16TH JACQUES POLAK ANNUAL RESEARCH CONFERENCE
NOVEMBER 5–6, 2015

The Case for Monetary Finance – An Essentially Political Issue

Adair Turner
Institute for New Economic Thinking

Paper presented at the 16th Jacques Polak Annual Research Conference
Hosted by the International Monetary Fund
Washington, DC─November 5–6, 2015

Institute for
New Economic Thinking

The Case for Money Finance: an essentially political issue

Sixteenth Jacques Polak Research Conference
International Monetary Fund

5 November 2015

Adair Turner
Chairman
Institute for New Economic Thinking

300 Park Avenue South - 5th Floor, New York, NY 10010

22 Park Street, W1J 2JB London, UK

Technical feasibility **vs** Political risks

Desirability of monetary finance if we could assume that governments/central banks could make credible commitments only to use it in appropriate amounts in appropriate circumstances

The risk that political dynamics make it impossible for governments/central banks to make commitments which

- They will actually stick to
- Are credible in advance

Institute for
New Economic Thinking

Monetary finance: increased fiscal deficit financed by permanent money creation

Option 1 Central bank directly credits government current account

Option 2 Government issues interest-bearing debt, which CB purchases and converts to non-interest bearing irredeemable "due from government"

Option 3 Government issues interest-bearing debt, which CB purchases and perpetually rolls over

Change in consolidated public sector balance sheet

A	L
	Non-interest bearing irredeemable money

Fiscal and monetary implications of alternative stimulus policies

Impact on:

	Current year fiscal deficit	Public debt stock	Monetary base
Money financed deficit	Increase	NIL	Permanent increase
Debt financed deficits	Increase	Increase	NIL
Quantitative Easing	NIL	NIL	Temporary increase
Debt-financed deficits plus Quantitative Easing	Increase	Increase	Temporary increase

Four propositions

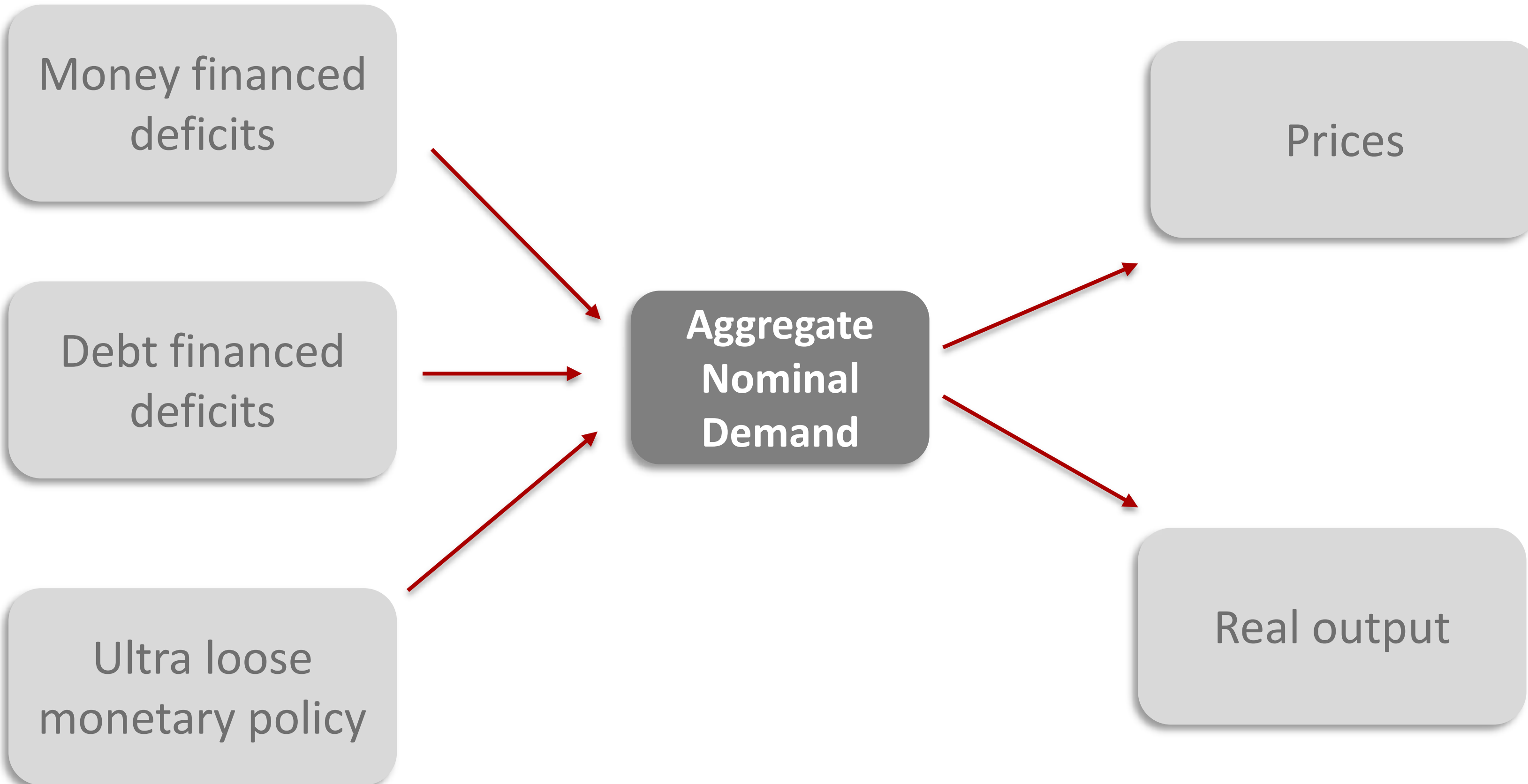
1. There exist circumstances in which appropriate to stimulate aggregate nominal demand — √ ?

