Monetary austerity explains everything

Markets should examine money and credit data

Steve H. Hanke, Advisory Board

In attempting to decipher the state of the European economy, many financial analysts have failed to keep their eyes focused on money and credit — the metrics that dominate. Continental Europe's three largest economies are in the grip of monetary austerity.

Germany, Europe's economic locomotive, surprised everyone, with GDP shrinking by 0.2% in the second quarter of the year.

Data on German money and credit tell the tale. Since early 2012, the money supply, broadly measured, has registered very anaemic growth and credit has been declining.

Tight monetary stance

This tight monetary stance, coupled with the repercussions of economic sanctions on Russia over the Ukrainian dispute, has taken the steam out of the German powerhouse.

In France, the euro area's second biggest economy, growth was flat in April-June for the second consecutive quarter.

With no growth in sight, Michel Sapin, the finance minister, threw in the towel and announced that France would not be able to meet its fiscal deficit target of 3.8% of GDP for 2014. The explanation is relatively clear – money and credit growth has been flat since early 2012.

In Italy, Prime Minister Matteo Renzi's honeymoon ended abruptly in early August, when Italy entered a triple-dip recession, contracting for two successive quarters for the third time since 2007.

Money growth in Italy has been flat for some time, and credit has been slowly shrinking since early 2009.

To find explanations for all this, we must revert to John Maynard Keynes at his best. Specifically, we must look at his two-volume 1930 work, *A Treatise on Money* – a work that Milton Friedman wrote about approvingly in 1997. Keynes separates money into two classes: state money and bank money.

State money is the high-powered money (the so-called monetary base) that is produced by central banks. Bank money is produced by commercial banks through deposit creation. Keynes spends many pages in the Treatise dealing with bank money.

This isn't surprising because bank money was much larger than state money in 1930.

Today, bank money accounts for about 90% of the total euro area money supply, measured by M3.

Anything that affects bank money dominates the production of money. And here we have to look at the issue of bank regulations – courtesy of the Basel regulatory procedures, backed by every political forum in Europe.

These new regulations have been ill-conceived, pro cyclical, and fraught with danger. And, by keeping bank money tight, they provide the main reason for the sluggish money and credit data.

The authorities have around 6,000 bureaucrats combing over 135,000 loan files at 130 of Europe's largest banks, aiming to make Europe safe from banks and bankers.

Bankers who have been covering up bad loans will be found out and taken to the woodshed; zombie banks will be liquidated or recapitalised. The Single Supervisory Mechanism, the pan-European mechanism for banking supervision under the aegis of the European Central Bank, started on 4 November. This will usher in stress tests as far as the eye can see. Bank money will remain tight.

Poor economic performance

Continental Europe's poor economic performance is not only a problem of banks failing to produce money and credit. Europe's stagnation and slump are also the result of major structural economic rigidities, in other words, lack of free markets. Mario Draghi, the ECB president, has repeatedly called for structural reforms.

If market-liberating reforms were implemented, that would give the euro area much-needed confidence boost. But that would not be enough. Money and credit fuel economies. Without enough fuel, economies stall. Moreover, money dominates fiscal policy.

Until Draghi and his colleagues start to release the regulatory squeeze on banks, bank money and credit – and the euro area as a whole – will remain in the doldrums. ▪

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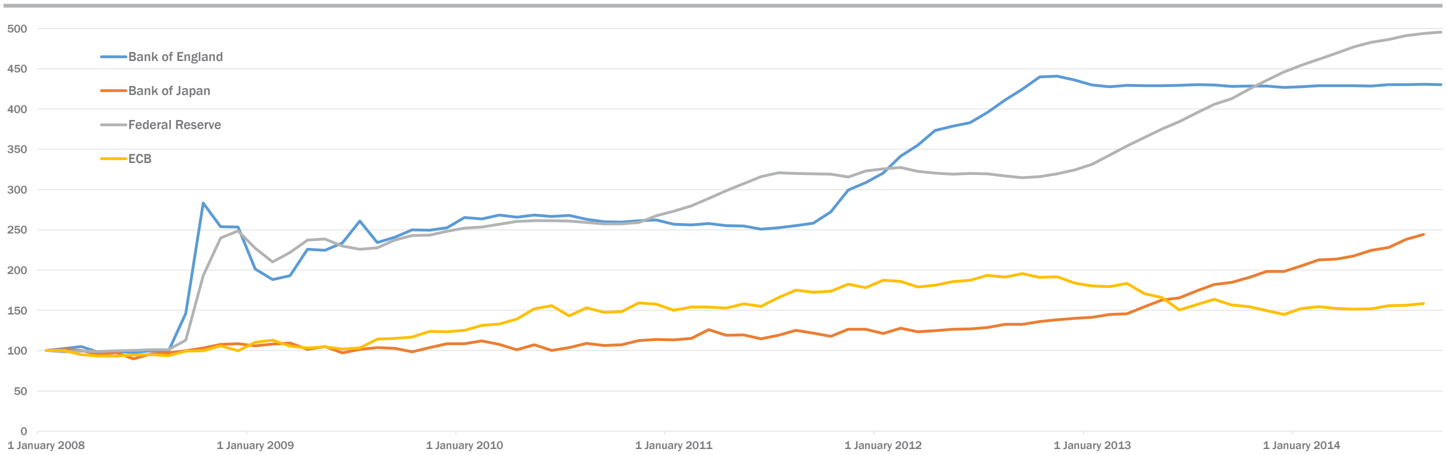
How ECB balance sheet has fallen – Central bank assets, national currencies, 1 Jan 2008=100



Source: Federal Reserve Bank of St. Louis Economic Data (FRED) and ECB Statistical Data Warehouse.