



Inflation Should Not Trouble Investors in the Near Term

Central bank money printing is supported by stable dynamics.

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Economist Milton Friedman famously said that “inflation is always and everywhere a monetary phenomenon.” If he were right, the world would be facing an inflationary inferno. The U.S. Federal Reserve’s balance sheet has increased by USD 2.5 trillion over the past six weeks—more than during the three rounds of U.S. quantitative easing (QE) in 2008, 2010, and 2012—and the European Central Bank has promised to expand the money base by close to EUR 900 billion before the end of the year. We only need to remind ourselves of what happened in Venezuela, Argentina, Zimbabwe, Iran, South Sudan, and Congo for evidence that out-of-control inflation can follow when the money printing presses have been deployed.

Yet the experience of developed economies in recent years has not followed the same pattern. Central banks have, over the past decade, been extraordinarily busy printing money, and—so far—this has not caused inflation. Is the logic of Friedman’s quote wrong after all, or do we just need to wait a little longer? Below, we try to answer this question by digging deeper into the ways that large-scale money printing impact economies and asset markets.



Nikolaj Schmidt
Chief International Economist

Money Demand Stability Is Key to Inflation

Money demand (the demand for cash or bank deposits rather than investments) is a key factor in determining whether money printing leads to inflation. When money demand is stable, central banks can print swaths of money without igniting out-of-control inflation; when money demand is unstable, printing money often results in a run on the currency and/or very high inflation. What, then, determines the stability of money demand?

When consumers believe the local currency is a safe vehicle for preserving the purchasing power of their savings, money demand is stable. Consequently, an economy where inflation is under control, the currency is stable, the fiscal and external accounts are well managed, and property rights are preserved through law and order is likely to exhibit stable money demand.

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This does not mean, however, that money printing is irrelevant when money demand is stable. To paraphrase former Federal Reserve Chairman Ben Bernanke, money printing may not work in theory, but it works in practice. When a central bank prints money, it restricts the relative supply of assets available to investors, which forces them to hold greater amounts of cash. But investors are rarely satisfied with the returns they obtain from cash, so they will likely seek to rebalance their portfolio out of cash and into riskier assets. This creates a bid for risky assets, leading to asset price inflation (as opposed to consumer price inflation).

Higher risky asset prices should result in lower finance costs for firms and greater wealth for those owning financial assets, both of which tend to raise the demand for goods and investments. By loosening financial conditions, money printing spurs economic growth (benefiting everyone), which, over time, puts pressure on inflation via tightening labor markets and associated wage pressures. So, money printing *can* eventually cause consumer price inflation, but we believe the transmission mechanism is much less dramatic than is implied by Friedman's quote.

Will the U.S. Follow Argentina and Zimbabwe?

So, what went wrong in Venezuela, Argentina, Zimbabwe, and the other countries where money printing generated very high inflation? As might be guessed, none of these countries possess currencies that score particularly highly as a store of value. They also tend to have high inflation expectations (due to a history of political cycles with economic overheating), poor management of the fiscal accounts and property rights, and other items of governance that are, well, not best in


class. If you don't trust your government, you will not store your wealth in money issued by your government.

Worse still, many of these countries operate with severe restrictions on capital outflows, which means that domestic savers cannot even get their hands on a stable foreign currency to keep their savings safe. Instead, they tend to store their wealth in goods (a car will not lose user value in the same way as high inflation might erode the purchasing power of your money). As the supply side is constrained in these economies, hoarding, as a vehicle for wealth storage, leads to shortages and rising goods prices.

It is highly unlikely that the U.S. will follow this path. The dramatic expansion of the Fed's balance sheet is the result of a surge in the demand for high-powered money. Faced with the prospect of at least four weeks of lockdown and, consequently, no income, households and companies rushed to the banks to borrow money to make sure they had access to the dollars they would need to pay for necessities and operating expenses during that period. Through the complicated chains of financial intermediation, this led to a run on the shadow banking system.¹

The Fed's rapid response meant that the shadow banking system avoided the dumping of assets on the market at fire sale prices—in other words, we avoided another Lehman Brothers moment. So the root cause of the increase in the Federal Reserve's balance sheet was an increase in money demand—very different from an implosion in money demand that leads to high consumer price inflation and a run on the currency.

¹ Bank runs occur when many clients try to withdraw their assets from a financial institution at the same time over fears of the institution's solvency. The shadow banking system comprises non-bank financial entities that provide credit and liquidity but which are subject to little, if any, regulation.



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Emerging Markets Could Face Inflationary Challenges

When money demand stabilizes, asset price inflation will likely follow, which is good news for investors. Money demand is a fickle beast: You want cash when it is not available, but not when it is readily available. In my view, we are well through the peak in money demand, and the portfolio rebalancing process has already begun. This explains the rapid recovery we have seen in the U.S. equity markets.

There are additional chapters waiting to be written on the saga of money

printing. Several emerging market economies, for instance, have indicated that they will expand their money base to facilitate the astounding fiscal deterioration that will play out across every economy in the world. And inflation expectations, fiscal management, law and order, and management of the external accounts are not quite as robust in emerging markets as they are in developed economies. Will money demand become unstable, then? Yes, probably, in a few of those countries. But this chapter is still to be written.

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