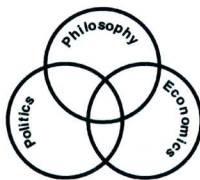




Institutions in Crisis

European Perspectives on the Recession

Edited by
DAVID HOWDEN



New Thinking in Political Economy

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David Howden

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NEW THINKING IN POLITICAL ECONOMY

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NEW THINKING IN POLITICAL ECONOMY

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Foreword

Jesús Huerta de Soto

The crisis that erupted in Europe in late 2008 and the accompanying recession that continues to this day have exposed the unsustainable situation the European Union has long promoted. What has been lost on commentators and economists alike is that the current problems have very little to do with the present state of affairs. This financial crisis began the moment that the market, which is a dynamically efficient process (Huerta de Soto, 2010c, pp. 1–30), discovered the true errors of its past.

Banks in particular realized that the loans granted throughout the boom were only backed by a smaller fraction of the asset values than they previously thought. Bank liabilities, primarily the deposits created during the boom, retained their value throughout the collapse. The specific characteristics of bank demand deposits, characteristics that they share with physical cash – that they are available continuously on demand and at par value – retained their value while the assets backing these liabilities quickly lost value. The resultant widespread illiquidity and eventual insolvencies were not the cause of the recession, but were some of its most important and early symptoms (Huerta de Soto, 2010a). Understanding the root causes to the crisis, and more importantly that the current recession is a necessary consequence of these causes, is essential to exiting the situation as quickly and painlessly as possible.

Indeed, a situation where a general cluster of entrepreneurial errors occurs, much like the present situation, can only arise through a general disruption to the common bond between all market transactions: money. The Austrian theory of economic cycles, as most fully propounded by Friedrich Hayek (1931) and Ludwig von Mises ([1949] 1998), describes much of the current imbalances in need of correction. The theory is, however, only a special and specific case of the more general theory of the impossibility of calculation under socialism, discovered and explained by Mises (1951).

Explaining why entrepreneurs fall prey to the false signals caused by artificially low interest rates is one area where the Austrian theory of the business cycle has traditionally been weakest. Several critiques have taken

aim at the supposed irrationality that entrepreneurs must be assumed to exercise in order continually to fail to understand that the interest rate as controlled by a central bank is not necessarily indicative of that set by social time preference (see, for example, Cowen, 1997; Wagner, 1999; Yeager, 1997). Some of my own work, as well as that of my students, has shown that even if entrepreneurs understand that the credit expansion is not sustainable, they are forced to participate via a 'prisoner's dilemma' situation (Huerta de Soto, 2009, pp. 664–71; Howden, 2010). Not partaking in the boom sacrifices market share and profit to those firms that do partake. Participation in a boom must be undertaken lest other less prudent companies participate successfully and push the more prudent out of business.

In this current book, Gabriel A. Giménez-Roche expands on the analysis of entrepreneurial error, and delves into the particular avenues where entrepreneurs see their plans disrupted during the boom. Financial intermediaries, despite having erred during the past decade and facilitating the current recession, do serve an instrumental role in the market. By connecting entrepreneurs with access to capital and other resources to those with the money capital necessary to put their plans into action, the financial entrepreneur is ultimately responsible for much of the plan coordination in the modern economy. Giménez-Roche outlines in great detail how the financial entrepreneur leads others into error as they are provided with false interest rate signals coupled with an artificially high supply of credit. Indeed, by furthering the work of Hülsmann (1998) he demonstrates how an analysis of entrepreneurship that incorporates both the social and institutional structures of the market exposes the illusory signals that the fractional reserve banking system provides. It is only when we view the market through the entrepreneur's compromised spectacles that we can gain understanding of how they err under such conditions.

While expansion of money and credit by the European Central Bank (ECB) has been somewhat less irresponsible than America's Federal Reserve system, it has not been entirely free of errors.¹ Indeed, during the early stages of the lead-up to and formation of the European Monetary Union (EMU) many countries previously notorious for their loose credit policies were tamed as part of the convergence criteria. Only several countries in Europe's periphery – the now infamous PIIGS of Portugal, Ireland, Italy, Greece and Spain – continued to be immersed with considerable credit expansion after the convergence process subsided. Understanding how high-inflation periphery countries experienced such high expansion credit rates goes far in understanding how the boom reached such dizzying heights. In 2006 the Spanish economy, for example, built 700,000 new homes – more than the total built in Germany, France and the United

