

The Greek Economic Drama: An almost perfect Austrian application

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Abstract

Possibly due to lack of reliable data an analysis of the Greek economic crisis in the context of the eurozone, along the lines of the Austrian theory, is not available. In this paper we employ the most recent data on money, credit, industrial production and productivity to show that the Greek drama is an almost ideal application of the Austrian ideas. Long term money and credit expansion along with expansion in the middle of the recession up to end of 2010, have distorted substantially the time structure of production resulting in low profitability, employment and output, high public deficits, and explosion of public debts.

Keywords: Austrian theory; Greek economic crisis; eurozone; European Central Bank; commercial banks.

“In the last two generations, hardly anyone, who has given this matter some thought, can fail to know that a crisis follows a boom. Nevertheless, it would have been impossible for even the sharpest and cleverest banker to suppress in time the expansion of circulation credit. Public opinion stood in the way.” (von Mises, 2007, p. 131).

1. Introduction

The Greek economic drama makes the headlines since the subprime crisis erupted. At this point Greek public debt somehow exploded and triggered chain reactions in most southern European economies. Following a long period of debt accumulation, the EU decided to support the Greek government through a policy of loans and “haircuts” to avoid collapse of the Greek economy and, as a result, the euro as a whole. This is the conventional wisdom. It started out, with the subprime crisis, by blaming the Greeks for everything under the sun, including low productivity and inefficient public sector in terms of tax revenue collections but it evolved into a quite different discussion concerning the future of the eurozone, the appropriate policies of the ECB and global financial stability.

In a monetary union that undergoes a recession, the problem must have started *somewhere*. In the eurozone the problem apparently started in Greece. In the U.S., the housing bubble that started as the result of credit expansion also occurred somewhere at first, but for the international markets this is immaterial since it affected the U.S. economy *as a whole*. Is the Greek drama a Greek problem or a European problem when analyzed in the proper context? In this paper, we use the most recent data available to argue that the Greek economy underwent substantial credit and monetary expansion (along with public debt increases) not only since the beginning of 2000s but also in the midst of the recession and up to the end of 2010. The long term credit expansion effectively destroyed the structure of production by creating artificial “capital deepening” that could not be sustained in view of the constellation of relative prices and interest rates. The result was a deterioration of profitability, employment and output with adverse effects on public sector’s claim to tax revenues.

From the data, we are unable to find evidence that average labor productivity in Greece is lower compared to Spain or Germany (in fact it is higher) nor do we find any evidence that average costs in any sector of the economy exceed the European norms. In fact, average costs are less than Spain’s and only slightly above Germany’s, but they are converging fast. We argue that this can be attributed to artificially high “capital deepening” or “capitalistic” methods of production which were the result of the long – term expansion of money and credit at artificially low interest rates since the 1980s.

A fact that contributed significantly to the Greek economic drama is the accommodation of public debt by the European Central Bank (ECB) and the overall monetary and credit expansion even two years *after* the subprime crisis has erupted. We argue, in turn, that deterioration in overall economic condition and tax revenues is mostly due to the extremely inefficient structure of production that emerged from the expansions.

The remainder of the paper is organized as follows. The fundamentals of the Austrian approach are presented in section 2. In section 3 we examine the role of the

commercial banking sector and the ECB. In section 4 we look at the data on monetary and credit expansion, the stock market and industrial production. Productivity comparisons of the Greek economy with Germany and Spain are undertaken in section 5. In section 6 we examine the policies of the ECB and their impact on the Greek economy. The final section summarizes main findings.

2. Fundamentals of Austrian theory relevant for the Greek Crisis

Regarding the great depression, Hayek argues that the government:

“...succeeded, by means of an easy-money policy, inaugurated as soon as the symptoms of an impeding reaction were noticed, in prolonging the boom for two years beyond what otherwise would have been its natural end. And when the crisis finally occurred, for almost two more years, deliberate attempts were made to prevent, by all conceivable means, the normal process of liquidation”. (Hayek, 1935, p. 162).

This summarizes Hayek's view on the matter. A monetary or credit shock that changes the equilibrium rate of interest and changes the distribution of resources across the time – profile of investment sets in motion a boom that will soon be followed by a recession to correct the malinvestments that emerged from the artificial reduction in interest rates. As Hayek writes:

“Once the monetary causes have brought about that development in the whole economic system, which is known as a boom, sufficient forces have already been set in motion to ensure that, sooner or later, when the monetary influence has ceased to operate, a crisis must occur. The “cause” of the crisis is, then, the disequilibrium of the whole economy occasioned by monetary changes and maintained through a longer period, possibly, by a succession of further monetary changes—a disequilibrium the origin of which can only be explained by monetary disturbances” (Hayek, 1935, p. 67).

The forces of competition will provide the commercial banks with enough motivation to expand credit, and the credit reduction would be enough to restrain the forces of recession:

“Only so long as the volume of circulating media is increasing can the money rate of interest be kept below the equilibrium rate; once it has ceased to increase, the money rate must, despite the increased total volume in circulation, rise again to its natural level and thus render unprofitable (temporarily, at least) those investments which were created with the aid of additional credit” (Hayek, 1935, p. 94).

