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On the Abuse of Monetary Policy

Abstract: The euro has been a political project since its inception. That is why the independence of the European Central Bank was in danger from the very beginning. Ultimately, it was—and still is—about "Cambridge or Vienna," that is, "Keynes or Hayek," alternative. The decision to favor Keynes led to an economic policy dispute, poor macroeconomic developments as a result of the liquidity glut created to save the euro, and an increasing politicization of monetary policy in the European Monetary Union. This abuse of monetary policy calls for a return to the findings of the Austrian School of Economics. The solution is "Vienna instead of Cambridge": economic revival and real growth, not through short-term stimulation of the economy, but by allowing structural adjustment and "creative destruction."

I. Money Is Always Political, but Politicized Money Is Different

Central banks that adhere to their mandate to keep the value of money stable are often caught in the political crossfire if their attitude interferes with the economic policy circles of the respective governments. It is therefore important for them to have the backing of the respective population. In this respect, money is a political medium. Politicized money is the consequence of political actions which, by manipulating the money supply and interest rates, seek to achieve political objectives such as budget financing and increasing employment.

The attitude of governments and populations towards money is also largely dependent on specific experiences with deflation and inflation. Therefore, Joseph Schumpeter says: "Nothing says so clearly what a people is made of as what they do in monetary policy." France's attitude has been shaped by the devastating deflationary processes in the wake of the return to the gold standard of pre-war parity in the second half of the 1930's. The Franc was overvalued as a result. Instead of devaluing, politicians chose the path of restoring international competitiveness through wage cuts. This led to impoverishment in France and triggered considerable social unrest. Germany, on the other hand, had suffered from runaway inflation in 1923, which expropriated from the owners of monetary assets and almost destroyed the middle class. In 1948, currency reform ended the backlogged inflation with a rationing system and strict merchandise management. That is why French politicians say that money is too important to be entrusted to independent experts. In Germany, money is too important to be entrusted to politicians.

With the introduction of the euro, politicians acted as if all participating nations were cut from the same cloth. The political tug-of-war over the appointment of the ECB President in May of 1998 already showed that this was a fallacy. Most potential Member States had chosen the Dutch central bank president, Wim Duisenberg, because he stood for the continuation of the stability policy course of the Deutsche Bundesbank, while the French President, Jacques Chirac, wanted to nominate the French central bank president. A compromise was finally reached: Duisenberg agreed to resign after only half of his eight-year presidency. If all politicians had adopted the German culture of stability, Chirac could have waited for his favorite to take his turn. The fact that the filling of the presidency is a political matter has also been demonstrated by the election of Mario Draghi as President of the ECB.

The ECB's monetary policy practice has also shown that independence alone is no guarantee of a policy that complies with its statutory mandate. It has even been misused to pursue a policy contrary to the Treaty. Walter Eucken's far-sighted words in 1952 are so accurate in their application to the ECB's policy in the Eurozone that one could almost call them prophetic:

> "Experience shows that a monetary constitution which gives those in charge of monetary policy a free hand places greater confidence in them than it is advisable [or] possible to do. Ignorance, weakness with regard to interest groups and public opinion, incorrect theories, all these things influence those responsible for monetary policy, to the great detriment of the task they have been assigned" (Walter Eucken, *Grundsätze der Wirtschaftspolitik* [Tübingen: 1952], S. 257).

II. The Economic Policy Dispute (John R. Hicks)

In the debate about the right monetary policy, theoretical orientation also plays a decisive role. It is apparent, for example, that Anglo-Saxon economists are relatively unbiased in their approach to the zero-interest rate policy. Maurice Obstfeld says: "Don't clear the bowl yet," while German economists emphasize the long-term damage—including the formation of bubbles—and attack redistribution from the bottom up. The American position is the consequence of the Keynesian legacy: to fight any economic slowdown, without a more precise diagnosis, with cheap monetary policy and budget deficits. The publication of Keynes' *General Theory of Employment Interest and Money* (1936) was celebrated at the time as a message of salvation. It was believed that they finally knew what to do to permanently live in the best of economic worlds. Schumpeter's and Hayek's ideas on economic theory were so far removed from the economic mainstream that both Schumpeter and Hayek devoted themselves to socio-political topics: *Capitalism, Socialism and Democracy* (1946) and *The Road to Serfdom* (1944). They had given up trying to stem the Keynesian wave. One of the great economists, John R. Hicks, was one of the few who did not yet regard the economic policy drama between Keynes and Hayek as finally decided in favor of Keynes.

