Hans-Werner Sinn

THE MIRACULOUS MONEY CREATION

National Debt, Negative Interest Rates, Inflation

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1. Introduction and Brief Overview: The Danger of Inflation

Europe is awash with money, but that doesn't make it rich because money is merely paper or a digit in a computer. It can create dangerous illusions, as a multitude of inflationary events in human history has shown. Similar to numerous predecessors in past centuries, the governments of the Eurozone countries have had their central banks print the money they believed they could not extract from citizens during the Euro crisis and the subsequent COVID-19 crisis. The Eurozone countries used the money to pay for the services they used and the goods they acquired, as well as to distribute social transfers and subsidies. Businesses and citizens received replacement incomes from the printing press, which took the place of sluggishly flowing market incomes. Additionally, some new money flowed as credit to the private sector, including builders, but that was only a small part of the overall scenario.

Certainly, the money was subsequently passed on by the recipients to others, who were now better able to sell their services. There were positive multiplier effects on the economic cycle. And it never flowed directly to the countries. Private commercial banks always acted as credit intermediaries. They obtained newly printed credit money from central banks, which they soon lent to governments and, in some cases, to companies and households. The banks made little use of the possibility to additionally create credit money from the base stock of central bank money circulating with them. With the new money, claims on goods and services were distributed that went far beyond what could be produced.

While the revenues of companies and the income of states typically come from the money already in circulation, which only changes hands when it is sold and taxes are paid, the money lent by central banks is provided without the public sector having to perform any service or take money from anyone. Apparently, no one has to forego the acquisition of goods that they could otherwise have purchased with their money. Manna seems to rain from heaven.

But appearances are deceptive because there are no mysterious powers capable of conjuring resources out of thin air for an economy. Money represents claims on portions of the national product, and if its quantity grows faster than the national product, there is a risk of inflation. There is no virulent danger when this money circulates unused in the financial world or is hoarded. However, if an excess of money is

created and distributed, and if money holders suddenly decide to exchange this money for the purchase of consumer and investment goods, and the sellers do the same with the money they receive, the value of monety value may erode very quickly.

This does not fundamentally argue against a policy of temporary monetary expansion. There are situations in which the drug of fresh money can stimulate a sluggish economy or save it from the forces of international speculation. It can therefore be assumed that the purchase of government bonds with the new money may have temporarily averted financial crises and national bankruptcies when international speculation lost faith in the stability of the Eurozone in the years following the financial crisis. States and banks remained solvent, and their creditors, investors from all over the world, were protected from bankruptcies. Chain reactions leading to a financial crash were avoided. In moderation, the printing of new money can indeed be justified if it serves to avoid temporary liquidity shortages but not to prevent a genuine insolvency caused by a flawed business model. However, a phase of reducing the money supply should follow thereafter.

The money supply in the Eurozone was primarily inflated through extensive government bond purchases, a practice that the ECB claims is done to generate moderate inflation. The ECB asserts that the Maastricht Treaty obliges it to pursue such inflation because it is tantamount to maintaining price stability. However, for many years inflation did not materialize because the newly created money was hoarded by banks and other market participants. This lack of effectiveness prompted the ECB to acquire more and more government bonds with fresh money from the printing presses.

The stock of central bank money in the Eurozone has increased almost sevenfold since the start of the financial crisis in the summer of 2008 until the last revision of this manuscript in September 2021, from 880 billion to almost exactly 6 trillion euros – much faster than economic output has risen. Of this, 4.9 trillion euros represent an excess of money above the level of money supply that had already proven to be sufficient for the Eurozone in relation to economic output before the Lehman crisis. Until September 2021, about four-fifths of this excess money had come into circulation through the purchase of government bonds. Approximately 70% of the economic deficits of the Eurozone countries during the crisis years since 2008 were financed by central banks via intermediary commercial banks. Nevertheless, according to the

European Court of Justice (ECJ), the monetization of government debt, prohibited by the Maastricht Treaty, did not take place. Everything complied with the agreed rules, it declared to the skeptical Federal Constitutional Court of Germany (BVerfG).

Meanwhile, however, inflation has begun. As the demand effect of government deficits coincided with the shortage of materials at the end of the pandemic, 2021 saw a knock-on inflation. In the coming years, further catalytic effects can be expected in a cost surge due to the energy transition, the retirement of the baby boomers, and a devaluation of the euro caused by interest rate differentials. All of these knock-on effects could lead to a change in inflation expectations, setting off a self-reinforcing inflationary spiral, in which the money surplus is discharged in an inflationary manner, similar to ketchup that has been in the fridge for a long time and squirts out of the bottle all at once after being shaken.

If such a situation were to arise, central banks would have to collect the surplus money by reselling the government bonds they have taken possession of. As countries would face considerable difficulties in the form of rising financing burdens, and banks, holding similar securities on their books, would have to absorb dangerous depreciation losses on their investment portfolios, it is to be expected that the Governing Council of the European Central Bank (ECB) will be very hesitant, if at all, to reduce the money supply. The knock-on effect is hitting an economy whose inflation brake has been destroyed.

