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# Greek Tragedy in European Theatre - the Economic Consequences of Depression Economics

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# Greek Tragedy in European Theatre; the Economic Consequences of Depression Economics<sup>1</sup>

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**Abstract:** In view of Keynes' intellectual heritage the essay highlights why one should expect that internal devaluation policies springing from classical orthodoxy, are futile and counterproductive in restoring economic activity. It highlights that Keynes's despair at the failure of the political and economic establishment of his own day to counter the Great Depression applies equally to current events. In summary, if private individuals or firms are unwilling to spend on new capital investment then it is essential the government does it for them. The central message of this essay is the vital necessity for the efforts to recovery to be well-orchestrated, well programmed by the strategic intervention of the government to increase economic activity.

Keywords, internal devaluation, Austerity, Keynes, European economy, Greek economy

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## Greek Tragedy in European Theatre; the Economic Consequences of Depression Economics

*'The liberty of a democracy is not safe if the people tolerated the growth of private power to a point where it becomes stronger than the democratic state itself. That in its essence is fascism: ownership of government by an individual, by a group, or any controlling power'*

Franklin D. Roosevelt "Message to Congress on Curbing Monopolies" April 29, 1938

### Prologue<sup>2</sup>: Capitalism and Neoclassical Economics

Robert Lucas, high priest of the neo classical/ neoliberal theory, has allegedly told his students at the University of Chicago that

*'we need to spend only ten minutes on Keynes; we know it does not work'.*

This is not an isolated opinion but the received wisdom religiously upheld in the neoclassical traditions that shape economic policy debate. For Lucas the only economic set-up that can deliver economic prosperity is that of the unhindered markets. Economists of my generation and after have become well trained in the 'wonders' of free market economics and its ability to bring prosperity. Keynes' views and analysis have largely vanished from economics classrooms, from economic discourse and economic policy debates.

Contrary to this belief in the power of markets to deliver prosperity, and as Figure 1 clearly highlights, the effect of unhindered markets on the fortunes and welfare of the people is by no means conducive to stability and prosperity. Figure 1 depicts the fluctuation of unemployment rates of four economies with different degrees of reliance on the efficiency of market mechanisms. This pattern is similar in most of the main western economies. Apart from a relatively short period between 1945 and the 1970s marked by active government intervention and regulated markets, capitalism exhibits a profound instability over time as both productive potential and associated employment levels fluctuate greatly. It is noteworthy that every dip in the business cycle is associated with heightened unemployment, despair and poverty for a large number of people. The size of the dip reflects the volume of despair. Although the high priests of neoclassical doctrine view this despair with abstract indifference, unemployment has both economic and human costs: costs in terms of lost output that could potentially be produced if people were productively

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<sup>2</sup> In ancient Greek Drama: A monologue or dialogue preceding the entry of the chorus, which presents the tragedy's topic

employed and the costs incurred as they end up to the dole. Unemployment costs the government lost tax receipts and falling employee contributions to pension funds but this is scarcely all the waste. There is a far greater loss to the unemployed themselves. First, the financial cost represented by the difference between the dole and their potential full wage and, second, the loss of psychological and physical health as well as the loss of morale.

Contrary to Lucas's 2003 assertion that the 'central problem of depression prevention has been solved',<sup>3</sup> when the economy collapsed in 2008 – 9 unrestricted free market policies did not deliver the expected outcomes. Almost ten years after the catastrophic events of 2008 western economies especially those of the European Union are in "long dragging conditions of semi-slump, or at least subnormal prosperity"<sup>4</sup> similar to that of the 1920s. Yet, the European political and economic establishment continues to pursue policies of austerity or policies for internal devaluation as the road to macroeconomic recovery for Europe as a whole and Greece in particular.

#### Austerity or Internal Devaluation: Definitions

Internal devaluation policies amount to reducing the prices and incomes of citizens of a country relative to other countries. The purpose is to change the real exchange rate in terms of commodities. In effect, internal devaluation reduces the ratio between the volume of the currency of a Eurozone country and its purchasing power in the form of money. This is said to increase the exchange value of the said Eurozone country in terms of commodities and relative to others. Thus the belief is that the individual country's goods become more competitive relative to other Eurozone countries and relative to other countries of the world.

The agenda of internal devaluation is deflationary. Even during a recession it takes the form of a programme of wage and income restraint, cutbacks in government expenditures and an expected fall in the government's deficit and debts. The proponents of such policies argue that economic pressure should generate a decline in money wages which in turn should reduce prices and the cost of living. At the end of the process, real wages are expected to be restored.

This policy agenda is not new. It is the foundation of classical economics. When during the Great Depression, A. C. Pigou, a Cambridge economist, was asked to explain to Britain's Macmillan Committee<sup>5</sup> why unemployment was so high his response echoed the strongly held beliefs that shape austerity economics today. This is how Pigou's response is recorded:

Chairman: Would you necessarily create vacancies ... by the reduction of wages?

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<sup>3</sup> Lucas R. E (2003) 'Macroeconomic Priorities', *American Economic Review*, 1-41, p 1

<sup>4</sup> Keynes J. M. 1931; *The Economic Analysis of Unemployment*

<sup>5</sup> Committee on Finance and Industry, *Minutes of Evidence* (London, H.M.S.O, 1931, II, p48)

Pigou: I think you would to some extent.

Chairman: If wages rates were reduced, you think there would be an increased demand for labour?

Pigou: Then, I think there would be an increased demand for labour.

In general Pigou held egalitarian views and was not a reactionary, but the belief that wage reductions even in a depression induce some industries to hire more was a strongly held view. It was the sound economic opinion of the day and it continues to be so today – at least for those versed in the wonders of ‘free market’ economics.