In general, a distinction is drawn between the business cycle theories of Schumpeter and Hayek. However, they are similar in essence: they are both based on the theory of roundabout or detoured production of Erich von Böhm-Bawerk. I must concentrate here on Hayek's theory of business cycles, and I can only summarize it. For Hayek, the starting point for a deviation of economic development from an equilibrium path is the perverse elasticity of credit supply: a greater demand for credit does not, in the initial stages, lead to an increase in interest rates, and thus does not segregate those production detours that are not profitable in the long run. The banks believe they have sufficient liquidity to meet the greater demand for credit at constant interest rates. The former German President, Horst Köhler, cited an "underpricing of risk" as the cause of the financial crisis he had just experienced. The wave of investment that was triggered in this way will eventually come to an abrupt end when interest rates rise—either due to market conditions or because of intervention by the central bank—and a number of production detours have to be discontinued. We can also say that too low interest rates have created bubbles that burst when interest rates are raised.

In the meantime, the perverse elasticity of the credit supply has been replaced by the central banks' low interest rate policy. We note that monetary policy has been used to increase employment, finance trade deficits or—as in the case of the European Monetary Union—to keep the Eurozone together. Monetary policy is being used for political objectives and is thus being abused.

III. Economic Mistakes in The Case of Liquidity Glut

How well the modified Hayekian theory explains "boom-bust developments" worldwide became clear to me during the Japanese asset price bubble (1989-90). In the mid-1980's, the U.S. government agreed with the Japanese government to use low interest rates to replace the Japanese yen under devaluation pressure, in order to spare the U.S. a higher interest rate to stabilize the dollar. The low interest rates triggered a real estate and stock market bubble in Japan, which mutually reinforced each other. Rising real estate prices were the collateral for massive loans, which boosted the stock market. The price rises here were the leverage for further property purchases. Thus, share price and real estate price increases drove each other up. When the Bank of Japan changed course and turned the interest rate dial back up, investors wanted to save their windfall profits and withdrew *en masse* from their commitments. As all investors liquidated their positions at once, both property values and share prices plummeted. As many investments were based on loans, and investors were forced to adjust their portfolios to the agreed ratios, there was no stopping them. In fact, Japan never really recovered from the shock of the bubble bursts. Companies and banks are still being dragged along as zombie companies and banks that should have gone bankrupt in the wake of the crash.

The Southeast Asian crisis in the mid- and late 1990's follows a similar pattern. Investment weaknesses in the Western and Japanese economies were combated with low interest rates; but they did not stimulate their own economies. Instead, the resulting liquidity glut spilled over into Southeast Asia, where higher yields were attracted. As the currencies of these countries were pegged to the dollar, investors believed they could neglect exchange rate risk, especially as the flow of capital increased the foreign exchange reserves there. As a result, interest rates fell, and a general investment boom set in. This went well until foreign investors wanted to put their money in a safe place because of the increasing risk of bankruptcy. The abrupt outflow of foreign exchange dried up the credit markets, interest rates shot up, and many of the production detours that had been started could not be brought to maturity—our well-known boom-bust phenomenon. In addition, speculative attacks finally forced the central banks there to abandon their dollar exchange rate peg. The resulting devaluations increased the debt burden for those national investors whose liabilities were denominated in dollars. But these—in some cases massive—devaluations strengthened the international competitiveness of these countries, which have now once again become respected players in the globalization arena.

