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Monetary Financing: A Response to Silke Tober

In the July/August issue of Intereconomics, Silke Tober criticised a proposal put forth by Andrew Watt to solve the euro crisis through the use of monetary financing of the public sector. Tober argued that there are valid reasons to keep monetary and fiscal policy separate from one another and that Watt's proposal blurred the line between the two policy areas. Here, Watt responds to his critic, followed by a reply from Tober.

There has been a recent flurry of academic and more policy-oriented articles dealing with monetary financing, i.e. the provision of central bank money to finance expansionary fiscal policy: tax cuts, transfers to households or public investment. As part of this debate, and against the background of the persistent inability of the euro area economy to emerge from the crisis, early this year I made a proposal for a specific form of monetary financing of public investment via European Central Bank (ECB) purchases, on secondary markets, of bonds issued by the European Investment Bank (EIB). This proposal – dubbed COMFOPI, conditional overt monetary financing of public investment – was published as IMK Working Paper 148.[1]

One of the purposes of the article was to stimulate a debate on the scope for monetary financing in general and the specific proposal. In that sense, the publishing of a critique of my article by Silke Tober in *Intereconomics* is welcome.[2] Unfortunately, however, this critique focuses on a side issue – whether monetary financing is a "free lunch". It contains a number of misrepresentations and does not engage with the literature on the subject of monetary financing in which my proposal is rooted. Nor does it offer an adequate appraisal of the European economic governance framework. There is a largely semantic critique of whether specific measures are to be considered monetary or fiscal, which is not helpful for policy development, while the issue of possible "functional equivalents" to the COMFOPI proposal and their pros and cons – which could have been the useful outcome of constructive criticism – is not examined.

This note seeks to correct misperceptions and thus reopen a debate on a possible role for monetary financing.

A free lunch? Answering the wrong question

The COMFOPI proposal is explicitly aimed at offering a pathway out of the crisis of high public debt, deflation (or stubbornly below-target inflation), low growth and high unemployment, given the current economic, political and legal conditions prevailing in Europe and especially within the eurozone. Assuming that there is consensus that such a pathway is indeed to be sought, a sensible critique of my proposal could attempt a number of things. It could show that the proposal will not generate the postulated positive effects if it were to be implemented. It could seek to demonstrate that it cannot for some reason be implemented. Or it could point to an alternative pathway that is (more) politically viable and/or will generate better outcomes.

Instead, the critique focuses, for reasons that are not explained, on the issue of whether COMFOPI constitutes a "free lunch". The rhetorical question is in the title, the headline of the main section and the critique's conclusion. Yet, this can clearly not be the key issue. Even if a critic successfully managed to demonstrate that monetary financing in this form is not a free lunch (whatever that means concretely), the appropriate response would be "So what?". The costs to the central bank or to any government of a scheme could be very large, yet if this were the best (not to mention the only) way to exit a stubborn slump and move towards full employment and stable growth, the proposal should be championed, not rubbished. The benchmark ought to be whether the proposal

1 A. Watt: Quantitative easing with bite: a proposal for conditional overt monetary financing of public investment, IMK Working Paper No. 148, March 2015.

2 S. Tober: Monetary Financing in the Euro Area: A Free Lunch?, in: Intereconomics, Vol. 50, No. 4, 2015, pp. 214-220.

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generates a net social benefit or is more or less effective than alternatives.

The chosen line of attack is all the more perplexing given that in at least four places in the original working paper it is *explicitly stated that monetary financing does imply losses*.[3] The point is made, however, that these losses take the form of additional inflation. This is normally undesirable, functioning as a sort of tax on private sector agents and potentially posing serious stability risks. This is why – as discussed in the article, but not referenced by Tober – it is generally right to impose limits on monetary financing. *In the specific context of deflation or excessively low inflation*, though, higher inflation is not a bug but a feature of the proposal.

