Europe's *Unusual* Inflation Risk

By Hans-Werner Sinn

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The increasing risk of a return of inflation in the United States and Europe is beginning to galvanize debates among economists. One key source of inflation fears is the expectation that, once the Covid-19 pandemic has been overcome by vaccines, pent-up demand will explode in an orgy of consumption. Moreover, today's unprecedentedly large government bailout programs will have powerful inflationary multiplier effects.

But the international debate has been strangely U.S.-centric. Few people have yet considered the particular inflationary dangers that lurk in the eurozone, where the monetary base has risen in recent years to a much higher level than in the United States, relative to annual economic output.

In January 2021, this ratio, known as the cash-holding coefficient in the economy, was 43 percent in the eurozone, almost double the 24 percent recorded in the United States. By contrast, when the global financial crisis began in 2008, the figures were almost identical—12 percent and 11 percent, respectively.

Since then, the monetary base in the eurozone has risen to about 3.5 times the level that was once sufficient for transactional purposes; in the United States, it rose to double its previous level. Accordingly, of the total central bank monetary base of €5 trillion ($5.9 trillion) recorded by the European Central Bank in January, close to three quarters (72 percent), or €3.6 trillion, is a mere overhang of money that is not really needed for transactions.

For the time being, this money overhang cannot cause inflation, because short- and long-term interest rates are near zero and the economy is currently in a liquidity trap. Indeed, this extra money is mostly being

Hans-Werner Sinn, Professor Emeritus of Economics at the University of Munich, is a former president of the Ifo Institute for Economic Research and serves on the German economy ministry's Advisory Council.

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hoarded by banks, rather than circulating in the wider economy.

This is the archetypal situation that Keynesians have pointed to for years as proof of the ineffectiveness of monetary stimulus. It is correctly described by the common metaphor that likens monetary policy to a string: it can be pulled, but not pushed, and only if it is held tightly.

From this point of view, the monetary overhang seems harmless. But it is not, because if aggregate demand increases after the pandemic, and is boosted by huge fiscal spending packages, then the string should be pulled to raise interest rates and curb investor purchases of machinery and building material. But such a response is not likely to succeed in the eurozone, because the Eurosystem would have to undo the many asset purchases that stand behind the expansion of the money base.

From the beginning of the 2008 financial crisis until January of this year, the net asset purchases of the ECB and the national central banks that form the Eurosystem have totaled €3.8 trillion. Of this amount, the lion's share, worth over €3 trillion, comprises securities issued by state and quasi-governmental bodies.

Political resistance to any reversal of these asset purchases is now so great that it can be assumed that it will not take place for the foreseeable future. Indeed, any such sales would destroy the market value of these assets, thereby forcing banks, which still have many similar assets on their books, to book huge depreciation losses. Should this unwinding begin, the bubbles created by the European Central Bank's zero-interest-rate policy (which account for a large share of banks' equity capital today) would burst, triggering a wave of bankruptcies.

Moreover, the European Union's Mediterranean member countries, whose debt has reached exorbitant levels, would have enormous difficulties in taking on new debt and rolling over their existing liabilities. From this point of view, the Eurosystem would be exposed as lacking any real brake on inflation when it matters.

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Some economists counter the fear of inflation by pointing out that central bank money is less important than the money that commercial banks create. Indeed, monetarists have rightly pointed out that the empirical correlation between inflation and money supply applies only to the higher monetary aggregates M1 to M3, which include, in addition to physical cash, book money and other liquid asset classes. Because the time paths of these monetary aggregates have increased at a moderate pace since the beginning of the financial crisis in 2008 (perhaps with the exception of the most recent few months), one might be inclined to believe there is no inflation risk.

If the economy recovers and fiscal stimulus turbocharges pent-up demand, a lot of bank credit could suddenly emerge from central bank money. Price growth will then begin to accelerate, and the European Central Bank will have a very hard time curbing it without having a functioning inflation brake.

But that would be premature. In order to be able to produce and lend the book money they create, banks need base money. The potential new book money is a certain multiple of the overhang of base money that depends on the minimum reserve requirements and the proportion of cash outflows. The huge hoards of base money that banks now hold in their central bank accounts are not even covered by M1 to M3 monetary aggregates. In this respect, these aggregates obscure the actual risk of inflation, which is already more than obvious from the monetary base itself.

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