Comment

Road map to regime change

- *Monetary policy is losing traction, increasingly overburdened, and rapidly running out of road*
- *Calls are growing for a dramatic reorientation of macro stabilisation policy, as in the early 1930s*
- *Direct debt monetisation, once the ultimate taboo, is increasingly appearing on the agenda*
- *Either another shock or the persistence of the 'new mediocre' could be the trigger for change*
- *A co-ordinated approach would be preferable, but much would depend on the policy of the US*
- *There is no guarantee that all this will happen; but it is worth laying out the steps to watch for*

Crossroads ahead

Resort to 'Helicopter money' may not be far away

Extraordinary as it may seem, two questions that are being asked with increasing frequency are whether or not central banks could soon come directly to monetise government debt, and under what particular circumstances this might occur.

This is something to which we have given considerable thought.[1] With existing monetary policy regimes having largely run their course, the case for a radically different approach to demand management – in particular, a formula involving a much closer inter-relationship between the operations of central banks and finance ministries, is in some countries, becoming increasingly appealing.

At the very least, such a departure would represent a change of *modus operandi* on a similar scale to the policy revolution seen in the early 1930s with the abandonment of the gold standard,[2] or a re-run, albeit in reverse, of Fed Chairman Paul Volcker's abandoning, in 1979, the Federal Reserve's long-standing gradualist approach to inflation control in favour of a full-frontal assault.[3]

Arguably, there are two feasible routes to such fundamental macroeconomic policy regime change.

It may come about because of another major trauma …

The first would be a need to react to another major negative demand shock. Perhaps the London G-20 summit of April 2009 offers the most relevant template for such a departure.[4] Responding to the post-Lehman bankruptcy collapse in global output, their backs to the wall, policymakers in the advanced economies put aside long-standing political and philosophical objections to aggressive policy activism and agreed on a co-ordinated programme of fiscal expansion (equivalent to some two percentage points of their combined GDP) to supplement the already increasingly forceful and unorthodox departures of central banks. In their respective foxholes, policymakers embraced Keynesianism with surprising gusto – even the German government, not least via its 'cash for clunkers' car scrappage scheme.

… or because recent mediocre economic trends persist

A second possible route could be a more gradual progression towards a fundamental change of tack coming about as a result of a continuation of recent macroeconomic and political trends. Under this scenario, economic growth continues to disappoint, cyclical upswings remain subject to set-backs, labour markets, and in particular wages, remain soggy, inflation is reluctant to move back to target, inflation expectations sink, public sector debt burdens remain onerous, and large income inequalities endure. The political environment thereby becomes ever more fractious, fragmented, and polarised, and social unrest builds.

Nothing to fear but fear itself?

The track record of monetary financing is not encouraging …

The history of direct debt monetisation is not, generally speaking, a happy one. There are numerous examples of its encouraging excessive government largesse and very high, if not hyper, inflation, and all the economic and political chaos that accompanies it. Indeed, it is often associated with Latin American dictatorships and failed states in sub-Saharan Africa.[5]

… although the idea has an impressive intellectual lineage

Yet, over recent months a number of moderate and respected commentators have suggested that it should not be quite the taboo that it is normally presented as being. Furthermore, the notion of the application of outright debt monetisation to macro stabilisation policy has an impressive intellectual lineage, stretching back through Friedman, Simons, Lerner, Keynes, Fisher, Buiter, and indeed Bernanke, a group of economists that can hardly be dismissed as inhabiting the realm of the buffoon or the witch doctor.[6] In which case, an unemotional assessment of its merits would appear warranted.

Describing the medicine

Direct debt monetisation is not the same as QE …

Direct debt monetisation can be defined as a central bank directly purchasing government debt in order to finance fiscal stimulus. In the process, it generates a permanent increase in the monetary base and generally thereby, over the long run, the price level. Under such circumstances, there would be no call on private sector savings: the extra output is produced from under-utilised, or newly-created, capacity. The technique could be used either to fund an existing government shortfall, or to finance a deliberate increase in the budget deficit. In this sense, it involves explicit co-operation between the fiscal and monetary authorities. In the process, the direct connection between the budget deficit and the outstanding level of public indebtedness is swept away.

Direct debt monetisation differs from quantitative easing (QE) in that, under the latter, the central bank purchases bonds on the open market in exchange for newly-created reserves, but the intention is that it will, at some stage, sell the bonds to the private sector.

… QE delivers only a temporary increase in the monetary base

Hence, QE involves only the temporary monetary financing of a budget deficit, and there is no explicit co-operation between the fiscal and monetary authorities. Ultimately, private sector savings will fill the gap, and the monetary base returns to its original level. Moreover, the link between the budget deficit and the stock of public debt endures.

Pros …

Monetisation could perhaps 'crowd in' private expenditure

The primary benefit of direct debt monetisation would be that it would break the policy logjam produced by a simultaneous requirement for deleveraging in both the private and public sectors. And, because it makes no demand on (existing) private sector savings, it should also prove more expansionary than QE or orthodox fiscal expansion on a unit-by-unit basis. Indeed, to the extent that it served to rebuild confidence, it could actually 'crowd in' additional private expenditure. Moreover, as long as any programme of direct debt monetisation was confined merely to closing a large output gap, or expanding capacity through increased investment, the inflationary impact should be limited.