As argued by Prychitko (2010) in an attempt to understand the bubble in the U.S.:

“The housing bubble developed between 2001 and 2006 when the Fed lowered the federal funds rate and government agencies (through the Community Investment Act and other devices) encouraged and targeted credit toward the housing industry in particular. During those years, credit-induced demands for new homes caused a doubling of their values—an historically unprecedented event. The housing industry, of course, is a latticework of timely production projects and draws a wide variety of specific (yet complementary) higher-ordered inputs into the housing market. Too many to list in detail, but such resources obviously included real estate, lumber, iron ore and its shipments, copper and wiring, PVC materials, and so on. Equally important, it included skilled and unskilled labor in these and other industries, as well as the financial sector itself. Higher relative prices and wages, salaries, and bonuses attracted millions—today the cyclically unemployed—into the housing and finance industry and away from sectors that would have maintained jobs without Fed generated interest rate reductions. The Fed-induced credit expansion prior to 2006 altered the saving-investment link and had real consequences that influenced relative prices in such a way that the change in prices—not the price level—mislead workers, firms, and investors”.

One author put it clearly as follows:

“When the dot-com boom came to an abrupt end in 2000–2001, the Fed responded quickly, cutting interest rates and injecting liquidity into the financial sector, as they had done before on several occasions. Investors, politicians and voters could breathe a sigh of relief. The monetary response cushioned the downfall, and only a modest recession followed. However, the Fed’s monetary response gave immediate rise to a new credit cycle, even more vicious and destructive than the last one” (Gustavson, 2010).

Of course it was not solely the dot-com boom but the bubble in the housing market as well. As Haberler says:

“If in a growing economy the central bank follows a monetarist policy of increasing the money supply to keep the price level stable, it imposes unsustainable forced saving. We have seen that this, according to Hayek, was supposed to have happened in the 1920s with disastrous consequences” (Haberler, 1986).

As von Mises describes concisely his business cycle theory:

“The inevitable eventual failure of any attempt at credit expansion is [...] the outcome of the fact that it is impossible to substitute fiat money and a bank’s circulation credit for nonexisting capital goods. Credit expansion initially can produce a boom. But such a boom is bound to end in a slump, in a depression. What bring about the recurrence of periods of economic crises are precisely the reiterated attempts of governments

and banks supervised by them to expand credit in order to make business good by cheap interest rates" (von Mises, 1912, ch.21, part 2).

In fact that was exactly what happened in the few years past 2008, since the beginning of 2000. The credit expansion facilitated an expansion of business, which was "over-production" in some sense. Business investments increased dramatically at the expectation of high profit possibilities which were then refuted by the facts, when it became evident that the lowering of interest rates was not due to plenteousness of capital goods but it was rather an artificial decrease caused by the banks and the government. This explains not only the recent crisis but the recurrence of crises in general which, at the final analysis, are produced by the recurrent monetary and credit policies of the government or the banking system.

When the credit expansion can no longer work because the recession is rather deep, we are informed that the eurozone is about to decrease interest rates to 1% (as of December 2011). The eurozone might as well proceed to increasing the money supply or the banking sector could proceed with credit expansion. The only reason these authorities do not do so is because the recent crisis is still very new and its lessons cannot be forgotten so easily. So they adopt the alternative, a decrease of interest rates which, according to standard analyses, will boost the economy, yield some inflationary pressures that can be minimized using fiscal measures etc.

The current depression is a correction of the mistakes of the boom of the period 2000-2008, whose cause was the previous credit expansion. By lowering the interest rates and creating another artificial credit expansion, the mistakes will only be corrected half-way through, and new investment mistakes will take place. What is fundamental to understand is that credit markets and investment markers must be left free to achieve a new equilibrium for the EMU as a whole. Otherwise, the systematic intervention of the ECB and its "guidance" of the commercial banks will produce a temporary recovery that will be followed, almost surely, by another slump. Any correction of mistakes, involves some annihilation of investments and jobs, and other resources. If credit was not made artificially cheap, such mistakes would not occur in the first place. By insisting *now* on *cheaper* credit, the Eurozone and the ECB are bound to make the state of affairs even worse.

The chaos that the Eurozone and the ECB face, is a dual image of the disequilibria in capital, money, credit and product markets. *The interaction of these disequilibria is disastrous*. The chaos reveals itself in a rather blatant way in terms of the explosion of public debt in nearly all countries of the Eurozone –despite the fact that this more apparent in Greece, Spain, Portugal, Ireland and Italy. Germany and France do not face lesser problems. If borrowing for international credit markets is possible only at high interest rates, producing the rising spreads, why should domestic borrowing become *cheaper*?

Of course, one can blame the "speculators" that "attack" the euro through its "weak links" like Greece, but the fact remains that no speculation would be possible if European central banks and monetary authorities could agree on how to handle collectively their debts and of course, if European productivity was expected to raise in the near future. Stable currency without stable productive conditions is unheard of in the past and it will be so in the present and future.

3. The role of ECB and the Commercial Banks

The mode of operation of the ECB rests upon the foundation of European commercial banks. If banks are allowed to fail because of their mistaken financial and investment decisions a domino effect would start that could threaten the entire system of commercial banking and thus the ECB itself. Apparently, there is no way a central bank would allow this. Therefore, the ECB's policy was and is, plain and simple, to rescue or bail out the banking system through: (i) Credit to governments in distress (Greece for example) which for the most part is used to pay interest and amortization to European banks that hold Greek bonds, and (ii) lower interest rates. The national bailout plans are for the most part bailout plans to rescue the profitability of European commercial banks. Since the bailout plans are not used explicitly to balance the budget, additional or "austerity measures" are necessary to improve the performance and, finally, ensure that public debt is sustainable.