One may react to this proposition as Keynes did by advancing the view that if one producer cuts wages, then, as long as no other producer does the same, he or she should be expected to produce more and seize more of the available trade. However, if wages are cut all round, the purchasing power of the community as a whole would be reduced by the same amount as the reduction of labour costs. The consequence would be that no producer could expect increased demand for his products.

Keynes also pointed out that even if Pigou’s policy could be carried through and even if it finally succeeded, one could expect that it would cause extensive injustice in the process. Inequality would greatly increase as weaker groups and industries lose out in favour of stronger ones.

Keynes was convinced of the futility of these policies. His work was largely devoted to putting an end to the misleading ‘classical’ doctrine which held that a competitive market economy would always ensure full use of potential resources. In effect, Keynes rejected the existence of self-correcting market mechanisms capable of eliminating any excess supply of labour and other productive resources. Importantly, he did not argue that competitive market mechanisms do not work because of unwise government intervention, or because of private activities such as trade union power or the actions of industrial monopolies. Instead, he contested the misleading ‘classical’ orthodoxy in its belief that competition is always able to adjust prices of products and factors of production so as to eradicate excess supplies in product and labour markets. He did not argue that the process of adjustment brought about by internal devaluation might take a long time. Instead he argued that it would not work at all.

## Parode<sup>6</sup>: The Wonders of Neoclassical Economic Policies

In view of Keynes’ intellectual heritage this essay highlights why one should expect that policies, such as internal devaluation springing from classical orthodoxy, are futile and

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<sup>6</sup> In ancient Greek drama, especially in tragedy: the first choral ode by the chorus after its entrance. An ode is divided into strophe and antistrophe usually alternating with the epeisodion.

counterproductive in restoring economic activity. Before this it will be instructive to review briefly the current outcomes of the internal devaluation policy agenda in the EU and Greece almost a decade after the 2008 events.

## Epeisodion 1: The European Theatre

One could sum up the Eurozone's economic performance (the 13 pre-2007 EU countries) as, at best, unsatisfactory. Europe's GDP is roughly where it was in 2007. Its per capita income, adjusted for inflation, has fallen. Even Germany, the power house of Europe, has exhibited growth of just 6.8% since 2007, that is an anaemic 0.8% per annum. This is noticeably weaker than the rate of growth in Japan, a country still mired in an almost 20-year recession. Germany's weak economic performance came following the severe internal devaluation policies implemented at the dawn of 21st century. These included severe cuts in Germany's safety net, the stagnation of real wages and the transfer of income from the poor and middle-income classes to those on the higher rungs of the income distribution<sup>7</sup>.

Even though some Eurozone countries have seen a moderate increase in real wages since 2007, real wage growth in the EU is disappointing. Table 1 shows the total wage growth rates for 2007 to 2015 using the OECD calculated real wages<sup>8</sup>. For most countries real wages have not increased for almost a decade. Real wages have either stagnated or increased at most by 1% per year and in some countries, notably Greece, the UK and Portugal wages have declined significantly.

The neoclassical belief that downward flexibility of wages always generates employment gains is disproved by Table 1. In the UK, as Tily (2016) has observed, in spite of the large fall in real wages - the longest and steepest decline in real wages since at least 1830 - there are remarkably smallish employment gains (in terms of the employment rate) and the similarly large fall in real wages in Greece has delivered no employment gains at all.

Contrary to neoclassical theory the European countries, whose workers enjoyed the highest gains in real wages, are also among those with the highest employment gains.

In summary, throughout the EU real wage improvement is feeble and employment gains, if any, are weak at best. In addition this labour market performance is coupled with the severe deterioration of employment conditions and of workers' rights; worsening terms of collective agreements, increasing the casualisation of employment and leading to the rise of zero hours contracts throughout the EU and the Eurozone. These employment policies, known also as labour market "flexicurity" mainly involve a maximum of flexible labour with fast vanishing elements of labour market security.

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<sup>7</sup> see Stiglitz (2016) The Euro, p.14

<sup>8</sup> The OECD uses figures derived from national accounts information, dividing total wages by hours worked and put into real terms with the household consumption deflator.

In the face of such deteriorating conditions of employment, unemployment in the Eurozone has been unprecedented in modern history. Across the Eurozone it averaged 11% in 2015, but in crisis countries it is double that rate. In Greece unemployment was over 25% for three years, peaking at almost 28% (and still 23% in late 2016). As a yardstick for comparison the unemployment rate during the Great Depression was around 11% in the UK and around 20% in the US. Eurostat estimates that 20.973 million men and women in the EU- 28, and 16.326 million in the euro area (EA-19) were unemployed in August 2016. Furthermore, 4.199 million young persons (under 25) were unemployed in the EU-28, and 2.927 million in the euro area<sup>9</sup>. This is a dismal performance.

Yet, nothing is more telling about the failed economic performance of the EU than developments on the poverty front. More than 120 million people (24% of the EU population) are poor, or live at risk of poverty or social exclusion. Their numbers have risen since 2011. These numbers include 27% of all children in Europe and 20.5% of those aged over 65. Among the EU population 9% are working poor and 10% live in households where no one has a job<sup>10</sup>. The distribution of wealth is heavily tilted against those on low and middle incomes. A recent Oxfam report reveals that the top 1% of the EU28 population owns 31% of wealth and the top 10% owns 69% of wealth. However the bottom 40% of the population owns just the 1% of wealth<sup>11</sup>.

