

## Political Economy, Theories of the State and Economic Crisis

**Dr. Ioannis-Dionysios Salavrakos**

University of Western Greece

Greece

### **1. Introduction**

The intellectual aspiration of the paper is to cover both theoretical aspects associated with political economy, the role of the state and economic policy, especially in the era of crisis. Traditional economic theory points out, that economic crises, are associated with theories of economic cycles. The theories of economic cycles have been developed from the French economist Clement Juglar initially in 1860; who identified cycles of 8-11 years of duration. The Austrian economist Schumpeter argued later, that economic cycles have four stages: (expansion, crisis, recession, recovery). According to Schumpeter the time duration of economic cycles is similar to the time horizon that Juglar had identified. The next essential contribution was that of Kuznets who identified medium economic cycles with a time duration of 15-25 years. Finally the Soviet economist Kondratieff identified long duration cycles of 40-50 years. An analytical presentation of the theories of economic cycles is beyond the intellectual aspiration or the purpose of the current paper. The reference to the above theories is valuable here just for one point: i.e the time duration. Thus economic change (and economic crisis), are long-term processes which are associated with micro and macroeconomic developments, as well as, with the developments in the financial markets.<sup>1</sup>

The current analysis analyses capitalist crises with the intellectual tool of political economy. The concept “political economy” *per se* has a broad array of interpretations. The concept of political economy, is broader and multidisciplinary. Actually, the term is used both in economic science as well as in international relations (political science).

Therefore the structure of the present introduction is as follows: The first part analyses the concept of “political economy” in the field of economics. There we can identify three streams of thought or traditions: 1) The ancient and medieval tradition, 2) the tradition of the two industrial revolutions and finally, 3) the tradition of new institutional economics.

The second part of this essay analyses the concept of “political economy” in the field of political sciences. There, we can differentiate between the realist and the (neo)-liberal school of thought. We argue that the above theories across disciplines are associated with economic crises and therefore the crisis can be explained from the above theoretical schemata. An intellectual nexus of the above schemata follows and it is applied in three cases: a) The era of the first modern globalization (1870-1914 period), b) the current era of the global economic crisis (2007-2012). The conclusions follow.

### **2. Theoretical Framework: Political Economy and Economic science: An old relationship.**

In the field of economics the term “political economy” can be defined by the debate about the importance of economics for the individual, the society and the state. Are the interests of the individual above those of the society or vice versa? What is the role of the state? Should the state promote policies which are beneficial for the whole of the society or just for some classes or social groups? As already stated the nexus between political economy and economic science has three main traditions. These traditions, have been shaped across time from the constant transformation of the real economic world and the interaction between real economic change and the transformation/evolution of theoretical concepts. We examine them briefly.

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<sup>1</sup> For the theories of economic cycles see: 1) M.W. Lee: “Economic fluctuations”, Irwing, 1995, 2) Kondratieff N.D. & Stopler W.F.: “The Long Waves in Economic Life”, Review of Economics and Statistics, Vol. 17 (6), 1935, pp: 105-115.

## **2a. The ancient and medieval traditions: The contribution of Greek, Jewish and Muslim economic thought.**

The pillars of political economy can be found in the two main ancient civilizations (i.e. Greek and Jewish). Later the Muslim world had also made essential intellectual contributions.

In ancient Greece various philosophers have written marginally or extensively on various economic issues related to private ownership, free trade, interest rates, shipping, profit, agriculture, handicraft. In the Greek philosophy money were essential. However there was a clear distinction between money earned by honest activities (“hrima”-*χρήμα*) and money earned either by illegal activities or excess profit (“argiria”-*αργήρια*). The term “economy” is a synthesis of two Greek words “ecos” (*οίκος*) and “nomos” (*νόμος*) and is related to the management of private wealth (land, slaves, animals etc.). Hesiod (c.730-680 BC) in his work “Jobs and Days”(*Εργασίες και Ημέρες*) condemns excess profit since, according to his view it generates immense personal as well as social problems. Democritus (c. 470/60-400/390 BC) was the second philosopher who realized that one society which is organised on the principals of private property is superior to [another] society organised on the principal of collective (social) property. This is a clear distinction between capitalism and central planning.<sup>2</sup> Plato (428/7-347 BC) has been an early Marxist. In his classic work “Republic” (*Politeia- Πολιτεία*) he distinguishes among social classes.

The upper class, is the own which has the moral and intellectual capabilities to govern the state; in order to avoid corruption from wealth there is only own solution. The concept of private property for this upper class must be abolished. Only common property is allowed for the decision makers. On the contrary for the low classes (farmers, peasants, traders, ship-owners and navy personnel, wage-earners, manufacturers) private property should be allowed. Aristotle (384-322 BC) opposes the idea of common ownership. He points out that households should have adequate wealth which will guarantee economic autarchy. On the other hand, excess money is morally unacceptable and it is destined to bring calamities. The central idea of Hellenic political economy is the concept of “Kalokagathia” (*Καλοκαγαθία*). Under this concept private wealth is acceptable, since it generates growth, however this wealth must be evenly created and or distributed. This will generate prosperity not only for the individual, but for the society as well.<sup>3</sup>

The Jewish contribution to political economy is equally important. The Jews have identified similar notions and concepts, just like the Greeks. The Jews have identified five main economic principles: personal work and constant innovation, protection of private property, accumulation of wealth and savings, social responsibility by compulsory charity for the poor and limited government. These principals can be found in old Jewish literature (Genesis, Talmud, etc).<sup>4</sup>

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<sup>2</sup> See: Gordon B: “Economic Analysis before Adam Smith: Hessiod to Lessious”, 1975, page 11.

<sup>3</sup> For the ancient Greek thought see analytically the following: 1) G.A. Petrochilos: “The Hellenic Contribution to Economic Thought”, *Global Business and Economics Review*, Vol.1/2, 1999, pages: 215-246, 2) G.A. Petrochilos: “Kalokagathia: The Ethical Basis of Hellenic Political Economy and Its Influence from Plato to Ruskin and Sen”, *History of Political Economy*, Vol. 34:3, 2002, pages: 599-631, 3) A. Kanellopoulos: “Modern Economic Thoughts of Ancient Greeks”, Athens, Nea Synora editions, 1996, (in Greek).

<sup>4</sup> The literature about Jewish contribution to economic thought is immense. The most essential recent writings, in alphabetical order are as follows: 1) W. Block.: “Jewish Economics in the Light of Maimonides”, *International Journal of Social Economics*, Vol. 17 No.3 1990, pages: 60-68, 2) D. Carlton & A Weiss: “The Economics of Religion, Jewish Survival and Jewish Attitudes toward Competition on Torah Education”, *National Bureau of Economic Research (NBER), Working Paper No. 7863, 2000*, 3) K.G. Elzinga.: “An Assessment of Jacob Neusner’s The Economics of the Mishnah”, *Cultural Dynamics* Vol. 7(3) ,1995, pages: 281-298, 4) T. Fahey: “Max Weber’s Ancient Judaism”, *American Journal of Sociology*, Vol.88, 1984, pages: 62-87, 5) A. Fishman: “Religious Socialism and Economic Success on the Orthodox Kibbutz”, *Journal of Institutional and Theoretical Economics*, Vol 150 (4), 1994, pages: 763-768, 6) E.M. Gershfield: “Business Regulation and Price Control in Talmudic Economics”, *International Journal of Social Economics* Vol. 13 (9), 1986 , pages: 45-51, 7) E. Kleiman : “‘Just Price’ in Talmudic Literature”, *History of Political Economy* Vol. 19(1), 1987, pages: 23-45, 8) E. Kleiman : “Ancient and Medieval Rabbinic Economic Thought: Definitions, Methodology and Illustrations”, in the volume: B.B. Price (ed.): “Ancient Economic Thought”, Routledge, 1997, pages: 76-96, 9) A. Levine & Moses I. Pava (eds.): “Jewish Business Ethics: The Firm and its Stakeholders”, Northvale, 1999, 10) R.A. Ohrenstein: “Business Cycle Analysis in Talmudic Literature”, *International Journal of Social Economics*, Vol. 20 (1), 1993, pages: 40-50, 11) R.A. Ohrenstein: “Economic Analysis of Talmudic Literature: Some Ancient Studies of Value”, *American Journal of Economics and Sociology*, Vol. 39(1), 1980, page 22, 12) R.A. Ohrenstein: “Risk Uncertainty and Expectation in Talmudic Literature”, *International Journal* 80

There are huge similarities between the Greek and the Jewish systems (as well as nations), which continue across time until today. To illustrate, both nations had developed strong immigrant communities across time with huge entrepreneurial activity the former in shipping, the latter in trade. The pillars of current capitalism are based on these principles.

The Muslim world traditionally had endorsed three principles totally different from the Greek and the Jewish traditions. First of all Islam opposes any innovation (bī'd'a), which opposes tradition (taqlid), secondly interest rates, or even better any return on capital is not allowed (riba), finally the concept of “kismet”, of predetermined action has immense role to play, thus it marginalizes (if not totally perishes), the development of the necessary institutional framework, which can promote economic growth. Furthermore, and, despite of the various religious groups (Sunni, Shiah, etc.) the Islamic states endorse the principals of “Choura” and “Shari’a”, which also impose economic constraints. However, an important element of the Muslim tradition is the (economic) solidarity of the across the various Muslims.<sup>5</sup>

In spite of the differences between the Greek and Jewish tradition from the one side, as opposed to the Muslim tradition on the other one element is common. There is a strong nexus between morality and economics. In other words the individual has a social responsibility to perform via the personal wealth.

All the above streams of thought were generated in a feudal pro-industrialized society. This society has been dominant in ancient as well as medieval times. To be more specific, during the medieval times in the Byzantine Empire the works of Georgios Plethon Gemistos (c.1360-1452), of Cardinal Bessarion (c. 1403-1472) and also the work of Georgios Scholarios (c.1400-1472) followed Plato’s tradition. In medieval Western Europe the works of St. Augustine (354-430) and of St. Thomas Aquinas (1224/5-1274) followed the Greek and Jewish traditions.<sup>6</sup>

However the two industrial revolutions (circa 1750-1850, 1870-1914) will create a new world and therefore the debate about the importance of economics for the individual the society and the state will change.

## **2b. The tradition of the two industrial revolutions (circa 1750-1850 and 1870-1914)**

Both Greek and Jewish traditions influenced, up to a point the tradition of the two industrial revolutions. In this period we can identify two streams of thought: the Anglo-Saxonic school and the schools of continental Europe (German and Austrian, Swedish, Italian, Greek economists).

