiency of markets and to the necessity of some form of government intervention to help the world pull out of recession.

In the US, this meant the adoption of non-standard monetary policy provisions and of a 'fiscal stimulus' out of pragmatism, more than out of new foundations (which is no surprise considering the US new administration's advisers belong to the mainstream).

In Europe, this meant an effort to build and adapt new policies within the existing set of rules. The ECB has made every effort to convince the public that any non-standard measure adopted has 'price stability' as its ultimate motivating factor. The EU Commission and EU governments have agreed on temporarily softening the Stability and Growth Pact by invoking a principle that was part of the Pact since the very beginning, i.e., exceptions in case of serious recessions, and

also agreed on the European Economic Recovery Plan (by making use of the flexibility offered by the revised SGP) intended to be 'timely, targeted, temporary, and coordinated'.

In an even more explicit fashion than its US counterpart, EU policymakers validate the notion that policy actions need only temporary corrections, not fundamental revisions.

So the alleged 'return of Keynesianism' seems largely inspired by a political necessity, justified by the 'Keynesian arm' of the New Neo-Classical Synthesis, and built within the existing policy rules. Not surprisingly, such exceptions do not happen without controversies, and while some observe the developments of rising fiscal deficits and 'quantitative easing' on the monetary front with increasing concern, a number of mainstream economists have not objected to the unusual adoption of liquidity measures and fiscally expansionary budgets, on the basis of the argument that after a shock of such magnitude self-adjustment would take a politically intolerable long time.

This validates a common view of Keynes as the 'quick-fix guy' we need when dealing with emergencies. If there is a 'Keynes moment' in the world economy at all, it is limited to this.

Keynesianism is reduced to the belief that cyclical use of fiscal policy may be warranted when a recession is too serious to be quickly fixed by usual adjustment mechanisms (on condition that national debt remains 'sustainable') and to the belief that the multiplier effect extends the benefit of public spending by limiting the impact on debt. 'Freshwater economics' opposes that the fiscal multiplier is small and the long-run effects of a rising debt on sustainability far exceed the benefits.

By contrast, a true return of Keynesianism would entail a different reading of the fundamental, long-run 'natural' tendencies of any monetary economy of production and an intellectual effort designed to change those 'natural' tendencies' for the sake of an improved public good. For Keynes, our economies are subject to several conditions of stability that prevent them from either reaching quickly a state of maximum efficiency or a state of total collapse. Keynes's analysis thus leads to the necessity of structural policies to permanently achieve a full employment growth path, not to the necessity of temporary policy actions to soften painful cycles. Temporary, quick-fix measures are in fact the opposite of Keynes's recommended policies, aimed at full employment and price stability. The end of a recession, for Keynes, happens 'naturally', simply relying on the 'natural' conditions of stability of the system. The real challenge begins with the character of the recovery. In Keynes' economics, mechanisms to maintain aggregate demand that support full-employment should be the core of public policy in any nation that chooses to attain this goal.

It would indeed have been the goal of a true Keynesian policy to prevent that the initial liquidity crisis developed into a systemic banking crisis and eventually in an economic crisis. The biggest macro failure in 2007-08 was the inadequacy of policy makers in preventing the slump. One can hardly describe what we have seen in the past three years as a successful return of Keynesianism, with public policy unable to act timely and preemptively.

Evidence that the Great Recession has not so far produced a genuine review of the dominating paradigm is found in the mainstream interpretation of the triggers, causes and remedies of the economic crisis. Far from assessing the shortfalls of macro public policy, the crisis is commonly seen as a microeconomic (behavioral) failure, driven by a combination of irrational exuberance, conflicts of interests, imperfect markets and contracts, which resulted inevitably in a macro failure that now needs to be fixed. In a slightly different perspective, all this was accompanied

by an ill-conceived monetary policy that kept interest rates too low for too long. In this logic, current 'Keynesian' macro policies are a second-best solution that is needed to bridge the gap, until we develop better ways to deal with imperfections and irrationality, so we can eventually dispose of such obsolete 'Keynesian policies' that we only need because the economy is still too imperfect.

