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A European Nightmare: How could it happen? And how could the Economists be so wrong on the Euro?

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Today is Remembrance Day – we are reminded not to forget the tragedies caused by the two European wars. The question is over and over again: How could it happen?[1]

The lecture today is also about Europe. An economic and social tragedy is unfolding in Europe; mainly in the so-called periphery of the euro-zone, but with repercussions for all the EU-countries – except Germany, where unemployment is lower than ever for more than 30 years. My focus point tonight will be on the role of the mainstream economists, who represent a clear majority among the advisors and the teaching staff at the faculty of economics all over Europe. How could they be so wrong in their judgments on the economic consequences of the euro, and not only of the euro, as I will demonstrate?

There is a certain irony related to this development within the European Union (for short the EU). Originally, it was set up back in 1957 to prevent future belligerencies between the major European nations. But, one consequence of the negative consequences of the euro is that the member-countries are becoming more antagonistic, there is an increasing risk of a renewed warfare, fortunately not fought with weapons; but in stead with money, debt and severe creditor conditionalities, which can have nearly as devastating consequences as warfare for ordinary people. The present days' generals – in Europe at least – are the bankers, the multinational

[1] The Sleepwalkers: How Europe Went to War in 1914, Christopher Clark, 2012

firms and the economists, which the elected politicians seemingly have difficulties to resist, domestically as well as at the European level.
So, my lecture will be more on economic ideas, than on numbers. And you will be surprised when you hear, how mainstream textbooks do analyse the current economic crisis.

The title of the lecture indicates, that we have two questions in front of us to be answered to night. ….. They are interrelated.

In some way Europe has been sleepwalking into a ***nightmare***, because no one intended it to happen and only a few saw it coming, but even worse, no one knows today, when the nightmare is over. If governments and Bruxelles go on listening to the present days' generals, there is a looming risk that the underperforming of the European economies will drag on into an uncertain future – similarities to the depression of the 1930s are striking. Do not forget – unemployment in Europe as a whole is at a peak for the entire after-war period. SLIDE 1

Therefore, we have to look at the mindset of the present days' generals, the mainstream economists. How could it be that they recommended governments to liberalize capital markets in the 1990s? and endorsed the setting up a monetary union consisting of so apparently different countries? They should have known better by taking advantage of previous historical mistakes among many, one could point at the Gold Standard lasting only from 1925-31 (which in its structures were quite similar to the EMU) and the Wall Street Crash, 1929, (with many similarities to the 2008 Lehman Brothers collapse and aftermath) – history tells us, that inadequate monetary and financial arrangements often cause unintended consequences of rising unemployment which can develop into political (and economic) nationalism. Why did the economists step back from telling about the past experiences?[2]

[2] Of course, I do not claim that history repeat itself; but on the other hand there are not reason to duplicate previous mistakes.

Anyway, I have to be cautious when I use the term ‘Economists’ unconditioned. Because, economists are not just one homogenous group. If anywhere we should be aware of that here in Cambridge, where economists are famous for having an independent mind. I will be back on the distinct Cambridge Tradition in economics; but just give you a few names: Maynard Keynes, Joan Robinson and the late Frank Hahn, who was a fellow of this college. Keynes is, in fact, known for having more than one opinion, and for good reasons, because economics is not an exact science – it is a human, or – to use Keynes’s expression – a moral science. Perhaps I should have said *was* a human science, because, I have my doubts with regard to the present day’s generals, because they think of economics as an exact and indisputable science when they deploy their mathematical models.

Some characteristics of Mainstream Economics

In any case, when we turn our attention to the Continental economists they seem to be more single-minded. Here, economists close to governments or to Bruxelles share to a larger extent a common mind-set – the neoclassical way of thinking, which in Germany is called Ordo-liberalismus. Probably you know, that ‘Ordo’ is an abbreviation for ‘Ordnung’ – in the sense that the market economic system is assumed to work the best, when it is controlled by competition, and government work the best, when it is required by law to balance the public budget.[3]

The fundamental assumption undertaken by these mainstream economists is that a ***private*** and competitive market system can always equilibrate demand and supply, if prices and wages are made fully flexible. Off course, the easiest example to explain what they have in mind is using the strawberry market as a metaphor. We all know from personal experience, that at the end of the day the seller is prepared to accept any low price - just to be sure that his desk is cleared with no unsold

