Working Paper No. 595

The Recycling Problem in a Currency Union

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May 2010

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ABSTRACT

The recycling problem is general, and is not confined to a multicurrency setting: whenever there are surplus and deficit units—that is, everywhere—adjustment in real terms can be either upward or downward. The question is, Which? An attempt is made to formulate the problem in terms of the European Monetary Union. While the problem seems clear, the resolution is not. It is proposed to engage the issue through a detour consistent with the Maastricht rules. Inadequate as this is, it highlights the limits of technical arrangements when governments are confronted with political economy—namely, the inability to set the rules of the larger game from within a set of axiomatically predetermined rules dependent on the fact and practice of sovereignty. Even so, an attempt at persuasion through clarification of the issues—in particular, by highlighting the distinction between recycling and transfers—may be a useful preliminary. Some of the paper's evocations, notably on oligopoly, may be taken as merely heuristic.

Keywords: Keynes; Economic Theory; International Payments; History of Thought; Competitiveness; Full Employment; Currency Union; Recycling Problem; Banking Principle

JEL Classifications: B2; E12; E20

The only economy that does not have an external surplus or deficit problem is the closed economy and, since Robinson Crusoe's time, there aren't any. By contrast, the situation of any open economy is eternally asymmetric, if in surplus it can carry on merrily, at least until something untoward, exogenous or perhaps internal, turns up, while, if in deficit, it is under pressure both externally and internally, additionally to any exogenous event.[1] Keynes (1980: 27) put the problem succinctly in his very first official memorandum, dated September 8, 1941, on the proposal of a Clearing Union, thus:

> "It is characteristic of a freely convertible international standard that it throws the burden of adjustment on the country which is in the *debtor* position on the international balance of payments—that is on the country which is (in this context) by hypothesis the *weaker* and above all the *smaller* in comparison with the other side of the scales which (for this purpose) is the rest of the world." [original emphasis.]

a definition of the problem and its resolution which was half-scuttled on the tortuous way to Bretton Woods, nevertheless functioned reasonably until abandoned some twenty-five years later.

Keynes himself, having "lost" the decisive argument for *symmetrical adjustment* of fixed but adjustable exchange rates in his own multicurrency Clearing Union did not further argue the case of a fully-fledged single Currency Union's possible additional or alternative internal arrangements. Yet after the nameless, dogmatic years in the doldrums between the Smithsonian and Maastricht, such a currency union eventually turned up in a tiny part of the globe called Europe, partly in response to the abandonment of Bretton Woods, but also, crucially, subsequent to the grand design of Europe led by the Marshall Plan and some peculiar pairs[2] of Enlightened European statesmanship constructing the Franco-German integrating dynamic, the rest following.

But the Euro-Maastricht architects constructed an EMU with the "E" effectively left out. The intra-union imbalance problem was thought to be settled by the fiscal rules, but it was not, and not because the fiscal rules were in practice inoperative, it would have turned up even if they were: the nominal uni-currency

[1] The obvious *ceteris paribus* qualification is implicit here, surpluses are necessarily matched by deficits so untoward feedback is certainly lurking somewhere, but this is in the "long run," etc.
[2] Monnet-Schuman, De Gaulle-Adenauer, Giscard-Schmidt, Mitterand-Kohl.

national accounts do not account for differential intra-union competitiveness, at best they only indicate it afterwards. “Real,” as distinct from now non-existent nominal exchange rates, conventionally proxied by intra-union differential unit labour costs (but see further below on “oligopoly”), remain to create “external” intra-union imbalances within the union even with balanced [fiscal] budgets. To focus the argument on fundamentals, not accounting devices, this latter condition will be assumed to hold throughout—it is, perhaps, when taken by itself, the least constraining of the Maastricht rules, neither preventive cure nor remedy for the recycling problem.

