The Japanization of the European Union[1]

Jesús Huerta de Soto

Introduction

The topic of my lecture today is "The Japanization of the European Union." I would like to start with an observation Hayek makes in his *Pure Theory of Capital*. (Incidentally, through Unión Editorial, we have just published an impeccable Spanish edition, and I recommend it to all of you.) According to Hayek, the "best test of a good economist" is understanding the principle that "demand for commodities is not demand for labor." This means that it is an error to think, as many do, that a mere increase in the demand for consumer goods gives rise to an increase in employment. Whoever holds this belief fails to understand the most basic principles of capital theory, which explain why it is not so: Growth in the demand for consumer goods is always at the expense of saving and the demand for investment goods, and since most employment lies in the investment stages furthest from consumption, a simple increase in immediate consumption always occurs at the expense of employment devoted to investment, and thus, net employment.

I would add to this my own test of a good economist: the Professor Huerta de Soto test. According to my criteria, the best test to determine whether we are dealing with a good economist (and I do not mean to detract from Hayek's test) is whether or not the person understands why it is a grave error to believe the injection and manipulation of money can bring about economic prosperity. In other words, the best test of a good economist according to Professor Huerta de Soto is understanding why the injection and manipulation of money are never the way toward sustainable economic prosperity.

As is logical, neither Keynesians nor monetarists would pass my test nor of Hayek's test, and therefore, they would fail and would not move up to the second year. For instance, Keynes never understood that it is possible to earn money even when sales of consumer goods do not rise. You see, profit is equal to income minus cost. Income may remain unchanged, but if you reduce costs, you can still make money. And how does one reduce costs at the margin in an environment of normal economic growth? Well, one replaces labor (which is more expensive than capital equipment, relatively speaking) with capital equipment. And that capital equipment which is going to replace labor in the stages closest to consumption must be produced by someone, and it generates a huge number of jobs: Machines never harm employment; on the contrary, they create it and on a massive scale.

This is something Keynes never understood, and hence, he would have failed both Hayek's test and mine. The same thing would have happened to one of the figures who, together with Keynes, has caused the most damage not only to our discipline, economic science, but also to society. The damage occurred mainly because in his work, *A Monetary History of the United States*, he defends the notion that the Great Depression of 1929 resulted from the Federal Reserve's failure to inject enough money; that is, its intervention or manipulation of the money supply was not sufficient. Obviously, I am referring to Milton Friedman (who is now so highly praised by all central bankers in favor of *ultra-lax* monetary policies). He would also have failed my test of understanding that monetary injections and manipulation are never the way to sustainable economic prosperity.

---

1 Text of the opening lecture at the Twelfth Conference on Austrian Economics organized by the Juan de Mariana Institute and the Universidad Rey Juan Carlos. The conference was held at the Vicálvaro campus of the latter on May 14 and 15, 2019.

History illustrates again and again the soundness of the essential question Hayek and I ask to determine whether an economist really knows what he or she is talking about. For example, we can look at the massive influx of precious metals into Spain after the discovery of the Americas. Far from generating prosperity, this influx made Spain a wasteland, a veritable economic desert which did not achieve the economic prosperity of its neighboring countries until many centuries later. In fact, the arrival of gold drove nominal prices up; that is, it sank the purchasing power of the monetary unit in Spain. As a result, Spanish products ceased to be competitive, and it became much cheaper to buy abroad, so as soon as the gold entered the country, it left our borders to pay for massive imports. As a consequence of this process, the traditional products of the Iberian peninsula were no longer competitive, and their producers went bankrupt and were forced to emigrate. Remember that there were basically three professional routes a person could take in Spain at that time: "the church, the sea, or the royal household." In other words, one could become a clergyman or enter a convent and live on ecclesiastical benefices, cross the Atlantic in search of one's fortune in the Americas, or serve the king as a soldier in Flanders. All of this accounts for the traditional economic backwardness of Spain, its relative lethargy and underdevelopment for centuries.

Another historical illustration is provided by the emergence of fractional-reserve banking: another attempt – at first a private one, and later in cooperation with central banks and public authorities – to inject money, based on the notion that the economy benefits from such injections. In other words, the idea is that creating loans from nothing without the backing of real saving is something positive and favorable, and any number of economists have defended it – even such renowned economists as Joseph Alois Schumpeter, who, therefore, would not pass my test either and would fail my exam. However, we will not now discuss the destabilizing effects fractional-reserve banking exerts on the economic system. You are already familiar with the content of my book, *Money, Bank Credit, and Economic Cycles* and the essential arguments developed in it.

Finally, another very clear illustration of the importance of our test can be found in the wild monetary manipulations and injections with which authorities around the world have reacted to the Great Recession of 2008. This reaction reaches its pinnacle in what we will refer to as the "Japanese economic illness" or the "malady of economic Japanization." What does this syndrome or disease, this "Japanese economic illness," consist of? We will first take a look at its symptoms and then theoretically analyze them from the perspective of the Austrian School. Then we will consider the extent to which this illness is contagious and a risk exists of transmission to other economic areas, specifically, to the European Union. But before we begin to analyze the symptoms of this sickness, let us outline the immediate historical background of the Japanese economy.

