OMFIF COMMENTARY

Tue 4 Aug 2015 Vol.6 Ed.32.2

Story of a failure

The danger signals from Greek money supply

By Steve Hanke

If all goes according to plan, the Syriza-led Greek government by 20 August will come to an agreement with its creditors over a third bail-out programme. This rescue package will probably be worth €86bn. So, since 2010, Greece will have received three bail-outs worth €430bn - €39,000 for every man, woman, and child in Greece.

Like past bail-outs, the third one will fail to stop Greece's economic death spiral. The experts from the European Commission, European Central Bank, and (especially) the International Monetary Fund have been wrong about the prospects for the Greek economy since day one.

The experts have failed to embrace a coherent theory of national income determination. Indeed, they have often engaged in ad hoc theorising that has, at times, appeared to be convoluted and politically motivated. The result has been a series of wildly optimistic forecasts about the Greek economy, followed by wrongheaded policies.

What has been missing from the experts' toolkit is the monetarist model of national income determination. The monetary approach states that changes in the money supply, broadly determined, cause changes in nominal national income and the price level. Growth of broad money and nominal GDP is closely linked, as the data show.

The ECB started to influence Greek monetary policy in 2001, when Greece was allowed to adopt the euro on what many believe to be false pretences. The experts at the Hellenic Statistical Authority are widely perceived to have cooked the books. The experts at Eurostat, the European statistical agency, has their suspicions over the data. Still, Greece was allowed to enter the euro bloc.

Following the Northern Rock fiasco and bank run in September 2007 and the bankruptcy of Lehman Brothers in September 2008, the ECB allowed the supply of state money to grow. Then, in 2009, Jürgen Stark, ECB chief economist, convinced Jean-Claude Trichet, ECB president, that state money (the monetary base) was growing too rapidly and that excessive inflation was just around the corner. In consequence, the ECB withdrew its non-standard measures (read: credit facilities) to Greek banks in spring 2010.

The ECB withdrawal marked a turning point in the growth of broad money in Greece. It, and the Greek economy, have been contracting ever since. This was in spite of a massive fiscal stimulus (a fiscal deficit of 12.7% of GDP) in 2009. Money dominates. The important thing to watch is the growth of broad money.

Greece was in trouble and needed a helping hand. But the European Commission and ECB didn't trust the Greek government under George Papandreou which came to power after the October 2009 elections. So in March 2010 the IMF was called in to help provide new Greek financing. Dominique Strauss-Kahn, the IMF's managing director, who was preparing to run for the French presidency as the Socialist candidate, was more than willing to help the Greek socialists.

In 2010, Greece received a massive bailout, breaking the record for the highest-ever IMF credit level relative to a country's quota. One of the conditions for the 'exceptional access' was that the country's debt had to be sustainable – which of course it was not. The IMF failures in Greece bring back vivid memories of the 1997-98 Asian financial crisis, when I saw the mistakes first-hand while advising Indonesian President Suharto as his special counsellor.

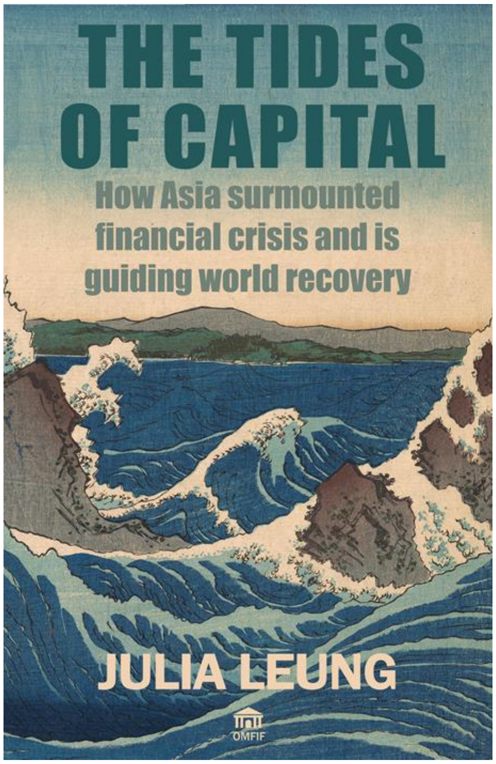
The first and second Greek bail-outs of May 2010 and February 2012 did boost the growth rate of Greece's state money. But, bank money, which accounts for over 80% of total money (M3), contracted at a very rapid rate. In consequence, M3 has plunged since the bail-outs, so has nominal (and real) economic activity.

The worst is yet to come. The last dismal data for state and bank money in Greece are for June. Since then, things have deteriorated, with bank closures and the imposition of capital controls. This spells more trouble for Greek banks that produce over 80% of Greece's money, and for the economy.

If current data were available, I believe the non-performing loans would be much higher than in the first quarter of 2015. With the collapse of the money supply and little chance of a recovery in the production of bank money, a high percentage of non-performing loans will be written off. In consequence, the Greek banking system will be insolvent. This means that calls for a fourth Greek bail-out are right around the corner.

Prof. Steve Hanke is a professor of Applied Economics at The Johns Hopkins University in Baltimore, a Senior Fellow at the Cato Institute in Washington, and member of the OMFIF Advisory Board. In 1998 he was Indonesian President Suharto's special counsellor on monetary affairs. A fuller version of this article, with accompanying charts, appears in the August 2015 edition of Globe Asia.

In her book The Tides of Capital: How Asia surmounted financial crisis and is guiding world recovery, Julia Leung, a former senior Hong Kong policy-maker, recounts behind the scenes tussles during the 1997-98 Asian



financial crisis and the global turbulence a decade later.

Leung outlines how the centre of gravity of global economics and finance has shifted progressively towards Asia and calls for greater coordination on world economic polices between the US and Asia, including a more important role for China.

To purchase a copy, please contact sales@omfif.org | +44 (0) 207 965 4494 or visit the OMFIF website directly.

The Tides of Capital is available on Amazon and as an e-book on Kindle.