To retain some acceptable standard of living with incomes and wages and purchasing power suppressed over time, Europeans have resorted to borrowing. The available data show that private sector debt (the stock of liabilities held by non-financial corporations, households and non-profit institutions serving households) is 133% of GDP in the EU<sup>12</sup>. But as internal devaluation takes its toll on the earning capabilities across the Eurozone, non-performing loans have been rising at a rate of €50 billion a year. The problem is most severe in southern Europe.

Faced with the adverse impacts of their favoured policy choices, and in order to stimulate the stagnant economy EU policymakers have resorted to a cheap money policy, otherwise known as Quantitative Easing. Roughly nine years of Quantitative Easing have led to historically low interest rates, including negative rates. Despite low interest rates and the expansion of the monetary base, growth has been nearly non-existent. Overall, €1 trillion in bond purchases by the European Central Bank has provided no appreciable benefit to the economy. It appears that the Bank is facing the limits of quantitative easing having

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<sup>9</sup> [http://ec.europa.eu/eurostat/statistics-explained/index.php/Unemployment\\_statistics](http://ec.europa.eu/eurostat/statistics-explained/index.php/Unemployment_statistics)

<sup>10</sup> Poverty and social exclusion, Employment Social Affairs and Inclusion, European Commission, <http://ec.europa.eu/social/main.jsp?catId=751>

<sup>11</sup> Hardoon Deborah, Oxfam GB. D. Hardoon (2015), <http://policy-practice.oxfam.org.uk/publications/background-data-for-oxfam-briefing-a-europe-for-the-many-not-the-few-exploring-575925>, based on data from Credit Suisse.

<sup>12</sup> <http://ec.europa.eu/eurostat/web/products-datasets/-/tipspd20>

apparently lost traction as its efforts at money printing and lowering interest rates have caused no economic growth. Instead Europe is mired in a Keynesian 'liquidity trap'.

Quantitative Easing has at least three deflationary impacts. First, it places significant pressure on pension funds that rely on a good return on financial investments to finance the payment of pensions. Second it creates adverse expectations for future pensioners who naturally curtail their current consumption. Third, low interest rates induce employers to borrow to finance labour-saving devices which under normal conditions would be unviable, thus worsening unemployment during a period of economic stagnation.

This policy of low interest rates puts the banks under pressure too. Since the financial crisis, banks have invested in 'low risk' government bonds. In 2007 a bank buying a government bond in the Eurozone could have received a 4.5% return. In 2016, such a government bond is expected to offer no return or even to offer a negative return. For instance, on 13 July 2016, the German government issued a 10-year bond with a yield of *minus* 0.05%. This is a major problem for banks since owning these bonds cuts expected revenue. Yet, they cannot transfer these losses on to customers since if this is done the customers will see their savings diminish and hence they are likely to withdraw deposits preferring to hold cash. Hence, banks worrying about their own liquidity, are unwilling to expand their lending. In view of this the European Central Bank has dropped its deposit rates to -0.4%, in order to discourage banks from hoarding money and to induce them to increase their lending. Since however, the economy is stagnant the demand for loans does not exist. The European Central Bank is caught in a double bind. It cannot raise interest rates either. Debt levels in the EU are too high to bear the cost of higher interest rates.

The only meaningful impact of the actions of the European Central Bank has been financial market inflation. The expansion in the monetary base has financed overwhelmingly asset purchases – in stock, bond, and real estate markets - which have driven up the prices of financial assets, but not made any significant contribution to the productive capacity of EU countries. Indeed, using Gross Fixed Capital Formation as a percentage of GDP (GFCF) as a proxy of investment activity for the EU 13, Table 2 shows that investment has almost uniformly fallen in the recent period. Looking at countries hit most severely by the 2007 recession the slowdown in investment is even more pronounced. To gain some yardstick for comparison one should consider that the GFCF of China was 25.7% of its GDP in 1990, increased in 2007 to 38.8% and in 2014 reached 44.3%.

One could summarise the above dismal performance of European economies in the terms Keynes used to summarise the state of affairs in the Europe of his day. Now as then, this

*“decadent international but individualistic capitalism, in the hands of which we found ourselves ... is not a success. It is not intelligent, it is not beautiful, it is not just, it is not virtuous –and it does not deliver the goods. In short, we dislike it and we are*



*beginning to despise it. But when we wonder what to put in its place, we are extremely perplexed".<sup>13</sup>*

Keynes's despair at the failure of the political and economic establishment of his own day to counter the Great Depression applies equally to current events.

## Epeisodion 2: The Greek Tragedy

Since 2010 the European Commission, the IMF and the Greek and European political establishment have imposed a full blown internal devaluation programme that in Greece has caused a depression unlike any seen in Europe since WWII. The main drivers of the programmes have been an exaggerated and cruel implementation of the neoliberal policy agenda including cuts in wages and pensions, increases in taxation, the total reversal of any collective agreements, redundancies for public sector employees, the sale of public assets at fire-sale prices and severe cuts in funding for an already underfunded health system. These deflationary policies have lately reinforced an even more outrageous policy prescription for an economy in severe depression: namely the requirement of a Primary Surplus. In other words, the attainment of an excess of government revenues over expenditures net of interest payments. Though this surplus is intended to generate the income needed to repay Greece's creditor countries, one should expect it to cause a further reduction of the purchasing power of Greek citizens over and above the decline associated with the earlier battery of internal devaluation policies.

The European economic and political elite, in supporting these policy prescriptions, argued that since over the pre-2010 decades the Greek economy suffered low productivity, these policies would redress the balance by curtailing spending - private and public - and somehow promote market confidence. In turn, the increased confidence would increase investment and thus outweigh the contractionary effects of austerity.