The Background of the Current Japanese Economy

We must go back to the 1960s, and particularly the 1970s and early 80s. I do not know if you are aware (though I certainly am, because I experienced it first-hand when studying for my Master's in Business Administration at Stanford University) that while it may come as a surprise now, during those years the Japanese economy was one of the most envied and admired in the world. At every business school, the "Japanese economic miracle" was enthusiastically studied. People praised and even worshiped the Japanese economic and entrepreneurial culture, which somehow seemed to have squared the circle. Workers were strongly protected in every company, in a quasi-family atmosphere, in exchange for the absolute reciprocal loyalty of each employee. This took place in a context of constant innovation and continuous economic growth in exports. It is true that the model largely rested on copying prior innovations and discoveries from the United States and Europe and launching them in the market at much lower prices and at a level of quality that was initially quite acceptable and later, even very high. However, this idealized model, which everyone wanted to follow as an example during those decades, turned out to be largely a mirage. It concealed the fact that both the Japanese culture and (especially) the Japanese economy were (and still are) extremely rigid and interventionist, and that what appeared during those years to be a highly prosperous and stable economy actually rested on a huge bubble of artificial growth, monetary manipulation, and credit expansion. The bubble took shape mainly around the real estate market, and prices in the most valued areas of Tokyo and other important Japanese cities reached even thousands of yen and were quoted per square centimeter. And in that euphoric environment and speculative binge, the large Japanese industrial conglomerates (zaibatsus) became de facto speculative financial institutions which, as a secondary activity, relatively speaking, also manufactured vehicles, electronic devices, etc. Well, at the beginning of the 1990s, the Japanese bubble burst, in perfect keeping with our Austrian theory of the economic cycle. Just to give you an idea, the Nikkei index fell from thirty thousand yen at the start of the 90s to twelve thousand yen ten years later. And still today, nearly thirty years later, it has yet to recover. There was a catastrophic collapse of the stock market, and a number of the foremost banks and financial institutions failed, one after the other.

We must focus our analysis on the reaction of the Japanese economic and financial authorities to the bursting of the bubble and the arrival of the financial crisis. But before we do that, we must remember the four possible scenarios that can follow the bursting of an irrationally "exuberant" financial bubble like this one in Japan.

The Four Possible Scenarios that Can Unfold After a Financial Crisis

Theoretically, there are four possible scenarios that can unfold when a bubble has burst and the subsequent, inevitable crisis and recession have hit. First, the economic and monetary authorities might insist on continuing to inject money in a never-ending flight forward which tends to prevent the arrival of the recession. Eventually, hyperinflation results, as we have seen at certain times in the past: for instance, following World War I, hyperinflation in Germany nearly destroyed the German monetary system and helped bring Hitler to power. This first scenario is possible, and it has unfolded on various occasions in the past, but it has not unfolded in the last cycle, nor in the case of Japan.

The second scenario is exactly the opposite. It consists of an absolute and total collapse of the banking and financial system. When the monetary system disappears, it must evolve again from scratch and new money must be chosen to replace the destroyed and defunct fiduciary money. This is another possible, catastrophic scenario which has not unfolded in the last cycle (nor in previous cycles, since central banks were created precisely to support private banks as much as necessary to keep them from suspending payments one after the other, in a chain reaction).

The third scenario is usually the most common. With great difficulty, and in spite of monetary manipulations that can be more or less timid or isolated, rhetorical or actual, the real economy ends up being restructured and adjusting to the new situation. In other words, productive factors are removed on a massive scale from unsustainable lines of investment and, in an environment of relative free enterprise, entrepreneurs eventually recover their confidence and start to detect new, sustainable lines of business and investment projects, and in this way, the recovery gradually begins. It is true that human beings do not learn, and once a sustained recovery has occurred, political and institutional incentives will sooner or later lead to new artificial credit expansion which will plant the seeds for the next cycle, and so on.

This third scenario is the one that has usually unfolded in the western world following the different financial crises and recessions that have devastated it. For instance, this scenario has played out in the United States following the most recent US economic cycle. We must remember that the bubble originated in the US economy, and after the crisis, the Federal Reserve injected a huge quantity of money (and in fact, the Federal Reserve led and directed the quantitative easing with Japan). However, the American economy is one of the most flexible in the world. In fact, in relative terms, if something characterizes the American economy, it is its great flexibility, its remarkable capacity to quickly remove productive factors and reallocate them to other, sustainable investments uncovered by an entrepreneurship that is quite free, restless, and creative. Therefore, despite all of the monetary aggression and growing interventionism in the American economy, again and again it ends up restructuring and starting down a path toward sustainable recovery. It is true that sometimes recovery begins sluggishly, and in fact even today, the American economy has not yet been fully restructured, nor has monetary policy been normalized. As we know, central bankers find it extremely hard to raise interest rates, and they are constantly looking for the smallest excuse to lower them. In this context, long-term interest rates were raised to 3 percent (which is insufficient, since interest rates should be around 4 or 5 percent when expected inflation is 2 percent). And more recently, in response to political pressures and on the pretext of an increase in uncertainty, not only has monetary normalization been paralyzed, but a step backward has been taken, and interest rates have been lowered a quarter of a point... But in any case, the American economy is highly flexible, and thus it provides the typical example of a recovery that sooner or later becomes a reality.