2. *READING KEYNES AS A (TRUE) CLASSIC*

The above considerations suggest that a meaningful inquiry about the return of Keynesianism ought to be spelled in the following, different terms: Is Keynes an author worth reading to learn more about our own times? This question fundamentally asks if Keynes should be considered a 'classic'.

This term, of common use in literature, is being used in sciences as well to describe a particular author who stands the test of time by providing 'lenses' to look through that offer suggestions and guidance of contemporary relevance. [I am using the term 'classic' in a similar fashion in which Skidelsky uses 'master of thought': 'Great masters of thought do not discover reality. By changing peoples' beliefs and behavior they create reality.']

In this sense, Keynes is a classic because his writings offer a perspective that can help us improve our current attitudes towards macroeconomic problems. Despite having written well over half a century ago when capitalism was significantly different today and the world economy was deeply shattered by military conflicts and a Great Depression under a gold standard system, Keynes can still enlighten the present and may provide lessons. Thus, the question about a return of Keynesianism is really the question of whether reading Keynes can still be instructive today in order to understand business fluctuations and use the best means to prevent them by pushing the economic system to its potential.

Going 'back to the classics' is common in hard times, and the global crisis will have served a purpose if it persuades us to reconsider some blindly accepted conventional wisdom pillars and use Keynes's insights, instead, to find better answers to our macroeconomic questions, and ultimately improving the economic world.

Keynes's theoretical construction was not a foundation for devising ways to soften cycles. Keynes's economics is not about approving a smaller or a larger fiscal stimulus. It is about aiming at full employment, and ultimately about proving an analytical point that provide support to a political decision of seeking ways to enhance economic prosperity by generating the conditions for full employment of existing resources. This was seen as a way to care for the future generations, and strengthen the liberal foundations of society. It was never a short-run, myopic plan, driven by a cynical attitude that in the long run we are all dead anyway.

Keynes developed several analytical points to strengthen his long-run argument. Yet, at a moment when Keynesianism seems to come back, these are not given a sufficient consideration for us to view the current situation in a different light.

Price and wage adjustment mechanisms. A traditional remedy to a slump is to let wages adjust so that a higher rate of employment and growth can be restored. European policy makers especially believe this being an important flexibility feature of any healthy economy. In Keynes's model, price and wage declines have an ambiguous and likely negative impact. This is due to the reduction of the prospective yield of investment spending, caused by an expectation of declining

wages and by the increasing burden on debt as a result of falling prices (as monetary debts do not deflate). Keynes admits that only a once-for-all wage cut 'by decree' could have positive effects by creating an expectation of rising wages (from that point on). On the contrary, downward flexible, sagging wages contribute to worsen the business climate. The only traditional channel through which lower wages could stimulate growth is if they cause a lower interest rate, but then it would be just enough if the central bank lowered rates directly. So Keynes did not see any helpful consequence of an increased flexibility in the labor market and concluded that there is 'no ground for the belief that a flexible wage policy is capable of maintaining a state of continuous full employment; — any more than for the belief than an open-market monetary policy is capable, unaided, of achieving this result. The economic system cannot be made self-adjusting along these lines.' (GT, Ch. 19)

Keynes's analysis is here clearly raising important questions for policy makers, notably in Europe, who consider wage flexibility being a condition for economic soundness and long-run growth.

The export industry as a demand engine. Countries that remedy a lack of domestic demand with an export-oriented policy pursue a socially harmful strategy that makes them dependent on foreign fluctuations of demand. By net exporting to the rest of the world, countries accumulate financial assets abroad at the expense of their current standard of living. In other words, they match the desire for savings of the private sector with a lower level of domestic consumption than if savings were matched by domestic demand. It means falling into the Mercantilist error of pursuing an accumulation of gold as a national objective. Keynes thought the Mercantilist true aim was to increase the stock of gold to allow a lower rate of interest. Outside the gold standard, when central banks are in power of interest rates, even this justification loses its appeal.

