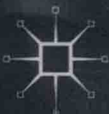
THIRD EDITION

EURO CRASH

How Asset Price Inflation Destroys the Wealth of Nations

BRENDAN BROWN

Foreword by Professor Joseph T. Salerno



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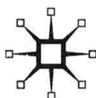

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'Fiat currency central banks claim to fight the inflation they cause, and likewise to offset the financial instability and systemic risk they create. The depreciation of the currencies they issue at will often cause falls in foreign exchange value, goods and services inflation, or asset price inflations. Of these, asset price inflations are the most insidious, for while they last they are highly popular, leading people to think they are growing rich and to run up their debt. When the asset inflations collapse, the central banks can come as the fire department to the fire they stoked. Nobody is better at diagnosing and dissecting these central bank games than Brendan Brown, whether it is the Federal Reserve (*The Global Curse of the Federal Reserve*) or the European Central Bank – this book, *Euro Crash*. It will give you a healthy boost in your scepticism about those who pretend to be the Platonic guardians of the financial system.'

—**Alex J. Pollock**, *Resident Fellow, American Enterprise Institute, Washington, DC; former president and chief executive officer, Federal Home Loan Bank of Chicago.*

Also by Brendan Brown

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To the memory of Irene Brown

Foreword

Brendan Brown is a *rara avis* – a practising financial economist and shrewd observer of financial markets, players, and policies, whose prolific writings are informed by profound theoretical insight. Dr Brown writes in plain English yet can also turn a phrase with the best. 'Monetary terror' vividly and succinctly characterizes the policy of the Fed and the ECB to deliberately create inflationary expectations in markets for goods and services as a cure for economic contraction; the 'virus attack' of asset price inflation well describes the unforeseeable suddenness, timing, and point of origin of asset price increases caused by central bank manipulation of long-term interest rates and the unpredictable and erratic path the inflation takes through the various asset markets both domestically and abroad.

Indeed Dr Brown's prose is reminiscent of some of the best writers in economics and economic journalism such as Lionel (Lord) Robbins and Henry Hazlitt. And like these eminent predecessors, Brown is generous to a fault in carefully evaluating the views of those he criticizes, while rigorously arguing his own position without waffling or compromise. Best of all, Brown is fearless in naming names and ascribing blame to those among the political elites and the upper echelons of financial policymakers whose decisions have been responsible for the chaotic state of the contemporary global monetary system.

In this book, Brown deploys his formidable expository skills to argue the thesis that the current crisis and the spectre of EMU collapse are attributable to profound flaws in the original monetary foundations of the euro. These flaws rendered the EMU particularly vulnerable to the asset price inflation virus which was originally unleashed on an unsuspecting world by the Federal Reserve shortly after the euro saw the light of day in 1999.

In the course of presenting his case, Brown courageously stakes out and defends several core theoretical positions that are in radical opposition to the prevailing orthodoxy. For example, Brown strongly dissents from the conventional view of what constitutes monetary equilibrium. He explicitly rejects the position associated with Milton Friedman and Anna Schwartz that is now deeply entrenched in mainstream macroeconomics and central bank policymaking. This superficial doctrine arbitrarily and narrowly construes monetary equilibrium as 'price stability'

in markets for consumer goods and services, while completely ignoring asset markets. In contrast, Brown formulates a much richer and more profound concept of monetary equilibrium that draws on the ideas of Austrian monetary and business cycle theorists, namely Ludwig von Mises, Friedrich Hayek, Lionel Robbins, and Murray Rothbard.

In Brown's view, a tendency toward monetary equilibrium obtains when monetary policy refrains from systematically driving market interest rates out of line with their corresponding 'natural' rates. Interest rates determined on unhampered financial markets are 'natural' in the sense that they bring about spontaneous coordination between voluntary household decisions about how much to save and what profile of risk to incur and business decisions about how much and in what projects to invest. Such coordination ensures accumulation of capital and increasing labour productivity and a sustainable growth process that maintains dynamic equilibrium across all goods and labour markets in the economy. The main thing that is required to maintain monetary equilibrium in this sense is strict control of the monetary base as was the case, for example, under the classical gold standard regime. In the context of existing institutions, which is Brown's focus, monetary equilibrium requires a rule strictly mandating the Fed to completely abstain from manipulating market interest rates and, instead, to exercise tight control over growth in the monetary base.

Brown's concept of monetary equilibrium therefore countenances – indeed, requires – price deflation over the medium run in response to natural growth in the supplies of goods and services. This was the experience during the heyday of the classical gold standard in the latter part of the nineteenth century when declining prices went hand-in-hand with rapid industrialization and unprecedented increases in living standards. For Brown, it is precisely the attempt to stifle this benign and necessary price trend by a policy of inflation targeting on the part of 'deflation phobic' central banks that inevitably distorts market interest rates and creates monetary disequilibrium.