The bursting of the real estate bubble in the U.S. and the resulting shockwaves around the globe warrant a whole separate lecture. Alan Greenspan's low-interest-rate policy and the internationally coordinated rescue of the LTCM Group initiated by him gave the international investment world the supposed certainty that, if worst came to worst, the U.S. Federal Reserve Bank would absorb economic downturns—the so-called Greenspan put. It lulled the commercial banks into such a sense of security that there were no limits to their willingness to grant loans. The liquidity flowed mainly into the real estate market. In addition, several factors triggered a general behavior of moral hazard: among borrowers, there was what is called the NINJA phenomenon, among loan brokers and banks that securitized mortgage loans through "special purpose entities" and had them rated by rating agencies. Dubious securities then entered the portfolios of globally operating banks via triple-A ratings. These ratings were intended to reduce risks in the credit sector. The liability ratio for triple-A securities was therefore halved. The risks in the banking sector thus seemed to be manageable. However, the opposite was true. These securities, purchased against the advice of some chief economists, have often put the banks in a precarious position. We again find striking confirmation that the perverse elasticity of the credit supply—made possible by the central banks' cheap interest rate policy—has created bubbles and that the central banks' interest rate hikes have forced investors to clarify their positions. Hence, the U.S. housing bubble burst. Real estate markets are an ideal terrain for our boom-bust phenomenon. Real estate prices are relatively inelastic: they rise sharply when demand rises because supply only reacts with a delay and, conversely, they fall rapidly because an increased supply pushes into the market when demand falls.

Monetary policy has both inflated bubbles and burst them through its restrictive reaction. Now, again, they are pursuing a policy that causes bubbles. But they have now become prisoners of their own policy: they are reluctant to move to a necessary restrictive course because they want to prevent bubbles from bursting. This is particularly true of the monetary policy of the European Central Bank, which wants to keep the Eurozone together and is putting banks at risk through its zero-interest rate policy and negative interest rates. However, in this way it prevents the governments of the distressed debtor countries from undertaking structural reforms in order to restructure their budgets.

IV. The Politicization of Monetary Policy in The European Union

Membership in the European Monetary Union was tempting for the potential entry candidates because they expected to benefit from low German interest rates after the founding of the Monetary Union. Their expectation has been fulfilled. This abrupt reduction in interest rates gave an enormous boost to private and public consumption and boosted investment activity, especially in the real estate sector. As the economies in the central states of France, Germany, and Italy weakened, the ECB lowered the interest rate to 2 percent—the lowest ever. The inflation rate in the countries that particularly benefited from the interest rate gift—Ireland, Spain, Portugal, and

Greece—was higher than the EU average. As a result, real interest rates in these countries were negative in the 2002-2007 period. If the economy is doing well, then the selection mechanism for lending becomes completely overridden. The markets go crazy. The increase in interest rates by the ECB then caused the bubble to burst. As wage costs had risen at an above-average rate in the course of the boom, these countries not only had to overcome the structural distortion of their economies but also lost their international competitiveness.

The players on the capital markets suspected that these countries might not be able to stay in the monetary union and that their governments would have difficulties in servicing and repaying their national debts in the long term. As a result, spreads—yield differentials between interest rates on German government bonds and the respective national bonds—rose sharply in the early summer of 2012. These countries would not have been able to cope with such interest rates for long. As a result, international investors, but also responsible politicians, expected the Eurozone to break up. As a result, there was a lively exchange between the responsible politicians and with the President of the ECB, Mario Draghi. The result: on July 20th, 2012, at an investors' conference in London, Mario Draghi announced that the ECB was in front of, alongside, and behind the euro: "whatever it takes." As a result, share prices skyrocketed—the index moved from around 5,000 to 12,600.

Draghi had thus promised that the ECB would buy the government bonds of the so-called program countries, which had sought protection under the rescue umbrella of the European Stability Mechanism (ESM), in the event of a fall. So far, the ECB has not had to make such "outright monetary transactions" (OMT purchases) because the players believe that the ECB's guarantee would provide sufficient security for the safety of its investments. President Draghi's justification for such announced OMTs is that the transaction mechanism of monetary policy was no longer guaranteed, as an ECB interest rate easing would no longer have an impact on the interest rates for government bonds and for loans in the distressed debtor countries. In this respect, the ECB's program was monetary policy-driven and not a contribution to financing distressed states. In a sensational ruling by the German Federal Constitutional Court (BVerfG), the ECB's action was considered an "ultra vires" action; however, it referred its ruling to the European Court of Justice (ECJ) for review. The latter rejected the judgment of the BVerfG and found the ECB's decision to be in compliance with the Treaty. For the sake of European legal peace, the BVerfG has complied with the judgment of the European Court of Justice.