### **2b1. The Anglo-Saxonic School**

Initially the Anglo-Saxonic school has been influenced from the writings of the Greek and Jewish scholars. To illustrate, Thomas Hobbes (1588-1679) and John Locke (1632-1704) propose the concept of social contract, (although in slightly different meanings) and also private initiatives. The influence of both Jewish and Greek tradition is obvious to the above scholars.<sup>7</sup> Adam Smith (1723-1790) realized very quickly, that in the era of industrial revolution that he was experiencing, Britain should follow the economic doctrines of Ancient Athens. Just as Athens promoted free trade and had a huge naval power to protect it, Britain should do exactly the same. Furthermore, just as in Ancient Athens the role of the state was minimal in the economy, Britain should do exactly the same. Adam Smith is equally influenced from contemporary Jewish entrepreneurs. Josiah Wedgwood (1730-1795) a thrilling figure of Britain’s first industrial revolution affected Smith tremendously.<sup>8</sup>

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*of Social Economics Vol.18(11-12), 1991, pages: 4-15. Finally see: Jerry Z. Muller: “Capitalism and the Jews”, Princeton University Press, 2010.*

<sup>5</sup> For the Muslim tradition see: Rodinson Maxim: “Islam et Capitalisme”, Seuil, Paris, 1966.

<sup>6</sup> For the role of Byzantine scholars see: 1) Tzermias P.: “The other Byzantium: The contribution of Constantinople to Europe”, Athens, 1995, Elliniki Euroekdotiki editions (in Greek), 2) C. M. Woodhouse: “George Gemistos Pleton: The Last of the Hellenes”, Oxford, Clarendon, 1986. See also: J.S. McClelland: “A History of Western Political Thought”, Routledge, 1996, pages: 92-126.

<sup>7</sup> See: J.S. McClelland: “A History of Western Political Thought”, Routledge, 1996, pages: 171-248.

<sup>8</sup> For the role of Josiah Wedgwood see: Nancy F. Koehn: “Josiah Wedgwood and the First Industrial Revolution”, in the volume: Thomas McCraw (ed.): “Creating Modern Capitalism How Entrepreneurs, Companies and Countries Triumphed in Three Industrial Revolutions”, Harvard University Press, 1997, pages: 19-48. For the influence of Wedgwood on Adam Smith see: Robert L. Heilbroner: “The Worldly Philosophers”, under the title: “The philosophers of the economic world”

Adam Smith is the first economist who will predict the possibility of a financial crisis in capitalism. He points out that: “if a big sum of gold and silver is transferred abroad...in order to fuel consumption without creating a constant economic resource this will promote profligacy...and from every respect it is harmful for the society...”<sup>9</sup> Adam Smith is the first to realise that banks need to use their reserves and deposits in order to finance real investment, if bank reserves are used in a short term speculative manner this is harmful for the economy and this policy will create a crisis. The moral responsibility of bankers is illustrated here vividly.

However the influence of the Greek and the Jewish tradition on the Anglo-Saxonic School will be terminated suddenly and paradoxically by the economist David Ricardo (1772-1823) who was of Jewish origin. Ricardo for the first time splits morals from economics, imposing an intellectual dichotomy. The creation of “Homo Economicus” is a reality.<sup>10</sup> After Ricardo the Anglo-Saxonic scholars will sporadically follow the old traditions. One of them is the English scholar John Ruskin (1819-1900), who in four different works (“The Roots of Honour”, “The Veins of Wealth”, “Qui Judicatis Terram” “Ad Valorem”) follows a social responsibility concept.

With the emergence of the Second Industrial Revolution (1870-1914) economic thought departs completely from the old moral traditions. The work of Alfred Marshall (1842-1924) illustrates the analogies between economics and the modern science of the time, biology. Just as in nature the dominant specie will prevail over the weak, the same will occur with industrial competition. Big firms will emerge winners, when competing with small and medium size enterprises (SMEs).<sup>11</sup> With the exemption of John Maynard Keynes (1883-1946) the other major scholars of the Anglo-Saxonic school tend to follow Ricardo’s dichotomy differentiating morals from economics.<sup>12</sup> During the era of industrial revolution economics change. Mass production and distribution, marketing, management, internal transformation of enterprises from Unitary to Multidivisional forms change the concept of economic science. Gradually but steadily business ethics decline. The neo-liberal economic doctrines which have prevailed in the Anglo-Saxonic world after the 1970s are the best illustration of an economic thought which differentiates morals and economics, and in which the individual is the core element. As Mrs. Thatcher, once, pointed out: “There is no such thing as society”. The old traditions would certainly disagree with the above assertion.

## **2b2. The schools of continental Europe (German and Austrian, Swedish, Italian, Greek)**

The contribution of Karl Marx (1818-1883) is well known and analysed. Here we point out that he has been influenced from both the ancient Greeks as well as from Ricardo. The old nexus between economics and morals is present in his work, regardless of any other reservations about other aspects of his writings and analysis of the capitalist system.<sup>13</sup>

Karl Marx however made an essential contribution because he analysed capitalist evolution and crisis. Marx admired capitalism, he points out in his work that the bourgeoisie: “[created] the big industry, which created the global market due to the discovery of America.

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Athens, Kritiki, Greek edition 2000, pages 87-88. For the influence of the Greeks on Adam Smith see: W. Scott: “The Greek Influence on Adam Smith”, *Archive of Economic and Social Sciences*, No. 27-29, 1947, pages: 81-108 (in Greek).

<sup>9</sup> See: Adam Smith: “An Enquiry into the Nature and Causes of the Wealth of Nations”, originally published in 1776, Greek edition, Volume 6 in the series: “Books that Changed the World”, To Vima editions, 2010, pages 352-353.

<sup>10</sup> For the role of David Ricardo see: Robert L. Heilbroner: “The Worldly Philosophers”, under the title: “The philosophers of the economic world” Athens, Kritiki, Greek edition 2000, pages 129-144.

<sup>11</sup> For the work of Alfred Marshall see: 1) Joseph A. Schumpeter: “Ten Great Economists From Marx to Keynes”, London, Routledge, 1997, second edition, pages: 91-109, and 2) Gavin C. Reid: “Theories of Industrial Organisation”, Blackwell, 1989, pages: 65-94.

<sup>12</sup> We can refer to Milton Friedman and the Chicago school as well as to Michael Porter, Robert Lucas etc. Obviously entrepreneurs like Andrew Carnegie (1835-1919) and Bill Gates (1955-) with immense social contribution are typical examples that the old traditions have not been totally perished. At this point we clarify that the work of Clark in 1940, a time when the strains of post 1929 economic crisis have not been healed in the USA and in Europe war already had broken who speaks about “workable competition” is rather the *altera pars* due to the circumstances. See: Clark J.M.: “Towards a concept of workable competition”, *American Economic Review*, Vol. 30, 1940, pages: 241-256.

<sup>13</sup> For various assessments see: 1) Joseph A. Schumpeter: “Ten Great Economists From Marx to Keynes”, London, Routledge, 1997, second edition, pages: 3-73, and 2) Robert L. Heilbroner: “The Worldly Philosophers”, under the title: “The philosophers of the economic world” Athens, Kritiki, Greek edition 2000, pages 187-232.

The global market developed immensely trade, navigation, terrestrial networks which also influenced the development of industry. As industry, trade, navigation, railways were developed the bourgeoisie was also developed, marginalizing the order of the medieval era....Every stage of bourgeoisie development was associated with political progress...[Thus] the bourgeoisie had a revolutionary role in history...and has achieved miracles different [and greater] than the Egyptian Pyramids the Roman water towers and the Gothic churches...The bourgeoisie is associated with constant revolutionary reclassification of the mean of production...”.<sup>14</sup>

Thus Marx admired capitalism for its ability to innovate, to achieve constant economic progress, which was associated with political progress and perish the old medieval status quo. However Marx realized that constant progress is associated with crisis as well. Thus the goods of capitalism go hand in hand with the evils of capitalism. Under this analysis fruits of capitalism evolution are extremely fragile. Thus Marx wants to keep the benefits of capitalism but avoid simultaneously the risks associated with a possibility of an economic crisis in the real sphere of the economy. His answer to this is Human Capital, associated with the level of wages and the over-value, of labour. His emphasis in human capital however contradicts with the immense error of his analysis the concept of unlimited class struggle. The notion that the clash of different social interests will go always to extremes was wrong.

The Austrian School is also influenced by the old Greek and Jewish schools. To illustrate, Carl Menger (1840-1921) has been influenced by Aristotele. The analysis of interest rates which another scholar [Eugen von Bohm-Baverk (1851-1914)] of the Austrian tradition makes has similarities with the Jewish tradition. In Sweden the great economist J. Knut Wicksell (1851-1926), founder of the Stockholm school of Economics, “fought for programmes of redistribution of wealth from the rich to the poor”.<sup>15</sup> In Italy Vilfredo Pareto’s (1848-1923) assertion about efficient allocation and equal utility for all individuals underlines the assertions of the old Greek and Jewish schools.<sup>16</sup> Finally modern Greek scholars like Stefanidis (1948) have also emphasized the importance of moral economics.<sup>17</sup>

The fact that nowadays in many EU countries (Germany, France, Greece, Italy, Sweden) there is, correctly or wrongly, a stronger presence of social state, compared to the Anglo-Saxonic world is not accidental. In these countries the influence of the old traditions are still present. At this point we have to emphasise on the writings of Adam Smith and Marx. They both predicted the possibility of a capitalist crisis. The former pointed out that free capital movements which are not associated with investments will generate crisis. The latter pointed out that due to constant change and limited returns to human capital capitalism may suffer from crises in the real sphere of the economy. The underling emphasis is both is morality, only if morals are present the positive forces of capitalism can promote growth and prosperity.

The above assertions were further buttressed by the writings of Max Weber. In his work “Protestant Ethics and the Spirit of Capitalism” Weber argues that the moral and altruistic bonds across generations fuel the positive forces of capitalist growth. In his analysis the Protestant ethics force parents to save for their children, thus the accumulation of capital can be used to finance investments and thus generate growth. Weber points out: “The doctrine *Deo placere vix potest* (=prosperity is liked by God) [is associated] also with the interest rate thesis of the Gospel [*meminem desrerantes* (=never become desperate, which implies that poor peasants can also have access to interest-free loans)]...As archives demonstrate people who died rich provided large funds in religious institutions as a “consciousness tax” and sometimes they returned [funds] to former debtors...professions [in Protestantism] endorse the principles of moral rules between *praecepta* (=commands) and *consillia* (=advices). ...fulfilling your obligations is the only purpose of life...”.<sup>18</sup> Again the moral principles are present. If capitalism is associated with morality prosperity will thrive.

<sup>14</sup> See: Karl Marx: “The Communist Manifesto”, published originally in 1848, Greek edition, Volume 9 in the series: “Books that Changed the World”, To Vima editions, 2010, pages 26-27.