Kingdom combined. Today more than 1 million of these homes are empty – more than the total for the whole of the US, a country with almost eight times the population.²

While the ECB for the most part pursued a tight money policy when viewing the Eurozone as a whole, the crisis of 2008 changed the situation dramatically. Credit expansion was still not pursued to the same extent as with the Federal Reserve's quantitative easing programs (QEI, and now QEII), but there was a severe reduction in collateral requirements on its refinancing operations. As Philipp Bagus and David Howden (2009a; 2009b) have demonstrated, the ECB continually altered its scope of accepted collateral to maintain lending operations to illiquid European nations. Each time a Eurozone member state had its credit rating cut over the previous two years the ECB responded by altering its acceptable loan collateral to accommodate these 'misfortunate' countries.

While these inflationary policies over the last decade brought on vast and evident entrepreneurial malinvestments, there is a more pressing problem now becoming apparent. Real economic growth did occur in the Eurozone over the past ten years. Unfortunately the inflationary malinvestments make it incredibly difficult to identify what Europeans did right, while shifting the focus to what was evidently done wrong.

Anthony Evans's contribution to the current volume assesses what was right and what was wrong in Ireland. One of the largest problems with the current recalculation is discerning what was and is misallocated capital. Although we know that there were many entrepreneurial mistakes incurred in the past, we also know that not every single entrepreneurial decision was misguided. Ireland underwent a boom due to real causes in the late 1990s and early part of the 21st century. Unfortunately, while some forms of growth were real, much was also fueled by an expansion of money and credit, which grew at rates many multiples faster than in the core of Europe.

The recognition of such prior malinvested capital can lead to surprisingly swift adjustments. For example, once Spanish economic agents realized the errors previously induced by the inflationary policy pursued by the ECB the adjustment was relatively swift. In less than a year more than 150,000 companies disappeared, mainly related to the housing sector, and almost 5 million workers previously employed in the wrong sectors were laid off. While the current economic situation in Spain today looks quite bleak, the shedding of these erroneous investments was a necessary step before commencing a period of economic growth. Prolonging these malinvestments in unprofitable industries, much as is happening today in many bailed-out areas of the European economy, serves no purpose other than to lengthen the difficult time necessary to be endured before recovery can commence.

When we compare the level of credit expansion with the volume of malinvestment produced from it, we would be inclined to state that this particular business cycle will be less severe in the Eurozone than in the US. While this may be true for the root causes of the bust, the current after-shocks of the crisis are being bred asymmetrically across the Eurozone's member states. In particular, while the core mostly muddles through today's recession at marginally higher unemployment rates and below-trend GDP growth, much of the periphery witnesses soaring unemployment rates, government deficits and debt.

David Howden looks into this asymmetry, and particularly at its effects in the labor market. Europe has always been 'victim' to a high long-run unemployment rate, at least by American standards. Despite these seemingly high average unemployment rates, throughout most of the post-war period the European economies have enjoyed prosperity in terms of productivity and growth on a par with their Anglo counterparts. Part of the reason for the current high unemployment rates is also the reason for the maintained performance during the post-war period. Highly regulated European economies, especially in Southern Europe, have seen their labor forces exit the official (taxpaying) sectors and enter into the grey, or shadow economy (non-taxpaying). This increase in regulation was sufficient to lead an entrepreneurial exodus from the formal economy, but it has been only partially successful in completely breaking the European entrepreneurial spirit. The shadow economy, which reaches as high as 25 percent of the official GDP in some Southern European countries, continues to flourish as increased regulation and increased taxes drive entrepreneurs from the more comfortable and legal formal economy.

In fact, while unemployment as reported has been strikingly high in many Southern European countries, the very construction of the unemployment figures masks the true situation of these blighted economies. Spain, which has 20 percent of its labor force out of work, has a sizable underground economy that employs hundreds of thousands of workers. The 20 percent unemployment rate is not necessarily a concern for many employees, who are able to find waged employment in the informal sector. There is no doubt that conditions, wages and benefits are much lower with informal work, but it would be a misnomer to pronounce these laborers as being 'unemployed'. These unemployed workers have exacerbated already tenuous fiscal positions, as they represent workers typically enrolled in some type of unemployment benefits program but not contributing to the system that funds it.

On their own, such conditions would only represent a misuse of resources. Today, however, they are indicative of a broader problem afflicting European countries to varying degrees as they search for

recovery. Labor rigidities in the form of high unemployment benefits and stringent employment laws restrict the ease to which misallocated laborers can be reallocated. Despite promising freedom of mobility within the European Union, heavily regulated labor markets form an implicit barrier to entry for most laborers regardless of their country of origin.

