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Consequences of the Public Debt Crisis on Growth and Stability

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Abstract: This research examines the public debt crisis that caused by the financial crisis in 2007-2008 after the immense involvement of the state as last resort. The purpose is to explain the consequences of the public debt crisis on growth and stability. This paper compares the macroeconomic policy of fiscal and monetary stability that characterizes modern Germany versus the expansive model that USA authorities exercise with fiscal stimulus and monetary quantitative easing. The author concludes that the restoration of the classical American constitutional tradition that restricts efficiently the expansive role of the state is the sufficient and the necessary condition, alongside a stable Germany, for divesting the disequilibria of the world economy. A balanced and symmetrical economic policy, based on the golden rule of stability, is the most effective way for the exodus of the world economic system from the global public debt crisis and for the global economic recovery.

JEL Classifications: D31, D63, H19, E52

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1. Introduction

The public debt crisis that has erupted in Greece is an excellent point of departure for us to examine the potentially dramatic consequences of uncontrolled public borrowing for the future of the world economic system stability. What has happened in Greece is already beginning to happen in a number of the world's most developed and powerful democracies. My assertion is that what lies behind the abandonment of economic rationality in management of the public finances of developed democracies is the predominance of Keynesian ideas, both in the immediate post-World War II period and in our day, with the resurgence of Keynesianism[1] as the most suitable economic policy for effective handling of the global financial crisis.

[1] Paul Krugman (2009a) emphatically underlines "they (economists) have to admit ... that Keynesian economics remains the best framework we have for making sense of recessions and depressions" additionally many works have been published the recent years that they reinforce the argument of resurgence of Keynesianism. Peter Clarke (2009), Paul Davidson (2009), Robert Skidelsky (2009), Bradley Bateman, Hirai Toshiaki, Maria Cristina Marcuzzo (2010), Roger E. Backhouse and Bradley W. Bateman (2011).

2. The Global Public Debt Crisis is Keynesian

In the democratic West in the immediate aftermath of the Second World, despite the alternation in office of conservative and progressive governments, economic policy was constructed and exercised on the basis of Keynesianism. Whether social democrats or conservative paternalists, politicians were devotees of Keynes and Franklin Roosevelt, and they flooded the most up-to-date and developed democracies that had ever been seen in human history with continuously high fiscal deficits that went on accumulating ever greater, ever more pyramidal, ever more unsustainable public debts. It is no coincidence that the Republican Richard Nixon who succeeded the Democrat Lyndon Johnson, the American political architect of the Socialist Great Society, proclaimed that "I am now a Keynesian in economics"![2]

These inauspicious developments in the West prompted very early the free market philosopher and Nobel Laureate economist Hayek[3] to write his book "The Road to Serfdom", analyzing and highlighting the existing danger for the democratic West that Social Democracy and conservative paternalism could be the Trojan Horse for destruction of our liberties and their unconditional surrender to statism and bureaucracy. On the other hand another Nobel Laureate economist James Buchanan[4] with his prophetic book "Democracy in Deficit" warned as early as 1977 that Keynesian deficits not only represent a clearly ineffective long-term policy but are also the key ideological lever for undermining the integrity of the supreme social contract, the Constitution, and ultimately the self-sufficiency, autonomy and independence of the Republic[5].

If to the two abovementioned contributions we add those of the most eminent free market oriented economists of the 20th century, Milton Friedman, Ronald Coase, George Stigler, Robert Lucas, Gary Becker, Robert Fogel, Douglas North - all Nobel Prize-winners[6] - but also many others in scholarly disciplines other than economics[7], it becomes possible to argue that the free market oriented economists have emphasized in the most rigorous analysis that the progress and stability of

[2] Nixon said that in 1971 after taking the United States off the gold standard. Nixon's phrase became popularly associated with Friedman's phrase "We are all Keynesians now". The true is that on December 31, 1965, *Time* magazine put John Maynard Keynes on the cover and quoted Friedman's above phrase but later Friedman said he was quoted out of context. "In one sense, we are all Keynesians now; in another, no one is a Keynesian any longer. We all use the Keynesian language and apparatus; none of us any longer accepts the initial Keynesian conclusions." Milton Friedman, "Why Economists Disagree," *Dollars and Deficits* (New York: Prentice-Hall, 1968), p. 15.