The redistributive effects triggered by a potential inflation are already very problematic in themselves, as they do not only affect the money holders themselves but also those segments of the population whose income is not inflation-proof and that is not rich enough to acquire real capital in the form of real estate or business holdings. Those who own Riester retirement plans, savings accounts, fixed-interest securities, or life-insurance policies, namely the lower middle class, are losing out. These savers are already losing their interest income due to the loose monetary policy and look ahead to their retirement with trepidation. If, one day, they discover that they are also losing their saved capital due to inflation, they will likely rebel and voice their dissatisfaction. Political consequences of significant magnitude cannot be ruled out.

Their frustration would be all too understandable. There are millions of citizens who do their hard work day in day out to buy essential goods and save up a few euros for their old age. They must count their euros carefully before spending them. By

contrast, there are those who have benefited directly or indirectly from the additional creation of money amounting to thousands of billions of euros, allowing them to acquire such goods easily. These include not only those whose incomes were supported as part of the COVID-19 policy measures but also the owners of large investment portfolios from around the world, whose claims against governments and private debtors that might otherwise have gone bankrupt, were saved.

The one toils to scrape together a bit of money, while the other is shielded from the consequences of their own bad investments by political processes, or they come into unexpected wealth without having had to make an effort. Pointing out this distribution conflict may have populist overtones, but it illuminates a core societal problem. Any responsible citizen must be deeply aware of this fact.

The nonchalance with which Brussels and Berlin are handing out billions of euros from the printing press, to protect creditors from the bankruptcy of their debtors or to distribute gifts, stands in stark contradiction to the value that money holds for the citizen who must earn it anew day after day by working to make ends meet.

The distribution issue arises not only within an individual country but also on an international level because – as measured by the so-called Target balances – a significant portion of the new money ended up in exchange for goods and assets in Germany. For the Bundesbank, and hence for the Federal Republic of Germany and its citizens, the risk of inflation also includes the danger of losing claims resulting from the imbalances in intra-European payment transactions.

All this is already problematic because the fundamental decisions were made by an institution, the ECB, which operates outside of any democratic control, which, according to the Federal Constitutional Court of Germany, is suspected of violating its mandate and is not even controlled by a court of auditors. This institution distributes bailout money from the printing press and makes bailout promises as it sees fit. Not only does it rescue governments but, above all, investors from all over the world who have recklessly stocked up on the bonds of highly indebted states, knowing full well that the ECB is assuming the risks.

The stability of money is a fundamental prerequisite for a market economy because it enables the smooth exchange of goods within a period of time and between these periods. One person is bold enough to save, abstains today and, in the form of money, relinquishes their claims on goods to other persons, who use it to finance investments they cannot cover with their current income. From these investments a

real capital stock emerges which, if not destroyed by wars, over time leads to in an increasing demand for labor. Via competition between companies, this results in ever higher wages and a higher standard of living for the masses. The process by which savings are transformed into investments and real capital is in fact the source of economic growth and prosperity for all. With inflation there is the danger that savers are reluctant to lend their money because inflation is fundamentally unpredictable and creates uncertainty for both the creditor and the debtor regarding the amount of real repayments and interest charges to be paid under a loan agreement. This uncertainty is like sand in the gears of a market economy and society.

In a hyperinflation scenario, as was the case in Germany 100 years ago, even the regular exchange of goods and services can be affected. This is because a significant devaluation of money occurs between the receipt of a sum of money and its expenditure for imminent consumption. Money then loses its function as a means of exchange, and people have to resort to the cumbersome practice of barter trade that was common before the monetary system evolved.

In his memoirs, Stefan Zweig vividly described how the German hyperinflation of the early 1920s affected people's daily lives. He portrayed the impoverishment of the lower middle class and the demoralizing experience of women taking the wage packets from their husbands at the factory gates to exchange them for consumer goods before the daily inflation eroded their value. Zweig also emphasized how inflation led to political radicalization in the Weimar Republic:[1]

> "Nothing ever made the German people – this must always be kept in mind – as bitter, as hateful, and as ready for Hitler as inflation."[2]

Even a purely academic economist who is wont to see inflation as a mere mathematical formula, would do well to read Zweig's numerous vivid descriptions of life and personal catastrophes in times of inflation, so as to intuitively grasp what is at stake and to understand the preciousness of monetary stability.

This book does not foresee an inflation like the one that occurred 100 years ago. There are no concrete grounds for such a scenario. However, we will show that there

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[1] Translated from: Stefan Zweig, Die Welt von Gestern, Kopenhagen 1942, 5th edition, Insel-Verlag: Berlin 2019, p. 334 ff.

[2] Ibid., p. 359.

are parallels to the inflation of the 1970s in terms of knock-on effects. The average annual inflation rate was around 5% at the time. Therefore, it is prudent to be vigilant. In fact, the volume of money in circulation in the Eurozone has been spiraling so much out of control since 2015, that there is cause for concern about the stability of the currency. This book discusses the mechanisms and conditions under which an inflation lies dormant, awakens, and may then become uncontrollable. It points to historical parallels and attempts to outline a path back to a sound financial system, as was envisaged in the Maastricht Treaty, but which, up to now, has not materialized.