MAKROSKOP Magazin für Wirtschaftspolitik

Why did the Greeks live beyond their means? The trap of monetarism

Von Friederike Spiecker | 14.03.2015

This is the (updated) translation of an article that was published February 27, 2015 on flassbeck-economics. We intend to publish one article in English every week to allow more readers to follow closely our analysis of global and European events.

"No one forced the Greeks to live beyond their means for years."

If this statement were true, the following reasoning would hold: "If the Greeks had lived beyond their means voluntarily, they would have brought the debt burden of their country on themselves. If foreign debts were Greece's main problem, the Greeks themselves were to be blamed for their countrie's plight. Then they would have to live below their means for a while, so that these imbalances could disappear. This process could be expected to be painful, but this is something that the Greeks would have to figure out for themselves. Therefore they cannot refuse to make the necessary changes. Debtors cannot be allowed to escape repaying their debts. And we cannot just give them new money, because then they would continue to live *beyond* their means and not *below* them."

A four months extension of the aid program for Greece has now been agreed. If the associated reforms and budgetary targets are not met (either because they are impossible to be met or because the Greek government does not want to meet them), the extension will turn out to be nothing more than a postponement, either of an explosion or of a new plea for another loan. Of course, the servicing of such a new loan (interest and principal) will not be any more probable than that of the loans granted to date. How should the EU decide in four months?

The answer to this question can be found in an examination of the claim made at the beginning of this text. Of course, no one forced the Greeks to take out loans and spend them on foreign goods rather than on domestic ones. But to most people in everyday life such a distinction is arbitrary and without real significance. Instead, before 2008 the Greeks were full of confidence. And why shouldn't they have been? Their economy was booming, income from labour was rising, unemployment was falling and the banks were willing to lend to consumers and investors. Debt will not be a problem if there is the reasonable anticipation that it can be paid back without problems. There was that

anticipation, because everything seemed to be going well. Aside from this, in a market economy, people purchase products on the basis of price and quality, not according to where these goods come from. Often enough, the origin of a product cannot even be determined by the one who buys it. Even if it can, the great majority of people will buy the product that has the best price to quality ratio. Purchases are not generally determined by patriotic sentiments or the desire to support local firms. Most people do not understand, do not foresee and cannot change that in the longer run her or his job can be jeopardised by buying more foreign than domestic products.

What I just said describes the simple, day to day, microeconomic logic of a market economy: no one needs to justify her or his 'voluntary' behaviour, the market works on the basis of consumer preferences. The same holds for workers, entrepreneurs, investors and even for bankers who provide loans. But why and how then did things go wrong in Greece and in other southern countries? Did economic policy-makers fail to implement the right macroeconomic policies?

Imagine a small child walking on the street. Would you let it walk wherever it wants to go? Or would you guide it and walk together with it? If you have children, you will probably spend some years carefully explaining traffic rules to them. Only when you are sure that they know and understand these rules and that they will comply with them, you will let your children out on the street. Of course, you will say, this is evident for children, but what has this to do with macroeconomics and with Greece's problems? After all, 'the Greeks' are not little children. That is true. My point is that in order to eliminate road accidents, it is necessary, first, to have reasonable traffic rules. Second, it is necessary that everyone knows them and, third, it is necessary that everyone complies with them.

The European Monetary Union (EMU) has failed on these three conditions from the very start. The most important traffic rule for the monetary union is that all member countries have to comply with the common inflation target. According to the Treaty of Maastricht, the inflation rate of a country that wants to join the EMU must not exceed the inflation rate of the three Member States with the most stable price levels by more than 1.5 percentage points. This is one of four conditions for entry. However, once the country joined the EMU, its inflation rate is suddenly no longer important. At the moment a country becomes a member, all that counts are levels of public borrowing and government debt. Why is this so?

Any country where prices of domestic products rise faster than prices of products from its major trading counterparts loses out on competitiveness. It cannot recover through depreciation, because it has no longer a currency of its own. But loosing competitiveness means automatically accumulating foreign debts through international trade. Why was this not foreseen by the architects of the EMU? Why was compliance with the Maastricht criterion on price stabilitiy not made into a *continuous* condition for the member states even *after* joining the monetary union?

The simple answer is that the architects of the euro area failed because monetarism is all they ever believed in and it is what they believe in to this very day. According to monetarist doctrine, the central bank only has to guard the overall rate of inflation, which is manipulated by the 'money supply' (whatever that is). As the system currently works, member countries abdicate their national responsibility towards domestic price stability as soon as they enter the EMU. There is no longer

anything that they can do anyway, as they hand over the authority of their national central bank and with it, of course, their monetary policy, to the European Central Bank.

Those who were behind the EMU construction have never thought of the relation between unit labour costs and inflation. The golden wage rule, although essential, was barely discussed. *As a consequence, neither was there a discussion about the responsibility of national wage policies or, specifically and most importantly, national collective bargaining and their wider macroeconomic consequences within the EMU*. In Germany, the governments disrupted the collective process of wage bargaining by putting enormous pressure on the unions and by implementing far reaching reforms, such as increased 'labour market flexibility'. After the implementation of Agenda 2010, and without a minimum wage, competition on the labour market degenerated into a merciless fight of every worker for himself. This evolution was (and is being) applauded by neoliberals, who see wage cuts as the way to decrease the rate of unemployment. The result is a sprawling low-wage sector in Germany. Wage dumping can be found everywhere. There is stagnant domestic demand and export of unemployment. These are the vicious results of mercantilism and monetarism.

