EUROPE'S IMMINENT GREAT DEPRESSION

Does the current crisis mean the end of the age of liberty, asks **Antonio Martino**

We always live in the long run (John M. Keynes notwithstanding).

Current events are generally the (often unintended) consequence of decisions made several years ago, just like the European debt crisis is the result of a long run that began sometime in the past. Europe is entering a severe economic crisis largely due to the decision to create a common European currency, the euro.

The euro

I have been subject to virulent criticism and called all kinds of names because of my euro-scepticism and denunciation of the whole construct the way the single currency was introduced, and the shortcomings of the fiscal and monetary constitution of the Eurozone.

The most serious drawback of the euro is probably connected to the way it was introduced. At the time of deciding the exchange rate between the euro and the national currencies, the people in charge were convinced that it was merely a technical problem—to find the most appropriate rate at which to convert national currencies into the euro. The idea was to avoid fixing it too high or too low so as not to give excessive commercial advantage/disadvantage to any one country. That approach, however, shows a complete misunderstanding of the transition to the euro.

The notion that a group of experts could determine the purchasing power of this new fiduciary currency reminds me of the superstition denounced by F.A. Hayek:

> During the Middle Ages … the superstition arose that it was the act of government that conferred value upon the money. Although experience always proved otherwise, this doctrine of the *valor impositus* was largely taken over by legal doctrine and served to some extent as justification of the constant vain attempt of the prince to impose the same value on coins containing a smaller amount of the precious metal.[1]

The euro was introduced by coercion, and its purchasing power supposedly determined by a group of experts. The idea that one euro should purchase exactly as much as 1,936.27 lire at its introduction and forever is the most bizarre idea in the whole construct. It is similar to taking a piece of paper that has never been used as money before and determining its exact purchasing power at the moment of its introduction and for the rest of eternity. As printing banknotes does not cost much, hypothetically, it would be possible to print unlimited amounts of paper money to create enormous wealth and wipe out poverty once and for all.

But things do not work out in this manner in real life. The purchasing power of money is determined by a gradual process of discovery;

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it results unintentionally from the millions of decisions of buyers and sellers through time. Even assuming for a second that at the time of the euro's creation, one could guess its value to be in the neighbourhood of 2,000 lire, there was no reason to expect it would remain the same forever.

What happened was that the people who were asked to use the newly created fiat currency treated it like a foreign currency. Indeed, when we travel to a foreign country using a currency other than our own, we have a hard time figuring out the meaning of money prices and we regularly translate them into our own money. This is why stores catering to tourists are generally more expensive than those serving local customers.

This is what happened to the euro in Italy and in other countries as well: prices went up, while the euro's purchasing power reduced substantially because consumers did not know its 'real' value. Today, the euro is estimated to have a purchasing power of roughly 1,000 lire. This means the real value of all nominal assets has been cut in half. No wonder the first five years after the introduction of the euro were years of relative stagnation in the Eurozone. EU nations that had not adopted the new currency in general had higher growth rates and lower unemployment than those using the euro.

The situation worsened when the euro was rejected by international markets. The value of the euro declined from $1.18 on 4 January 1999 to 85 cents on 7 June 2001; this trend changed when the euro was gradually accepted by the markets and became stronger as a reserve currency versus the US dollar: On 20 September 2007, the euro crossed $1.40 for the first time. The initial depreciation of the European single currency made European products more competitive in the American market, but this did not completely offset the negative impact of the reduction in the internal purchasing power of the new currency. When the domestic adjustment was completed, the increase in the international value of the euro made European products less competitive and this prolonged the stagnation.

The monetary and fiscal constitution

The creators of the euro were well aware of the importance of the currency's stability, and correctly included a clause in the Stability and Growth Pact (SGP) that did not allow debt monetisation in the European Central Bank (ECB). The ECB was not allowed to purchase national governments' bonds because this money creation would weaken the rock that was the euro currency. To ensure there would be no temptation, the SGP set rigid criteria for national budgets to obey.

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This was an admirable set of rules but with no credible guarantee of enforcement. To show their eligibility to join the monetary union, most of the interested countries indulged in 'creative accounting' to 'fulfil' meeting the parameters when their real economic health was quite different (at the time of the introduction of the euro, only Luxembourg met all the criteria!). This dodgy accounting continued even after the creation of the euro, and is largely responsible for the financial problems of Greece and other countries.

It should have been obvious from the beginning that the threat of high fines to countries not meeting the standards was not credible: if a country runs a large and unsustainable deficit, it is hardly likely to find additional resources needed to pay the EU fine or reduce its deficit by imposing a supplementary expenditure. Had the expulsion from the monetary union been adopted as a punishment, countries would have followed tighter monetary and fiscal policies rather than risk such a drastic consequence.

