NEW PERSPECTIVES ON POLITICAL ECONOMY

A bilingual interdisciplinary journal

Vol. 11, No. 1–2, 2015

CEVROINSTITUT ACADEMIC PRESS

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[vysoká škola]

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Published by CEVRO Institute Academic Press

EDITORIAL ADDRESS:

New Perspectives on Political Economy
CEVRO Institute, Jungmannova 17, 110 00 Praha 1, Czech Republic
Manuscripts should be submitted electronically. All manuscripts and correspondence should be addressed to nppe@vsci.cz.
Full text available via DOAJ Directory of Open Access Journals and also via EBSCO Publishing databases.

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ISSN 1801-0938 (on-line)
ISSN 1804-6290 (print)

MONETARY UNION WITHOUT FISCAL UNION? THE EURO CRISIS AND THE MOVE TOWARDS EUROPEAN FISCAL UNION

FRANCESCA SPIGARELLI[1] AND NIKOLAI G. WENZEL[2]

ABSTRACT

This paper examines the European Monetary Union (EMU) and the euro crisis through the lens of a robust political economy. Based on the history of monetary unions, monetary union is unlikely to survive without a fiscal union or strong constitutional constraints. The EMU has neither, and its institutional structure makes it unsustainable. Since the euro was (and is) fundamentally a political – rather than economic – project, we argue that policymakers will not allow the EMU to fail. Rather, continued movement towards greater EU-level fiscal, and ultimately a fiscal union, are likely.

KEYWORDS

monetary union, fiscal union, euro, crisis

1 University of Macerata, Italy.

2 Flagler College, USA. Corresponding author, email: nikolaiwenzel@hotmail.com
For feedback and comments, the authors thank Jerry O'Driscoll, David Hebert, Larry White, and participants at the 2012 meeting of the Association of Private Enterprise Education, and Andrea Caligiuri. Special thanks to Daniel Rottig for organizing the Florida Gulf Coast University faculty exchange program. Financial support from the H.B. Earhart Foundation is gratefully acknowledged. The usual disclaimer applies. An earlier version of this paper appeared as F. Spigarelli and N. Wenzel, "Unione monetaria senza Unione fiscale: un binomio sostenibile?, in La Crisi Dell'eurozona E La Riforma Del Governo Economico Dell'unione Europea, Andrea Caligiuri (ed.) (forthcoming). The usual disclaimer applies

1. INTRODUCTION

The European debt crisis has multiple causes ranging from politics to culture, and from public finance to monetary policy. At the heart of the matter lies the institutional framework of European and national entities – a competing and messy web of conflicting interests. A monetary union without a fiscal union is not sustainable unless there exists a commodity backing or some effective constitutional constraints; the EMU lacks all three. However, we argue that the EMU was (and is) fundamentally a political, rather than an economic project. Thus, it is no surprise that the EMU is moving towards fiscal union, rather than an end to an unsustainable monetary union.

Section one reviews the history of the European Union (EU). Section two examines the current crisis, along with special measures developed by the EU to respond to this crisis (and consolidate its power in the process). Section three discusses possible futures – that is, once the temporary band-aids and postponements have failed (as they must and will) – what institutional arrangements are likely to emerge from the rubble. We foresee three possibilities: the end of the euro; some sort of managed split of the EMU; or increased "harmonization" of fiscal policy towards, perhaps, a European Fiscal Union. We argue that the last possibility is the most likely. The final section concludes.

2. THE ORIGINS OF EUROPEAN MONETARY UNION

The EU was born, in the form of the European Coal and Steel Union, from the ashes of World War II with the purpose of intertwining the German and French economies sufficiently enough to prevent any future wars. From the 1957 Treaty of Rome to the 2007 Treaty of Lisbon (which established an EU constitution by treaty after a proposed constitution failed in national referenda), the EU story is one of incremental federalism and *acquis communautaire*, or increase in central prerogatives over member state powers (see, *e.g.*, Sidjanski 2000, de Jasay 2003a and 2003b, Wenzel 2007, European Constitutional Group 2004, Petroni 2004, Schwartz 2004). In short, the EU has grown gradually from a common market to a regulatory state, with gradual but steady central growth and erosion of national prerogative.

2.1. FROM ECONOMIC COMMUNITY TO MONETARY UNION

The idea of an economic and monetary union in Europe started well before the treaties established the European Communities after the Second World War. In 1929, German foreign minister Gustav Stresemann called for a pan-European currency as a remedy to the economic division ensuing from the increased number of Nation-states after World War One.[3] There were several unsuccessful attempts throughout the 1960s and 1970s to realize

3 See ec.europa.eu/economy_finance/emu_history/part_a.htm

an economic and monetary union. In June of 1988 the European authorities called for an Economic and Monetary Union (EMU) and mandated a committee chaired by Jacques Delors (President of the European Commission) to study and propose concrete stages leading to a union. The resulting Delors Report proposed that an economic and monetary union should be achieved in three discrete, but evolutionary, steps.4 As reported in table 1, the third stage, beginning on the 1st of January 1999, marked the effective start of EMU. From that date, the European Currency Union (ECU) came to be based on a currency in its own right, renamed the euro, with a quotation and exchange rate corresponding to supply and demand of the markets. For the first three years, the currency was used as a "book currency" on the financial markets (for accounting, electronic commerce and transactions between banks), while the old currencies continued to be used for cash payments. On the 1st of January 2002, euro banknotes and coins were introduced in twelve Member States of the European Union, effectively replacing the old national currencies. The introduction of the euro was a major step in European integration: roughly 330 million citizens in 17 of the EU's 28 member states now used it as their currency.

TABLE 1: THE EMERGENCE OF THE EURO

1st Stage starting 1 July 1990	Complete freedom for capital transactions Increased co-operation between central banks Free use of the ECU (European Currency Unit, forerunner of the euro) Improvement of economic convergence
2nd Stage starting 1 January 1994	Ban on the granting of central bank credit Increased co-ordination of monetary policies Strengthening of economic convergence Process leading to the independence of national central banks, to be completed at the latest by the date of establishment of the European System of Central Banks Preparatory work for Stage Three
3rd Stage starting 1 January 1999	Irrevocable fixing of conversion rates Introduction of the euro Conduct of single monetary policy by the European System of Central Banks Entry into force of the Stability and Growth Pact

4 See: http://www.ecb.int/ecb/history/emu/html/index.en.html

2.2. THE EMU WITHIN THE GREATER EU PROJECT

Four particulars regarding the EMU are worth mentioning.

First, the euro represents, at its base, a public choice story with multiple sets of interests. On the one hand, there are the various national interests vying for closer integration of economies and polities, balanced with worries about inflation. On the other hand, we see a Eurocrat and Euro-centralizing interest. The EU interest clashes with some national interests but agrees with others. More specifically, the European Central Bank (ECB) is subject to member-country and EU pressures. Bagus (2010, p. 100 *et seq.*), for example, refers to the Euro as a tragedy of the commons, whereby "several governments are able to finance themselves via a single central bank: the ECB." Vaubel (2004) explains the public choice of national jockeying on the ECB board, concluding that "the government which most closely shares the inflation preferences of the median national central bank governor will have the strongest bargaining power" (see also Schwartz 2004).

Second, there was no clear economic case for launching the euro (and possibly a weak argument against adopting it). The literature overwhelmingly agrees that the Eurozone is not, and was not in the 1980s and 1990s, an Optimal Currency Area (OCA)[5] due to institutional and structural disparities among member countries; differing labor regulations; and divergences in fiscal policy, public finances, and debts levels. In addition, language barriers led to lower labor mobility among countries; and the soon-to-be EMU countries had surprisingly low levels of intra-European trade – a problem compounded by lingering barriers to trade, including *exceptions nationales*, such as technology and energy "national champions" that were exempted from free trade arrangements (see Krugman *et al.* 2012). Therefore, only small gains from trade, based on reduced exchange rate costs and continued integration, were expected. Finally, the adoption of the euro involved a significant risk of overall inflation, as well as higher interest rates (for Germany and other countries with relatively sound public finances). For more details on the weakness of the economics justification for the Euro, see Salin (1990), DeGrauw (1996), Eichengreen (1993), Feldstein (1997), or Von Hagen and Eichengreen (1996).

Third, economics was ultimately irrelevant: the euro was launched for political reasons, as part of the process of explicit European integration, and implicit federalization; Feldstein (1997), for example, bluntly concluded that "[it] is clear to me... that the decision will not depend on the *economic* advantages and disadvantages of a single currency." Likewise, Bordo and Jonung (2003, p. 63) explained "the EMU is basically a political project, reflecting a strong will to eventually create political unity within Europe." For details on the primacy of

5 An OCA is defined as an economic zone whose economies are so thoroughly integrated, in terms of trade, institutions, regulatory environments, culture, etc., that they are optimal for a shared currency (Mundell 1961).

the political over the economic in the euro's genesis, see Schwartz (2004), Vaubel (2004), or Salin (1990).[6]

Fourth, the adoption of the euro was fraught with lies and "creative" data *ab initio*... surely a bad omen for economic stability. The "good" countries (France and Germany) tinkered with the rules almost immediately, so they could join the EMU even though their public finances violated the founding requirements. Greece, in addition, outright lied and faked its accounting to gain admittance (see Pisani-Ferry 2004).

3. THE CURRENT CRISIS

3.1. PROBLEMS OF STRUCTURE AND PATTERNS OF INTERVENTION

Three fundamental difficulties compound the problems that were present from the beginning, in what Pisani-Ferry (2004) call "the impossible trinity." First, a strict policy of no monetary financing of national debts by the ECB exists (even though the ECB has repeatedly circumvented this, and despite the fact that this policy creates a moral hazard for countries that "won't be" financed by an institution that is committed to preserving the euro).[7] Second, the EMU countries suffer from strong bank-sovereign interdependence (a polite way of describing the effects of crony capitalism or national corporatism: undercapitalized banks are dependent on the solvency of heavily indebted states, and vice-versa).[8] And, third, an official rejection of co-responsibility for public debts leaves member countries simultaneously unable to conduct monetary policy or engage in strategic devaluations, and able to hijack supranational monetary policy by engaging in reckless fiscal policy that jeopardizes the entire Europroject.

However, within all these considerations we must remember the underlying moving force for the EU: the political primacy of the Europroject, as part of the EU's institutional growth.

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6 James (2012, p. 1) offers the dissenting view that the quest for European monetary coordination "was not... a fundamentally political project." However, while James (2012) is a good source on history, we must remember that it offers a quasi-official account that was commissioned by the ECB and the Bank for International Settlements (James 2012). For another rich, insider's history, see Thygesen (2005). See also Capie and Wood (2003) on the primacy of the political over the economic in the formation of monetary unions, generally; for a history of monetary unions, see Bordo and Jonung (2003).

7 Interestingly, Issing 1999 predicted that, through EMU safeguards, "the separation between public finance and monetary policy is... ensured" – a sentiment echoed by Huerta de Soto's (2012) claim that the Euro offers a disciplinary mechanism against monetary nationalism. Alas, this did not account for the moral hazard of the EMU as political project (as pointed out by such prescient voices as White 1999) or the temptation of any central bank to succumb to inflationary biases (see Boettke and Smith 2011; Hayek 2008[1978]; Mises 1949). One need only look at the ECB's new project of Quantitative Easing.

8 This would later affect EMU rescue policies: not surprisingly, sovereign debt holders were exempted from the haircuts in the Greek debt restructuring.

The EMU created a moral hazard by leaving member countries free (if only *de facto*) to engage in profligate fiscal policy – especially due to the system's "no-exit" clause. While this could be construed as an incentive for member countries to manage their national fiscal affairs with an eye to preserving EMU-wide fiscal health, the unintended consequences are obvious. In sum, member countries, (a) maintain independent fiscal policy; (b) may not exit the euro; and (c) operate under supranational institutions dedicated to advancing European centralization, preserving the euro, and maintaining EMU-wide economic stability. What could offer a stronger incentive to let national fiscal policy run wild, secure in the faith that the ECB and other European institutions will do everything in their power to preserve the Euro... including bailing out bankrupt states? In the words of Bagus (2010, 108): "the tragedy of the euro is the incentive to incur higher deficits, issue government bonds, and make the whole Eurogroup burden the costs of irresponsible policies – in the form of the lower purchasing power of the euro."

3.2. THE NEW ECONOMIC GOVERNANCE

The economic and financial crisis has revealed a number of weaknesses in the economic governance of the EMU. The EU economies are characterized by a double disparity. First, while financial markets are recovering from the global crisis, the real economy remains weak. Second, growth differentials across member states remain very large. Member states have different external and internal rebalancing needs, labor market situations, and export capacities (Commission Staff Working Document, European Economic Forecast, Winter 2013, pp. 8–9).