A bailout program is primarily a program to rescue the profitability of commercial banks or what is known as "big players" in the terminology of Prychitko (2010). As he argued:

"Big players create big unintended consequences as they, too, act only under conditions of uncertainty and ignorance. The Greenspan Put (now evolved into the Bernanke Put) serves as a stark example. By announcing in the midst of the housing bubble that speculative investment banks could retain their extraordinarily high profits and count on the possibility of a loss-floor, those firms evolved into Big Players themselves. They placed higher bets as the discipline of profit and loss—especially loss in this case—was systematically weakened. The unintended consequences behind the Put—the moral hazard—became all too clear. Their waves of failure beginning in 2007 were a direct result of adjusting their speculative and Ponzi-financed plans in light of the monetary expansion and the promises made by the Greenspan Fed".

The public debt explosion was no different in that respect, and laid at the very foundation of the EMU. Not only the commercial banks themselves, the primary concern of the ECB, but governments running huge public deficits could safely count on a bailout. In fact, the bailout did not come in the explicit form they were probably expecting, because they are not "big players". The big players are only the commercial banks and the ECB that could lose from a possible bankruptcy of a country – member of the EMU. What is worse is that the European commercial banks continue to have no incentives to rationalize their investment portfolio since they can always rely on ECB's plans to secure "financial stability" in the eurozone. In fact, "financial stability" means that no commercial bank is allowed to fail and go bankrupt, like ordinary firms¹ so the banks can continue with their financing plans as usual, without due attention to the risk of investment that they finance. A policy of lower interest rates makes the situation even worse since, at the same level of risk as before, commercial banks can rely on higher *ex ante* margins. Apparently the

¹ Steele (2008), p.8.

commercial banks *must* have gotten wiser after the subprime crisis but the fact of the matter is that they have no real incentive to do so.

The flaws of the “textbook” approach of the EMU and the ECB, can be traced back to both the Keynesian and Monetary traditions in which the dominant role of “the” money supply and its effects upon “inflation” are greatly exaggerated. As Hayek emphasizes regarding Friedman’s approach:

“It’s chief defect in any situation seems to me to be that by its stress on the effects of changes in the quantity of money on the general level of prices it directs all-too exclusive attention to the harmful effects of inflation and deflation on the credit or debtor relationship, but disregards the even more important and harmful effects of the injections and withdrawals of amounts of money from circulation on the structure of relative prices and the consequent misallocation of resources and particularly the misdirection of investments which it causes” (Hayek, 1990, p. 80).

This misdirection of investments is, of course, the chief cause of anomalies in capital and investment markets which, in turn, adversely affects the credit markets and the access of firms to new capital in the stock markets. In essence, the financial turbulence is nothing but a predictable effect of interest rate or money supply policies on the markets –that is the global set of plans and expectations of economic agents.² This can be compared directly to the practice of price controls who are supposed to benefit the “general public” but in turn, they only create excess demand to be covered by other means, legal or not.

This interference with global resource allocation is totally foreign to the managers of the ECB or the Bureaucracy in EU, the EPC, and the EMU. Although it is convenient for these decision makers to think in terms of a single market of goods and services, and even a single market where money demand for the euro is well defined, in fact, this is absolutely flawed. In the context of global turbulence and disarray, the policy makers insist on thinking in terms of textbook models, without regard for the real processes of resource allocation in Europe. *In fact, the whole idea of economic policy in the Eurozone is surprisingly similar to the role of a planning authority in a socialist economy.* Since relative prices cannot be dictated to coordinate perfectly the global set of expectations and transactions, the whole task is flawed from the beginning. In particular:

“No authority can beforehand ascertain, and only the market can discover, the ‘optimal quantity of money’. It can be provided only by selling and buying at a fixed price the collection of commodities the aggregate price of which we wish to keep stable” (Hayek, 1990, p. 81).

Admittedly, this looks easier compared to the problem of socialist planning. After all, given a basket “*of commodities the aggregate price of which we wish to keep stable*”, monetary policy can accommodate this objective. In fact, the idea goes back to Fisher (who proposed an “index number” to peg the currency, and provoked

² For a lucid treatment, see Kirzner, 1979, pp. 146-151, also pp. 26-29.

the severe criticism of von Mises). The problem is solved once we allow for the miraculous “*collection of commodities*” to be part of the market’s learning process as well. But this, in turn, is nothing more and nothing less than freely – competing currencies not only in the context of the EMU but inside national borders as well. Of course, the market can always discover the “*optimal quantity of money*”, but the solution has to be optimal in a broader context than systems of national currencies, inside closed borders, without allowing for competition.

Apparently the value of “money”, like the value of any other commodity has to be determined eventually by the processes of the market. In that sense, the only reasonable recommendation for a sustainable and reasonable financial system is *market determination of currency zones or “optimal currency areas”*. This is to be discovered by the markets, and there is really nothing more we can say on that. As Kirzner put it, the function of the market is to facilitate learning about that which is not known as of yet (Kirzner, 1979, p. 138).³ The role of the market is to coordinate expectations about others’ plans, so as to facilitate learning about things that do not exist (as of yet) and to allow certain agents to capitalize, and thus make profits, during the process of coordination.