As for the monetary constitution, the SGP correctly states that the ECB's main duty is to guarantee monetary stability. However, what happens if that goal is not met? The SGP is silent on this essential point, and does not even consider the problem of the ECB's accountability. Apparently, the ECB responds only to God for its behaviour!

Finally, the credibility of the European commitment to monetary stability has been destroyed by the recent decision to allow the ECB to buy, albeit indirectly, national government's bonds. Debt monetisation, the single most important cause of inflation, is no longer forbidden.[2]

Toward a catastrophe?

The possibility of a Greek default has frightened European policymakers. Chancellor Merkel, fearing that Germans may turn against the common currency in the belief that its survival would involve making them pay for the behaviour of other less responsible member countries, is insisting that members of the Eurozone subscribe to a 'fiscal compact' and commit to balancing their budgets by 2013.[3]

The German and the French are running scared mainly because their banks hold a large quantity of Greek debt. A Greek default would cripple the banking system of both countries. Yet, their concern over Greece's predicament is scarcely credible, as they imposed on the country the purchase of expensive weapons built in France and Germany, so that the Greek Defence spending has gone up by 20%.

Balanced budget

At low levels of public spending, a balanced budget is desirable because it forces politicians to consider the cost of alternative projects. Under a rule imposing an annually balanced budget, public spending decisions should be less irrational than otherwise.[4]

This, however, is not the case in Europe. In almost every Eurozone country, public spending has skyrocketed because of unbelievably generous welfare spending. Reducing total spending to manageable dimensions is almost impossible without a drastic reform of health, retirement and other mandatory spending items. In Italy, total public sector spending is more than 52% of gross domestic product. At that level of spending, it does not matter whether it is financed entirely or partially through taxation. The overriding priority should be the reduction of total spending by reforming welfare transfers. Instead, following the lead of Merkel, Eurozone countries have committed themselves to balancing the budget by 2013.

Should they pursue that goal by reforms and spending reductions, if successful, they would boost economic growth. But this, unfortunately, will not be the case. Almost every country is trying to increase revenue by raising existing tax rates or introducing new ones. An average tax burden of 52% will kill the Italian economy and all other countries involved in the project.

The market economy and its future

For believers in freedom, the last 30 years have been the most exciting in the entire history of mankind. Never before has the march of freedom seemed so irresistible. One dictatorship after another collapsed, the biggest and most brutal tyranny in the world, the 'evil empire,' disappeared, inflation rates reduced everywhere, international trade increased by leaps and bounds, stock markets boomed, regulations and controls reduced substantially, tax rates went down almost everywhere, and a number of countries adopted a flat tax. Arthur Seldon's predictions in 1980 that the Soviet Union would not last to the end of the twentieth century and that China would go capitalist, which at that time seemed like a far-fetched English witticism, proved to be accurate.

Here is a story that illustrates how much things have changed since the late 1970s. I used to start my course on Monetary Theory at the University of Rome by displaying a $20 bill and saying: 'This is conclusive evidence that your teacher is a criminal!' At that time, it was a criminal offence to possess foreign exchange in Italy. In 1980, I moved with my family to spend a sabbatical year in Washington. When we checked into the hotel, the young lady at the reception desk asked for my credit card. When I told her I did not have one because Italians were not permitted to have a credit card that was valid outside of the country, she talked to the manager and informed me that we could stay only if I paid a week in advance. I did so, using $100 bills. Maybe it was because we were Italian, those $100 bills, or the lack of a credit card … but we've never been treated as well as in that Washington hotel!

The gradual liberalisation of international capital movements that took place in the last two decades of the twentieth century was in effect a mechanism for policy competition, forcing governments all over the world to pursue monetary stability, fiscal prudence, low taxation, deregulation, and respect for human rights and liberties. Capital movements have profoundly contributed to changing the world and making policies more compatible with human freedom and economic progress.

The increase in liberty has made possible amazing progress in science and technology. Life expectancy has increased, new medical treatments have been discovered, and unimaginable progress in communication has taken place. In 1979, we did not have the mobile phone, the fax machine, or the personal computer—and three Ws did not mean anything. I very much doubt there has been a comparable 30-year period of progress in the past thousand years.

In the late 1970s, the United Kingdom was the sick man of Europe, prompting Samuel Brittan to write a paper titled 'How British Is the British Sickness?'[5] Then came Margaret Thatcher. In the United States, at the end of the 1970s, the economy was in a shambles: the 'misery index' (the sum of the inflation and unemployment rates) exceeded 20%. Then came Ronald Reagan.

The Reagan revolution inaugurated one of the longest expansions in the history of the United States, while the success of Thatcher's policies was so clear that no Labor government has tried to undo them since. We have followed these developments with excitement and enthusiasm: Capitalism did indeed work—economic liberty was a potent engine of economic, social, and scientific progress and an effective promoter of prosperity.