To illustrate the oddity of the “internal” imbalance notion, imagine a sublunar visitor to China where he observes a Chinaman holding a dollar note. The visitor immediately knows where that one came from: “it” has crossed a monetary border. As for its destination he may ask the bearer, who, being a law abiding man, is already on his way to the office where the foreign body in his hands is to be exchanged for what in his country is called “money.” The receiving authority will then do its mediating job, likely ending up by holding an alternative asset yielding some return, most usefully American Treasuries, thus recycling the value of the item, helping the world to sustain deficits elsewhere—Adam Smith might have said this was no part of anybody’s intention, in the present context falsely. But what if the sublunar visitor were to land in Germany there to observe a Germanman holding a euro note? Nobody, including the bearer, would have the means to know where that token body came from; it is not “it,” but just *money*. Borderless transition of the token of value annuls the question of its origin; its destination is as mystical. Who and by what observing instrument can tell whether that euro note is on the wing or heading for a temporary abode or plain hoard, in principle immune from the necessity of intermediation? Yet in this one-money sublunar world there are still surpluses and deficits and their myriad offshoots; the problem is their implications when the surplus and deficit units are sovereign states. So what precisely is the *internal*, intra-union “external” imbalances “problem,” what rules might be devised to meet it in a union-wide acceptable form? The ongoing and perhaps deepening crisis is not crucial to the argument that follows, though it serves as backdrop and certainly as origin for concentrating the mind wonderfully.[3]

It is convenient to think of country-members of a currency union as composed of differentially powerful *oligopolists*,[4] they predicate "power" leading one to think in terms of (partial equilibrium) "neo-mercantilist" or "vent for surplus" national strategies, though eventually coming up against those ultimately constraining (general equilibrium) identities—for we cannot all be simultaneously successful neo-mercantilists.[5] The stylized facts of the currency union disequilibrium case are then summarized thus:

a) the definition of the problem is assisted by the fact that the EMU is only marginally in surplus with the rest of the world: to the extent that some member countries are in surplus with the rest of the world, that part of their overall surplus can be ignored as being someone else's problem, so the effective stylized fact is that there is no rest of the world, all "external" imbalances are internal to the currency union; and

b) the currency union *regime,* thus being the whole world, is only a union insofar, positively, as **free and stable**—a tall order (for labour markets even taller)—**markets** rule the game, but also, negatively, insofar as oligopoly,[6] as the prevalent subspecies thereof, induces a dynamic asymmetry of endogenous action and response which *regime* rules allow but cannot handle, thus triggering the equivalent of Keynes's diagnostic statement quoted above: thus, ultimately, insofar as—though in merely accounting terms—fiscal imbalances are concerned, the rules can only work downwards, the asymmetry is dynamically part of the system and cannot be corrected.

[3] Recall Dr. Johnson's dictum, that *if a man knows he will hanged, it concentrates his mind wonderfully*. (Nicholas Theocarakis adds: In his journal entry for September 19, 1777, Boswell noted that a friend of Johnson's told the great man he suspected Dodd didn't write the piece himself, because it was so good: "Why should you think so?" responded Johnson. "Depend upon it, Sir, when a man knows he is to be hanged in a fortnight, it concentrates his mind wonderfully.")

[4] This tack is more in line with an earlier theory, due to Kałecki rather than Keynes (misemployed in a stable equilibrium context, e.g., in Kaldor's MkIII growth model) where price markup and margin, profit size, rate and share, with positive feedback on profitable accumulation, etc., thus taking the argument beyond the simple unit labor cost proxy for differential competitiveness.

[5] For the revived neo-mercantilist notion invoked here I am pleasurably indebted to the errant pair denoted by HV—in terrestrial terms Joseph Halevi and Yanis Varoufakis, not entirely responsible for what follows, but also belatedly to Jörg Bibow, *inter alia* Levy scholar, whose latest (November 2009) working paper, is yet again from this student a source of support and enjoyment. (NT again adds: exchange in mercantilism was always perceived, in modern terminology, as a zero-sum game [Heckscher 1935, II: 25–28]).

[6] Note that "oligopoly" is here understood as both micro but more particularly macro-agent or entity; it is but another name for "vent for surplus"—differential profit is part and parcel of dynamically differential market share.

The otherwise unseeable (by the national accounts) "causal" imbalances in the real economy will be reflected in falling real wages and employment.