The EU and its member states have therefore taken a series of important measures to strengthen economic and budgetary coordination for the EU as a whole and for the EMU in particular. Within these new measures and tools, we see two telling patterns. First, member countries routinely violate the terms of the euro contract.[9] Second, we have seen supranational bailouts of individual countries for the sake of preserving the overall project. But outright bailouts are only the most glaring example. We have also seen a number of policies that look suspiciously like bailouts: cheap loans to banks by the ECB and ECB sovereign bond purchases (if indirect), all the way to an implicit inflation-tax on all EMU countries, caused by low interest rates. See Bagus for more information (2010).

In all of the following actions and institutions, the attitude of federalization and centralization lurks not so discreetly in the background – from wider fiscal review and enforcement powers for the European Commission, to increasing mutualization of bail-outs.

9 And, in all fairness, why should such peripheral countries as Portugal, Ireland, Greece and Spain behave responsibly if the core countries of France and Germany bent the initial rules to accommodate their own shortcomings?

A. PREVENTIVE AND CORRECTIVE ACTION

To ensure maximum EU surveillance of member-state economic and fiscal policies, a new set of rules for economic governance entered into force on the 13th of December 2011. The new measures aim to ensure that member states discuss their budgetary and economic plans with their EU partners. Budgetary, macroeconomic and structural policies are coordinated to allow member states to take EU considerations into account at the early stages of their national budgetary processes, and in other aspects of economic policymaking. The EU can give policy guidance to member states before decisions are finalized at the national level. Four programs can be examined.

First, stronger preventive action is targeted through a reinforced Stability and Growth Pact (SGP).[10] The SGP is a rule-based framework for the coordination of national fiscal policies in the EMU; it is based on preventive and dissuasive arms. Under the provisions of the preventive arm, member states must submit annual stability or convergence programs; through these programs, they must show how they intend to achieve or safeguard sound fiscal positions. Expenditure benchmarks will now be used alongside the structural budget balance to assess progress. An interest-bearing deposit of 0.2% of GDP will be imposed on non-compliant EMU countries.

Second, a stronger corrective action has been set. The SGP's dissuasive arm is based on the excessive deficit procedure (EDP), which can be triggered by excessive government debt or deficit. Member states with debt in excess of 60% of their GDP must reduce their debt; if it is discovered that a member state's deficit is excessive (greater than 3% of their GDP), the EU will issue recommendations to the concerned member state for correction of the excessive deficit and give it a timeframe for compliance. A non-interest bearing deposit of 0.2% of GDP may be requested from an EMU member country that has been placed in EDP. Non-compliance with EU recommendations triggers further steps in the procedures, including the possibility of sanctions.

Third, minimum requirements for national budgetary frameworks have been set. Member states must ensure that their fiscal frameworks follow minimum quality standards and are comprehensive (i.e. they involve all administrative levels). National fiscal planning must adopt a multi-annual perspective. Finally, member country fiscal rules also promote compliance with EU deficit and debt guidelines.

The fourth milestone has do to with preventing and correcting macroeconomic imbalances. The new Macroeconomic Imbalance Procedure (MIP) involves EU monitoring of macroeconomic trends. This surveillance mechanism aims to identify potential risks promptly, prevent harmful imbalances and correct existing imbalances. The MIP is based on a graduated approach that takes into account the gravity of imbalances. Sanctions on EMU member states are enforced on those that repeatedly fail to meet their obligations under the corrective arm of the MIP. The enforcement regime is based on a corrective arm, made of a two-step approach: after one failure to comply with the recommended corrective action,

10 See: http://ec.europa.eu/economy_finance/

an interest-bearing deposit can be imposed; after a second compliance failure, the interest-bearing deposit can be converted into a fine (up to 0.1% of GDP).

B. NEW TOOLS TO ASSIST EU MEMBER STATES FINANCIALLY

To preserve the financial stability of the EU and the EMU, a package of EU financial assistance for member states was created. The new framework – based on financial assistance mechanisms linked to macroeconomic conditionality – has a stronger focus on debt sustainability and more effective enforcement measures. Prevention is the key strategy, with the aim of reducing substantially the probability of a future crisis.

In May of 2010, in the midst of the global crisis and severe tensions amongst sovereign debt markets, the EU and the EMU set up a stabilization mechanism based on the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF). The EFSM and the EFSF can be activated only after a request for financial assistance has been made by the concerned member state and a macroeconomic adjustment program has been approved by the EU, in liaison with the ECB. In addition, in October of 2012, the European Stability Mechanism (ESM) was introduced as the primary support mechanism to EMU member states, complementing the new framework for reinforced economic surveillance in the EU. Alongside the EFSM, EFSF and ESM, funding from the International Monetary Fund (IMF), and ECB purchases of sovereign debt on secondary markets are both available. Those measures create a safety net, providing financial stability support. Furthermore, for member states that have not yet adopted the euro, Balance-of-Payments assistance is available.[11] Although this framework allows for loans solely from the EU, in recent practice the assistance has usually been extended in co-operation with the IMF and other international institutions or countries.

First, the EFSM provides financial assistance to EU member states in financial difficulty. Under EFSM, the EU is allowed to borrow up to a total of €60 billion on international financial markets under an implicit EU budget guarantee. The EU then lends the proceeds to the beneficiary member state. This particular lending arrangement implies that there is no debt-servicing cost for the EU. All interest and loan principal is repaid by the beneficiary member state via the EU.

Second, the EFSF was created specifically in response to the ongoing financial crisis. As the financial difficulties experienced by member states posed a potential threat to the financial stability of the EU as a whole, it was deemed prudent to establish the EFSF to provide temporary stability support to EMU member states. The objective of the EFSF is to preserve the financial stability of the EMU by providing temporary support to EMU member states, linked to appropriate conditionality. It obtains its financing by issuing bon-

11 Under Balance of Payments, the EU can provide mutual assistance to non-euro area member states when a Member State is in difficulty or is seriously threatened with difficulties with regard to its balance of payments. BoP assistance is designed to ease a country's external financing constraints. See http://ec.europa.eu/economy_finance/european_stabilisation_actions/index_en.htm

ds or other debt instruments on the financial markets, backed by guarantees of the shareholder member states. The EFSF can use several instruments to support member states temporarily, including loans to governments for the purpose of recapitalization of financial institutions, and interventions to the primary and secondary debt markets. In addition, on the 26th of October 2011 the capacity of the EFSF was boosted by two additional lending mechanisms: sovereign partial risk protection and a co-investment fund. The EFSF provides partial protection to newly issued bonds of a member state, giving the holder a fixed credit protection in the range of 20–30% of the principle amount of the bond. Furthermore, the co-investment fund allows a combination of public and private funding, which could then be used to purchase bonds on either the primary or secondary markets on behalf of a beneficiary member state.

Third, the European Stability Mechanism (ESM) plans to take over the providing of stability support to euro-area member states. This permanent international financial institution assists in preserving the financial stability of the EMU by providing temporary stability support to EMU member states facing financial instability that may pose a threat to stability of the EU as a whole. The ESM can issue bonds or other debt instruments on the financial markets to raise capital in order to provide assistance to member states. The ESM is based on the same tools that are available to the EFSF; however, the ESM ensures more robust capital and an enhanced governance structure. It can provide immediate help to member states in difficulty, and it is not affected by volatility of the rating of member states. Finally, interventions of the ESM are not charged to the public finance statistics of member states.

4. AVOIDING A MELTDOWN: TOWARDS EUROPEAN FISCAL UNION?

4.1. THE SCENE

The euro crisis continues, the Eurozone hobbles on, and euro leaders find themselves in a difficult position. To summarize the situation, Greece is insolvent and flouting the terms of repeat bailouts while other countries follow close behind. France and Italy, while relatively solid, are heavily indebted and struggle with messy public finances. For better or for worse, the EMU was indeed successful at integrating its member economies; in addition, bank-sovereign interdependence continues, along with core-periphery interdependence. All of this means that a chaotic "Grexit" (Greek exit) or break-up of the EMU would be costly to all members. The ECB is statutorily forbidden from engaging in the monetary financing of debt (even though it has provided cheap loans to banks and indirectly purchased sovereign bonds – and, even now, is engaging in Quantitative Easting). The EMU officially rejects debt mutualization... yet it has approved various bailouts and implemented what are, in effect, Eurobonds. The German electorate is tired of bailing out the profligate Greeks – who are ungrateful for what they perceive as German tutelage. Finally, the weaker EMU member

countries, by and large, lack the political will to engage in the structural reforms that would make them more competitive (in the absence of monetary policy, and without engaging in further deficit spending); Mario Draghi specifically reminded EMU member countries that Quantitative Easing was not sufficient for growth and that member countries had to engage in structural reforms for increased competitiveness (see, *e.g.* Draghi 2015). One can only assume, given the magnitude of the Quantitative Easing and the continued rumblings of a break-up of the Euro, that the ECB governor is not particularly optimistic about countries taking the necessary steps.

Euro-area leaders have sought to avoid a disorderly breakdown of the euro, which could occur if Greece were to exit the euro unilaterally. But this could also occur if a Greek collapse were to lead to a run on Greek banks – and thus a run on the euro itself, with system-wide repercussions. Bordo and Jonung (2003, p. 61) explained before the crisis, that there could be many possible causes of an EMU collapse – and all of them would come down to political will.

4.2. THE OPTIONS

In order to avoid chaos, policymakers have three options: first, end the euro now; second, split the euro (through a "Grexit", "Gerexit" or two Eurozones); or third, continue the current situation but with stronger supranational fiscal safeguards. Which is likely to prevail?

A total end to the euro is unlikely. The euro was, and is, fundamentally a political project of European integration. Beyond the high economic and transaction cost of disintegration, an end to the euro would be an embarrassing political failure and an abrupt break in the 60 years of progress towards European integration. It is a small wonder that ECB Governor Mario Draghi was recently quoted, stating that: "within our mandate, the ECB is ready to do whatever it takes to preserve the Euro." In this European parallel to the "Greenspan put," the euro is "irreversible," according to Draghi.[12] It is very unlikely that policymakers will intentionally dissolve the euro, and they will do everything in their power to prevent a messy, accidental break-up.

The jury is still out in regards to the other two options (splitting the euro, or continuing with stronger fiscal safeguards). Both have high costs, and both are unpalatable to Germany (see the delightful, tongue-in-cheek, "memorandum" to German Chancellor Angela Merkel on breaking up the Euro, in *The Economist*, August 14, 2012). The EMU could expel Greece (and, in the future, other insolvent countries that don't reform their public finances or fail to adhere to bailout conditions). This would avoid the cost of further bailouts, especially since the Greek government has lost all credibility and the German electorate is fed up with bailing out its irresponsible southern neighbors. But the consequences of a break-up would be costly – from the cost of printing new money, to the possibility of a Greek bank run or default, which would lead to EMU-wide contagion (not to mention the political cost).

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12 See *The Economist*, August 14, 2012. On the "Greenspan put", see "'Greenspan put' may be encouraging complacency", by Peronet Despeignes, *The Financial Times*, December 8, 2000

Ending the euro, expelling Greece, or creating two euros within the euro might be the best solution in the long run, as Germans and others grow tired of throwing good money after bad. Any of these, nonetheless, would be an admission of political defeat. The third option – a revamped EMU – seems much more likely. Indeed, we are already seeing stronger EU-level reviews of national budgets; *de facto* mutualization of debt (how long before official Eurobonds?); penalties that are actually enforced; real strings attached to further bailouts; and increased "harmonization" (which, in EU code, translates to the movement centralized of power away from member states and into EU institutions).

The EMU and EU are already moving – slowly and surreptitiously as always – towards increased EU powers and... European Fiscal Union?

5. CONCLUSION

It is, of course, impossible to predict policy actions, let alone the delicate balance between the interests of powers like the German electorate, the ECB, individual politicians, the Greek street, financial markets, the EU bureaucracy, etc. Needless to say, however, things cannot continue as they are – economically or institutionally: that much is certain. It is also unlikely that any politician wants to be associated with a potential break-up (especially accidental and disorganized) of the euro, if such a political failure can be avoided.

The mechanisms recently adopted certainly look a lot like a movement towards a European Fiscal Union (especially EU review of national budgets, and increasing mutualization of debt, if unofficial for now); James (2012, p. 400) explains that "most of the innovative solutions...to address current weaknesses involve some measure of fiscal federalization." This makes sense for two reasons: Primarily, due to the EU's long tradition of backdoor federalism and increased power to Brussels, as the EU continues its relentless move from a customs union to a regulatory apparatus of economic central planning we are reminded of Wilhelm Roepke's (1964) prescient warning that, in any proposed European Union, "the highest degree of inflation in any member country will be adopted by the others along with the longest paid vacations and the greatest measure of intervention or planning." Secondly, the theory and history of monetary unions predicts that a monetary union is unlikely to survive without an accompanying fiscal union due to the inherent moral hazard, unless, of course, some other effective constraint is present.[13] It is not surprising that 37 of the 49 monetary unions have strong fiscal restrictions, while the others rely on constitutions, tradition and other effective guardians (Hagen and Eichengreen 1996). This is because in

13 On the relationship between monetary and fiscal union, generally, see Chadri and Kehoe 2008, Beetsma and Bovenberg 2001, Cooper and Kempf 2004, Kirsanova et al. 2007, Fuchs and Lippi 2006, Dellas and Tavlas 2005, or Dixit 2000. However, we find that these mainstream contributions tend to be very mathematical and theoretical, and thus somewhat detached from the institutional context of the EU's political economy.

order for a monetary union to be successful, it must have a commodity backing, strong constitutional constraints, and/or a fiscal union. Otherwise, the members will have incentive to engage in profligate fiscal policy to affect macroeconomic outcomes (generally, see Huerta de Soto 2012). Schwartz (2003, 110) concludes "fiscal autonomy must be sacrificed by the member countries along with monetary autonomy for monetary union to be successful." More specifically, Bordo and Jonung (2003, 43–44) explained, even before the crisis, that the absence of a fiscal union was the shortcoming of the EMU. Even James (2012, 400), the official "biographer" of EMU, conceded that "in the 1990s, critics often pointed out that monetary unions were fragile without some measure of fiscal union. In the aftermath of the post-2007 Great Recession, this lesson has become brutally apparent."

