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Euro Crash – How Asset Price Inflation Destroys the Wealth of Nations

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Brendan Brown:
Euro Crash – How Asset Price Inflation Destroys the Wealth of Nations
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The book discusses the financial crisis of 2007–2008 from the angle of asset price inflation, and shows that the monetary policy flaws of the Fed, the European Central Bank and even the central banks of emerging countries (especially China) contributed to the meltdown. Largely ignoring developments in the US economy, Brendan Brown's main focus is on the European economy, in particular, the series of policy mistakes by the European Central Bank (ECB). The author arrives at his conclusions drawing on his practical financial expertise and the monetary policy approach of the Austrian School of Economic Thought. He argues that the ECB made a series of blunders under the presidency of Jean-Claude Trichet, while his successor, Mario Draghi, played an important role in preventing the deepening of the sovereign euro area crisis with the political support of Angela Merkel. At the end of the book, Brown describes the functioning of a deeper monetary integration as a possible way to seize the opportunities presented by the crisis generated by the Federal Reserve (the bursting of the asset price bubble).

The book begins with a basic question: Why did the European Monetary Union suffer an existential crisis soon after its creation? According to the German view, everything would have been fine if it had not been for certain Member States contriving to circumvent the strict fiscal rules stipulated in the Stability and Growth Pact. By contrast, the Paris and Brussels view attributes the crisis to a failure of the EU Treaty to provide for a framework of fiscal, debt and banking union. In Brown's opinion, it is mainly the flawed structure of the EMU that should be held responsible for the crisis and the near break-up of the euro area that followed; the architects of the EMU failed to build a structure that would withstand the external or internal forces driving monetary instability.

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The Economic and Monetary Union suffered a virus attack of asset price inflation. Although the virus can be traced back to its original source, the Federal Reserve System of the USA (Fed), the European Central Bank's (ECB) monetary policy (or rather, deficiencies thereof) exacerbated the effects of the attack. When asset price inflation progressed into deflation, the European political elite could no longer deny the damages sustained by the European Union. They refused to accept monetary explanations even amid the new wave of asset price inflation set in motion by Fed chairman Ben Bernanke. The extended period of quantitative easing launched by the Fed, as well as the Fed's long-term interest rate manipulations (2011–2012) gave rise to such a speculative fever that culminated in the purchases of European sovereign and bank debt. The growing interest in sovereign and bank securities bought some time for the euro area in its existential crisis. According to the author, Germany's agreement to the bailout of weak euro area Member States reflected the fact that the German export machine was successful in selling its products to emerging economies that temporarily benefited from the speculative fever originating in the Fed's series of quantitative easing measures. The tolerance of German taxpayers for sovereign bailout programmes (and Angela Merkel) will only last until the asset price deflation morphs into inflation once again.

In the first chapter of the book, Brown describes an intriguing phenomenon related to the asset price inflation: the complete denial of early leading monetarist economists about its existence. Neither Friedman and Schwartz, nor Meltzer mentions the phenomenon in their famous studies. It is particularly interesting in Friedman's case, as he taught and conducted research on the same campus as Hayek who, as early as the 1920s, set out to examine which monetary policy steps of the Federal Reserve Bank of New York had led to asset price inflation. One explanation may be the fact that, on the one hand, it is difficult to fit asset price inflation into the approach of positive economics represented by Friedman. On the other hand, the measurement and empirical testing of speculative fever are also challenging tasks. It is a basic hypothesis of the Austrian School of Economic Thought that monetary disequilibrium causes asset markets to display excessively high relative prices, the repercussions of which include mal-investment and a long-term erosion of the risk appetite essential to the functioning of capitalist market economies.[1] The writers of the Maastricht Treaty were not aware of the phenomenon of asset price inflation, and the central bankers devising the uniform monetary policy merely considered the price of goods and services as a measure of inflation.