Almost ten years of strict implementation of these policies has created only despair for the Greek nation. The Greek national debt - the reduction of which was the supposed reason for these policies - has instead increased from around 109% in 2008 to almost 180% of GDP today<sup>14</sup>. Meanwhile the country's GDP has declined by more than 25% over the same period and Gross Fixed Capital Formation as percentage of the GDP (GFCF) has uniformly fallen from 26.0% in 2007 to 11.7% of the GDP in 2015.

The unemployment rate has increased from 11% to over 23% after reaching a peak of 28%. Youth unemployment, after reaching an extraordinary 60%, is still around 44%<sup>15</sup>. It is noteworthy that this recent minor fall in unemployment figures reflects first, the ruthless

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<sup>13</sup> Keynes J. M (1933) National Self-Sufficiency' New Statesman July

<sup>14</sup> <http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=teina225&plugin=1>

<sup>15</sup> [https://ycharts.com/indicators/greece\\_youth\\_unemployment\\_rate\\_ufs](https://ycharts.com/indicators/greece_youth_unemployment_rate_ufs)

casualisation of labour, and the resulting low, miserable wages. Recent data released by the Labour Ministry show that 126,956 employees in the private sector are paid a gross monthly salary of just €100. 343,760 employees, mainly employed in part-time or rotating work contracts for 2-3 days per week or even a few hours per week, are paid monthly salaries between €100 and €400 gross. Second, the fall in unemployment figures reflects the rising outflow of Greek nationals who leave the country in search of better living standards elsewhere in the EU and beyond. A 2013 study has found that since the start of the crisis in 2010 more than 120,000 professionals, including doctors, engineers and scientists, have left Greece<sup>16</sup>. A more recent European University Institute survey has found that of those who emigrated, nine in ten hold a university degree, more than 60% have a master's degree, and 11% hold a PhD. This drain of talent and skill is a calamity for the Greek economy. Not only has the Greek nation – whether as parents or tax payers, or both – already paid for the skill accumulation of those who leave, but Greece now is unable to capture any returns from its investments in human capital. The long run economic repercussions of this brain drain will be detrimental to the future social and economic prospects of the Greek nation<sup>17</sup>.

The destruction of the Greek economy is best highlighted by reports regarding rising inequality and poverty. Greece has the largest increase in income inequality (before taxes and transfers) in Europe since 2010 – inequality is now the highest in the EU<sup>18</sup>. In 2014, over a third of the population was at risk of poverty or social exclusion (36.0 %) and one in five Greeks was experiencing severe material deprivation, a figure which has nearly doubled since 2008. It is also noteworthy that in 2010, 27% of the Greek population were classified as poor or living at the risk of poverty. That figure currently stands at 56%. Furthermore, 44% of pensioners and almost 44% of children live below the poverty line<sup>19</sup>. Finally, a study conducted by diaNEOsis, a non-government research and analysis organisation, shows that in 2009 only 2.2% of Greeks lived in extreme poverty. The number increased to 8.9% in 2011 and rose to 15% in 2015. 1,647,703 Greek citizens, of whom 17.6% are children and 24.4% are youths aged 18-29 now live in extreme poverty. Those most at risk for falling into extreme poverty are the unemployed, of whom 70-75% live in extreme poverty. In 2011 that figure was less than 50%<sup>20</sup>.

The health consequences of this degradation of the welfare of the Greek population are

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<sup>16</sup> Labrianidis L., N Vogiatzis (2013) 'Highly Skilled Migration: What Differentiates the 'Brains' Who Are Drained from Those Who Return in the Case of Greece?', *Population, Space and Place*, 19- 5, 472–486

<sup>17</sup> Gropas Ruby and Anna Triandafyllidou (2014) 'Emigrating in times of crisis Highlights and new data from an e-survey on high skilled emigrants from Southern Europe and Ireland' Global Governance Programme, European University Institute, survey Report.

<sup>18</sup> Haroon Deborah (2015) Oxfam GB. D

<sup>19</sup> [http://ec.europa.eu/eurostat/statistics-explained/index.php/People\\_at\\_risk\\_of\\_poverty\\_or\\_social\\_exclusion](http://ec.europa.eu/eurostat/statistics-explained/index.php/People_at_risk_of_poverty_or_social_exclusion)

<sup>20</sup> <http://greece.greekreporter.com/2016/06/09/study-fifteen-percent-of-greeks-live-in-extreme-poverty/#sthash.Hk41Din3.dpuf>

enormous. The suicide rate has risen by 35% between 2010 and 2012<sup>21</sup> and an estimated 800,000 Greeks are without access to medical care due to lack of insurance or poverty<sup>22</sup>. A 2014 report in the medical journal, *The Lancet*, highlighted the devastating social and health consequences of austerity policies. This is due to the scale and speed of economic policies which worsened the capacity of the public health system to respond to the needs of the population.

But this Carthaginian destruction of the Greek economy has not distracted the European policymakers from their neoclassical focus. The new August 2015 agreement between European creditors and the Greek government stipulated that if set fiscal targets are not met, additional austerity measures will kick in automatically. As the agreement triggers an automatic built-in destabiliser, the Greek economy will contract further.