Finally, a fourth scenario also exists and arises when the economic environment, in sharp contrast with that in the United States, is very rigid and fraught with taxes, interventionism, and regulations. In this highly rigid context, when monetary authorities insist on injecting a large quantity of money, the syndrome I have called the “Japanese economic illness” or “economic Japanization” inevitably occurs. And this cocktail of great institutional rigidity, heavy taxes, highly regulated labor markets, together with growing state intervention in the economy at all levels, intense manipulation, and unbridled injections of money, is precisely what characterizes the economy of Japan and threatens to spread to other economic areas in the world, starting with the European Union.

Indeed, Japanese authorities responded to the bursting of their bubble with an *overly lax* monetary policy, in which it was also decided that there would be a continual rollover of loans. In other words, companies unable to repay their loans were offered new loans with which to pay off the old ones, and so on, and the Japanese central bank backed and promoted the whole thing. In Japan, it is culturally unacceptable for a company to fail; it is culturally unacceptable for workers to be let go. Each company is like the mother of a large family, and she must keep all the members safe and employed. Though officially, the unemployment figures may be very low, and everyone may seem to have a job, we must remember the photographs of those big departments in many Japanese companies, where employees are seen sleeping or doing nothing. Officially, they are working, but obviously, the hidden unemployment is massive, and the drop in productivity and the ongoing loss of relative competitiveness are very high (especially with respect to China, South Korea, and the other emerging Asian economies). Moreover, interest rates were slashed almost to zero, and on top of that, the government added an aggressive fiscal policy which pushed public spending through the roof.

Well, this whole mix of economic policy measures is responsible for generating the fourth scenario, which we have called “Japanization,” and to which I am devoting my lecture today. In an environment of great institutional and economic rigidity, as in Japan, massive monetary manipulation and the unbridled increase of public spending block any possible incentive to spontaneously restructuring the economy. As a result, productive factors are not transferred from the projects where they were erroneously invested toward alternative, sustainable lines of investment, which entrepreneurs could discover only in an environment of liberty, economic flexibility, and confidence. This is how Japan entered an indefinite period of recession and economic lethargy that has already lasted several decades and from which it has not yet managed to emerge.

So-Called Abenomics and the Current Main Symptoms of the Syndrome of Economic Japanization

It would be pointless and boring to analyze now all of the vicissitudes of the Japanese economy in recent decades, but we will focus on (and this provides an excellent illustration of my point) Abenomics, the umpteenth and most recent attempt to stimulate the Japanese economy. Abenomics is an economic policy of more of the same. It takes its name from its sponsor, the Prime Minister of Japan, Shinzo Abe, who designated Haruhiko Kuroda, the Governor of Japan’s central bank, to implement what has been a failed attempt.

What does Abenomics consist of? As I have said, it consists of doing more, much more, of the same. If anything characterizes the economic policy of Japan, it is that it has used and applied – and with great enthusiasm and naivete – the entire arsenal of monetary and fiscal interventionist prescriptions contained in the manuals of monetarism and Keynesianism, but without achieving anything. In the last chapter of Abenomics, the Bank of Japan adopted an even more aggressive (if possible) and completely *ultra-lax* monetary policy. In fact, “unconventional monetary policies” originated not with the Federal Reserve, but, beginning in March of 2011, precisely with the pioneering implementation of quantitative easing by the Japanese central bank. All of this was combined with an additional, even larger and more disproportionate dose of public spending, which caused the fiscal deficit to skyrocket. And this prescription of more of the same is what the Japanese authorities depended on to pull Japan out of its lethargy. Well, except for a short-lived economic “improvement” which stemmed from the depreciation of the yen and initially boosted exports somewhat, the lethargy again promptly returned. En short, nothing was achieved, except to make Japan’s economy the most indebted in the world.

In fact, Japan’s public debt is equal to 250 percent of its GDP. That is easy to say, but here in Europe, we are criticizing Portugal and Italy, whose indebtedness is between 110 and 130 percent, and Greece, with a figure of 170 percent. That is, these countries are roughly half as indebted as Japan is, at 250 percent of GDP. As for the annual deficit in the Japanese public accounts, it is not, for instance, the 3 percent established as a limit in the Eurozone, nor even 4 or 5 percent. The annual deficit in the Japanese public accounts is 6 percent, while economic growth has nearly flatlined. In other words, it is a case of clear economic lethargy and very low inflation (which we will discuss later): interest rates around zero or even negative rates, inflation of 1 percent, and seemingly “full” employment (with a very high volume of hidden unemployment and ongoing losses in productivity and competitiveness).

To use a military term, Japan has already used up all its available interventionist ammunition, and not only has it not achieved anything, but the result has been counterproductive and disappointing. Everything that could be tried has been tried, and no palpable goal has been reached. And now the key question is: Why has nothing been achieved? And the answer is clear: because in all these decades, there have been no structural reforms to liberalize the economy, to liberalize the labor market, to introduce deregulation in the midst of suffocating interventionism at all levels, to lower taxes across the board, to reorganize and balance the public accounts, nor even to reduce public spending.

