Epilogue: From Pandemic to High Inflation

Question 1

Simonnot: At the moment of writing this epilogue to our dialogue, the economy of the planet is suddenly ravaged by a global pandemic. The last great world pandemic (the so-called Spanish Flu) claimed the lives of millions. Indeed, those terrible effects were aggravated by the fact that the front-line population attacked by the virus had been weakened during four years of a war which had surpassed all previous records of atrocity. Should one not fear the economic and financial consequences of the present pandemic will be magnified due to our governments having beaten all records in recent years for bad monetary management as we have shown in this book?

Brown: The COVID-19 pandemic and the Crash of March 2020 (from mid-February to mid-March the S&P 500 fell by one third) are intimately connected events. Coincidence and sequencing, however, do not establish causality in any ultimate sense. Rather, we should view the Crash as originating in the preceding years of radical monetary inflation (starting say in 2012/13), which spawned a long and virulent asset inflation.

Asset inflation transitioning into a bust phase (one symptom of this process is stock market crash interpreted to include the phenomenon of two or more crashes say within a year or 18 months with strong rebounds in-between) under the impact of supply shock, in this case pandemic, would have historical parallel. The OPEC Oil Embargo of Autumn 1973 played a starkly visible role in the bursting of the great asset inflation dating back to 1962. (There had been an earlier mini-burst, not fatal to that great asset inflation, in 1969.) The bursting was symptomized by multiple crashes through until winter 1974–75.
The searcher for fundamental causality would look back to the great monetary inflation from the early-mid 60s onwards and the severe tightening of US monetary policy which had started in the spring (1973) in response to a sudden surge of reported goods and services inflation.

Many contemporary observers of global asset inflation in recent years have suggested that a sudden rise of goods inflation and the Federal Reserve’s hypothesized late but tough reaction to this would again be the trigger to burst this time. Another mainstream scenario has been that the narratives which had built up and fuelled hot speculative temperatures would fade amidst accumulating earnings disappointment stemming most likely from over-investment or malinvestment.

History sometimes short-circuits and so it might be with the Great Asset Inflation of 2012/13-20. A massive supply shock—the COVID-19 pandemic—not a spike in goods inflation and the Fed’s response, nor an endogenous fading of narratives, turned up as a powerful potential catalyst to asset inflation transitioning into its burst phase. Income-famine investors chasing thin and highly leveraged returns on risky credit products, comforting themselves by listening to highly speculative narratives about why good fortune would continue indefinitely, suddenly woke up in fright.

The extent of wake-up and of a related burst in asset inflation is still in doubt at the time of this book going to press. A huge known unknown is the length and severity of the pandemic itself. It might still be the case that only harsh monetary tightening will finally burst the Great Asset Inflation. Perhaps that end will come after many years of high goods (and services) inflation in the aftermath of the pandemic. In any case, by mid-July 2020 massive central bank money printing led by the Fed and buttressed by its announcement of vast asset purchase programs in the credit markets had, according to contemporary reports, stimulated considerable new inflows into high-yield debt funds whilst the S&P 500 had recouped almost all of its earlier losses. Large price gains for “pandemic stocks” (businesses making higher profits due to the health emergency—for example big tech firms servicing the “stay at home” economy—or likely gaining further ahead from increased monopoly power) offset stock losses in hard hit sectors.

Amidst concerns about high inflation in the aftermath of the pandemic, a strong precautionary demand for some types of real asset which could not be debased by government (through money printing) would be fully understandable. Most obvious here could be the equity of big tech monopolists (two of these were suffering from a serious decrease in business spending on adverts during the pandemic, but their share of the shrinking pie climbed abruptly) and of the number one on-line retailer also dominant in cloud computing.
Speculative narratives about present and visible potential future monopolists “inheriting the earth” were alive and thriving, not fading.

Speculative frenzy in a recession is not a new phenomenon. In the small sample sizes available from the laboratory of history one could look at the 50 per cent bounce of US stocks from November 1929 to March 1930 or the bubble in oil and commodities during Spring and Summer 2008. No doubt the Fed’s radical response to the pandemic fanned the frenzy in this case. It also produced a remarkable compacency about the danger of global credit crisis which would mean a difficult journey to full economic recovery. After all, collateral for mountains of debt have already been exposed as including huge expanses of malinvestment effected during the past quarter century or more of asset inflation. Think here of the shale oil sector, the airline industry, shopping malls, the auto industry and the huge capital investment of the past quarter-century into global supply chains.