The above state of affairs both in Greece and the EU in general paints a bleak picture for European capitalism. It is an almost total negation of the extensively lauded and advertised European Social Contract, which was supposed to guarantee positive rights and freedoms for European citizens in the fields of health, labour rights, employment, working hours, and social security and to provide social and legal protection from poverty and social exclusion. In contrast the current actions of the European policymakers in their almost religious belief in the neoclassical doctrines of unrestricted market capitalism have created a situation where as in Keynes's time

*“on the one hand the labouring classes accepted from ignorance or powerlessness, or were compelled, persuaded, or cajoled by custom, convention, authority, and the well-established order of society into accepting, a situation in which they could call their own very little of the cake that they and nature and the capitalists were co-operating to produce. And on the other hand the capitalist classes were allowed to call the best part of the cake theirs and were theoretically free to consume it, on the tacit underlying condition that they consumed very little of it in practice.”<sup>23</sup>.*

Most importantly, internal devaluation policies implemented in a stagnant economic environment show that

*“today we have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the workings of which we do not understand. The result is that our possibilities of wealth may run to waste for a time – perhaps for a*

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<sup>21</sup> Rachiotis George, David Stuckler, Martin McKee, Christos Hadjichristodoulou (2015) 'What has happened to suicides during the Greek economic crisis? Findings from an ecological study of suicides and their determinants (2003–2012)' *British Medical Journal*, *BMJ Open* 2015;5:e007295 doi:10.1136/bmjopen-2014-007295

<sup>22</sup> <http://www.bbc.com/news/world-europe-33507802>

<sup>23</sup> Keynes J. M. (1919) *The Economic Consequences of the Peace*

*long time.”*<sup>24</sup>.

Just as for Keynes in 1930, this muddle which has jammed the machine is the result of an insistence by European economic and political elites on policies dictated by the mistaken classical economic ‘orthodoxy’.

### Stasimon<sup>25</sup>:The Economic Consequences of Internal Devaluation.

To trace the economic consequences of internal devaluation this section aims to sketch Keynes’s main analysis of the repercussions of the deflation of wages, incomes and prices on economic activity.

The policy debate in Greece and the EU is subordinated first to hysteria over the budget deficit and public debt. The proposition is that the less the government borrows the better. Policy, therefore, takes the form of pressure on the State to curtail as far as possible all capital expenditure, without concern for whether such cuts in investment are productive and desirable. Furthermore, cuts in government expenditures are not to be used by the government to tax less the general population but to borrow less on the assumption that if the government borrows less the private sector necessarily borrows more. Moreover, lowering taxes on the highest rungs of the income distribution might cut government revenues, but nevertheless are considered desirable as an incentive to private investment. Led by the belief that the main thrust of policy should be internal devaluation, the government has implemented a program of cutbacks in expenditures, a decline in the budget deficit and public debt, combined with wage and income restraint in a time of recession.

The idea is that if producers have cut labour costs they will produce more and the prices of goods will fall as wages fall. However, as noted above, Keynes pointed out that there is no reason to expect that any reduction of purchasing power will be offset by increases in other directions. Certainly, this reduction of purchasing power may cause a reduction of domestic expenditures on imports, which may improve the trade balance. It may also reduce savings, as public employees, whose salaries are cut, together with the unemployed save less or draw on their past savings to maintain habitual standards of living. However, producers will find that correspondingly, the expenditures of consumers (public employees, pensioners and the unemployed) fall too. Consequently the producers can only match this fall in their revenues by either cutting their own expenditure or making some of their employees redundant, or both. A necessary consequence of reduced incomes and profits is an increase in unemployment and a fall in government tax revenues.

### Effects on Lenders and Borrowers

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<sup>24</sup> Keynes J. M. (1930) The Great Slump of 1930

<sup>25</sup> In ancient Greek drama; the final choral ode, preceding the exodos.

Importantly, as Keynes<sup>26</sup> noticed, the deflation of wages, incomes and prices transfers wealth from the rest of the public to rentiers and to those who hold titles to money. In effect, internal devaluation redistributes wealth as it transfers money from borrowers to lenders.

The real assets in the country constitute the wealth of its citizens. Such real assets are buildings, stocks of commodities, goods in the process of production and the like. As is usual practice, owners of these assets frequently purchase them with borrowed money through the commercial banking system. For the number of borrowers there is always a number of lenders who have entitlements, not on the real assets, but on money used by the borrowers - the asset owners - for the purchase of assets. Banks assure depositors that their money will be paid back on demand. This promise is given on the assumption that borrowing customers will honour the terms of loans made by the bank, and repay the debts used to buy their real assets.

However, a change in the value of money affects the relative position of those who possess claims to money and those who owe money. *A decrease in prices and wages is equivalent to an increase in the value of claims on money.* Hence real wealth is transferred from the debtors to the creditors since a larger proportion of the real assets is represented by the claims of the lender (the depositor) and a smaller proportion goes to the owner of the asset who has borrowed money to buy the real asset. In short, the real value of the loan increases for the creditor and the real burden of the debt increases for the borrower. Hence, debt service is a higher proportion of debtors' incomes, and there is a reduction or even elimination of the borrowers' margins of equity. This disqualifies debtors from further access to credit. Hence, debtor bankruptcies and defaults follow as a vicious circle sets in. This transmits the distress of debtors to their creditors which threatens the solvency and liquidity of the lenders – banks and other financial institutions.

### Effects on the Banking Sector

The above is only the first-round effect of the deflation in prices and wages. The second-round effect comes in the position of the commercial banks. Banks give a guarantee to their depositors of getting back their money on demand. They do so without any concern for the worth of money. Indeed, small downward fluctuations in the value of money have no repercussions for the banks as it is a common practice for them to allow for small decreases in the price of real assets by financing only a part of the initial purchasing price of the asset. This 'margin' protects the bank in ordinary circumstances where the downward change in the money value of the assets is within conventional limits. But this guarantee to the lender can be honoured only if the money value of the asset that the borrower has purchased remains constant or fluctuates within narrow limits over a significant period of the loan.