2. Monetary finance will <u>always</u> stimulate aggregate nominal demand — √√√

3. In some circumstances it will do so more certainly and with less adverse side effects than available alternative policies — √√

4. The degree of stimulus can be controlled — √√

Policy tools and effects: the ‘Independence’ Hypothesis



Independence Hypothesis:

Division of increase in nominal demand between prices and real output is independent of the choice of policy tool used to stimulate nominal demand.

Proposition 2: Money finance will always stimulate nominal demand

- A direct fiscal stimulus – but with no danger of Ricardian Equivalence offset
- An increase in household nominal net worth
- An asymmetric effect on private and public balance sheets
  - Household gross nominal wealth increase
  - No increase in NPV of public sector liabilities

Proposition 2: Money finance will **always** stimulate nominal demand

- A direct fiscal stimulus – but with no danger of Ricardian Equivalence offset
- An increase in household <u>nominal</u> net worth
- An asymmetric effect on private and public balance sheets
    - Household gross nominal wealth increase
    - No increase in NPV of public sector liabilities

➢ Inadequate demand, deflation, low-flation are <u>policy choices</u> and <u>never</u> unavoidable effects

➢ Faced with inadequate nominal demand governments/central banks <u>never</u> run out of ammunition

Institute for New Economic Thinking

Proposition 3: Monetary finance vs alternative policy options: impact on nominal demand

Money financed deficits	≥	Debt financed deficits	• Same first round fiscal effect • No possible Ricardian Equivalence offset
Money financed deficits	**More certain than**	Forward guidance to influence expectations	Ability to change expectations through current words or actions is uncertain
Money financed deficits	**More certain than**	Quantitative Easing	Given uncertain/indirect transmission channels
Money financed deficits	**Less adverse side effects than**	Sustained negative interest rates	Given potential harmful effects of excessive private leverage growth

