Inflation risks and the global monetary boom

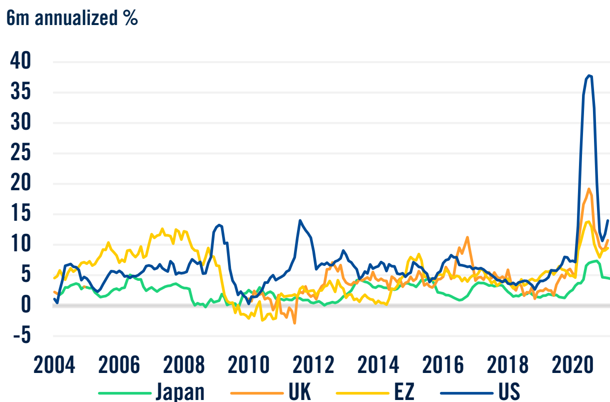
April 2021

Market nervousness about inflation has increased in recent weeks, due partly to strong monetary growth in the advanced economies. Central bank asset purchases are the main driver of money growth and look like they will keep it strong throughout 2021. Private credit growth has weakened but economic reopening might give it a boost and also push up the 'velocity' of money, raising inflation risks. Concerns about higher inflation are already partly priced into government bond yields, but the balance of risks remains skewed towards higher yields.

In recent weeks, markets have become more nervous about inflation risks, with some measures of long-term inflation expectations rising, spilling over into high government bond yields. One reason for the nervousness is strong monetary growth in the advanced economies. Six-month broad money supply growth has eased from its 2020 highs but remains elevated at around 10% (annualized) in the US, eurozone, and UK (see fig. 1).

Fig. 1: Major economies broad money growth

6m annualized %

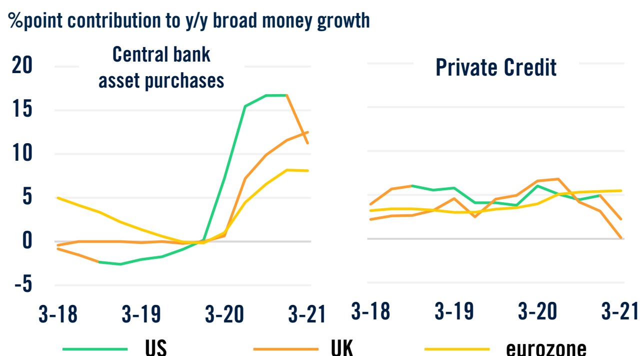


Source: Oxford Economics/ Haver Analytics

The main driver of monetary growth in the last year has been large-scale asset purchases by central banks. These accounted for 70%-80% of total monetary growth at the end of 2020 in the US, UK, and eurozone (see fig. 2).

Fig. 2: Key drivers of monetary growth

%point contribution to y/y broad money growth



Source: Oxford Economics/ Haver Analytics

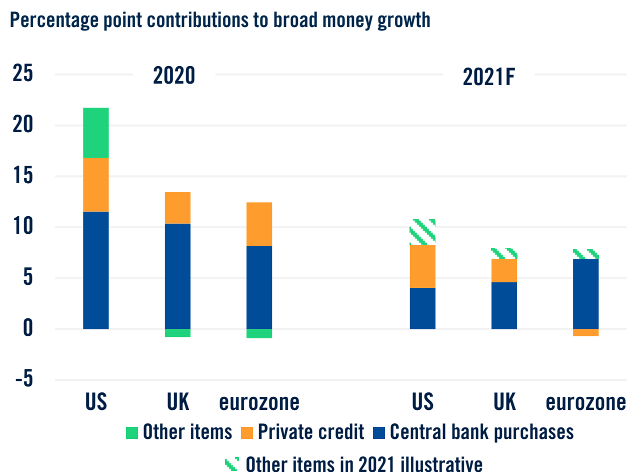
The scale of asset purchases ought to shrink somewhat in 2021, although our baseline forecast still points to them adding some 4ppts-7ppts to broad money growth this year.

Also, there may be upside risk to asset purchases in. some economies given the high levels of budget deficits forecast this year.

This would provide a substantial base for overall money supply growth in 2021. Add in other broad money counterparts like private credit growth and purchases of government bonds by banks, and it is quite plausible that money growth in the US, UK, and eurozone could be in double digits between Q4 2020 and Q4 2021 (see fig. 3).

Fig. 3: Money supply growth for 2020-2021

Percentage point contributions to broad money growth



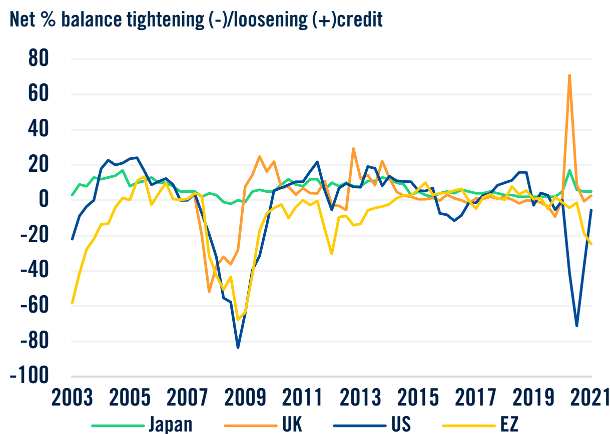
Source: Oxford Economics/Haver Analytics.
Forecasts may not be achieved and are not a guarantee or reliable indicator of future results

Six months ago, we thought money growth would be unlikely to be this strong because private credit growth would become a major drag on money growth. We are less confident about this now. As we suspected, precautionary borrowing undertaken by firms in 2020 has shown signs of unwinding – large UK firms for example repaid most of their early 2020 borrowing by year end.