[3] In UK and US this way of thinking economics comes close to monetarism

strawberries left, which have no value next day. The price is considered as the effective clearing mechanism by mainstream economies. So, if all markets were organized this way and had a size of a local market place, where sellers and buyers easily can overlook the trading, then a generalized strawberry model might work well. But when it comes to the economy as a whole the relevance of using the strawberry market analogy seems to vanish. But the macroeconomic model of most mainstream economists does look like an expanded strawberry model with hundreds of clearing markets, where demand equals supply, and prices and wage level is made fully flexible. For instance, in any mainstream textbook on macroeconomics you will find the labour market presented as though it could be analysed like such a strawberry market – wage flexibility secure that the market will clear. Therefore, mainstream economists give one and only one answer to the question, of how to reduce unemployment: lower wages. You hear this advice over and over again, and the logic seems crystal clear: when the price of a good falls, it is more easy to sell it, that we know from the strawberry market.

Unfortunately for the mainstream economists and for those who follow their advices, it could be recognized that a labour market is nothing like a strawberry market – for many reasons.

Let me explain one of them which is *the fallacy of composition:* That the sum of microeconomic experiences do not necessarily add up to the macroeconomic outcome – i.e. the economy considered as a whole.

Let us take an often debated example: What happens in the economy as a whole, when wages are reduced? Wage-earners loose purchasing power – so they buy less good than previously. If, for instance, a 10 percent wage cut is undertaken by all wage earners fewer goods will be sold and production will fall accordingly and so will employment. Even in an extreme case, where all prices also fell by 10 percent – then we have unchanged purchasing power and nothing is expected to happen! But many prices, for instance house rents, instalments on loans, and import goods are fixed. Hence, lower wage means reduced demand and production. This is one of the explanations behind the deep recession which Europe is going through these days, and recommended by the modern ‘generals’ of economic warfare. Often it is at this point argued that lower production cost would improve the country’s international competitiveness – and by that increase export, which might be correct for a single country, but not for Europe as a whole. I will be back on this European *fallacy of composition*.

Let us look at one more dominating mainstream **Conclusions (2),** which says that austerity policy is necessary in the present situation, and such policy is a **pre**condition for re-establishing economic growth in this assumed self-adjusting private sector. The budget deficit is considered as an impediment on the private sectors ability to start growing, because it hampers the adjustment process by reducing the competitive pressure on wages. Hence, the mainstream economists advice is, that a credible economic policy has to correct the existing budget deficits by austerity measures. An expansionary policy would in that case only at the best prolong the period with high unemployment, but more like make the situation even worse. This conclusion is derived from, what I have called the mainstream ‘strawberry model’, where a perfect and self-adjusting market system is the underlying assumption, which will be obstructed by any expansionary policy.

Therefore, in this strawberry model the best policy is – you guess - no policy, and a budget deficit, perhaps inherited from a former more casual government, has to be reduced by any responsible government – seemingly that the private sector will start to grow sooner rather than later. The finest hour of this mainstream way of thinking was back in 1995, when the American economist Robert Lucas was awarded the Nobel prize for having discovered – you guess - ‘*policy* ***in****effectiveness’* within this type of economic models. And as late as in 2004 Robert Lucas proclaimed that"central problem of depression-prevention [has] been solved, for all practical purposes". and Keynes's *General Theory* should only be read by political scientists if at all.

This brings me to the European question, why mainstream economists in general could be so wrong on the economic consequences of the Euro**.** The majority concluded that the European Monetary Union would enhance the growth potentials of the private sector by increasing competition, lower transaction costs, remove exchange rate uncertainties and lower rates of interest. These positive outcomes should be institutionalized by the creation of a **politically** independent European Central Bank. It was explicitly mentioned in the Maastricht Treaty, that the board of the European Central Bank was not allowed to take any counselling from the European politicians, and decisions taken by the ECB should only be directed towards price stability. Furthermore, the European so-called **Stability Pact**, which is a part of the EMU set-up, was deliberately intended to prevent the national politicians undertaking expansionary fiscal policy – recall the conclusion concerning policy ineffectiveness. Furthermore, the EU-commission was entitled to fine governments, which run excessive deficits, i.e. more than 3 percent of GDP.

This way of thinking on **macro**economics and economic policy is mainstream in Europe. It dominates textbooks; it is expressed as the correct opinion by most media, bankers, bureaucrats and governments, often independently of the political inclination – being right or left, because Economics has got a status as an objective science, which cannot be disputed – like astronomy. Policy conclusions are presented as scientific facts: that the economic crises can be overcome by more wage-flexibility to reduce unemployment, by austerity policy to balance the public budget and by a fiscal union in Europe with strict rules to save the euro. More market, less politics - listen to the economists, because they know!

