

## BOOK REVIEW

### *EURO CRASH: HOW ASSET PRICE INFLATION DESTROYS THE WEALTH OF NATIONS*

BRENDAN BROWN

BASINGSTOKE, ENGLAND: PALGRAVE MACMILLAN, 2014, 262 PP.

WILLIAM N. BUTOS

It's hard to walk away from Brendan Brown's most recent book without a feeling of deep disappointment in modern day central banks. The 3<sup>rd</sup> edition of *Euro Crash* brings up to date the policies of the European Central Bank (ECB) and European Monetary Union (EMU) and further corroborates and extends the many insights and good sense Dr. Brown offered in previous editions. With a clear theoretical framework in hand, the book provides a detailed, sustained and engaging narrative of the consequences of central banking without sound monetary principles. This was compounded by policy mistakes of the ECB, liabilities that made them vulnerable and ultimately incapable of countering or

---

William Butos (William.butos@trincoll.edu) is the Ferris Professor of Corporation Finance and Investments, Department of Economics at Trinity College, Hartford, Conn. and Associated Scholar at the Ludwig von Mises Institute.

escaping from the “US monetary chaos” (p. 210) created under Greenspan, Bernanke, and now Yellen.

Brown’s message in *Euro Crash* is that the U.S. and EMU failed to provide “monetary stability” and that absent a monetary constitution, unconstrained central banks will continue to produce financial and economic upheaval. His narrative, woven through eight tightly argued chapters, contains an articulated theoretical framework informed by a deep and extensive command of the relevant history of the ECB (and the Fed, as well) and of financial economics. This is a powerful and indispensable combination for successfully dealing with the subject matter. While the narrative requires the full attention of the reader, the effort is entirely satisfying. This is a book that should not be missed by anyone interested in the role of recent central banking policy in the global financial crisis, the subsequent recession, and prospects for the future.

Asset price inflation (API), its causes, propagation, and effects, is the principal phenomenon *Euro Crash* analyzes. In the first three chapters Brown focuses on the effects and policy responses in Europe of a global virulent API during 2003–2007 that “attacked markets in real estate, sovereign debt, financial equities and credit generally” and which emerged in stages well into 2010, 2011 and 2012 as the sovereign debt crises erupted...” (p. 37). These are consequences of monetary disequilibrium, by which Brown means that central banks have manipulated yields away from their natural (or “neutral”) rates, especially for medium to long term assets. The road to asset price inflation (API) is paved and sustained with cheap credit and the expectation that these conditions will continue. But unlike a generalized credit expansion, which affects prices and activities in all markets to varying degrees, API tends to be “rotational” in that it can move around quicksilver-like from one market to another market and is especially vulnerable to speculative frenzy induced by so-called “irrational exuberance.”

Brown forcefully maintains that asset price inflations share commonalities with the Austrian theory of business cycles with interest rates maintained by the central bank below their natural values, price and allocation distortions in markets, and the necessity of market correction. “Monetary disorder” and the resulting monetary disequilibrium, Brown argues, becomes J.S. Mill’s famed “monkey wrench” that disables “all the other

machinery in the economy” and manifests itself (1) as asset price inflation across a wide range of financial markets rotationally and (2) as an inflation in the prices of goods and services characterized by an unsustainable boom and distortions (malinvestments) in the capital structure. Although it’s difficult not to see (1) and (2) processes ordinarily appearing jointly, especially with modern day central banks, Brown claims that API is a distinct species of the monetary chaos genus. According to Brown, the propagation mechanisms and empirical characteristics of API differ from an Austrian unsustainable boom-bust episode and that an API may appear absent a corresponding Austrian cycle. Such differences highlight the importance of the finance side of monetary disorder, a subject area certainly compatible and relevant to Austrian money-macroeconomics, a point understood by many on Wall Street.