When asset price inflation attacks the economic system, various forms of irrational exuberance emerge. Irrational exuberance is a state where investors tend to assign

[1] According to Brown, "mal-investment means capital spending that would not have occurred if price-signalling had been undistorted". And the distortion is caused by the speculative fever itself.

a lower probability to negative outcomes, and an excessively high probability to positive future scenarios. The question is how this process is facilitated by monetary disequilibrium. The author offers three possible answers to this question:

i. Under monetary disequilibrium, the manipulation of medium and long-term interest rates far below the neutral level generates excessive capital market demand;

ii. A long period of low interest rates – even if in line with neutral – may trigger "yield desperation" fuelled by investors' search for higher-yield investment instruments;

iii. Fear of high future inflation may stimulate excessive investment in certain assets in the present, and this process may eventually become irrational.

Both types of inflation (asset price inflation and goods inflation) are hard to recognise at an early stage; indeed, reliable statistical approaches do not even help. Brown stresses that major central banks and the central banks of currency areas have a key role (asymmetric power) in the generation of asset price inflation. He brings up the Fed's role as an example: if the Fed manipulates long-term interest rates downward, it will stimulate investors to assume a degree of irrationality across the entire US dollar zone in their search for higher yields. After the emergence of asset price inflation only one question remains: how will the asset price bubble burst? The end of asset price inflation generally signals economic dislocation for a certain period of time. Due to its unpredictability, the virus usually runs its course without monetary policy intervention; monetary policy intervention only takes place at a time when the asset price deflation is already unavoidable.

The second part of the book is dedicated to the current problems faced by the euro area, drawing on the conclusions of the aborted attempt at a Franco-German dollar union. De Gaulle and Adenauer could have agreed on a monetary union between France and Germany, with both countries participating in the dollar standard within the framework of the Bretton Woods monetary system at the time. The Deutsch mark and the French franc would have become fully convertible to each other, and any fluctuations against the US dollar could have been managed (in order to keep the currency within the permitted fluctuation band) through adjustments to the monetary base. Instead, a generation of French politicians invested an enormous amount of effort to end the monetary hegemony of Germany until they eventually established the Economic and Monetary Union with the European Central Bank. The ECB can only function within the framework of certain rules; however, the single monetary policy cannot resolve the economic problems of each individual Member State, especially in periphery countries. Instead of a single monetary

policy and the reform of the ECB, in line with German expectations, they confined sovereigns within counterproductive, long-term, strict fiscal rules.[2]

The next question Brendan Brown poses in his book is how the virus of asset price inflation infected the euro area. Numerous experts, politicians and journalists strived to identify the reason behind the deepening of the euro area crisis, generally exploring the following topics: global lending bubble in the mid-2000s and its burst, the flaws of monetary policy doctrines, regulatory regimes, the system of financial intermediation which systemically underestimated risks and maintained questionable remuneration standards, and the pricing deficiencies of capital markets. The culprits included prominent central bank actors (Alan Greenspan and Ben Bernanke) and collective entities, such as China (due to its exchange rate policy), the excessive savings rates of Eastern Asian households and corporations, regulators, such as the US Securities and Exchange Commission or the Bank for International Settlements, as well as European central banks or quite simply, the United States.

The central bank of the euro area had a faulty monetary framework and a deficient mandate from the start. Brown cites the monetary policy objectives enshrined in Article 105 of the Maastricht Treaty, pursuant to which the primary objective of the European System of Central Banks is to maintain price stability. Over the long run, price stability and monetary stability are partially overlapping concepts, but the goal of monetary stability should nevertheless have been included in the Treaty.[3] In developing the monetary policy of the ECB, the Issing Committee could have chosen from numerous alternatives, including Anglo-Saxon monetarist traditions of even the Austrian School of Economic Thought. The monetary targeting of the ECB – i.e. in the medium term the average value of the harmonised consumer price index may not exceed 2 percent – jeopardised the monetary union three times in its first decade, generating severe imbalances in all three cases.[4] In this chapter the author explores additional problems as well: first and foremost, the ECB had no scenario for emergencies; in other words, it did not have any contingency plans for a deep economic recession or a financial panic. Secondly, the ECB has been widely criticised for the excessive role of German-oriented aspects in the conduct of monetary policy exceeding the economic weight of Germany. Thirdly, the ECB failed to detect the spread of the monetary disequilibrium generated by the launch of the euro, despite the increasingly overheated financial markets. And

[2] It should be added that, following the Fed's example, the ECB took numerous unconventional, albeit belated, monetary policy steps, some of which are not covered by the ECB's mandate.