Ignoring the relevant and bringing in irrelevant context

This brings us to a second, related shortcoming. The original article goes out of its way to emphasise the specific nature of the current deflationary environment, in which the European Central Bank is desperately seeking, most recently by means of substantial quantitative easing measures, to raise the rate of inflation to meet its target. There is a discussion of Japan's long stagnation and the lessons drawn from it by former US Federal Reserve Chairman Ben Bernanke. By contrast, the critique does not refer to Japan at all and to deflation just once (in passing in a footnote near the end of the text). On the other hand, it does refer to Weimar and remind us that "history is littered with examples of governments using the central bank to finance public expenditure (...) More often than not the result was spiralling inflation".

True, but irrelevant. The critique fails to take on board that the proposal is designed for and – a point to which I now turn – is explicitly limited to a specific historical context.

Serious misrepresentation of a key argument

Ms. Tober writes that my proposal "calls in question the inflation target of the ECB", going on to explain that "[t]he monetary financing is supposed to continue even when inflation overshoots the ECB target of about 1.9 per cent".[4] Were this to be the case, the proposal would certainly be dead in the water. However, the claim is a calumny and the supporting argument specious.

My proposal – drawing on literature contributions by Bernanke, Turner and others – repeatedly emphasises how crucial it is to give the central bank the right to decide when to say no to further monetisation. It is a key feature of the proposal that it contains an explicit "trigger mechanism" which the ECB itself defines, precisely to ensure that its mandate cannot be called into question. This essential information is withheld from the reader, however.

Moreover, she justifies her claim by reproducing a sentence from my text: "For instance central bank purchases could be wound down to zero over a six month period after the core inflation rate in the euro area has exceeded 2.5% for three consecutive months."[5] First, the phrase "for instance" clearly indicates that what follows is one possible example of a suitable trigger, the precise formulation of which is not critical to the proposal.[6]

Second, even taking the quoted formulation without context, her attack is surely misplaced. Monetary policy experts, not least Tober herself,[7] are at pains to emphasise the medium-term nature of the ECB's inflation target. The risks of becoming locked into a deflationary trap are very considerable; this is something my critic has rightly emphasised in her own work. Therefore to claim that, after a very extended period of substantially below-target inflation, it would be to "call into question the inflation target of the ECB" to allow (core) inflation to run at 2.5 per cent *for three months* is inexplicable. I would be more than happy to see core inflation at that level for one quarter as an indication that the euro area economy had finally emerged from the deflationary trap. But in any case, it would not be for me or my critic to decide, but the ECB, which is hardly likely to call into question its own inflation target.

Ignoring the relevant literature

The proposal contains an extended discussion of the literature relating to monetary financing, including papers by leading economists and monetary theorists and central bank experts (such as Bernanke, Buiter, Gali, Goodhart, Whelan, Wren-Lewis and Woodford).[8] Tober makes no attempt to situate my proposal in the context of this literature nor engage with that literature herself and its im-

3 A. Watt, op. cit., pp. 14, 17, 19, 20.
4 S. Tober, op. cit., p. 218.

5 A. Watt, op. cit., p. 24.
6 And sure enough, the previous sentence, not quoted, reads "[t]he trigger to safeguard the independence of the ECB to pursue its mandate can be defined in various ways". And the sentence that follows, also not quoted, reads "[o]ther rates and durations could be chosen". Ibid.
7 See e.g. S. Tober: EZB-Politik mit restriktivem Unterton, WSI-Mitteilungen, Vol. 9, No. 9, 2009, pp. 481-488.
8 See A. Watt, op. cit.

plications for her own views.[9] The COMFOPI proposal is an attempt to operationalise, within the specific European and contemporary context, concepts that have a well-established pedigree in economics, and not – whatever its possible flaws – a dreamt-up, baseless scheme that implausibly imagines something can be got from nothing.

"Burying debt" and central bank balance sheets

I criticised above the undue focus on the implications of monetary financing for central bank balance sheets for being a side issue by which to evaluate the proposal. It is nonetheless worth looking at this critique in its own terms. For this, we need to get to the nuts and bolts of the proposal. The original proposal was arguably lacking in precision here, and several alternatives were discussed which probably did not aid the clarity of exposition. Constructive criticisms and suggestions are helpful.

