The Case for Monetary Finance – An Essentially Political Issue

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5 November 2015

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Chairman
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### Technical feasibility

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.

### Political risks

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
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

<table>
<thead>
<tr>
<th>Change in consolidated public sector balance sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
</tr>
<tr>
<td>Non-interest bearing irredeemable money</td>
</tr>
</tbody>
</table>
## Fiscal and monetary implications of alternative stimulus policies

### Impact on:

<table>
<thead>
<tr>
<th></th>
<th>Current year fiscal deficit</th>
<th>Public debt stock</th>
<th>Monetary base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Money financed deficit</td>
<td>Increase</td>
<td>NIL</td>
<td>Permanent increase</td>
</tr>
<tr>
<td>Debt financed deficits</td>
<td>Increase</td>
<td>Increase</td>
<td>NIL</td>
</tr>
<tr>
<td>Quantitative Easing</td>
<td>NIL</td>
<td>NIL</td>
<td>Temporary increase</td>
</tr>
<tr>
<td>Debt-financed deficits plus Quantitative Easing</td>
<td>Increase</td>
<td>Increase</td>
<td>Temporary increase</td>
</tr>
</tbody>
</table>
Four propositions

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

2. Monetary finance will *always* 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 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

- Inadequate demand, deflation, low-flation are policy choices and never unavoidable effects
- Faced with inadequate nominal demand governments/central banks never run out of ammunition
### Proposition 3: Monetary finance vs alternative policy options: impact on nominal demand

<table>
<thead>
<tr>
<th>Money financed deficits</th>
<th>Debt financed deficits</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>≥</strong></td>
<td><strong>• Same first round fiscal effect</strong></td>
</tr>
<tr>
<td><strong>• No possible Ricardian Equivalence offset</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Money financed deficits</th>
<th>Money financed deficits</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>More certain than</strong></td>
<td><strong>More certain than</strong></td>
</tr>
<tr>
<td><strong>Forward guidance to influence expectations</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Quantitative Easing</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Money financed deficits</th>
<th>Money financed deficits</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Less adverse side effects than</strong></td>
<td><strong>Sustained negative interest rates</strong></td>
</tr>
<tr>
<td><strong>Given potential harmful effects of excessive private leverage growth</strong></td>
<td><strong>Given uncertain/indirect transmission channels</strong></td>
</tr>
</tbody>
</table>
Public sector balance sheets with debt-financed deficits plus QE

1. After QE operation but before exit

<table>
<thead>
<tr>
<th>Government</th>
<th>Central Bank</th>
<th>Consolidated Public Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>L</td>
<td>A</td>
</tr>
<tr>
<td>Future tax claim on private sector</td>
<td>Interest bearing bond</td>
<td>Interest bearing bond</td>
</tr>
</tbody>
</table>

2. After exit and resale of bonds to private sector

<table>
<thead>
<tr>
<th>Government</th>
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<th>Consolidated Public Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>L</td>
<td>A</td>
</tr>
<tr>
<td>Future tax claim on private sector</td>
<td>Interest bearing bond</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Future tax claim on private sector</td>
</tr>
</tbody>
</table>
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

Degree of stimulus is proportional to the scale of the drop

• $10bn

... unless the “one of” promise is incredible

• $10tr

... and expectations of future further drop are induced
Policy tools and effects: Do expectational effects override the ‘Independence’ Hypothesis?

Possible expectational channel

Money financed deficits
Debt financed deficits
Ultra loose monetary policy
Prices
Real output

Aggregate Nominal Demand
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
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

% per annum

US: 2.9
UK: 2.4
EU: 1.0
Japan: -0.1

Source: IMF WFO Database 2015, ECB statistical Data Warehouse
Debt overhang and/or secular stagnation

Global debt

Real yields to maturity

Institute for New Economic Thinking
Ensuring long-term Japan debt sustainability: IMF scenarios

Required cyclical changes in adjusted primary balance
\% of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>2010</th>
<th>2014</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change</td>
<td>-6.5</td>
<td>+6.4</td>
<td></td>
</tr>
<tr>
<td>Change</td>
<td>-6.0</td>
<td>+5.6</td>
<td></td>
</tr>
</tbody>
</table>

Continuous surplus thereafter to reach

- 80% net debt
- 200% gross debt
by 2030