4. The Greek crisis in the data

It is instructive to look at some statistics for the Greek economy. The data in this section come from the Greek Statistical Authority (ELSTAT). The data is quarterly for the period 2000.I to 2011.III. In Figure 1 we plot the growth rates of the components of money supply for the entire period.

From 2004 onward, both M2 and credit expand on the average by 2.5% relative to the previous quarter. In the midst of the crisis (2008) the rates of expansion are still positive and only in the second quarter of 2009 M2 begins to decline. Despite this fact there is a huge credit expansion close to 17% in 2010 which amounts to 20% in terms of quarter – to – quarter changes. The average rate of growth of M2 and credit, quarter – to – quarter, is almost 10% for the period 2000 – 2009.

In Figure 2 we plot the rate of growth of industrial production (quarter – to – quarter) and the sum of growth rates in M2 and credit. Although the correlation is not perfect it is evident that monetary and credit changes are associated with episodes of growth in industrial production.

³ “Subjectivism suggests that things about which men are completely ignorant are things that, in the sense relevant to economic theory, *simply do not exist*”.

Figure 1. Growth rates of M2 and Credit

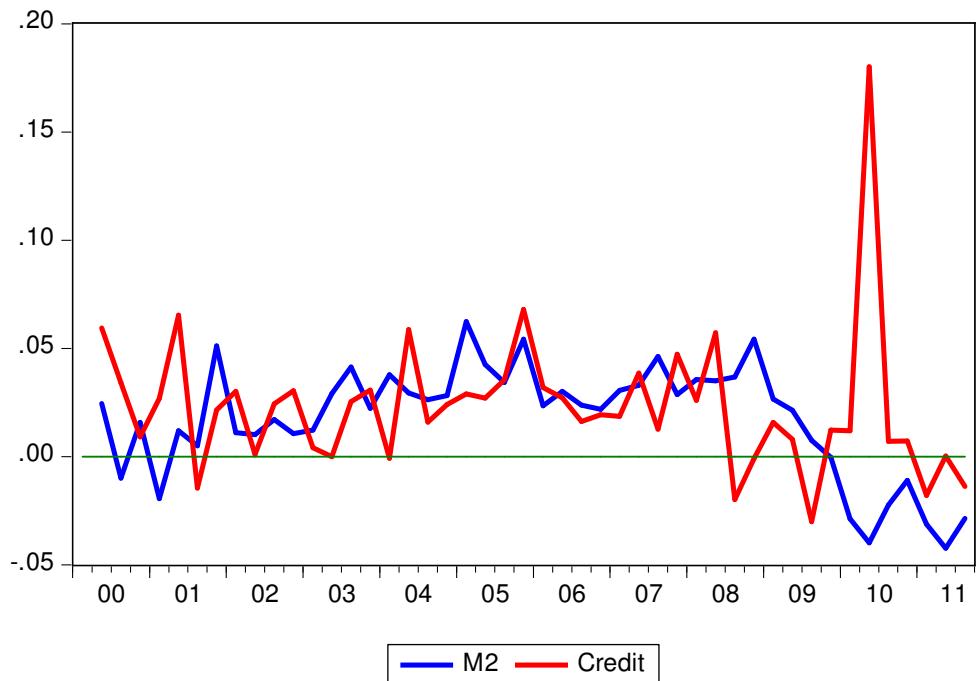
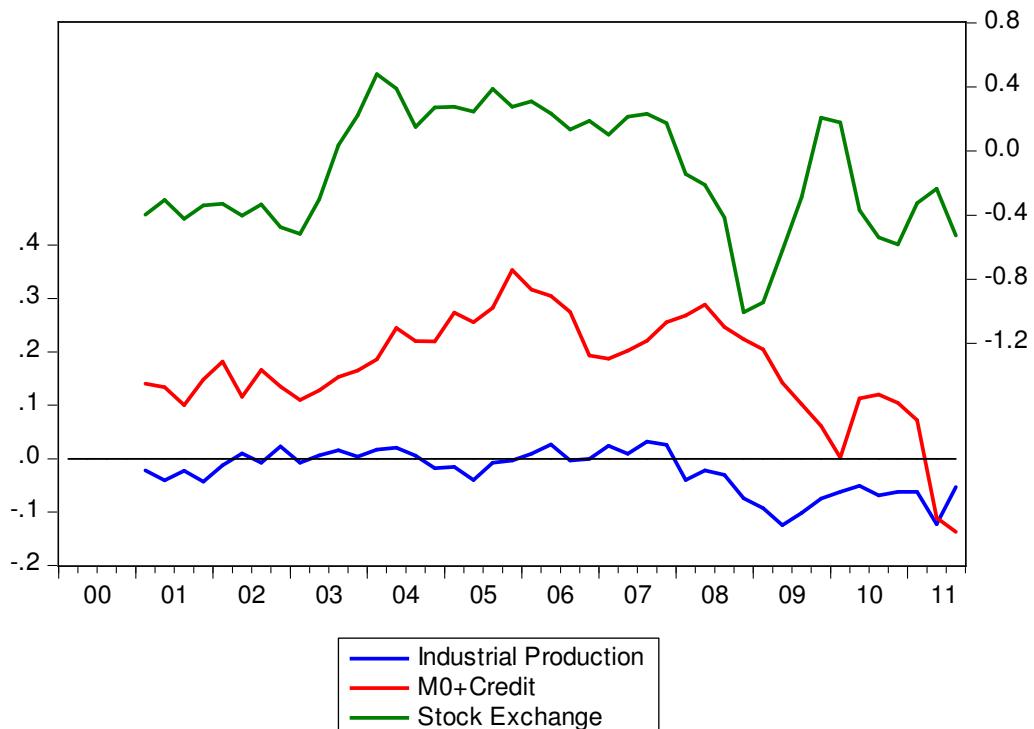