Let us start with a simple case in which the EIB gives the money it has received from the private sector as a grant to member state governments and the EIB bonds purchased by the ECB sit on its balance sheet (i.e. are "buried") as worthless perpetual zero interest bonds. (This is also at the heart of a separate proposal, by Pâris and Wyplosz,[10] that Tober also reviews unfavourably.) The question is whether this is in any real economic sense a loss or a problem for the central bank. In my critic's view, it is both.

But the question is whether these losses, which indisputably exist in a bookkeeping sense, have any meaning in an economic sense. Many leading monetary authorities (cited in my working paper) argue that it is not. These experts do not see a notable impairment to the operation of the central bank from accounting losses.

Bookkeeping losses to the central bank are likely to occur in the case of the QE programme because the central bank buys assets when interest rates are low (and prices are high) and may well sell them back to the private sector when the economy recovers and interest rates rise (and thus prices are lower). As Wren-Lewis has argued, once you support QE, it does not make sense to reject monetary financing on the grounds that it leads to central bank losses.[11] After all, in Friedman's original thought experiment, monetary financing takes the form of tossing bank notes out of a helicopter. There is no immediate balance-sheet counterpart but a reduction in the future stream of seignorage income. As already pointed out, the "cost" of this is the debasement of money; but as long as inflation is stuck below its target level, this is a feature not a bug.

The key point is that the central bank can create base money essentially costlessly. If the EIB loans the money to the governments and the ECB takes interest-bearing debt onto its books, then we enter a circular process: governments will make debt service payments to the EIB which are used to make payments to the central bank, but these earnings are returned to governments as central bank profits. There may be accounting issues to be resolved here. Interest rate differentials may be relevant. This is a point on which a constructive debate is useful. But ultimately, such transfers between public sector bodies can be considered macroeconomically irrelevant, or at most a second-order issue.

Indeed, Tober seems to recognise this basic logic. However, her discussion of the issues is not always clear. As an illustration, consider the following passage:

> Monetary financing of public investment is not a free lunch, as contended by Watt. Although EIB-ECB financing would mean that governments do not pay interest on the funds used for public investment, the Eurosystem would not earn interest on the corresponding assets, thus generating less profit than in the case of standard quantitative easing. Provided the ECB pursues its inflation target, the impact on the fiscal budget is the same whether public investment is financed regularly or by the central bank.[12]

The second sentence compares monetary financing of public investment with QE. The third sentence compares bond-financed public investment and monetary-financed public investment. Regarding the second sentence, the fact that a central bank does not accrue interest income

9 My critic finds one quote from Wren-Lewis that, taken out of context, appears to suggest that he is opposed to the mixing up of fiscal and monetary policy implied by "helicopter money" (see S. Tober: Monetary Financing..., op. cit., p. 218). In fact, Wren-Lewis – one of the UK's leading macroeconomists and long an advisor to the Bank of England and British Treasury – has intensively discussed and is broadly in favour of helicopter money (monetary financing), when responsibly pursued in deflationary circumstances. Among other things, he is a signatory of a Financial Times letter explicitly calling on the ECB to engage in monetary financing. See Better ways to boost eurozone economy and employment, in: Financial Times, 26 March 2015. He also is on record as characterising as "misleading" the argument that monetary financing mixes up fiscal and monetary policy – an argument which forms a prominent part of Tober's case against COMFOPI. See M. Blyth, E. Lonergan, S. Wren-Lewis: Now the Bank of England needs to deliver QE for the people, in: The Guardian, 21 May 2015.

10 P. Pâris, C. Wyplosz: The PADRE plan: Politically Acceptable Debt Restructuring in the Eurozone, VOX CEPR's Policy Portal, 28 January 2014.

11 S. Wren-Lewis: When central bank losses matter, Mainly Macro, 20 January 2015.

12 S. Tober: Monetary Financing..., op. cit., p. 219.

(which it would transfer to the governments) can hardly be construed as a loss or cost. Regarding the third, the whole point of the distinction between "regular" and "monetary" financing of investment is that the former is not happening and, in my judgement, is regrettably not likely to happen to anything like the required extent (see next section).