And although this is a very pitiful result, the main message of my lecture today is that this Japanese economic illness or syndrome could easily be transmitted to other economies and cease to be exclusive to Japan. In other words, this Japanization scenario could unfold in any other economy in which the same conditions exist and are responded to in the same way – namely any highly rigid environment with no economic flexibility, in which entrepreneurs are unable to recover the necessary confidence because they are overwhelmed with the regulations, taxes, intervention, and harassment of the state, along with serious monetary and fiscal manipulation. But before we analyze whether or not a risk exists of this happening in the European Union, let us first make some analytical reflections which will enable us to better interpret what could happen (if it is not already happening). Specifically, what does Austrian economic theory have to say about this phenomena related to the Japanese economic illness, or the syndrome of economic Japanization?

The Austrian Analysis of the Syndrome of Economic Japanization

In short, the main message revealed by the analytical tools of the Austrian School is that the only way to recover sustainable economic prosperity following a speculative bubble and credit expansion (which, as we already know, invariably lead to a financial crisis and an economic recession) is to promote economic liberalization and free enterprise at all levels. There is no other way.

This means that in very rigid economies, a number of fundamental structural reforms must be carried out. Basically, these are all microeconomic in nature, and none has to do with the macroeconomic manipulation of the money supply or of fiscal spending. Politicians and monetary authorities inevitably succumb to the temptation to engage in such manipulation in contexts of great institutional rigidity, financial crisis, and economic recession. Precisely what do the necessary microeconomic reforms consist of? Basically, they consist of systematically deregulating the economy; liberalizing markets, particularly the labor market (key in the case of Japan and of the European Union); reducing and rehabilitating the public sector and public spending; minimizing subsidies and reforming the "welfare state" to return responsibility to the citizens; and lowering the taxes that overburden economic agents, especially taxes on entrepreneurial profits and capital accumulation.

We must remember that profits are the signals which guide entrepreneurs in the market in their constant search for sustainable investments. And a tax system that falls on profits essentially smudges the traffic signals that guide us in the market, and this inevitably makes economic calculation chaotic and gives rise to a misallocation of scarce resources. Also, taxes on capital have a particularly adverse effect on wage earners, and especially on the most vulnerable, since their pay depends on their productivity, which in turn depends on the accumulated amount of well-invested capital per worker. Therefore, to stimulate economic development and push up wages, what is needed is the accumulation per capita of an ever-increasing volume of well-invested equipment goods. If capitalists are harassed and capital is taxed, the accumulation of capital is blocked at the expense of labor productivity and, ultimately, wages.

All of the reforms mentioned are geared toward encouraging the dynamic efficiency of our economies and promoting an environment in which entrepreneurial confidence is quickly recovered and entrepreneurs can detect the investment errors committed in the bubble stage and massively transfer the productive factors from projects in which they were mistakenly invested to sustainable investment projects. Certainly, these new, sustainable investment projects are not going to be discovered by the state, nor government ministries, nor public officials or experts, but only by an army of motivated entrepreneurs in a context in which they have recovered their confidence.

Therefore, we need an environment friendly to the world of entrepreneurship and the free economy, an environment in which taxes are low and never expropriatory, and in which it is worthwhile for entrepreneurs to accept the uncertainty in the continual search for and undertaking of profitable investment projects.

What happens when, instead of encouraging these structural reforms, none of them is implemented, the economy remains rigid, and the only reactions, as we have seen in the case of Japan, are a massive injection of money supply, the lowering of interest rates to zero, and an increase in public spending? In this case, two very important effects are brought about. First, an *ultra-lax* monetary policy is self-defeating; in other words, it prevents itself from fulfilling its intended aim, and thus, it cannot possibly produce any of the expected results (for reasons we will soon consider). Second, an ultra-lax monetary policy acts as a true drug which blocks any potential political and institutional incentive to launch, support, and complete the necessary structural reforms. These are the two most important effects. An ultra-lax monetary policy is self-defeating and fails to achieve its objectives, and at the same time, it almost automatically blocks any incentive to carry out structural reforms in the right direction. And, as we will see, this hits home to us in Europe, especially if we recall the monetary policy the European Central Bank has employed.

There are various reasons an ultra-lax monetary policy is self-defeating. To begin with, if the interest rate is forced down to virtually zero, the opportunity cost of holding cash balances is practically eliminated. That is, in a normal economy in which interest rates are between 2 and 4 percent, holding money in cash involves that opportunity cost. If you do not invest the money, you are not receiving that rate of interest. If central banks artificially lower the interest rate to zero, the cost of holding that money in cash in your pocket is zero in terms of interest. This explains why ultra-lax monetary policies are always accompanied *pari passu* by a rise in the demand for money. In other words, people keep in their pockets much of the injected money. Above all, if, as occurs in our environment, structural reforms are not carried out, the economy remains highly rigid, thus fueling considerable uncertainty about the future. In fact, one of the main reasons for holding cash balances is precisely to be able to cope with and respond to any unexpected event that may take place. A desire to be able to cope with future uncertainties is one of the main reasons we demand money. And under such circumstances of great uncertainty and a rigid, highly controlled economy flooded with injected money, where the opportunity cost of holding cash balances is zero, without a doubt the most sensible thing to do is to hold onto your liquidity.