Public sector balance sheets with debt-financed deficits plus QE

1 After QE operation but before exit

Government

A	L
Future tax claim on private sector	Interest bearing bond

Central Bank

A	L
Interest bearing bond	Non-Interest bearing irredeemable money

Consolidated Public Sector

A	L
Future tax claim on private sector	Non-Interest bearing irredeemable money

2 After exit and resale of bonds to private sector

Government

A	L
Future tax claim on private sector	Interest bearing bond

Central Bank

A	L
0	0

Consolidated Public Sector

A	L
Future tax claim on private sector	Interest bearing bond

Proposition 4: The degree of stimulus can be managed

Case 1: In the simple imagined helicopter drop world

- Money supply = monetary base

'One-off' drop of

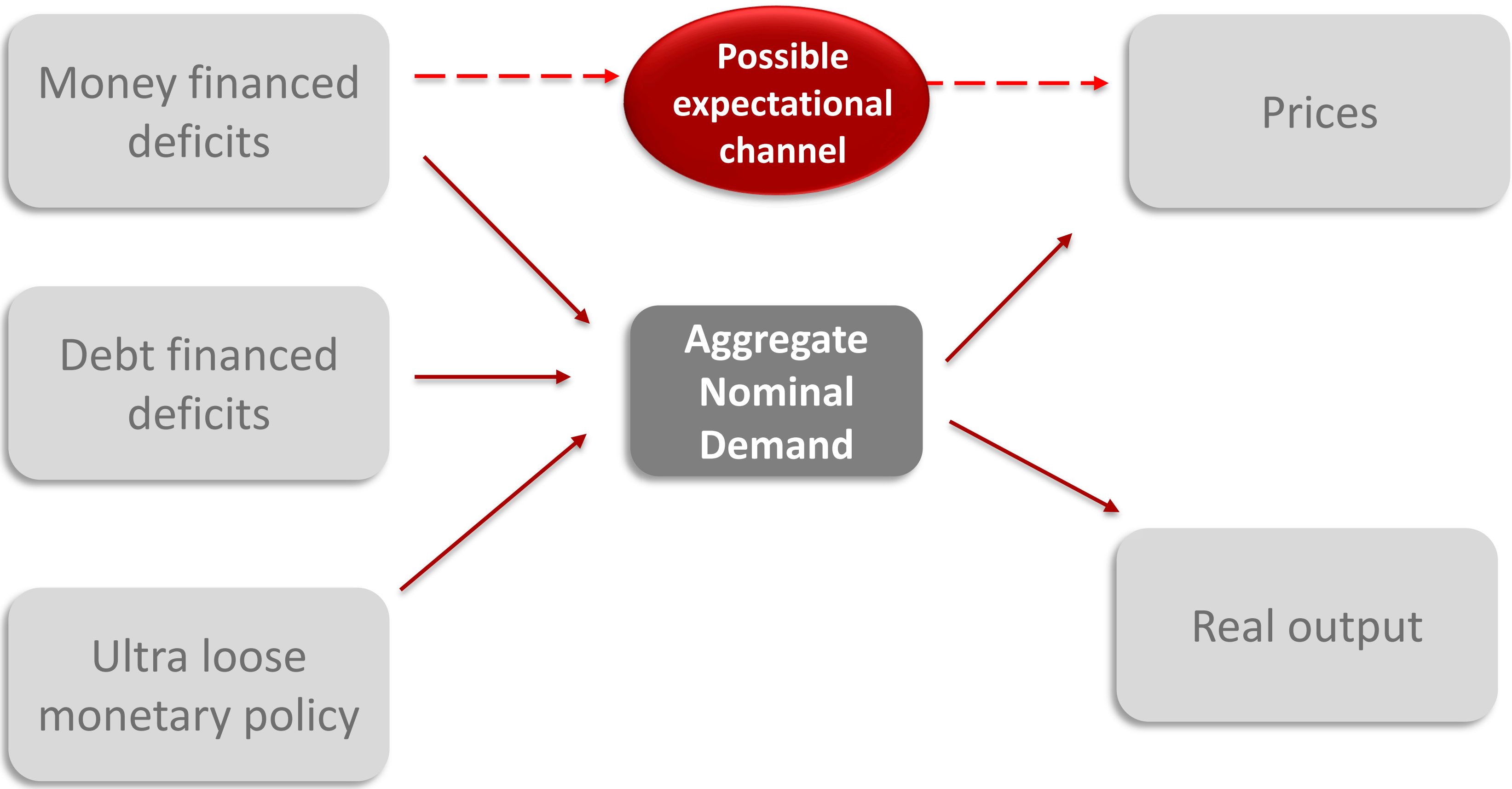
- $10m
- $10bn
- $10tr

Degree of stimulus is proportional to the scale of the drop

… unless the "one of" promise is incredible

… and expectations of future further drop are induced

Policy tools and effects: Do expectational effects override the 'Independence' Hypothesis?