Brown explains that such monetary disequilibrium is not necessarily manifested in consumer price inflation in the short run. In fact, it is generally the case that the symptoms first appear as rising temperatures on assets markets. Indeed some episodes of severe monetary disequilibrium, such as those that occurred in the U.S. during the 1920s, the 1990s, and the years leading up to the financial crisis of 2007–8, may well transpire without any discernible perturbations in goods and services markets. Yet overheated asset markets are completely ignored in the Friedmanite view of monetary equilibrium that underlies the Bernanke–Draghi

policy of inflation targeting. Brown perceptively argues that one reason for the wholesale neglect of asset price inflation is the positivist approach that is still dominant in academic economics. Speculative fever in asset markets is nearly impossible to quantify or measure and thus does not fit neatly into the kinds of hypotheses that are required for empirical testing.

Having laid out his theoretical approach, Brown uses it as a foundation to construct a compelling interpretive narrative dealing with the origins, development, and dire prospects for the euro. In the process, he pinpoints and details the flawed decisions and policies of the ECB and the Federal Reserve that account for the current condition of the euro. But *Euro Crash* tells more than the story of the currency of its title; it unravels and makes sense of the complex tangle of events and policies that have marked the parlous evolution of the global monetary system since the 1990s.

This book is a radical challenge to the prevalent, but deeply flawed, doctrines that have defined monetary policy since the 1980s. Be forewarned: reading it is a bracing intellectual experience. Like a headlong dive into a cold pool, it will refresh your mind and awaken it to a wealth of new ideas.

Joseph T. Salerno
Academic Director, von Mises Institute

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Elizabeth V. Smith, who recently obtained a Master's in Economics from University College London, provided invaluable help in research, and in toiling through the manuscript at its various stages of preparation.

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In developing my ideas about asset price inflation I have benefited immensely from my discussions with Alex J. Pollock, Scholar at the American Enterprise Institute, and he has given me the great opportunity to present my views to meetings there.

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1
Asset Price Inflation: What Do We Know about this Virus?

Why did European Monetary Union (EMU) enter existential crisis so soon after its creation? According to the 'Berlin view' everything would have been fine if it had not been for a number of governments contriving to circumvent the strict fiscal discipline stipulated in the budget stability pact that accompanied the launch of the euro. The 'Paris and Brussels' view by contrast traces the crisis to a failure of the founding Treaty to provide for a fiscal, debt and banking union.

The leading hypothesis in this book puts the blame for the crisis and for the highly probable eventual break-up of EMU on the failure of its architects to build a structure which would withstand strong forces driving monetary instability whether from inside or outside. These flaws could have gone undetected for a long time. In practice though, very early in the life of the new union, the structure was so badly shaken as to leave EMU in a deeply ailing condition.

A severe economic disease, called 'the asset price inflation virus', attacked EMU. The original source of the virus can be traced to the Federal Reserve, but the policies of the European Central Bank (ECB) added hugely to the danger of the attack. Serious inadequacies in Europe's new monetary framework meant that EMU had no immunity.

When the disease of asset price inflation 'progressed' into the phase of asset price deflation, the political elites in Brussels, Paris, Berlin, Frankfurt and Rome could not deny (though they could struggle to downplay the extent of) the damage to their union. Yet they remained united in their refusal to hear monetary explanations of the catastrophe. This unwillingness to listen continued amid the new wave of asset price inflation fever that started to spread around the global economy from 2010 onwards as the Federal Reserve chief, Professor Bernanke, pursued his Grand Experiment. (The hypothesis tested: 'well-designed'

non-conventional monetary tools 'applied skilfully' can accelerate the pace of economic expansion in the 'difficult aftermath' of financial panic and great recession when the self-recovery forces of the capitalist economy 'are feeble'.)

At first this new strain of disease largely passed EMU by but not altogether. As the US monetary experimentation intensified, however, with the launching of 'QE infinity' (summer 2012) and a new version of the Fed's 'long-term interest rate manipulator' (2011–12), symptoms of speculative fever became apparent in the form of yield-hungry global investors buying recently distressed European sovereign and bank debt.

The speculative fever helped bring some transitory respite for EMU from its existential crisis. The eventual agreement of Berlin to a series of bail-out programmes for weak sovereigns in Europe reflected the contemporary German export machine's particular success in selling to those countries around the globe (China, Brazil, Russia, Turkey, Middle East oil exporters) whose economies were 'enjoying' (during 2010–11/12) the temporary stimulus of speculative fever originating in the Bernanke Fed's new asset price inflation virus. The tolerance of German taxpayers for such bail-outs – essential to Chancellor Merkel's political calculation – could break if and when asset price deflation follows asset price inflation.

