UNDERSTANDING MONETARY INFLATION

Posted on August 18, 2022

All we need is for our governments to make one error, and the inflation powder keg explodes.

Category: COMMENTARY
Tags: economics, inflation, monetary inflation, Sven R. Larson

Inflation is close to its top in Europe. American inflation has probably already peaked: the latest numbers from the Bureau of Labor Statistics show that both producer and consumer price inflation for the month of July were lower than in June.

It is too early to say definitively that inflation will subside going forward. Experience from the notorious stagflation era four decades ago suggests that it could take a year before inflation returns to “normal” rates.

That said, there is also a fairly high risk that we will see *higher* inflation going forward, both in Europe and America. The reason is to be found in the very cause of our current inflation; unlike more common types, the monetary inflation we currently have is fast, fluid, and uninhibited by the economic mechanisms that keep a leash on other types of inflation.

It does not take much of an error by European and American governments to pour more fuel onto the inflation fire. Hopefully, though, the same governments will use what policy tools they have in order to prevent higher inflation and put us on a path back to price stability.

Before we learn how to manage our current inflation, we need to understand why other, non-monetary explanations of this inflation are invalid. We do not have so-called demand-pull inflation, which is caused by excess demand during times of maximized capacity utilization. Once Europe and America opened up again after the 2020 pandemic, spending levels on both continents were good but far from spectacular. Europe has just recently returned to the same employment levels as before the pandemic.

We can also rule out supply-chain restrictions as a cause of inflation. The reason is simple: all the productive resources that went idle with the artificial economic shutdown in 2020 were still there when governments started easing their restrictions. With the exception of the microchip issue—which is not even close to important enough to explain inflation—it is impossible to quantitatively explain our current inflation rates with supply

restrictions. The numbers simply do not add up.

In a sense, it would have been better if one of these two causes could explain our current inflation. They are self-contained in a sense that monetary inflation is not: free markets respond to rising prices, mitigate spending, and dampen the inflationary pressure.

At the same time, while we do have monetary inflation, it is important to not fall for the story of conventional monetarist wisdom. It says, in a nutshell, that a one-percent increase in the money supply equals a one-percentage point increase in inflation. This type of symmetric, instantaneous inflation does not exist, but as we will see in a moment, there are exceptional circumstances when monetary inflation can look much like this textbook picture.

And we have created those circumstances. All we need is for our governments to make one error, and the inflation powder keg explodes.

Monetary inflation happens when there is a pipeline, a transmission mechanism, from the central bank's money printing to households and businesses in the real sector of the economy. Broadly speaking, there are two types of these transmission mechanisms: financial and fiscal. The financial mechanism sends newly printed money into the financial system—think commercial banks—while the fiscal mechanism pipelines the new cash into the government budget.

The financial mechanism is far less dangerous than the fiscal mechanism, which is the one that is currently operating in our economy.

Oddly, the economics literature on monetary transmission mechanisms ignores the one where government is involved. All attention is on the financial mechanism. "Monetary Policies and the Economy" by Economics Nobel Memorial Prize Laureate James Tobin (*Southern Economic Journal*, January 1978) serves as a classic example.

Another highly noteworthy contribution comes from Mark Gertler and Ben Bernanke (yes, the former chair of the Federal Reserve) in “Inside the Black Box: The Credit Channel of Monetary Policy Transmission” (*Journal of Economic Perspectives*, Autumn 1995). Gertler and Bernanke look at how newly printed money moves into the economy through bank credit.

This bank-dependent, financial transmission mechanism rarely drives up inflation to any dramatic levels. Every step of this money-to-inflation pipeline has to pass through a market with a price mechanism: the interest rate itself is a good example, especially in the context of the credit-rating system by which banks select customers for their new loans. They have a limited pool of first-tier borrowers to lend to; once they turn to less qualified borrowers, they charge higher interest rates—raise the price of credit—whereby demand is dampened.

There are more price mechanisms at work. Even the first-tier borrower may balk at new debt. He has to decide how much of his pay, and thereby his labor supply, he will want to set aside for paying back the loan. His only two choices are to work more or to redistribute his existing income. Either way, though, his decision will be a free-market one, by means of which the economy self-regulates a monetary expansion. Whether he decides to work more or to spend less on other things, his decision will absorb some of the price shock that otherwise would reverberate throughout the economy.

All these self-regulating price mechanisms are bypassed when the central bank uses the fiscal transmission mechanism for its newly printed money, i.e., when it lends money to government. While the bank-based transmission mechanism limits how much of a monetary expansion eventually makes its way out in the economy, the government-based mechanism comes with no such limits. A government that borrows from the central bank will pipeline all of the money out into the economy, in three steps:

1. The treasury prints new securities, i.e., bonds, bills and notes, that it sells on the sovereign-debt market.
2. The central bank buys the treasury securities. The payment goes into the treasury’s

bank account, directly or through a secondary-market intermediary.
3. The treasury spends the money on whatever budget priorities the legislature has made in its budget.

