THE FINANCIAL PECULIARITY OF GREECE:
SOME LESSONS FOR A THEORY OF FINANCIAL CRISIS

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This paper presents a critical appraisal of financial crisis theories and their ability to illuminate the present crisis in Greece. The paper suggests that financial crises are differentiated because of global financial integration of economies that are different due to international economic specialisation and division of labour, giving rise to different debt structures in different countries. The policy response of governments has been one of institutional inertia and refinancing of banks through multilateral and state channels. This effectively makes banking crisis into a crisis of the state. The relevant theory becomes the Luxemburgist political economy of the state as refinancer of last resort, at the expense of the non-financial (real) economy.

1. Introduction: The failure of economic theory

The financial crisis that is spreading out from countries with the most ‘advanced’ financial systems to the rest of the world has not been well served by economic theory. That is to say, economic theories did not, as they should, prepare policy-makers and practitioners for the crisis and few theorists have been able to illuminate the course of the crisis and its implications with anything other than the insights that had conspicuously failed to prepare us for such a crisis.

In the mainstream, New Classical economics has modelled a very attenuated financial system, driven by ‘rational’ individuals exchanging real resources to obtain such allocations in general equilibrium that maximize utility functions now and over time. Disturbances arise because of unanticipated ‘shocks’, following which general equilibrium is resumed. This unworldly philosophy ignores the very apparent macro-economic imbalances that built up over many years (and therefore can hardly be described as ‘unanticipated shocks’) and which are now working themselves in the deflation of economies. However, the New Classical approach still plays a very real part in the thinking of key advisers to policy-makers. Their general equilibrium models still reassure us that what is clearly emerging as a lengthy deflationary process is a temporary response to the shock of bank defaults, and that stable growth will be shortly resumed (Bank of England 2008).

The New Keynesians have also been intellectually hamstrung by a methodological addiction to general equilibrium. This was used to model under-employment equilibria due to market ‘rigidities’. The more dynamic ‘financial accelerator’ model has a credit cycle driven by fluctuations in net wealth. However, this is still within a general equilibrium framework and with little explanation of the financial mechanics that have now broken down. Such mechanics are replaced by arbitrary constraints and lags imposed on the general equilibrium model, in order to generate a cycle (Bernanke and Gertler 1989). Among behavioural economists Robert Shiller stands out for his embrace of what he regards as more realistic financial economics that rejects ‘realism’, i.e., the notion that monetary and financial relations are a mere veil over real economic relations.

Outside the mainstream, Post-Keynesians have traditionally emphasized low growth and high unemployment as consequences of the departure from 'Keynesian policies', which range from cheap money to fiscal activism (Coddington 1983, Tily 2007, Chick 1973, chapter 8). For Post-Keynesians, almost without exception, instability arises out of some combination of speculation and financial deregulation (e.g., Kregel 2008, Wray 2008). Over the years since Post-Keynesianism emerged in the 1970s, its partisans have had one major methodological advantage over New Classical and New Keynesian economists, namely the Post-Keynesians' rejection of general equilibrium. This advantage is now apparent but that was of precious little benefit to Post-Keynesians in the mean-time and led to their being cast out of the mainstream. The rejection of general equilibrium inspired Post-Keynesians to embrace an approach to financial market dynamics that may be described as 'market process'. Within this Post-Keynesians have emphasised the generation of economic disequilibrium because of uncertainty, perverse or fluctuating expectations, highlighting in particular the role of speculation in financial markets as a factor in capitalist instability.

Outside the mainstream have also been old Keynesians critics of financial markets, such as Charles P. Kindleberger and John Kenneth Galbraith. Their economic historical approach to their subject, rejection of the scientific pretensions of modern quantitative finance theory, and doom-laden forecasts as the markets rose, caused their ideas to be marginalised in their senior stratum of their profession.

The present crisis has not dealt kindly with any of these schools of thought. The principal flaws have not been either a devotion to the efficiency of financial markets, or a belief in the inefficiency of those markets, since the former were, superficially at least, right through the long financial boom, and the latter are quite clearly right in the current crisis.

