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Introduction

When are global asset markets and ultimately the global economy most vulnerable to the forces of irrationality?

There is a loud and clear answer in this book. The greatest danger is when the US is leading the world in a monetary experiment which distorts the key capital market signals guiding the invisible hand.

The "Great Monetary Experiment" (GME) launched under the Obama Administration by its chosen Federal Reserve Chief Ben Bernanke was not the first in contemporary history. Indeed, since the Federal Reserve opened its doors, there has been a perpetual rolling out of monetary experiments, albeit the main officials in charge would never have agreed with that description. At most, they would have conceded that circumstances had forced them into monetary innovation, but this had not been their choice.

Those responsible for designing and implementing the GME had no such reticence. As we shall see in this volume, they were ready to gamble US and global prosperity on a set of theoretical propositions and innovatory tools as pioneered under their own chosen brand of neo-Keynesian economics. The justification for doing so was the darkness of the economic landscape in the immediate aftermath of the Great Panic (Autumn 2008) and their promise of an early dawn.

The big new idea in the Great Experiment was to "drive up asset prices" whilst simultaneously striving to prevent any whiff of price deflation appearing. "Quantitative Easing" was brandished as the magical tool. In fact, the experiment and the tool were not so new, and any transitory apparent effectiveness depended on a real life replay of the Emperor's New Clothes fable. As the real world theatre performance continued, many practical business decision makers remained anxious.

Intuitively, they realized the presence of asset price inflation, even though general knowledge about this disease remained scarce. A general foreboding that the end phase of the disease could be devastating – including possibly another crash and great recession – made many businesses and their shareholders cautious about entering into long-run high-risk ventures. In other cases, the trio of excess leverage, overinvestment and mal-investment, a hallmark of the disease, became apparent with the passage of time.

The plunge in energy prices during late 2014 and the extent of revealed overinvestment and mal-investment in the energy extraction industries suggested that energy might be the equivalent of US housing in the previous episode of asset price inflation disease or telecommunications in the one before that. An overpricing of high-risk debt issued by these lead sectors was a common feature in all three experiences.

In particular, the interest income famine under the GME led to a wide range of risky debt selling at prices which could not be justified on sober-rational calculation. These securities had been prominent in financing the shale oil and gas boom. They were also the key source of fuel to private equity which after suffering a near-death experience in 2008 entered an even bigger boom under the Great Monetary Experiment.

The investors buying the high-yield debt at inflated prices are in many cases aware of the irrational forces at work. Maybe they are confident in their ability to exit the inflated markets before they deflate. Alternatively, they may come to believe that "there is simply nowhere else to go" in their flight from the interest income famine in the safe bond markets. Or they may put an unjustifiably high probability on a miracle turning up which would underpin assets at their present inflated prices. Or they may have repeat to themselves that weary phrase "it is vain to fight the Fed".

The investors and commentators who steadfastly prevent their minds becoming enfeebled by such mantra face a challenge. They realize the danger of becoming the permanent pessimist who forecasts the next crash five years in advance and miss all the opportunities meanwhile. Ideally, they should read up on everything available about the disease of asset price inflation and develop skill and talent in its diagnosis and prognosis. Even so, they cannot predict the course of the disease exactly or time its end with precision. Nor can they be 100% certain of their provisional diagnosis.

This book is about the disease of asset price inflation, and one of the aims here has been to heighten our powers of diagnosis and prognosis. No two episodes of the disease are identical, but there are common elements. As Balzac wrote, the challenge for the author is to individualize types and typify individuals. The same challenge faces the analyst of business cycles and the would-be experts in asset price inflation.

There is also a bigger aim. How can the US and the world rid itself of this disease – asset price inflation? It is not enough just to say "End the Fed". First, a keen and widespread awareness must emerge that the Fed has indeed been responsible for spreading a deadly plague of market irrationality which has undermined economic prosperity and become a danger to economic and political freedoms.

A key step in creating awareness about this plague should be the exposure of deflation phobia as prevalent amongst leading monetary officials. Asset price inflation in modern times has originated always in a context where the Fed is fighting against an "incipient danger of deflation" – trying to stabilize prices or even push them up by 2% p.a. when the natural rhythm would have been downward for some time. Yet in today's world of information technology, this phobia of deflation becomes harder and harder to comprehend.

In this latest period of monetary experimentation led by the Federal Reserve, the central bankers have sought to terrify their audiences about widespread price falls and so justify their quantitative easing policies and use of other non-conventional tools, including negative interest rates. They are the Don Quixote of the monetary theatre, but unlike the fictional anti-hero, they have the real power to destroy and impoverish.

Beyond the cure of deflation phobia, there is the challenge of creating a new stable monetary order in the US. Is this possible without a return of the US dollar to a gold standard? The approach taken in this volume is to examine how the automatic mechanisms operating under the gold standard brought about monetary stability in general terms and then to examine whether these could be recreated without the dollar being convertible into gold.

The functioning of the automatic mechanisms depended on a tightly constrained growth in supply of monetary base in which there was nonetheless some flexibility in line with evolving cyclical and secular economic conditions, a strong demand for monetary base and no direct or indirect official interventions in the setting of long-term (or short-term) rates. In principle, a monetary system in the US could be reproduced with these qualities.

Without gold convertibility (meaning the widespread use of gold coins with these obtainable on demand against dollars at a fixed parity), though, there would have to be a vigorously defended monetary constitution beyond the reach of political interference. That aim of monetary stability enshrined in constitutional law would require for its fulfilment a general rolling back of financial regulation, deposit insurance and implicit promises of bailouts for "too big to fail" financial institutions.

To many, this may seem like an unrealistic agenda. But revolutions always seem impossible long in advance. And in the meantime, there is much work to be done both in the understanding of how irrational forces in asset markets become empowered by US monetary instability and in mobilizing opinion behind a US monetary reform agenda.

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