One has to wonder if the Maastricht framers were really naïve... Indeed, it is much more likely that they knew full well that (a) they couldn't get fiscal federalism quite yet, for lack of political readiness in the EU; (b) monetary union without fiscal union was doomed to fail, as a result of moral hazard and because the EMU was not an OCA; and therefore (c) fiscal union would be demanded when monetary union inevitably failed (and would thus be obtained through the usual EU "backdoor to federalism"). The Delors Report, which paved the road to Maastricht, did indeed foresee that "monetary policy alone [was] insufficient." This theory would certainly fit within the pattern of EU expansion and mission creep that has existed *ab initio*.

As economists, we remain champions of "EU Mark I," the reduction of trade barriers. We remain skeptical of "EU Mark II" – the growing bureaucratic apparatus of regulation and central planning into which the EMU has sadly been lumped – and even though EMU has some characteristics of Mark I, it has become another instrument of EU central planning and implicit federalization. Central bankers – like any other central planners – lack the requisite knowledge and incentives to avoid damage, as they will face inflationary biases (see Boettke and Smith 2011; Hayek 2008[1978]; Mises 1949). This general problem is compounded by the public choice particulars of the ECB; as member countries lose control of national monetary policy and face constraints on national fiscal policy, they seek to capture the central bank (see Bagus 2010, Vaubel 2004, Schwarz 2004). Economists who are skeptical of central banking have proposed different alternatives – both in theory, and in the particular case of an integrating Europe. For example, Hayek (2008[1978], p. 126) argued that a system of competing currencies would be "both preferable and more practicable than the utopian scheme of introducing a new European currency, which would ultimately only have the effect of more deeply entrenching the source of all monetary evil, the government monopoly on the issue and control of money."[14] Under such a system, the market could have sorted among the different European currencies and the most stable (presumably the Deutschmark) would have emerged as a Euro-wide currency. Alternatively, Huerta de Soto (2012) advocates the more radical abolition of all central banks, with a return to the

14 For examples of currency competition, see White (1992), Selgin (1988), Hayek (2008[1978]), Smith (1990[1936]) or Hogan 2012.

gold standard and the reestablishment of a 100-percent reserve requirement.[15] Under such a system, market disciplinary forces prevent any of the money-issuing banks from engaging in credit expansion.[16]

Unfortunately, given the political primacy of the Euro, neither of the economically more viable systems of currency competition or free banking is likely. And, while central banking poses great difficulties, we must also remember the Misesian theory of the dynamics of intervention predicts that limited intervention is unsustainable, as intervention begets intervention (see Mises 1979). The second best option (after currency competition or free banking) is not a lonely monetary union, as such a system will fail due to the absence of additional constraints. Instead, a more interventionist system (monetary union with fiscal union) is emerging in the European case. Alas, this compromise is a very distant second-best. The EMU is not yet out of the proverbial woods. Unfortunately, there will be more pain.

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15 Again, Huerta de Soto (2012) is surprisingly generous about the Euro as a second-best to his ideal monetary system, because the Euro offers a disciplinary mechanism against monetary nationalism. Alas, the ECB has fallen prey to the same inflationary pressures as other banks, a point he foresaw in 2012, when he wrote "the fatal error of the ECB consists of not having managed to isolate and protect Europe from the great expansion of credit on a worldwide scale by the US Federal Reserve beginning in 2001. To Huerta de Soto's credit, the ECB has moved from ineffective barrier to eager collaborator in the great game of credit expansion.

16 For details on free banking, see Mises (1949), Selgin (1988), or White (1992).

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INFORMATION, SHADOW BANKING AND FLUCTUATIONS

VLADIMIR KHRAPKO[1]

ABSTRACT

This paper attempts to emphasize the role of information, and new financial schemes and instruments in the creation of monetary trade cycles in the framework of Austrian economics. Using an approach initiated by F. A. Hayek, the classical mechanism of credit creation is exposed. The shadow banking role and its informational features that played significant role in the recent creation of the Great Recession are explained within the Austrian approach.

KEY WORDS

Austrian school, Cycles, Shadow Banking, Information

1 Associate professor at the Taurida State University, Department of Management and Marketing.

1. INTRODUCTION

The recent economic downturn draws the attention of economists to the potential causation of this phenomenon. The Austrian Business Cycles Theory explained this event with consistency and logical clearness. It is worth noting that the basic concepts of the theory were elaborated at the beginning of the 20th century and the roles of banks and the distortions of interest rates were emphasized. At present, the development of financial markets gives us new examples of possible causes for the distortions of markets, so a wider informational-based discussion may be possible.

The information retrieving and processing in an economy is an important issue. Unevenness and asymmetry of information access may create conditions for economic effectiveness. On the other hand, the lack of relevant data creates a environment prone to incorrect decisions. This article discusses the following closely related issues: financial markets, information and its role to the economy, and new financial instruments and their role in market downturn.

F. A. Hayek emphasized the importance of the information issues in his work on the role of knowledge in society (Hayek 1948). "Which of these central or decentralized systems is likely to be more efficient depends mainly on the question under which of them we can expect that fuller use will be made of the existing knowledge."

Economic problems concerning human actions and interactions are sometimes quite difficult to tackle with precision. Nevertheless, in practice and with relative success, businessmen solve their tasks in most cases using available data, and as a result the economy develops smoothly.

When starting the decision making process, the subject almost always has some prior information. This data may be consciously gathered through purported efforts, hoping to use the information beneficially in the future; or, on the other hand, an economic agent can rely on his previous knowledge based on his prior experience. The planning to achieve a desirable outcome includes not only data, but also the process of transformation – using logical rules; previous experience; previously discovered laws; and methods or algorithms that help to reformulate data in short, clear and applicable statements to make decisions in different situations. The process of planning is a crucial aspect of entrepreneurial activity.

The planning usually prioritizes economic calculations. These calculations aim to transform available data into concrete magnitudes that guide the entrepreneur to his goals of economic efficiency (expressed in the profitability and/or riskiness of his or her economic actions). If calculations are incorrect, this results in poor decisions and malinvestments. Therefore, malinvestments are basically the result of information deficiency, or errors in data processing. Considering the significance of data and decision-making, we shall discuss interrelationship between risk and information in the markets.

2. INFORMATION, MARKETS AND RISKS

Information is the basis for predictions and foresight. If anticipations are correct, then errors are absent and decisions are made correctly; alternatively, outcomes do not coincide with anticipated situations and are perceived as an error. The absolute knowledge is not accessible to any particular participant in the economic process; it is impossible to be omniscient economic agent. Every entrepreneur has his or her limited volume of information and scope.

Foresight – as argued by Hayek (1948) – is one of the important issues in dynamic economics. He wrote: "It has become more and more obvious that, in the treatment of the more "dynamic" questions of money and industrial fluctuations, the assumptions to be made about foresight and "anticipations" play a(n) ... central role..." This ability to forecast future situations is a crucial point in economic development and competition.

When market interaction (exchange) takes place, one of the information sources is price. Usually price reflects the level of compensation for received value and includes the seller's costs. In many markets, prices are easily available, although their sufficiency for correct economic decision and prognosis is disputable. This idea of prices as an important informational signal is strongly expressed in the definition of different forms of security market efficiency. Although, the applicability this hypothesis to the real markets is still questionable. But even if we accept this hypothesis, the risk still remains for an investor, and malinvestments are possible.

The process of economic decision typically consists of several steps including the identification of information sources, the extraction of relevant subsets of data, processing said data, and making conceivable conclusions and foresight.

The interaction is an important feature of the human society as a whole and in economic relations as well. This interaction is established through the interchange of information and coordinated actions. The more complex the structure of interactions, the more difficult and error prone the process of decision making is in regards to effective resource allocation between different economic actors.

We have two possible situations, the first of which is when two interactive agents have the same information and similar goals. If their preferences and forecast possibilities are the same, they will act in the same manner. As a result, these two interacting parts have to find a compromise to solve the contradiction or start competition. On the other hand, if agents differ in their available information set and/or goals then they may find a synergetic solution that can help each other make more profit: e. g. the value creation through a supply chain to the customer, different unions, associations etc.

When the quantity of actors is increasing and links between them become numerous or complicated, the risk becomes larger and more severe. For example, if there are two interacting agents only one link exists between them. Three agents have three links with each other. A dozen has already 66 links and so on. This complexity is increasing exponentially and it has negative influence on the accuracy of decision process because of additional uncertainness.

As noted earlier, an additional source of risk and uncertainty originates from the natural desire to have exclusive information that gives competitive advantage to an in-

dividual or a firm. It implies the possibility to have internal information unknown to others with commercial value that is not available to competitors. This situation creates the basis for an advantage, at the very least, for direct competitors. Such exclusive knowledge usually is defended by law as trade secret, and helps the secret possessor to gain monopolistic position to extract additional profit compensating the costs produced by innovations. Monopolistic profits stimulate rivalry companies to copy the advantageous innovation. (Cf. von Mises 1944, 1998, p. 27) This means that information asymmetry may be useful and stimulating economic efficiency by the creation of a new method of resource use. Patents and goodwill support the stimulus for economic improvement and overall progress.

When an entrepreneur wants to increase profits, usually it relates to their decision in regards to the future. The situation of future markets cannot be known in details, and there is always some degree of uncertainty and risk. Risk, as defined by the Webster dictionary is the possibility of loss, possibility that something bad or unpleasant (loss, injury) will happen. Rational human behavior implies that an actor should try to identify such possibilities, enumerate them, evaluate the degree of possible costs and make appropriate provisions. Such possibility always implies absolute or relative insufficiency in data or data processing and forecasting efficiency.

The source of risk embedded in the interaction of different agents because of their diversity. The actions of partners in the course of economic intermediations and propensity to extract informational rent during this process makes interacting parts take additional efforts to hide proprietary information about "knowhow," and retrieve more information about the reality of the counterpart.

Economic agents have different sources of possible errors: insufficient data, incorrect data or inappropriate mechanism to infer conclusions. The last statement may be illustrated by the stock market example. If both investors want to be in a long position when one sells a share and the other buys it, then the first investor believes the future price will fall; on the other hand the second believes that the price will grow. This means that two agents having practically identical accessible data came to two separate conclusions. If the information set is approximately, or even absolutely, the same for all investors, their decisions and actions may be substantially different. In this case, the ability to forecast future changes in the market is crucial to success for the investor.

Different circumstances lead to limitations on economic decisions, making them local with less forecasting power and poorer prognosis value. Consequently, during a boom, when the relative cost of capital is low, businesses may overestimate opportunities and underestimate future risk. Concerning incorrect estimations, one recent example may be explored: the president of Bear Stearns (global investment bank and brokerage agency) stated that the company did nothing wrong and did not take risks they did not understand, even when the bank was going toward bankruptcy.

In general, activities in finance and financial markets are always exposed to risk and error, and this might lead to remarkable downturns in financial markets with widespread repercussions on a global scale.

3. FINANCIAL MARKETS

In a modern economy, financial activity is very important for economic relations, and it concentrates not only on traditional bank related areas, but also on financial markets where shares, bonds, CDOs and other instruments are traded. So not only banks supply the necessary funds to business, but other possibilities exist for entrepreneurs to obtain necessary finances. The financial markets are well known for their volatility; prices change because participants are influenced by information and circumstances. Therefore, these markets are information sensitive, and especially risk prone.

During last twenty years, the growth of financial markets was spectacular. For example, as reported by Security industry and Financial Market Association (2014), a growth of IPO from $4.5 billion in 1991 to $58.7 billion in 2013 was observed, and the same rate was matched by bond financing. U.S. Corporate Bond Issuance rose from $343.7 billion in 1996 to $1.3659 trillion in 2013. These instruments (shares and bonds) are traditional ways to attract funds from investors. The modern financial market works with traditional methods (bonds and shares), and new instruments such as CDO, MBS, ABS, etc. These innovations in finance create complex and complicated schemes of intermediation, creating hazy relationships between market participants and the generation of asymmetric information. Sometimes modern banks create new entities to give them the riskiest businesses, avoiding the disclosure of the real situation with their assets position.