To this, we must add that most entrepreneurs are still wary and fearful, due to what happened in the last financial and economic crisis, in which they lost a great deal, and they see that the economy is still highly controlled, that it is practically impossible to take a single step without asking permission from the authorities, that there are many bureaucratic and labor-related difficulties, and so on. Moreover, entrepreneurs are fully aware that if, in spite of everything, they hit the mark and are successful, the state, through various taxes (corporate tax, income tax, and wealth tax), is going to take more than half of the profits they earn. Under such conditions, we can understand that the great temptation entrepreneurs face is to throw in the towel and avoid trouble. ("¡*Que invierta su puta madre*!" [Let some other damn fool invest!] as the sentiment is so graphically expressed on t-shirts my students designed and are so successfully distributing around the university campus.)

We must bear in mind that all economic actions are incremental and that at the margin, many thousands of introductory steps that would have been taken to seek out sustainable entrepreneurial projects in the right direction and launch them are not taken. And this accounts for the difference between an economy that starts to sustainably recover, though perhaps with great difficulty, as in the case of the United States, and an economy that remains indefinitely lethargic or in recession, as in the case of Japan.

However, central banks sell us the idea that the solution lies in injecting massive amounts of money and lowering interest rates to zero so that the banking system will grant loans (whether viable or not) and people will be inspired to request them. And so that bankers will avoid mistakes and lend wisely (not to the wrong people), all sorts of precautions, inspections, and new banking regulations (Basel I, II, and III) are established, along with higher and higher capital requirements, etc. And in the end, what happens? Well, the banking system is unable to lend the money it is practically given, because ordinary entrepreneurs as a group remain wary in an environment of great uncertainty and distrust, and thus, they return their old loans faster than they request new ones. This causes an additional monetary contraction which largely blocks, compensates for, and sterilizes the expected effects of the injection of money.

Hence, monetary injections are self-defeating; they do not achieve any of their objectives; they block and paralyze the recovery; and they never increase prosperity.

At this point, we come to the maximum outrage: negative interest rates. In a natural, uncontrolled market economy, interest rates can never be negative. If the interest rate is negative – for instance, if I lend you one thousand euros, and at the end of one year, you have to return only 990 – obviously, this is an encouragement for people to do nothing and avoid investing. It motivates people to leave the money in their pockets and a year later, to pay back exactly 990 euros, and make ten euros without doing anything and without having to take on any entrepreneurial risk or endure the harassment and incomprehension of bureaucrats. If, as an entrepreneur, I ask for trouble, invest, and things go badly, I may not be able to return even the 990 euros, and if I earn something, half of it will be taken away, public officials will come after me, and unions will make my life miserable. In contrast, with negative interest rates, the best thing to do is to endlessly request loans, sit on them and do nothing, and then pay back less than the borrowed amount, keep the difference, and make a sure profit without taking on any risk. Therefore, in conceptual terms, a negative interest rate leads directly to doing nothing, to lethargy, and to economic Japanization.

Furthermore, the aberrant monetary policy of negative interest rates has another very harmful side effect: The policy is used to automatically finance the public deficit at no cost and without limit, thus blocking the few incentives that might remain for governments to implement any structural reform. In contrast, such a monetary policy encourages the authorities to increase subsidy policies and vote buying, which inevitably sink our societies into demagoguery and populism. Indeed, we have a crystal clear illustration of what I am talking about: In our own country, Spain, and in the rest of Europe, practically the same day the European Central Bank introduced quantitative easing in 2015, all reforms were paralyzed. And the countries that needed them the most and were about to adopt them, but had not yet done so, shelved them indefinitely. Therefore, policies of monetary manipulation do not achieve any of their objectives; they are self-defeating; and they block the only thing that could pull the country out of its lethargy: the necessary structural reforms and economic liberalization.

And now, the final blow. Stunned and disconcerted, central bankers see that they are achieving none of their objectives and are simply turning their economies into drug addicts, since at the slightest mention of withdrawing the stimuli, the economies sink into recession. And because these authorities see no way out of this vicious circle they themselves have created, all that occurs to them is to recommend the adoption of a fiscal policy involving vigorous increases in public spending. This is even worse, because it distorts the real economy even further by placing a growing number of productive factors in projects which depend on the government and have no more sustainability than a mere political decision. For instance, in Spain, employment has increased due mainly to the public sector and to projects related to it (and in the case of Japan, to projects connected with the 2020 Olympic Games). However, the growing volume of public-sector employment is not sustainable, and its continued existence is not backed by consumers and will depend solely on the future decision of politicians to maintain that expenditure or not. Again, such fiscal policies prepare the ground even more (if that is possible) for the development of the Japanese economic illness.

The Chances of the Japanese Illness Spreading to Other Economic Areas: The Case of the European Union

We will now analyze the influence this Japanese illness has been exerting on other economic areas, particularly following the last financial crisis and the Great Recession of 2008.