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<sup>26</sup> Keynes J. M. (1923) *Alternative Aims to Monetary Policy*, in *Essays in Persuasion* (1963), Norton, NY.

When in a brief period of time the money value of the asset declines excessively in a way that exceeds the set margin, the bank is unprotected. A severe decline in the money value of real assets, as experienced in recent years in Greece and elsewhere across the EU, jeopardises the whole banking system. There is a degree of deflation in the price of real assets which cannot be endured by any bank, and the Greek banks are a case in point.

### Effects on expectations

As the devaluation of wages and prices takes its course, and there is a gradual rise in the value of the country's money, the process announces to every producer that in future any stock held in goods or raw materials will steadily depreciate. Simultaneously the process announces to everyone who has borrowed that the real value of their debts will steadily increase. In view of this, any sensible producer will postpone any orders as long as possible and any sensible borrower will prefer to go out of business rather than borrow for further investment. Furthermore any sensible citizen will turn any asset in his or her possession into cash and wait for the appreciation of its value. Thus, as pessimism sets in the circulation of money is expected to fall, which will further intensify the slowing down of economic activity. As Keynes put it "a probable expectation of deflation is bad enough; a certain expectation is disastrous". Indeed, under these conditions economic activity can be brought to a standstill as is the case in Greece. But the rest of the EU cannot escape as it suffers from the same conditions as Greece does: deflating prices and wages, and the rising cost of debt.

### Say's law: When doctrines defy logic

The classical tradition proposes that internal devaluation policies benefit the community as a whole by reducing the cost of production, which in turn induces producers to increase the *volume* of production and hence *employment*. This is because labour costs are what the producer pays for the production of goods, and prices determine the producer's income when products are sold. For the community as a whole, as sales proceed the same amount paid out to employed labour in the course of production is the income the public uses to buy the products produced. Thus, supply creates its own demand.

This Keynes denied. He argued that it is not true that what producers pay out as costs of production necessarily returns as the proceeds of product sales.

*"It is a delusion to suppose that they [producers] can necessarily restore equilibrium by reducing the total costs whether it be by restricting output or cutting rates of remuneration;... For the reduction of their outgoings may, by reducing the purchasing power of the earners who are also their customers, diminish their sale –proceeds by a nearly equal amount."*<sup>27</sup>.

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<sup>27</sup> Keynes J. M (1930) The Great Slump of 1930

Why then does the total cost of production fall short of the total sale proceeds? To answer this it is instructive to outline briefly Keynes' explanations as they appear in his 'Treatise of Money' which precedes his masterpiece; The General Theory.

Keynes starts from the premise that the total costs of production – which is also the total earnings of the community - are divided in some proportion between the cost of production of consumer goods and the cost of production of capital goods. The incomes of the public (the total earnings) are also divided in some proportion between the expenditures on consumer goods and on savings. Overall, if the proportion of the cost of production on consumer goods is larger than the proportion used by the public to purchase consumption goods then the producers of consumption goods will receive less sale proceeds than their production outlays. Hence they incur losses.

However, the profits of the producers of consumption goods will be reinstated only if the proportion of the income that the public spends on consumption goods increases (i.e. the public saves less) or if a larger proportion of production is dedicated to capital goods (since this reduces the proportion of production devoted to consumption goods). However, capital goods cannot be produced in a higher proportion unless the producers of such goods foresee that they are going to make a profit. Hence, the issue lies in identifying the determinants of the profits of the producers of capital goods. Clearly, they depend on whether the public prefers to keep savings as cash or to use them to buy capital goods. If the public does not buy capital goods then the producers of capital goods are set to make a loss. Hence fewer capital goods will be produced. If so, then the producers of consumption goods will make a loss. In the end, all producers will make a loss. This will cause a rise in unemployment and a vicious circle will be triggered. This simplified picture of the production – expenditure process highlights the essential variable in Keynes analysis of new capital investment. The fundamental cause of the recession or slump is the insufficient output of new capital investment.

So in view of this why is there an insufficient output of new capital goods today? In my view this is due to a number of combined circumstances. First, the fall in incomes and prices has been catastrophic to those who have borrowed. Those who have postponed new capital investment and business initiatives have gained by the postponement. Second, the lack of sufficient demand generated by austerity policies exacerbated the reluctance of the producers of capital goods to borrow. Third, both the European Central Bank policy of cheap money and the shift of wealth from the low and middle incomes to the top have affected the preferences of lenders towards speculative use of funds and encouraged them to take part in Stock Exchange speculation. Fourth, in view of the borrowers' reluctance to borrow, instead of financing new investment the savings of the lenders are being used up either to finance business losses and distressed borrowers or to finance labour saving devices which under normal conditions would have been considered unviable thus exacerbating

unemployment.

### Is there an Exodos<sup>28</sup> in this Greek Tragedy and the European Stagnation?

Any recovery is inseparably tied up with the re-establishment of both the purchasing power of the public and the restoration of demand at higher levels and importantly and the establishment of a higher volume of new capital investment. This should involve first, maintaining low interest rates and second, the return of confidence to the business world to induce favourable expectations for the future, so that they are confident in investing in new capital. However, confidence cannot return without the experience of improvement in business profits; but business profits cannot return without an increase in new investment relative to savings.