Understandably, believers in big government did not share our enthusiasm. For them, the developments of the last 30 years were not a source of joy. Increased freedom in international trade produced undeniable benefits for all countries involved, disproving the case for protection; freer capital movements imposed discipline on all governments of the world; and a reduction of tax rates promoted growth; all the arguments of believers in the free market seemed to be undeniably confirmed. This was a veritable nightmare for our enemies.

It is understandable then that they are enjoying the current crisis so much, arguing that it proves the enormous damage done to the world by 'unregulated capitalism,' the nefarious influence of Hayek, Friedman and the Chicago school. Innumerable newspaper articles and other publications point out the crimes committed by greedy capitalists with the blessing of free-market economists, philosophers, and other 'reactionary' scholars. Keynes has been reinvented, Mussolini's corporate state is enjoying a revival of popularity, and, sooner or later, Karl Marx will be resurrected.

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But unreconstructed Keynesians and orphans of Stalin have not been the only ones to draw the wrong conclusions from the crisis. Even the supposedly reasonable social democrats have joined the chorus of the 'capitalism is dead' crowd. As the former European commissioner for economic and monetary affairs, Joaquin Almunia, wrote for the *Wall Street Journal*:

> While fixing the abundant short-term problems remains the priority, we should not lose sight of the need to lay the foundations for sounder and more responsible global financial and governance systems. If one thing is certain at this stage, it is that what remained of the Thatcher and Reagan ideological heritage—the aversion to any attempt to correct the undesirable effects of the 'laissez faire, laissez-aller' approach—has collapsed.

I suspect that Almunia's certainty will meet the same fate as the Marxist prediction of the imminent collapse of capitalism, which has failed to materialise in more than 150 years. But while I am optimistic about the future of the market,

I am also frightened by the probable long-term consequences of the policy actions being taken all over the world to fight the recession. Almost everywhere these have comprised increases in government spending, nationalisations, and other less traditional forms of expansion in the size of government.

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The nature of the problem

At stake is the contrast between what is in the general long-run interest and the politicians' interest in their limited time horizon.

The market is a resilient institution but will it survive this additional burden? Today's increases in government spending will almost inevitably translate into tomorrow's increases in taxation. The trade-off between an immediate (albeit dubious and temporary) advantage and a secondary but long-lasting damage may appear beneficial only to politicians for whom, to use Harold Wilson's felicitous expression, 'A fortnight is a long time in politics.'

Politicians want the public to believe they are doing everything possible to stem the recession; every other consideration is irrelevant. Tomorrow's problems in many cases will be somebody else's concern; what matters is the present and the immediate future. As Roland Vaubel states in a paper:

> Politicians, like bank managers, are appointed for a limited period of time. Like managers, they have a short time horizon. Yet, they are not paid according to success, nor are they stakeholders, nor is there a political equivalent to bankruptcy.[6]

The most urgent task for liberal scholars is to devise a mechanism that can make it in the interest of politicians to care for the long-run, unintended consequences of policy decisions. But, as long as their perceived interest remains confined to the short run, individual liberty and economic prosperity will continue to be in danger.

Is the golden age of the market coming to an end? Are we returning to the prevalence of mercantilism, state ownership of industry, central planning, price and income policies, confiscatory taxation, monetary instability, and deficit spending? Maybe, but on that issue I can't help being optimistic. Throughout human history, but especially so in the last 30 years, economic liberty has provided ample and sure illustrations of its superiority over any other kind of social arrangement. No one, except in Burma and at Harvard University, today believes there are better alternatives to the free market. Only unadulterated folly can make humanity move in the wrong direction.The market, one of the greatest discoveries of the human race, is here to stay, despite the politicians' attempts to kill it.

Endnotes

1 'Denationalization of Money,' *Hobart Paper Special* 70 (London: Institute of Economic Affairs, 1976).

2 The ECB is currently lending to European banks at 1%, and banks use these funds to purchase government bonds yielding 3% or more. Debt monetisation not very cleverly concealed!

3 The fiscal compact has been accepted at a European summit in early March 2012, but it has to be ratified by national parliaments. Ireland has already announced that it will hold a popular referendum on the issue.

4 However, balanced budget rules often end up being disregarded. See Antonio Martino, *Constraining Inflationary Government* (The Heritage Foundation, 1982); Veronique de Rugy, 'The Never-Ending Budget Battle,' *Reason* (January 2012), 21–21.

5 Samuel Brittan, 'How British Is the British Sickness?' *Journal of Law & Economics* 21:2 (October 1978), 245–268.

6 Roland Vaubel, 'Lessons from the Financial Crisis: The International Dimension,' *Economic Affairs* 29:3 (September 2009), 22–26.