Perhaps the greatest casualties have been suffered by New Classical ideas. The attenuated view of financial markets put forward by their most mathematically sophisticated exponents such as Michael Woodford has left them with little in the way of diagnostic equipment to bring to the analysis of the crisis. The equilibrium business cycle idea that real economies are briefly disturbed by 'shocks' is clearly inconsistent with not only the long-term structural disequilibria, most notably the macroeconomic imbalances of the United States, that preceded the crisis, but also the deflation now unfolding in the world economy.

The New Keynesian approach, focusing on information asymmetries, is also unsuitable for dealing with long-term imbalances. At best it produced a financial cycle based on *ad hoc* lags and restrictions. For all of their claimed insight into credit market operations New Keynesians offer little in the way of a theory of credit or liquidity, other than a balance sheet of net wealth, that is supposed to respond to changing financial conditions by inflating or deflating the economy. However, in a credit economy, it is not obvious that 'agents' may increase their 'net wealth' without an increase too of some other 'agents'', or the government's liabilities. The key contribution of New Keynesians to financial instability theory is the 'financial accelerator' model. Like Real Business Cycle theory, the Bernanke-Gertler model relies on 'shocks' to a system of general equilibrium. Bernanke and Gertler then introduce various 'asymmetric information' conditions to prolong the adjustment to the new equilibrium. In the course of these adjustments the value of borrowers' assets changes and these affect the quality of credit (Bernanke and Gertler 1989). This is inadequate because it is apparent that behind the present crisis are a series of structural imbalances, rather than shocks. For example, the fiscal deficits of the United States (or Greece) stretch back for nearly a decade, and the accumulation of foreign currency reserves by, say, China, has been going on for two decades if not more.

Apart from a confusion about the debt deflation theory of Irving Fisher (in which debt deflation is alleged to be caused by 'an unanticipated fall in the price level') the financial accelerator model suffers from the key defect of lacking a theory of the firm. The Bernanke-Gertler model merely divides individual agents into 'investors' and 'entrepreneurs', with the latter borrowing from the former. Not only is this patently inadequate for understanding the very specific problems of household indebtedness that set off the present financial crisis. It also means that the balance sheets of non-financial firms, that have been the key transmission mechanism whereby a banking crisis has become a macroeconomic crisis, do not appear in the model except obscured behind a veil of 'principal-agent problems'.

Much the same is true of the New Keynesians' cousins in the behavioural finance school. Their clear focus on the limitations of individual 'agents' understanding and rationality, also obscures the balance sheet operations by which modern firms make their adjustments to business conditions. (The behavioural finance school also has the disadvantage of being led by someone whose touching faith in the ability of futures markets to secure us against all economic disasters, is dramatically out of tune with what we now know about the risk-reducing efficiency of financial derivatives [Shiller 1993]).

The 'Old Keynesians' of Kindleberger and Galbraith seem to be amply vindicated by the events of the crisis. Their accounts of greed, enrichment through financial manipulations, the hubris of finance leading to the nemesis of depression, cannot be read without evoking vivid parallels with our times. Nevertheless, their insights, however profound, do not add up to a systematic analysis, in the sense of laying out the market mechanisms by which financial markets are inflated and then deflated. In the final analysis, attributing financial boom and collapse to some nebulous 'confidence', or 'euphoria' followed by a 'loss of confidence', or 'panic' reduces experience to perceptions of that experience, rather than explaining events. (c.f. 'Bagehot's *Lombard Street* is the psychology of finance, not the theory of it.' Keynes 1915).