By nature, financial markets create the possibility for poor decisions. Newly introduced financial instruments may enhance this possibility, creating grounds for the undervaluation of risk exposure in the investments of assets. That is, complexity and information uncertainty hide the intrinsic value and risk relationship for entrepreneurs who act as investors. (A. P. Mueller 2001)

Usually the entrepreneur's decision in investment may be represented in such a manner. At the beginning the entrepreneur finds a market opportunity from which he or she can profit, then they try to acquire the necessary resources to implement this new business idea. Often he approaches banks or other financial market intermediaries trying to gather the necessary funds to start or enlarge a business.

Modern financial markets are information sensitive and volatile. A hypothesis in regards to their efficiency was proposed to describe such features. This hypothesis of efficient markets argues for the informational efficiency of security markets and asserts that all information processed by markets is reflected in the asset prices. From this standpoint, the conclusion is drawn that all fluctuations in the short run are random, and in the long run there is no inefficiency that leads to downturns in security markets and the economy as a whole. When this hypothesis is accepted then the prices are believed reliable indicators for decision-making, because they reflect intrinsic asset value. But in practice, the information conveyed by prices often is insufficient to make valid economic decisions. The downturn of the stock market in 2001 (dotcom bubble), and in 2008 (start of Great Recession), show that the hypothesis of stock market efficiency does not always hold true. The financial crush in 2008 started a bust in real economy all over the world, Europe especially. (J. H. Tempel-

man 2010). These facts support the Austrian theory that points out the causes of trade cycles are rooted in finance and related to money and banks.

4. THE CORE OF THE AUSTRIAN BUSINESS CYCLE THEORY

F. A. Hayek (1933) and von Mises (1953) described in detail the banks' role in the economy and in the generation of economical fluctuations. Banks' ability to create additional money is one of main causes of creating economy deviation from the equilibrium (see Hayek 1933, 147 and further). A bank as a part of banking system creates new credit money from obtained deposits. For example, when the Bank A receives a loan, the definite part of it is stored as a reserve to compensate unexpected reduction in money inflow. The bank may grant the rest of money as a loan. The depositor does not know exactly that his money gone away and is not available, although the bank gives an assurance to the depositor that money is available at any time, which is confirmed by the deposit contract. This position is not absolutely guaranteed, but only with a certain degree of probability. Such a situation of informational asymmetry gives the advantage to the banks, but makes their position vulnerable.

F. A. Hayek wrote: "the primary cause of cyclical fluctuations must be sought in changes in the volume of money, which are undoubtedly always recurring and which, by their occurrence, always bring about a falsification of the pricing process" (Hayek 1933). The main issue regarding cyclical changes in economic activity is the excessive volume of fiduciary money. This excessive quantity of money gives false informational signals, changes the equilibrium perception for customers; suppliers; households; and firms, enforces them to adapt their time preferences for current and future needs of resources to the current supply of money. This supply changes the level of prices and time preferences, lowers interest rates; these changes are not the same in different economic sectors or under different circumstances. This leads to the disruption of equilibrium and generates boom-bust fluctuations. The constant overflowing economy with fiduciary money and the possibility to receive bail out support for banking systems distorts risk perception for the entrepreneur.

As argued by Huelsmann (1998), the main cause of economic fluctuations is the cluster of errors created when an entrepreneur incorrectly assesses money volume and prices for the future. If the entrepreneur knew relevant data, there would be a chance for them to discover the incorrect decision earlier and avoid erroneous actions with greater probability.

The generation of additional money by a banking system is based on the information asymmetry concerning the money deposited in the banking system. In fact, check accounts and time deposits are also liable to withdrawal of deposited balances from the bank at any time. The bank believes depositors will not simultaneously demand a major portion of their balances, and after necessary reserving (usually small fraction of deposits), the bank will legally grant the rest of money as a new loan. If the given money is absent for the reason of partial reserve, the demand may be met not only from reserves, but also from other depositors' money (de Soto 2009).

To coordinate inflows and outflows is a nontrivial task for bank management. Different deposits and loans have different conditions; especially as their maturity and risk levels differ significantly. Mismatching maturities creates additional risk for serving time deposits and deposits on demand. The ABCT asserts these situations in banking system activities as the main source of economic fluctuations and crises (Salerno 2012; Miller 2012). As of 2003, the range of bank reserves in different countries around the world fluctuates from zero to 20 per cent of deposit volume and issued banknotes.

To create a critical downturn in economy, several interlinked circumstances have to occur. Firstly, malinvestments are made as a result of incorrect signals given by unnaturally low interest rates. Secondly, soft financial policies combined with the readiness of governments to bailout banks in trouble occur and distorts the perception of risk. In addition, nowadays banks participate in so-called shadow banking schemes. This activity is new to the ordinary entrepreneur; essentially the shadow bank entities try to hide information about the risk level of their instruments from the entrepreneur. It is worth noting that the last new world recession brought to the light the role and importance of shadow banking activities.

5. SHADOW BANKING

The innovations in the financial intermediation and structures are developing constantly, and new methods and financial instruments are always appearing. This process of facilitating credit creation has inherent drawbacks and risks and may lead to economic fluctuations. Like any usual banking system, shadow-banking institutions deliver loan facilities to the public and enterprises, making it easier to obtain the necessary financial resources for business or consumer needs.

The shadow-banking system may be defined as the financial intermediation activities that involve entities external to the usual banking system. In the papers discussing the shadow-banking system, authors often argue that the demand for money-like, relatively riskless, debt instruments is high. The supply from the side of the US government Treasuries is insufficient for large institutional investors and corporations. One of the reasons for pursuing new forms of savings is the growth of demand from corporations for the safe, short-term money instruments from corporations. Usually the guaranteed redemption of a bank deposit, before the 2007–2009 crisis, was no more than $100,000. For corporations such an amount is relatively small. The demand for new possibilities was growing rapidly. Some estimations show a tenfold growth of the assets mentioned above during the past decade. The volatility of the market was remarkable, e.g. in 2005 about $30–40 billion of short-term, money-like instruments were issued in the US financial markets according to the information from the Securities Industry and Financial Markets Association. Then, in the following year it grew to $100 billion, followed by a growth volume plummet to a mere $5 billion per quarter – twenty times lower (Coval et al. 2008). After the financial crisis of 2008, the

recovery of activities outside the bank system rose. By the end of 2013 the activity of other Financial Intermediaries grew to $71 trillion worldwide. The size of assets belonging to the shadow-banking system was estimated to be 24% of total financial assets. The 20% growth demonstrated by emerging market economies overcame the growth of developed jurisdictions (FBS 2013). Like usual banking systems, these institutions delivered loan facilities to the public and enterprises, making it easier to obtain the necessary financial resources for business or consumer needs. Often these entities affiliated with usual banks, helping banks to make their activities more flexible, use leverage, and avoid regulation restrictions. Such entities may be organized as special purpose vehicles (SPV). SPV is a fixed income maturity transformation fund that adapts instruments with different maturity condition to specific needs. Usually, it transforms risk and opaque, long-term obligations into short-term money-like instruments. Shadow-banking system functions are implemented through the chain of activities using debt in different forms: commercial papers, student loans, mortgages etc. The activities of shadow banking are more complex than the usual bank loan/credit policies.

In the first step, a bank receives money as a deposit, and after reserving the definite part of it, the rest of money is granted as a loan. When this loan is issued then the newly created loan contracts may be combined with similar loan contracts in a portfolio or a bundle. This bundle may be sold to the other entity, a part of shadow banking system, with the intention of further slicing it into liquid financial instruments. When receiving the payment for the bundle, the bank creates a new additional loan starting the second round of loan expansion. We can see the interlinked complex of banks and other financial institutions, which use a collateral to obtain cash. For example, the first level entity that needs money may supply, as collateral, some quantity of riskless Treasury bonds when approaching bank #1. Then, this bank #1 may use the collateral for insuring funds which it procures from bank #2, and so on. The chain mechanism described is one of the mechanisms used to provide new debt money-like instruments; another one is pooling debt instruments.

To manipulate liquidity and maturity, SPV entities use portfolios or bundles as collateral for newly issued debt instruments – pooling debt contracts into a bundle, selling these bundles, restructuring the bundles by issuing asset-backed obligations, and then selling the obligations in the markets.

Through this mechanism, the SPV may issue debt obligations with higher quality than the underlying collateral. Methods of slicing the primary portfolio may be illustrated by a simple example. Let us examine a collateral portfolio (bundle) consisting of two bonds. Every bond has a nominal value of $1. Every bond was assigned with probability of default equal to q. When they are combined in a portfolio, we create four combinations A={1,1}, B={0,1}, C={1,0}, D={0,0}, where 1 on the first place means no default of the first bond, and 0 means a default outcome. The use of this portfolio as a collateral may be direct without additional transformations. In this case there is no changing the quality of newly issued collateralized debt obligations (CDOs); all risks are transferred. But when the SPV slices the underlying collateral into two different tranches the situation changes. Let us divide the collateralized issue into two tranches. The first (senior) tranche defaults when both underlying

bonds default, that is when outcome D occurs. This event has the probability equal to $q \times q$ or $P(D) = q^2$ when the defaults are independent. The other (inferior) issue defaults when outcomes B or C or D occur, or in other words: W = B + C + D and its probability P(W) is $2\times(1-q)\times q + q\times q$, or $P(W) = 2q-q^2$. Let us suppose that the underlying collateral default of q = 10%, then the probability of the senior tranche default is P(D) = 1%, and the probability of the inferior tranche default is P(W) = 19%. The senior tranche has a probability ten times lower to default than the underlying collateral. In this manner, the SPV generates a much less risky asset from the risky one.

To compare risk formulated by a default probability, the empirical data from one Moody's rating agency is provided. The process of assigning rating to debt instruments is mainly an informational process conditioned by uncertainty with the goal of assessing the level of the issuer's creditworthiness. The rating assignment processes infortmation with the goal of aggregating the available data and knowledge of obligation issuer fundamentals, and shaping it in a concise and consistent manner in the form of a conclusion on quality and risk level in regards to the instrument in consideration.

During the last century, obligation ratings became very popular among investors. There are three world known rating agencies: Moody's, S&P and Fitch. The rating process as described by the rating agency is a typical process of drawing a probable and dynamic conclusion based on economic and financial data. The rating is an opinion of creditworthiness for the future, and is calculated by using credit and fundamental analysis, including financial statements and management performance analysis. This scheme is applied to different scenarios and external conditions – from good to pessimistic and stressed. The rating agency activities improve and facilitate access to economically important information for investors, reducing information asymmetry and the costs of gathering and processing information. Hopefully, assigning the correct rating score will increase the information efficiency of the market. Rating information gives the probability of default associated with level of rating A, B, C. This empirically derived probability differs significantly. When assigned high-level A, the probability of default is very low (see Table 1). The agency Moody's (1996) published empirical probabilities of default, conditioning on the assigned rating grade (see Table 1).

TABLE 1: EMPIRICAL DEFAULT PROBABILITIES ASSOCIATED WITH CORRESPONDING RATING GRADES BY MOODY'S USING PROPRIETARY DATA FROM 1928 TO 1996

	Rating grade	**Default Probability**
Investment grade	Aaa	0.00%
	Aa	0.03%
	A	0.00%
	Baa	0.13%
Speculative grade	Ba	1.42%
	B	7.62%

(Source: Moody's, 1996)

This research uses only standard (not CDO) bonds, which does not collateralize so-called single corporate issues. Only 1% of them are rated as AAA, in contrast with about 60% of the asset-backed issues that received the highest rating level. As we see above, the use of collateralizing and tranching low-rated collaterals may transform into CDO with a remarkably higher quality. Starting from the speculative grade B, a new instrument may be graded as Baa, or even A. But when economic conditions change, the statistical independence disappears. In this case, tranches with low rates of default acquire the same default probability as underlying assets, and high quality tranches deteriorate and become tranches of low quality.

Additionally, shadow-banking entities do not take deposits, so they are not subject to central bank surveillance or tight regulations. On the other hand, they do not have access to central bank reserves and debt-guarantee facilities.

As in usual bank practice, the shadow-banking activities can create additional loans on the stage of bundling. In this case, additional uncertainty and risk is added because the conversion through the bundling into asset-backed obligations increases not only funds for credit creation, but also the complexity and fragility of financial intermediation, and has inherent additional risk when economic conditions worsen. The increasing risk augmented by the creation of new entities without reserves and appropriate central bank overview and control may add volatility to financial markets. As Z. Pozsar et al. (2012) argue in their report, the shadow-banking system intermediates credit creation using a large set of different financial instruments and complicated chain of intermediaries.