Yet, while loose credit conditions have worsened an already problematic European labor market, they are only incomplete explanations for why the crisis was as extreme as it was, and why the present recession has persisted for as long as it has.

The acceptance of international accounting standards (IAS) and the incorporation of them into law in many European countries has abandoned the traditional principle of prudence that accounting abided by. As the historical cost accounting was replaced by 'fair value' assessments for balance sheet assets, particularly financial assets, an illusion of wealth drove firms to take on ever-riskier positions. This turned into a feedback loop, as rising financial asset values ballooned firms' balance sheets, thus allowing them to take on ever-increasing amounts of liabilities. The shift away from prudent accounting rules acted in a pro-cyclical manner. During prosperous times a false 'wealth effect' increased risk taking. As financial asset values dried up, a feedback loop commenced that required firms to recapitalize their balance sheets, leading to shifts out of newly risky (i.e. deflating) assets and into 'safer' assets – traditionally thought to be government debt. María Alvarado, Laura Muro and Kirk Lee Tennant's contribution to this volume explains the effects of these accounting rule changes on firms, and specifically what macro-events resulted from the shift from tradition to the unknown (and untested).

Similarly, Antonio Zanella probes into insurance regulations, specifically the Solvency Accords governing the capital requirements of the European insurance industry. While the European Commission functions as the ultimate regulator for industries within its jurisdiction, few have questioned whether a stark conflict of interest exists between the regulations that businesses are subjected to and the welfare of the greater European project. Indeed, prior to the current recession there was little reason to believe that there was any such conflict.

In response to increasing pressure on Eurozone sovereign debt starting in 2008 the insurance industry has been subject to more stringent capital requirements. Although higher capital ratios must be increased across the board, the asset-specific capital ratios have been altered to provide more favorable incentives for the insurance industry to hold sovereign debt. As the insurance industry currently holds in excess of €2.5 trillion in fixed income securities out of over €6.5 trillion of total assets, it is a sizable increase in funding to troubled governments. The result has been

a continued deterioration of the insurance industry's balance sheet, as increasing levels of risky government debt are taken on just to satisfy the regulators who are also the originators of these risky assets. A more severe repercussion has been yield compression, which has allowed unsustainable government finances to persist. By legislating an artificially increased demand for sovereign debt through the not insubstantial insurance asset market, several European countries have found willing buyers for their debt that would normally be purchased only with some reluctance. This decreased cost of borrowing has allowed, in turn, sustained budget deficits to reach a breaking point – one that is becoming all too obvious today.

As European regulators are only concerned with risk-weighted assets, and not total leverage, there were no red flags raised by financial institutions overleveraging their balance sheets. Lulled into complacency that the Solvency and Basel Accords would adequately define the necessary capital to mitigate illiquidity-induced losses, the financial system continued overextending itself. This past trend has not been rectified; the financial system still finds itself needing to adequately meet a risk-weighted capital level – one for which the actual weights of the different asset classes are skewed from where reality (and prudence) would suggest they should be. Sovereign debt has proven itself to be anything but 'risk free' over the past two years. Yet such fixed income securities still enjoy a prized place atop the risk-classification ladder as the safest, and hence least capitalized, asset class.

While one of Zanella's conclusions is that the European insurance market artificially sustains the sovereign debt market, Philipp Bagus peers into the structure of the European Central Bank's refinancing operations to show a similar effect. By backing its balance sheet with European sovereign debt, structural support for government deficits was built into the ECB from its very inception. The bailout that has been explicitly given to some countries is only a special example of the implicit bailout that has been ongoing in the Eurozone for a decade. As the ECB exchanged Euro funding for sovereign debt collateral, an increased demand for Eurozone government debt was created. Countries were effectively rewarded for increasing their debt loads.

More troubling was that the countries that took on the largest debt-financing schemes gained at the expense of the more prudent. As the ECB effectively monetized a large portion of all Eurozone government debts, the effect of this monetization – price inflation – spread throughout all of the countries using the common currency. Highly indebted peripheral European countries saw the real value of their debts reduced through inflation, while their more prudent core European counterparts bore the costs of this increased inflation. In essence, the core has been giving implicit aid to the periphery for over a decade.