Financial engineers had enjoyed boomtime during the asset inflation. They could thank the weakening of rational scepticism amongst investors due to desperation for yield and an impairment of judgement by strong feedback loops (capital gains enhancing confidence in dubious speculative narratives). They found innovative ways to increase leverage—often camouflaged—and so enable the equity owners to score in a marketplace mesmerized by momentum.

The private equity “industry” was at the forefront of the financial engineering boom. Its basic strategy was buying up companies, revving up their leverage by issuing high-yield debt at sky-high prices, and expecting to re-sell the companies into the public market at substantial capital gain in an ever trend-ing-up equity market. Alongside, the private equity firms promoted to investors credit funds stuffed with high-yield corporate debt. They also became notorious for their network of cronyism in Washington (including revolving doors to top positions and targeted election campaign contributions) and other power centres. No wonder then that in early April 2020, the Fed and Treasury launched a massive corporate debt purchase program which shored up the price of high-yield corporate bonds.

The Fed programs for buying corporate debt became the subject of a powerful speculative narrative, lifting the price of both this and equity. According to the story-tellers the Fed would be holding down the cost of corporate credit into the long run and extinguishing bankruptcy risk over large parts of the US business landscape. In rational mode, investors would have been sceptical, viewing the Fed as a price taker rather than maker in the context of huge global credit and equity markets. The corporate debt in the Fed’s balance sheets would surely not become gifts, rolled over in perpetuity at artificially low credit cost to the borrower. In a bankruptcy, the Fed would try to salvage
what it could alongside other creditors (albeit that the Treasury in its role as limited partial insurer of the Fed with respect to corporate paper holdings would be an active party in such proceedings).

More generally, in a sober-rational marketplace, firms (especially those in sectors greatly exposed to the business cycle) would not find themselves piling on new debt to an already highly leveraged capital structure in the midst of a pandemic. They would have bolstered the share of equity in their capital structure during the good times (and well beyond the superficial rise of the equity–debt ratio, as calculated on the basis of market prices, brought about by hot speculative temperatures during the asset inflation).

If COVID 19 had struck the global economy under a sound money regime, rather than the current actual highly unsound one, there would still have been economic costs alongside human suffering. The economic system, however, would have had great potential to absorb shock. Instead, asset inflation had caused serious mis-signalling by capital market prices over many years and this had curtailed any shock-absorption capacity. Financial fragility had grown in line with rapidly accumulating malinvestment and swollen leverage.

The corollary of severely damaged shock absorbers: big government with its massive money printing apparatus responded to the pandemic in spring 2020 by orchestrating an emergency explosion of public and private debt, declaring there was no alternative way to avoid national calamity. Common sense seemed to rule out any alternative course. Anyhow, the money printers had just been absolved of any possible blame for burst, crash, or recession in the present; it was all the fault of COVID-19, stupid!

Citizens beware: did Adam Smith not say “there is a lot of ruin in a nation” (meaning that in a wealthy free market economy the scope for recovery from adverse shock is huge; Smith was admonishing a student for declaring that the loss of the American colonies would spell ruin for Britain); and do we not know from history that the political force of debtors (both private and public sector) standing to benefit from high inflation to cut the real value of their liabilities can destroy even the most powerful of fiat monies?

The business sector with a normal thick cushion of equity capital (as under sound money) could have borne in general the brunt of supply shock, in this case pandemic. According to the implicit “social contract” of capitalism, equity shareholders (business owners) earn a risk premium which in part reflects the fact that when adverse events occur they are in the front line (rather than the wage earners or secured bond holders).
Under a sound money regime, yes, the supply shock would deplete equity cushions. The rational response across many firms would be to make these good by issuing more equity in exchange for debt. If the equity owners are not at bankruptcy’s door (which for the main part they would not be in the hypothetical situation of having raised plenty of equity capital during the good times), they should be able to reach a cooperative agreement with debt holders on a strategy (of which key component is debt–equity swap) whereby both share the gains from a strengthening of the corporate balance sheet (thereby reducing the danger of bankruptcy and its deadweight costs for all). The financially restructured firm would be in a better position to raise capital as might be required during the continuation of the pandemic and its aftermath. Much of that capital would be in the form of equity rather than debt.

Equity markets under sound money would price in the loss of corporate earnings during the duration of the supply shock. Tapping the equity market for new funds under those circumstances would be a fully sensible and feasible strategy for many businesses.