Related considerations apply to Post-Keynesian accounts of the crisis, attributing it to either speculation or deregulation. The Post-Keynesian view, as indicated above, is firmly rooted in the market process in the financial markets. However, it provides for weak accounts of business cycles. In the version put forward by Keynes and Kaldor, speculation and volatile expectations are permanent conditions of financial markets (Keynes 1936, chapter 12, Kaldor 1939). They may provide an explanation of economic or financial instability, in the sense of something approaching stochastic changes in output and financial variables. But something more is needed to account for *extended* financial booms and collapses. As for deregulation as a factor in the financial crisis, it may be a necessary condition of the crisis, but it is not a sufficient one. The major dismantling of financial regulations in the U.S. and the U.K. took place in the 1970s and the 1990s. By the 1990s it was virtually complete. Yet it took another decade and a half for the deregulated edifice to collapse. If anything, this would suggest that deregulation provided the economy with a stable boom, rather than financial disorder. An additional complication in the Post-Keynesian case, perhaps, is that Keynes himself opposed ‘Schachtian’ policies of financial regulation except in the international monetary sphere.

The crisis has also provided some vindication for the views of Marxists and institutionalist followers of Veblen, whose analyses of capitalism rested to some extent at least on the immanence of its failure. We now know much more about the financial theories of Marx and Veblen, and can marvel at the sophistication of their analysis and even their anticipations of certain aspects of twenty-first century financial capitalism. However, most contemporary Marxists still regard twenty-first century capitalism as essentially the same as the entrepreneurial capitalism of Marx’s time. By contrast, few latter-day institutionalists bother to read the key analysis of money and finance that Veblen advanced in his *Theory of Business Enterprise*, let alone extend it to a global credit system. Neither Marxists nor insitutionalists have been able to develop any theory of money and finance for modern financial capitalism that can provide insights to match or even go beyond those of Keynes, Kalecki, Steindl and Minsky.

The laurels for anticipating the crisis must assuredly go to Hyman P. Minsky, the leading late twentieth century exponent of the inherent instability of modern financial capitalism. In his work, more than in that of any other economist, may be found the essential ideas and concepts that are necessary to understand the generation of the crisis and its consequences. The flaws in his work arise not because his insights were incorrect but because, put together into a systematic analysis, they contain inconsistencies in monetary theory (See Toporowski 2008). Central to Minsky’s explanation of crisis is the emergence of over-indebtedness in the economy, i.e., excessive debt in relation to the income that is supposed to service it. This he drew from the debt deflation theory of Irving Fisher (Fisher 1933). However, over-indebtedness is difficult to reconcile with the boom in equity financing since the 1980s, and in the years preceding the 1929 Crash. By all accounts equity financing is a stabilising feature of financial systems rather than a destabilising one (‘… the greater the weight of equity financing in the liability structure, the greater the likelihood that the unit is a hedge financing unit.’ Minsky 1992, p. 7).

In general, the financial crisis, like the 1929 Crash and the Great Depression which succeeded it, has confounded general equilibrium theorists and justified those critics of capitalism who view the system as prone to crisis. But if the crisis reveals the credulity of general equilibrium theorists, the catastrophists have an equivalent defect in their argument. This is in their failure to explain the relative stability of financial capitalism in the decades before the crisis, with only peripheral, if no less catastrophic for the markets concerned, crises up to 2007. Monetarists have sought to explain this stability and subsequent collapse by attributing it to loose monetary policy before a tightening in 2007-2008. This view has two flaws. In the first place, monetary policy was hardly loose in the countries now most affected by the crisis, such as the U.K. More importantly, monetarists never put forward financial crisis as a possible consequence of loose monetary policy. In their view, loose monetary policy was supposed to generate inflation in wages and product markets, rather than in the financial markets. The absence of such wage and product market inflation prior to the crisis is an inconsistency in the monetarist explanation.

2. The Financial Peculiarity of Greece

In analysing financial crises, the most common approach in mainstream economics has been to treat financial crises as a stable population of incidents, whose common characteristics may be isolated and linked up by estimated parameters which can then indicate the likelihood of a crisis (e.g., Reinhart and Rogoff 2010, Barrell et al. 2010). This pooling of crises ignores the evolutionary character of the economic and financial structures within which crises occur. Pooling makes it impossible to distinguish, say, the crisis in the United States, from the emerging market crises of the 1990s and the early part of this century. Over an extended historical period, by excluding historical phenomena such as the emergence of financial markets and the rise of the modern capitalist firm, studies such as that of Reinhart and Rogoff (like Kindleberger, for that matter) can only analyse crisis in terms of the most common human attributes and institutions: folly, money and government.