Without naming names, the currency union equilibrating game is thus intra-union competitively disinflationary: taking unit labor cost as the proxy metric, oligopolistic power will turn up on either the numerator falling or the denominator rising—real wages must fall or productivity must rise. Oligopoly is precisely the power to do either or both, differentially. It is also the differential power to enforce unemployment or anything else interfering with the "vent for surplus" overarching objective, the ultimate *raison-d'être* of any respectable oligopolist. But the resulting deflationary underemployment equilibrium is dynamically unstable, asymmetrically affecting the currency union's members, a game without endogenous issue until the vanishing point, a subzero equilibrium solution eventually detrimental to the surplus unit—if only the world could wait for it.

The question of the present exercise is, given the Maastricht-EMU rule-book as is, can there be an acceptable mechanism for **recycling surpluses** so as to offset the deflationary impact of deficits?—the answer being, if not plainly "no," then decidedly unpleasant unless some additional not incompatible rule may be devised and accepted. To investigate this we must look at the flow of "external" surpluses once earned and trace the path of their eventual destination.

Since, by definition, in a currency union all flows are denominated in the same currency, it will simplify investigation to assume that the union consists of two countries, one surplus one deficit, taking the most favorable benchmark for the exercise: both countries have zero fiscal deficits and are, however mediately, equally financially served (in terms of collateral, etc.) by the single Currency Union Central Bank called the CUB, assumed to be subject to present European Central Bank (ECB) rules.[7] The "single market" in everything then implies a "single price" for everything insofar as everything is the same—which it is not[8]—thus, in the oligopolistic setting of the modern world, also differential markups and margins (therefore profits), the

[7] Though not ideology, a real-world dimension from which I am tortuously attempting to abstract.
[8] Ignoring Polish plumbers and the like, whatever other than geographical this may mean; given product and factor differentiation, the relatively powerful oligopolist is the one who in man-to-man competition always wins, comparative advantage yields to absolute advantage, however transient—how else to explain the obfuscated notion of "competitiveness" in a world where congruent demands and supplies are hierarchically (perhaps better, lexicographically or at least semi-lexicographically), as well as price, determined: "value for money" is but a mystical expression. Measurement in terms of relative unit labor costs remains, unfortunately, the only plausible quantitative benchmark.

surplus country being the differentially high profit country. Tracing the path of profits is then tracing the path of surpluses.

The question now is: where do these profits go? Is there financial intra-union but inter-country intermediation of profits or are differential profits so to say "oligopolistically" intra-country retained, effectively intra-country "hoarded," thus ruling out surplus recycling?

The private sector financial system is itself ruled by asymmetry and surplus units are ever more creditworthy than are deficit units, etc., therefore the dynamics work out so that surplus country profits are retained by the surplus country and cannot be recycled to the benefit of the deficit country (net of foreign investment plus transfers of all kinds by the surplus to the deficit country). The original deflationary impact on the deficit country is thus not recyclable.

In this case, Keynes's Essential Principle of Banking[9] is nullified and there can be no recycling since there is hoarding prior to banking. So the question becomes:

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[9] This will be a long end-note:
The expression **"essential principle of banking**" turns up *à propos*—in a credit money economy—in the first instance in Keynes's (1980) second draft of the proposal of what he still then called a Currency Union (November 18, 1941), thus:

> "The idea underlying my proposals for a Currency Union is simple, namely to generalise the essential principle of banking, as it is exhibited within any closed system … This principle is the necessary equality of credits and debits, of assets and liabilities. If no credits can be removed outside the banking system but only transferred within it, the Bank [sole intermediating agent] *itself* can never be in difficulties. It can with safety make what advances it wishes to any of its customers with the assurance that the proceeds can only be transferred to the bank account of another customer. Its problem is solely to see to it that its customers behave themselves [*sic*!] and that the advances made to each of them are prudent and advisable from the point of view of its customers as a whole." (p. 44, emphasis in original).