And cons …

But it could also raise huge issues of 'moral hazard' …

The arguments against direct debt monetisation largely fall into two related categories: the moral hazard it encourages; and its inflationary potential. The disruption of the connection between government decisions on the size of its budget deficit and the willingness of the private sector to fund that deficit at interest rates that are in any sense reasonable sweeps away at a stroke one of the most important disciplines the market imposes on politicians. And with that discipline swept away, the door is open to the most irresponsible and ultimately inflationary policies. This could, at the very least encourage a significant increase in inflation expectations and inflation risk premia.

Any substantial change in demand management that would involve a form of direct financing of expenditure by the central bank would therefore raise concerns in a number of quarters:

… leaving policy makers reluctant to embrace it

- Central bankers would be instinctively resistant;
- Many politicians would resist on similar grounds;
- Legal and constitutional objections could be raised in some countries.

Reconciling the two

Supporters of direct debt monetisation argue that the division of the impact of stimulus between prices and real activity achieved by such a policy need not differ from a stimulus resulting from more orthodox initiatives. The problem, they assert, lies in the disapprobation historically attached to the approach. As such, the taboo is artificial rather than deeply rooted in in economic principles.

The approach need not therefore necessarily always be a bad idea, and lead inevitably to an inflationary outcome. There can be circumstances where it is a good idea, if not the only viable policy option. The key is how it is put into operation.

Robust institutional checks and balances would be essential

Clearly, for the public and markets not to fear the worst, robust institutional checks and balances would need to be put in place before direct debt monetisation could be implemented. For example:

- Direct debt monetisation would best be applied within the context of an explicit inflation, price level, or nominal GDP target framework, and all the transparency and accountability that goes with it.

- It would make sense that any final decision to go down this route be put in the hands of a central bank's policy-making committee, rather than a government.
- The extent of the resort to direct monetary financing would need to be legally ring-fenced, and confined to a specific amount over a specific period – say 3% of GDP over 2 years.
- Rather than financing tax cuts, which no doubt would increase consumption and exert an immediate impact on a government's popularity, it would be better to concentrate on funding a specified number of public infrastructure projects, which could add to an economy's productive potential and perhaps subsequently be at least partially sold back to the private sector.
- Finally, as an additional symbol of the authorities' good faith, it would also make sense to combine the stimulus with a round of new structural reforms.

A timeline for change

Many of the conditions for regime change are in place …

The world is not, it would seem, yet at that point when pressure for such regime change is imminent; and it may well not get there at all if global aggregate demand picks up in the coming quarters. If it does not, however, things could play out somewhat along the following lines. Indeed, arguably elements of steps 1-5 of this timeline are already in place.

1. **The costs of present monetary policies continue to rise**. Excessive continuing reliance on monetary policy leads to growing costs in terms of bank profitability, asset market volatility, currency instability, and consumer and business confidence.
2. **Criticism grows in the media and the broader commentariat**. Attention focuses particularly on:
   - The failure of central banks and policymakers in general to re-establish the economic conditions that prevailed prior to the 2008 crisis;
   - In some case perhaps also the failure of much of the middle classes to benefit from rising aggregate prosperity for the past several decades.
3. **Fringe political parties gain ground**. Moderate/establishment parties progressively lose ground, being dismissed variously as: out of touch; failing to address the needs of the common man; not putting the country's interest first; giving in to pressures from abroad; being soft on negative aspects of globalisation.
4. **The drift towards more fragile and atomised coalitions continues**. Governments prove increasingly fragmented, hard to put together, short-lived, and dysfunctional. Hence, the pressure to secure a sustainable recovery and encourage a more stable political environment becomes overwhelming.
5. **The international organisations start to speak up.** Notwithstanding opposition from some member countries, various of the international institutions, most notably perhaps the OECD and the IMF, make the case for a coordinated fiscal policy response. Their central argument is that the effects on public sector deficits are much smaller – the multiplier is bigger – when countries act in concert.

… although political critical mass has not yet been reached

6. **Institutional arrangements increasingly are questioned.** Well-embedded, previously taken for granted institutional arrangements, such as the euro, the EU, and free trade and capital movements, are increasingly called into question.
7. **Establishment politicians start to identify scapegoats.** Criticism starts to be levelled at central banks, and in turn their governors, for inappropriate policies which:
   - Propped up asset prices, serving the interests of the already-privileged classes;
   - Did not re-establish adequate economic growth; and
   - Did little or nothing for the ordinary working man or woman.
8. **Inflation targets are criticised**. Arguments are increasingly voiced that inflation targets may have been appropriate for an earlier, inflationary, epoch; but their time has passed.
9. **Growth, or more growth-focussed policy targets, are increasingly called for.**
10. **New, more flexibly-minded, central bank governors and board members are appointed.**
11. **Some countries call for a concerted action plan.** Not only do they argue that such policies work better when all countries act together, but they also argue that a substantial part of any such fiscal expansion should be financed by central banks.