However, in analysis, and more so in crisis policy, it is necessary to discriminate between crises. It is fairly obvious to anyone who has been following the spread of the international crisis since 2007 that it differs in different countries. Moreover, in each country that has succumbed to crisis, there are common factors, such as financial deregulation, but also key differences. The case of Iceland, with credit expansion feeding off stock market inflation abroad, for example, is very different to that of the United States, with a residential housing bubble. The Greek crisis, as better informed observers have noted, differs from the crises of other Southern European members of the European Monetary Union, Portugal and Spain, in being a crisis of public sector indebtedness, rather than private sector indebtedness. Nevertheless, those countries are the geographical space within which a crisis of the Monetary Union has emerged.

The financial crisis that now threatens to engulf the Eurozone, and for which present and past Greek Governments are now being blamed, is in fact mostly due to policy errors by the leaders of the European Union and the faulty institutional design of the Eurozone. In both of these Greek Governments have played only a minor part. Indeed, if Greece were not part of the European Union, then the faults would simply emerge elsewhere. Even if the European Union were reduced to its northern fringe, say Scandinavia, Germany, Austria Benelux and France, then the crisis would break out in the Netherlands, where Government indebtedness relative to national income is not much below that of Greece (i.e., 99% of GDP in 2009, compared to Greece’s 108%). This is because the critical variable is not the absolute level of government indebtedness, or even the level of that indebtedness relative to national income, as put forward in the Maastricht Treaty, but the level of indebtedness that central banks refuse to refinance.

The principle that central banks should not refinance government borrowing gave rise to the paradoxical operating framework of central banks in the European Union in which central banks may buy in corporate and other bonds, even the collateralised debt obligations made infamous in the U.S. financial crisis, but not bonds issued by governments.

It is this aspect of central bank operations that has given rise to fears of default on their debts by governments. In fact, given that their borrowing is in their domestic currency, the danger of default is easily removed by allowing governments to refinance their debts, in the same way that companies refinance theirs. Many central banks, such as the Bank of England, were originally set up to manage their government's debts, i.e., buying and selling government bonds, to keep a stable market in those bonds. This function was finally killed off when the European Central Bank was designed at Maastricht in 1992 by central bankers convinced that commercial banks and their interbank markets, and capital markets and their credit ratings agencies, are better at evaluating financial risks than central banks.

This touching faith in wisdom and foresight of commercial bankers and credit ratings agencies has survived despite the mounting evidence (from the emerging market crises to the Collateralised Debt Obligations revelations of 2008) that commercial bankers and ratings agencies are in fact very poor judges of financial soundness. There is a very simple reason for this. The financial success of commercial bankers and ratings agencies depends not on their prudence but on their judgement of financial market consensus at any one time, *however senseless that consensus may be*. As Keynes wrote, 'a "sound" banker, alas! is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no once can really blame him' (Keynes 1931, p. 176). In the wake of the 1929 Crash, Keynes concluded with words even more appropriate today: 'The present signs are that the bankers of the world are bent on suicide. At every stage they have been unwilling to adopt a sufficiently drastic remedy. And by now matters have been allowed to go so far that it has become extraordinarily difficult to find any way out.' (op. cit. p. 178).

The Schachtian principle was just such a senseless consensus. It was partially remedied at the beginning of May 2010 when the Eurozone Governments finally agreed to set up a €720bn stabilisation fund for the Eurozone government bond markets. This can only be a first step towards a formal system for regulating the markets for government securities.