By contrast, if the supply shock were to coincide at some stage with an implosion of speculative narratives and bubble bursting (notwithstanding massive money printing), the loss of market value (debt plus equity) across the business sector might well go far beyond any actuarial appraisal of cumulative earnings loss. Many highly leveraged businesses (note that at market value the leverage ratio rises as equity prices fall) would find themselves at bankruptcy’s door.

In the context of crash and speculative liquidation, only a feeble supply of new capital (from private sources) would come into the enterprise sector to bolster firms’ preparedness (including balance sheet repair) to meet the rebound in economic activity likely to follow the supply shock and to bridge transitory losses during the pandemic. Hence, the state enters the stage as the lender “of last resort” to salvage the system, presiding over a fantastic growth in borrowing backed by the central bank (usually on condition that the finance ministry or treasury is providing a backstop up to a given date, including at least a limited insurance of the central bank against loss on extended credit). By reducing the real value of those loans, high inflation can make feasible an eventual return of the borrower to private capital markets without government (also the central bank) help. In effect, high inflation reduces leverage of firms which have revenues and assets which rise with prices of goods and services on average, so long as nominal interest rates remain far below the current inflation rate.
Simonnot: On March 12, 2020, Christine Lagarde, president of the ECB, at a press conference, uttered this phrase, immediately judged by markets as dangerous: “It is not the job of the ECB to tighten the spread” (the difference between the yield on government bonds, viewed as the safest paper, and that on the bonds of other member countries). The Italian spread jumped, moving in a few days from 1.6% to 2.6%. Mme Lagarde seemed to be taking an opposite position to her predecessor, Sig. Draghi. This panic response in the markets where one envisaged already a dislocation of the euro-zone forced Mme Lagarde to change her tune. Two days later she launched a record asset purchase programme amounting to €750 billion. Didn't that violate the founding treaties of the European Monetary Union and without any voice of protest? And where will this course of action now lead us?

Brown: Perhaps the best way to interpret Mme. Lagarde's initial statement is as part of a continuing game-plan to build Berlin's trust in her. Surely, she intended to draw on that reservoir later to progress a “European” agenda as favoured of course in Paris. Consistent with that hypothesis, at the same press conference she also ruled out a cut of the deposit rate at the ECB further into negative territory—knowing full well that negative rates are especially unpopular in Germany. But this publicly aired confidence-building exercise by Chief Lagarde did not go down well in the marketplace where many were unconvinced that this was just a diplomatic sweetener without any real content.

In justifying previous support operations for weak members, the line from the ECB had been that the operation of a common monetary policy for the whole euro-zone meant the suppression of any “country premium” emerging on money market rates within the union (e.g. Italian banks paying a higher wholesale money rate than banks elsewhere). Mme. Lagarde was surely not questioning that line. Anyhow, given the market jitters, she followed up with the aggressive asset purchase program. The Machiavellian analyst could argue even that she took a gamble with testing the market at the press conference with the purpose of demonstrating to Berlin that a bold asset purchase program, presumably growing in spurt going forward, was essential to monetary union holding together.

Why no protest? The battle against the ECB conducting huge operations involving implicit transfers from strong to weak members had long since been lost. There was surely no chance of the few constitutionalists and hard money advocates left (essentially in Germany) in launching a successful new offensive in the midst of pandemic. The German Constitutional Court did rule in
May 2020 that an earlier asset purchase program by the ECB seemed to have “disproportional” broad effects outside its stated purpose of achieving the inflation target. The German government should put this concern to the ECB and do a better job of getting justifications, if any. Surely, however, Angela Merkel, now riding high in the opinion polls due to her perceived successes in dealing with the pandemic, would sort this difficulty out with Christine Lagarde. The Chancellor, after all, had consented to the now disputed program in a direct meeting with the previous ECB Chief, Mario Draghi. Chancellor Merkel could still pander to voters on the anti-euro right, standing firm against coronavirus bonds whilst cynically acknowledging in quiet that the amount of funds exiting the ECB back door to the weak nations exceeded many times over any amount from such open operations. In the midst of pandemic, Chancellor Merkel could even support further quantitative easing operations in the ECB bought large amounts of weak sovereign debt (along with the strong in due proportion) as essential to “combating deflation and depression”).