I am not going to expand too much on the United States. I have already mentioned that the fundamental difference between the Japanese and the American economies is that the latter is far more nimble and flexible. That is why, despite all of the errors and monetary aggression, the American economy has been realigned relatively rapidly. In other words, despite quantitative easing, it has come out of the recession because it has very significantly restructured and corrected many of the errors committed. Nevertheless, this has not been fully achieved: There are still very large companies and sectors in the American economy that remain heavily dependent on cheap money. In any case, the Americans have dared to raise interest rates, though they have done so very hesitantly and later lowered them, which could mean they are in the typical starting phase of a new expansion of credit, which would, in turn, indicate the beginning of a new cycle within a few years. The obstacle is posed by Trump's policy of protectionism, because if new tariffs are established, they would artificially force an erroneous allocation of productive factors toward a more closed economic and entrepreneurial structure, one that is, therefore, less productive and less open to foreign trade. This added uncertainty has been used by the Federal Reserve precisely as an excuse to temporarily suspend or even reverse its policy of monetary normalization. On the slightest pretext, central bankers are always ready to justify lowering interest rates, but they find it extremely difficult to start raising them. However, though the US economy is the largest in the world, let us not dwell any more on the United States, with its particular problems. Instead, let us focus on the economic area closest to us and currently of the most interest to us.

The case of the European Union is far more interesting. To begin with, the policy of the European Central Bank has gone through two very distinct stages. There was a prior stage, in which the European Central Bank intervened, more or less like the Federal Reserve did, but still without taking the step toward aggressive quantitative easing. During this first stage, which lasted until the year 2015, the euro served to discipline the most spendthrift European governments, above all those of the periphery countries. As there were public deficit obligations to meet, a crisis of sovereign debt (not of the euro) emerged in certain countries, including Spain, and the European Central Bank used this crisis to force the implementation of the necessary reforms in various countries, including Spain. The ECB even intervened in the economies of several countries, among them, Ireland, Greece, and Portugal. In the countries where reforms were put into effect, economies were restructured and eventually overcame the crisis. This is the case of our own country, Spain, in which the government, with great difficulty, in a very lukewarm manner, and committing the grave error of emphasizing tax increases more than reductions in public spending, took several steps in the right direction by undertaking certain structural reforms our economy needed.

The most serious problem has arisen during the second stage, when the ECB introduced needlessly (since M3 growth was already close to 4 percent at the beginning of 2015) its ultra-lax monetary policy of lowering interest rates to zero (and even less than zero), and especially when it implemented its own, very aggressive quantitative easing. In fact, the ECB actually purchased sovereign and corporate debt at a pace of eighty billion euros a month, which meant almost one trillion euros of newly created money (or increases on the ECB's balance sheet) per year. This was equal to 10 percent of the GDP of the Eurozone for almost all of four long years – 2015, 2016, 2017, and 2018, when the program was temporarily suspended and then reintroduced amid strong controversy and with the express opposition of Germany, France, Holland, and other countries in November of 2019 (at a pace of twenty billion a month).

This second stage of the ECB has been disastrous. At the very moment this ultra-lax monetary policy was initiated, as the case of Spain illustrates, all of the policies of structural reform, reductions in spending, and liberalization that the very rigid European economy needed were suddenly suspended. Clearly, compared with Japan, Europe is composed of a heterogeneous set of economies. While Japan comprises a very uniform economy and society, the economic variety in Europe is much greater. Some of Europe's economies were already on a relatively sound footing, for other historical and political reasons, as in the case of the German economy. Other economies are very rigid, and in a certain sense more Japanized, despite their wealth, and these are the truly "diseased economies of Europe": France and, particularly, Italy. These economies have a very long list of pending structural reforms, and they have implemented practically none of them, especially since the ECB started purchasing their public debt. Finally, another group of countries had launched structural reforms in the right direction; some of these countries – like Ireland and Portugal, and even Greece – have already nearly completed them; while others – like Spain – are only halfway there. The countries that have managed to complete their reforms are very fortunate. But in Spain, all subsequent reforms – those which had been planned but were still pending – were suspended. If we are not careful, this will have a very high social and economic cost, especially if populism is strengthened, based on the increases in taxes, subsidies, and public spending the socialist administration has announced.

In many ways, the German economy is paradigmatic. To begin with, it is an export power. But how has it come to export so much? It exports so much, because it produces very high-quality products. And why does it produce products of outstanding quality? Because traditionally, the German entrepreneurial culture has developed in a very difficult trade environment; that is, with a currency, the German mark, that has steadily appreciated, thus making it harder and harder to export anything. And in this context, the only way to export products is to produce the best ones in the world. In other words, under such circumstances, the Germans had no choice but to discover, innovate, produce, and introduce the very best products in the world – whether vehicles, precision instruments, machinery, etc. So, in spite of all the false logic of the competitive monetary depreciation advocated by Keynesians and monetarists, Germany became one of the strongest export powers in the world. This flies in the face of the protectionist analysis of Keynesians and monetarists. It is a strong currency, and not a weak one, which in the long run fuels entrepreneurial success and triumph as an exporter. But most analysts are conceptually impaired by their mathematical models, in which competitive depreciation appears to be the ideal recipe, since it immediately leads to an apparent, short-term prosperity which derives from the fleeting increase in exports that every depreciation makes possible. This prosperity is "bread for today, hunger for tomorrow." It is fundamentally deceptive and short-lived, and it involves the unavoidable cost of dampening the creative and innovative entrepreneurial spirit, the drive to make things better and better. Why should we make an effort, if, with a weak currency, our products sell themselves? Remember my "best test of a good economist": Monetary and fiscal manipulation will never produce sustainable economic prosperity, but the opposite. However, most of my colleagues would fail my exam; the proof of that lies in the fact that they constantly praise quantitative easing whenever it is launched in Europe. Without a doubt, this policy depreciated the euro, and the euro's loss in value has permitted Germany, in the short term, to export products much more easily, and consequently, it has neglected, relatively speaking, its traditional competitive advantage based on perpetual improvements in quality. The depreciated euro has acted like a drug. It has generated fat instead of muscle on the German economy and, to a certain extent, has allowed it to rest on its laurels. As a result, Germany is now obliged to at least recover its lost muscle, if the country does not actually go into a recession.