Compared to usual banks that have access to public source of liquidity as FRS discount window and Federal Deposit insurance, the shadow-banking system relies only on private sector money generation. The basic mechanism of credit creation in shadow banking uses liquidity and maturity transformations. When the bank grants a credit, e.g. a credit for a house purchase, the bank can get additional cash by selling packaged debt obligations to another shadow-banking entity. The bank uses the cash to grant additional loans. A shadow-banking entity issues short-term commercial papers with shorter maturity and lower interest rates to pay, receiving profit on the maturity and interest gap.

Following the dotcom bubble burst, the soft FRS policy stimulated low interest loans for housing and made the policy in loan creation less responsible by lowering interest rates and easing loan qualifications. In addition, the fore mentioned risk transfer by securitization made errors in investment decisions more proliferous. Easy and allegedly safe money leads to errors in calculations and business planning. These factors lead to the expansion of the housing bubble and the following burst with global economic consequences (Fligstein, Goldstein 2010).

The novelty and complexity of new instruments combined with the willingness of banks to hide risk associated with new methods of debt generation and the overoptimistic high grade assignments by rating agencies creates and environment prone to incorrect conclusions made by ordinary investors. To avoid such a situation it is necessary for investors/entrepreneurs to study carefully not only the financial position of the issuer, but also the structure of the proposed collateralized instruments. In addition, they have to review their

portfolio, taking into account that in some situations the quality of such novel instruments may deteriorate to the quality of underlying assets.

6. SOME CONSIDERATIONS ON PUBLIC POLICY

Though the problem of information does not pertain solely to the economy, the economic information problems influence practically all sides of economic process. Informational openness provides economic agents with the ability to make their planning process more coherent, relevant to goals pursued by them. As remarked by Hayek (1945), the pieces of information are dispersed over the total population, so the correct and overall picture is not accessible to just any economic agent. Additional efforts to provide information to market participants are plausible and lead to increasing market efficiency. This, in turn, leads to decreasing errors in decision-making and diminishes the probability of busts. The government efforts, to induce market agents for disclosing their financial information, will make markets more predictable and less error prone. Special attention needs to be drawn to new forms of financial intermediation, such as shadow-banking activities. Its functions are useful for the economy, though some measures of transparency and correct assessment of risks are needed.

7. CONCLUSION

Austrian theory proposes one of the comprehensive monetary explanations of economic fluctuations. One of the main proponents of Austrian school F. A. Hayek argues the role of information and ability of foresight in economic decision. The modern, more complicated, structure of credit generation may create new credits in modern finance framework, and because of its complexity it does not provide sufficient information to make valid investment decisions. These new features of the modern financial system stimulate malinvestments and inevitably lead to booms and busts.

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ECONOMIC FREEDOM, REFORMS AND ENTREPRENEURSHIP IN GEORGIA

PAVOL MINÁRIK, MAREK VOKOUN, ALENA ZEMPLINEROVÁ[1]

ABSTRACT

The role of entrepreneurship is recognized in economic theory as well as in economic policies, particularly in post-communist countries. This paper examines environment for small and medium enterprises in Georgia, a country that is highly ranked for its institutional environment. In a survey of local stakeholders we have confirmed that institutions are not the major obstacle for Georgian entrepreneurs. However, we have discovered additional obstacles responsible for the hindrance of entrepreneurship in Georgia, particularly difficult access to finance and adequate human capital.

KEYWORDS

Economic freedom, transition, entrepreneurship, Georgia

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1 All authors are from the Department of Economics and Management, Cevro Institute College, Prague, Czech Republic. Correspondence shall be directed to Pavol Minárik, email: pavol.minarik@vsci.cz.
This paper has been prepared within the project "Transfer of know-how for small and mid-size businesses" financed by the International Visegrad Fund (IVF) and the USAID. Support of both institutions is gratefully acknowledged. Authors have also benefited from cooperation with the CASE-Georgia and the International School of Economics at the Tbilisi State University (ISET), in particular with Lasha Labadze, Irakli Galdava and Maya Grigolia.

1. INTRODUCTION

Entrepreneurship is the cornerstone of economic development. Austrian economists have recognized this fact for a long time and it is also accepted among other mainstream economists. Reforms in many post-communist countries have aimed at restoration of institutional conditions in which entrepreneurship can flourish. Of all the post-Soviet transition economies Georgia is often cited among the most successful. Although this assertion holds some credibility, caution should be advised as to not overestimate Georgian advances.

Georgia's economy still faces many problems. Even with the successful reforms of past decades, a considerable portion of the population faces economic hardship. There are aspects of the institutional environment that have made significant improvements, but various problems remain. In this paper, we explore the benefits of the Georgian reforms in contrast to their shortcomings.

This paper combines the knowledge from publicly available sources with our own data from local stakeholders. Among these we have not only included entrepreneurs who are the usual target of surveys but other representatives of Georgian society as well. This diverse dataset highlights a unique contrast between the typically bright picture portrayed by various indices and reports, and the reality experienced by local actors.

The paper is organized in the following manner: Part 2 summarizes theoretical concepts regarding entrepreneurship and institutional environment; Part 3 briefly outlines economic development in Georgia over past decades; Part 4 outlines improvements to Georgia's institutional environment as measured by different indices reflecting the quality of institutions; Part 5 presents our findings from local stakeholders; Part 6 concludes our findings.

2. ENTREPRENEURSHIP, INSTITUTIONS AND ECONOMIC GROWTH

Since the famous contributions to the understanding of market economies by Israel Kirzner's 1997 "How Markets Work: Disequilibrium, Entrepreneurship and Discovery," the role of entrepreneurship in market economies is hard to overlook. For these purposes, however, merely acknowledging the importance of entrepreneurship will not suffice; more is needed to gain a better understanding of the current entrepreneurial situation in Georgia. Persistent research has successfully identified influential factors key to the decision making of individuals in regards to the engagement of entrepreneurial activities. An overview of these factors is discussed in the following paragraphs succeeded by a breakdown of the institutional environment.

It is important to understand that several methods can be utilized to better understand the determinants of entrepreneurship. The first of which used in our analysis was one developed by Audretsch, Grilo and Thurik in 2007, which distinguishes the *demand for entrepreneurship* as well as the *supply side of entrepreneurship*. In regards to the demand for entrepreneurship, factors such as technology developments, demand shifts and resource availability

help create business opportunities. Typically, incumbent businesses or potential new firms (latent entrepreneurs) are the first to capitalize on such determinants. Alternatively, the supply curve of entrepreneurship is subject to the abilities, resources, preferences and attitudes of a given population; factors that heavily depend on *demographics* and *culture*. Thus, in this instance the intersection of supply and demand reflects the decisions of individuals to either pursue entrepreneurial opportunities or the available alternatives, such as outside employment or unemployment.

A decomposition into individual factors, like the ones mentioned above, allows us to determine which types of interventions have effects on which types of determinants of entrepreneurship. The framework provided by Audretsch, Grilo and Thurik (2007) also explores potential consequences of public intervention. For example, public interventions can potentially influence the demand, the type, the quantity and even accessibility for entrepreneurial opportunities. There are a plethora of examples where public outcry has ceased important research and development, which otherwise likely would have yielded important technological advancements. In addition to the effects of public intervention on the determinants of demand, determinants of supply are also subject to public interference. For example, population policies (particularly policies related to migration) can greatly affect the preferences and/or attitudes of a population.

Alternatively, the supply of entrepreneurship may actually benefit from interventions. Primarily, public interventions can improve the abilities and resources available to potential entrepreneurs. These improvements are reflected both in material resources [typically understood as access to finance or financial capital], and the knowledge and skills of people (human capital). Further interventions may be directed towards changing the attitudes regarding entrepreneurship as an alternative to employment. Although these attitudes and risk preferences are embedded in culture and difficult to change as a result, they may respond positively to increased education and media coverage on the topic of entrepreneurship.

Another set of public interventions affects the choice between entrepreneurship and (un)employment. Different policies regarding taxation, the regulation of businesses and labor markets, unemployment benefits, bankruptcy laws, etc., can have crucial impacts on the choices of individuals. On the demand side, public policy also determines whether or not new entrepreneurs, rather than incumbents, would use new market opportunities. Competition policy plays an important role in this respect, as well as the protection of intellectual property and the regulation of the business establishment.

We may produce yet another classification of problems and obstacles to SMEs development based on the problems' source. The two principal sources are inadequate environment for entrepreneurs and inadequate resources, both material and immaterial. The environment is composed of many different aspects. It comprises political stability, legal framework for entrepreneurship (particularly property rights and contract law), taxation, regulation and law enforcement (including impartial judiciary and corruption).

Availability of resources may limit entrepreneurship even when the environment is perfect. Regarding material resources, the chief limitation is typically access to finance and the cost of

credit, if accessible. Additional limitations stem from the availability of required skills, both of the aspiring entrepreneur and the necessary workforce. Finally, inadequate information might restrict entrepreneurship: information about the market opportunities (domestic and foreign), financing options, regulatory environment, etc. Ignorance of market opportunities or insufficient skills to expand into new markets decreases the de facto size of the market.

The different shortcomings of each environment and each market call for different interventions. The general policy regarding the environment shall provide a "level playing field" for entrepreneurship; that is, equal conditions for all entrepreneurs. Further measures shall address particular market failures. In line with the "level playing field" idea, competition policy attempts to prevent excessive market power. Asymmetry of information is another source of market failure; it is particularly pronounced in the credit market. Finally, various positive externalities are connected to entrepreneurship, especially their contributions to innovation, productivity growth, product diversity and job creation. Without public intervention the production connected with such externalities may be suboptimal.

This paper focuses on the institutions as the key determinant of entrepreneurial activity. The impact of the institutional environment on other economic variables is now widely recognized among economists. Limitations of choice faced by individuals include those that are not only physical in nature, but also man-made intangible constraints. Thus, the framework for economic activity is formed by a combination of scarce productive resources and institutions that limit their use in different ways.

Following Aoki (2001), we may distinguish three views of institutions based on game-theoretic perspective. First, institutions may be viewed as they are in daily conversation, as prominent organizations (i.e. as players of the game). Second, following North (1990), institutions are viewed as the rules of the game, distinct from the players. As put by North: "Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction."(North, 1990, p. 3)

There are two types of rules in the game: formal ones (constitutional, property rights, contract law) and informal ones (norms and customs). The key issue with establishing the institutions as the rules of the game is their enforceability. While the formal rules may be transferable from country to country, the informal rules are more resilient. Thus, borrowed institutions may be neither enforceable nor functional. Including the issue of enforcement and the enforcer's motivation into the analysis leads to the third view of institutions. As put by Aoki (2001, p. 2), "[t]he most reasonable way of approaching institutions from this perspective is then to conceptualize an institution as an equilibrium outcome of the game." In the end, however, "[a] proper formulation of a concept, such as that of institutions, may depend on the purpose of the analysis." (ibid.)

For these purposes, we understand institutions as the rules of the game. Enforcement of these rules is viewed as their characteristics (qualities).[2] Defining institutions as the

2 Following another definition by North (1988, p. 4): "Institutions are rules, enforcement characteristics of rules, and norms of behaviour that structure repeated human interaction."

rules of the game still leaves us with a great selection of different measures. There are many different rules that govern life in a society. As we mentioned above, there are formal rules, best represented by constitutions and statutory laws, but also binding court decisions (precedents) and such. Furthermore, there are different informal rules, ranging from well-known and well-described conventions to obscure customs having the nature of Hayekian tacit knowledge. As for enforcement, methods range from self-enforcement to enforcement by the power of state.[3]

In the following analysis we focus on several broad categories of institutions affecting entrepreneurship, particularly the rules related to property rights and contracts. These seem to have the most direct effect on economic activity. Property rights generally define who has the decision-making authority over use of particular assets. Limits to contractual freedom put restrictions on which property rights can be traded among individuals and under what conditions. We examine the impact of various settings on economic performance below. Finally, we explore the importance of process law. It determines the quality (especially the cost) of enforcement. As we have defined enforcement of particular rules as one of the characteristics of those rules, we will not deal with process law further, and we consider it subsumed in the quality of property-rights and contract rules.

The term "property rights" stands for a complexity of rights; each of which represents a different aspect of property ownership. Among these rights is the right to use an asset, the right to exclude others from using it, and the right to transfer the asset to others. Property rights allow the owner to determine the uses of the asset and to derive value from the asset (Anderson & Huggins, 2003). The notion of property rights allows us to better interpret property and government intervention. In fact, nominal ownership may be incomplete; i.e. the owner may not have all the property rights. For example, if there is a requirement to obtain a license for particular use of an asset, part of the property rights belongs to the government, who can decide whether the asset can be used and the manner in which it can be used.

Well-defined property rights affect economic activity in two ways. First, they are a solution for the tragedy of the commons, and second, they provide, or rather promote, incentives for savings and investments. Both of these outcomes originate from clearly defined and protected property rights that establish precisely who has the right to use an asset and derive benefits from it, or – otherwise stated – to exclude others from using it. The combination of open access and scarcity results in conflict and/or destruction of the scarce resource in the well-known "tragedy of the commons." If a society fails to develop a solution, either by establishing private property or some form of communal property governance, the effects are grave.[4]

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3 For details see Voigt (2002, chapter 1).