Yes, it seems that EMU is headed down a new express journey of vast transfers via the ECB to the weak nations—most of all Italy and followed by Spain. One can even imagine France being drawn into the weak category given the severity of the pandemic there and the high exposure of its banks to Italian risk amongst other issues. Indeed, it seems that France will be in the same semi-weak category with respect to the China-style stimulus plan for pandemic-struck regions of the EU as proposed by Chancellor Merkel and President Macron in May and approved by a special summit in Brussels at end-July (2020). Poland and Hungary are due to be the biggest recipients of aid per capita with Italy receiving a net cumulative amount for approved projects of around 6% of its GDP, whilst its government debt to GDP ratio was set to exceed 150% in 2021. The agreement was for an EU-wide total of €390bn of gifts and €360bn of concessionary loans to be disbursed over seven years from a fund financed by bonds issued in the name of the EU and repaid by budget contributions from all EU members in treaty-set proportions.

The potential ultimate brake on all of this: a swing in the German political pendulum away from eurocentrism to hard money principles, with populists stirring justifiable fears about German taxpayers eventually bailing out the ECB or the ECB resorting to high inflation to remain solvent. The origins of this high inflation would be the ECB powerless to “normalize” policy when the post-pandemic boom eventually arrives, given that its balance sheet is full of junk. The ECB would realize that huge losses consequent to “normalization”, whether derived from disposals of junk or from the spread widening between what this institution pays on deposits and what it could collect from its loans, could inflame German populist anger.
Simonnot: In the US during the night of 24–25 March, 2020, the Congressional leaders of the Republicans and Democrats agreed on a $2000 billion “stimulus” plan. This plan, beating all previous records (including Roosevelt), includes a direct distribution of $500 billion to individuals. Helicopter money had taken off for good purpose—could one have done anything differently under such circumstances? And what will be the result?

Brown: The distribution of helicopter money under these circumstances is an absurdity. This cannot ameliorate or reverse what is fundamentally a supply shock (pandemic). The essence of this supply shock is that suddenly safe and infection-free services (e.g. travel, eating out, shopping in brick-and-mortar stores, concerts, sport events) become unavailable across a broad span of the global economy. Instead, these services in established form now carry serious virus risk; demand may be so weak as to prompt widespread stoppage and shutdown. Potentially, suppliers could modify services to become less subject to virus risk (e.g. airlines keeping half their seats empty, stores limiting number of customers inside at any time); in the midst of the pandemic, those modified services might enjoy demand such that the supplier could charge premium prices (relative to the pre-pandemic prices) or otherwise limit access by the imposing of time-waste (in line-ups for example). In practice, governments step in and impose rationing and shutdowns.

Also, in the pandemic, many forms of labour become vulnerable to infection (one can think here of the worker in on-line distribution warehouses). Employers could reduce that infection risk—for example, keeping bigger distance between workers or in meat-packing plants; that would mean less output, less efficiency and thereby higher unit costs (some of which might be passed on to customers, depending on specific market conditions, including present shortages). How far they move in that direction depends on the bargaining power of labour (e.g. to demand big supplements to their wages for bearing infection risk, buttressed by ability to demand compensation and re-employment rights when electing to withdraw from employment during the pandemic) and on emergency regulations to protect worker safety.

For government, there are three broad economic policy responses to the pandemic supply shock, transcending the detailed enforcement of rights as described, which would be consistent with free markets and sound money—and indeed we could imagine these as hypothetically taking place under a gold standard regime.
First, there would be an expansion of social insurance to alleviate the situation of pandemic victims (including those who become unemployed—whether through lay-off or withdrawal from the workplace due to especially high vulnerability to the virus whether on account of age or medical conditions—and small businesses which lose the bulk if not all of their revenues and never had the potential like larger public companies to build equity cushions by new issuance during the good times). Alongside the big prospective rise in public sector outstanding debt related to funding expanded social insurance, the government would announce a long-run plan for post-pandemic fiscal normalization, including items such as a 10-year solidarity tax heavily focused on monopoly rents.

The details might not be legislated until the pandemic were over. But the knowledge that such fiscal action lay ahead would sustain confidence in the long-run continuation of the sound-money regime and avert a possible slump in the government bond market (provoked by anxiety about permanently vast funding requirements or in the context of say a gold standard by a feared suspension of convertibility). Alongside this social security funding, there is the question of a big bulge in government deficits (federal, local and state) due to fall in tax revenues as the economy shrinks under the supply shock. Long-term fiscal plans should illuminate how tax revenues in a post-pandemic boom would be used towards retiring debt raised during the pandemic. Under a sound money regime (including gold), confidence in such planning would be essential to allaying fears that the exit from public debt explosion will be currency debasement.