<sup>15</sup> See: Enresto Screpanti & Stefano Zamagni: “An Outline of the History of Economic Thought”, Oxford, 2001, page: 202.

<sup>16</sup> See: 1) Enresto Screpanti & Stefano Zamagni: “An Outline of the History of Economic Thought”, Oxford, 2001, pages: 203-210, 2) Joseph A. Schumpeter: “Ten Great Economists From Marx to Keynes”, London, Routledge, 1997, second edition, pages: 110-142.

<sup>17</sup> See the three volume work of D. Stefanidis: “Social Economics in its historical evolution”, Athens, 1948-1950, in Greek.

<sup>18</sup> See: Max Weber: “Protestant Ethics and the Spirit of Capitalism”, originally published in 1904, Greek edition, Volume 7 in the series: “Books that Changed the World”, To Vima editions, 2010, pages 57-58, 62, 153-154, 162.

The rationale of the strong nexus between economics and morality is present in the work of John Maynard Keynes. Keynes distinguished eight motives for savings. Among them Keynes points out that savings occur “in order to secure any difference between the current and the future relation between income and the needs of the individual or his family, for example for old age, education, or the preservation of dependent family members”.<sup>19</sup>

From the above it is obvious that the driving force of successful capitalism implies the presence of ethics. If the nexus is not strong then economic power may lead to misallocation of resources and corruption. These two in the long run will undermine capitalist growth and prosperity.

### **2b3. New Institutional Economics (NIE): An American contribution**

The NIE approach attempts to analyse why inefficient institutions, enterprises, societies, etc. may continue to survive for a great / lengthy period of time. There are three main areas where inefficient institutions occur. The first, is the “institutional inefficiency”. The second one is the “technological inefficiency” and finally the third one is the “spatial inefficiency”. For the current introduction we focus exclusively in institutional inefficiency. In this case suboptimal institutions continue to exist for long time periods. Typical examples refer to states (and societies) which in spite of being in a huge social, political, moral and economic crisis continue to remain inert, thus abolishing any possibility of reforms.

There are four main reasons behind this evolution. First, transaction costs of creating new institutions are considered very high from the society. This assumption of course is a fallacy. Since the society has not experienced any changes the attempt to evaluate the cost and the benefit of them in advance is false. However the society is afraid of changes thus it prefers to sustain the already unsatisfactory network of institutions. Furthermore, if any changes are adopted these are associated with additional transaction costs due to new technologies, production techniques, learning curve, patterns of investment etc.

The second reason which explains institutional inefficiency is associated with the personal cost versus benefit of the decision makers per se. Even if decision makers (politicians, military planners etc) realize the need of change they may still veto or oppose any change because they may consider that the changes will affect their personal interests negatively. If this is the case opposition to change will persist.

The third reason which may explain institutional and social inertia is related to the fact that new strategies or ways of thinking may be totally different from the dominant strategies and ways of thinking. If this is the case, again decision makers will veto any change.

The fourth reason which can explain the phenomenon is related to bounded rationality. In this case societies and decision makers are...blind. They cannot see that changes have already occurred elsewhere. Worse they may believe that the changes refer to different, distant cultures; thus they fail to realize that changes occur due to broader social phenomena and are also affected by them. The above framework has been used successfully by various scholars [North (1990, 1993)] in order to explain why states across time emerge or decline in power.<sup>20</sup> In a way NIE theory provides the intellectual “bridge” between economics and political science. Thus we can now turn our attention to the nexus between political economy and political science. The “Square of Power”, i.e. the intellectual apparatus of 1) state mechanism (with emphasis in tax regimes), 2) Institutions (with emphasis in Parliament and legal framework which promotes social stability and cohesion), 3) Public debt, 4) Central Bank is a key contribution to the field of sciences. According to the “square of power” economic growth and prosperity can be achieved in long run under four preconditions. The state mechanism functions smoothly and especially the tax collection mechanism gathers taxes in full and uses these funds efficiently and morally. The Parliament legislates in such a way that promotes social stability and cohesion. In other words the conflicting interests of various social classes are balanced. Public debt has to be low and the Central Bank has to increase money supply in such a way that it will not trigger hyperinflation, and speculative currency demand.<sup>21</sup>

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<sup>19</sup> See: John Maynard Keynes: “The General Theory of Employment, Interest and Money”, originally published in 1936, Greek edition, Volume 11 in the series: “Books that Changed the World”, To Vima editions, 2010, pages 149-150.

<sup>20</sup> See: 1) Douglas C. North: “Institutions, Institutional Change and Economic Performance”, New York, 1990, 2) Douglas C. North: “Institutions and Credible Commitment”, Journal of Institutional and Theoretical Economics, (JITE), 149-1, 1993, pp. 11-23.

<sup>21</sup> For an application of the Square of Power paradigm see: Niall Ferguson: “The Cash Nexus Money and Power in the Modern World, 1700-2000”, Penguin books, 2001.

Thus in the NIE paradigm moral standards are also implied. The NIE also implies that there is a *mondus operandi* between social classes and political leadership. In other words all social classes will make compromises in order to achieve stability and growth in the economy. The political parties in power will also promote social cohesion instead of legislating exclusively for the benefit of their social supporters (voters).

### **3. Theoretical Framework: Political Economy and Political science: Another old relationship.**

In the field of political science the term “political economy” can be defined by the debate about the importance of economics for the state. To what extent, economic power, influences military power? To what extent bilateral trade can minimize conflict across states? To what extent financial markets and other economic actors, beyond the control of the state can influence social and political evolution? However additional issues are associated with the structure of the state regime (democracy, oligarchy, monarchy, absolute monarchy, dictatorship, fascism, communism), the style of leadership, the rule of law. All the above issues are also related to ethics: i.e. the ethics of the state, the ethics of the leaders, the ethics of the society. Actually all the thirteen major theories of International Relations have a small or broad nexus with Political Economy. The thirteen major theories are as follows:

1. The historical approach
2. Idealism
3. Realism
4. Behavioralism
5. Neo-realism
6. Neo-liberal institutionalism or pluralism
7. Hegemonic stability theory
8. Long-cycle theory
9. World system theory or Globalism
10. Dependency theory
11. Comparative foreign policy or foreign policy analysis theory
12. Geopolitical analysis theory
13. Communication process theory.

We briefly describe the above theories

**1. The historical approach** points out that by examining the historical evolution of diplomacy and IR we can deduct important conclusions about the role of various factors such as leadership, political structure, economic and military planning etc. All these factors were unique in the past and obviously can not be repeated in full in the current or future era; however partial similarities may occur.<sup>22</sup>

**2. Idealism** emerged with the termination of the Great War (1914-1918). According to this assertion human nature is good and altruistic. Progress is possible since human beings have a social responsibility. “Bad or diabolical” behaviour is associated with states or institutions and not with individuals. International organisations can stop wars thus individuals have to endorse their role. Wars can be avoided via four elements: 1) The establishment of a global governance, 2) Constant arms reduction, 3) Any conflicts or disputes need to follow the international justice / legal path for resolution, 4) State interdependence has to increase. Thus high bilateral trade and Foreign Direct Investments (FDI) can promote interdependence and thus minimize conflict.<sup>23</sup>

**3. Realism** points out that political behaviour is associated with the concepts of “personal interest and human nature”, “power”, “national survival” and “global anarchy”. States in order to survive will have to follow these principles, increase their military and economic power, create alliances, use unorthodox methods to achieve their goals etc.<sup>24</sup>

<sup>22</sup> See: Charles Kegley Jr. & Eugene Wittkopf: “World Politics: Trend and Transformations”, St. Martin’s Press, New York, 1993, pp: 19-38.

<sup>23</sup> See: John Spanier: “Games Nations Play”, CQ Press Washington, 1993, pp: 11-21, also see: John H. Herz: “Political Realism and Political Idealism”, University of Chicago Press, 1951.

<sup>24</sup> See: Hans J. Morgenthau: “Politics Among Nations: The Struggle for Power and Peace”, McGraw Hill, New York, 1993 (revised edition by Kenneth W. Thompson), especially pages 3-16. See also: H. Morgenthau: “Thucydides History of the Peloponnesian War”, Penguin, 1982.

**4. Behavioralism** although it was developed in the 1960s and 1970s it has its roots in the writings of Watson (1925).<sup>25</sup> According to this stream of thought IR analysis has to follow the principals of 1) informational saturation, 2) refutability or falsifiability, 3) verifiability, 4) predictability.<sup>26</sup>

**5. Neo-realism** is mainly expressed by Waltz (1979). Kenneth Waltz promotes the writings of Hans Morgenthau by replacing the inductive / deductive methodology of realism with the “systemic” or “reductionist” methodology. Thus the theory has to cast light to the expected course of various systems and also to highlight how the structure of the system influences the various parts and then how these parts influence the system.<sup>27</sup>

**6. Neo-liberal institutionalism or pluralism** is originated in the writings of Haas (1958) and Mitrany (1966).<sup>28</sup> These ideas promote further the concept of international organisations and their pivotal role in IR. They also point out state interdependence.<sup>29</sup> We point out that British academics use the term pluralism in their writings when they refer to the US concept of neo-liberal institutionalism.<sup>30</sup>

**7. Hegemonic Stability theory** is based on Kindleberger (1973).<sup>31</sup> According to this stream of thought the world was stabilised after an immense global crisis due to the positive hegemonic role of the US. Thus the presence of a global leader or hegemon was positive and created a global order. If the leader was not present instability and anarchy would have been the alternative. The assertion is correct especially for the 1945-1973 period the era of Pax Americana and the positive influence of the US with the establishment of NATO, the GATT, the Bretton Woods system, the IMF, the World Bank.

**8. The long-cycle theory** is based on the notion that pre-determined historical cycles exist and they repeat. Thus global history will always be between periods of war and peace. According to this assertion cycles may occur every 200 years (Richardson 1960), or every 177 years (Dewey 1964), or 50 years (Quincy 1942), or more than 100 years (Tonybee 1947).<sup>32</sup> The ideas of Modelski (1983) should be included in this theory. According to Modelski (1983) after 1500 there is a repeated cycle in every prime state which will eventually create an open military conflict.<sup>33</sup> Finally, in this theory, one may include the theories of economic cycles as well. The theories of economic cycles have been developed from the French economist Clement Juglar initially in 1860; who identified cycles of 8-11 years of duration. The Austrian economist Schumpeter argued later, that economic cycles have four stages: (expansion, crisis, recession, recovery). According to Schumpeter the time duration of economic cycles is similar to the time horizon that Juglar had identified. The next essential contribution was that of Kuznets who identified medium economic cycles with a time duration of 15-25 years. Finally the Soviet economist Kondratieff identified long duration cycles of 40-50 years. An analytical presentation of the theories of economic cycles is beyond the intellectual aspiration or the purpose of the current paper.