Ms. Tober is correct to point out that central bank/treasury relations in the euro area are more complex than implied by the above discussion, as there is not a simple unity within one "state". For these reasons attention does need to be paid to issues of the distribution of additional spending power and subsequent debt servicing. I sketched out some alternatives in my Working Paper. In the simplest case the ECB capital key is used (as with QE), and redistribution between countries is not an issue. It could be considered to organise all the additional public investment on the EU rather than national level. This is likely to have drawbacks, though. I now think it would be preferable for the EIB money to be lent to Member State governments and for the circular interest payments to be made. This is with a view to the balance sheet of the EIB, not the ECB, however. Clearly, this requires agreement that this debt is not counted against the deficit.

I welcome work and also criticism that helps to develop these ideas. It is true that we are in uncharted waters. The nuts and bolts of the scheme can and should be discussed.

Failure to weigh alternatives to monetary financing

Tober and I are in fundamental agreement that the European economy needs a phase of highly expansionary monetary policy combined with expansionary fiscal policy, and that the latter should focus on higher public investment. The question is how to achieve that combination. My IMK working paper contains a discussion of the likelihood that policies currently on the table or under discussion – for example the Juncker Plan – can be expected to lead to a monetary-fiscal policy mix that generates sustained and sustainable economic growth and a return to price stability and close-to-full employment.[13] The upshot of this review, which I do not repeat here, is that it is highly unlikely. This is a judgement about future outcomes that by its very nature is uncertain and about which reasonable people may disagree (partly but not only because there is no clear benchmark for the speed and durability of recovery that would constitute policy making success). As indicated earlier, a reasonable criticism would be that this view is too pessimistic and that other measures have a reasonable chance of being implemented that would generate similar or even better economic outcomes.

13 A. Watt, op. cit., pp. 6-12.

Clearly, such a line of argument would not make COMFOPI bad policy nor justify its out-of-hand rejection. One could, for instance, suggest that it be refined and elaborated further for the event that the existing QE programme does not deliver the hoped for results.

But my critic has not weighed fairly the pros and cons, the risks and rewards of possible alternatives. Rather, she claims that in order to finance public investment, “fiscal deficits could be increased even in those countries that currently are said not to have fiscal space” because the euro area is “obviously in an unexpected adverse economic situation”.[14] While this is a comforting view, she quotes no literature to support it. More pertinently, unfortunately it is not obious that those institutions with actual powers over the matter take this view. It also ignores the fact that euro area countries have all introduced balanced budget rules (i.e. debt brakes) which, while their details vary, have in common that they do not make a golden-rule-type exception for public investment. Surely the dramatic austerity of recent years and the massive fall in public investment as a share of GDP is rather difficult to explain if it were really the case that countries “not thought” to have fiscal space could simply point to the adverse economic situation and ramp up public investment.

What is certainly conceivable – and this is discussed in the original article[15] – is that the existing fiscal rules are set aside on an ad hoc or even a more permanent basis. A little fiscal relief may be forthcoming in this way. One needs to be clear, though, that a substantial and lasting easing would be a transgression of primary EU law and also of many national laws (often of constitutional rank). I would argue that this is substantially more difficult than finding a “fudge”[16] to enable ECB purchases on the secondary market, circumventing the treaty ban on financing government deficits. A political decision to engage in monetary financing could, I would argue, be easier to realise than solving the thorny collective action problems needed to permit fiscal expansion.

Whatever view one takes here, the key fact is that *any* effective remedy will come up against the inadequate legal framework of the euro area and/or the constraints foolishly written into national law. Something has to give! These issues need to be weighed in a balanced way – and further work will need to be done by legal scholars.

Similarly, the original paper discusses the risks of relying heavily on QE (at the time of writing the proposal, the QE programme was just getting under way).[17] The risks include distributional outcomes (which may have knock-on effects for the sustainability of growth) and risks to financial stability. In evaluating the COMFOPI proposal, one should surely consider the possible risks of alternatives like relying on QE.

