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Origins of the Euro-Bubble

How were such great hopes dashed?
Here was a new central bank and a new monetary union which started up at the end of the 1990s. Yes, there were the cynics right at the start, including Milton Friedman who warned that EMU would not survive the first serious recession. And as is often the case some of the cynics turned out to be partly right but for the wrong reasons. They had written much about misaligned business cycles and inflexible labour markets but little if anything about the potential dangers of monetary instability (including the key dimension of temperature rise in credit and asset markets) in a union presided over by a rate-fixing and inflation-targeting central bank unconstrained by constitutional monetary rules.

In contrast the euro-enthusiasts – and they were now in charge of Europe’s monetary destiny – had boasted that a new financial economic and political future dawned. The boast proved to be empty of content. Just over one decade later the monetary union was submerged in the aftermath of a credit bubble which was as bleak – and on some accounts bleaker – than in the US! Political integration had made no progress at all (despite the claim of Jacques Delors that monetary union would be the catalyst to political union – see Brown, 2004) and in some respects had moved backwards. Financial integration had moved into reverse gear.

A flight of capital out of the government bond markets and banks in a range of financially weak member countries had brought the scenario of EMU break-up or shrinkage within the mainstream of investor vision around the globe. Embarrassed euro-officials who had been praising their own record at the official tenth anniversary events had to issue statements of denial, mainly to the pompous effect that anyone who argued for a strategic retreat of EMU into its core must be idiotic or deluded!
In this chapter the task is to study EMU in the years up to the peak of the bubble, say early 2007, and pick out the salient factors behind the ensuing malaise. In effect this chapter assembles the evidence from this period towards justifying the indictments of Chapter 1.

**Historical observations of Otmar Issing**

Let us start with the evidence provided by Professor Otmar Issing, founder member of the ECB Board and its first Head of Economics and Research.

Much of this testimony can be found in his book *The Birth of the Euro* (2008). There he states (written in late 2007?):

Nine years on (from the run-up to the launch of EMU), the ECB can lay claim – virtually undisputed – to the success of its monetary policy. Those observers that remain sceptics at heart might at most add the qualification ‘so far’. Over this period, the average annual increase in the HICP (euro-area CPI) has been 2.06 per cent. [...] Even the D-mark performed considerably less well over the period from 1950 to 1998, with a rate of 2.8%.

Well here is the statement of a single-minded general who achieved his self-selected target, which incidentally did not make much sense in terms of broad strategy, never mind the cost! As we saw in the previous chapter, the aim of monetary stability should not be interpreted as a stable inflation rate over the short- or medium-term but in considerably broader terms which includes temperature level in asset markets and also the possibility of ‘good deflation’. And the bill for single-minded ‘success’ was soon to be presented in the form of an almighty bursting of a massive credit bubble. The historical comparison (with the D-mark) on close examination includes an element of fiction alongside fact (see p. 134).

Let us start with the first big policy decision in what Professor Issing claims was a decade of monetary policy success.

**First big monetary policy decision was a big mistake (1998–9)**

With inflation in the euro-area as a whole running at just 1% p.a. at the start of monetary union, the ECB decided in favour of monetary easing. In early December 1998 while the national central banks were