So, here we are.

II. Reality challenges 'Mainstream'

Previously, the academic critique of this mainstream way of thinking on economic policy was dismissed straight away - considered to be grounded either in political ideology, in anti-European sentiments or most likely in both.

But, the present crisis has challenged mainstream conclusions – at least to some extent. This challenge has not yet made an impress on the textbooks, but for sure on the media – take for instance, Martin Wolf in the Financial Times or Paul Krugman in NY-Times, once a week they have a comment where conventional wisdom is challenged always with reference to reality.

Hence, in this second part of my lecture I will demonstrate that reality does not real support or correspond to the mainstream economists' arguments, because:

1. **The private sector is not self-adjusting** – The market system does not work like one big strawberry market at the macro level. Too much savings hampers the demand for goods and service. Further, the private(!) banking sector is in a mess, causing financial turmoil, which has a damaging effect on providing the credit, which is so much needed for business planning to undertake real capital investment. On top of this households and firms are forced to pay back parts of their previous loans. These disruptions have increased the imbalance in the private sector. There is a massive financial excess savings, which is laid idle, because firms dare not undertake real investments. – **see slides 2 and 3**.

   Here, one lasting and useful lesson could be learned from Keynes's *General Theory* about the damaging effects of financial excess savings. This mismatch consists of households on the one side who save in financial assets to reduce uncertainty with regard to future events, and of private firms to the other which dare not undertake real investment due to uncertainty about what households will buy in the future. A vicious cycle inherent in the private sector easily develops, which may be enforced by falling wages and prices causing further uncertainty. Hence, an increase in excess savings in the private sector is destabilizing and causes production to fall and unemployment to rise .

2. **Let us turn to reality and a public deficit.** A persistent private sector surplus of financial savings (not transferred into real capital investments) has to have a deficit counterpart somewhere (else) – this is an undeniable bookkeeping relation. In a modern welfare society this deficit is, fortunately, partly generated automatically through increased social spending (unemployment benefit) and reduced tax payments. Hence, in that case an increased public sector deficit is *not a cause, but a consequence* of the private sector mal-adjustment. Therefore, the right remedy to reduce a public sector deficit cannot be *austerity policies*, which will increase unemployment even more - domestically and abroad. There are significant spill-over effects in Europe via the balance of payments, so *austerity* in one country has a spreading effect. Once again we could benefit from the writings of Maynard Keynes – where he made the logical – not political – conclusion that government should '*Look after unemployment, and the budget will look after itself*. This he said back in 1933 as support to the newly elected American president Franklin D. Roosevelt as a support to his fight with the economists at his time about the 'New Deal' policy.
3. **Increasing unemployment.** For these reasons (lower wages, financial sector turmoil and austerity policies) unemployment has never been higher in Europe than today. 26 mill. people – more than 12 percent - the highest number, ever and still at an upward trend. (SLIDE 4) - But even worse, this high number is very unevenly distributed among the European countries. The **extreme** numbers are concentrated within the Monetary Union. If any economist five years ago had claimed that unemployment rates could come anything near the present level of 25 pct. in Spain and Greece, he/she would not have been taken seriously. And even less, if he/she at the same time had claimed, that one

would find the lowest unemployment rates in Europe within the euro-zone too: Austria, Netherlands and especially Germany have today unemployment rates around 5 percent, which is low; perhaps not in a longer historical comparison where you include 1960s, but it has not been as low in Germany for more than 30 years. **SLIDE 5.**

What the different is numbers of unemployment tell us, is that within a monetary union there are **gainers and losers**, so the monetary union cannot be to the benefit of all participating countries. Who become the **losers**? One can see that it is employees and firms in industries, in regions and in some cases in an entire country where production costs have risen too quickly, which are most likely to loose out. The mainstream economists had assumed much too strong competition and flexibility when they concluded that a single European market would prevent cost levels in the different regions and industries to drift apart. But they were wrong **(SLIDE 6),** for at least three reasons**:**

a. Reality tells quite another story, as you can see,
b. In addition there is a theoretical defect in the argument, because all countries cannot be net-exporters at the very same time. Any economist should know that a balance of payments surplus of one country has with mathematical certainty to be match by a deficit of equal size in one or more other countries, and that the **negative effect** in the deficit country(ies) is of equal size, euro for euro. This is a so-called zero-sum game. Hence, the negative consequences of the German b-o-p surplus we find mainly in the Southern periphery[4]. **Slide 7** Economists who