Second, the government would help provide an obstacle-free setting where debt–equity swaps could take off to a huge extent towards reversing damage to corporate financial structures including the banking sector as outlined in the answer to question one. Limited and selective debt moratoriums, which could be lifted on application by the creditor, if offering to negotiate (with the debtor) a prescribed loan modification including debt–equity swaps, could be part of that process.

Third, the central bank would boost its supply of high-powered money to meet an increase in demand for this (currency and deposits at the central bank). This surge would be due to multiple factors—including widespread distrust of banks, as depositors worried that credit impairment especially in sectors of the economy most hit by supply shock could mean bank failures. (In the context of a competitive and well-capitalized banking system, not plagued by potential malinvestment and over-leverage from asset inflation, these worries should be subdued.)
Some banks might find they are suddenly obliged to honour lines of credit to now weak borrowers and that they have problems with raising funds in the deposit markets (including from other banks) to cope with this; so they have to be able to liquidate other assets in exchange for high-powered money. This increase in high-powered money supply occurred even under the context of the gold standard, where according to Bagehot’s principles, the central bank increased temporarily its supply of banknotes and deposits (with itself) in a crisis, but crucially coupling this with an absolute commitment to withdraw the extra high-powered money once the crisis is over.

Back to the US package of March 24/25. This was totally different in concept from the above. First, there was the helicopter money distribution to a very large majority of taxpayers irrespective of insurance need. Second there were massive bail-outs to particular hard-hit industries (including airplanes)—in effect sparing present shareholders from greater loss, never mind that their companies had not raised equity during the good times (and in many cases bought this back thereby increasing effective leverage). Also, the Treasury was to spend up to $500 billion on insuring the Federal Reserve against losses on its holdings of corporate debt as a backstop so that the central bank could buy much larger quantities of such paper consistent with its legal mandate. Finally, the infinite QE and zero rate policy announced by the Fed alongside had no time limit and absolutely no promise of reversal when the crisis was over.

A widespread view that the exit strategy from massive increases in government debt (and some contemporary projections put the 2-year increase in Federal debt at 35% of GDP) would be a vast levying of inflation tax is fully understandable. Indeed stripped of the ability to levy this tax (as would be the case under a sound money regime), or its variant of monetary repression tax, big government may have given much more painstaking consideration (perhaps in the midst of a tumbling market for its debt) to alternative strategies for coping with the medical emergency which would not impose the vast costs of a command-economy “lockdown”.

We can think of a wartime analogy, though not complete. Large sections of enterprise and labour becoming economically inactive during the pandemic has similarity to large parts of civilian industry and employment becoming redundant during war and re-directed (either by market forces or conscription) to military combat and munitions production. The “emigres” from peacetime economic sectors (production of butter) get pay instead for producing and using munitions (guns). Supply restraints during the pandemic or war (intensified by mandatory rationing or shutdowns) go along with elevated savings. Some economists describe these as “forced saving”—an appropriate label where rationing or other obstacles to consumption are widespread.
during the emergency, but less so where households are responding to high prices in the immediate reflecting supply shortages in the expectation that lower prices for these items will prevail later. These high savings flow directly or indirectly into vast government bond issuance whilst investment in the peacetime or non-health-sector related economy collapses. In the aftermath of war or pandemic, these forced savings become an element in pent-up demand.

During the supply shock itself, whether war or pandemic, big government assumes emergency powers which impede markets responding freely and efficiently to scarcity, all amidst much deference to “fairness” and “social cohesion”. Big business out of self-interest may well visibly respect this deference. Why risk incurring political backlash against “price gouging” when doing very well from the authorities turning a blind eye to their monopolistic abuses and meanwhile winning the prizes of cronyism?

The supply shortages during war are more acute than in pandemic because the non-civilian economy, the military sector (including defense forces and munition factories) is bidding for labor and commodities. In the pandemic, analogous shortages emanate from demand for resources by the health sector, the pharmaceutical industry, the manufacturers of protective clothing and sanitizers, equipment and chemicals, and constructors of partition systems for social distancing. In broad terms we can compare the big price rises for “war stocks” with those of the “pandemic stocks”.

