Brendan Brown – Tokyo Speech (March 15, 2012)

In Europe, what can we find good to say about the euro as it passes the 15th anniversary of its launch?

Well let me tell you, it depends on who you are and where you are!

ECB officials tell us that EMU has been fundamentally successful because inflation has averaged just 2% p.a., even slightly better than the 20-year record of the Old Bundesbank.

Some German politicians claim that the euro saved their country from a huge currency appreciation which would have happened if the DM were still in existence.

German exporters in the main agree with those German politicians.

The French policy elite celebrate in private the destruction of German monetary hegemony and the erosion of US hegemony which EMU has brought.

And at an individual level, there have been big and less big winners.

There are the investors and borrowers in Spain, Italy, Portugal and Greece, who have enjoyed having as their own money a world currency rather than as previously suffering the disadvantages of a second class local money

And we should not overlook the fact that many Spaniards, Italians, and Greeks, did very well financially during the bubble years and they have been able to since bail out at no loss due to the massive support from the ECB and the EU.

In Eastern Europe there have been many years of boom, albeit in some cases later turned to bust, that would not have occurred without EMU. Germany had to agree to EMU in exchange for France agreeing to the extension of the EU into Eastern Europe. And the first decade of EMU went along with a fantastic lending boom into what some observers describe as Europe's "Wild East".

In sum there have been many gainers. It is now becoming clear though that these gains came at considerable cost – albeit that the potential losers are different people in many cases from the gainers.

The costs and disappointments of monetary union in Europe are of such a dimension that I can only imagine a bright future for the euro if there is a radical reform of the whole project.

I am not pessimistic about the prospects for radical reform but these depend on political dynamics, most crucially in Germany, France and yes, the USA.

A key tension which could determine the future of the euro will be between Berlin and Frankfurt.. Germans are increasingly anxious about the huge dangers emanating from the ECB's massive lending operations. In particular there are the spectres of higher taxes and inflation.

Another key factor determining the euro's future will be the extent of US monetary instability.

If there had been US monetary stability through the last four decades, European monetary union would never had become a live issue.

In an imaginary world where the Federal Reserve had pursued a stable monetary path and Washington refrained from launching currency wars most of the world including the European countries would have loosely remained in a global dollar monetary system.

We all know the history of US monetary chaos which started to erupt in the early 1960s, including the launch of four currency wars of which the most recent has been dominated by the QE campaigns of the Bernanke Fed
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The first European response to US monetary chaos was disjointed. Each country went its own way. Germany found the best way. The old Bundesbank under Dr. Emminger launched a monetarist revolution and created the hard DM.

The success of the DM was such that many other European countries decided that their best course was to become satellites in the German monetary area.

Of course this was anathema to the French political elite who resent one fact more than US hegemony, and that is German monetary hegemony.

And so we had the long journey to European monetary union which had as its ultimate destination the transformation of the German monetary area with its array of satellites into a supranational currency zone under a European central bank.

This transformation, however, was deeply flawed, as is now growingly apparent.

Most of all the monetarist principles which had made the DM great were jettisoned.

In truth, these principles had been jettisoned already in the last decade of the DM, as the old Bundesbankers had left the field and been replaced by politicos. These more or less toed the line laid down by Chancellor Kohl first towards German political union and then towards EMU.

The ECB designed a monetary framework which in many respects was indistinguishable from that of the Greenspan/Bernanke Fed. There were the same key elements of inflation targeting, deflation phobia, manipulation of interest rate expectations so as to influence medium-term rates, removal of monetary base from the pivot of the monetary system and the ignoring of asset price inflation

And what was the result? Europe became immersed during the first decade of the 21st century in a credit bubble at least as great as that in the US. Of course the Greenspan/Bernanke credit bubble would have had an influence in Europe even if the old Bundesbank had still been pursuing monetarism. But the contagion would have had less devastating impact than what occurred.

In Europe the asset price inflation generated by monetary instability infected an array of markets. We could all agree on a list which includes weak European sovereign debt and Spanish real estate.

The speculative flow of capital into Europe's hot spots during the bubble years drove the price levels upwards in Spain, Italy, Portugal, Ireland and Greece, leaving their industries seriously uncompetitive when the bubble burst.

All of this is now history but it is not a history that has permeated into European political debate.

There is no Senator Bunning in the European Parliament shouting at M. Trichet or Sig. Draghi "you are the systemic risk". There is no broad political movement demanding reform of the central bank and monetary system such as we have within the US Republican Party.

Yet strangely I am optimistic about the euro project's future although some of you might be disturbed by the path I outline along the way to that hopeful destination!

First, I suggest that in the US there will be growing revulsion in coming years against the Bernanke Federal Reserve. Its deliberately created inflation, asset inflation, and interest rate suppression, will be the catalyst. Revulsion will show itself up in academic work and in the political arena. There will be (good) contagion from this revulsion into Europe

Second, there will be another huge wave of capital flight in Europe, which will bring a crisis in the relationship between Berlin and the Draghi ECB. Most likely that wave will emanate from Spain

Third, that huge wave will trigger showdown. Berlin will insist that the Draghi ECB stops expanding its Bad Bank. One, two, three or four countries will leave emu. There will be an agreement between Paris and Berlin on a new version of monetary union in which crucially an exit route would always be open an exit route for member countries who cannot sustain their membership without continuing bail-outs.

Fourth, the markets will play a key role in the reform process. In particular at some point German banks will start pulling their vast excess reserves away from the ECB, out of concern that these are not totally safe. Instead, they will plough these into domestic bonds at negative yields and start charging fees on deposits. German households and businesses will react by pulling funds from the banks and holding hoards of banknotes. Inflation and asset inflation risks will rise in Germany. This will power a tide of popular dissatisfaction which would ultimately bring monetary reform.

50 years ago Chancellor Adenauer and President de Gaulle signed the French-German friendship treaty. As a European I leave you with the hopeful scenario that the leaders of those two countries will sign a new monetary treaty within the next five years. And no, I do not mean by that the fiscal stability pact now absorbing so much of the euro-headlines.