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[4] The American Treasury accused quite recently Germany of being an obstacle to the smooth working of the Euro-zone and by that of the world economy.
The German respond came prompt, '*The current account surplus is no cause for concern, neither for Germany (*surprise)*, nor for the eurozone, or the global economy* – to the contrary said a spokesman for the German government*, the country contributes significantly to global growth through exports and imports of components for finished products'*[4]
'This reaction is as predictable as it is wrong' commented Martin Wolf in the Financial Times, 6.11.2013

claim that all EMU-countries should just do like Germany are making a European *fallacy of composition*; because they cannot – someone has to be a net-importer, which happens to be countries with the weakest international competitiveness.

c. When a country gives up its own currency and by that its own exchange rate, it becomes extremely dependent on the development in costs within the other member-countries. So, if you join a club a heavy-weights and you are only a medium weight yourself, you are doomed to loose **each** match. So, most countries joining the monetary union with Germany would knew that they quite quickly get a competition problem, because Germany is world champion in industrial productivity. Here, we have the European heavy-weight – you can't beat the Germans. Hence, Germany shortly after the creation of the EMU established herself right in the power-centre of the European Union with an unmatched and unmatchable balance of payments surplus. (**Slide 8)**.

4. An unchanged domestic German policy means increased economic power and hereby more political dominance on Europe – a German Europe is looming in the horizon – what does it mean and what to do? Angela Merkel and her lieutenants claim, we see 'no problem, you should just do like us. Make order in your own house!' But as we now know this can only happen, if Germany will accept a balance of payments deficit for a substantial period of time. That could make the euro-zone to survive. If Germany only would realized how much she has benefitted from the euro-zone through increased export due to a strongly underrated cost level thanks to the shared exchange rate which the weaker counties make undervalued. If Germany would use just a little of its accumulated foreign wealth to practice some monetary solidarity with the losers, there would be a much higher chance of saving the euro. But until now,

the conditions related to loans provided to Greece, Portugal and Ireland has not cost Merkel one euro – to the contrary she gets a higher rate of interest on these emergency loans than she pays when selling German bonds. This narrow-mindedness also explains the German resistance towards the idea of EuroBonds with a shared responsibility of all euro-countries. But until now the German chancellor has been merciless in her request - inspired by the ordo-liberal and mainstream economists - that public debts and deficits have to be reduced. 'Ordnung muss sein' – you cannot spend more than you earn', says die hausfrau Merkel.[5]

Concluding remarks: The European future is uncertain

So the reason for this European nightmare can be placed at least partly on misunderstood economics and misguided politics. But what to do, because these mainstream economists – the present days' generals - dominate the advisory boards on economic policy all over Europe. The Economic consequence is that living conditions for ordinary people are just getting worse. Some mainstreamers have hesitantly admitted that maybe the euro was premature; but now we have got the euro, it cannot be dismantled, they argue, due to even higher cost. So, the euro should be saved by all means. That is concluded undertaken without much theoretical or empirical backing, mainly due to lack of what the consequences of a dissolution might be. The cost of uncertainty seems to be judged quite high, without having knowledge whether the salvation of the euro will be successful. History should not make one an optimist.

Hence, my recommendation is somewhat different, 1. look at reality what do we know and 2. take the best and lasting elements from the well known Cambridge Tradition in macroeconomics. It has, in fact, a reasonable good record

[5] Within this political and economic thinking the public sector debt is a problem by itself and a burden on future generations (sic!) – if anything it is a burden on the many unemployed right now! And it makes absolutely no impress to say, that the Public Debt in the mid-1970s was at its lowest for 100 years; and it started to grow when oversaving in the private sector caused unemployment to rise.

from the middle of the 1930s until the early 1970s. Off course, one should learn from previous mistakes and adjust this Tradition to the present situation, but similarities to the past are striking, how the Gold Standard with free capital movements, lead to the Wall Street crash, followed by austerity policies - causing unbearable high unemployment and political turmoil in Europe.

Anyhow, believe it or not, I am like Keynes an optimist, and let his words be mine, said when he retired from being editor of the *Economic Journal* back in 1945 – just after the war: '*economists are the trustees - not of civilisation – but of the possibilities of civilisation'*

Thank you.

Litteratur:

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