Conclusion

A debate in Europe is urgently needed about how to emerge from economic stagnation, high unemployment, public debt and the threat of deflation. Certainly there is no silver bullet. The COMFOPI proposal is potentially a building block in that debate. Contributions that seriously engage with the issues and that develop alternatives, even imperfect ones, and offer constructive criticism that moves the debate forward are welcome. What should be avoided is to close down, without proper and balanced reflection, potentially interesting avenues for policy development, leaving Europe exposed, with an inadequate policy framework, to major risks of underperformance and longer-term stagnation.

14 S. Tober: Monetary Financing…, op. cit., p. 220.
15 A. Watt, op. cit., pp. 7-8.
16 The term “fudge” is borrowed from W.H. Buiter; see A. Watt, op. cit., p. 15.
17 A. Watt, op. cit., p. 11.

Silke Tober

Monetary Financing, Take Two – A Reply

In the eighth year of the crisis, the euro area’s economic situation is characterised by high unemployment, large output gaps, low private and public investment, as well as an inflation rate substantially short of the ECB’s inflation target. Against this background, a recent article by Watt and its precursor in the independent Annual Growth Survey (iAGS) outline a scheme to increase public investment that aims to neither impact on the fiscal deficit or public debt nor involve higher taxes.[1] The scheme is straightfor-

1 A. Watt: Quantitative easing with bite: a proposal for conditional overt monetary financing of public investment, IMK Working Paper No. 148, March 2015; and Observatoire Français des Conjonctures Economiques (OFCE), Institut für Macroökonomie und Konjunkturforschung in der Hans-Böckler-Stiftung (IMK), Economic Council of the Labour Movement (ECLM): independent Annual Growth Survey 2015, Third Report, Brussels 2014, pp. 125-129.

ward: the European Central Bank (ECB) promises to buy newly issued bonds from the European Investment Bank (EIB) in the magnitude of €750 billion over a period of five years. This promise allows the EIB to raise its loan volume by 175 per cent without increasing its capital or losing its triple-A rating. The money thus obtained by the EIB is transferred to the member states, which use it to raise public investment.

The "free lunch" dimension of the EIB-ECB plan – echoed in the title of "Monetary Financing in the Euro Area: A Free Lunch?"[2] – is not as peripheral to the scheme as Watt makes it out to be in his reply.[3] Indeed, it is an important part of the narrative. At its core lies the idea that public debt transferred to the ECB "might as well be extinguished".[4] The only "cost" is higher inflation, which in the current situation "is a boon not a bug of the scheme".[5] ECB-financed public investment "is not just a free lunch, it is a meal that diners are being paid to eat".[6] Lack of cost is an essential element, because it underlies the claim that higher public investment in this scheme does not entail higher fiscal deficits or higher public debt.

Contrary to Watt's assertion, however, higher inflation does not represent the costs of increased public investment in this scheme. Instead, the costs are the opportunity costs that arise because non-interest-bearing EIB bonds take the place of interest-bearing debt on the balance sheets of the Eurosystem. For the ECB, faced with a longer-term low inflation outlook and subdued inflation expectations, the alternative to monetary financing is not inactivity but rather other forms of monetary expansion, such as quantitative easing. Monetary financing as proposed in Watt's scheme does not affect the amount of asset purchases by the Eurosystem but only their composition. Substituting non-interest-bearing bonds for interest-bearing bonds reduces central bank profits and thus negatively impacts on national fiscal balances. Except for possible differences in interest rates, the fiscal impact is therefore the same, regardless of whether public investment is financed by credit or by newly issued bonds monetised by the central bank.

Analogously, public debt does not disappear once transferred to the Eurosystem. It is important to bear in mind that central banks have to be able to reverse or neutralise any monetary policy operation to maintain price stability. Once the economic situation normalises, the currently high level of liquidity may not be needed anymore. To absorb excess liquidity, a central bank that monetised debt might have to issue interest-bearing debt certificates rather than being able to sell the bonds it bought while engaging in quantitative easing. Shifting debt to the Eurosystem does not make it disappear but instead reduces the central bank's net assets.

