Economic Insight

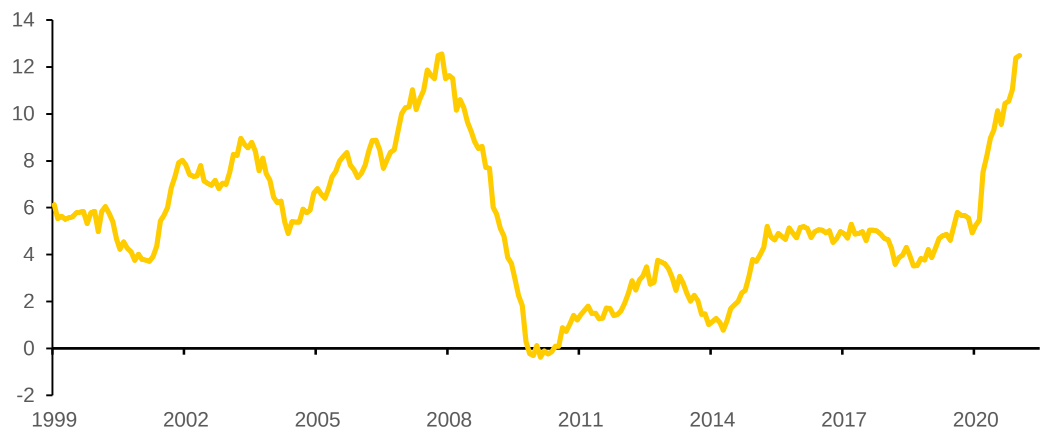
2 March 2021

Take money supply seriously again!

Is the specter of inflation returning? After all, money supply has been growing far too fast since Corona. An inflation potential is building up. The ECB must not continue to neglect money supply.

It was like every time: At her press conference in January, ECB President Christine Lagarde routinely went through the money supply and its components. At the end, she once again stated that "a cross-check of the outcome of the economic analysis with the signals coming from the monetary analysis" argued for a continuation of loose monetary policy. But this business-as-usual is no longer appropriate. After all, growth in the M3 money supply, which includes currency in circulation, overnight deposits, time deposits, savings deposits and other near-money assets, has accelerated sharply since the Corona crisis – from five percent to more than ten percent. This is almost the highest value since the founding of monetary union (chart 1).

Chart 1: Money supply rising too fast since Corona
Money supply M3 in the euro area, annual rate of change in %.



Source: ECB, Commerzbank Research

Money supply still says a lot about future inflation

This should be a wake-up call. It is true that the money supply cannot be used to forecast how inflation will develop in the short term; oil prices or labor costs are more helpful for that. But the money supply still tells us a lot about the medium to long-term trend in inflation. For example, low money supply growth in the ten years before the Corona crisis helps to explain why inflation in the euro area remained well below the ECB's target of just under two percent on average over this period.

Too much money in circulation for a long time to come

To reach this mark in the long term, the money supply must grow by a good five percent a year. However, if it goes up by more than ten percent, as it has since the Corona crisis, too much money will be in circulation and an inflationary potential will build up. This is what will happen in the coming years if the ECB does not take the money supply seriously again.

- First, budget deficits will be higher than in previous years after the Corona crisis has subsided. The pandemic has strengthened people's faith in the importance of the state everywhere in the euro area. In this political climate, citizens will continue to accept high budget deficits for a long time. The banks will continue to satisfy the states' hunger for credit by buying government bonds for as long as they can pass them on to the central bank under the ECB's purchase programs. The banks will then continue to transfer the equivalent value of the bonds to the central bank accounts of the finance ministers, who will use them to make payments to private households and companies, thus putting money into circulation and increasing the money supply.

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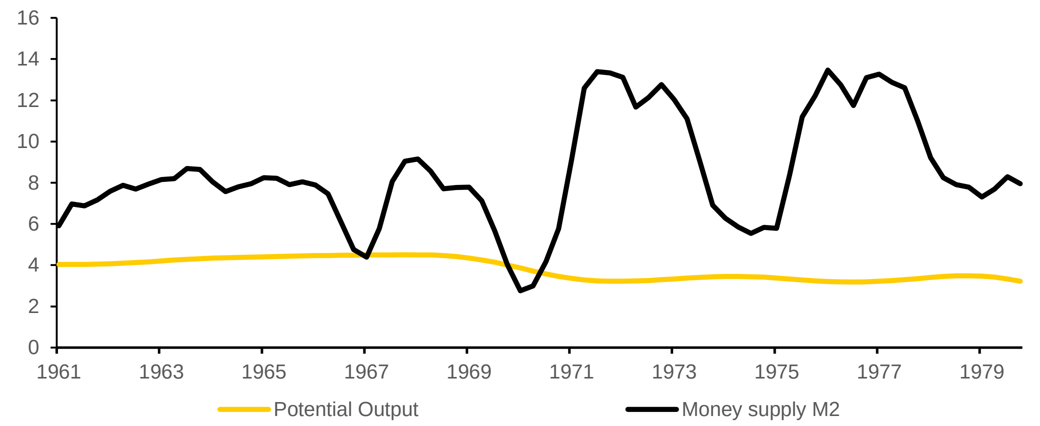
- Second, once the crisis is over, companies and home builders will be tempted to borrow too much if monetary policy remains too loose. The disbursed loans end up in the accounts of companies and private individuals, causing the money supply to rise just as the ECB's bond purchases do.

US experience in the 1960s as a warning

Ignoring excessive money supply growth has proven dangerous time and again. An alarming example is the USA of the 1960s.[1] At that time, the central bank had to keep government bond prices stable during the issuance of new bonds, which often forced them to make extensive bond purchases. Thus, too much money came into circulation (chart 2). This began to be reflected in higher inflation in the mid-1960s, after the U.S. unemployment rate had fallen to very low levels, without the central bank, which was stuck in the Keynesian *zeitgeist*, seeing this as a problem. By the end of the 1960s, inflation had already risen to five percent. The double-digit inflation rates of the 1970s, which many associate with the oil price shock of 1973, was primarily caused by ignoring excessively strong money supply growth in the preceding decade.

Chart 2: Money supply increased too much in the 1960s
Potential output and money supply M2, annual rates of change in %.



Source: Fed, Commerzbank Research

Significantly higher inflation looms in a few years' time

The euro area faces a similar threat in perhaps four or five years' time, when the unemployment rate will be low again after the Corona crisis has been overcome. The damage from higher inflation could be even greater this time, because of the additional threat of price collapses in the financial markets. As long as inflation and interest rates are still low, the loose monetary policy will continue to drive up the prices of stocks, bonds and real estate. But if inflation then rises and the ECB has to end its negative interest rate policy, highly valued assets are likely to come under severe pressure, which could trigger a financial crisis.

A more prominent role for money supply again

To prevent all this, the ECB should not continue to neglect money supply. It deserves a prominent role in the monetary policy strategy framework that the ECB is currently revising. Monetary aggregates should be at the center of the second pillar of its strategy. This must not become a hodgepodge of indicators that have found no place in the first pillar on the real economy. Above all, however, the ECB should take the signals coming from money supply seriously.

[1] See Allan H. Meltzer, **Origins of the Great Inflation**, Federal Reserve Bank of St. Louis Review, March/April 2005. [back]

In accordance with ESMA MAR requirements this report was completed 2/3/2021 08:51 CET and disseminated 2/3/2021 08:51 CET.

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