Proposition 4: The degree of stimulus can be managed

Case 2: In the real world of fractional reserve banks

- Money supply large multiple of monetary base

Constraining future demand creation via banking multiplier → Requires imposition of quantitative reserve requirements

Ensuring that consolidated public sector has a permanent non-interest bearing liability → Requires mandatory reserves to be non-interest bearing

- Even if marginal reserves remunerated at positive policy rate

Technical feasibility vs Political risks

There are no valid technical reasons for excluding money finance from our policy toolkit

- Always stimulates nominal demand
- And technically possible to manage the degree of stimulus

Great political risks that if taboo is broken, monetary finance will be used to excess

Respectable argument: although MF is technically feasible and in some circumstances the best policy, we should exclude its use entirely in order to avoid political risks

Containing political risks: a manageable challenge?

Possible regime

- Independent central bank pursuing inflation target, given authority to approve specific $bn of monetary finance to ensure inflation in line with target
- Government decision on the precise use of additional fiscal resources
  - Investment?
  - One-off tax rebate?

Possible example

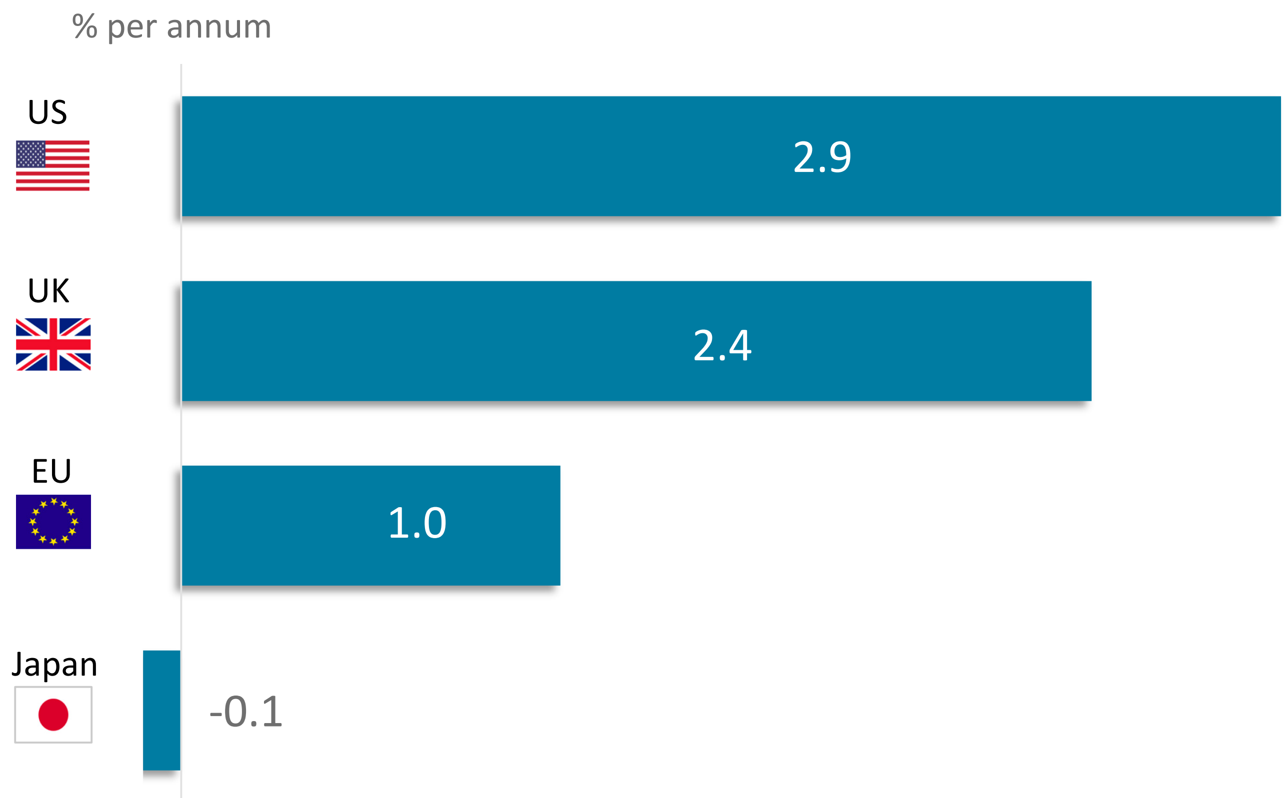
UK Monetary Policy Committee 2009 – 2012