Figure 2. Growth rates of industrial production and M2+Credit



From the same Figure, it is also evident that the stock market (measured here by the FTSE ASE 20 index) began dropping in mid 2007 along with industrial production but the rate of monetary and credit expansion began to be negative only after mid 2010! *In the course of the subprime crisis, for almost two years, credit and money*

supply were increasing. Even in mid 2009 the rate of increase did not become negative and for the most part of 2009 and 2010 the expansion continued on a quarter – to – quarter basis. The stock market predicted accurately the crisis since the end of 2007, and correlates with the changes in money and credit conditions. To be fair we have to mention that M2+credit has a declining growth rate since the end of 2005. The disturbing fact is of course that the declining growth rates are still substantial and close to 30% in the second quarter of 2008.

Here is how von Mises argues about central interventions to bailout the banks:

“In any event, the practice of intervening for the benefit of banks, rendered insolvent by the crisis, and of the customers of these banks, has resulted in suspending the market forces which could serve to prevent a return of the expansion, in the form of a new boom, and the crisis which inevitably follows. If the banks emerge from the crisis unscathed, or only slightly weakened, what remains to restrain them from embarking once more on an attempt to reduce artificially the interest rate on loans and expand circulation credit? If the crisis were ruthlessly permitted to run its course, bringing about the destruction of enterprises which were unable to meet their obligations, then all entrepreneurs—not only banks but also other businessmen—would exhibit more caution in granting and using credit in the future. Instead, public opinion approves of giving assistance in the crisis. Then, no sooner is the worst over, than the banks are spurred onto a new expansion of circulation credit” (von Mises, 2006, p. 127).

Apparently the monetary and credit authorities of the EMU believe that the expansion of credit is the key to the problem of the recent depression. The lowering of interest rates is a policy action that comes in the worst possible time - in the middle of the depression. The depression itself is the outcome of the credit boom of the 2000s which distorted considerably all European and factor markets. It is exactly in a new artificial boom that the ECB and the Eurozone try to find out the solution of the problem. But the problem is entirely due to a credit expansion, in the first place. In the words of von Mises:

“The discrepancy between what the entrepreneurs do and what the unhampered market would have prescribed becomes evident in the crisis. The fact that each crisis, with its unpleasant consequences, is followed once more by a new “boom,” which must eventually expend itself as another crisis, is due only to the circumstances that the ideology which dominates all influential groups—political economists, politicians, statesmen, the press and the business world—not only sanctions, but also demands, the expansion of circulation credit” (von Mises, 2006, p. 128).

Apparently the banks should be wiser after the crisis and they should limit their credit by directing funds only to “relatively riskless” investment projects. But what constitutes a “relatively riskless” project cannot be decided by the bank alone. Otherwise, the banks would not have gotten into credit problems anyway. There is naturally a herding behavior on the part of the banks, in that they follow what other banks too, but the essence of the matter is that, profitable projects are decided by the

market and its condition. With distorted product and factor markets, many projects that look profitable *ax ante*, are likely to prove failures *ex post*.

It is true that, on paper, the EU has tried to pursue free or more open markets, remove barriers to entry (but not exit), and the European labor markets are severely regulated by the state and numerous interest groups. But even if all markets were free to perform their functions, an artificial decrease of the rate of interest would bring about a crisis. Not as severe as the current crisis but a depression, nevertheless. With markets heavily regulated at all levels, by EU law-making and national idiosyncrasies, another artificial expansion of credit or an artificial reduction in the interest rate, will be catastrophic. In a nutshell, the EU, and other has less confidence in markets than it does to its own interventions and law – making. *What is not being understood is that, the current severe crisis must be allowed to run its course, re-instate relative prices and interest rates at more reasonable values, and proceed from there onwards by allowing at the same time, free credit, factor and product markets.*

5. Productivity

Several of the policies of the Greek government are aimed supposedly towards improving competitiveness and productivity in the economy. The decision makers of the eurozone are of the same opinion, namely that productivity and competitiveness should improve through lower real wage rates, reduction of non – wage costs, opening up the markets *etc*. Such general prescriptions are not wrong, of course. However, the first critical issue is whether there is any room for improving Greece's productivity compared to the rest of the eurozone. The second critical issue concerns the expected effect from a reduction in real wages across the board. Although across the board real wage reduction are not possible, let us ignore it as a first approximation. Lower real costs of labor will provide an incentive for entrepreneurs⁴ to use less capitalistic or less round about techniques of production, if the reduction in real wages is expected to be persistent. As consumer's demand decreases due to lower investment, investment will be reduced even further and capital will become more "shallow"⁵. Since output falls in the consumer or final good sectors, employment will begin to decrease in both the investment and consumer good sectors. Prices of consumer goods and profits will fall, eventually, and real wages will rise again, adversely affecting the profitability of the less capitalistic investment projects. What is of concern to us is the final effect of this cumulative process during a recession. As Hayek wrote summarizing his analysis:

"...I see no reason why in the depression a reduction of money wages should not lead to a fall in real wages. And a reduction of real wages, by raising the rate of profit, will have the desired effect of preventing investments of a too capitalistic type" (Hayek, 1975, p. 63).