The upshot of my reasoning above is that the analysis of the costs of monetary financing is logically flawed in Watt's scheme – a flaw not shared by Pâris/Wyplosz.[7] The only "benefit" of the scheme is that there is a chance that the higher public debt may be effectively hidden and therefore not subject to the stringent fiscal rules in the euro area.

Contrary to Watt's assertion, Bernanke provides no theoretical backing for Watt's scheme either.[8] In his analysis of Japan, Bernanke was dealing with the problem of Ricardian equivalence, which renders fiscal policy ineffective because economic agents anticipate future tax burdens as a result of deficit spending and reduce current consumption accordingly. Bernanke's recommendation is quantitative easing, as already practiced by the ECB, combined with price level targeting and expansionary fiscal policy. In addition, Bernanke proposes measures to protect the central bank's balance sheet by transferring risk to the national ministry of finance, not the other way around as in Watt.[9] Watt's scheme, on the other hand, attempts to get around the very different problem that policy makers in the euro area are not willing to increase deficit spending or change the fiscal rules they themselves legislated.

As a side issue, Watt reaffirms his view that it is compatible with the ECB's inflation target to continue expanding its balance sheet for six months after *core* inflation has exceeded "2.5% *for three consecutive months*".[10] I disa-

2 S. Tober: Monetary Financing in the Euro Area: A Free Lunch?, in: Intereconomics, Vol. 50, No. 4, pp. 214-220.
3 A. Watt: Monetary Financing: A Response to Silke Tober, in: Intereconomics, Vol. 50, No. 6, pp. 356-360.
4 OFCE et al., op. cit., p. 129.
5 Ibid., p. 127.
6 A. Watt: Quantitative easing … , op .cit., p. 20.

7 P. Pâris, C. Wyplosz: The PADRE plan: Politically Acceptable Debt Restructuring in the Eurozone, VOX CEPR's Policy Portal, 28 January 2014.
8 B. Bernanke: Some Thoughts on Monetary Policy in Japan. Speech Before the Japan Society of Monetary Economics, Tokyo, 31 May 2003.
9 A. Watt: Quantitative easing … , op .cit.
10 Ibid., p. 24 (emphasis added).

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gree, not because of a half percentage point, but because inflation targeting requires a credible target and a central bank that acts in a forward-looking manner, adjusting its policy instruments based on its inflation forecast rather than actual inflation. If the ECB reacted only after underlying inflation was well above the target – and core inflation in this context cannot be but synonymous with underlying inflation – it would risk higher inflation expectations, which, in turn, tend to feed back into actual inflation. The medium-term perspective of the monetary strategy evoked by Watt is important because it allows for fluctuations in *headline* inflation, for example as a result of exogenous shocks, such as oil price hikes.[11] It is not the purpose of the medium-term perspective to blur the target for underlying inflation and its role as a stability anchor. There may be good arguments for adopting a price level target as suggested by Bernanke for Japan;[12] my disagreement with Watt concerns the purported compatibility of the only quantified trigger mechanism with the ECB's inflation target.

It can be frustrating to watch the ECB strenuously attempting to "push a string". The euro area needs higher aggregate expenditure, and only fiscal policy can deliver this directly. Fiscal policy has eased a bit in recent years, as convincingly analysed in other sections of iAGS and more recently in Horn et al.[13] Making the case for public investment and expansionary fiscal policy may be cumbersome and it might fail. But trying to circumvent the rules by saddling the Eurosystem with non-interest-bearing, illiquid bonds and potentially weakening the ECB's ability to deliver monetary and financial stability is neither a realistic nor a viable alternative.

11 S. Tober, T. Zimmermann: Monetary Policy and Commodity Price Shocks, in: Intereconomics, Vol. 44, No. 4, 2009, p. 231-237.

12 B. Bernanke, op. cit.

13 OFCE et al., op. cit.; G.A. Horn, S. Gechert, A. Herzog-Stein, P. Hohlfeld, F. Lindner, A. Rannenberg, S. Stephan, T. Theobald, S. Tober: Im Aufschwung – Prognose der wirtschaftlichen Entwicklung 2015/2016, IMK Report No. 104, April 2015.