In chapters 4–6 Brown provides a detailed analysis and blow-by-blow account that exposes the “how and why” of policy making by the ECB since 1998. In “How the Bundesbank Failed Europe and Germany,” “The Bursting of Europe’s Bubble,” and “Guilty Verdict on the European Central Bank,” Brown unpacks the context and significance of policy decisions and the reasons why most were either ineffective or exacerbated the problems at hand. His analysis and insights of the ECB’s decisions is nuanced, analytically tenacious, and grounded in the real world. From the beginning the ECB was given a flawed monetary framework and together with the policies of Trichet (2003–2011) and Draghi (2011–) and also Issing (Executive Board Member and Chief Economist of the ECB, 1998–2006), this confluence produced an asset price inflation and ensuing asset price deflation. Remediation requires, according to Brown, a fundamental restructuring of the EMU based on a sound monetary constitution.

The unfolding of events beginning in 1998 and the ECB’s series of blunders (missteps, misreadings of data, wrong analytics, and excessive reliance on econometric forecasting models) at virtually every turn created and sustained the “virus” of monetary disequilibrium and financial chaos in Euroland. The initial absence of a monetary constitution (or set of monetary principles) to ensure monetary stability left the ECB rudderless. As Brown notes, Article 105 of the Maastricht Treaty charged the ECB with the objective of simply maintaining price stability without specifying what that meant or how to achieve it. The ECB exercised its discretion to

set as its monetary goal a target of 2 percent inflation rate over a two-year desired path for consumer prices (measured by a “harmonized index of consumer prices”). In the aftermath of the financial crisis, the ECB also settled on what Brown describes as a bogus “separation principle,” which stipulated that the ECB ensure a single overnight rate pegged to the ECB’s official repo rate. The separation principle was also applied during the ECB’s operations of sterilized lending to banks to—justified to maintain “liquidity”—that required the rates to borrowers be the same and pegged to the announced repo rate.

The ECB’s commitment to its inflation target generally dominated policy even in circumstances, Brown argues, where this prevented appropriate markets adjustments. The question here is whether the value of money should be allowed to rise or fall in response to increased output and exogenous supply-side shocks. For the ECB (and the Fed, too) deflation phobia requires that the targeted inflation rate must be maintained even if prices are being pressured downward from increased output. This view requires credit expansion to breathe more inflation into the system. Instead of letting prices fall (or rise due to some supply-side catastrophe), a price level stabilization rule will create monetary disequilibrium and generate unsustainable side effects throughout the system. This story is well-known by Austrians, and Brown makes good use of it in identifying and understanding the causes and character of API.

Meanwhile, the aforementioned ECB “separation principle” prevented markets from establishing true market prices for assets having different risks. Brown emphasizes this became especially important for discriminating among assets in the midst of the financial crisis when money markets threatened to seize up. Since the spreads between assets are not allowed to price risk differences, banks and investors have an incentive to sit on cash (or hold it as reserves). In the case of Europe, ECB reverse-sterilized these reserves (without expanding its balance sheet) by extending subsidized loans to the weakest banks. The ECB’s implementation of the “separation principle” had three principal and significant effects:

- (1) Interest rates become a “house of mirrors” with little connection to one another or grounding in reality, in much the same sense that yields in the U.S. have been manipulated across the term structure via Fed “credit

easing” and “operation twist.” In such circumstances, valuable market information is suppressed, leading to real sector distortions and, of special interest to Brown, to unsustainable asset market inflation.

- (2) The ECB (like the Bernanke Fed) thought the financial crisis in the U.S. and Europe was fundamentally a liquidity problem. Brown will have none of that and, like many others, argues it was a solvency problem that called for the ECB to allow the market to price loans to reflect differences in risk; the “separation principle” trumped such adjustments. This prolonged and intensified the crisis because the recapitalization of insolvent banks and other financial intermediaries could not proceed effectively in the absence of yield gradations across assets.
- (3) Without the ability to price assets efficiently, loans remain unwritten and cash tends to flow into reserve balances given the low interest rates. At the time, the ECB had no authority to expand its balance sheet as a means to provide loans to banks. But the banks’ deposits held by the ECB allowed it to lend them at risk-subsidized rates to weak banks, as noted above. The added significance of these “Long-Term Refinancing Operations” also rendered the ECB a “transfer union” and brought it ever so much closer to the role of a fiscal agent (like the Fed). It was not long before Draghi in the fall of 2011 persuaded Merkel to “reinterpret” the Maastricht Treaty to allow the ECB to directly lend to sovereigns, thereby externalizing the ECB risks to German taxpayers. Brown’s account of this in chapter 7 (“From Fed Curse to Merkel-Draghi Coup”) is riveting and illuminating.