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<sup>25</sup> See: J.B. Watson: “Behaviorism”, New York, Peoples Institute Publishing, 1925.

<sup>26</sup> See analytically: 1) M. Kaplan: “Systems and Process in International Politics”, Wiley, New York, 1957, 2) Heinz Eulau: “The Behavioral Persuasion in Modern Political Analysis”, Englewood Cliffs, Prentice-Hall, New Jersey, 1963, 3) David Singer (ed.): “Quantitative International Politics”, Free Press, New York, 1968, 4) John Loossee: “A historical introduction to the Philosophy of Science”, second edition, Oxford, Oxford University Press, 1980.

<sup>27</sup> See: Kenneth N. Waltz: “Theory of International Politics”, New York, McGraw-Hill, 1979, especially pages 40 and 73.

<sup>28</sup> See: 1) Ernst Haas: “The Uniting of Europe: Political, Social and Economic Forces 1950-1957”, Stanford University Press, 1958 and 2) David Mitrany: “A Working Peace System”, Quadrangle, Chicago, 1966.

<sup>29</sup> See: 1) R. Keohane & J. Nye: “Power and Interdependence: World Politics in Transition”, Boston, Little Brown, 1977, 2) Richard C. Cooper: “Economic Interdependence and Foreign Policy in the Seventies”, in World Politics, No.24, January 1972, pp: 158-181, 3) Stephen D. Krasner: “International Regimes”, Cornell University Press, 1983. We point out that the term **Neo-realism** was first introduced in Robert Keohane: “Neorealism and its critics”, Columbia University Press, New York, 1986.

<sup>30</sup> See: Paul R. Viotti & Mark V. Kauppi: “International Relations Theory: Realism, Pluralism, Globalism”, McMillan, Publishing, New York, 1987, pp: 5-14.

<sup>31</sup> See: Charles P. Kindleberger: “The World in Depression 1929-1939”, University of California Press, 1973, especially pages 291-308.

<sup>32</sup> See: 1) Lewis F. Richardson: “Arms and Insecurity”, Boxwood Press, Pittsburgh, 1960, 2) Edward R. Dewey: “The 177 Year Cycle in War 600 B.C.-A.D. 1957”, Foundation for the Study of Cycles, Pittsburgh, 1964, 3) Wright Quincy: “A Study of War”, University of Chicago Press, 1942, 4) Arnold J. Tonybee: “A Study of History”, Oxford University Press, 1947.

<sup>33</sup> See: George Modelski: “Long Cycles of World Leadership”, in the volume: William R. Thompson (ed.): “Contending Approaches to World System Analysis”, Sage Publications 1983, pp: 114-131.

The reference to the above theories is valuable here just for one point: i.e the time duration. Thus economic change (and economic crisis), are long-term processes which are associated with micro and macroeconomic developments, as well as, with the developments in the financial markets.<sup>34</sup>

**9. World System Theory or Theory of Globalism** points out that earth as a planet is the location of all changes and IR needs to be explained from long term trends and historical experience. Mechanisms of Domination allow to some states, social classes or individuals to have access to super-normal profits and wealth, whereas others (states, social classes or individuals) are marginalised. Finally economic and sociological aspects of capitalism need to be addressed in order to have a macro-historical approach.<sup>35</sup>

**10. Dependency Theory.** This stream of thought has purely Marxist and communist origins and is introduced by Prebisch (1963).<sup>36</sup> The theory points out that some “core and rich states” dominate the “periphery-poor states”. According to the Western academics who follow this approach underdevelopment in the Third World is the outcome of domestic barriers and rigidities of these states (corruption, poor government structures, bureaucracy, infrastructure shortage). However academics from Third World states point out that it is the structure of the global capitalist system *per se* the main reason for underdevelopment. Colonialism, foreign intervention are essential explanatory reasons for the underdevelopment of these states.<sup>37</sup>

The dependency theory has also a cultural aspect. Karl Popper in his pivotal book *The Open Society and Its Enemies* points out that liberal / open societies are those which accept and adopt easily and quickly to progress and new methods of production, organisation of society etc. Contrary to the Open Societies are the Conservative closed societies which do not accept social change easily. Furthermore, they fail to adopt quickly (if they adopt at all) to new changes. Typical examples of liberal / open societies are the Anglo-Saxons, the Dutch, the Jews, whereas Russia and part of Islam can be regarded as traditional societies.

**11. Foreign Policy Analysis Theory** points out that across states foreign policy is conducted through certain similar if not identical structures (state bureaucracy, organisational structure, predetermined decision making processes etc). In addition to this, human traits (presence or absence of charismatic leaders, heroic individuals etc) as well as political traits (absolute monarchy, dictatorship, parliamentary democracy etc) will determine foreign policy goals, methods etc.<sup>38</sup> In order to analyse the diplomatic factor we have to take into account the distinction of Rosenau (1981) about foreign policy. He distinguishes four foreign policy types. These are: 1) The acquiescent adaptation, 2) the intransigent adaptation, 3) the promotive adaptation, and the 4) preservative adaptation.<sup>39</sup>

The “acquiescent prototype”, refers to the type of foreign policy of a state which follows exactly the international environment’s perceptions and the will of the Great Powers. In other words the foreign policy of the country follows completely that of the Great Powers. If this is the case we refer to a “country satellite” or to a “banana-Republic”. As Rosenau (1981:63, 64) remarks: “officials perceive themselves ... as lacking the capacity to alter or offset the demands [of the superpower] and thus they are not inclined to bargain with those that make them. Stated in game theory terms, they see themselves as participants in a zero-sum game in which they are bound to be the losers. ...The officials need not, and indeed dare not, be innovative...The possibility of breaking old alliances or creating new ones is not theirs to consider.

<sup>34</sup> For the theories of economic cycles see: 1) M.W. Lee: “Economic fluctuations”, Irwing, 1995, 2) Kondratieff N.D. & Stopler W.F.: “The Long Waves in Economic Life”, Review of Economics and Statistics, Vol. 17 (6), 1935, pp: 105-115.

<sup>35</sup> See: 1) Immanuel Wallerstein: “The Capitalist World Economy”, Cambridge University Press, 1979, 2) Immanuel Wallerstein: “The Modern World System II: Merchantilism and the Consolidation of the European World Economy, 1600-1750”, New York Academic Press, 1980, 3) Ray Maghroori & Bennett Ramberg (eds.): “Globalism versus Realism: International Relations’ Third Debate”, Westview Press, 1982, 4) Charles W. Kegley & Eugene R. Wittkopf: “World Politics: Trend and Transformation”, St. Martin’s Press, 1989.

<sup>36</sup> See: Raul Prebisch: “Towards a Dynamic Development Policy for Latin America”, New York, 1963.

<sup>37</sup> See: 1) Paul Baran: “The Political Economy of Growth”, Monthly Review Press, New York, 1968 and 2) Amin Samir: “Accumulation on a World Scale: A Critique of the Theory of Underdevelopment”, Monthly Review Press, New York, 1974.

<sup>38</sup> See: Loyd Jensen: “Explaining Foreign Policy”, Prentice Hall 1982, 2) Irving L. Janis: “Crucial Decisions: Leadership in Policy Making and Crisis Management”, Free Press, 1989, 3) Roger Hilsma: “The Politics of Policy Making in Defence and Foreign Affairs: Conceptual Models and Bureaucratic Politics”, Prentice Hall, 1990.

<sup>39</sup> See J. N. Rosenau: “The Study of Political Adaptation”, Nichols Publishing Co., New York, 1981, pages: 63-87.

Nor do they initiate interventions in the affairs of other societies or use creative diplomacy to seek out new foreign markets or develop new sources of military or economic assistance...The politics of acquiescent adaptation is not free of difficulty. Foreign policy officials may not be faced with great challenges ...but their domestic policy counterparts ...may not always find it easy to cope with the internal consequences of external acquiescence. Acquiescence adaptation can be sustained only if internal debates over foreign policy issues can be avoided and domestic publics remain docile about the conduct of external affairs”.

The “intransigent prototype”, refers to the type of foreign policy of a state which attempts to force with various means the international environment to follow its own structure and political goals. In other words, in this case the state attempts to force the international environment to follow its goals. In Rosenau (1981:66,67) terminology: “Stated in terms of game theory, the officials of intransigent societies assume that they are participants in a zero-sum game in which they must be winners. Their rationale for such a posture is that the internal attributes are too important to be subject to negotiation. ...Officials may differ among themselves over tactical questions of when and how to be intransigent, but their shared commitment to the broad strategic posture of making the environment compatible with the demands of the society...”. However Rosenau (1981:69) points out that: “Whatever the ease with which officials are able to sustain intransigent adaptation, the external politics are extraordinary difficult [since] altering attitudes and changing behaviour abroad is the hardest of all political tasks. The societies and international organisations that comprise the environment are not readily disposed to put their own internal demands aside in favor of demands made by the intransigent society. For this reason it might be concluded that in the long run the politics of intransigent adaptation are bound to fail”. In these societies the role of the military is essential.

The “promotive prototype”, refers to the type of foreign policy of a state which attempts to keep a balance between its internal structure, aims and expectations and those of the international environment. In order to make this successful the state has to assess correctly the domestic and the international expectations. For this type of policy Rosenau (1981:72) remarks that: “The policy makers of promotive societies ...are not subjected to unyielding demands from either domestic or foreign sources and are thus relatively free to attempt to promote changes at home and abroad that will move toward a desired equilibrium between the essential structures of their society and its present environment...In game theory terms, they can and do regard themselves as participants in a nonzero game in which the sum is always positive”.

Finally, the “preservative prototype”, refers to the type of foreign policy of a state which attempts to survive from the pressure of the internal environment and from that of the international environment. According to Rosenau (1981:76, 77): “the intense and conflicting demands emanating from both the domestic and foreign scene ...are so strong that the officials ...can achieve consistency between them by, in effect, bargaining them off against each other and preserving whatever equilibrium exists between their respective strengths...their freedom of choice is severely limited. ...Officials of a preservative society cannot afford to bargain on behalf of long-run goals. The demands upon them are such that they must confine their efforts to preserving as much of their present essential structures and environment as they can. This means that short-run changes at home and abroad must be their prime concern...In game theory terms, they know they are participants in a nonzero sum game in which the sum may be negative”.

We stress that the four prototypes are not mutually exclusive. What is essential here is that Rosenau’s model attempts to bridge internal and foreign policy. In other words the model says that internal political goals can be served by foreign policy. Here again moral conduct by the state is implied.