France and Italy are horses of a different color. Their economies are extremely rigid, and it is practically impossible to carry through a single reform in them. Take, for instance, Macron, with all of his promised reforms, practically none of which he has accomplished. Adopt reforms in France? Never! It is practically impossible, and so France, which is a very wealthy country, is rapidly approaching Japanization and the illness of indefinite lethargy.

Italy's situation, though more picturesque, is even worse than that of France. And as for the rest of the periphery countries, we have already discussed them, especially our own country, Spain. All signs point to a slowing down of the economic growth Spain has enjoyed due to the timid reforms in the right direction adopted in the past and to a number of tailwinds that are tending to disappear. This situation certainly does not bode well, especially if, as the socialist administration is announcing, taxes and public spending are raised and regulations are tightened (minimum-wage increases, the regulation of the rental market, the obligation for workers to clock in at work, etc.).

Several Unsustainable Economic Myths

I would like to conclude with a critical look at several powerful and tiresome economic myths we read and hear about again and again in the newspapers and on television.

The first myth is that the increase in the minimum wage in Spain (from 600 to 900 euros, and eventually to 1,000 or 1,200 euros) is not having a negative effect on employment. All of economic theory shows that rises in the minimum wage do boost unemployment, the underground economy, and the misallocation of the labor factor. Theoretically, the only way such a rise could possibly not have these negative effects would be if the government set the new wage lower than the already freely existing market wage. But in that case, why set one at all? However, that is not the way it works. Moreover, as a result of this change, if, in the constellation of different jobs and wages, there is even one worker whose discounted marginal value product is less than the legal minimum, that will be sufficient to keep that worker from being hired or, if already working, to cause that worker to be let go. Without a doubt, this measure will cause – and is already causing – unemployment and a misallocation of resources (though in economics, changes always take place gradually and at the margin). The very Bank of Spain has published a study in which it predicts that at least 150 thousand jobs will be destroyed, and these are jobs done by the most vulnerable people (young people just entering the workforce, women, immigrants, etc.). For instance, it is obvious that an immigrant who has, with great difficulty, managed to get his papers in order, is going to have a very hard time finding a job if the cost to the entrepreneur of hiring him is going to be, including social security, over sixteen thousand euros a year (nine hundred euros a month, in fourteen paychecks, plus 30 percent in social security). Nobody is going to hire him! (And clearly, very few families are going to be able to afford to pay sixteen thousand euros a year to the people who care for their elderly members, or to their domestic workers, a sector which, up to now, has employed hundreds of thousands of people.) So, our immigrant will most likely be forced to wander from place to place in the underground economy. The government hypocrisy in this matter is staggering. We welcome everyone ("Refugees welcome!"), but mind you, no one is going to find a job here in the formal economy, because now the minimum wage is 900 euros , and the government plans to raise it to 1,000 and even to 1,200 euros . (And why not raise it to two thousand or even more, if employment will not be affected?)

The second myth I have often commented on is that central banks saved our economies during the Great Recession. This is the myth of the arsonist-fireman, for it was precisely central bankers themselves who orchestrated the credit expansion and generated the bubble that later led inexorably to a crisis and a recession. And now they look like the ones responsible for saving the day, because they kept banks from failing. Then again, they saved Bankia, but they allowed the Banco Popular to go under, because it was smaller. They made mistakes, like when they let Lehman Brothers collapse and everything else nearly collapsed with it. Clearly, central bankers have intervened in an irresponsible, ad hoc manner that generates great uncertainty and constant financial instability.

The third myth is that quantitative easing was necessary to avoid a deflationary crisis. This is untrue. For instance, the European quantitative easing was unnecessary. When it was initiated in January of 2015, the European M3 was already growing on its own at a rate of 4 percent; that is, at a rate very close to the target of 4.5 percent. Quantitative easing was totally unnecessary, and as I have argued, it has had a very damaging and self-defeating effect and has completely blocked the reforms the Eurozone needed. Even Mario Draghi's old rhetoric that monetary policy does not replace the necessary structural reforms the different countries must make to meet their Maastricht obligations was, after the quantitative easing, almost totally forgotten and replaced with a desperate request for more fiscal spending. By now, it is so obvious that no one is making structural reforms because the European Central Bank is financing governments for free that it would be hypocritical to keep mentioning such reforms. It is obvious that the ECB has betrayed its founding principles. Ultimately, it is financing the public deficit of all the countries. (Remember that it already owns 30 percent of their outstanding public debt, including Spain's.) Furthermore, it attempts to stimulate economic growth (like the Fed), when it has authority only to maintain monetary stability. Consequently, the ECB has become a hostage to its own errors, its ultra-lax monetary policy. The moment it announces it is withdrawing this policy, a recession will hit, and no one is willing to deal with it. And if the ECB continues to inject money, it will fully Japanize the Eurozone and sentence it to indefinite lethargy in an environment of constant discord between the members of the governing board, which is already thoroughly politicized.