However, while private credit growth has slowed in the US and UK it has not in the eurozone and it is not clear the slowing trend will continue. Without a big rise in unemployment we doubt household credit will be very weak. Meanwhile, central bank surveys suggest that supply constraints on credit to firms are not going to be the sort of drag they were after the global financial crisis.

While corporate credit standards did tighten a lot for a few quarters in 2020 in the US, the latest survey showed only a slight tightening – this tightening cycle may already be over. And across advanced economies bank credit standards are not tightening like they did in the global financial crisis. Banks in the UK and Japan report modest easing of loan standards and while eurozone standards are tightening, they are not doing so to the extent seen in 2007-2008 (see fig. 4).

Fig. 4: Corporate credit standards in G4



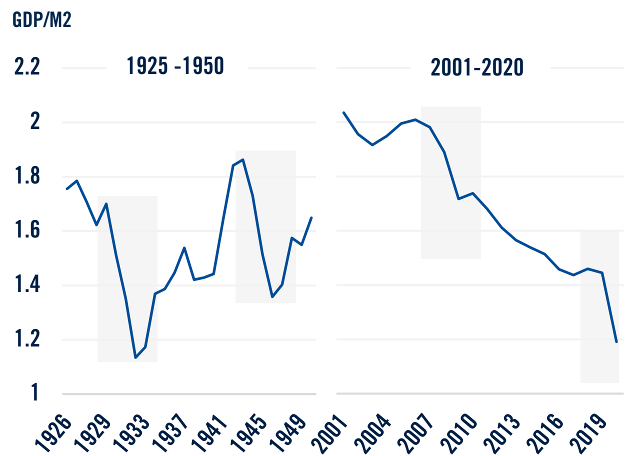
Source: Oxford Economics/Haver Analytics

Overall, while private credit growth has slowed, it has not done so enough to offset the central bank liquidity injections. Nor is it clear that it will. Indeed, economic reopening could give it a boost. So, money growth could stabilize at a double-digit annualized pace, raising inflation risks.

As economies unlock, it is also possible that the 'velocity' of money (the rate at which money is exchanged in an economy) could rise. This is important because last year, velocity collapsed, and this offset the strong rise in the money supply. There was huge demand for liquidity due to coronavirus-related uncertainty and central banks (correctly) accommodated this.

How velocity will behave is very uncertain. After the global financial crisis, velocity kept on declining for several years (partly due to regulatory changes). If this pattern were followed again, high money growth might not be a problem. But it is not clear this is the right model for what may happen now. In contrast to the GFC experience, US velocity recovered after the 1930s depression and at the end of WWII (see fig. 5).

Fig. 5: US money velocity in two periods



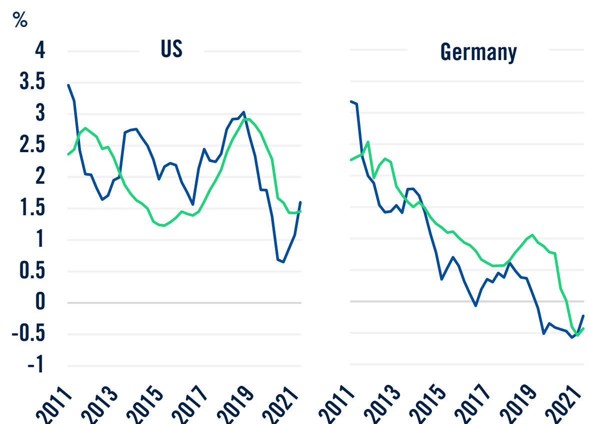
Source: Oxford Economics/Haver Analytics

This time, velocity might rise because people start to spend savings accumulated over the last year due to coronavirus restrictions (here, there is a similarity to WWII when rationing and controls forced up saving) and because perceived financial and economic risks decline.

If velocity picks up while money growth is in double digits, this implies a rise in inflation, perhaps to a rate of around 5%. Inflation is an inertial process so we doubt it would immediately jump to this level. But central banks will certainly need to keep a close eye on inflation risk indicators in the coming quarters.

Government bond yields are one such indicator. Our modelling suggests that US and German 10-year yields are now close to equilibrium levels, having been too low before the recent rise (see fig. 6). But we cannot assume yields will necessarily settle at this level. Past experience shows substantial overshoots are possible, most notably in the 'taper tantrum' of 2013-14. A further upward re-pricing of yields is a risk if money growth remains high and inflation indicators start blinking. Heavy bond issuance linked to large government deficits only adds to this upside risk for bond yields.

Fig. 6: US and Germany 10-year yields



Source: Oxford Economics/Haver Analytics

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