In a micro dimension, exports do reward business excellence. In a macro perspective, they should be used to provide room to imports so that a country can transform the real goods released abroad to real goods acquired from abroad. By contrast, net accumulation of financial assets will match a parallel reduction of real output consumed domestically.

The fact that such strategy requires that other countries pursue an opposite strategy (they must be willing to net import) entails that it can hardly be claimed to be a principle of soundness. An export-led growth model, as practiced by the economically more powerful euro member, is self-defeating as it makes Euroland dependent on foreign business cycles, as well as it reinforces divergence and internal deflationary tendencies.

Similar concerns have been rising in the US, following a reading of the crisis as a result of 'too much consumer spending and too few exports' in the last decade.

On curbing booms. A popular explanation is that the Great Recession is partly the consequence of the excessive boom that preceded it. If this is true, the best action to prevent a slump is to curb 'over-investment' by timely raising the rate of interest. In the General Theory, Keynes offers his assessment of this argument.

For Keynes, the most appropriate notion of over-investment is not applicable to a boom, but rather to 'a state of affairs where every kind of capital-goods is so abundant that there is no new investment which is expected, even in conditions of full employment, to earn in the course of its life more than its replacement cost.' By contrast, during booms, we observe a different kind of 'over-investment', i.e., 'investments which are destined to disappoint the expectations which prompted them for which there is no use in conditions of severe unemployment.' In other

words, it is not a problem of investment being excessive relatively to the growth possibilities of the nation. Rather, it is a problem of investment being excessive relatively to the current demand conditions of the economy. For Keynes, booms turn into slumps not because the interest rate is too low but because some investments is misdirected (driven by speculative excitement in directions that are in special danger of being over-exploited, something that happens often, not necessarily during a boom), or expectations are too buoyant ('over-optimism triumphs over a rate of interest which, in a cooler light, would be seen to be excessive'). Policy makers, in such case, should lower interest rates (notably, long-term rates), until full employment is reached, and before disillusion turn expectations into excessively pessimistic. This is the situation that Keynes considered the main point that economics should explain: 'a condition where there is a shortage of houses, but where nevertheless no one can afford to live in the houses that there are'. In other words, a recession is caused not by a decline of production possibilities, but by a monetary obstacle that prevents us from fully using the existing resources of the nation: 'poverty in the midst of plenty'.

Raising interest rates is a way to overcome the speculative excitement and, at the same time, check every kind of reasonable new investment, an action that 'belongs to the species of remedy which cures the disease by killing the patient.' Keynes again: 'The right remedy for the trade cycle is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom.'

The desire for private and public savings. There is no macroeconomic reason for encouraging the private sector to further increase its savings beyond the existing desired level through a reduction of spending. A stimulus to savings is only healthy when it happens with an increase in spending! Savings are the accounting equivalent of investment spending, so their total, aggregate size is not under the control of the savers. Savings (notably, net financial savings) do matter because when the private sector feels it does not have enough savings, a reduction of spending and a decline of output and employment will ensue. When the private sector feels it ought to restore its savings, it reveals a need to repair balance sheets. Considering macroeconomic flows, there are only three possible means to accommodate and compensate this desire for savings by the private sector:

- a) a sufficient flow of business investment – that could only spark from a spontaneous change in confidence;
- b) a sufficient net flow of exports – that depends on foreign economic dynamics and means to surrender sovereignty to the economic and political power of foreign nations;
- c) a sufficient flow of net government deficits – i.e., a reduction of public savings that entails an increase in private savings by matter of accounting.

US policy makers have moved in this direction, although with declining conviction, as they now concede to the need of checking the financial burden on future taxpayers, and thus sending conflicting signals about the future of the stimulus.