- £375bn of temporary QE

Or

- E.g. £37.5bn of additional fiscal stimulus financed with permanent money creation

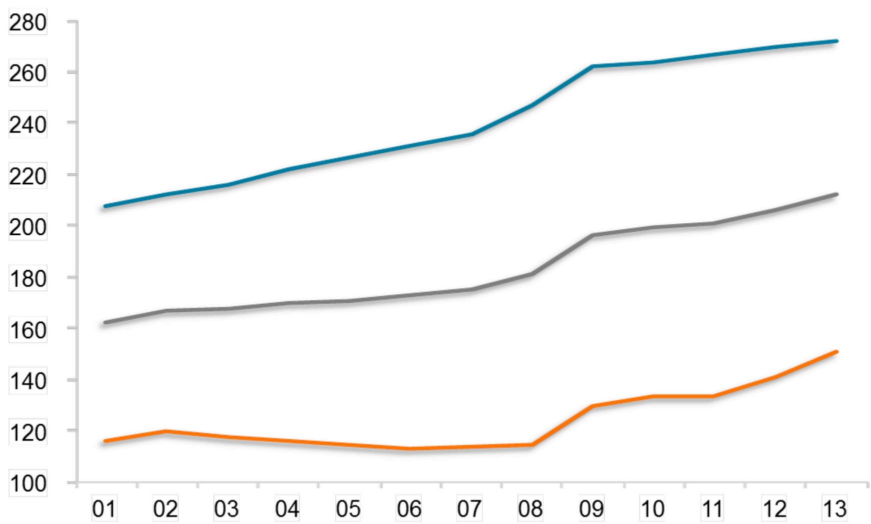
Nominal GDP growth 2008 – 2015



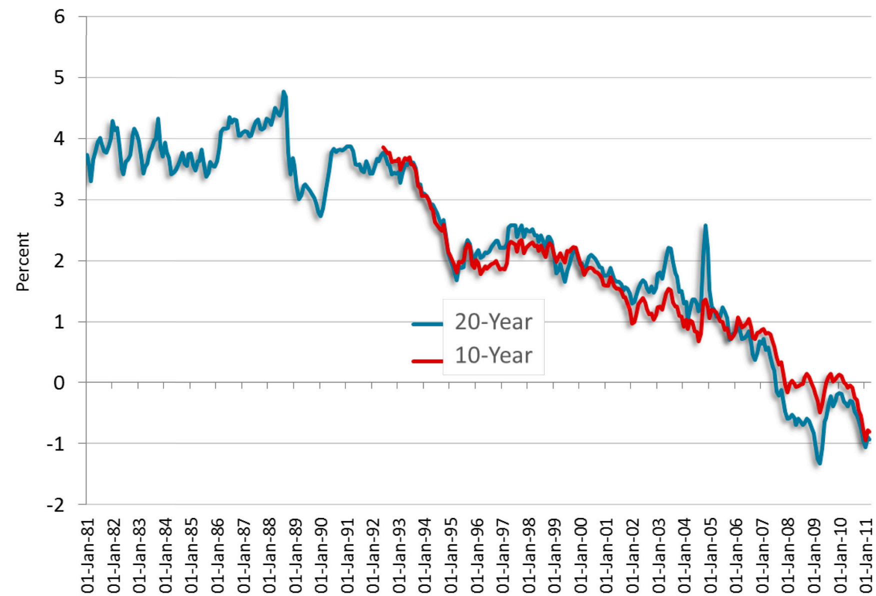
Source: IMF WFO Database 2015, ECB statistical Data Warehouse

Debt overhang and/or secular stagnation

Global debt



Real yields to maturity



Ensuring long-term Japan debt sustainability: IMF scenarios

Required cyclical changes in adjusted primary balance
% of GDP

	2010	2014	2020
November 2010 Fiscal Monitor	- 6.5		+ 6.4
October 2014 Fiscal Monitor		- 6.0	+ 5.6

Continuous surplus thereafter to reach

- 80% net debt
- 200% gross debt

by 2030