[3] Hayek Friedrich, (2007), *The Road to Serfdom*, Routledge.

[4] Buchanan, James M. and Wagner, Richard E., (1977), *Democracy in Deficit: the Political Legacy of Lord Keynes*, Academic Press, New York.

[5] Buchanan, James M. and Wagner, Richard E., (1978), *Fiscal Responsibility in Constitutional Democracy*, Martinus Nijhoff, Leiden.

[6] The cycle of the economists of Chicago school is based on economic liberalism and free markets. The University of Chicago department has been awarded more Nobel Prize laureates and John Bates Clark medalists than any other university.

[7] As the most characteristic examples are Robert Nozick in Political Science and Richard Posner in Law.

Democracy has its basis in the limited and frugal state[8], which rather than allowing itself to be eroded by high public deficits and heavy public debts is duty-bound to uphold and defend individual rights and extend the liberties of individuals and the self-regulating institutions brought into existence by free individuals, such as the market, price mechanisms, competition, property rights, contracts and agreements, the rule of law and the eternal and permanent moral conventions and customs that in the long course of history have come to embody the great virtues of social harmony, co-operation and intercourse.

The great classical liberal thinkers of the 20th century overturned the historical trend towards social-democracy. With the powerful momentum that characterized them, their ideas overwhelmed and then overturned the traditional state paternalism in the conservative parties and finally won over their social democratic opponents politically, with the coming to power of Thatcher and Reagan who, in a series of dynamic reforms, restored development and progress to the democratic West, overcoming the stagnation and checking the inflation that had been so symptomatic of the post-war domination of the West by Keynesian policies of deficit and debt. The Political Economy of Classical Liberalism has thus led to a general discrediting of Keynes and Roosevelt and the elevation of Hayek and Friedman in academia, and Thatcher and Reagan in politics.

The Political Economy of Classical Liberalism has once again led the world into exceptional progress and economic growth, this time on a scale unprecedented, with continual and successive waves of innovation that through the mechanisms of the free market have been disseminated automatically to the whole planet, abolishing all borders and casting aside all obstacles, from simple tariff walls to the once impregnable iron curtains of every species of communism.

Notwithstanding all this, with the outbreak of the global financial crisis, the Political Economy of Classical Liberalism has once more been targeted as responsible. It has been openly inculpated and dropped like a hot brick, while significant and up-to-date scientific accomplishment like the efficient market theory has become the butt of ironic remarks, even in academic circles[9]. As a result, the global economy is being surrendered to the same old-fashioned, anachronistic Keynesianism that has led to the greatest global public debt crisis ever, to which Greece constitutes a mere footnote, the only anxiety it induces being that of the collapse of a section that could pull down the great walls of public debt that have been erected in the USA, in Japan, in the United Kingdom, in Italy, in Spain and other major countries of the global economic system.

The reappearance of Keynesianism in consequence of the global financial crisis and the electoral victory of the principal social-democratic political representative of our times, Barack Obama, is what I would give the name “The Great Regression”. As I analyzed in Economic Affairs, December 2009, “The 1930s and the Present Day – Crises Compared”[10], there can be no greater offence against democracy and economic rationality than the pyramidal public borrowing bring pursued by Obama, funded so profusely by the most blatant and unbridled monetary policy ever

[8] James M. Buchanan, (2005,p.28), “Such an idealized capitalistic system would, at most, command collectively up to fifteen percent of national value product” and W.Lee Hoskins, (2001,p.259), “A constitutional amendment limiting government share to something less than twenty percent over a multiyear period would provide the necessary long term focus for fiscal policy, giving it some credibility and predictability.”

[9] Akerlof G.A.& Shiller R.J., (2009), *Animal Spirits,* Princeton University Press, Princeton.