During war, rationing is instituted on the claim that allowing steep price rises for certain staples, especially food, would stimulate social divisiveness rather than national cohesion. During a pandemic, premium prices which would allow some consumers to enjoy special low infection-risk services, without any indirect rationing in the form of waiting in line or spending hours online, are branded “socially unacceptable”. In many countries, choice in health care including access to premium services is totally suspended, with all medical resources relevant to the pandemic requisitioned by the national health provider. These types of restrictions fade once the emergency is over as and when determined by government.

The end of war or pandemic brings about a vigorous economic expansion (specifically in the non-military or non-health sectors) from a sunken level. (Peace or end of pandemic should be distinguished from armed truces or pauses in the conflict with further offensives still probable in the near term; sometimes the distinction relates mainly to “state of mind”, as conflict and illness can be eternal). Supply and demand bounce upwards; business non-military or non-health capital spending is a key swing variable, rising from its depressed level during the war or pandemic. But there will be severe restraints on supply during the re-bound; in the case of war these restraints take the
form of physical destruction (plant, equipment, infrastructure), accumulated obsolescence and some financial crippling; in the case of pandemic serious financial crippling, also accompanied by evidence of destruction in the sense of revealed malinvestment from previous asset inflation.

In both cases, given its huge indebtedness, government is keen to have its central bank suppress its cost of borrowing whether by monetary repression or inflation taxation. The combination of emerging capital shortage (explained by previous capital stock destruction or obsolescence matched by the growth of new investment opportunity) and curtailed supply of savings (households now have so much additional personal wealth in government debt and money issued during the war or pandemic to finance “transfers”—whether salaries in the military sector or stay-at-home supplements—that they now opt for a savings holiday) causes interest rates to come under upward pressure. The central bank resists this and so starts the journey to high inflation. In effect, high inflation is a windfall tax on capital invested directly or indirectly in loans to government and it may induce an increase in savings as households try to rebuild their wealth.

The exact path of post-pandemic high inflation including its starting date is unknowable in advance. Much depends on the extent of supply-side impairment, monopoly pricing power of the financial fit and related impairment of competition, weakening of non-monetary disinflation (including globalization) and pent-up demand.

Government actions during the Covid-19 pandemic have tended to enhance monopoly power, already well entrenched due to preceding asset inflation. For example, there was the heavy-handed closing down of brick-and-mortar stores coupled with a lack of safety regulation or market power for labour (together with legal steps to impede virus spread) in the warehouse distribution systems vital to online shopping. Separately, “cooperation” between the big tech monopolists in tracking virus spread was welcomed by Big Government rather than setting off an alarm in anti-trust enforcement offices (admittedly this alarm had long been dysfunctional). The monopolists and oligopolists claimed that their goods and services were essential to sustaining economic life during the pandemic; but 5 Apples, 5 Amazons, 5 Microsofts, 5 Facebooks, and 5 Googles, and so on could surely have done this in a more consumer and liberty-friendly way. Virulent asset inflation, however, in the decades before had smothered that potential.

In the post-pandemic economy high unemployment and high inflation could co-exist, explained by the heterogeneity in the labour market, and sudden obsolescence of human capital in occupations allied to now exposed mal-investment from the last cycle. Tightness could develop in broad sub-sectors, even with high unemployment persistent elsewhere.
What we do know in advance is that governments of several large economies with projected outstanding debt in 2021 totalling some 30–35 percentage points higher relative to GDP than on the eve of the pandemic, private sector borrowers lamed by crushingly high leverage, and pension funds massively invested in vulnerable high-yield corporate debt matched at least partly by their own fixed nominal pay-out streams, are well-disposed to inflation. They would cheer (at least in silence) the central bank seizing any opportunity presented by a rise of inflation momentum to press down hard on the monetary accelerator by vetoing any rise in nominal interest rates. In the interim, before the outbreak of high inflation, they will also be partisans of monetary repression—meaning interest rates manipulated downwards in the context of inflation obstinately low due to the operation of non-monetary disinflationary forces (including business cycle weakness, plentiful availability of commodity resources, for example).

Doesn’t Japanese history, though, suggest that huge public sector indebtedness on its own is not a sufficient condition for a transition to high inflation? The concise answer is no. In Japan, virtually a one-party democracy, a highly distorted electoral system gives disproportional power to elderly conservative savers (who would have considerable clout even without distortions). In the last quarter century, there have been tremendous cumulative real income gains in Japan from that country’s rapid integration with East Asia; and so there has been no groundswell of discontent focused on the critique that the huge absorption of savings by the public sector has meant the Japanese are poorer than otherwise. The corporate sector has de-leveraged in the decades since the late 1980s’ bubble economy, all within the context of a huge private sector savings surplus.