**12. The Geopolitical schools.** The Geopolitical schools are across different nations. The Anglo-Saxonic School is based on the writings of Alfred Th. Mahan (1840-1914), Halford J. Mackinder (1861-1947), Nicholas Spykman (1893-1943).<sup>40</sup> The German School is based on the writings of Friedrich Ratzel (1844-1904), Karl Haushofer (1869-1946) and the Austrian count Richard Nikolaus Coudenhove Kalergi (1894-1972).<sup>41</sup>

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<sup>40</sup> See analytically: 1) G.O. Tuathail: “Critical Geopolitics”, Routledge, London, 1996, pp: 24-35, 38-43, 50-55, 75-110 and 2) Geoffrey Parker: “Geopolitics Past Present and Future”, Pinter Publishers, London, 1998, pp: 97-135.

<sup>41</sup> See analytically: 1) G.O. Tuathail: “Critical Geopolitics”, Routledge, London, 1996, pp: 37 and 46, 2) Geoffrey Parker: “Geopolitics Past Present and Future”, Pinter Publishers, pp: 27-29, 3) Christian Spang: “The Effect of Karl Haushofer in the 88

The French geopolitical school is based on the writings of Vidal de la Blanche, Demangeon and Yves-Marie Goblet.<sup>42</sup> The Russian geopolitical school is historically dichotomised between the pro-western attitudes (Zapadniki) and the pro-Slav attitudes (Slavjanofili). A third stream in the Russian school is expressed by the writings of Nicholas Daniliefski (1822-1885) who expresses the “Eastern Geopolitical Approach” (Vostochniki), i.e. that Russia is a unique case, a country that is the bridge between the Western civilization and the Asian civilizations of China and Japan.<sup>43</sup> The Italian School is based on the writings of Bortoreli published in 1911 by the Institute of Naval Warfare (Istituto di Guerra Marittima). The Great Mediterranean Concept is introduced there.<sup>44</sup> Finally the Japanese School introduced initially in the early Meiji era was formed in the notion of the Greater East Asia Co-Prosperity Sphere.<sup>45</sup> In this school the dichotomy between “land powers” and “sea powers” is the core idea.

**13. Communication Process Theory.** This is based on the writings of Deutsch (1953, 1963, 1988).<sup>46</sup> According to Deutsch the essential theoretical issue in international relations is not associated with “power” but with “communication”. Bilateral and multilateral communication can integrate and unite different individuals, social classes, institutions, political parties etc. Thus the quantity and quality of communication will determine the prosperity of the society and the nation. All the above theories address the following issues to some extent:

### 3a. Economic and military power

There is a tendency to overestimate economic power versus military power. The nexus between economic and military power is very well documented. Perhaps Kennedy (1989) is the most well known and influential writer on this issue. Economic power is a precondition for military power. Furthermore in most conflicts historically the winner is the wealthier side, i.e. the one with more economic power.<sup>47</sup> However, a closer look demonstrates that this rule is shaken as time goes by. Examining the military conflicts of the 1800-1849 period we can see that in the 88.2% of the cases the side with more economic resources prevails. For the period 1850-1899 the figure is 79.5%. For the period 1900-1949 the figure decreases to 65%, but still the side with more resources prevails. Astonishingly for the 1950-1999 period it is the weak side which prevails (51.2% as opposed to 48.8% of the side with more resources).<sup>48</sup> The ongoing war in Iraq is a typical illustration that there are cases which do not follow Kennedy’s assertion.<sup>49</sup>

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German and Japanese Military Doctrines”, in the volume: HCMH (=Hellenic Commission for Military History): Proceedings of the International Conference of Military History, Athens 19-25 August 2001, published in 2002, pp: 115-122.

<sup>42</sup> See: Geoffrey Parker: “Geopolitics Past Present and Future”, Pinter Publishers, pp: 46-57.

<sup>43</sup> See: I-D Salavrakos: “Money, Politics and War Co-operation and Competition from the Industrial Revolution to the 21<sup>st</sup> Century”, Kadmos editions, 2008 (in Greek), pp: 41-42.

<sup>44</sup> See: Pier Paolo Ramoino: “The Italian Geopolitical vision of Greater Mediterranean”, in the volume: HCMH (=Hellenic Commission for Military History): Proceedings of the International Conference of Military History, Athens 19-25 August 2001, published in 2002, pp: 307-316.

<sup>45</sup> See: Ramon H. Myers & Mark R. Peattie (eds.): “The Japanese Colonial Empire 1895-1945”, Princeton University Press, 1984, pp: 3-58 for an overall discussion. See also: Peter Duus: “Japan’s Wartime Empire: Problems and Issues”, in the volume: Peter Duus & Ramon H. Myers & Mark R. Peattie (eds.): “The Japanese Wartime Empire 1931-1945”, Princeton University Press, 1996, pp: xi-xlvii (in Latin).

<sup>46</sup> See: 1) Karl W. Deutsch: “Nationalism and Social Communication”, MIT Press, 1953, 2) Karl W. Deutsch: “The Nerves of Government: Models of Political Communication and Control”, Free Press, 1963, 3) Karl W. Deutsch: “The Analysis of International Relations”, Prentice Hall, 1988.

<sup>47</sup> See: Paul Kennedy: “The Rise and Fall of the Great Powers”, Fontana Press, 1989.

<sup>48</sup> See: Ivan Arreguín Toft: “How the Weak Win Wars. A Theory of Assymetric Conflict”, Cambridge University Press, 2005.

<sup>49</sup> According to the most recent estimates made by the economist Joseph Stiglitz the cost of the Iraq war has been higher than \$3 trillion. See: Joseph Stiglitz & Linda Bilmes: “The Three Trillion Dollar War”, Allen Lane, 2008, pages 211-231. However a classical example which jeopardizes Kennedy’s thesis is the case of the German-Soviet war of 1941-1945. According to data provided by Eichholtz (2003) the German economy with the other economies of Europe in June 1941 had a huge economic advantage over the USSR. This advantage simply became broader during the June-December 1941 period, when the Soviet Union lost an immense part of its economic, demographic and industrial resources. In spite of the complete economic superiority the German Kriegswirtschaft delivered smaller quantities of all types of defense articles (guns, tanks, airplanes, SP artillery etc) during the next three years (1942-1944). The outcome is well known. For the initial complete economic advantage of the Axis over the USSR See analytically: Dietrich Eichholtz: “Geschichte der Deutschen Kriegswirtschaft 1939-1945”, Band I, KG Sauer Verlag, 2003, page 223. For the immense economic losses of the Soviet

### **3b. International trade and war**

Here the relationship between trade and war is explored. According to the neo-liberal approach the high volume of trade between two countries reduces the possibility of war between them. Both countries have multiple benefits from bilateral trade, and high costs if they decide to fight. The theory was first introduced by Richard Cobden during the 1850s decade.<sup>50</sup> Abraham Lincoln said that: “Borders which are not passed by goods are violated by soldiers”.<sup>51</sup>

Exactly the opposite is the analysis which the realist school is making. According to this stream of thought: “economic interdependence not only fails to promote peace, but in fact heightens the likelihood of war. States concerned about security will dislike dependence, since it means that crucial imported goods could be cut off during a crisis. This problem is particularly acute for imports like oil and raw materials ...states dependent on others for vital goods have an increased incentive to go to war to assure themselves of continued access of supply”.<sup>52</sup> According to Mearsheimer (1990, 1992): “[countries which] depend on others for critical economic supplies will fear cutoff or blackmail in time of crisis or war”. Thus “they may try to extend political control to the source of supply, giving rise to conflict” [Thus interdependence] “will ...lead to greater security competition”.<sup>53</sup> Mansfield (1994) points out that: “struggles over the principal arteries of commerce have been constant sources of interstate conflict”.<sup>54</sup> The Nazi-Soviet war is a typical example of the above theoretical approach.

A “modest”-intermediary approach is introduced by Copeland (2001), who points out that what is important is not the current trade volume, but the expected future trade exchanges. If the expected future volume is high, then friendly relations will occur between the two countries. However if the expected future volumes are low and the two states have clashing interests then the probability of conflict is high.<sup>55</sup>

### **3c. Politics (power) versus Economics (wealth)**

Here three main questions need to be addressed: a) to what extent political developments (changes) create similar economic changes? Or is the opposite rotation? (economic changes which create political change), b) to what extent the global economic evolution affects the economies of nation-states or regional trade blocks as well as the issue of national security? c) how global (or domestic) economic powers and interests including financial markets, shape internal political structures in nation-states? There is an impressive literature on these issues. For the first question classical economists fail to identify a relationship, whereas the Marxists point out that economic change is the precondition for political change.<sup>56</sup> For the second question the classical school believes that participation of nation states in the process of globalization is beneficial for local economies, because it will result to greater growth and prosperity. On the opposite side the various critiques point out that in globalization the weaker states are constantly exploited by the stronger ones.

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Union during June-December 1941 see: M. Burleigh: “The Third Reich A New History”, Pan Books, 2001, page 498. For the huge numerical difference between the production of the defense industries during 1942-1944 see: Mark Harrison (ed.): “The Economics of World War II”, Cambridge University Press, 1998, pages: 15-16.

<sup>50</sup> See: R. Cobden: “The Political Writings of Richard Cobden”, T. Fisher Unwin, 1903, London, page 225.

<sup>51</sup> For an ample discussion see: Joanne Gowa: “Allies, Adversaries and International Trade”, Princeton University Press 1994. The most recent work which analyses the influence of trade on global evolution is the work of Ronald Finley & Kevin H.O’ Rourke: “Power and Plenty Trade, War and the World Economy in the Second Millennium”, Princeton University Press, 2007, which provide evidence in favor of both the realist and the liberal schools.

<sup>52</sup> See: Dale C. Copeland: “Economic Interdependence and War. A Theory of Trade Expectations”, in the volume: M. E. Brown & R. Cote, Jr. & S. M. Lynn-Jones (eds.): “Theories of War and Peace”, MIT Press, fourth edition 2001, pages 464-500, especially page 469.

<sup>53</sup> See: 1) John J. Mearsheimer: “Back to the Future: Instability in Europe After the Cold War”, International Security vol. 15, No. 1, Summer 1990, pages 5-56, 2) John J. Mearsheimer: “Disordered Restored”, in Graham Allison and Greory F. Treverton (eds.): “Rethinking America’s Security”, New York, Norton, 1992, page 223.

<sup>54</sup> See: Edward D. Mansfield: “Power, Trade and War”, Princeton University Press, 1994, page 146.

<sup>55</sup> See: Dale C. Copeland: “Economic Interdependence and War. A Theory of Trade Expectations”, in the volume: M. E. Brown & R. Cote, Jr. & S. M. Lynn-Jones (eds.): “Theories of War and Peace”, MIT Press, fourth edition 2001, pages 464-500.