Now lawsuits against the mass purchase program of government bonds and corporate bonds are pending before the BVerfG. The purchase program has been increased from 1,260 trillion euros (60 billion per month) to 1,800 trillion euros (80 billion per month). Draghi justifies this with the need to boost investment activity in the Eurozone and prevent a dangerous deflationary spiral. The sanction of charging banks a negative interest rate of 0.4 percent because they do not use their cash reserves to grant loans is along the same lines. Here, it is the central bank that, with its political perversity of credit expansion, is driving the banks into foreseeable difficulties. The fact that it considers the price dampening effect of imported primary energy to be a deflationary factor turns things upside down: cheaper energy imports release domestic purchasing power and thus stimulate the internal economy. If interest rates are deliberately eliminated as a selection criterion, there are of course inevitable misguided developments that will not be perceived as such until the players in the individual markets can achieve the expected returns and do not yet feel any unrest among their peers. With its zero-interest policy, the ECB is also deliberately interfering with the distribution of income: it is at the expense of savers and owners of fixed-interest securities, and in favor of debtors—both private and public.

The ECB's justification for having to stop a dangerous deflationary spiral is based on a false theory of inflation. Inflation is not a rise in prices of consumer goods—that is merely the consequence of them—but an inflation of the liquidity available to private and public actors, which can drive up both asset prices and the prices of consumer goods. At its core, inflation is "money supply inflation," which is particularly dangerous if it causes economic misalignments. Wilhelm Hankel, my late colleague and friend, said that of course there is inflation, you just look for it in the wrong place.

The reason for this perverse attitude on the part of the ECB is ultimately a political objective: it wants to hold the Eurozone together by means of negative interest rates and the purchase of government bonds. But in doing so, it prevents the governments of distressed debtor countries from implementing the necessary structural reforms in their social systems and labor markets. The motto for governments is: Why make yourself unpopular with the population with unpleasant reforms and lose the next elections if we can get into debt at will and pay no or hardly any interest? This postpones the problem of cleaning up the Eurozone until "February 30th" (or "*ad calendas graecas*").

The danger of the ECB's mishandled monetary policy is illustrated by the compilation of newspaper articles (with titles translated into English) in its "Extracts from Press Articles" No. 16 (17 April 2017):

- Challenges for the Banking Sector (Weidmann)
- Fierce Dispute over the End of the Money Flood
- Dangerous ECB Record
- ECB Allows State Aid for Italy's Crisis Banks
- Europe's Zombie Banks
- The Billion Dollar Bomb (Dombret)
- Europe's Trillion-dollar Risk at the Banks
- Schäuble Gives Euro-budget a Rebuff
- Agreement in Principle with Greece
- All Questions Open
- Greece's Creditors Must Act to End the Gridlock
- Prisoners in Crisis
- Debt Mountain Grows Dangerously Fast in the World
- The Caution and the Fed
- "I see no sense in higher inflation targets" (Caruana)
- IMF: Danger of Permanent Low Interest Rates

This list also reveals the deep skepticism of the Deutsche Bundesbank towards Mario Draghi's policies. However, Jens Weidmann cannot assert himself in the Central Bank Council. This also shows that the decisive reason for the creation of the euro was to disempower the Bundesbank.

V. Creative Destruction as A Prerequisite for Sustainable Growth

A large part of the economic establishment, supported by international institutions such as the IMF and OECD, sees insufficient overall economic demand as the reason for the weaker growth rates. The International Monetary Fund, for example, titled its latest global economic outlook "Subdued Demand: Symptoms and Remedies." The ultra-loose monetary policy of the central banks is to be continued and supplemented by additional fiscal policy stimulation. At present, the internationally renowned U.S. economists Summers and Krugman are calling for the ultra-loosening of monetary policy to continue even after the economic recovery is realized in order to stimulate inflation expectations and achieve a higher inflation rate: that is, real interest rates should be lowered further. The adjusted real interest rate has already been negative for some time, but due to the low inflation rate, it is not yet negative enough to generate higher overall economic demand. In a situation like the current one, the central bank must "credibly promise to be irresponsible," as Krugman already demanded in 1998.

