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Book Review

The Euro: How a Common Currency Threatens the Future of Europe

Joseph E. Stiglitz
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As Joseph Stiglitz sees matters, the euro suffers from a fatal flaw. The euro is the currency of 19 European countries; and common money blocks efforts of nations that, according to Stiglitz, need to devalue their currencies. More generally, attempts to restrict government control of the economy arouse the wrath of this implacable enemy of the market.

As he explains,

> When two countries (or 19 of them) join together in a single-currency union, each cedes control over their interest rate. Because they are using the *same* currency, there is no exchange rate, no way that by adjusting their exchange rate they can make their goods cheaper and more attractive.

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> Since adjustment in interest rates and exchange rates are among the most important ways that economies adjust to maintain full employment, the formation of the euro took away two of the most important instruments for insuring that. (p. 87)

This limitation on government policy is more than a theoretical possibility. The Troika (European Commission, European Central Bank, and International Monetary Fund), influenced by nefarious German bankers, insist on "sound" money, much to the distress of Greece and other countries in need of economic stimulus. Making matters worse, the Troika demands that these countries raise taxes and slash government services, in order to reduce their huge debts. If these demands are refused, the Troika threatens to cut off further loans to the ailing governments.

If the euro is not to Stiglitz's liking, the gold standard is even worse:

> America's depression at the end of the 19th century was linked to the gold standard... with no large discoveries of gold, its scarcity was leading to the fall of prices of ordinary goods in terms of gold---to what we today call deflation…. And this was impoverishing America's farmers, who found it difficult to pay back their debts…. So too the gold standard is widely blamed for its role in deepening and prolonging the Great Depression. (p. xii)

Stiglitz fails to note that many of the strongest defenders of the gold standard, e.g., Jacques Rueff, strongly condemned the gold exchange standard that prevailed in the 1920s. But never mind his historical mistake; let us concentrate on the most essential issue. Why does Stiglitz think that people cannot adjust to falling prices? Why must government control the money supply and, more generally, regulate the free market?

Here we arrive at the key to Stiglitz's thought. He is a Nobel laureate, according to many the most important economic theorist of his generation, and he claims to have *proved* that an unregulated free market must almost inevitably fail.

> There is an abstract theory (called the Arrow-Debreu competitive equilibrium theory) that explains when such a system of unrestrained competitive markets might work and lead to overall efficiency. It requires markets and information that are far more perfect than that which exists anywhere on this earth.... The circumstances that they [Arrow

> and Debreu] identified where markets did not lead to efficiency were called *market failures*. Subsequently, Greenwald and Stiglitz showed that whenever information was imperfect and markets incomplete—essentially always—markets were not efficient. (pp. 303, 335, note 33)

Stiglitz's criticism of the market rests on a false assumption. General equilibrium theory describes an artificial situation irrelevant to the actual working of the market. (The conditions resemble what Austrian economists call the evenly rotating economy [ERE].) On the free market, the wish to earn a profit induces producers to meet consumers' demands. We grasp how this process works through simple common sense reasoning. As Mises explains,

> This state of equilibrium is a purely imaginary construction. In a changing world it can never be realized. It differs from today's state as well as from any other realizable state of affairs… it was a serious mistake to believe that the state of equilibrium could be computed, by means of mathematical operations, on the basis of the knowledge of conditions in a nonequilibrium state. It was no less erroneous to believe that such a knowledge of the conditions under a hypothetical state of equilibrium could be of any use for acting man in his search for the best possible solution of the problems with which he is faced in his daily choices and activities. (Mises, 1999 [1949], pp. 707, 710–711.)

Stiglitz would no doubt respond with derision. For him, mathematical models trump common sense reasoning. As he remarks elsewhere,

> The standard theorems that underlie the presumption that markets are efficient are no longer valid once we take into account the fact that information is costly and imperfect. To some, this has suggested a switch to the Austrian approach, most forcefully developed during the 1940s and later by Friedrich Hayek and his followers. They have not attempted to 'defend' markets by the use of theorems. Instead, they see markets as institutions that have evolved to solve information problems. According to Hayek, neoclassical economics got itself into trouble by assuming perfect information to begin with. A much better approach, wrote Hayek, is to assume the world we have, one in which everyone has only a little information.... The new information economics substantiates Hayek's contention that central planning faces problems because it requires an impossible agglomeration of information. It agrees with Hayek that the virtue of markets is that they make use of the dispersed information held by different participants in the market. But information economics does

> not agree with Hayek's assertion that markets act efficiently. The fact that markets with imperfect information do not work perfectly provides a rationale for potential government actions.

Stiglitz "gives it away" in his last two sentences. The free market is deemed faulty because it falls short of the artificial standard of general equilibrium "efficiency." Where the free market is concerned, Stiglitz is a hanging judge.

Stiglitz has another argument to deploy against the free market, one that does not rely on the standard of competitive equilibrium. Keynes has shown that the free market needs to be propped up through government spending in order to maintain full employment. "An economy facing an economic slump has three primary mechanisms to restore full employment; lower interest rates, to stimulate consumption and investment; lower exchange rates, to stimulate exports; or use fiscal policy—increasing spending or decreasing taxes.... I have just described the standard Keynesian theory on economic downturns." (p. 94–95). It is significant that here Stiglitz does not require a mathematical model that proves Keynesian stimulus policies must work. What happens, e.g., if people fail to spend—in the manner that Keynesian theory assumes—the money they receive to stimulate consumption?

But why might fiscal stimulus not work? Here Benjamin Anderson and Robert Higgs, among others, have a convincing response. Uncertainty about what the government might do leads investors to lack confidence. If so, Keynesian stimulus will fail. What is needed instead is a "business-friendly" policy from the government. Stiglitz's objection to this line of reasoning should by now be obvious. No mathematical model supports it: "There is a persistent view that confidence can be restored if governments cut deficits (spending), and with the restoration of confidence, investment and the economy will grow. No standard econometric model confirmed these beliefs." (p. 384, note 41) Stiglitz does not point out that there is substantial historical evidence, e.g., in a classic paper by Robert Higgs (1997), that uncertainty about government policy does indeed inhibit investment.

For Stiglitz, the principal enemies are the "market fundamentalists," but he has odd views about what support for the free market entails. "Faith in markets by neoliberals not only meant

that monetary policy was less needed to keep the economy at full employment; it also meant that financial regulations were less needed to prevent 'excesses.' To conservatives, the ideal was 'free banking,' the absence of *all* regulations." (p. 152). But the free market ideal, as described by Mises and Rothbard, is very far from a system of unlimited private creation of fiat money. If the "excesses" Stiglitz mentions refer to speculative loans made possible by fractional reserve banking, the expansionist policies he supports lead to much greater instability than "market fundamentalism" tolerates. One wonders, further, why the Troika's demands that governments raise taxes to pay off large debts incurred by these governments are regarded as expressions of "market fundamentalism." It would seem more natural to regard these demands as one government program designed to remedy the defects of another.

Stiglitz does not consider Mises and Rothbard worthy of discussion. "Today, except among a lunatic fringe, the question is not *whether* there should be government intervention but how and where the government should act, *taking account of market imperfections*." (p. 86) He almost without exception proposes interfering with the free market, without demonstrating that the free market does not work. He agrees with the Queen in *Alice's Adventures in Wonderland*. "Sentence first—verdict afterwards."

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