Unfortunately a lack of logic has swept the European continent. The drive for market liberalizations spawned a prosperous epoch throughout the late 1990s and 2000s. This causal connection has been seemingly forgotten as policymakers – both of the individual member states and the centralized European Commission – clamor for increasing interventions. A crisis brought on by an excess of government spending and deficits is now, according to prevailing Keynesian theories, going to be resolved via additional doses of government spending and deficits.

Fernando Ulrich exposes some of the myths of these government spending programs. Indeed, while short-term gains may be realized by these ‘make work’ projects, three conditions will lead to longer-term problems. First, as governments turn to deficit financing to fund these projects, we see the crowding-out effect via reduced private investment. Indeed, in some countries where the private sector is smallest (the Greek public sector, for example, accounts for approximately 40 percent of its GDP) the resultant minor tax base has made deficit financing the sole method available to finance these spending programs. Second, these spending programs will need to be paid back some day. When they are repaid, we can expect below potential growth, as resources will be redirected to the spending programs of today. It is questionable in some cases whether today’s debts will ever be paid back. Ireland’s bailout of €85 billion has come at an interest rate of 5.8 percent. Irish economic growth will almost assuredly be lower than this for the foreseeable future. As the ability of the country to repay these loans can be thought of as a ratio with GDP growth in the denominator, and the applicable interest rate as the numerator, we see that Ireland will have increasing difficulties finding the revenue to repay this loan as the recession progresses (Gros, 2010). Finally, government spending is rarely viewed as bringing high growth opportunities. At what price has the current increase in government expenditure come at? If we think of a generation of government projects returning lower yields than the comparable private sector investments were capable of, this loss of long-term growth potential could be devastating.

Indeed, although ‘austerity’ has been a new rallying cry within the EU, the Commission itself has taken a different approach. While urging national governments to control their deficits, the European Commission seeks a 5.9 percent increase in its own budget for 2011 (Castle, 2010). In total, the budget is about €3.5 billion more than the member states say they can afford. EU officials took a ‘heroic’ pay cut of 0.4 percent recently, and Spanish public workers took an across the board 5 percent wage reduction. Getting member state finances in order has taken precedence over that of the larger EU – a case of do as I say, not as I do.

Indeed, the levels of indebtedness are a little paradoxical to the uninitiated

and may come as a shock to those who understand the founding principles of the EU and EMU. The signing of the Treaty of Maastricht in 1992 was supposed to usher in a period of stability for Europe, constrained by a rule of law designed to impose strict limits on the governments making up the new European Union. In particular one rule – that a member state government may only run a deficit of 3 percent of GDP in any one year except for rare and exceptional circumstances – was reckoned to be the tool necessary to rid Europe of its public spending excesses of the past. As Malte Tobias Kähler illustrates, the change from a rule-based regime to discretion over the course of the recession has brought a new crisis to the EU. Lacking clearly defined operating rules, uncertainty has increased as to what the future holds. The European Central Bank (ECB), founded upon the constrained rule-based operating policies of the German Bundesbank, has shed any semblance to rule-based management that could be thought of. At any rate, if the ECB is currently following a set of predefined rules we are hard pressed to identify what exactly they may be.

Rules are not established for the ‘normal’ times when events seem to unravel exactly as planned. Rules are thought out in advance and enacted for those exact moments when the tempest hits, and if there is no clear view of the way out of the storm, trust must be placed in a guiding compass to lead the way. Europe’s rule-based compass was not designed for when the boom was in full force; rather it was to guide it to dry ground when market conditions significantly worsened. Now is just such a time.

Indeed, entrance to the European Union was initiated by many neighboring countries under the pretense of increased stability. Especially in Eastern Europe, years of post-communist political charades attracted voters to a more accountable and secure Western European existence.

Economics, like all the social sciences, lacks the ability to compare directly two specific groups when placed in similar situations. The fall of the Berlin Wall and the reunification of Eastern and Western Germany provide as close an approximation to a controlled test as we can normally hope to attain in the dismal science. Jiří Schwarz and Josef Šíma make use of another similar economic transition – the breakup of Czechoslovakia into its two component states of the Czech Republic and Slovakia – to assess how each fared during the last decade. While these two countries commenced from essentially identical starting points – similar geographies, standards of living, traditions and citizens – they diverged as Slovakia vied for entrance to the Eurozone and the Czech Republic opted for monetary independence.