Default is therefore not a problem. A much more serious possibility is that of debt deflation. Debt deflation has already started. Businesses and households throughout Europe, but especially in Britain and southern Europe, are being squeezed by excessive debt. Their response to this is to use income to pay off their excess debt. This takes money, nowadays in the form of bank credit, out of normal circulation, where it would be spent on goods and services, and instead uses it to pay off debt. In the balance sheets of banks, both debits and credits are cancelled by this process, and bank balance sheets are reduced. The effect is falling bank credit and reduced expenditure in the real economy. Since the best (i.e., most liquid) borrowers pay off first, bank borrowing becomes concentrated more and more on worse borrowers, i.e., those who cannot pay off their debts.

In this situation, the best that governments can do is supply good quality assets to banks, in other words to borrow more from banks, and not less. If governments join in the deflation by cutting their expenditure, then the policy becomes self-defeating. GDP may then fall faster than the reduction in debt, so that the ratio of government debt to GDP continues to rise. Under the current IMF programme, the debt/GDP ratio of Greece is expected to rise to 145% by the end of 2011 (still well below that of Japan, currently at 192%). However, as a result of fiscal austerity, civil disorder and reduced business investment, the gross domestic product of Greece is likely to fall by 12% by the end of 2011. This would bring the government debt to GDP ratio up to 155%. In simple terms, it is just not possible to reduce the ratio of debt to GDP by cutting expenditure. The only way in which that ratio can be reduced is by economic growth: increasing the value (relative to debt) of economic activity.

Apart from the defective principles guiding the establishment of the Monetary Union in Europe, the other crucial institutional factor in the crisis is the integration of banking and financial markets that has been going on in the Eurozone since capital controls were abolished at the beginning of the 1990s (see Toporowski 2009a). Although the claims for greater economic efficiency that were made for banking and financial integration were always hugely exaggerated, there is no doubt that this integration has had the political effect of increasing solidarity with Greece among the governments of the European Union. Financial integration now means that banks in other countries hold Greek government debt and are prepared to exert pressure to ensure that their assets are adequately refinanced.

In the years before financial integration the surpluses that German business obtained through its foreign trade were accumulated in German banks. The system of foreign capital controls meant that German banks acquired foreign assets through markets controlled by the German Government. The trade deficits of countries such as Greece effectively drained the foreign currency reserves of the Greek banking system. But this too was managed by the government of the deficit country. Such foreign capital controls therefore interposed elements of government guarantee for the foreign assets of banks.

With financial integration, these government guarantees have been removed. Processes of competition in banking markets oblige German, French and Dutch banks to acquire as assets the weak debts of southern Europe. Therefore the commercial bank deposits of German, French and Dutch businesses and households are backed to some degree by the assets that their banks hold in Greece, Italy, Portugal and Spain. For the sake of their banks and the deposits of their businesses and households, the Governments of Northern Europe must refinance the debts of Southern Europe.

3. The Political Economy of Financial Crisis

The common feature of modern financial crises therefore is not the imprudence of individuals, bankers, or governments, since crises have affected countries where individuals, bankers and governments behaved prudently (e.g., Ireland), while other countries with imprudent individuals, bankers and governments have failed to fall into crisis (e.g., Poland, Albania). Nor is it the structure of financial crisis the same in all countries: In Ireland, for example, the basis of the crisis was a boom and bust in real estate; in Iceland it was foreign corporate finance; in Germany it has been the foreign exposures of German banks resulting from European financial integration and the desire of German banks to maintain leading positions in European banking and finance. The common feature that emerged from the beginning of the nineteenth century was the intervention of governments to support banks when they fail. This is an outcome of the growing importance of banking in an increasingly capitalist economy (i.e., an economy in which production requires large-scale finance). As the recent crisis has shown, the modern ‘responsible’ government enters banking as a ‘refinancer of last resort’. This function too had been lost sight of, in recent years as bankers came to take for granted seemingly permanent liquidity in the financial markets. With liquid money markets, there was no apparent need for central banks to operate as lenders of last resort and central bankers removed themselves from the money markets, except in the matter of guiding benchmark interest rates, in the belief that the money markets are the most efficient at pricing risk.