An increase in investment relative to savings can only take place first, when there is a rise in prices. Price rises would increase the ability of debtors to reduce indebtedness as would the alleviation of the debts or at least the writing down of debts to match the market value of assets. Both measures would go a long way to restoring confidence. Second, when expectations for business men and women are favourable because of the expected future yield of a unit of new capital asset compared to current production cost of this unit of capital asset, that is an improvement in the Marginal Efficiency of Capital. The question then becomes what methods can be implemented to increase the volume of investment which is the expenditure of money on the output of new capital goods. In the current state of affairs there are two ways to this end: The first is the restoration of confidence in business prospects so that businessmen have a reasonable prospect of earning sufficient return from a new capital investment. However, restoration of confidence cannot be based on unclear hopes and rhetoric but on real improvement in the demand for goods and services. This result can be achieved only by a second scheme.

This scheme consists of a total reversal of the current policies and a drive for new public capital investment under the direct auspices of the State or other public authorities.

To be clear at this point new capital goods investment does not mean raising revenues by the government selling state assets through privatisations. Classical thinkers such as John Stuart Mill viewed State assets such as ports, water, electricity, railway companies, the hospitals and the universities as entities, which are not supposed to operate for profit but rather to establish an infrastructure in the country conducive to providing a stable and low cost environment for all citizens and the business world, within which they could pursue their interests. Privatisation not only negates this vital purpose but in addition introduces monopoly power in the market since most of State assets are to an important degree natural monopolies, and it is well known that private monopolies are detrimental to market

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<sup>28</sup> The ancient Greek drama: The final chorus; the catastrophe.



functioning. Second, when a country sells its assets, its net worth is decreased with long term consequences. Importantly the country not only does not own the asset but also forgoes any yields arising from ownership. Furthermore the sale of public assets results in increases in the government's cost outlays when the state is obliged to buy back the services or goods that the forgone asset provided. This is counterproductive to the road to recovery.

### Should government forsake active intervention?

Given the lack of demand, high levels of private indebtedness and a widespread lack of confidence, governments should take an active role in establishing new capital investment. Contrary to current policy prescriptions the government should set up an authority whose business should be to make sure that detailed plans are prepared for new capital investment to be undertaken directly by the State. Thus the port, water, electricity, railway companies, the local authorities, the hospitals and the universities and other entities should be asked to investigate and then detail the projects that could be usefully undertaken if capital were available so projects can be launched. This was Keynes's advice for the road to prosperity during the 1930s and his advice is fully applicable today. It is also noteworthy that investments in health and education are the most valuable and effective part of a public investment programme as they lead to a more efficient, dynamic and productive economy

Importantly, new capital investment can be further encouraged if the government enacts legislation to facilitate the establishment of worker cooperatives backed up by access to favourable credit facilities to establish new businesses or to turnaround indebted private companies. The establishment of worker cooperatives provides an alternative to the capitalist enterprise and an alternative model of economic regeneration, where workers and their communities can decide what to produce, where to produce, how to produce and what do with the profits. MONDRAGON Corporation, the co-operative corporation in the Basque Country and other similar worker cooperatives, are models to aspire to in this respect<sup>29</sup>.

The government revenues required for this extensive government intervention can be secured by what Keynes termed 'loan-expenditure' and by fair and strictly progressive taxation. The extraordinary increase in the degree of inequality is an outcome of government policy in terms of what it does and what it does not do. Much of the income accumulated at the top end of the income distribution is not one based on individuals' contributions to society but is instead the rents captured by inappropriate rules including tax breaks and tax exemptions, exploitation and monopoly power – notwithstanding

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<sup>29</sup> For a perspective regarding this policy see Richard D. Wolff (2013) *Democracy at Work: A Cure for Capitalism* Haymarket Books

corruption. These rents have transferred income from the bottom and the middle income deciles to those at the top over several of the past decades. This trend should be reversed<sup>30</sup>. Indeed, if there is an

*“undue concentration of incomes and probably a resulting tendency to over-saving’ if a more equal distribution ‘were achieved mainly at the expense of reducing a volume of savings so swollen that a considerable part of it goes to waste, the change would be very nearly a clear gain.”<sup>31</sup>.*

Progressive taxation will mobilise inactive savings and reverse the trend of transferring income from the bottom and the middle to the top, providing revenues for the active government intervention and increase demand for goods and services as it places income with those with a high propensity to spend on domestically produced goods and services, thus enhancing demand.

Contrary to current policy prescriptions, the times for reducing the deficit and the debt are boom times not times of slump and recession. Thus, as Keynes urged amidst the Great Depression, the government should borrow from its own citizens in order to spend in building prosperity. This undoubtedly increases the nation’s debt. But as Keynes also pointed out, the debt of a nation to its own citizens is a very different issue from the debt of an individual or debt to non-national entities. The citizens comprise the nation and to owe money to them is like owing money to oneself. In so far as interest payments will have some adverse redistribution effects as wealth goes to the lenders this is a disadvantage, but it is a small matter compared with the importance of facilitating the establishment of general prosperity.

In summary, if private individuals or firms are unwilling to spend on new capital investment then it is essential the government does it for them. But there is no justification for not doing it at all. Apart from the human costs of austerity policies outlined earlier, Franklin D. Roosevelt has warned us:

*“We have come to a clear realization that true individual freedom cannot exist without economic security and independence. People who are hungry and out of a*

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<sup>30</sup> In this respect the rhetoric currently in fashion that taxing the top incomes has deleterious effects on investment activity has no historical basis. For instance during the Roosevelt era the marginal rate for the top incomes (those earning over \$25000 equivalent roughly to current \$370000) in the US was 94%. This means that for every dollar of income earned above the \$25000 threshold, 94 cent was taken by the tax authorities. As history shows this did not prevent the US investment rates from increasing at an extraordinary rate. In contrast over the last 30 or so years the marginal tax rate for top incomes in the US has declined to roughly 36% with an effective marginal tax rate of roughly 26%. This significant reduction of the tax burden for the top incomes had overall anaemic effects on investment. Similar historical trends are observed for most advanced economies.