As Schwarz and Šíma convincingly argue, entrance to the Eurozone provided a commitment mechanism that led to many meaningful and positive market reforms in Slovakia. The Slovak economy consequently pulled

ahead of its western Czech neighbor. With the onset of the recession and Slovakia's simultaneous adoption of the Euro (finalized in 2009) a considerable cost was borne by the small nation's business community. While the longer-term benefits of increased investment may some day be realized, the short-term costs could not have come at a worse time. As the process of striving to meet the convergence criteria brought positive institutional change to Slovakia, it is difficult to say whether many additional gains will be made now that Eurozone entrance is secured. By opting not to join, the Czech Republic lacked the commitment mechanism to reform its political (and monetary) frameworks. Slow reform is better than none and it may well be that refraining from becoming entangled in an ever-expanding bureaucratic European monetary alliance will reap longer-term benefits on the Czech nation and its citizens.

Understanding where Europe stands today requires some knowledge of how it came to be here. The unification of Europe under its political and monetary unions promised important reforms, but an important step was missed. Already top-heavy bureaucratic countries joined an increasingly bureaucratic centralized union, whether centralized in Brussels or Frankfurt. While some evident advantages and liberties seemed to be gained (one could now travel from Barcelona to Paris without a passport), many unseen losses are unaccounted for.

In a timely piece, Brian Ó Caithnia looks into the EU's largest spending program, the Common Agricultural Policy (CAP). That the policy is one of the least understood EU policies is testament to the web of complications that underlie its organization. Indeed, the CAP has been the pride of European integrationalism since its inception in the late 1950s, yet it has grown to be a behemoth. It is a show of the strength of political will to ignore all evidence that it has overgrown its original purpose, uses a disproportionate share of the EU budget and has wasted untold billions of Euros in political rent-seeking and failed agricultural policies. Indeed, while the EU tries to secure its 2011 budget, earmarks for agriculture abound: €300 million for dairy farmers, €10 million for a school fruit plan, €8 million for beekeeping and €8 million just for promoting awareness of the bloc's agricultural policy (Castle, 2010).

Countries joining the European Union under the pretense of a forward-looking progressive future are soon greeted with a backward-looking monstrosity – a policy designed to keep farmers on their land, instead of allowing for productivity increases to permit (if they choose) these producers to strive for an alternative life. While some farmers have been better off, the vast majority have seen their livelihoods robbed from them. As Canny sums it up: 'Intellectually, the CAP is in tatters. It has failed on *all* of its intended objectives.'

The CAP is just one of many failed European policies over the last half-century. Europe, for better or worse, has a rich and long history – political, economic and cultural. Understanding where it came from is essential to understanding where its future lies. Europe's continuing recession exposes some of the deeper-rooted issues at stake. A drive for increased integration has failed to ask the critical question: at what cost? Europe could have achieved integration easily in a heartbeat. Opening the labor markets and reducing regulatory hurdles could have been enacted at any point (even unilaterally if need be). Instead a political apparatus was implemented that soon became the *raison d'être* for the new Europe. Exit from the political or monetary union is now so unthinkable that politicians are willing to save it at any cost.

While the essays contained in this volume were written in 2010, some recent events have proven their messages to be prescient. The deep-rooted issues of the common currency area have intensified, leading to a bailout of Portugal. Fiscal imbalances have not improved, and politicians have yet to learn that debt-fueled crises cannot be solved by running perpetual deficits. In my own country of Spain, valiant efforts to get the public deficit below 6 percent of Spanish GDP for 2011 have met resistance. It was not so long ago that the Maastricht Treaty calling for deficits of no more than 3 percent of GDP were strictly adhered to. While much has been learned over the past several years, there is still room for improvement.

Almost 20 years ago my own book, *Socialism, Economic Calculation and Entrepreneurship*, looked at a similar crisis (Huerta de Soto, 2010b). The failure of socialist doctrines, concretely manifested in the fall of the Berlin Wall, left an ideological gap. The years that followed witnessed a revival of liberalism in Europe – east and west. A similar crisis is before us now, this time operating in reverse. The current European recession is being offered as an excuse for a wider, more expansive centralized Europe. Failure to recognize the true causes of the recession – failed institutions that have plagued Europe for years, and will continue to do so if permitted to continue – will prolong the current malaise, and hold Europe back from its new future. Let us hope that the current volume does much to bring this new Europe to us.

NOTES

1. This is not to imply that Europe's recession is not severe, or that it will not worsen in the future. Already the future levels of longer-term European economic growth are suspect. Jörg Guido Hülsmann's chapter assesses some of the prospects for Europe's exit from recession. A depletion in the capital stock of European industry has left the continent with largely depreciated and increasingly obsolete means of production. This has not