In Europe, the last option can hardly be generated within the existing constraints on government deficits. In the tool bag of Euroland, the management of aggregate demand is absent. An aggregate demand response beyond automatic stabilizers could only come from a political body either at the EU level, or at the level of nation states contemplating breaches of the Stability and Growth Pact. In November 2008, a modest fiscal stimulus was approved. The aim of the European Economic Recovery Plan was to 'stop the downward spiral of demand, investment and

employment.’ The EERP has been budgeted for roughly 1.5% of the EU’s GDP. Along with a revised Stability and Growth Pact that allows longer deadlines to adjust public finances if growth turns negative (and not necessarily -2%), it aimed at creating more ‘fiscal room’ for countries (though manifestly insufficient to deal with the crisis).

Conversely, intended deficit reductions to meet fiscal discipline criteria and increase public savings will lower the available savings of the private sector and thus hurt the economy well beyond any interest rate effects of ‘deficit-biased budgets.’

The relative effectiveness of monetary and fiscal policy. Business investment is restored when a confident business climate is restored. A variation of the rate of interest cannot by itself restore a confident climate, but only influence the yield at which investors discount their future expected proceeds. It also influences, in an opposite fashion, the net flow of income paid by the Treasury to Treasury securities holders. For Keynes, ‘it is not so easy to revive the marginal efficiency of capital, determined, as it is, by the uncontrollable and disobedient psychology of the business world. It is the return of confidence, to speak in ordinary language, which is so insusceptible to control in an economy of individualistic capitalism. This is the aspect of the slump which bankers and business men have been right in emphasizing, and which the economists who have put their faith in a “purely monetary” remedy have underestimated.’

Keynes stressed how differently monetary and fiscal policy function.

While monetary policy operates by modifying the forward price of money, fiscal policy operates by modifying incomes and net worth of the private sector: ‘a large capital programme would increase the profits of business men [and] would increase the wealth of the country’ (XX 361). He rather expected ‘to see the State, which is in a position to calculate the marginal efficiency of capital-goods on long views and on the basis of the general social advantage, taking an ever greater responsibility for directly organising investment’ (P. 164, my emphasis).

It is possible that governments’ loss of credibility with respect to their capacity to effectively manage expenses and taxes is the effect of a lack of leadership in those long views of the general social advantage. Reducing sovereignty as Europeans have done, however, is not an effective answer, and it recalls the remedy of curing the disease ‘by killing the patient’. When sovereignty is limited, it is likely to strike back in the form of populism or other non-democratic forms of power.

Full employment and financial stability. The most effective way to end a financial crisis and restore the ability of paying debts is to increase employment. The defaults that bring systemic damage are not those coming from frauds. Rather, it is the defaults that are caused by a decline in incomes, cash flows, and available jobs. So there is a connecting link between demand, employment and the financial health of the private sector. Following this logic, restoring demand and jobs has a more direct effect in restoring the health of the banking system than capital injections. Not only unemployment is ‘an absurdity, a confession of failure, and a hopeless and inexcusable breakdown of the economic machine’ (XX 321), but full employment and the ensuing increase in incomes would also increase the number of credit-worthy customers seeking funds.

This relation between employment and financial health, however, is absent from most of the current debate at the level of policymakers, who prefer to see employment as the outcome of a financially healthy environment (rather than the reverse). Employment is not the primary objective of the ECB. Yet, if employment builds financial stability, and financial stability is a

condition for the functioning of monetary policy, then employment should be given comparable priority.

3. A CASE OF MONEY ILLUSION IN MAINSTREAM ECONOMICS?

The title of this Conference highlights the relation between economic policies and the monetary and financial dimension of our economies.

In this respect, it is interesting how the mainstream approach to this question seems to suffer of 'money illusion'. This seems bizarre, considering that in neoclassical economics, money illusion indicates a serious fault in decision making, or a questionable assumption in economic models. It shows when economic agents mistaken changes in nominal values for changes in real values. This was also the critique of IS-LM-based Keynesian models where the system's lack of automatic adjustment depends on agents aiming at maximizing nominal, rather than real, values. The same critique would also apply to expansionary policies that aim at increasing nominal GDP.