<sup>31</sup> Clark J. M. (1934) ‘Strategic Factors in Business Cycles’ National Bureau of Economic Research

*job are the stuff of which dictatorships are made.”<sup>32</sup>*

The central message of this essay is the vital necessity for the efforts to recovery to be well-orchestrated, well programed by the strategic intervention of the government to increase economic activity. As Keynes put it

*“ I expect to see the State ... taking an ever greater responsibility for directly organising investment... a somewhat comprehensive socialisation of investment will prove the only means of securing an approximation to full employment.”<sup>33</sup>.*

Is this programme towards prosperity feasible for Greece or other EU countries within the EU whether inside or outside the Eurozone? The answer to this is left to the reader’s judgment.

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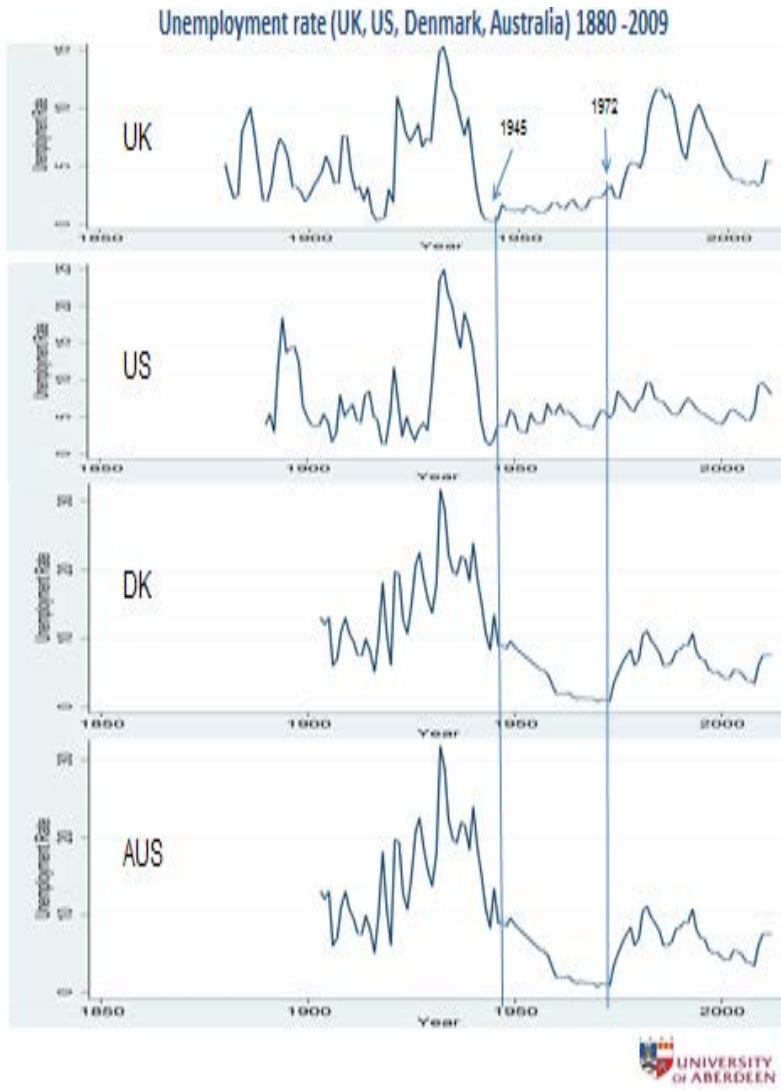
<sup>32</sup> State of the Union Message to Congress, January 11, 1944

<sup>33</sup> Keynes J. M (1936) *The General Theory of Employment, Interest and Money*, Macmillan

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Figure 1: Unemployment rates 1880-2009 for UK, US, Denmark and Australia



**Table 1:** % Change in Real Wages and % Change in Employment since Q4 2007 (Q4 2015)

	<u>Real Wage</u>	<u>Employment</u>
	Wage Down	Employment Down
Greece	-10.4	-9
Portugal	-3.7	-5
	Wage Down	Employment Up
Great Britain	-10.4	0.6
	Wage Up	Employment down
Italy	0.9	-2.3
Ireland	1.6	-7.9
Spain	2.8	-8.5
Netherlands	3.4	-1.7
Finland	4.3	-3.8
Belgium	4.4	-0.7
Slovenia	7.2	-4.3
France	10.5	-1.8
Luxemburg	11.1	-1.2
	Wage Up	Employment Up
Austria	6.5	1.2
Germany	13.9	5.1

Note: OECD calculated real wages (derived from national accounts information) by dividing total wages by hours worked and put into real terms with the household consumption deflator.

Calculations by G.Tily (2016) ToUChstone blog.org.uk. <http://touchstoneblog.org.uk/2016/07/uk-real-wages-decline-10-severe-oecd-equal-greece/>

Table 2: Gross fixed capital formation as a percentage of GDP, Selected EU countries

	1990	2007	2015
Germany	24.4	20.1	20
France	23.3	23.1	21.5
Netherlands	23.5	21.8	19.5
Austria	25.5	21.4	22.1
Finland	29.7	24.2	20.3
Belgium	24.1	23.2	23.3.
Ireland	19.2	28.7	19.2
Spain	25.9	31	20.4
Portugal	26.7	22.5	15
Greece	24.8	26	11.7.

Note : Gross fixed capital formation (GFCF) refers to the net increase in physical assets (investment minus disposals) within the measurement period. It does not account for the consumption (depreciation) of fixed capital, and also does not include land purchases. It is a component of the expenditure approach to calculating GDP