[10] Evangelopoulos Panagiotis, (2009), "The 1930s and the Present Day - Crises Compared", *Economic Affairs*, Wiley Blackwell, Vol. 29(4), pages 80-82, December.

implemented by the FED, by the zealot for printing fresh money, its director Ben Bernanke. If the post-war Keynesian policies of deficits and the generation of debt led to the collapse of Bretton Woods and stable exchange rates, the post-global-financial-crisis expansionism and out-of-control Keynesian fiscal and monetary policies[11] will lead to total lack of credibility for state paper money (fiat money) and to innovative medium of exchange as a new alternative of the gold standard of Classical Liberal Political Economy.

The discussion about a new alternative of the gold standard has already opened in the contemporary application of macroeconomic policy and its specification on the monetary policy. Its origin is coming from the concept of the real bills doctrine argued by Adam Smith[12] and it is strongly connected with the advocacy of the modern free banking. Thomas J. Sargent (2011, p. 198) explains "The real bills doctrine is alive and well today, and it provides justification or consolation for the massive holdings of private securities on central bank balance sheets." Sargent (2011, p. 199) continues in his analysis "It is feasible for the bank notes to be convertible on demand into gold because the short-term loans backing them are risk-free. This policy would prompt private agents to rearrange their cash holdings in a way that would induce a country as a whole to export the gold coins displaced by the more convenient to hold but "good as gold" bank notes and to use the proceeds to finance imports of goods to be consumed or invested. Smith said that this operation would have no impact on the domestic price level but that it would make the country better off."

So the problem is neither the free banking nor the financial engineering by the banks and the interrelationship of the markets for money and credit exercised by other intermediaries but the crucial role of the central bank. David Ricardo (1809, III, 21-2) very early had warned on the dangers of the power of the Bank of England "… By lessening the value of the property of so many persons, and that in any degree they pleased, it appeared to me that the Bank might involve many thousands in ruin. I wished, therefore, to call the attention of on the public to the very dangerous power with which that body was entrusted; but I did not apprehend, any more than your correspondent, the signature of "A Friend to Bank Notes" that the issues of the Bank would involve us in the dangers of national bankruptcy.". In our modern times the role of the central bank has worsened dramatically, making bubbles and causing crises from period to period. But after the last financial crisis in 2007-8 the worst has already started to happen. Steele (2009, p. 95), in his article on Great Crash/Credit Crunch, based on Hayek's business cycle theory, writes "that easing bank credit cannot remedy inappropriately structured investments. Instead, it can only exacerbate the

[11] Against this trend, which was made fashionable with public opinion by the mainstream press, stands the declaration of the more than 300 professional economists, led by three Nobel Laureates in economics, James M. Buchanan, Edward C. Prescott and Vernon L. Smith under the auspices of the Cato Institute (2009): "Notwithstanding reports that all economists are now Keynesians and that we all support a big increase in the burden of government, we the undersigned do not believe that more government spending is a way to improve economic performance. More government spending by Hoover and Roosevelt did not pull the United States economy out of the Great Depression in the 1930s. More government spending did not solve Japan's "lost decade" in the 1990s. As such, it is a triumph of hope over experience to believe that more government spending will help the U.S. today. To improve the economy, policymakers should focus on reforms that remove impediments to work, saving, investment and production. Lower tax rates and a reduction in the burden of government are the best ways of using fiscal policy to boost growth."

[12] "… a bank discounts to a merchant a real bill of exchange drawn by a real creditor upon a real debtor and which as soon as it becomes due is really paid by that debtor", Smith (1806, p. 44).

problem". Continuing both the long and strong tradition of the Classical Political Economy from Ricardo to our modern times, decades ago Hayek (1978), in his work *Denationalization of Money*, examines exhaustively both the misuse and the abuse of the money by central monetary authorities. What we remark now, after the financial crisis and before the future secondary deflation period that is going to come, is obviously that the only purpose of the implementation of the monetary policy by the central bank, is for supporting and financing an expansionary fiscal policy, euphemistically called fiscal stimulus, by the government. Both the central bank and the government, free from any kind of rule like the gold standard, systematically choose a discretionary policy that government is continuously spending more and more, creating mountains of public debt and the central bank readily is financing it through printing of money, euphemistically called quantitative easing and setting the price of money, the interest rate, closely to zero.