<sup>56</sup> See for the classical assertion: John Hicks: “A Theory of Economic History”, Oxford University Press, 1969. For the Marxist view see: Jones Barry (ed.): “Perspectives on Political Economy”, London, Pinter, 1985.

A rather middle approach is the one of the realists which point out that each country is making certain economic concessions, in order to see the other countries following a similar path.<sup>57</sup>

The third question is more complicated. To illustrate, Thurow (1997) points out that democracy and capitalism should not be compatible.<sup>58</sup> However, historically, economic power (domestic or global) has shaped political structures, events and strategies. According to Arrighi (1994:45-46) in the United Provinces “The Dutch capitalist oligarchy...had a strong common interest with the emerging dynastic states in the liquidation of the claims of pope and emperor [however at the same time]...the Dutch...continuously sought ways and means to prevent conflict from escalating beyond the point where the commercial and financial foundations of their wealth and power could be seriously undermined”.<sup>59</sup>

### **3d. Overview of the theoretical argument: The process of economic and political crisis**

We have to provide an overview of the argument. In the field of economics the concept of political economy was associated until the first industrial revolution with moral conduct. Money was good, since it promoted prosperity, but it was evil as well, since it could promote personal corruption and social misery via misallocation of resources. Thus in order to avoid such phenomena social responsibility and solidarity was an important *sine qua non*.

With the emergence of the new era of industrial revolution, in economic thought a dichotomy was imposed. The questions of good or evil should be addressed by the philosophers, not the economists. Under this new rationale, economics become more and more a science, rather than art. However the creation of the welfare-social state and the existence of philanthropist entrepreneurs is an indication that the old ideas have not been faded totally. These characteristics however become, more and more, rare, after the end of the 1970s.

In the field of political science again the neo-liberal tradition is currently dominant. Markets are more important than states and economic power is a precondition to military power. Actually sometimes economic power may even be superior. Trade development can minimize conflict. Also high growth rates can minimize conflict, since countries which experience high quality of life have no interest to fight. Under this rationale Great Powers simply defend the existing status quo. Finally international organizations can guarantee peace and stability.

Contrary to the above the realist school, assumes that in many cases superior economic power is not associated with military power and final victory. Great Powers are not liberal, but hegemonic, thus their aim is to increase their influence and power *viz.* a *viz.* the power of the other states. Under this assertion, the various powers will constantly act in order to change the status quo, making it more favourable for their own interest. States are more dominant and long-living than markets or national enterprises, or multinational enterprises (MNEs), which perish under the economic cycle. Contrary to the previous argument the realists will point out that international organizations failed many times to preserve stability and peace.

The NIE paradigm provides an intellectual distillation of ideas across the various disciplines described above. In this stream a strong financial position of the state presupposes four pillars: These are: an efficient tax-collecting bureaucracy and a low debt which practically refer to a strong fiscal position, an independent and efficient central bank which refers to monetary policy and a strong parliament, which refers to political stability and efficient institutions. Thus efficient (strong) financial status is associated with efficient government and institutions. Under these preconditions, (i.e. the smooth operation of the above four factors) military victory in case of war can be achieved, regardless of the duration of the conflict.

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<sup>57</sup> See the following: 1) Marc Williams: “Rethinking Sovereignty” and 2) Philip G. Cerny: “What Next for the State?”, both in the volume: E. Kofman & G. Youngs (eds.): “Globalization Theory and Practice”, Pinter, 1998, pages: 109-122 and 123-137 respectively. See also: Haas E.B.: “Why Collaborate? Issue-linkage and International Regimes”, in the volume: O.R. Young (ed.): “The International Political Economy and International Institutions”, Edward Elgar, UK, 1996, pages: 184-233. See also: 1) Peter Dicken: “Global Shift”, SAGE, 2004, pages: 122-197, 2) David Held & Anthony McGrew & David Goldblatt & Jonathan Perraton: “Global Transformations”, Polity, 2001, for an overall discussion.

<sup>58</sup> See: Lester C. Thurow: “The Future of Capitalism”, Nea Synora editions, 1997, page 354, (in Greek).

<sup>59</sup> See: G. Arrighi: “The long Twentieth century: Money, Power and the Origins of our time”, Verso, London-New York, 1994. See also the earlier work of Knorr Klaus: “Power and Wealth: The Political Economy of International Power”, New York, Basic Books, 1973.

However at this point, the NIE analysis takes a different path. It goes without saying that efficient government and institutions are associated with a type of moral conduct. To put it differently corruption can be an essential precondition for the fall of Great Powers, if the phenomenon is continued for an immense period of time. To illustrate, Ferguson (1990), refers to the “Silverbridge Syndrome”. He concludes that corruption per se is not the exclusive factor which can lead to the fall of Great Powers. However if it is associated with additional characteristics (wrong fiscal-monetary policies) the outcome will be catastrophic.

These will occur after the following sequence of events: A) moral decay (shortage of business ethics, financial scandals, collapse of welfare state, limited social responsibility by national and international corporations, individuals with immense influence etc.) will lead eventually to crisis and collapse of the process of globalization. B) Then states associated with destabilizing economic policies (fiscal and monetary expansion which lead to high deficits-debts as well as inflation), will experience immense economic pressure and in extreme cases collapse since they will not be able to repay their debts. C) At the same time the inability to lead by one or more powers will create a power vacuum. D) Other parameters (religious extremism, internal institutional inefficiency in various countries, demographic-environmental change) will create a greater wave of destabilization. If all the above occur the outcome can be a large economic catastrophe or even a global scale military conflict.

It is obvious that Plato’s assertion is still valid. Plato had observed the decay of Ancient Athens. In order to avoid decay and demise according to Plato one strategy should be followed: “Either the kings [i.e. those with power] become philosophers [i.e. wise] or the philosophers will have to become kings”. A nexus of crises, (morals, beliefs, institutions, states, social tensions, opposing state interests, generation gaps between traditional and progressive societies and individuals) all trigger economic and eventually political crisis.

#### ***4. The past and the current economic crisis as an outcome of the above process.***

Using the literature of political economy and that of theories of the state we just modelled economic and even political crisis as the outcome of a four chain event:

Moral decay of individuals and institutions, b) expansionist fiscal policies associated with high levels of deficits and debt, c) absence of a hegemonic actor who could have a positive stabilizing role for national or even international system, d) additional problematic traits in the periphery (i.e small size states or institutions) which can have an additional harmful effect on the (global / or national) system. These are associated with costly arms races or costly conflicts (wars) in the periphery.

We shall apply this four principle model in three historical periods: The period of the Second Industrial revolution before the First World War (1870-1914), and the period of the current economic crisis (2007-2012).

##### **4a. The 1870-1914 period**

The era of the belle époque is considered as an era of tremendous economic progress. This is associated with the developments of new technology (telegraph, telephone, steamship, railways, internal combustion engine, car, airplane etc). However the period is associated with immense economic crises. These are as follows:

###### **a1. The 1873 crisis**

The crisis occurred in the German Empire and spread to Austria-Hungary. The excess liquidity in the German economy which occurred after the French reparations of 5 billion francs in gold triggered a stock market crash in both Berlin and Vienna (May 1873), which affected the real sphere of the economy, and was spread across Europe and the US.<sup>60</sup>

###### **a2. The 1890 crisis**

The crisis started in 1888 when the German investors stopped buying Argentine bonds. This was viewed in London as a unique opportunity for investments. Thus the British Barings Bank by 1890 had invested £19.2m in the bond market of Argentina from a total global bond market exposure of £100.

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<sup>60</sup> See: 1) W.O. Henderson: “The Rise of German Industrial Power 1834-1914”, London, Temple Smith, 1975, pages 161-170, 2) C.P. Kindleberger: “Manias, Panics and Crashes A History of Financial Crises”, USA, Basic Books, 1989, pages 48, 145-146, 162, 3) L. Neal & M. Weidenmier: “Crises in the global economy from tulips to today”, in the volume: M.D. Bordo & A.M. Taylor & J. G. Williamson (eds.): “Globalization in Historical Perspective”, USA, University of Chicago Press, pp: 473-514.

However, between January-November 1890 the Russian government, withdraw £6.5 m of its deposits from the bank, creating havoc in the financial markets. Barings defaulted and was rescued by a banking consortium. However the crisis was spread across Europe and Argentina, forcing the latter to abandon the Gold Standard.<sup>61</sup>

#### a3. The 1893 crisis

The crisis started in the US, when the price of silver was reduced to \$0.93 per ounce and the US Treasury had silver reserves valued at \$380 m. At that time the country had high silver reserves which lost their value and very limited gold reserves. The outcome was catastrophic since more than 15,000 enterprises defaulted between May-December 1893. The crisis was terminated until 1897 when new gold mines were found in Alaska and South Africa.<sup>62</sup>

#### a4. The 1907 crisis

The roots of the crisis are traced in the San Francisco earthquake of April 1906, which perished the city. The insurance companies had to pay enormous funds, thus from October 1906, immense loans were made between the US insurance industry and the banking institutions of London and Paris. Due to the massive capital outflow to the US the central banks of Britain and France intervened and the outflow was terminated by the autumn of 1907. Back in the US the general public was astonished with the financial inability of the US insurance companies and thus a confidence crisis erupted across the banking financial system from October 1906. The crisis became greater after October 1907 when the news about the termination of European loans were made public. Thus between October 14<sup>th</sup>-24<sup>th</sup> 1907 many companies defaulted and the crisis was spread across European economies (Britain, France, Germany, Austria-Hungary, Belgium, Holland, Russia, India, Australia).<sup>63</sup>

However the crisis of 1870-1914 was not only economic; it was institutional as well. Thus old and new institutions clashed across states and within states. To illustrate from the one side one could easily spot the liberal democracies of US and France, the liberal monarchy of Britain, as opposed to the old autocratic monarchies of Austria-Hungary, Imperial Germany and Tsarist Russia. In the first three states (France, US and Britain) all social forces had some political representation. To illustrate, industrialists, bankers, merchants, peasants, laborers, were all enjoying, some short of political rights and representation, with the strong exemption of women who in the case of Britain had established the dynamic suffragette movement. In these three states national minorities were also enjoying some liberties, with the Jewish community as a prime example.<sup>64</sup>

The situation was different in the old monarchies of Europe. There it was mainly the land-owners which enjoyed immense power, followed by industrialists, bankers and merchants. The low and middle classes were marginalized and ethnic minorities especially in Tsarist Russia and the Habsburg Empire were under pressure. To illustrate in Austria-Hungary the rotation of power was between Austrians and Hungarians, all other minorities (Slavs, Poles, Ruthinians, Czechs, etc) were all marginalized.<sup>65</sup>

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<sup>61</sup> See: 1) C.P. Kindleberger: "Manias, Panics and Crashes A History of Financial Crises", USA, Basic Books, 1989, pages 147, 168-170, 2) L. Neal & M. Weidenmier: "Crises in the global economy from tulips to today", in the volume: M.D. Bordo & A.M. Taylor & J. G. Williamson (eds.): "Globalization in Historical Perspective", USA, University of Chicago Press, pp: 473-514, especially 488-492, 3) P. Ziegler: "The Sixth Great Power Barings 1762-1929", London, William Collins Sons & Co. Ltd, pp: 244-266.