German politicians are very prudent in their efforts to avoid a discussion of European wage policies. This is because wage *policies* are pretty much the exact opposite of what we are having now, a race to the bottom – 'every worker for himself.' In order to take wage policies and social policies serious, one has to acknowledge that unfettered 'free markets' do not automatically produce desirable and sustainable macroeconomic outcomes for all and not even for a majority of citizens. As the system currently works, the country that puts most pressure on wages will reap the greatest gains. Domestic prices fall relative to countries where the 'law of the jungle' does not (yet) apply. Members of a currency union cannot protect themselves against wage dumping within the union through devaluation. The only possibility is to capitulate and introduce the 'law of the jungle' to their own country. Countries that are not following this logic automatically – *but not voluntarily*! – accumulate foreign debts. (This is the case even more, if they kick over the traces of the golden wage rule, i.e. the more they let nominal wages grow faster than the sum of productivity growth and the inflation rate set by the ECB.)

It is this, then, that no one in power in Europe ever explained to the Greeks or to any of the other members at the start of the monetary union. The wage rule states that wages should rise equal to the growth of productivity plus the inflation target. As *productivity levels* differ across countries, there are rich and less rich countries within the EU, i.e. countries with higher and lower *wage levels*. And as *productivity growth rates* differ, there are countries with higher *wage growth rates* and some with lower wage growth rates. This is not dysfunctional. The idea was not that Germany would undercut its trading partners by putting enormous pressures on wages. But given all of this, is it really the Greeks who are to blame for their foreign debt? Are they responsible for having violated an essential rule which was never explicitly stated, while others, such as Germany, violated the same rule and with much greater consequences, but in the other direction?

Why has it taken so long for the ECB to realise that competition on the basis of wages was explosive? Former ECB President Jean-Claude Trichet kept the rate of inflation under, but close to the ECB target for ten years (and was awarded the Charlemagne Prize in Aachen for this achievement). But he knew

very well that the inflation rate was *only the average of all the countries combined* and that some countries strongly deviated from the target. The ECB made a crucial mistake. When for each new year after 1999, contrary to what the ECB expected, the inflation rates of the member countries were increasingly diverging, although the ECB provided all the member countries with the same 'money supply,' it did not start doubting its deeply founded monetarism.

Instead, the ECB tried to argue away the disastrous consequences of the differences in inflation with an argument that is bizarre and incoherent. The ECB admittted that countries with higher levels of inflation lose out on competitiveness. They lose out on domestic demand for foreign suppliers. However, according to the ECB, this disadvantage in international trade would be offset by the domestic advantage of lower real interest rates. These differences in real interest rates promote domestic property and other investments. In short, the 'competition channel' and the 'interest rate channel' compensate for one another.

But the ECB made an error of basic economic logic. The actual problem is that the gap in price levels between EMU member countries persists when rates of inflation equalise, while real interest rate differentials disappear when rates of inflation equalise. In other words, competitiveness trumps interest rates, because competitiveness is permanent and real interest rate differences are not. This makes sense. After all, trading and consumption do not depend on the comparison of price changes, but on the comparison of prices themselves. No one buys a product because it became more expensive at a slower rate than before compared to a similar product from a competitor. People just buy the least expensive product (taking quality into account, of course).

All of this can be explained in less technical terms: real investment does not pay off if it is not used. Investments provide short-term demand, but in the medium and long term they are dependent on consumer demand so that their capacity can work. If domestic consumer demand is absent, because the products of foreign suppliers are cheaper, domestic investors benefit little, regardless of any real interest rate advantage. The considerations of the ECB regarding the 'competition channel' and the 'interest rate channel' have been proven wrong. Apparently, to uphold monetarism was more important to the leading staff than preventing the dangers of turmoil within the Union. Whatever it was, the ECB did not warn Greece and other member states of the looming danger. Instead, they let them walk into the trap of monetarism.

If the managerial and scientific staff of the ECB did not even understand these basic relationships, and if policy-makers still remain captive to failed theory and to the economic power-elites who thrive on it, how can it be expected that citizens of the EMU countries realise that the system will never function without wage regulations and social standards? Anyone who understands the background of the Euro crisis realises that the Euro zone is still in great danger. Saving the Euro zone requires a fundamental change of course in European policy and especially in German economic policy away from monetarism, fiscal austerity and mercantilism towards a coordinated European, non-deflationary wage policy and growth agenda. New loans for crisis countries such as Greece are certainly important in order to gain time while pushing for change, but they do not solve anything of themselves. Without real change, any effort will turn out to be in vain.

Transl. W. Denayer

Über den Autor

Friederike Spiecker ist Diplom-Volkswirtin und lernte das Handwerkszeug zur theoretischen und empirischen Makroökonomie am Deutschen Institut für Wirtschaftsforschung, Berlin. Heute arbeitet sie als freie Wirtschaftspublizistin und ist in der wirtschaftspolitischen Beratung von Parteien, Gewerkschaften und Verbänden tätig.

Veröffentlicht am: 14.03.2015
Erschienen unter:
https://makroskop.eu/2015/03/why-did-the-greeks-lived-beyond-their-means-the-trap-of-monetarism/