In generating this global scenario of mountains of state debt to be accumulated by the world's greatest economies, Greece is paradoxically playing a leading role on the front pages of the world's largest and most reputable newspapers, as if it is the key protagonist. In reality of course it is merely a negligible afterthought, which for all that happens to be the critical weight on the scales, determining the direction (euro or dollar) and velocity with which one side will hit the bottom. If Obama is succumbing to the Greek problem of public debt, he is doing so because he brought the public debt of the United States to the maximum constitutionally permissible point, which is only a step away from the most shattering bankruptcy in the economic history of human civilization. If Greece remains excluded from the markets, the position of the USA vis à vis its creditors is no less problematic. Both monetary and fiscal policy in the USA is required to justify the devaluation of the dollar and the flood of new bonds that its creditors must absorb to keep alive the debt-ridden American economy.

Today's well-mannered social-democrats are under siege from the results of the actions of theirs that have emerged from implementation of their mistaken ideas. Perhaps they revere Keynes and Roosevelt, but application of their ideas and policies has led them into the impasses of today. Today's well-mannered social-democrats, like the well-mannered feudal lords of the old times, are up to their eyes in debt and deficits, and thus bereft of the traditional Keynesian economic tools for stimulating effective demand and reheating the economy. Under siege, trapped and disarmed, they are unable to deal with the crisis effectively. Robert Barro[13] (2009) explicitly explains how the revival of traditional Keynesianism in its newer version (Stiglitz 2010, 2012, Krugman 2009a, 2009b, 2012, etc.) and in its application of the contemporary macroeconomic policy for saving the global economy from the crisis, the famous "Voodoo Multipliers", cannot work anymore, neither for stabilizing the economy nor for making it feasible for a recovery rebound.

3. Stability *versus* Expansionism

On the contrary Germany is the counterexample of USA. Germany despite the difficulties and the challenges that faced in the last decade, has managed through strict discipline both in the workplace and business world and in its governmental policy, to become the first among the developed economies to overcome the serious economic crisis and display significant and stable growth, along with an impressive fall in the rate of unemployment. Despite the fact that the German

[13] "Going back to the spending side, my main point is that we should not use the cover of fiscal stimulus to undertake massive public-works programs that do not pass muster from the perspective of cost-benefit analysis. (And, by the way, "shovel-ready project" is probably the silliest term I have ever heard in a discussion of macroeconomic policy.), Barro (2009, p. 3).

economy and fiscal system suffered relentless blows from the crisis, with quite a few banks still licking their wounds, as it were, Germany has recovered and is showing the way forward to a rational and stable upturn.

So, how was this remarkable German recovery achieved? In a particularly tough economic environment swept by the global crisis but also a tough monetary environment, with the Euro undergoing constant revaluation, rallying again and again against almost all other currencies, Germany continues to excel as an exporter and to achieve trade surpluses, economic growth and reduction in unemployment. The German success is attributable to the undeniable fact that it has never surrendered to the logic of bloated fiscal deficits, pyramids of accumulated public debt, and has never permitted the European Central Bank to become the printing press for cheap state money. Whatever the difficulties, Germany opted for fiscal and monetary stability. From the outset it chose sacrifice and effort so as to reap the rewards that all of the rest in the European periphery want in the form of long-term loans to secure their survival.

When I cite Germany as an example, my objective is of course not to compare it with Greece or other weak links of the European periphery, but with the USA. Uncontrolled expansionism[14], fiscal and monetary, from the Obama/Bernanke duet[15], is going to have dramatically negative consequences.

Gold will continue breaking one record after another in its long term skyrocketing upward trajectory. Despite of its short run fall like it happened in 2013 and in 2014. Prices of commodities, with first and foremost oil, but also metals, agricultural products from that white gold cotton to cereals, will continue to rise and in the world of strong international currencies when euro against dollar goes over any psychological barrier the European Central Bank will sound the alarm.

The only solution – assuming rejection by Germany of any relaxation – will be to promote a bankruptcy declaration of some kind, not only by Greece but also by other European Union countries, so as to check the erratic course of the Euro as against the dollar, without this posing any threat to German supremacy.

