Pandemic's high inflation aftermath – most of all in Europe

Brendan Brown (Market Eye, submitted April 8, 2020) published April 25, 2020 Nikkei Veritas

Many years of high inflation is the most likely long-run outcome of the surge in government borrowing financed by money printing now taking place around the globe. Governments will not raise taxes and cut spending towards tackling their ailing finances in the years following the pandemic. Rather they will harness their central banks to raise revenue from inflation – inflicting huge real losses on holders of government paper. The initial spark to high inflation will come from the combustion of pent-up demand with supply restrained by widespread financial crippling. In Europe, existential weakness of the euro adds to the high inflation danger.

Towards understanding the enormity of the global inflation threat imagine what the economic policy response to pandemic would have been under a sound money regime as against the actual highly unsound one. Yes, central banks would have provided emergency injections of monetary base in response to the immediate liquidity crisis but on the clear understanding that these would be reversed once the crisis was over. Yes, governments would have embarked on huge social security programs to help the victims of pandemic but simultaneously announcing plans to levy a solidarity tax for a decade afterwards to bring down their huge debts. That would free up private savings for productive use. We are a far cry from all of this.

The US is set on a path which will take the federal government debt to GDP ratio to near 150% by end 2021 (105% on the eve of the pandemic) with the Federal Reserve entrenched in policies of perpetual stimulus. As the supply shock of pandemic fades, and investment spending surges from depression-low levels, some upward pressure on interest rates would naturally form. This would reflect an emerging shortage of capital – a reflection of so much savings having gone into financing government during the pandemic alongside the economic obsolescence of mal-investment effected in the long pre-crisis bubble. Central banks by resisting rate rises stimulate high inflation, abetted by de-globalization.

In Europe government debts are also exploding most of all in the hard-stricken areas of Italy and Spain, whilst the ECB has put its money printing press into over-drive. For now, ECB President Lagarde may seem a little tame compared to Fed Chief Powell, but let's make allowance for her effort to build confidence in Berlin. She has every intention of drawing on that trust in due course. Already her rejection of further cuts in interest rates below zero and her public comments against using monetary policy to support the price of Italian bonds have gained Chancellor Merkel's tolerance for the ECB's new asset purchase programme aimed at purchasing debts of Southern European member countries.

In fact, there are two factors which make the European inflation more threatening than the US. First the ECB balance sheet is filling up with junk at a break-neck speed – mainly loans to weak sovereigns and weak banks. When a strong economic rebound emerges in the aftermath of pandemic, the ECB will not be able to raise rates or shrink its balance sheet without exposing severe loss. Second, the ECB's vast loan operations into Italy and Spain are leading to huge round-tripping of deposits into Germany.

Deposits with German banks are viewed widely as safer than elsewhere in the euro-zone, given the assumed protection of the German government. The result of ECB loans flowing back to Germany could be the credit balance of the Bundesbank with the euro-zone clearing system doubling this year to 40% of German GDP. Berlin realizes that this vast credit could mean German taxpayers bear the full burden of Italian or Spanish default. Cumulative high inflation would reduce the threat in real terms. Alternatively, Germany could exit EMU, refusing to convert non-resident euro deposits with German banks into Deutsche marks. If Europe is seen going down either road, the euro would collapse.