<sup>62</sup> See: 1) C.P. Kindleberger: "Manias, Panics and Crashes A History of Financial Crises", USA, Basic Books, 1989, page 163, 2) L. Neal & M. Weidenmier: "Crises in the global economy from tulips to today", in the volume: M.D. Bordo & A.M. Taylor & J. G. Williamson (eds.): "Globalization in Historical Perspective", USA, University of Chicago Press, pp: 473-514, especially 492-497, 3) J. Hughes & L.P. Kain: "American Economic History", Addison Wesley, 1998, pp:384-386.

<sup>63</sup> See: 1) L. Neal & M. Weidenmier: "Crises in the global economy from tulips to today", in the volume: M.D. Bordo & A.M. Taylor & J. G. Williamson (eds.): "Globalization in Historical Perspective", USA, University of Chicago Press, pp: 497-501, 2) R.F. Bruner & S.D. Carr: "The Panic of 1907: Lessons Learned from the Market's Perfect Storm", John Wiley & Sons, 2007.

<sup>64</sup> See: 1) A. Devere-Summers: "War and the Royal Houses of Europe", London, 1996 for a brief introductory analysis of the role of monarchies in WWI and WWII. 2) For the role of ethnic minorities see: Niall Ferguson: "The War of the World", Allen Lane, 2006, especially pages xlii-lxxi (introduction) and pages 3-42.

<sup>65</sup> See: 1) John C.G. Röhl: "The Kaiser and his Court", Cambridge 1994 for an excellent analysis of the conservative nature of the German monarchy. For Austria-Hungary see: 1) R. Okey: "The Habsburg Monarchy", St. Martin's Press, 2001, 2) For the unbalanced economic growth and income distribution in Austria-Hungary see: 1) D. F. Good: "The Economic Rise of the Habsburg Monarchy 1750-1914", University of California Press, 1984, 2) I. T. Berend, and G. Ranki: "Economic

However institutional and social clash existed within states as well, with Germany as the prime example. German capitalism was based on a social compromise. The landowners (Junkers) needed the termination of cheap Russian wheat imports, in order to achieve high prices for agricultural products. The industrialists opposed the idea, since higher prices for food would mean higher salaries for industrial workers. The syndicates objected to the idea as well. However eventually the state decided to terminate Russian cheap imports; however in exchange of higher food prices the landowners accepted the development of a big German navy (a move associated with huge demand for iron and steel, thus high profits for the heavy industry). In exchange of the higher food prices, the labour movement was compensated with the creation of a welfare state (free health and education for the working class).<sup>66</sup> All this was associated with an immense arms race throughout the 1900-1914 period for both land and naval armaments and a spirit of militarism and colonialism.<sup>67</sup>

The First World War was the outcome of a very powerful mixture:

1. The challenge of ethics associated with immense political and social change (i.e. the old empires and the dominant land-owners clashed against the liberal democracies and the socialist movement, which represented the new bourgeoisie and the workers classes respectively).
2. The immense structural economic problems. These were associated with the emergence of industrial capitalism and mass production / consumption. The mass production techniques reflected the immense demographic increases and the high demand for consumer goods from a growing prosperous part across societies. However the Gold Standard (i.e the idea that money supply had to follow gold reserves) was an immense obstacle. There was high demand and supply but not much money in circulation in order to buy the additional goods. This resulted in high inflation which partially triggered financial and economic crises.
3. The third trait was the existence of a multi-polar world with two main opposing blocks (Entente versus the Central Powers) which both had high nationalist passions and an immense military-industrial complex apparatus.

Therefore we can argue that the First World War was the outcome of problems in the “fundamentals” of the system. At that time we had a nexus of structural economic problems associated with social changes, introduction of new morals, arms races and conflicts in the periphery of the European system (colonial antagonism etc). A nexus of economic, social and political forces destabilized the status quo and created the scenes of a new dawn in human history.

#### **4b. The 2007-2012 crisis: A political economy analysis.**

The current economic crisis has been seen by many academics as the biggest economic challenge after the Great Crash of 1929. However in this intellectual exercise we have avoided any reference to the 1929 Crash, and contrary, we have pointed out that the current situation is similar to the 1870-1914 period. The above assertion needs a brief explanation. In October 1929 the collapse of the US stock market created immense harmful ramifications to the US economy. Thus, during 1929-1934, the astonishing number of 16,305 banking institutions had collapsed; and only 14,771 banks remained operational.<sup>68</sup>

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Development in East-Central Europe in the 19<sup>th</sup> and 20<sup>th</sup> Centuries”, Columbia University Press, 1974a, 3) I.T. Berend, and G. Ranki: “Hungary. A Century of Economic Development”, Newton Abbot, 1974b, 4) I.T. Berend, and G. Ranki: “The European Periphery and Industrialization 1780-1914”, Cambridge University Press, 1982. For **Russia** see: 1)

<sup>66</sup> For the rise of human capital in Germany see: 1) ) A.D. Chandler Jr.: “Scale and Scope The Dynamics of Industrial Capitalism”, Harvard University Press, 1990, pages: 399-400, 425, 2) R. Chickering: “Imperial Germany and the Great War 1914-1918” Cambridge, 1998, page 2, 3) P. Watson: “The German Genius”, Simon & Schuster 2010, pages 340-397 (with the nexus between sciences and economics), 4) J. Fear: “German Capitalism”, in the volume: Th. K. McCraw (ed.): “Creating Modern Capitalism”, Harvard University Press, 1997, pages: 135-184 and especially pages 141-152. See also: 5) K.D. Barkin: “The Controversy of German industrialization, 1890-1902”, University of Chicago Press, 1970. Finally see: S. Halperin: “War and Social Change in modern Europe”, Cambridge 2004, pages 148-149 where there is an excellent analysis of the class struggle inside Germany and the ramifications that this struggle had on Germany’s foreign relations.

<sup>67</sup> See: 1) D. Stevenson: “Armaments and the coming of war”, Oxford University Press, 2000 for the broader consequences of arms races and 2) A. Maddison: “Class structure and Economic Growth”, London, Allen & Unwin, 1971, especially pages 35-75, and also 3) G. Clark: “The Balance Sheets of Imperialism”, Columbia University Press, 1936 for the broader ramifications of colonialism.

<sup>68</sup> See: J. Hughes & L.P. Cain: “American Economic History”, Addison Wesley, 1998, page 483.

The result was that people lost their savings which reduced the aggregate demand in the economy, which in turn forced enterprises to make workers redundant and the vicious cycle of recession forced unemployment further up, with even greater catastrophic results for GNP.

However the experience of the current crisis is different. First it was triggered (but not started) by the bad loans in the US housing market. Although certain financial institutions collapsed again during this crisis (like Lehman Brothers in the US and Northern Rock in the UK), across states governments did not allow the complete collapse of the banking / financial sector. To illustrate in the US the Bush Administration proposed a \$700 billion bailout package, which failed to pass in the Congress, whereas the Obama Administration, endorsed, initially a rescue package of \$787 billion, which eventually increased to more than \$830 billion. In the UK the British government endorsed a rescue plan of £400 billion for the financial sector. In Germany a €500 billion rescue scheme was announced; France followed with €360 billion, Italy with €40 billion in capitalization and “as much as necessary” in guarantees, Holland endorsed a rescue package for the financial sector equal to €200 billion and Austria and Spain introduced a package of € 100 billion each.<sup>69</sup>

Thus the overall global banking crisis was averted; however the rescue packages of financial institutions triggered a debt crisis across developed capitalist economies. To illustrate, the US continued to have high debt due to high deficits in the trade balance and the USD was undermined in the international markets. Eventually the US economy lost the triple A (AAA) assessment by S&P (August 6<sup>th</sup> 2011).<sup>70</sup> The US economy is facing immense challenges: High debts due to fiscal and trade deficits, immense competition from the emerging economies (BRIC), especially from China, and immense internal social changes with the middle class marginalised and a growing gap between the rich and the poor.<sup>71</sup>

In the EU the banking crisis was transformed to state crisis. The countries of the European South (Portugal, Spain, Italy, Greece) as well as Ireland, during the 2010-2012 period, observed extremely high fiscal deficits, above the acceptable levels of the EMU criteria, and had to follow austerity policies in order to reduce government budget deficits. However these policies have not been accompanied by structural economic changes and inflow of FDI. Thus although in the short term budget deficits have been reduced; the long term prospects remain uncertain.

The European crisis has an additional aspect. According to Miller & Schiaccitano (2012): “Only the European Central Bank... maintains control over the money supply of the eurozone. Unlike the FED, the ECB does not have a dual mandate to pursue low employment as well as low inflation... and the ECB is prohibited from directly buying government bonds. The ECB is authorized to buy government bonds only on the secondary bond market, when original purchasers resell them. The result of these policies is that eurozone countries must sell their bonds on the open market. That leaves them entirely dependent on private bond buyers (i.e. lenders), whether from their own country or other countries, to finance their government deficits. Governments must offer their bonds for sale with rates of return (interest rates) that will attract those bond buyers...”.<sup>72</sup> According to this assertion the ECB follows the wrong policy (not printing money), whereas the FED is pursuing the correct policy of quantitative easing (increase of money supply). According to this assertion the catastrophic policy of the ECB is the reason why the European crisis is persisting since 2010. Thus, whereas in the US, the Treasury sells bonds directly to the FED, in the EU that option is not possible. According to this rationale the ECB should follow the example of the US central bank. According to this rationale the US monetary policy achieves to goals simultaneously. The first is the demonetization of the debt, and the second is a low exchange rate between the USD (\$) and the other major currencies, which boosts US exports, which eventually boost jobs inside the US.

All the above are the mainstream assessments about the current economic crisis. However the political economy explanation may differ completely from the above assertions.

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<sup>69</sup> See: G. Brown: “Beyond the Crash”, Simon & Schuster 2011, pages 60, 66.

<sup>70</sup> For the pressure on the USD see: J. Rickards: “Currency Wars”, Penguin 2011, pages 164-167. See also: R. Fisk: “The Demise of the Dollar”, Independent 6-10-2009.

<sup>71</sup> See: G. Brown: “Beyond the Crash”, Simon & Schuster 2011, pages 146-147, where it is stated that middle class incomes in the US has fallen between 1979-2009. Furthermore the extreme poor families which during 2006-2007 were 11.7 million by 2009 were 18.9 million almost a 62% increase.