This is repeated in the third draft, still calling the project a Currency Union, insisting that "its members behave themselves," but expanding on the rules *vs.* discretion problem of the management of the mediating authority, this being "a typical problem of any super-national authority" (p. 73).

The fourth draft (January 25, 1942) is more forthright on the objective of the exercise, thus:

> "The plan aims at the substitution of an expansionist, in place of a contractionist, pressure on … trade … A country is in credit or debit with the Clearing Union [note the shift of nomenclature] as a whole. This means that the overdraft facilities, whilst a relief to some, are not a real burden to others. For credit balances … represent those resources which a country voluntarily chooses to leave idle. They represent a potentiality of purchasing power, which it is entitled to use at any time. Meanwhile, the fact that the creditor country is not choosing to employ this purchasing power would not necessarily mean … that it is withdrawn from circulation and exerting a deflationary and contractionist pressure on the whole world including the creditor country itself ['vent for surplus' countries, underline this last one]. No country need be in possession of a credit balance unless it deliberately prefers to sell more than its buys (or lends); no country loses its liquidity or is prevented from enjoying its credit balance whenever it chooses to do so; and no country suffers injury (but on the contrary) by the fact that the balance, which it does not choose to employ for the time being, is not withdrawn from circulation. In short, the analogy with a

can the currency union's CUB act **anti-asymmetrically** to offset this bias—can the

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national banking system is complete. No depositor in a local bank suffers because the balances, which he leaves idle, are employed to finance the business, of someone else."

The revolving fund of finance doctrine thus settled, he goes on:

> "Just as the development of national banking systems served to offset a deflationary pressure which would have prevented otherwise the development of modern industry, so by extending the same principle into the international [including intra-currency union arrangements] field, we may hope to offset the contractionist pressure which might otherwise overwhelm in social disorder and disappointment the good hopes of our modern world." (p. 113).

But there is more:

> "The proposal put forward … aims at putting some part of the responsibility for adjustment on the creditor country as well as on the debtor … The object is that the creditor should not be allowed to remain entirely passive. For if he is, an intolerably heavy task may be laid on the debtor country, which is for that very reason in the weaker position." (p. 117)

And [the dates no longer matter]:

> "In short, the analogy with a national banking system is complete. No depositor in a local bank suffers because the balances, which he leaves idle, are employed to finance the business of someone else. Just as the development of national banking systems served to offset a deflationary pressure which would have prevented otherwise the development of modern industry, so by extending the same principle into the international field we may hope to offset the contractionist pressure which might otherwise overwhelm in social disorder and disappointment the good hopes of the modern world. *The substitution of a credit mechanism in place of hoarding would have repeated in the international field the same miracle, already performed in the domestic field, of turning a stone into bread"* (emphasis added, p. 177).

The "**potential miracle**" yet suffers the eternal threat of the eternal evil spirit:

> "*The world's trading difficulties in the past have not always been due to the improvidence of debtor countries. They may be caused in a most acute form if a creditor country is constantly withdrawing international money from circulation and hoarding it, instead of putting it back into circulation, thus refusing to spend its income from abroad either on goods for home consumption or on investment overseas*" (emphasis added, p. 273),

concluding with a warning, in a private letter, his persuasive Golgotha (as if this were aesthetically possible within his "open" paradigm) with:

> "In all this you have to bear in mind that there were some quarters who confidently believed until recently that all these plans would die a natural death. Since it now seems possible that nature cannot be relied on to do the work, it is felt, not put it more strongly, that there is no need officiously to keep alive any conception of any kind of an international scheme" (p. 394)

and, the by-now chastised adventurer-reformer turned Stoic philosopher nonetheless hopefully noting (in a private letter again) that:

> "You will see that *the arts of government as we understand them* are not practiced in this [who?] country. *It may be that some other art, which we have difficulty in apprehending*, is being employed. Indeed, if it were not so the final outcome must be a great deal worse than it actually is. Anyhow, it is important to bear in mind the total absence of the arts of government as we understand them. For otherwise we are led to impute to malice or unfriendliness what is in fact due to nothing of the kind" [emphasis added, p. 370],

therewith ending the sermon.