Disease denial and then acceptance

Asset price inflation is a disease about which still much is unknown. Indeed early leading monetarist economists were in a state of denial about the phenomenon. A reader of *A Monetary History of the US* by Milton Friedman and Anna Schwartz (1963) does not find one mention of this virus (asset price inflation) and the same is true for Allan Meltzer's epic *A History of the Federal Reserve* (2004). Why were those economists so determined not to even entertain the idea that monetary disequilibrium could be the source of a virus which would cause speculative fever to build and spread in the asset markets, choosing instead to focus entirely on the potential consequences of goods and services inflation? The question is particularly pertinent to Milton Friedman, given that for many years he walked the paths of the same campus at the University of Chicago as Friedrich von Hayek who, in the 1920s, had written about the creation of asset price inflation by the Federal Reserve Bank of New York (then the centre of power within the Federal Reserve) under Benjamin Strong and who had warned about the likely denouement of bust and depression (see Hayek, 2008).

One answer lies in Milton Friedman's emphasis on positive economics. Almost by definition the concept of asset price inflation is difficult to fit into positive economics. Measurement of speculative fever is notoriously challenging – so how can the positive economist design neat empirical tests of various theoretical hypotheses concerning the disease? Moreover, for Milton Friedman 'asset price inflation' would have meant the original Austrian concept built around distortions in the relative price of capital and consumer goods. The 'Austrian' hypothesis was that that monetary disequilibrium (with interest rates manipulated say, far below their 'natural' level) would cause the relative price of capital goods (in terms of consumer goods) to be artificially high. The result would be over-production of capital relative to consumer goods. That is a distinct and less widely appealing concept than asset price inflation as now widely understood albeit that the two ideas overlap.

According to this popular modern definition, monetary disequilibrium causes a wide range of asset markets to display (not all simultaneously but rather in a process of rotation – see below) excessively high prices (relative to fundamentals) due to a build-up of speculative fever (sometimes described as 'irrational exuberance'). The ill-results include mal-investment and a long-run erosion of the risk-appetite essential to the free market capitalist economy delivering prosperity. Mal-investment means capital spending that would not have occurred if price-signalling had been undistorted by the monetary virus and which eventually proves to be economically obsolescent.

The writers of the Maastricht Treaty had no knowledge about the disease of asset price inflation let alone any prophetic vision of its potential threat to the survival of their cherished monetary union. The monetary constitution in the Treaty was put together by a committee of central bankers who made low inflation (euphemistically described as 'price stability'), as measured exclusively in the goods and services markets, the key objective. The famed monetarist Bundesbankers of the 1970s (subsequently described in this volume as 'the Old Bundesbankers') had departed the scene to be replaced by politicos and econometricians.

The Old Bundesbankers, in fairness to their successors, also had no clear understanding of asset price inflation. But they did instinctively realize that strict monetary base control (MBC) in which interest rates were free of manipulation was essential to overall monetary stability in a wide sense (which transcended the near-term path of goods and services prices). Instinctively they applied a doctrine of pre-emption.

According to this the pursuance of strict monetary control would mean less danger of various forms of hard-to-diagnose economic disease (possibly as yet unclassified), including those characterized by excessive financial speculation, with their origin in monetary disequilibrium.

The intuition of the monetarist Bundesbankers took them one stage further than Milton Friedman's famous pronouncement that 'inflation [goods and services] is always and everywhere a monetary phenomenon'. Indeed, we should say the same about asset price inflation. Goods (and services) price inflation and asset price inflation are the two forms of monetary disease that plague the modern economy. They have their joint source in money 'getting out of control'.

J.S. Mill famously wrote (see Friedman, 2006) that: '*Most of the time the machinery of money is unimportant. But when it gets out of control it becomes the monkey wrench in all the other machinery in the economy*'. In modern idiom we would say that 'most of the time the software of money does not matter but when it mutates it spreads a virus which attacks all the other software behind price signals (in both the goods and capital markets) that guide the invisible hands of the capitalist economy'. An economy afflicted by monetary disequilibrium will eventually display symptoms of one or both types of virus attack – goods and services inflation and asset price inflation.

These two forms of economic disease of common origin (monetary disorder) have many similarities and also some dissimilarity. Moreover, if the virus of goods and services inflation is rigorously specified in monetary rather than crude statistical terms, then it would be rare not to find this present albeit in a weak form alongside the virus of asset price inflation (see next section, p. 7).