The Germans will use the European periphery so as to secure sufficient removal of the spreads from the countries of the European periphery to put a brake on the revaluation of the euro against

[14] Ludwig von Mises who anticipated the Great Depression, writes in the preface to the English edition of his book "The Theory of Money and Credit" (firstly published in 1912) in Vienna, "And the thing which is chiefly advocated as a remedy is nothing but another expansion of credit, such as certainly might lead to a transitory boom, but would be bound to end in a correspondingly severer crisis" and Mises adds in the last words of his preface, impressively earlier than what we are facing right now "Recurring crises are nothing but the consequence of attempts, despite all the teachings of experience and all the warnings of the economists, to stimulate economic activity by means of additional credit".

[15] The problems that arise from Obama's administrative initiatives, directed by old-fashioned Keynesianism and voracious expansionism, reinforced by organized political groups and unions that contributed so much crucially to the Obama election, are deeply and brightly examined by Rowley and Smith (2009). The recent research very fairly changes the roles of Keynes and Roosevelt into the faces and policies of G. W. Bush and Barack Obama. The paper explains how the *laissez-faire* capitalism developed the dynamism of the American economy. In our tough times, the book concludes, we can revive the American economy by keeping the principles and operations of market capitalism and applying a list of policies based on a public choice approach.

the dollar. This is why it is not enough just to look at Greece to find out what we are up against. Only a generalized crisis of confidence vis à vis the European periphery will send investors back to the dollar.

The more FED keeps printing dollars, the more inclined the Germans will be to place in jeopardy the credibility and creditworthiness of the European periphery. The financial recklessness of the FED is unquestionably placing overt pressures not only on Germany but also on Japan, as well as pinning China into a mandatory and generalized rejection of any possible consideration of revaluing the yuan. Henry Sender (2014) underlines the paradoxes of the move of the Asian currencies, both yen and yuan, according to the anomalies of the world financial system caused by the policies of the central monetary authorities[16, 17]. Bernanke's injections of money to safeguard the shallow and fragile American upturn and in the final analysis to stave off – desperately – the risk of a second recession or twofold bottoming-out make his policy destabilizing for the global economy and so ineffective and dangerous.

Germany will defend by all means its policy of strictness and discipline. There is no way that it will risk its own stability and prosperity for the sake of undisciplined never-do-well peripheral European economies. It is not a new kind of German hegemony on the European periphery, perennially discussed by marginal publications and analysts but the stamp of its own historical memory on account of the fatal mistakes and tragic failures of the inter-war Weimar Republic[18]. The Germans today, more than ever, base their democracy on stable long-term foundations, resolutely rejecting unsound expansionist policies and untenable iconoclastic approaches.

The more American laxness feeds German severity, the heavier will fall the shadow of this unequal relationship with Germany on the weaker members of the European periphery. The unorthodox and anti-conventional measures employed by Bernanke from the first Bush-Paulson package to the second mammoth Obama-Geithner package and up to the latest movements represent one failure after another. It is all absorbed by the financial sector, with nothing going into the real economy.

Like the supernova that radiates its full brilliance just before its conversion into a black hole whose magnetic field absorbs everything around it, this is precisely the mode of operation of the US financial system. After the splendor of the 2003-2007 periods with its dazzling profits and radiant unearned increments, it is as if it has been extinguished forever and is drawing everything into itself. It does not allow anything through into the real sector the US economy.

The new money is invested in gold exchange-traded funds, in oil futures, in commodity derivatives, in the new speculative bubbles that are being prepared in the emerging countries. What little remains in the USA goes to Dow Jones and in the hope of a dollar devaluation making American products cheaper. But as Germany has shown, competitiveness is not to be achieved in this way. This is why America is staggering through a fragile upturn, accompanied by growing unemployment and the lurking great risk of a double dip. Ohanian (2010) in his work analyses the causes of the financial crisis that drove the whole economy to a deep recession. He shows that we have not still understood the channels through which financial distress reduced so dramatically the

[16] Sender (2014) "…on the part of certain US Treasury officials and politicians that the value of the renminbi (yuan) was being artificially driven down to support the Chinese export machine."