"lender" turn round to become "spender," let alone, in crisis, the before-the-last-resort lender and presently the first-resort spender?

It possibly can—if it subsumes the functions now entrusted to the European Investment Bank, with the latter's rules as they now stand—the EIB can lend to both the private and the public sector of any currency union country as well as others, **not on collateral, but rather on prospective yield,** noting also that public borrowing from this source need not, by present rules, counted in the national debt.[10]

This institutional twist represents a novel degree of freedom for the adjustment process, a window of opportunity akin to, though more proactive than the conventional discount window of a standard central bank in normal times. The CUB/EIB thus reconstructed is then more than a lender of last resort to the financial system—though by rule explicitly not currency union governments—it is also **"like" a fiscal authority** to the extent that it is a spender of first resort, albeit **on commercial rather than distributional criteria**: the principles of Maastricht-EMU are not disturbed. But EIB finance is also hereby undisturbed, its creditworthiness is, if anything, enhanced, it can directly and indirectly draw surplus profits arising from external surplus into proper and appropriately prudential intermediation directly aimed at productive profit-yielding investment.

To the extent that such an institutionally based recycling device is effective, it obviates the deficit government's investment needs to borrow from the market, by construction on terms more onerous than those available to the surplus government's country. For the CUB/EIB construct, apart from borrowing on its own creditworthiness, which should be similar if not, on the grounds of scale, superior to the creditworthiness of the surplus country, can, as part of its primary inflation targeting mission, expand credit autonomously just like any central bank can within its remit, but in this case CUB/EIB credit expansion in the form of enhanced liquidity would be linked to and locked by the extent to which the deflationary impact of unrecycled surplus works against the CUB's inflation target.

There is here implicitly a growth-and-employment objective that has slipt into the argument: but is this not ever so in the reality of actual practice? And, this being the case, is it not enticing for formalist enthusiasts to devise the right rule transforming, say, output gaps and the like (e.g., "foreign gaps," let alone unit labour

[10] For this enlightened, if intriguing, detail, I am indebted to Stuart Holland.

cost gaps) into algorithmic solutions concerning the CUB's accommodating finance to her EIB sister, perhaps "modeling" these two on the fantastic Washington twins?

Not necessarily, in this line of thinking. The revolving fund of finance which is at the back of the preceding argument does not preclude the notion of growing financial support for a growing currency union economy hopefully aiming at stable full employment, not rule-based but judgment-based, a political matter here taken as exogenous.

This may be taken as fudging the issue: it is not an original thought that the EIB should be brought into the picture, it has already been so—nor, which is perhaps more important, have the orders of magnitude being taken into account other than in qualitative terms: what proportion of imbalance should EIB finance offset which would correspond to a recyclical revolving fund equilibrium?—here tempting the algorithmic response above rejected. The issue now and beyond is rather not how much but to what purpose, in regard particularly to **the problem of institutionally evolving toward the solution of recycling surpluses**, not to the current short-term problem of boosting investment expenditure, immensely necessary as this is. Immiseration, either in the form of falling real wages or unemployment, is the road to destruction of what still bears the name of Europe. In a nutshell, the EMU must start on the long road to bring the "E" to conjoin the "MU." This all has to do with investment, not consumption. Only this can be the offset for oligopolistically crippling vent for surplus.

Recycling is thus not a redistributive transfer, let alone bailout, from the surplus to the deficit fiscal authority, but a straightforward application of the Banking Principle.

It would mean that the effective EIB spending leg of the CUB/EIB construct has a lower-than-the-market financing cost, as dictated by the CUB's intervention rate which is the prime instrument directed to achieving the counterinflation target. By being consonant with, this would also help to enrich the CUB's armory *vis-à-vis* the yield curve, thus enhancing the noninflationary growth prospects of the currency union as a whole. If the argument is correct, it may be only an acceptable beginning, perhaps in a small way, but it may instruct the course for the future. *In fine*, an otherwise desired sound financial policy would be compatible with a nondeflationary mechanism of adjustment. The policing rules of the mechanism are simple and should be obvious, but these fall under the head of politics.

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