The neoclassical criticism of money illusion in Keynes's economics, however, is not applicable to Keynes's writings. Keynes never confused nominal with real values (and in The General Theory macroeconomic magnitudes are expressed in terms of wage units). Rather, he considered a false division the one between the theory of relative prices and the theory of money. In contrast, he argued that a more productive distinction would be that between the theory of industry, or firm, and the theory of output and employment in the economy as a whole, where the latter requires the theory of a monetary economy, where expectations of cash flows influence the present actions.

Keynes stressed the view of money as an instrument that may lead to persistent stagnation or economic prosperity, depending on how we handle fiscal and monetary management. While monetary management should be aimed at preventing speculative excesses and investment misdirection by holding rates not too high, fiscal management should be aimed at generating sufficient private incomes to maintain full employment.

Keynes had manifested his dissatisfaction with 'the 'sound currency' dogmas of the mid-nineteenth century early in his life. His constant battle to design a monetary system that do without gold was intended to free the economic system from unnecessary constraints. He thought that monetary and economic soundness can be achieved at full employment, not when the economic system underperforms and fluctuates below full employment (just like in today's Europe).

Later in his life, after the General Theory, Keynes worked with the British Treasury to design the post-war policy framework [CW, XXVII]. This is another 'classic' reading for us today.

Just like today's confusion about the issue of rising government borrowing needs, people were asking 'where will the money come from'. Free of 'money illusion', Keynes explains that:

- what's needed for reconstruction, as well as for restoring growth after a recession, is real resources, not money per se: anything we can do, we can afford;

- the problem of finance for an individual is completely different from the problem of finance for the community as a whole;
- rising employment 'improves' the budget;
- sophistry and fallacy governs our collective action: it is folly to 'keep labor unused and unhappy in enforced idleness';
- a cut in payroll taxes (workers' Social Security contributions) is a very effective way to sustain demand and a mechanism that adjusts contributions automatically with the cycle would be useful;
- government-guaranteed debt can increase without problems in a healthy economy;
- Lerner's argument on functional finance 'is impeccable. But, heaven help anyone who tries to put it across the plain man at this stage of the evolution of our ideas.'

Far from ignoring future generations, Keynes's approach was designed for the long run. In this sense, a budget deficit (given we no longer have a gold standard) contributes to the utilization of real resources and makes more real resources available to the future generations.

There is always an alternative option: that we discard Keynes as a visionary, for he believed that men and women can find a way to govern the economy by breaking the monetary constraints and escape from allegedly natural tendencies.

4. POSTSCRIPT: A REAL PROBLEM FOR EUROPE

The creation of a single currency area (Euroland) has meant a net reduction of political sovereignty of European countries. For all nations that have entered the single currency area, national sovereignty on setting, issuing and spending the nationally enforced means of payment was strictly limited at the country's level, and yet these powers were only partially transferred to a European body.

The most vital purpose of this approach was the creation of a 'state-of-the-art' monetary system (based on a sound, 'virtuous,' currency) that, if necessary, would act to 'discipline' countries so they comply with common rules. Such currency would be a functional piece of technology made possible by recent advances in economic theory and central banking techniques. It was meant to be a perfect form of money that needs no gold or state 'backing' it.

Thus, the creation of the euro was felt to be a win-win proposition: in the best-case scenario, it would be a means to promote 'sound money' and pave the way to the integration process; in the worst-case scenario, it would remain as a monetary accomplishment, even in the face of future political setbacks. This reflects the belief that the monetary and the political powers are more efficient when they act separately. A parallel political problem was that only a subset of countries in the EU have so far adopted the single currency, while others are either not ready or not willing to join. Because the single currency was intended to be a unifying process, it was not viable to separate these two groups politically. The lack of a distinct body assuming responsibility for economic governance for Euroland is partly the outcome of the problem of developing such entity separately from the rest of the Union.