At no point in steps 1 and 2 is there a price mechanism involved. Except for the overhead cost of operating government, a euro printed by the central bank is a euro in someone's pocket.

This is very significant, in fact essential, if we want to understand why this government-budget based monetary expansion is so dangerous in terms of inflation. To see why, let us now return to the bank customer who was contemplating how to pay for his loan. In order to pay for the loan, he had to make sure that he was putting value into the economy, value that would earn him enough money to pay for the loan.

Once he takes out the loan, whatever spending he does will be balanced against the value he has already put into the economy. When we aggregate this value-in, value-out balance to the entire economy, we have myriads of price mechanisms working every day to absorb, mitigate, and eliminate the shock that a monetary expansion causes. For one, if the interest on the loan went up too much, the borrower would not consider it worth the while to work the extra hours, or rearrange his own budget, in order to take out the loan.

By contrast, when the newly printed money goes through government, the value-in part of the equation is removed. The same guy who just considered working more in order to afford a bank loan, now gets cash from government. Without having to do anything, he suddenly has more money in his pocket.

The bigger our entitlement benefits become, the bigger a wedge it drives in between the value-in and value-out sides of the economy. This is the same as fuel for inflation.

There is only one price mechanism at work here, and that is at the consumer end of the chain. More consumer demand at a given supply always pushes prices upward. However,

when households (and sometimes even businesses) get handouts from government, they are more or less immune to that price mechanism. Since they do not have to work for the money they spend, the impact of inflation on their own pocketbooks is considerably less pronounced than if their income was work-based and thereby subject to a labor-market price mechanism, a.k.a., wages.

Things get even worse when the entitlement programs that hand out the money are indexed to inflation. This is common among welfare states in Europe and North America. When inflation rises, the central bank's printing presses have to work harder.

Monetary inflation becomes a self-perpetuating phenomenon.

Europe and America are not there yet, and it does not look like we will get there either. However, we have seen this process wreak havoc on other welfare states, particularly in Latin America. Therefore, we know that it exists and we know its devastating results; no welfare state is immune to it. Therefore, it would be wise of the bright minds governing the EU, the euro zone, and the North American economies to start working on reforms that dismantle the fiscal transmission mechanism.

Time is not on the side of the legislative sloths. As the following two charts will show, we have already had an uncomfortably close encounter with this more potent form of monetary inflation.

We start in America, in 2008-2013, in Figure 1 below. This was the first episode of so-called Quantitative Easing, or QE; the Federal Reserve printed a large amount of money in the wake of the terrorist attack on September 11th, 2001, but that monetary expansion was concentrated on the financial sector.

As seen in Figure 1, that changed in 2008, when the QE program made purchases of government debt normal for the Federal Reserve. The green function shows the Fed's purchases of U.S. government debt, in billions of U.S. dollars. The dark dashed line

illustrates newly printed money (measured as M2, for all you monetary nerds out there), in billions of U.S. dollars.

The bumps after 2008 are compelling—but they are nothing compared to what happened in 2020:

Figure 1

Source: Federal Reserve

In other words, Figure 1 allows us to see, with our naked eye, how newly printed money works its way into the U.S. Treasury. Since about 70% of the Treasury's spending pays for assorted welfare-state benefits, the effect on inflation is direct and powerful.

Now over to Europe, specifically the euro zone, where the correlation between monetary expansion (again measured as M2) and deficit monetization is even more pronounced. Unfortunately, it is more difficult to obtain quality data from the European Central Bank than it is from the Federal Reserve; furthermore, whatever data is available is limited in time. Therefore, we can only review money supply and treasury securities purchases from 2009.

Nevertheless, the picture in Figure 2 is stunning (the scale is, of course, in billions of euros):

Figure 2

Source: European Central Bank

The two early spikes are related to the ECB's purchases of euro-denominated government debt during the austerity crisis. The second spike, in 2015-2018, was proactive in the same way as the Federal Reserve's QE program.

After a pause in 2018 and 2019, the ECB launched a pandemic-related monetary expansion similar to what we see in Figure 1. There is an almost perfect correlation between sovereign-debt purchases and the expansion of the money supply.

With double-digit inflation in many euro-zone countries, and with American inflation persistently above eight percent, Figures 1 and 2 give us a chilling demonstration of what brought about those rapid price hikes. These two illustrations also tell us that we have everything in place to cause much higher and much more persistent inflation.

When we no longer have to wonder where inflation came from, we now need to ask: what do we do to prevent it from persisting, or even accelerating? If a deficit-ridden welfare state can funnel newly printed money into the economy and cause inflation in the 10% region, it can easily drive inflation to 20, 30 or 50%. Or higher.