4 More on this subject can be found in Eggertsson (2003), or the chapter 2 in Anderson and McChesney (2003).

Moreover, well-defined and enforced property rights encourage investments. In a free access setting, everyone is motivated to maximize present use of a resource. However, if the future revenue from investment is guaranteed to the owner, he has an incentive to maximize the present value of future returns. Therefore, he is willing not only to economize on scarce natural resources, but also make improvements to enhance their productivity. Overall benefit to economic welfare is thus enhanced.

After the rather lengthy discussion of property rights, let us add a short remark on contractual freedom. It is generally assumed in economic theory that voluntary exchange increases welfare of both trading parties.[5] Therefore, it is the role of institutions to facilitate exchange by decreasing transaction cost. However, some rules are specifically designed to increase transaction costs and to limit contractual freedoms. These rules may follow some social purpose other than maximization of welfare to contractual parties, e.g. the elimination of some kind of externalities or the enforcement of moral principles.[6] Generally, high transaction costs caused by government regulation or insufficient contract enforcement, discourages specialization and division of labor, and ultimately slows down economic development.

Economic growth and development is significantly dependent on the institutional environment. Generally, institutions work to reduce strategic uncertainty naturally involved in all interactions among people. In other words, institutions do reduce transaction costs. As a result, the number of transactions increases, allowing division of labor and greater specialization in society. As pointed out by Adam Smith, division of labor is the key to economic growth.

Furthermore, this analysis focuses mainly on formal institutions (i.e. institutions enforced by the state). North (1988, p. 7) points out "a critical and neglected aspect of economic history: the essential role of third party enforcement of contracts for human economic progress." As opposed to personal exchange that solves the problems of contract fulfillment by repeated dealings and a network of social interaction, modern societies must rely on different institutional settings.

Therefore, formal institutions and government performance in general are important elements of economic development. As noted further by North "while third party enforcement is far from perfect, there are vast differences in the relative certainty and effectiveness of contract enforcement, temporally over the past five centuries in the Western world, and more currently between modern Western and third world countries" (ibid.). It is precisely these differences and their impact on productivity that is the subject of present research, as Georgia's transition is characterized primarily by the adoption of Western institutions and the Western mode of enforcement.

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5 Abstracting from various discussions on rationality, ex-ante and ex-post utility and exchange between persons with limited capacity.

6 Examples may include drug prohibition, occupational safety and health regulation, prohibition or regulation of Sunday shopping, production and sale of pornography, etc.

3. INSTITUTIONAL DEVELOPMENT IN GEORGIA

Georgia has a small open economy that transformed from a Soviet-type economy to a modern market economy. For the Georgian transition, weakened by military conflicts, the role of the International Monetary Fund (IMF) and other institutions such as the World Bank and the European Union was crucial. The IMF helped coordinate the transformation process (Papava, 2003). As a result there were important achievements in the 1990s: A new financial system with national and commercial banks was established: hyperinflation was curbed, price liberalization began, the privatization of state banks was completed, Parliament was approving the national budget, foreign trade was liberated, foreign debt was restructured, and Georgia became a country capable of paying its debts. In 1993 Georgia withdrew from the ruble zone and introduced a national currency in 1995. In the same year, prices were liberalized and privatization began. Although this was an economically efficient solution, it also led to much confusion. More than 90% of retail turnover was private by 1997, and 11.5 thousand small businesses (with less than 50 employees) had been privatized mainly by insider sales by the next year. The energy industry had unbundled and was privatized in 1998, followed by other industries including land, water supply, ports and telecommunications.

In general, economists do not possess a universal blueprint that can successfully transform a communist economy into a competitive market economy with limited government. Traditionally, the transformation process in post-communist countries includes an establishment of political and market competition; that is, it removes the previous authoritarian regime and initiates the deregulation and trade liberalization, which leads to massive structural and institutional changes and a new market orientation. These reforms require countrywide support for the new regime, which includes national elites and new regional leaders. Transparent cooperation without corruption and rent-seeking behavior is necessary. According to Gould and Sickner (2008), this was not the case in Georgia, where corruption and rent seeking was common practice among economic and political agents. The support of regional and national elites was very limited up to the Saakashvili reforms.

Nonetheless, the Georgian economy saw significant growth over the last decade. From 2003 until the financial crises the average growth rate was 9.3 percent. Georgia experienced a setback, however, due to the coinciding financial crisis and armed conflict with Russia in 2008. In 2009 the growth declined to −4.0 percent. Despite achievements in the last decade, Georgia still remains in an unstable macroeconomic environment majorly impacted by political challenges. It suffers from a high unemployment rate and low income for most of its population.

4. MEASURING INSTITUTIONAL CHANGE IN GEORGIA

The key problems of institutional analysis are measurement and quantification. In this paper we use different indices that reflect quality of institutions in Georgia and its changes

in time. These indices reflect different aspects of institutional environment. Altogether they show a positive image of Georgian institutional development – a picture that Georgia proudly presents to the outsiders.

The Economic Freedom of the World project conducted by the Fraser Institute produces annual reports of economic freedom around the world. The index measures the degree to which the policies and institutions in different countries are supportive of economic freedom – defined as "personal choice, voluntary exchange, freedom to enter markets and compete, and security of the person and privately owned property" (Gwartney, Lawson, and Hall, 2014, p. v). The chief components include the size of the government (expenditures, taxes, and enterprises), the legal structure and security of property rights, access to sound money, the freedom to trade internationally, and the regulation of credit, labor, and business.

In the latest report that reflects the situation of 2012 (Gwartney, Lawson, and Hall, 2014), Georgia was ranked as the 16th economically freest country in the world. It excels mainly in the field of international trade (eighth in the world), business regulation (ninth) and credit market regulation (14th). The index does not allow tracking institutional change far back, as complete data for Georgia are only available since 2004. However, it is fair to say that Georgia was a free country in that year and its ratings have improved even further since then.

The Heritage Foundation and the Wall Street Journal publish the Index of Economic Freedom jointly. It defines economic freedom as "the fundamental right of every human to control his or her own labor and property" (Heritage Foundation 2015). The index is based on 10 quantitative and qualitative factors reflecting four broad categories of economic freedom: the rule of law (property rights, freedom from corruption), limited government (fiscal freedom, government spending), regulatory efficiency (business freedom, labor freedom, monetary freedom), and open markets (trade freedom, investment freedom, and financial freedom). Thus, the approach roughly corresponds to that of the Fraser Institute's Economic Freedom of the World project – although, it should be noted that the data sources and evaluations somewhat differ.

In the latest report (Heritage 2015), Georgia is ranked as the 22nd economically freest country in the world. It is highly rated in trade (seventh in the world) and business (16th) freedom, as well as monetary freedom (22nd), which combined mean stable currency for Georgia. The index also allows tracking institutional improvements in Georgia since 1996. The Georgian economy has improved from controlled (rating 44.1 out of 100) to one of the freest economies in the world (the latest rating is 73.0). The world average over the same period has changed from 57.1 to 60.4: Georgia has significantly outperformed the world in this respect.

The Global Competitiveness Report published by the World Economic Forum (2014) evaluates different aspects of an economy's competitiveness. Out of twelve pillars of competitiveness, as defined in this evaluation, institutions are the first and they are included among the most basic requirements of competitiveness. The Global Competitiveness Index allows for cross-country comparison over several criteria – although due to the infancy of the index it does not allow for comparison over time.

Georgia's overall performance as measured by the Global Competitiveness Index is 4.2 out of 7, which ranks Georgia 72nd in the world. The score has improved even further in recent years. Institutions are among the relatively best components of Georgia's score; the score of 4.0 out of 7 places Georgia at the 64th place in the world. According to the Global Competitiveness Report (2014) major obstacles to conducting business include access to financing, inadequately educated workforce, poor work ethic among national labor forces, and policy instability. The latter two problems are basically institutional, although they are not easily solved by economic policy.

The Doing Business survey by the World Bank (2015) presents a rather different picture of Georgia. The survey focuses on 11 areas that affect the ease of doing business: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts, resolving insolvency, and labor market regulation (not included in 2015 edition).

Georgia is ranked as the 15th best country in the world for doing business. In several components it has received even better rankings: starting a business (5th), dealing with construction permits (3rd), registering property (1st) and getting credit (7th). Georgia's institutional performance has continuously improved over the past decade according to the Doing Business survey and it appears to be one of the best places in the world to start and conduct a business.

5. PERSISTENT HINDRANCES TO ENTREPRENEURSHIP IN GEORGIA

Economic performance of Georgia does not conform to the bright picture portrayed by several indices presented above. There are manifold obstacles that prevent the Georgian economy from achieving higher outputs. We present findings from our survey of Georgian stakeholders that point to certain problems hindering entrepreneurship in Georgia.

Georgian small and medium enterprises have a lower share of employment and output in comparison to developed European countries. Papiashvili and Chiloglu (2012: 22) show that "there is a set of macro factors (for example, unstable legal environment, low purchasing power of the population, lack of qualified human resources, lack of market information, etc.) and micro factors (such as low coordination between organizations supporting the SME's, lack of proper marketing and managerial skills, uncompetitive products, and the like) that still brake the development of the SME sector in Georgia." It is an important task in economic policy to identify and address these problems.

5.1. FINDINGS FROM A UNIFORM QUESTIONNAIRE

In our research project a uniform questionnaire was prepared and sent out to various stakeholders and experts. To help the respondents, the questionnaire was translated and distributed both in English and Georgian. The selected group included 13 respondents. In the first part of the questionnaire template respondents were asked to evaluate to what extent

the factors listed were impeding the development and activities of the SMEs in the country. On a scale from 1 to 4, 1 represented "not at all", 2 represented "somewhat", 3 represented "significantly", and 4 represented "very significantly." An NA option was provided in case the respondent did not know.

Parallel to this exercise, respondents were asked to mark "help" in case they thought that an intervention would be advised and welcomed.[7] Some respondents marked "help" parallel to giving a number from 1 to 4, thus signaling the importance of the given topic. Other respondents understood "help" as the way of expressing that the issue was of crucial importance and policy recommendations and knowledge transfer were most welcome regarding the given issue; they marked only marked "help" instead of giving a value from 1 to 4. We coded these responses as 4.

The questions targeted six domains relevant to the development and daily activities of SMEs. The main domains were: Labor and skills, Red tape/bureaucracy, Tax burdens, Law and order, Market specificities, Finance and other issues. Statistics on survey responses are summarized in the Appendix.

Evaluations of the Georgian institutional environment in various indices presented above are generally confirmed by our survey. As we expected, red tape and bureaucracy domain was considered to be the least important problem for the Georgian small and medium enterprises (SMEs). Similarly, the taxation system did not seem to be a major source of difficulty – although, some point to frequent changes and certain ambiguities (e.g., Kuriakose 2013). Regarding the rule of law, survey respondents cited weak property rights and weak judiciary as problematic areas. Again, this confirms the existing information on the situation in Georgia.

The most impeding factors identified by our respondents were within the domains of labor and skills, and market and finance. In the first domain, respondents cited low market skills of entrepreneurs and lack of business experience. Low availability of high skilled workers was another problem in this area that hinders the development of businesses in Georgia. In the market domain, the most impeding factors were weak market position of SMEs, which could be linked with the excessive market power of some of the companies, and perhaps also linked weakly to unfair competition and weak SME organizations. Furthermore, respondents pointed to political and macroeconomic instability and barriers for exports.

To sum up, the problems for enterprises in Georgia are not dominantly institutional. However, the situation is not very favorable for Georgian entrepreneurs. Among the institutional problems political instability is perhaps the most serious. Otherwise, entrepreneurs face problems with regards to resources, both human and material. In this respect, our findings are in line with previous observations from the literature.

Political stability is an important factor in the entrepreneurship environment. This may be especially important for foreign trade partners and potential investors. In this respect, the recent history does not provide a very optimistic picture of Georgia. Political instability

7 Our research was part of a larger project seeking to provide suggestions for interventions in SME policies in cooperation between Visegrad countries and Georgia, Moldavia and Ukraine.

is cited as the main obstacle by representatives of small, medium and large firms in Georgia (World Bank 2013). However, the political situation and international relations can hardly be seen as a possible target of entrepreneurship policies. Regardless, we shall be mindful of these limitations within the environment for the activities of the SMEs. Also, the image of a country vis-à-vis (potential) foreign business partners can be improved in a planned and coordinated manner.

Unlike the institutional environment, the availability of resources is not very favorable for entrepreneurship in Georgia. This is true both for material and immaterial resources. Existing literature as well as our survey point to problematic access to finance, inadequate skills of entrepreneurs and labor force, and insufficient information among SMEs. Our survey confirms that access to finance is an important domain to be addressed by public interventions. Respondents pointed to difficulties in accessing financial services and high cost of credit. Help in this area is needed to overcome the existing problems.