According to Joseph Schumpeter, who stood as the antithesis to John Maynard Keynes in the 20th century, it is precisely this irresponsibility on the part of central banks and the constant support of macroeconomic demand through government debt that would be the reason for ongoing stagnation. In his *Theorie der wirtschaftlichen Entwicklung* (1908), published in English as *Theory of Economic Development* (1961), he first worked out the core ideas of bubble formation: In the course of a lasting prosperity phase, many things float along without their own driving force; if speculative anticipation gains significance, the symptom of prosperity itself becomes a prosperity generator again in a well-known way. The whole world invests in or buys companies, or shares in companies, without carefully checking whether it is worthwhile in the long term.

Schumpeter is thus saying that these exaggerations cause undesirable developments in the overall economic production structure. In an inevitable economic downturn, such malinvestments would have to be eliminated from the production process. The released production factors are raw materials for subsequent prosperity phases, which are mainly driven by product and process innovations. Of course, this selection process would be perceived as painful, because assets and livelihoods would be destroyed and unemployment would rise, but it would be wrong to overlook the positive effects that would be associated with it. Schumpeter later described this phase as "creative destruction."

A policy that tries to prevent this process with "cheap money" and governmental demand stimulation in the hope that such weaknesses can be eliminated when the economy picks up, assumes that the given production structure can also satisfy future needs. This, however, is the crucial fallacy: a policy that seeks both to save what is viable and to preserve what is not viable prevents the economy from moving towards a sustainable growth path. This is exactly what has happened since the bursting of various bubbles since the beginning of this century. In the short term, the necessary economic adjustments have been prevented by ever lower interest rates, more liquidity, and ever-increasing public debt.

The current development can be seen as a confirmation of the Schumpeterian view. The monetary policy interventions described above are gradually undermining the credibility of the central bank. Confidence is being lost because the effectiveness of the measures is being called into question, and the "unintended consequences" of this policy, which the Bank for International Settlements has been pointing out for several years, are becoming increasingly apparent. Central bank policy leads to financial instability and to new market excesses, as interest rates have lost their steering and signaling function. Central bank policy is then no longer part of the solution but becomes part of the problem. The economy is threatened with zombification. Necessary corrections to bank and corporate balance sheets are delayed, unproductive companies remain in the market, banks with insufficient equity capital and a lack of a viable business model continue to exist. All this imposes a considerable economic burden and leads to significant losses in productivity.

For me, one thing is clear: the currently prevailing Keynesian formula does not contribute to a sustainable solution to the problems. It is geared towards short-term effects. In the medium term, it leads to new excesses and exacerbates the crisis-prone developments in public finances and the negative consequences of today's ultra-loose central bank policy. It is time for economists to emancipate themselves from Keynes and his disciples, to turn their attention to the Austrian School, and to reflect on the insights of its most important representatives: Carl Menger, Eugen von Böhm-Bawerk, Joseph Schumpeter, Ludwig von Mises, F.A. Hayek, and Gottfried von Haberler.

Therefore, we want to leave the final word to Ludwig von Mises. "The economist's job is to inform about the more remote effects so that we can avoid actions such as trying to cure present evils by sowing the seeds of future greater evils." ■

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Prof. Dr. Dr. h.c. Joachim Starbatty (b. May 9, 1940, Düsseldorf). Graduating from a classical secondary school, he studied economics and political science, completing graduate studies in economics in 1964, and earning his doctorate in 1967; he was a research assistant to former State Secretary Alfred Müller-Armack from 1965-1969, and a scientific advisor for European and international economics of the CDU/CSU parliamentary group, 1970-1972; he received his postdoctoral qualification (Habilitation) in economics at the University of Cologne in 1975; he was then Professor of Economic Policy at the Ruhr University Bochum, 1976-1983, and Full Professor of Economics with a specialization in Economic Policy at the University of Tübingen 1983-2005. He was a Founding Senator of the European University Viadrina Frankfurt/O., 1991-1993; he has also had visiting professorships at Doshisha University in Kyoto and Washington University in Seattle. He took legal actions against the introduction of the euro and against various rescue operations before the Federal Constitutional Court.

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