The fourth myth (or rather, dogma of faith) is that inflation must be less that 2 percent but close to 2 percent. But why? Where did that magical figure come from? It came from mathematical models. All the "experts" locked themselves into a meeting room – the governors of the ECB, the Bank of Japan, the Federal Reserve, the Bank of England, etc. And bingo! They determined the rate should be 2 percent. But why 2 percent? It is a bizarre, totally arbitrary target and one that is very difficult to reach in an environment in which productivity has risen as much as it has at the beginning of this century, as a result of the technological revolution and the introduction of numerous innovations. In this context, 2 percent is an unrealistic goal, and attaining it requires a super-lax monetary policy which causes all of these effects we have discussed. These effects destabilize the economy and the financial world and, as we have seen, they lead to the process of Japanization in rigid economies like ours. A couple of years ago, I was invited to a meeting at the Kiel Institute for the World Economy. The meeting was also attended by, among other experts, a former head economist at the ECB. Well, we eventually arrived at the conclusion that, under the current circumstances, the inflation target should not be 2 percent, but 0 percent, and the reference target for M3 growth should be between 2 and 2.5 percent. If this had been the target, we would have been spared the ultra-lax monetary policy and the Japanization process. And – paradox of paradoxes – very recently, there has been talk of making the target more flexible, but not to suspend the ultra-lax policy (an unnecessary policy when the inflation target is lowered to 0 or 1 percent), but to justify higher inflation rates throughout the cycle (which "compensate for" the prior downward disparities). What logic!

The fifth myth you will have heard is that the natural rate of interest is falling. What hypocrisy! They artificially lower the interest rate to zero (or even make it negative), and then they argue that the natural rate is dropping! Nobody can observe the natural rate of interest. All that can be observed is the gross interest rate in the credit market. In the absence of coercive intervention, this rate includes the natural rate of interest, premiums for expected inflation or deflation, and risk premiums (and occasionally, in the very short term, a negative liquidity premium). But it is obvious that no one can observe the natural rate of interest. Some people say: "Well, a proxy might be provided by the interest rate on 'risk-free' bonds." One moment! It is precisely risk-free sovereign bonds that you are compulsively buying and generating in their markets a bubble the likes of which had never been seen before! What brazenness and hypocrisy!

The sixth and last myth we are going to discuss is the mantra that interest rates are very low because people are saving a lot and the population is aging. It is said that Japanization is due to the fact that the Japanese population is aging more and more and is saving a great deal. This argument is false and confuses saving with inflation (inflation in the traditional Austrian sense of monetary growth). Benjamin Anderson used to say that according to this argument, the bigger the injection of money, the greater the saving! Of course, money is injected, and people all hold it in their pockets, as we have seen, and then it is argued that people are doing a lot of saving. But no. What is happening is that there is an increase in the demand for cash balances (stock), which should not be confused with an increase in saving (flow). And as for the aging of the population, that argument is also weak. When people retire, they consume what they had saved before. We must realize that in Japan, the demand for money has increased dramatically, and this increased demand is largely being channeled into government bonds, which are treated as cash. What a time bomb for Japan should the bond markets collapse!

Remember what we have said about these tiresomely repeated myths, so that you can refute them when you hear them even from prestigious minds in our discipline.

Conclusion

I will now conclude where I began when I presented my alternative test to complement Hayek's, and my conclusion is that monetary and fiscal stimuli fail because they do not attack the underlying problem. The underlying problem is the rigidity of the economy; that is, excessive regulation, high taxes, unbridled public spending, and the resulting demoralization of entrepreneurs. An economy can emerge from a crisis and a recession only if the entrepreneurial class is motivated. I am not talking about Keynes's "animal spirits," which make us manic depressive. We entrepreneurs have been harassed and demoralized by force. As long as the authorities continue making regulations, raising taxes, and giving money away, the easiest thing to do is to hold onto our money and let others do the investing, those who want to (and there are very few of them, if any). Furthermore, easy money blocks the implementation of any free-market reform and makes it politically impossible. So, the only way our economies can escape Japanization – structural stagnation and low inflation – is blocked. And what is our only escape from this problem, toward which we are dangerously sliding in the Eurozone? Our escape is our great challenge for the coming years: the challenge facing France (which seems to have no escape), the challenge facing Italy, and the great challenge facing Spain as well. It is true that France has a very wealthy economy and a large amount of accumulated capital, as Japan does, but this tends to conceal the problems. The stubborn facts and results are clear: lethargy and the failure of any reform-oriented policy. What is the only way out of this vicious circle we are dangerously entering? Well, that is clear: We must normalize monetary policy as soon as possible and create a framework that forces governments to implement the painful structural-reform measures our economies need. The current ultra-lax monetary policy benefits only a few: spendthrift governments and holders of fixed-income securities, hedge funds, and speculators, to the great detriment of most citizens, particularly savers. Also, this policy has created a bubble in fixed-income markets that dwarfs the real-estate bubble generated by the last Great Recession.

Once we normalize monetary policy, governments will be obliged to control their spending, introduce austerity policies, and encourage the necessary liberalizing reforms, which were suspended or postponed at the wrong time and which we desperately need today to recover our sustainable prosperity.