Following the outbreak of the crisis, the ‘refinancer of last resort’ function has been revived, at considerable fiscal cost. Governments were forced to borrow large amounts of money, in relation to total GDP. In 2009 and 2010, the net borrowing of the Greek Government is estimated at 10.79% of GDP. This is exceeded by the British Government’s net borrowing, 11.14% of British GDP, the U.S. Government’s net borrowing, 11.73% of American GDP, the Irish Government’s net borrowing, 11.80%, the Icelandic Government’s net borrowing of 10.89%, and the Spanish Government’s net borrowing of 10.92% of GDP. Curiously, fiscal prudence appears unrelated to ‘sound’ economic fundamentals: The Icelandic Government was running a fiscal surplus of 5.4% of GDP in 2007 thanks, as we now know, to a financial bubble that blew out in the following year. (Net borrowing data are from the CIA World Factbook and estimates by the International Monetary Fund, reported in the London weekly *The Observer* on the 8 August). Moreover, in cases where the Government acquired bank assets (e.g., in Ireland, the U.K., the U.S., and Iceland) the value of those assets (and all other assets owned by the government in question) needs to be deducted from total government borrowing before arriving at any notional ‘burden on the taxpayer’.

It is this ‘refinancer of last resort’ function of governments that is the distinguishing common feature of all countries affected by the crisis. The revival of that function brings with it a political economy of banking that was first put forward by Rosa Luxemburg. In her *Accumulation of Capital*, Rosa Luxemburg argued that banking serves to maintain capital accumulation in the advanced capitalist countries with loans finance capital exports to developing countries (Luxemburg 1951, chapter xxx.) In her analysis, the financial system is international, but based in the advanced capitalist countries (as it is today). Governments are weak and, in the poorer countries, are dependent upon the international financial system for financing their loans.

Luxemburg was remarkably prescient in recognising that, in poorer countries, the socialisation of financial risk, through state guarantees of commercial foreign debts, has costs that are unequally distributed between locally-based and foreign-based enterprises. The locally-based ones, largely in traditional activities, have virtually no possibilities to escape from the tax demands of their government. Foreign-based enterprises, usually in the more modern sector of the economy, have huge possibilities of escape. Hence, the costs of foreign indebtedness in less developed countries are borne by the traditional sector that benefits least from foreign investment. Over the longer term, the traditional sector becomes economically marginalised, and the traditional state that underwrites the country's foreign debts becomes politically marginalised. In this way the developing world approaches the neo-liberal ideal of a small state, whose apparent partiality for business masks an oppressive concentration of tax and debt burdens on households and businesses in the traditional sector. The economic dynamics of such states are then determined by financial inflows of foreign aid, and the pulse of foreign direct investment, punctuated by natural disasters and civil disorders (Toporowski 2009b).

The refinancing of banks in difficulty in the advanced capitalist countries has reproduced this socialisation of bank risks in the advanced capitalist countries. However, the key social, political and economic divide is no longer between a traditional and a modern sector of the economy and society, but between different classes in society: the capitalists, whose industrial and commercial wealth is being reduced by the deflation of the real economy; the middle class, whose consumption was sustained through the early years of this century by asset inflation, with the result that they are now burdened by excessive debt (that is, debt that the household would prefer to pay off before increasing consumption); and the working class that faces unemployment at a time when welfare provision for the unemployed is being squeezed. The Luxemburgist political economy that has been put to the top of the political agenda in Europe is which of these 'cash-flow-challenged' classes is to pay for what is deemed to be a fiscal crisis of the state, while measures are slowly put into place to refinance governments. However, while individuals may pay off their debts, as Irving Fisher showed it is a fallacy of composition to believe that an economy as a whole, or even a government, can without deflating the economy. The Keynesian answer is a hope that fiscal stimulus will generate economic growth. The Japanese precedent, from the mid-1990s, is not encouraging.

The challenge for political economy is therefore to go beyond arguments over which class will pay (or how much each respective class will pay) towards the control of public debt, or how fiscal stimulus may improve matters, beyond even arguments about how banks should be organised and run, and onto a discussion of how the economy can be socialised.

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