12. **The international organisations develop a plan for coordinated expansion.** Big divisions between countries are exposed, however.

… and the US attitude may well prove decisive

13. **The United States proves pivotal.** As in so many matters, it becomes clear that, if the US indicates its support, or even a desire, for coordinated action, many countries will get behind the proposal. But if the US economy is doing well, or if it is in the wrong phase of the electoral cycle, or if its government is intrinsically less internationally-minded than some have been in the past, the putative move founders.

The US joins in

14. **An agreement is negotiated**. However, this takes six months.
15. **Infrastructure investment is put at the core**. There is a growing recognition of an infrastructure shortfall in the major economies and that infrastructure is important not just from the perspective of demand management, but also productivity and supply-side enhancement. The OECD has suggested that infrastructure spending equivalent to around 3.5% of GDP is necessary in the advanced economies to avoid detrimental implications for living standards, quality of life, and competitiveness. Spending rarely matches this goal.
16. **Independent entities are created to oversee the implementation of individual public investment programmes.** They would operate with a fixed budget, be headed by a politically neutral figure with the appropriate competency, and mandated to confine their outlays to economically productive projects.

The US does not join in: some countries go it alone

In the absence of a (US-led) coordinated fiscal expansion underwritten by central banks, some countries might 'go it alone'. Hence this raises the question of which countries these might be, and the order in which they might individually take this leap of faith.

Japan is perhaps the country most likely to go it alone …

17. **Japan**. The most likely candidate given its now generation-long deflationary funk is Japan. Moreover, it has embraced direct debt monetisation in the past (in the 1930s, with at least some initial success), and both PM Abe and BOJ Governor Kuroda have hinted at a sympathetic attitude to this approach. And Japan has a long-standing cultural inclination to policymaking by consensus.
18. **The US**. Notwithstanding some especially sharp divisions in politics, the US has since the Great Depression prioritised growth and, as demonstrated during the depths of the global financial crisis, its policymakers have proved particularly flexible and practically-minded.
19. **The UK**. Probably ranks next. The current government's policy substance has in practice proved rather more flexible than its austere rhetoric. And the UK has a long history of policy activism.

… while the euro area would be the most reluctant participant

20. **Finally, there is the euro area**. Notwithstanding the ECB's ventures into unorthodox territory, the political, institutional and legal obstacles to direct debt monetisation and regime change in general are much greater in the euro area than elsewhere, with Germany's deeply-entrenched conservativism perhaps the over-riding constraint on a dramatic re-orientation of macro policy.
    - Cries of alarm about the euro grow. With many in Europe calling for an entirely new economic policy agenda, there would be increasing concern that the euro was in grave danger of breaking up.
    - Germany starts to soften its attitude. A half-hearted institutional arrangement is cobbled together to channel ECB finance into infrastructure investment.

Watch fors

- The first five or so steps having already been taken – and assuming that matters may move at least somewhat along the lines we suggest, watch for an evolution broadly along the lines sketched from step six onwards.■

#Comment: Another major demand shock or the persistence of the 'new mediocre' could be the trigger for direct debt monetisation, once the ultimate policy taboo.

[1] See, for example, Turner. A. *Between debt and the devil.* Princeton university press. October 2015. Also, Jones. R. *Nothing to fear but fear itself*. Llewellyn Consulting Comment. February 2015. Jones. R and Llewellyn. J. *The end of the monetary policy road.* Llewellyn Consulting Comment. April 2015. Jones. R. *The road to nowhere?* Llewellyn Consulting Comment. September 2015. Jones. R. *The end is nigh.* Llewellyn Consulting Comment. November 2015. Jones. R. *You wouldn't want to start from here.* Llewellyn Consulting Comment. March 2016.

[2] Eggertsson, G. *Great expectations and the end of depression.* American Economic Review. 2008. Also, Temin, P. and Wigmore, B. *The end of one big deflation*. Explanations in economic history, 27 (4).

[3] Axilrod. S. *Inside the Fed. Monetary Policy and its Management. Martin through Greenspan to Bernanke*. MIT press. 2009.

[4] G-20 London summit leaders' statement 2 April 2009. https://www.imf.org/external/np/sec/pr/2009/pdf/g20-040209.pdf

[5] Cagan. P. *The monetary dynamics of hyperinflation* in Friedman.M. (ed). *Studies in the Quantity Theory of Money.* University of Chicago press. 1956. Also, Federal Reserve Bank of Dallas. *Hyperinflation in Zimbabwe*. Globalisation and Monetary Policy Institute 2011 Annual Report. www.dallasfed.org/assets/documents/institute/annula/2011/annual11b.pdf

[6] See for example, Keynes. J.M. *The General Theory of Employment, Interest and Money.* Macmillan. 1936; Friedman. M. *A monetary and fiscal framework for economic stability*. American Economic Review. June 1948; Lerner. A.P. *Functional finance and the federal debt*'. Social Research. February 1943; Bernanke. B. *Deflation: making sure 'it' doesn't happen here*. November 2002. http://www.federalreserve.gov/boardDocs/speeches/2002/20021121/default.htm

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