Comeback of the Inflation Specter

by Thomas Mayer
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A specter is haunting Europe and the rest of the world - the specter of inflation. For a long time, it was thought to be dead for good. Now it is back. In recent months, inflation in the USA reached its highest level since the early 1980s, and in the euro zone it rose to its highest level since the introduction of the euro. Ostensibly, inflation was driven by a surge in commodity prices reminiscent of the "oil price explosion" of the 1970s. But prices for intermediate products also rose, so that in a second round, prices for final products are now rapidly increasing.

Inflation becomes endemic when wages rise in a third round. There are already clear signs of this in the USA. By contrast, collectively agreed wages in Europe are still low because the unions have been caught on the wrong foot by inflation. But members would hardly forgive their union bosses if they did not soon extract a substantial wage supplement to compensate for the loss of purchasing power.

Central banks were also caught on the wrong foot by the return of the inflation ghost. Since the great financial crisis of 2007/08, they had insisted on seeing deflation as the greater risk to price stability and had scrambled to push inflation up. Having exhausted the scope for cutting their key interest rates, they had bought bonds as part of their "quantitative easing" policy to push capital market rates down further.

During the corona pandemic, they expanded these purchases to an extent never before seen in peacetime. Moreover, the purchases took on a new meaning. If they had previously supplemented interest rate policy, they now served monetary government financing: Central banks created the money for the government to spend on its citizens as compensation for lost earnings during the lockdowns. In the euro area, the European Central Bank financed almost all, and in the U.S.A. and Japan more than half, of new government debt in 2020.

As a result, the total balance sheet of the three central banks, expressed in U.S. dollars, increased by 70 percent in 2020-21 alone. The result of the balance sheet expansion was a 31 percent increase in the total narrow money supply (M1 or M2) - at a time when real GDP was barely making up for the pandemic-induced slump. In earlier times, the resulting constellation was called a "money overhang." It was reduced by price increases because the real economy could never grow fast enough into the oversized money mantle.

Now it is even worse. Contrary to the central banks’ expectations, the increase in supply after the end of wide-spread lockdowns was hampered by bottlenecks. Supply chains could not be fully restored as ships remained stuck in the wrong places and, more recently, a new wave of lockdowns hampered production in China. The Ukraine war exacerbated the problems as the scarcity of energy and food increased. The world economy is being hit by a big “stagflationary” shock.

In principle, central banks could now choke off inflation by selling their bonds and raising their policy rates to clear the money overhang. U.S. Federal Reserve chief Paul Volcker provided the blueprint for this in the early 1980s when, by raising the federal funds rate, the Fed's lending rate, to 20 percent, he provoked a rise in the yield on 10-year U.S. Treasury bonds to as high as 16 percent. The recession was harsh, but the economy and finances remained intact. The decisive factor was that debt was very moderate - and for the U.S. government, for example, it was only around 30 percent of gross domestic product.

At the same time, the Reagan administration embarked on a policy of deregulation and tax cuts, which raised the supply potential of the economy. Other countries, notably the UK under the leadership of Prime Minster Margret Thatcher, followed similar policies. Sound monetary and supply-side policies laid the ground for the subsequent period of low inflation and rising prosperity.

Today, the indebtedness of states and companies in particular has reached historic record levels. It is no longer possible to combat inflation robustly by raising interest rates without provoking defaults by sovereigns, companies and even private households. Since this would trigger a new financial crisis, central banks consequently have no choice but to cautiously follow inflation with interest rate hikes instead of getting “ahead of the inflation curve”. This means that interest rate hikes above inflation are hardly to be expected and real interest rates, i.e. interest rates minus the inflation rate, will remain negative.

At the same time, governments have adopted more interventionist and protectionist economic policies. Governments interfere to make the economy “greener”, and an emerging new cold war between the West and East raises new trade barriers. As a result, the supply potential of economies is more likely to decline than to increase.

From the debtors' point of view, negative real interest rates are desirable. Because if, in the face of increased inflation, their income exceeds their interest expenses, they have room for other expenditures. And if, on the due date, a debt has to be repaid with money whose purchasing power has fallen significantly, they can even make a good deal. The bill is paid by the creditor, who can buy less for the interest on his investments and the amount at repayment.

If the debtors have the longer political lever in their hands, they can fleece the creditors in this way. This is particularly the case when the largest debtors are the sovereigns themselves. Since central banks are government agencies, it is safe to assume that they will by no means accept the bankruptcy of the sovereign above them. During the 2010-12 euro crisis, there was admittedly ambiguity about the European Central Bank's relationship with euro area sovereigns. But with his famous phrase that the ECB would do whatever was necessary to protect the euro, its then-President Mario Draghi unmistakably positioned it as a lender of last resort to sovereigns threatened with default.

Citizens would be challenged to raise their voices to ensure that the state manages its finances properly and does not use a specific group, that of creditors, to finance it through a hidden tax. Unfortunately, however, most lack the financial literacy to recognize the consequences of hidden government debt relief through inflation. The most serious of these may be that as purchasing power dwindles, citizens lose confidence in money as a means of storing value. An example of this is provided by the Italian lira, which lost internal and external purchasing power as a result of the Banca d'Italia's creation of money for the state. Citizens fled to real estate as a means of storing value and were eventually happy to give up the lira for the euro.

Within the class of currencies in the fiat credit money system, the euro is the most vulnerable, as it is the youngest of the major currencies and issued by a central bank influenced by 19 governments of economically diverse countries. As the euro is likely to face a similar fate as the Italian lira with the merging of monetary and fiscal policies, it is likely to go through a creeping monetary crisis in which there will eventually be a growing willingness to replace it with more stable-value money. Instead of investing only in real estate, as the Italians did, citizens of eurozone countries may over time increasingly also seek their salvation in gold and cryptocurrencies. While government regulators are throwing sticks between the legs of these currencies as best they can, they will not be able to prevent their rise any more than the machine wranglers prevented the introduction of mechanical looms in

19th century England. If politicians really wanted to save the euro, it would make more sense to think about how they could create stable public finances and an attractive digital euro.

At present, the debate is focused on softening European debt rules and introducing a digital euro as a limited alternative to paper money. With a little more courage, however, it could also be discussed whether the digitization of the euro should not be combined with a one-off debt cut along the lines proposed in the Chicago-Plan of 1933. The first step would be to create a euro bank deposit fully backed by central bank money. The European Central Bank could create the central bank money needed to cover the deposit by using the government bonds it has already acquired and buying more government bonds if necessary to satisfy demand for the safe deposit.

In a second step, the safe euro deposit could be consolidated on the ECB's balance sheet and set up as digital central bank money. The future increase in money supply would take the form of additional purchases of government bonds by the ECB, decided by the Governing Council independently of political influence and on a long-term basis. To avoid money creation for fiscal policy purposes, governments would be required to distribute the money they receive from bond sales directly to their citizens as a "monetary dividend." Since the cover pool would remain permanently on the balance sheet of the ECB, the outstanding government debt of the euro states on the market could be reduced to little more than 42 percent of GDP.

It would be naïve to hope that policymakers might decide to boldly rescue the euro. We are likely to slip into a euro crisis as part of a larger crisis of the existing fiat credit money system before comprehensive reform is possible. Those who see this as a wild dystopia should take a look back - and they will see that the history of money is a history of its crises.

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