The euro was meant to be the golden apple of Europeans, and to be such it had to be 'technically' sound. It was a compromise between Hayek's denationalized, private, competitive money and the traditional state monopoly assigned to the chartered central bank. It was denationalized, yet not private; public, yet chartered by a supranational Treaty. It was created to be a means to reduce policy mistakes, such as those made when central banks 'lean towards inflation' with rising unemployment, or when 'undisciplined fiscal policy' actions are undertaken by an expansion-oriented political process leading to national default or inflation. These should have become mistakes of the past, not to be repeated.

Euroland economics spelled its own conditions for soundness along two principles. First, the new single currency must provide an anchor of price stability for which the ECB is responsible. Second, national fiscal policies must accept to stay within the limits in their actions dictated by rules that prevent them from interfering with monetary management and are aimed at preventing default (not of inflation, because 'monetization' of debt is precluded in a system where governments have lost monetary sovereignty).

'Sound currency' so defined would be a necessary, though not sufficient, condition for long-run economic prosperity. In this construction, two additional policy tools must complement the monetary action. First, fiscal budgets must build adequate room for automatic stabilizers to play their part during the business cycle. Second, a largely national effort (although coordinated and encouraged at the EU level) would modify some institutional characteristics of European economies in an effort to enhance the degree of competition and wage and price flexibility, and ultimately increasing the capacity of the economy to flexibly achieve its long-run potential output growth path.

The theoretical background of the above policy propositions includes the following beliefs:

- a) monetary policy can do nothing to directly promote growth except providing a medium / long-run anchor to prices;
- b) fiscal policy can do nothing to directly promote growth except refraining from interfering with monetary management and providing a medium / long-run fiscal sustainability framework that allows for temporary deviations aimed to counter business cycles;
- c) because temporary demand shocks cannot be avoided, there must be a sufficient power for self-adjustment, and this is partly provided by automatic stabilizers (but only to those 'disciplined' government that can afford them), and partly by market mechanism whose functioning can be enhanced by structural reforms;
- d) structural reforms will primarily serve the purpose of sustaining long-run growth by increasing the efficiency by which existing resources are used.

When one considers this configuration, it does not seem very different from what was in vogue at the time Keynes was writing *The General Theory*: price stability would be strengthened by the gold standard, automatic stabilizers would contain fluctuations, and the best way to enhance growth is by raising its supply possibilities.

This design of removing political sovereignty from the European single currency conflicts with the reality of how the monetary system in Europe has been shaped by political decisions and how monetary developments have responded to political announcements. Indeed, management of a monetary system cannot do without the sovereignty dimension.

The 'sound, or 'virtuous,' currency syndrome is clear: the ECB intends to manage the euro as if it was backed by gold. This means that debts owned and debts owed entail not just monetary but rather real resources, or at least they should be treated as such. The sovereignty deficit thus looks intentional, as nations are forced to comply with rules that mimic those of the gold standard.

A form of money illusion may indeed belong to the current policy framework in Europe. The ECB's approach separates monetary from economic soundness: the former can be technically achieved, even when governments do not do enough to achieve economic soundness. But this primacy of monetary soundness is illusory unless it is accompanied by effective macroeconomic governance, and thus economic soundness. Without the latter, the ECB cannot effectively be accountable for its medium-term policy strategy.

In this sense, European rules and policy paradigms can be seen as manifestation of a new form of money illusion: that money soundness can be separated from economic soundness, and that money soundness is achieved by limiting the growth of nominal income to less than 2% higher than real output, and consider such goal as an essential pre-condition for growth.

When analyzing the economy as a whole, Keynes was thinking not in terms of relative prices but in terms of cash flows, sales proceeds and balance sheets, that act as constraints on what ultimately matters to nations' standard of living, i.e., output and employment. Policies should thus be aimed to free the system from such monetary constraints.

Euroland (and European) policy-makers follow a very different direction. Even when they seem to acknowledge that hard times require a somewhat different approach, they are not sending a signal that after the recovery Europe will be on a track different from the one of price stability and stagnation of the first ten years of euro.