<sup>72</sup> See full article in : <http://www.dollarandsense.org/archives/2012/0112millersciacchitano.html>

Thus according to the political economy model that we have developed the banking crisis in the developed western economies can be seen as the outcome of shortage of business ethics. To illustrate the former US President George Bush Junior point out in his book that: "I had read about the financial panics of 1893 and 1929. Now I had witnessed firsthand the bursting of a speculative bubble".<sup>73</sup> The former British Prime Minister Gordon Brown points out as well: "International economics is not just about numbers...but about the lives of people. For too long it has been assumed that the cost of crises will inevitably be paid by putting more burdens on the poor-by cutting health, education, and basic social services. This is wrong in the short term and it will not work in the long term because it erodes both the economic and the political foundations of a society. ...This is a historic opportunity to realise the enduring public purpose, the high ideals of 1945...We should [create opportunities] for all by investing more not less in education, employment and vital public services".<sup>74</sup> The answer to the crisis is the return to the ideals of 1945, and these ideals are well known.

At the end of the Second World War the US epitomized the ideals of free world, free entrepreneurship with government support for the less well off across the world (Marshall Plan), for one purpose the establishment of a new world order where human rights would be respected. Furthermore, extremist regimes like Nazi Germany, Fascist Italy would not be tolerated. Another former British Prime Minister, Tony Blair, pointed out that the financial crisis continues for such a long time, partially, due to banking "extremism": "At present, we have gone from irresponsible lending to the other extreme whereby even worthy businesses and customers are refused credit".<sup>75</sup> Again an innuendo about morals is present, the use of the term "irresponsible lending" is essential. Therefore it is obvious that the roots of the current economic crisis can partially be traced to the absence of business ethics to some members of the global financial industry. This part of the argument co-insides with the economic aspects of political economy. (Obviously throughout this time the economic policy of the states did not have a moral dimension as well.) Most states continued to accumulate debts, thus the generation in power finances a good life through loans which have to be repaid by later generations, this is certainly, not moral nor altruistic.<sup>76</sup>

Turning to the political theories of political economy the argument continues as follows: The crisis of 2007 did not occur out of the blue. The US after the terrorist attacks of September 11<sup>th</sup> 2001, have been engaged in two wars in Iraq and Afghanistan. Acting in Iraq and Afghanistan the US had followed various political theories. To illustrate the supporters can claim that US action followed the theory of Idealism, since the US were promoting democratic ideals in the volatile regions of Central Asia and the Middle East by crushing two dictatorial regimes. Opponents can claim that US followed realism, hegemonic stability theory, geopolitical theories and even Rosenau (1981:66,67) "intransigent prototype", foreign policy.

Here, however the argument is associated with the economic cost of these conflicts, and the ramifications of this cost for the US economy as well as for the global economy. According to Stiglitz & Bilmes (2008) the total direct and indirect cost of the two conflicts during the 2003-2007 period was between \$2.2-4.9 trillion, thus the \$3 trillion war cost was a reasonable estimate.<sup>77</sup> The actual cost of the conflict is debatable, however what is not debatable is the opportunity cost of the conflicts. As long as the US is absorbed in various conflicts other Powers (such as China) can develop their economic power (and later transform this economic power to military), thus challenging US supremacy. Therefore under the political economy analysis the current economic crisis is directly associated with the high military expenditure which the US and their Allies had made for the various peripheral conflicts. We can summarize the argument as follows: Across the Western world both states as well as financial institutions had followed an irresponsible behaviour.

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<sup>73</sup> See: G.W. Bush: "Decision Points", Virgin Books, 2010, page 441.

<sup>74</sup> See: G. Brown: "Beyond the Crash", Simon & Schuster 2011, pages 262-263.

<sup>75</sup> See: T. Blair: "A Journey", Hutchinson, 2010, page 668.

<sup>76</sup> Here we use the term in the sense of Max Weber's argument about the altruistic bonds between generations and the need that parents have to save for their children.

<sup>77</sup> See: J. Stiglitz & L. Bilmes: "The Three Trillion Dollar War", Allen Lane, 2008, pages 130-131. It is interesting that for the 2003-2007 period the authors provide a direct financial cost for the UK economy as well. According to the authors the cost was £7 billion. It is interesting that for the earlier (1999) Kosovo conflict the total cost for the international community was £7.7 billion. See: N. Ferguson: "The Cash Nexus. Money and Power in the Modern World 1700-2000", Penguin, 2002, page 412.

The states had continued to create debts for decades and the major financial institutions (both in retail as well as in investment banking) had also made lending financial decisions, with harmful, if not disastrous consequences. These decisions reflect partially a shortage of business ethics. Furthermore the Western states have been engaged also in various costly conflicts which had also negative economic outcomes.

Perhaps the long term solutions to the current economic challenges are not the austerity packages of the Berlin / Brussels policy makers. The problem with the Berlin / Brussels austerity policy is associated with the complete collapse of domestic demand, which create a huge problem in domestic enterprises. We have always to remember that the majority of enterprises, especially in the EU South (Greece, Italy, Spain, Portugal) are small and medium size (SMEs) family firms. The majority of these firms do not hold an international competitive advantage, thus they cannot sell their products or services in the international markets via exportation. Most of these SMEs are totally dependent from their sales in the domestic economy. Since domestic demand is collapsing (due to higher taxation, lower salaries etc) the profits of these enterprises are becoming losses and thus the austerity policy creates greater recession and so on. Under this policy the EU as a whole and the Euro-zone in particular will in the long term suffer from investment shortages, thus the EU will have a small -or even worse- negative growth rate viz. A viz. other economies. The austerity policy is not the long term answer for Europe.

However the answer may not exist in the quantitative easing policy of the US FED. The policy of higher money supply according to the FED has three major advantages. The first is that the debt is demonetized, the second is associated with the exchange rate of the USD viz. a viz. other currencies. Thus a weak USD assists US exports and thus eventually create jobs in the US economy. The third argument in favour of the quantitative easing policy is associated with domestic demand, which is expected to increase, thus creating further profits for US enterprises. The problems with this policy however are also obvious. The counter-argument for the demonetized debt is associated with investors preferences. Investors will not buy US bonds in the long run since they will easily understand that the returns of their investment is negative.

Already China the biggest investor in US bonds has changed its policy. The Chinese are buying short term US bond, not long term ones for some time now and this is policy change is not accidental. The second argument associated with the exchange rate of the USD viz. a viz. other currencies (mainly the Chinese Yuan and the €) is also problematic. German and Chinese exports are higher than US exports. In this “trade / currency war” exchange rates play an auxiliary role. Trade surpluses are not associated with exchange rates but with broader issues related to competitiveness, foreign direct investments, productivity of labour force etc. Finally there are reservations for the third argument that increased money supply is associated with higher demand. The problem with this argument is the Keynes liquidity trap proposition. People may have more money, but they do not spend them; they prefer to save them because they have negative expectations about their jobs in the future. If people believe that they will become unemployed in the near future or if they expect future lower salaries or higher taxes they will not consume, but they will prefer to save. Thus for various reasons if money supply is increased let us say by 10% this does not mean that consumption will also increase by 10%. Consumption may increase just 1% or 2% since the velocity of money is not determined by the monetary authorities (central bank), but by the households.

Therefore both conflicting economic doctrines in the US and in Europe endorse immense elements of risk. The above policies do not also take into consideration broader political and social phenomena. To illustrate, both the advocates of austerity as well as the advocates of growth do not take into consideration broader demographic trends (i.e. gradual decline of US and EU population viz. a viz. the demographic increase of Islam, which obviously has partially different consumer needs), social trends (i.e. the greater gap in western societies between rich and poor). Furthermore, the current economic planning does not take into consideration potential future conflicts which may destabilize further both the economies of the Western states as well as the global economy. The economic consequences of environmental changes (from Katrina to the Japanese earthquake and Tsunami) are not also taken into consideration.

The current situation is extremely complex just as it was in the 1870-1914 period. We currently observe the systematic decline of the West. Both the US and the EU have a debt problem which is associated with:

- a) The demographic changes in these regions (low birth rates, high life expectancy). This changes labour demand and supply and has created immense pressure in the pension systems,
- b) The competitiveness shortage compared with other economies. Although the majority of R&D continues in the western economies the overall competitiveness shifts constantly from the Western to Asian economies. This is associated with various factors (low wages in Asia, prolonged working hours, etc.)
- c) The gradual industrial decline of these regions viz. a viz. other players in the international economy. The secondary sector has a higher added value compared let us say with services or with the primary sector. Many industrial products are dual commodities and many industrial by-products can be used across different industries. This is certainly not the case with other economic activities like tourism, trade, shipping etc. The epicentre of industrial production is Asia.
- d) The fragile banking institutions. Both retail and investment banking institutions across the western world have made irrational decisions and as already pointed out had absorbed huge amounts of funds in order to remain operational. Obviously if these institutions were economically healthy these funds could have been used in a different way.

However it is not only the economic fundamentals which are problematic. New economic and political powers emerge. Some of these new powers are promising emerging economies (the BRICs are the best example). These countries can play a positive role in the international political and economic system under certain conditions.

However other emerging regional powers (North Korea, Iran etc) may have a destabilising role in international affairs. In addition to this, the anti-western attitude of various Islamic Fundamentalist movements will continue and the internal social dichotomy in various western economies will also continue.

### **5. Concluding remarks**

The research related to the causes as well as the outcomes of the current global economic crisis is already immense. The intellectual aspiration of the current paper was to use different theoretical paths from the economics science as well as from political science and demonstrate that the current crisis has many interrelated aspects and broader ramifications. One of the most essential contributions to the literature is the work of Reinhart & Rogoff (2009).<sup>78</sup> The authors point out that the current financial crisis is different from those of the past. The contribution is excellent; however the aim of this paper was to point out that any crisis emerges after a long period of incubation and although it may be triggered by one specific event (in this case the house crisis in the US) every crisis has too many problematic elements (political, social and economic), which have to be addressed simultaneously, if our aim is to overcome the crisis.

In the current case we have demonstrated that the current crisis is associated with absence of ethical and responsible conduct by individual business entrepreneurs as well as states, prolonged and costly military conflicts, emergence of new economic powers, social changes in the developed world etc.

The answer to the current economic challenges may exist in the writings of two ancient philosophers. According to Plato: "Only if philosophers become kings or the kings become philosophers progress and development can occur in human societies". Furthermore the Greek philosopher Aristotele points out: "The gravest injustices are never done by those in distress, but by those who go to extremes".

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<sup>78</sup> See: C. M. Reinhart & K. Rogoff: "This Time is Different", Princeton University Press, 2009.