Therefore, at least partly, reductions in real wages will prevent some of the malinvestments that would otherwise take place in view of a long period of monetary and credit expansion and artificially low interest rates or help liquidate some of them. The reduction in real wages is of course *ceteris paribus*; in particular it is assumed

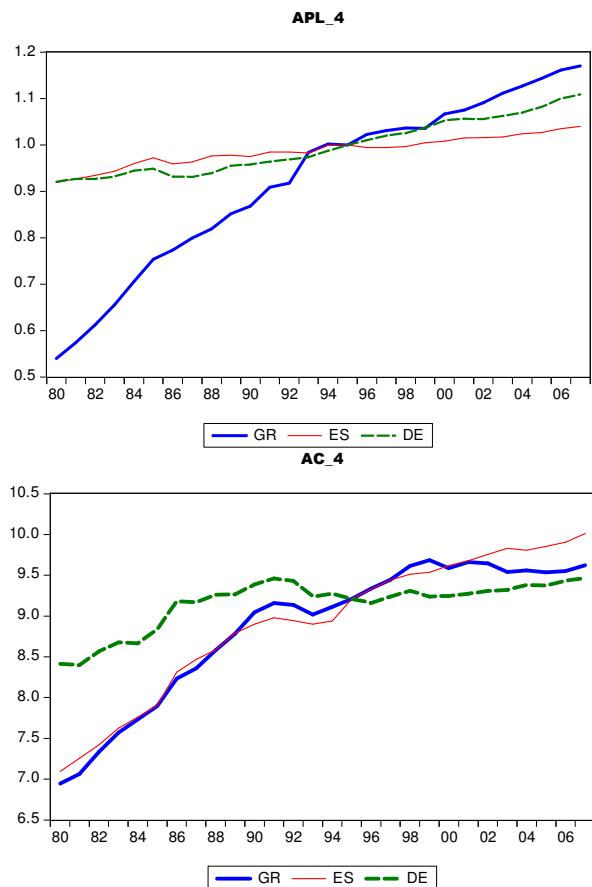
⁴ See Hayek (1975), pp. 38-42.

⁵ As opposed to capital deepening, see Hayek (1975), p. 40.

that monetary and credit expansion is stopped and the capital market is free to determine the rate of interest in equilibrium, close to the rate of profit. If the expansionist policies are followed instead, the time structure of production will be affected again towards more round about or capitalistic processes, setting the economy into a new cycle and canceling the effects from the reductions in real wages.

The first question, whether there is any room for improving Greece's productivity compared to the rest of the eurozone is more subtle. We have little choice but to look at the data without making strong assumptions about the technology. It seems worthwhile to investigate average costs across similar sectors in the eurozone for Greece, Spain and Germany. The source of the data is the EU KLEMS database (1980-2006). Although we have looked at all sectors available the results are qualitatively the same with manufacturing so we restrict attention to this sector⁶. In Figure 3, we present "average productivity of labor" defined in the familiar way as $APL=Y/L$. *The evidence is quite damaging to the idea that APL is much lower in Greece compared to Spain or Germany; in fact it has dramatically improved over the years and is currently higher. Average cost is less than Spain's and only slightly larger (but converging) compared to Germany's.*

Figure 3. Average productivity of labor and average cost in manufacturing



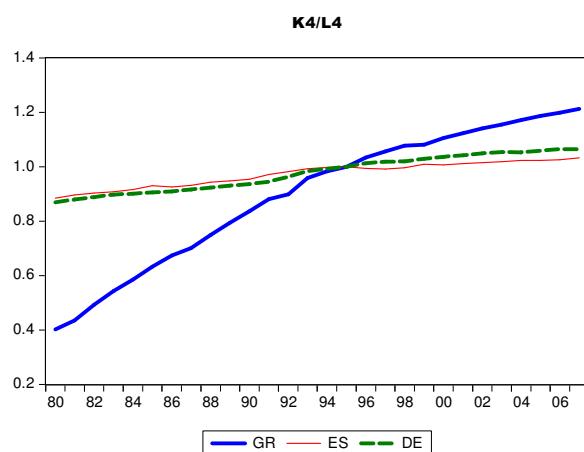
The explanation for the "apparent paradox" is that for a very long time credit / monetary expansion has been quite extensive. This distorted the comparative

⁶ The analysis is available on request.

advantages of the Greek economy and the time structure of production in favor of significantly capitalistic methods of production, that is methods of production that were artificially “deep” in terms of capital. However, for this explanation to have some promise it must be the case that a rough measure of “capital deepening” like the capital – labor ratio (K/L) increases over time and significantly more so compared to either Spain or Germany. From the evidence presented in Figure 4 we see, in fact, that: (i) During 1980-1994 the Greek capital – labor ratio converged quickly to the German and Spanish ratios and (ii) it was about 1.2 compared to 1.0 for the German and Spanish ratios in 2006. Since the capital – labor ratio is only a rough measure of capital deepening (if at all) it does show that distortions in the capital and money market were substantial enough to distort the time structure of production in favor of significantly capitalistic methods of production.