Inadequate skills are also cited as a problem both in previous studies and our survey. The World Bank report (Kuriakose 2013) lists "difficulty recruiting highly skilled employees" among the most frequently cited obstacle to SME's development and recommends reforms to education systems. The World Economic Forum's 2013 Global Competitiveness Report ranks this issue as the second most important (access to finance being the first). In our survey, respondents point to low skill or education of entrepreneurs, lack of experience as well as low availability of high skill workers. Low labor market flexibility and lack of language skills are also rated as significant.

Finally, there is a major issue concerning information of business opportunities, especially concerning foreign trade. The size of the market is assessed as one of the weakest points of Georgian economy in the World Economic Forum's 2013 Global Competitiveness Report. Expansion of exports requires specific skills and information on potential foreign partners that are obviously scarce in Georgia. In our survey, lack of experience in foreign trade, particularly with the EU, and lack of knowledge of EU regulations (coupled with institutional differences with the EU) is marked as a significant problem that requires intervention. Lack of language skills and contacts abroad is also considered as a somewhat serious problem among our respondents, as well as foreign barriers to trade (although these are not specified). Finally, our respondents point to lack of open communication channels with the EU.

5.2. INTERVIEWS WITH SELECTED STAKEHOLDERS

Interviews with stakeholders shed some light on the actual state of the Georgian economy and revealed some serious problems. All interviews were carried out in Tbilisi in February 2014. We conducted 12 interviews, which took approximately an hour each. We interviewed major public and private institutions dealing with SMEs and SME administration. The goal of these interviews was to provide a first-hand experience and gain additional insight to the Georgian economy. In other words, we wanted to unravel issues and possibly even expose informal institutions, which are usually not visible to foreigners.

Many respondents described the problems mentioned above such as the lack of skilled personnel, high collateral for SME loans and general lack of awareness about publicly

funded projects. However, we identified three additional major issues in the health sector, banking sector and the system of public procurement.

One of the respondents described issues regarding the health sector and the establishment of a non-profit, non-governmental organization (NGO). For an NGO it was problematic to become registered and established in the 1990s. Later, a tax for NGOs was introduced that destabilized this sector in Georgia. This tax led to salary cuts for the most qualified workers, coincidentally the most difficult to find. In the health sector there have been radical changes in nearly every political cycle since the 1990s. This has led to under-investment in the sector. Investors are very cautious when it comes to long-term investment in the Georgian health-care sector because their predecessors were heavily indebted and often went bankrupt.

Another respondent described issues in regards to the banking sector. Leasing officers use the same restrictive approach to SMEs as their colleagues from the loan departments. This makes both financial and operational leasing an inaccessible alternative to the problematic loans. Moreover, we were informed that loan officers do not honor the secrecy of business projects. However, we were not able to verify this statement because all major banks in Tbilisi rejected our requests to meet and discuss the SME agenda and related issues in the banking sector.

Yet another respondent stated that there were issues in the very modern and transparent electronic system of public procurement. According to the respondent, large companies predominantly control it and there are barriers for SMEs. The procurement specifications lack more categories to ensure quality and they are tailored to the needs of large companies. Also services such as catering and cleaning are secured and provided by internal sources from the public sector. These services could be outsourced to SMEs. As we have stated above, large companies are perceived as dominant in Georgia. However, Georgian ministries and statistical office do not have the exact numbers of SMEs and large companies according the European definition of enterprise categories, so the actual ratio is difficult to verify.

6. CONCLUSION

The institutional environment is undoubtedly an important factor affecting entrepreneurship and economic progress. Post-communist countries have undergone a profound institutional change in quest for institutions better suited for a market economy. Some countries have been quite successful while others struggle. Georgia presents an interesting case in this respect – some reforms work well and put Georgia on top in country ratings, while some areas remain problematic.

Our survey aimed to achieve a perspective on Georgian economy that is different from what is presented by existing surveys of institutional or business environment. Local stakeholders point to certain hindrances to the rapid economic growth of Georgia. Predominantly, however, these are not concerned with institutions. In fact, the institutional envi-

ronment – with the unfortunate exception of political stability – is quite favorable. The most important shortcomings are in the area of resources, both human and material. The experience of Georgia highlights an important fact: although institutions do matter, they are merely a part of the necessary infrastructure for economic development.

In the following years, political, economic and institutional development of Georgia will be significantly affected by its cooperation with the European Union. The relations with the EU present both opportunities and threats. The regulatory framework of the EU that will be transplanted to Georgia may reduce some of the economic freedom developed by Georgians. On the other hand, however, the cooperation with European countries presents vast opportunities for enlarged markets; that is, both an increase in the potential demand and the potential supply of resources in Georgia – including finance. Furthermore, European countries could share some of the good practices in governance with Georgia. Improvements to governance capacity combined with sound law on the books could improve the Georgian economy even further.

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APPENDIX

GEORGIAN EXPERTS' SURVEY RESULTS

LABOUR AND SKILLS DOMAIN

1	Domain/Obstacle	Mean value	SE	Obs.
A	Low market skills of entrepreneurs / Inadequate business education	**3.31**	0.21*	13
B	Lack of business experience	**3.00**	0.28	13
C	Lack of experience in foreign trade, in EU in particular	2.54	0.18*	13
D	Lack of knowledge of EU regulations	2.69	0.24*	13
E	Lack of language skills and contacts abroad	2.69	0.24*	13
F	Low availability of high skill workers	**3.00**	0.25	13
G	Low availability of low-skill workers	2.08	0.14*	13
H	Demographics / low number of young labour market entrants	2.15	0.25*	13
I	High emigration	2.54	0.24*	13

J	Expensive labour / Mismatch between labour cost and productivity	2.31	0.29	13
K	Employer-employee conflicts	2.00	0.25	13
L	Low labour market flexibility	2.77	0.23*	13
M	High syndicalization / Excessive power of labour unions	1.62	0.31	13
N	Low labour ethics	2.54	0.18*	13
O	Low business ethics	2.85	0.19*	13
1	Labour & Skills	2.54	0.23*	13

**) Mean value significant at 5 %*

RED TAPE AND BUREAUCRACY DOMAIN

2	**Domain/Obstacle**	**Mean value**	**SE**	**Obs.**
A	Difficulties in registering company	1.25	0.25	12
B	High cost of market entry	2.18	0.30	11
C	Difficulties to expand business activities / bureaucratic obstacles	1.75	0.25	12
D	Non-transparent / inconsistent regulations	2.00	0.16*	13
E	Poor overall regulatory framework / Excessive burden of regulations	1.92	0.19*	12
F	Foreign trade barriers	2.92	0.23*	12
G	Institutional differences with EU	2.83	0.30	12
2	Red Tape /Bureaucracy	2.12	0.24	12.00

**) Mean value significant at 5 %*

TAX BURDEN DOMAIN

3	**Domain/Obstacle**	**Mean value**	**SE**	**Obs.**
A	Unstable and non-transparent tax rules and/or their applications	2.33	0.22*	12
B	High cost of compliance	2.25	0.18*	12
C	High effective SME presumptive tax rates	2.11	0.11*	9
D	High effective personal income tax rates	2.33	0.26	12
E	High effective corporate income tax rates	1.90	0.28	10
F	High effective value added tax / trade tax rates	2.36	0.31	11
G	High custom charges	1.91	0.25	11
H	Other high taxes and fiscal fees/charges	1.89	0.35	9
3	Tax burden	2.14	0.25	10.75

**) Mean value significant at 5 %*

LAW AND ORDER DOMAIN

4	Domain/Obstacle	Mean value	SE	Obs.
A	Weak property rights / weak contract enforcement	2.69	0.26	13
B	Crime and violence (low safety)	1.58	0.23*	12
C	Corruption / Clientelism / Favouritism	1.83	0.27	12
D	Weak judiciary	2.77	0.26	13
4	Law and order	2.22	0.25	12.5

**) Mean value significant at 5 %*

MARKET DOMAIN

5	Domain/Obstacle	Mean value	SE	Obs.
A	Small market size / Weak demand	**3.23**	0.28	13
B	Barriers for exports to foreign markets	**3.15**	0.19*	13
C	Unfair competition / Uneven playing field / Informal economy	2.58	0.19*	12
D	Monopolization / Excessive market power of some participants	**3.00**	0.23*	13
E	Weak market position of SMEs	**3.38**	0.14*	13
F	Weak professional organizations of SMEs	2.92	0.18*	13
G	Weak analytical and policy advocacy of SME organizations	**3.25**	0.13*	12
H	Discriminatory practices of authorities	2.00	0.17*	12
I	Unfair privileges for foreign investors	1.75	0.18*	12
J	Macroeconomic instability (demand, inflation, exchange rate)	2.92	0.21*	13
K	Political instability	**3.00**	0.23*	13
L	Insufficient market information/governmental support for SMEs	2.92	0.23*	12
M	Weak support/lack of support by international organizations	2.42	0.19*	12
N	Low level of activities of venture capital	**3.25**	0.25	12
5	Market	3.03	0.20*	12.5

**) Mean value significant at 5 %*

FINANCE AND OTHER DOMAIN

6	Domain/Obstacle	Mean value	SE	Obs.
A	Difficulties in accessing financial services	**3.15**	0.27	13
B	High cost of credit	**3.31**	0.24*	13

C	Inappropriate infrastructure	2.45	0.25	11
D	Weak professional organizations of SMEs	2.75	0.18*	12
E	Difficult access to internet / Lack or low quality of business websites	2.50	0.23*	12
F	Lack of open communication channels with EU	**3.00**	0.19*	11
6	Finance and other	2.86	0.23*	12

**) Mean value significant at 5 %*

BOOK REVIEW

DOES ECONOMIC THOUGHT ALWAYS REFLECT HISTORY? A BOOK REVIEW OF THE ECONOMIC CLASHES OF THE LAST HUNDRED YEARS BY LARRY H. WHITE, 2012. CAMBRIDGE UNIVERSITY PRESS, 440 P

Is L.H. White's book, *The Economic Clashes of the Last Hundred Years* (2012), a modern text book of the history of economic thought? Kuhn (1970) argues that scientific development is a matter of the competition between theoretical paradigms. Coase (1994) applies this argument on the development of the economic theory. White (2012) tries to illustrate this argument on the development of economic theory of the last hundred years. In my opinion, this is how modern and advanced text books of the history of economic thought might be written.

The fact is that since Schumpeter's *History of Economic Analysis* (1994) a few quality historical illuminations of the development of economic analysis were written. Even though Schumpeter's *History of Economic Analysis* (1994) is not a text book, almost all modern textbooks of the history of economic thought uses it at least as a source of very valuable facts. The point, however, is that this monumental opus ends with marginal revolution. Development of the history of economic analysis after marginal revolution in such a large format was not written yet. For this reason, we must appreciate all attempts to cover the history of economic thought after marginal revolution. In Europe, a lot of very good economists were trained in the history of economic thought. Advanced history of economic thought text books thus significantly contributed to development of the profession. As Kuhn explains:

Textbooks thus begin by truncating the scientist's sense of his discipline's history and then proceed to supply a substitute for what they have eliminated. Characteristically, textbooks of science contain just a bit of history, either in an introductory chapter or, more often, in scattered references to the great lessons of an earlier age. From such references both students and professionals come to feel like participants in a long-standing historical tradition. Yet, the textbook derived tradition in which scientists come to sense their participation is one that, in fact, never existed. For reasons that are both obvious and highly functional, science textbooks (and too many of the older histories of science) refer only to that part of the work of past scientists that can easily be viewed as contributions to the statement and solution of the text's paradigm problems. Partly by selection and partly by distortion, the scientists of earlier ages are implicitly represented as having worked upon the same set of fixed problems and in accordance with the same set of fixed canons that the most recent revolution in scientific theory and method has made seem scientific. No wonder that textbooks and the historical tradition they imply have to be rewritten after each scientific revolution. And no wonder that, as they are rewritten, science once again comes to seem largely cumulative. (Kuhn 1970, p. 137–138)

What is the difference between history of economic analysis and Professor White's history of economic thought book? White (2012) does not describe, explain and classify theoretical apparatuses in detail; he rather tries to cover the theoretical development within the context of overall historical, political and economical circumstances and with its public policy implications and their consequences. A lot of arguments on the context of the historical development of certain theoretical apparatuses, explaining their relevance and generality like for instance in the case of lord Keynes' *General Theory,* were offered. White (2012), aware of the fact that economic theories are usually developed by humans for humans living at certain places and in certain time periods, gives us interesting insight into the context of developing certain economic theories with their applications and with their application's consequences. This is why Professor White's book gives us very good overall coverage for history of economic thought courses. In this spirit, Professor White quotes Keynes' statement:

The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. (Keynes 1963, p. 383 according to White 2012, p. 3–4)

White (2012) introduces us into the development of economic thinking of the last hundred years. In **the first chapter** Professor White offers an opposing hypothesis that economic theories, i.e. the theory of Vilfredo Pareto, do not have any impact on practical public policies. Even Keynesian public policies were adopted before Keynes' *General Theory* publication. Nevertheless, Professor White tries to prove Keynes' or alternatively Hayek's hypothesis instead of the opposite one. Professor White introduces the reader to the several clashes between the most influential theoretical opinions on the function of the government with markets.