At root Brown argues that API and the costs of the ensuing asset price deflation are a direct consequence of the failure to both implement a monetary constitution and to constrain central banks with monetary rules. So, what suggestions for resolving and preventing such episodes does Brown offer? He proposes a principle of “monetary stability,” by which he means “price stability over the very long run.” According to Brown, the central bank would be able to achieve this goal by adjusting the monetary base. However, Brown insists that general movements of prices up and

down should not trigger monetary interventions; such changes in the value of money, especially when caused by real sector events, are perfectly normal and benign.

Brown holds that central bank policies consistent with these provisions will not prevent cyclical fluctuations, but they will allow the system to avoid serious instabilities, similar to Leijonhufvud's (bounded) "corridors of activity." Operationally, for Brown, the key to preventing API is to ensure that interest rates are at their "neutral" (or for Austrians, natural) level and under a monetary base rule (defined as cash and reserves that pay zero interest), "steering the monetary base along a steady low-growth path" would leave interest rates to be determined in the market while allowing the central bank to "efficiently aim for monetary stability." This is not *laissez-faire* banking, but it does provide a fairly straightforward framework arguably superior to the current rogue operations of the Fed and ECB. Even so, Brown provides several illustrations in his discussion of the ECB's response to the financial crisis and subsequent problems in which a fair amount of ECB tinkering should have been made via adjusting the monetary base and interest rates in order to avoid monetary disequilibrium, even if such adjustments required pushing rates away from their neutral values for a while. For example, an excess demand for money and the prospect of seriously falling prices may require the central bank to increase the base and reduce interest rates below their neutral levels, meaning in practice there may be tradeoffs in play between "monetary stability" and stable prices. But as a practical matter this kind of central bank counter-movement seems to strain the ability of policy makers (or anyone, for that matter) to actually know what the true neutral rate is, by how much market rates should be adjusted, and whether the excess demand for money (or decline in velocity) is simply transitory or something systematic and long term.

In promulgating API and the resulting asset price deflation, the ECB has created "a massive tax burden of bailing out insolvent sovereigns (and their banking systems) in EMU" that has sapped savings and wasted resources and generated low growth (p. 227-28). Brown sees little hope for the EMU because the monetary regime is profoundly and irremediably flawed. The solution, Brown argues, is to recast the EMU as a Paris-Berlin monetary union ("EMU-2")

and to open it up to members of the current EMU, although he acknowledges that the “weakest at the periphery” are not likely to make the grade. The key monetary framework of EMU-2 would be a “monetary authority separate from government” but “tightly subject to constitutional rules” that would “strictly limit the growth of high-powered money” to ensure “price level stability over the very long run” but with “considerable scope for price level fluctuations over the short and medium run” (p. 235). More specifically, Brown recommends a growth rate for the monetary base equal to the estimated long-run growth rate for the real demand of high-powered money. “Overruns or undershoots” of the targeted monetary base might be required to offset changes in the demand for high-powered money. Brown emphasizes these adjustments, however, “would be according to set principles which mimicked the gold standard system” (p. 235).

Brendan Brown brings his considerable insights from finance, monetary policy, economic history and theory to address some of the most important issues of our time, foremost of which is the absolute necessity for sound money. Brown explores this matter in the context of a system of central banking governed by strict monetary constitutions and for that world his solutions would surely be a major step up from the current fiat and non-constitutionally based regimes. *Euro Crash* is a provocative book and essential reading for specialists in monetary affairs, policymakers, and serious observers of financial markets. It is also, I might add, an excellent complement to Brown’s *The Global Curse of the Federal Reserve* (2011).