The distortion of the time structure of production resulted in “over – capitalization” in manufacturing but also for all other sectors of the economy as well. Since this structure does not correspond to the constellation of relative prices, consumer preferences and interest rates, profit rates have deteriorated, widespread unemployment is prevailing and prospects are dismal under the current time structure which, of course, does not correspond at all to a structure that would yield comparative advantages for Greece in the international markets. What are these comparative advantages and what constitutes an “optimal” time structure of production cannot be known in advance, but the two problems are two sides of the same coin. Comparative advantages have to be determined by the markets provided, first of all, that they are allowed to operate and clear so as to bring the configuration of relative prices closer to what would be a “dynamic equilibrium” outcome.

Figure 4. Capital – labor ratio in manufacturing



6. European Policies and the Greek Drama

The Greek drama was not played out of context; in fact it took place in the *wider context* of long – run Greek economic policies and the policies of the decision

makers of the eurozone⁷. The “capital deepening” of the Greek economy would have not been possible without extensive borrowing and accumulation of public debts in the 1980s and 1990s. That was a predetermined variable when Greece entered the eurozone or in the 2000s when credit and money continued to increase along with public debt, a sizeable public sector, inflexible markers, price rigidities, non – competitive conditions in almost all markets *etc.*

Despite all alarms, European commercial banks and the ECB accommodated Greece’s public debt creation through the purchase of government bonds. The public debt is approximately evenly split (50:50) between domestic and foreign debt so, to a large extent, the Bank of Greece and the ECB alike accommodated the creation of debt. This accommodation was nothing but money and credit expansion for practical purposes inside the eurozone. The question of whether the public debt explosion should have been unexpected has a clear answer: To the extent that Greece experienced tremendous monetary and credit expansion for a long period of time and even before the end of 2010; to the extent that public debt accommodation adds another component to this expansion; and to the extent that (as a result) profitability, employment and output have been destroyed, the explosion of public debt is nothing but a situation of hyperinflation. Not a hyperinflation at face value but a situation, a configuration of relative prices that has the same disastrous effects.

From the point of view of the Austrian theory the explosion of public debts is not really an outcome that calls for explanation. *In the context of the EMU, the explosion of public debt is really monetary and credit expansion* similar to a Ponzi scheme. This is by definition unsustainable because in a production structure that is falling apart (due to severe misallocations of resources and malinvestments) the public sector cannot collect the tax revenues required to balance the budget *and* repay interest plus amortization. Allowing a Ponzi scheme to run, for any finite period of time, by any member of a monetary union that is accommodating the debt, must come either from current or expected budget surpluses (which are nowhere to be found in the eurozone) or from fiat money creation; what in fact has happened, and is still happening, is the second⁸.

In this sense the “public debt problems” reduce to the ECB’s purposeful objective to maintain the stance of large commercial European banks –an objective that cannot be justified on any grounds. The European banks are precisely “*the happy few with good connections to the politico-monetary establishment*” (Hüllsmann, 2003) in this instance. The ECB and its tremendous credit expansions created a latent inflation problem in the eurozone. The subprime crisis propagated explosively the problems that resulted from such policies. Instead of reverting to stable money, the

⁷ Bagus (2010) provides the first coherent theory of the eurozone based on political considerations, see in particular chapter V, on “*Why Germany gave up the DeutschMark*”, especially pp. 56 – 58.

⁸ From the recent literature it turns out that a monetary union is recommended mainly to avoid inflationary pressures or biases (Barro and Gordon, 1983) or monetization of debts and accommodation of the financing needs of the national governments (Alessina and Barro, 2001). This involves two (related) assumptions: *First*, that the Central Bank is, somehow, better equipped than national governments, to accomplish these goals. *Second*, that a system of freely floating currencies is worse than a monetary union. Of course, the Central Bank of an economic union can solve the coordination of national policies only to the extent that the political and economic authorities of the Union can do so.,

ECB continues its “price stability” policies which are totally wrong in view of the malinvestments that have been created as the result of its past and current policies.

That the situation is similar to a hyperinflation or at least observationally equivalent to it, comes through when we consider possible remedies. In his analysis of the European hyperinflations following World War I, Sargent (1986) reached several important conclusions⁹. To summarize his main results let us consider the following citations. As Sargent argues:

“...the substantial changes in ways of formulating monetary and fiscal policy associated with the end of the four inflations studies here can themselves be considered to have been caused by the economic events preceding them” (Sargent, 1986, p. 107, footnote 27).

Arguably,

“...previous attempts to stabilize the exchanges in Hungary [...] and also in Germany, failed precisely because they did not change the rules of the game under which fiscal policy had to be conducted” (Sargent, 1986, p. 101).

Given the historical experience, the European debt crisis could have been resolved if (i) fiat money and inflationary finance was to be excluded and also if (ii) upcoming payments of matured debt could have been secured through tax revenues or

“an independent special fund to pay off outstanding government debt [...] a newly created agency independent of the treasury and with its own earmarked revenues...” (Sargent, 1986, p. 119).