The second chapter starts with the historical description of the implementation of central planning inspired by Marxist theory. Professor White realistically describes its economic consequences and explains the Austrian critique. The major part of the chapter is dedicated to the survey of the calculation debate including contributions of Ludwig von Mises, Friedrich August von Hayek, Oskar Lange, Israel M. Kirzner, Thomas Sowell, Paul Samuelson, William Nordhaus, and even an opinion of Joseph Alois Schumpeter. Nevertheless, Professor White also explains the development of the theory underlining the calculation debate. First, he starts with the assumption of the labor theory of value, and then he explains how calculation debate developed from labor theory of value determining the costs, hence distribution of wealth, to the general equilibrium framework invented by León Walras.

The third chapter introduces the USA boom between 1921–1929. Professor White argues that the great depression was inevitable because there was nothing to invest in. It is not true that Keynesian public policies were implied only by Lord Keynes's *General Theory*; Keynesian public policies were also implied by Pre-Keynesian theory. As Professor White stands: "Keynes and his followers would find these [Pre-Keynesian] explanations lacking in

various respects, but it can't accurately be said that before Keynes' *General Theory* the leading economists offered nothing." (White 2012, 82) Then Professor White explains and compares Austrian business cycles theoretical argumentations, which, of course, are against Pre-Keynesian and Keynesian public policies. First the Mises's theory of business cycle is surveyed, then the Hayekian triangle explained. Both Mises and Hayek argued that the cure against business cycle is free banking organization. Background theory of interest rate offered by Eugen von Böhm-Bawerk, Knut Wicksell and Banking School is also explained. The exposition of opinions of participants in the dispute between Keynes and Hayek and their opinions on Hayekian public policy suggestions is, however, interesting.

The fourth chapter is dedicated to institutionalism and its influence on Fascist, Nazi and New Deal public policies. Professor White explains the influence of J.A. Hobson, Rexford Guy Tugwell, Simon Patten Thorstain Veblen, Clarence Ayers, John Maurice Clark, Gardiner Means, Wesley C. Mitchell, Richard T. Ely, John Commons, Adolf A. Berle and Frederic Winslow Taylor. After criticism of NRA and NAA New Deal public administration, White (2012) argues that institutionalism was significantly influenced by the German Historical School and criticizes this approach as interventionism without sound economic theory. Moreover, White (2012) argues that American Institutionalists have similar opinions on social organization regarding the opinions of Socialists. He proves it by explaining the opinions of Frederic Winslow Taylor on proper social organization which are, according to White (2012), similar to Lenin's visions. Then Taylor's vision is described.

The fifth chapter is the chapter which might be referred as the one most connected with Professor White's hypothesis. It is dedicated to the influence of *General Theory of Employment, Interest and Money* and Great Depression. First Professor White introduces Keynes explanation of the Great Depression. Lord Keyness developed the argumentation based on inherent instability of a market economy, thus governmental intervention is, according to Keynes, necessary. The Great Depression was a result of stopping governmental intervention. Professor White describes Keynesian public policy and theoretical apparatus. Moreover, Professor White also explains the difference between Keynesian macroeconomics and Hayekian macroeconomics and thus demonstrates his expertise. Keynesian argument that the macroeconomic system creates involuntary unemployment due to underconsuption was not original; therefore, the dispute between Thomas Robert Malthus, Jean-Charles-Léonard Simonde de Sismondi, David Ricardo and Jean-Baptiste Say is explained with the original Keynes argumentation. Then modern development of Keynesian economics, including IS-LM model, Phillips curve, Post-Keynesian economics and New Keynesian economics, is explained.

The sixth chapter starts with the story of how Nazis came to power in Germany. Interestingly: "Hayek... viewed Nazism as an offspring of the socialist doctrines promoted by the German Historical School..."(White 2012, p. 197) Since Nazis refused the idea of classical liberalism, F.A. v Hayek and Walter Eucken were strongly opposing to such a system of political and economic control. In the famous *The Road to Serfdom* Hayek argues that there is no principal difference between Socialism and Nazism, because both are dictatorial regimes necessarily suppressing personal freedoms. In the sixth chapter, Professor White presents several arguments how the lack of classical liberalism ideology in the historical

evolution of German economic thought caused the benevolence of the German people to Nazism. Hayek later opposed central planning in his series of essays on the inability of central planners to collect enough information for successful coordination of economic activities to fill this gap, but his crucial message was hidden in the emphasis of the inability to control dictatorial behavior weather dictators are Socialists or Nazis. This argument was explicitly presented in *The Road to Serfdom*. As Professor White argues, this was the crucial message of F.A. v Hayek that started the thinking about weak parts of democratic planning.

The seventh chapter is dedicated to thepostwar era in Great Britain. British postwar Socialism and Fabian Society organization was highly inspired by war planning.

The general belief that a peaceful society might be similarly successfully planned like a war economy, British politicians created an organization full of strong economic interventions. *Fabians* even led the labor movement to nationalization. Professor White describes contributions of the most important Fabians-Sidney James Webb, Beatrix Potter, George Bernard Shaw, Harold J. Laski and William Beveridge – to nationalization, and then he explains how these contributions were influenced by works of Henry George, Jeremy Bentham and John Stuart Mill.

In the eighth chapter Professor White describes organization of the first Mont Pelerin Society (MPS) conference after World War II. According to Professor White, establishment of MPS was one of the key steps in spreading classical liberalism ideas after the WWII. Together with the Foundation of Economic Education in New York (NY) and the Institute of Economic Affairs in London (GB), MPS became the most prestigious classical liberalism think tank ever. The founder of classical political economy Adam Smith provided intellectual background for MPS activities. Adam Smith has a great intellectual influence on the western world, but as a typical Hayekian successor, Professor White also stresses Smith's opposition to exclusive privilege to issue bank notes dedicated to the Bank of England (White 2012, p. 281). Then Smith's contribution to economic science – spontaneous order theory, his critique of mercantilism, his opinion on the role of the government in the economic system and his opinion on banking and finance together with David Hume's, Adam Ferguson's, Physiocrat's and Carl Menger's contribution to economic science is explained.

The ninth chapter describes the atmosphere after WWII in Germany together with explanation of Ordoliberalism theory. Ludwig Erhard's shock therapy strategy for German recovery after WWII inspired by Ordoliberalism was successful. Walter Eucken's theoretical concept of Ordoliberalism was inspired by a younger historical school with stronger opposition to state interventions. Ordoliberalism rooted at Freiburg; therefore, it is sometimes referred to as the Freiburg School. The public policy implications of Ordoliberalism might be simply explained as creating "conditions under which the 'invisible hand' that Adam Smith had described can be expected to do this work." (White 2012, p. 324) Another great proponent of Ordoliberalism ideas was Wilhelm Röpke. Both Walter Eucken and Wilhelm Röpke contributed to modern competition policy and theory of rent seeking.

The tenth chapter starts with the historical introduction into political development in India. An independent Indian state was organized in the second half of the twentieth century in more interventionist manner than in the spirit of free market ideology. Indian or-

ganization was inspired by communist philosophy and Fabian pragmatism. Many Indian economists trained at western universities were arguing that the Indian economic education system was targeted toward stressing the necessity of governmental interventions. Even western economists were advising more planning for India. One of those was, for instance, John Kenneth Galbraith. First, a central plan was developed for the period from 1951 to 1956. For the second stage of central planning experts from the Soviet Union were invited. To describe some theoretical foundations for Indian central planning Professor White introduces Wassily Leontief. An era of slow growth in the sixties was a result of central planning failure. This fact was stressed by Bellikoth Ragunath Sheony. This opinion was also supported by Milton Friedman. It took several decades till Indian liberalization was discussed. The second planning stage from 1955 to 1960 started a theoretical debate on development economics using mathematical and econometric arguments. Peter Thomas Bauer was an economist who contributed to development economics theoretical debate with liberalization arguments. Modern development economics, instead of relying on neo-classical growth models, stresses the importance of freedom and rule of law.

The eleventh chapter is dedicated to Great Inflation and Monetarism. During WWII American monetary policy was targeted to provision for cheap credit. Such policy of FED resulted in the Great Inflation. While Keynesian economists were not able to explain Great Inflation, Milton Friedman succeeded with update of quantitative theory of money or rather quantitative theory of price level. To characterize Monetarist theory, Professor White introduces its founder Milton Friedman and some of his theoretical contributions. Even though Milton Friedman admits Keynesian theoretical apparatus, he stands on the quantitative theory of money and stable money demand. Another economist introduced by Professor White is Irving Fisher. Monetarist research became mainstream in macroeconomic research and in 1970s, it rejected the Keynesian proposition of Phillips curve slope. It highly inspired modern macroeconomics, including New Keynesian Economics with its original public policy suggestions. In the end of the chapter Monetarists and New Keynesian public policies implications and their problems are described.

The twelfth chapter explains historical development toward Bretton Woods and the International Monetary Fund. It explains Lord Keynes's rejection of the gold standard and how the Bretton Woods conference accepted a Keynesian view of the international monetary system. After this historical introduction, Professor White summarizes functioning of the gold and silver standard. He starts with David Hume's arguments based on quantitative theory of money and connects it with Free Banking School proposals. Then some contributions of Nassau Senior are explained. Nassau Senior, in essence, formulates equilibrium conditions when production together with gold or silver standard generates inflation close to zero. According to Professor White, despite several discoveries of gold and silver supplies in the nineteenth and twentieth century, inflation under the gold and silver standard was still pretty low. Then "danger" of Grasham's law is explained. A very interesting part is also dedicated to a political discussion on bimetallism in the USA. After some discussion of monetary regime proposals made by Alfred Marshall and Irving Fisher, Professor White describes gold standard exchange rate functioning and with an assumption of a benevolent

despot such as a government and central bank, he closes monetary history and debate in the USA.

In the thirteenth chapter the growth of the government in the twentieth century from the perspective of Public Choice is described. It begins with the famous Coase theorem debate in Chicago which resulted in The Problem of Social Costs article published in the Journal of Law and Economics. Then discussion on how "good" government looks is presented. It starts with Adam Smith's idea of small and restricted government providing national defense, civil justice and public goods. What are public goods, how Pareto efficiency normative benchmark evolved and what did modern public goods theory look like? Those are question answered in this chapter. A link to the problem of externalities is provided and a solution from the Arthur Cecil Pigou's theoretical framework and the Ronald Coase's theoretical framework is explained. With the emphasis on Coasian solution, the reader is introduced to Public Choice economic analysis.

The fourteenth chapter is dedicated to free trade, protectionism, and trade deficit. Arguments against tariffs and import quotas are well known, thus what is the justification for existence of organizations like GATT and WTO? Professor White provides the answer based on Mercantilism and Public Choice theory. He explains that even Adam Smith was able to recognize how protectionism favors special interests. Professor White describes Adam Smith's example of British colonialism, and classical political economists' Corn Law discussion illuminating absolute advantage and comparative advantage theoretical arguments. Then almost all for protectionism theoretical arguments are presented and from the perspective of classical political economists rejected.

The fifteenth chapter connects Milton Friedman's argument that protectionism can lead to higher public deficits and explains theoretical discussion behind the emergence of sovereign debts in countries like Greece or Ireland. More generally, it presents historical insights into evolution of the theories which provided arguments for emergence and against prevalence of the recent European fiscal crises. Short history and some forecast of European and American fiscal deficits are therefore described. First Professor White explains that it was Keynesian economics that provided a rational for loosing fiscal discipline in the USA and other countries in the world. And again, it was Adam Smith, Jean-Baptiste Say, David Ricardo, Milton Friedman, and Friedrich August von Hayek, who provided solid arguments against loose Keynesian fiscal discipline. Then Professor White summarizes arguments against Alvin Hansen's and Abba P. Lerner's fiscal Keynesianism emphasizing the fact that the government is in essence a violent organization spending taxes in order to maintain its power to the expense of future generations. This is the argument precisely formulated by James M. Buchanan. After an explanation of Ricardian equivalence, Professor White closes with Laffer Curve, Keynesian multiplier and its criticisms.

The great contribution of White (2012) is an explanation and comparison of the development of the most influential contributions to economic thinking written by the most influential economists of the last hundred years. Explained and compared economic theories are given into the context of how they influenced politicians, bureaucrats, professional economists and the general public. Such explanation and description gives to students an

essential overview of the development of economic theories, which moved with real public policies, and thus it provides them with a plastic insight into the historical and economic development of the last hundred years through studying history of economic thought. As White (2012) stands:

The real point of picturing intellectual activity this way, though, is to give greater concreteness to the view that to understand economic policy change we need to understand the preceding developments in economic ideas from pure theory on down. (White 2012, p. 7)

In my opinion, an advanced textbook on the history of economic thought does not exist which would not be theoretically biased. I am, therefore, very happy for such an impressive neo-Austrian overview of the modern history of economic thought.

Tomáš OTÁHAL

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LIST OF ARTICLES