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November 9, 2011
THE ECONOMIC ANTIDOTE
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The Drachma is Dead: So Is the Welfare State

There is a simple rule in monetary economics, which many seem to have forgotten. *A weak currency cannot replace a strong currency.* In other words, the existence of the euro will force the countries of Europe to confront budgetary problems fiscally, not monetarily. No wonder governments are collapsing across the continent.

The Greek government, and some misguided economists, think the failure of the welfare state could be averted if Greece would only devalue its currency. This is a sad statement. A de-valuation is just a default by another name. It puts most of the burden on creditors, savers, and income earners, who face the pain and loss of reduced purchasing power.

Without the ability to devalue, the pain of restructuring falls on those who benefit from the largesse of government spending. Government jobs, pension payments, subsidies, and services will all need to be cut. The pain will fall inordinately on those who count on government for some form of support.

No wonder governments often choose devaluation instead of austerity. Devaluations can be blamed on the markets and Wall Street. But spending cuts hit constituents – those who voted for politicians who promised that government would never run out of money. This is why governments are collapsing, and will continue to collapse. Voters are completely disillusioned and they are facing a great deal of pain as they get a very expensive education in basic economics.

These countries cannot devalue their currency because they gave up the management of money to the European Central Bank. One benefit (or curse) of giving up sovereignty over money was that these countries were able to continue borrowing (in euros) well beyond what they could have borrowed in their local currency. Meanwhile, regulators let banks treat government debt as risk-free, creating artificial demand for this debt. (Just like Fannie Mae and Freddie Mac created artificial demand for subprime debt in the US.)

As a result, Greece and other nations are more deeply indebted than they would, or could, have been if they had kept their own currency in the first place. And this is key…the markets will never allow these old currencies to come back again. At least not in the foreseeable future. The drachma is dead.

The reason is simple. Consumers and creditors would not accept the drachma today because it would not be a viable store of value. It would be a useless currency that hardly anyone, outside of government, would choose to accept. Imagine if you were a Greek citizen and the government said, "please give us your euros in exchange for these drachma." You would say "get out of here, go pick some olives." No one in their right mind would trade a stronger currency, like the euro, for a weak currency that the authorities want to devalue.

Moreover, because Greek debt was issued in euros it cannot be repaid in drachma. Creditors would not want to accept it because it would be a weaker currency than their debt is already denominated in. In other words, devaluing into the drachma would lead to explicit debt defaults anyhow.

If for some reason property rights were violated and government used force, even guns, to implement a change to the drachma, Greek society would collapse. The underground economy would explode using other currencies and barter, creditors would not lend to Greece again for a very long time. The markets would stop working.

The simple rule of money – a weak currency cannot replace a strong currency – suggests that only the British pound, the dollar, gold, or possibly the German mark could replace the euro. This is true for Greece, or for any other non-German European nation. No other revived currency, except for the German mark, could compete against the euro.

As a result, Greek fiscal problems must be solved by a shift away from the welfare state. This is true for Italy, Spain, Portugal, and for every other nation in Europe which will eventually face the reality that the experiment with the welfare state has failed.

This is the real lesson of European budget problems. Government spending does not create wealth. It never has, it never will, and monetary shenanigans cannot change that fact. Free markets are the only way to create wealth.

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