Sargent refers to measures taken by the R. Poincare government in France (1926). Poincare took many additional measures like raising taxes to balance the budget, raise of indirect taxes and reduction of the highest income tax from 60% to 30%, increase of customs duties, increase of basic income taxes from 12% to 18% on income from land, from 7.2% to 12% on income from securities, and a once-for-all tax of 7% on the first sale of real estate or a business. The debt agency which was created to accommodate the public debt had

“...its own earmarked revenues from the tobacco monopoly, the total receipts from the inheritance and estate taxes, and the new 7 percent tax on the first sale of real estate and businesses” (Sargent, 1986, p. 119).

Some of the Poincare measures in 1926 are quite similar to the measures taken by the Greek government. The fundamental difference is that it is not clear that the Greek measures are oriented exclusively towards repayment of the outstanding public debt. In fact the bailout plan secures repayment of the outstanding public debt so the additional “austerity” measures seem out of place. Certainly, there cannot be a continuation of the bailout plan in the indefinite future. The purpose of any bailout plan is to help the economy in the short run, provided that the government can secure,

⁹ See also Sargent and Wallace (1973).

in the medium run, the necessary funds for pensions and salaries as well as interest payments of the debt. However, there is an additional conclusion that Sargent draws:

“The essential measures that ended hyperinflation in Germany, Austria, Hungary, and Poland were, first, the creation of an independent central bank that was legally committed to refuse the government’s demand for additional unsecured credit and, second, a simultaneous alteration in the fiscal policy regime” (Sargent, 1986, pp. 99-100).

Regarding the change in the fiscal policy regime, we have little to say beyond Sargent’s competent historical presentation. However, *Sargent places little emphasis (if at all) on the “creation of an independent central bank” that, after the hyperinflation, soon forgot its “legal commitment” and embarked on monetary and credit expansion.* This shows the value of “legal commitments” and the political interplay that can emerge from an “independent” Central Bank and the government. The “independent” Central Bank can do much to reduce hyperinflation indeed. When the problem is not inflation per se but rather the extensive misallocation of resources due to credit and money or debt expansion, then there is nothing to be done. When all practical and relevant sources of tax revenue have been exhausted the role of the Central Bank in “changing the rules of the game”¹⁰ or restoring price and financial stability is questionable. In fact it is precisely the possibility of credit and money expansion that motivates the creation of a Central Bank from a system of commercial central banks, in the first place.

“Even if legal reserve requirements remain the same, the centralizing of reserves into the hands of the Fed by itself permits a considerable inflation of money and credit.” (Rothbard, 1983, p. 105).

To expect that a central bank or the ECB, in particular, would set things straight by maintaining financial stability in the sense that investment equals savings, a first – year macroeconomics textbook conclusion– is, indeed, too much. It is simply not possible by the “rules of the game” in Sargent’s terms¹¹.

Another misconception is that a “*Eurobond*” would solve many of the current problems because the ECB would send a “strong message” to the “markets” –apparently that the ECB is determined to sustain the exchange rate of the euro. In fact, the “*Eurobond*” is practically here, in the sense that the ECB is willing to accommodate the poor public finances and exploding debts in the European South by extension of credit, loans and “haircuts” of public debt possibly to the “private sector” as well through the PSI plan. A “*Eurobond*” would be nothing else but an official statement that the ECB is willing to increase credit and money supply to the extent necessary to finance the fragmented and shallow production structures of the European South. That would be a “strong message” to the “markets” that inflation will go up in the eurozone along with deterioration of profitability, employment and output. What is required is a strong signal that the deteriorating production structures are beginning to recover *in order* to produce tax revenues and better performing public budgets. This signal cannot be an official statement but rather a policy aiming

¹⁰ See Zingales (2011) for a thorough analysis of the fundamentals of this “game”.

¹¹ See Rothbard (1984) for an excellent analysis of the argument that the central bank is, effectively, a cartelization device.

at more open investment and labor markets along with a commitment to let interest rates vary freely and a commitment to retraction in the credit and monetary fronts so that savings better reflect and determine investments: This is, in fact, the good advice that one should offer in favor stability of the commercial banking system in the eurozone.

Summary and Concluding Remarks

In a precise sense, the Greek economic drama was shown to be an almost ideal or almost textbook application of the Austrian theory. After long term, vast increases in credit and money, the production structure was heavily oriented towards capitalistic methods of production that are not sustainable given current savings or the constellation of interest rates and relative prices. As a result, employment, output and profits deteriorated along with the public sector's ability to collect tax revenues. The Austrian theory is found to be consistent with the data, and provides an almost perfect application of the ideas developed by von Hayek and von Mises.

The ECB's policy was and is, to rescue or bailout the banking system through: (i) Credit to governments in distress (Greece) which for the most part is used to pay interest and amortization to European banks that hold Greek bonds, and (ii) lower interest rates. This policy is bound to replicate in the future the problems of the past. Save for reductions in real wages, these measures are bound to result in further distortions of the time structure of production which hamper Greece's comparative advantages. Given the ECB's foundation upon the stability (survival) of European commercial banks it seeks highly unlikely that the ECB will adopt policy measures to liberalize capital markets and facilitate the liquidation of *malinvestments* that practically *determine* the current profile of the Greek economy.

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