[3] Monetary stability is a state when money does not become the source of severe disequilibrium in the economy.

[4] First occasion: between 1994 Q4 and 1999; second occasion: between 2003 and 2005/2006; third occasion: between 2007 H2 and 2008 Q3.

finally, again and again, the ECB underestimated the effects of the US economy on Europe, especially at the time of the recession in the United States.

Similar processes – monetary policy steps – led to the bursting of the European asset price bubble as to the Great Depression of 1929. Brown puts the blame on US and European policymakers and on emerging markets – especially China – for failing to do everything in their power to ensure the convertibility of the yuan. The measures of the ECB could not be effective as they did not recognise the true nature of the crisis; instead, the events were misdiagnosed as a liquidity crisis. Had it been a liquidity crisis, the liquidity injected by the ECB would have restored the imbalances on interbank markets within a matter of days, and the ECB could have withdrawn its support. In several cases, the central bank of the euro area provided far more liquidity than needed, thereby creating a transfer union. As to why this had happened, the author offers several answers. First and foremost, policymakers should have reformed the monetary policy strategy of the ECB, setting a quantitative target for the monetary base; however, evidently, this is not possible in the midst of a crisis. Secondly, by reducing interbank interest rates to zero the ECB could have forced commercial banks to invest their funds in short-term government securities rather than keeping their reserves risk-free at the ECB. Thirdly, the ECB relied too heavily on its methodological (econometric) model at a time when it could not provide any insights with respect to monetary and financial developments. Finally, the ECB should have assumed the role of lender of last resort.

Moreover, the ECB overestimated the role of temporary and short-term effects in measuring and forecasting inflation, while it was not prepared for the phasing out of the unconventional monetary policy steps adopted during the crisis. The European insolvency crisis, in turn, deepened in 2008, which led to a situation where sovereigns were forced to bail out banks teetering on the edge of bankruptcy. This put sovereigns themselves into jeopardy far before Greece became the focus of attention. Analysing the speeches of ECB presidents, Brown concludes that none of them took responsibility for any mistakes in managing the crisis, even at a time when they failed to launch a quantitative easing programme in parallel with the rest of the central banks.

In the seventh chapter, the author points out that the sovereign crisis of the euro area unfolding in the midst of the asset price inflation engendered by the Fed has become, despite the flaws of the ECB's steps, a driver of integration, giving new momentum to Europe. Brown alludes to the Draghi–Merkel duo. In the autumn of 2011 Mario Draghi and Jean-Claude Trichet negotiated together with the Fed chief and the US Finance Minister about a substantial dollar swap facility, which enabled the ECB to launch two long-term refinancing operations (LTROs). In the author's opinion, from the side of politics, Angela Merkel supported Mario

Draghi's unconventional monetary policy steps with the implementation of outright monetary transactions (OMT) at the core. This meant that, under suitable conditions, the ECB was capable of providing completely efficient support to distressed euro area Member States.

In the final chapter of its book, instead of summing up his conclusions, Brendan Brown outlines his vision for the Economic and Monetary Union. He presents a new monetary union to be established by the Paris–Berlin axis. Although there has been some speculation about such a plan in the press, any specific intention (a finalised scenario) would give rise to grave problems: on the one hand, it would generate strong tensions among the central bank leaders and finance ministers of the euro area countries, and, on the other hand, it would trigger yet another wave of the speculative attacks from financial markets. Instead, a new monetary union could be established within the euro area which, drawing the lessons from the failures of the Maastricht-based monetary union, would have a far more stable architecture than the existing EMU.