Now, as real income gains from integration with East Asia (especially China) go into reverse, public finances ailing accelerates markedly, and banking sector plus pension woes related to bad investments during the great global asset inflation of the past decade and beyond materialize, the same coalition of forces in favour of high inflation could emerge in Japan as elsewhere. One-party democracy could suddenly spawn victory for a new populist party.

Question 4

Simonnot: Since the eruption of the medical crisis, the euro-zone has become more divided than ever before, notably on the eventual issue of corona-bonds. What should we make of this new attempt to mutualize debts?
As regards the Franco-German “monetary coup”, which we described earlier in this dialogue, is this aggravated disunity not an opportunity?

If yes, how to seize it?

Brown: It is wholly understandable that the governments of countries in the European Monetary Union hardest hit by the pandemic (whatever the mix of factors in that vulnerability) should play to European solidarity to get outside aid and reduce the eventual fiscal burden (including potential inflation tax burden) on their own citizens. Outside aid would be both for contributing to expanded social security and to aid firms (including banks) on verge of collapse. As a practical matter, the hardest hit member countries are also the financially weakest (Italy and Spain). Underpinning their calls for “European solidarity” has been the implicit threat that otherwise their dire situation would “bring the whole house down”, meaning that an existential crisis for the European Monetary Union with its epicentre in the weak sovereigns would erupt.

We should view the whole discussion of corona-bonds within that context. The challenge for the weak (in terms of credit rating) governments pressing the case for these bonds to be issued has been at a public relations level. Their goal has been to turn sympathy for the plight of those suffering a humanitarian crisis in the South into support for European solidarity where that means huge aid directly or indirectly to Rome and Madrid. Governments joining to issue bonds whose proceeds are primarily destined for Italy and Spain but backed jointly and severally by all is a form of aid from the North to South, albeit camouflaged to a small extent.

How to turn humanitarian concern into European solidarity expressed as fiscal transfers to governments and the elites in the South? Unhelpful in this regard has been the broad knowledge about health service incompetence in the South—including flawed strategies for containment at the start (even if geneticists now trace Munich as one original source of infection into Italy), then the lack of hospital intensive care capacity and related protocols which denied COVID-19 patients hospital admission until it was often too late to administer successfully any therapeutic cure.

All this was not due to disparity of income levels between North and South but specific institutional and policy failure. So how now to politically justify solidarity with the governments and elites which had failed their peoples, even more than had been the case in the North? Surely European solidarity in the context of pandemic should mean first and foremost mutual aid in improving health sector response through close sharing of data and of specific resources (including new drugs, equipment, vaccines, human capital) or research where possible.
Yet could there be anything intrinsic to monetary union in Europe which obligates the financially stronger to aid the financially weaker—also in this case the hardest hit—in times of natural disaster, in this case pandemic? The short answer is no. In the counterfactual case of pandemic striking countries under a gold standard regime, the weak and worst hit countries would likely be forced into suspending gold convertibility. They could then resort to the money printing press to meet emergency financial requirements amidst a sharp devaluation of their now fiat currency.

By contrast, the financially strong countries under the gold standard have scope to make an emergency issuance of high-powered money in the form of banknotes and deposits at the central bank (subject to retirement after the crisis) without undermining confidence in their continued adherence to gold convertibility of their money. Their promise to take remedial fiscal action after the crisis and recession is over would be credible in the marketplace.

A gold-based regime does not rule out European or any other type of solidarity in its widest sense, if there is indeed the political backing for this. Germany and other more fortunate North European countries could decide to make mega-aid available to Italy, where the principle of European solidarity was buttressed by calculations of long-time economic and geo-political advantage. Solidarity, however, would not be built in to the “automatic rules of the gold standard”.

In our earlier dialogue we discussed a new euro based on gold. If pandemic had struck this, and Italy had been in this new euro union, what would have occurred without European solidarity? Analogous to under the gold standard, the Italian state and banks would have paid out obligations as they fell due in paper Italian euros, no longer convertible into gold (or the European euro). Deposits at Italian banks would no longer have been transferable at par within the European payments system.