The exact path and strength of each monetary virus (asset price inflation, goods inflation) varies considerably between different business cycles. Just as Balzac wrote that the author's skill is to typify individuals and to individualize types so it is with business cycle analysis. The analyst realizes that the key dynamic in each and every business cycle is the path taken by the two monetary viruses and how these paths interact. Yet each cycle is unique in that the paths are never identical.

Sometimes the cycle is dominated by the virus of asset price inflation without clear symptoms of the goods inflation virus ever emerging. Sometimes the virus of goods and services inflation plays a disproportionately large role. Sometimes this large role is anticipatory – long-term interest rates spike due to fears of building goods inflation; this spike in turn causes asset price inflation to turn to asset price deflation.

Similarities and dissimilarities between the spread of asset and goods inflation

How the disease forms and spreads is somewhat different in the case of asset price inflation from that of goods and services inflation. In the spread of the latter disease (goods and services inflation) key catalysts can be the exchange rate (which often plunges at an early stage), inflamed expectations regarding future prices, and strong demand in several important commodity, product, service, rental, or labour markets (there are many markets for highly differentiated types of labour). In the spread of the former disease (asset price inflation), catalysts include positive feedback loops (price gains apparently justifying a tentative speculative hypothesis), the emergence of popular new stories (for example technological innovations), and central banks of countries subject to hot money inflows (many of these economies are regarded widely as dynamic and so provide fertile ground for exciting speculative stories) deciding to inflate rather than allow their currencies to appreciate sharply (see below).

As the disease of asset price inflation attacks the economic system, various forms of irrational exuberance emerge (see Shiller, 2005 and Brown, 2013). We can think of irrational exuberance as a state where many investors are wearing rose-coloured spectacles that exaggerate the size of expected returns and filter out the risks (the dangerous possible future scenarios). More technically, it is a state where investors tend to put too low a probability (relative to actual level) on bad possible future scenarios and too high a probability on one or more good possible future scenarios. How does monetary disequilibrium encourage them to do this? There are three possible connections (see Brown, 2013).

First, monetary disequilibrium characterized by medium-term and long-term interest rates manipulated far below neutral level creates some froth in capital markets. In those asset classes where there is an appealing speculative hypothesis (illustrations include Spain as the Florida of Germany; EMU financial integration causing yields in the various government bond markets – Greece, Portugal, Germany, etc – to converge and providing European banks with great new opportunities to expand; the Draghi–Merkel coup against the Maastricht Treaty ending the crisis of EMU; Abe economics bringing long-run prosperity to Japan), asset market froth is seen as evidence by investors that the hypothesis is true (positive feed-back loops as described by Robert Shiller).

Second, a long period of low interest rates, even if in line with neutral, may stimulate 'yield desperation' by investors if there are no

periods during which monetary assets deliver a real bonus (as would occur under a regime of monetary stability where the prices of goods and services would sometimes fall and sometimes rise – consistent with stable prices in the long run – and where market interest rates fluctuate freely).

Third, monetary disequilibrium and distortion, by generating terror about an outbreak of high inflation at some distant point in the future, can stimulate a scramble into real assets in the present, where this scramble is characterized by some degree of irrationality.

Both viruses – asset price inflation and goods inflation – are hard to detect at an early stage. This difficulty is particularly great with respect to asset price inflation as there are no statistical yardsticks which could even half-reliably suggest the presence or severity of the suspected virus infection.

A senior Federal Reserve official, Professor Janet Yellen, once remarked that if price-earnings (P/E) ratios in the US equity market are below 15 and rental yields on housing above 4% there can be no irrational exuberance, but this totally misses the point that sometimes there are one or more potential future states of the world of significant probability of becoming reality which are highly menacing. At such times a failure of the earnings yield (inverse of P/E ratio) or rental yield to rise well above normal level could be evidence of irrational exuberance. Famously, in early summer 1937, on the eve of one of the greatest stock market crashes in US history, a sober-rational P/E ratio taking account of then huge political, geo-political and monetary uncertainty, might have been nearer 10 than the actual 15.

By contrast, for goods and services inflation, a diagnosis *sometimes* can be made with the help of direct statistical evidence. Even this is easier said than done! The confirmation of a rising trend in goods and services prices can take considerable time given the extent of white noise in the data. And even once reasonably sure of the trend, the analyst should then consider whether the rising trend is monetary in origin.

Moreover, there are occasions when monetary goods and services inflation is present even without any statistical finding of general price level rise being possible. This would be the case where equilibrium prices in some key labour and commodity markets have fallen. A driving force behind the fall could be strong productivity gain or severely increased competition from abroad.

As illustration, computerization and digitalization plausibly led to the substitution of capital or cheap foreign labour for domestic US labour in many routine 'white collar' jobs during recent years, with

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