Finally I understand the euro game: it's a game of chicken [1]

Written by **Tim Worstall** [2] | Saturday 3 December 2011

Apologies, it's taken me a long time to finally understand what is going on over in the eurozone. The curtains lifted when I saw this Greg Mankiw post [3]. My conclusion is a little different, but the thought that there was a deal is what triggered my understanding.

For, you see, there's a very simple explanation for what is happening right now: they're mad or ignorant, one or the other. Leave aside all the stuff about banks, about government borrowing as well. What we're right in the middle of is a collapse in the money supply. And that's something we really don't want to have. It's not actually a necessary condition for a recession, depression, there are plenty of other ways those can come about. But it is a sufficient condition for such as Uncle Milt and Anna Schwartz showed in their analysis of the Great Depression.

Whatever else we're going to do, don't let the money supply fall!

And yet the money supply is falling, right across Southern Europe. We're getting falls of 10-20%, higher even in some countries. This is when a central bank should simply be printing money and buying any and every bond in sight. No, it doesn't matter about anything else, not in the midst of such a monetary contraction.

But this is exactly what the ECB refuses to do, the quantitative easing that both the BoE and the Fed have done, just as Friedman would insist they should (and Ben Bernanke has specifically made the point that the Fed isn't going to make the same mistake that Friedman identified they did in the 30s).

Now, I had thought that the ECB were simply ignorant of all of this but I've changed my mind now to thinking that they're mad. There's a deal afoot you see: the ECB is only going to start printing, buying bonds and monetizing the debt once everyone has signed up to the new Europe of coordinated budgets and strict fiscal policy. In one manner this is fine: the carrot and the stick to bring everyone into line. You agree to be good boys in the future and we'll take away the current economic pain.

There are however two problems with this deal. The first is that it's by no means certain that everyone will agree. The second is that it's almost impossible that they will agree in time: politics takes a long time to bring anything to fruition and this falling money supply matter is something that has to be dealt with in the next week or two.

So what we've really got here is a giant game of chicken: the ECB is driving the car of no monetisation, no

QE, full tilt at the politicians coming the other way at full speed declining to agree to full fiscal union. One or other must flinch, turn away, or there will be the most almighty smash.

At which point I plump for the explanation that they're all mad. For I don't think it is possible for there to be the necessary political agreement before it will be too late to do the monetary easing.

Have a cheerful rest of the weekend.

blog comments powered by Disqus [5]

Source URL: http://www.adamsmith.org/blog/international/finally-i-understand-the-euro-game-its-a-game-of-chicken

Links:
[1] http://www.adamsmith.org/blog/international/finally-i-understand-the-euro-game-its-a-game-of-chicken
[2] http://www.adamsmith.org/taxonomy/term/5778
[3] http://gregmankiw.blogspot.com/2011/12/draghi-deal.html
[4] http://disqus.com/?ref_noscript
[5] http://disqus.com