[17] Sender (2014) "Still, it is an odd world when despite everything Japan has to drive the yen down, the yen continues to serve as a heaven."

[18] Feuchtwanger, E. J (1995), Kershaw Ian (Ed.) (1990), Peukert, Detlev (1992).

labor input [19] that finally caused the deep recession. In his research enterprise, Ohanian is approaching the explanation that the failure of the economic policies that applied for the financial crisis, caused the deep recession[20]. On this line of explanation of the deep recession caused by the failed economic policies, he names the contributions of Taylor (2010a, 2010b), Cochrane and Zingales (2009), Jagannathan, Kapoor, and Schaumberg (2009), and Mulligan (2010a). Under the above mentioned well evidenced researches, my argument is becoming much stronger that this situation of various failed economic policies both by the government and FED, has been brought about by the latest desperate, and riskier than ever, expansive monetary policy under the euphemistic title quantitative easing.

Many free market oriented economists are opposed to this unacceptable, uncontrolled and chaotic situation and want to restore fiscal and monetary stability and above all the Classical American Constitutional Tradition[21] of the limited but stable state, dynamic private sector, hard work and initiative. Their proposals are simple and easily comprehensible. No to abolition of tax breaks, yes to smaller deficits and finally a balanced budget, smaller public debt and no more newly-printed dollars.

The reality is that the Republicans' opposition influence in American politics is based on the restoration of the economic rationality into the political process. The effective result of this development could be the exercise of political pressure for supervising the Treasury and keeping the constitutional limit of public debt at a potential control level. The next intermediary elections are both the challenge and the opportunity for the restoration of fiscal rationality in the public finances of USA. A new solid Republican majority both in the House of Representatives and the Senate can undertake control of, and immediate curbs on, public expenditures, accompanied by retention and consolidation of the tax exemptions. Lower taxes will promote development and curtailment of public expenditures will impose stability.

Only such a world, with a stable America alongside a stable Germany will be in a position to exert significant and real pressure on China to revalue the Yuan so that the global economy can start to divest itself one by one of the disequilibria both in trade balances and in finance. These are the prerequisites for a stable and reliable global upturn based on the performance of the real economy and on heightened competitiveness.

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[19] Ohanian (2010, p.52) "Thus, the key to understanding this recession is finding a factor that works like a large increase in the tax on labor income that depresses the incentive to work relative to the observed marginal product of labor.". Ohanian (2010, p. 54) "These findings suggest that understanding the 2007-2009 U.S. recession requires a theory of the labor market in which employment is well below its normal level."

[20] Ohanian (2010, p.61) "A policy explanation for the 2007-2009 recession is that economic policies, including the 2008 tax rebate, the Troubled Asset Relief Program (TARP), the American Recovery and Reinvestment Act (APRA), Cash for Clunkers, Treasury mortgage modification programs, and other policies significantly contributed to the recession. The common argument here is that these policies distorted incentives through their deficient design and also increased uncertainty about the underlying economic environment."

[21] Douglass North and Thomas (1973) showed that the rise and success of the western world historically was based on prevailing institutions of individual liberty, free enterprise and secure property rights, Douglass North in his book (1981) page 188 warns and writes "The story of this chapter (14) is how the framers of the Constitution attempted to control the state and how ultimately those controls broke down."

4. Conclusion

My conclusion is that the ultimate purpose of the contemporary macroeconomic policy in the developed countries, facing the problems and the challenges of the public debt crisis, is to build an environment of fiscal and monetary stability, which has to be balanced and symmetrical over the whole scale of magnitudes, imposing a decisive and prohibitive check on movements of speculative capital, predatory exploitation of wealth which in its next phase will most certainly involve tapping of the tremendous potential of the emerging countries. The developed countries need to redesign their economic policies exercised by their central authorities on the consolidation of the rules of stabilization both in the public finances and in the markets of credit and money. The restoration of economic rationality from the side of central authorities will improve dramatically the operation of the markets, will correct the distortion of the labor market increasing remarkably the level of employment, and will significantly decrease the uncertainty of the economic system as a whole.

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