The Maastricht Treaty makes no provision for temporary exit from monetary union. Forced exit could nonetheless occur, but there is no ready-made protocol. Taking the legal texts at face value, whereby temporary exits are impossible, the rules of the game do indeed induce a degree of European solidarity, most directly in the form of the ECB acting as transfer agent, lending through its front and back doors into the weak countries (with little prospect of repayment) and borrowing in the strong.

In the pandemic crisis that means the ECB prints money which flows into Italy and Spain for meeting emergency financial needs of the sovereigns and banks there; but the increase in deposits which match this lending does not stay in those weak countries, instead they flow principally to Germany, where deposits are viewed as safer (in terms of default risk and currency risk, were
EMU to break up). The target 2 credit of the Bundesbank with the ECB correspondingly explodes, with counterpart debits for Italy and Spain.

Ultimately, German taxpayers could escape the intensification of long-run burden implicit in all this by the Federal Republic pulling out of EMU (and possibly launching a new euro with narrower membership) and converting only euro-denominated domestic assets (German government bonds, German bank deposits) held by German citizens (not foreigners) into the new Deutsche mark; or alternatively going along with high euro-inflation, in which case inflation tax is levied on all euro-citizens, including Italian and Spanish. High inflation would wipe out in real terms much of the indebtedness of weak sovereign and banks in Europe, so bolstering the viability of monetary union going forward subject to one big proviso. The high inflation debt cure might turn the public, especially in the North, against the whole euro-project, and bolster the yearning for a return of the Deutsche mark.

Is there any prospect that a French-German monetary coup could emerge from these profound challenges? During the height of the pandemic this seems remote. Any possibility of sound money reform is off the table for now. The Merkel government is seeking to impose some accountability and medical prioritization for aid, though this is effectively undermined by its tolerance of unrestricted backdoor lending via the ECB and its backing of EU budget expansion for a pandemic aid fund (the so-called Macron-Merkel plan). Perhaps in the aftermath of pandemic, the German electorate will shift towards supporting euro-reform in a sound direction and that could frighten the French euro-centrist establishment into new diplomacy with Berlin involving a new euro—but any sign of this is absent at this stage.

**Question 5**

Simonnot: Under these conditions, doesn’t “dollar hegemony” as we have described it in this book risk becoming prolonged and even reinforced?

Brown: The most likely aftermath of pandemic—an era of high global inflation in which the US is leading the way with infinite QE and endless zero rate policy—would challenge dollar hegemony. Ultimately though, high inflation could set off a chain of events which would enhance dollar hegemony.

As inflation rises to a high level (say 5–10%) it also becomes more variable. No longer would there be steady-state expectations as when inflation has been running near 2% for many years. Along with the increased perceived variance of inflation both in the US and abroad nominal exchange rates of the dollar against foreign currencies would become more variable. A tendency of a rise
inflation to foster anxiety about even higher inflation could cause the dollar to fall into a downward spiral. For example, were the US to enter a period of high inflation compared to Europe the dollar could sink far in real terms; and conversely when European inflation was higher than in the US, the euro could fall into a downward spiral against the dollar.

The greater volatility of exchange rates both in nominal and real terms would mean greater insulation between the various currency areas. A big and variable exchange risk premium between the dollar and foreign currencies means greater scope for monetary independence. Businesses and individuals would become more expert at hedging exchange risk exposures; global investors would see benefits in terms of reducing exposure to inflation risks in holding a diversified portfolio of currencies, less concentrated on dollars than previously. Central banks outside the US would have a stronger rationale to aim for a radically different monetary policy—even sound money—at the cost of considerable pain for their export sector in the short run from exchange rate appreciation. By contrast, during the era of the 2% inflation standard (say mid-1990s to 2020) the benefits of sound money versus low inflation may not have justified (from the perspective of the governments ultimately responsible) a dash for monetary independence by countries outside the US.

A journey of the euro-zone into much higher inflation than the US could stop and reverse the decline of US hegemony under conditions of global high inflation. A long drawn-out existential crisis of the euro would have similar effect. The next chapter in that story could be the birth of our new euro which would challenge dollar hegemony.

Could dollar hegemony finally emerge in strengthened form from all these possible variations in the high inflation aftermath of the pandemic? That depends on whether a powerful political force forms in the US which would repudiate high inflation. If a sound money revolution were to triumph there, and sustain itself in the long run, the dollar could enter a golden century of global hegemony. That would be progress for humanity and more narrowly for Europe from the crisis-ridden century of unsound dollar hegemony which opened in the immediate aftermath of the First World War.