Monetary policy and treatment of public debt

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The webinar was moderated by Dominique Plihon (University of Paris 13, Sorbonne Paris Cité).

Introductory remarks :

The current economic and health crisis suggests a reorientation of academic work towards economic policies to overcome the crisis. The challenge is therefore to succeed in implementing these policies without delaying the impulse for ecological transition. Among them, monetary policies have been of strategic importance since the financial crisis of 2007-2008. Conducted by the European Central Bank (ECB) in the euro zone, these policies are closely linked to the fiscal action of European governments at the national level. Indeed, when the ECB carries out massive repurchases of public debt on secondary markets, it facilitates the financing of Member States.

Rethinking the action of central banks seems necessary in order to respond appropriately to economic difficulties, without delaying the ecological transition. Cancelling the public debt held by the ECB, finance green investments, or monetising public spending, are all proposals that go in this direction. These proposals were presented successively by two researchers associated with the Chair:

- **Laurence Scialom,** professor at the University of Paris Nanterre.
- **Jézabel Couppey-Soubeyran,** lecturer at the University Paris 1 Panthéon-Sorbonne.

1. Laurence Scialom, professor at the University of Paris Nanterre

Laurence Scialom and Baptiste Bridonneau, "Des annulations de dettes publiques par la BCE : lançons le débat", *Terra Nova,* 17 April 2020.

In this Terra Nova note, Laurence Scialom and Baptiste Bridonneau propose the cancellation of public debt, conditional on reinvestment of the same amounts in green public investments financed by new debt issues. This conditionality mechanism is an incentive mechanism that would force the crisis exit plan to be massively oriented towards the ecological transition.

More specifically, the ECB should cancel part of the sovereign debt it has bought back since 2015, representing on May 2020, €2,320 billion for the euro zone as a whole and €457 billion for France. This would enable States to finance the ecological transition by taking on debt, without increasing the ratio of public debt to GDP.

This proposition is not about cancelling sovereign debt securities held by commercial banks and institutional investors. Not only would this harm savers, but it would also cause financial instability in an already vulnerable system, which will be exposed to massive losses as a result of the looming recession.

A conductive environment for a recasting of the principles that should govern the action of central banks

C. Goodhart's work demonstrates the plasticity of central bank doctrines throughout their history, particularly in periods of major economic crises and war. Goodhart describes the presence of stable central banking regimes over fairly long periods of time followed by very rapid shifts from one regime to another in certain circumstances. There are a number of indications that are on the verge of such a changeover:

- A heightened awareness of financial climate risks and their systemic potential.
- Recognition of the failure of the self-regulated markets paradigm.
- The need to loosen the debt straitjacket inherited from the management of the last two systemic crises.

Some contextual elements to understand the interest of the proposal

Even before the health crisis, we were in a situation of so-called **secular stagnation,** i.e. a situation characterized by the decline of potential growth, deflationary pressure and acute public investment needs for the ecological transition. Even before the health crisis, monetary policy was reaching its limits, and many economists argued, unsuccessfully, for fiscal policy to take over. Empirical studies show that fiscal multipliers are high and, indeed, that this is a good time for fiscal action. The proposal would thus :

- Restore margins of error for fiscal policy.
- Avoid the increase of the public debt-to-GDP ratio being used to justify fiscal tightening that would increase deflationary pressures and destroy the capacity of financing the ecological transition.
- Prevent possible Ricardian effects by committing not to raise taxes for financing debt cancellations.

This proposal responds to three crises: the economic, the ecological and the political crisis that are all undermining the euro area. We're therefore facing life-threatening dangers that appear in different temporalities:

- **In the short term, there is** a real risk of the euro zone breaking up. The European Commission's recent proposals to issue mutualized debt and to allocate part of the funds raised to donations for governments is a step forward. This remains insufficient in view of the structural tensions that undermine the cohesion of the euro zone and the rise on populist parties. This financing plan consists of 750 billion euros spread over 4 years, even though the fall in investment planned for 2020-2021 is predicted as way more important.
- **In the longer term**, Europe, like the rest of the world, must respond to ecological rising risks. However, the operational rules hinder a response that is strong enough with respect to the challenges.

A situation of exceptional seriousness in multiple dimensions must find a solution that is itself exceptional.

Methods of implementing the proposal

The idea is not to cancel all the public debts held by the ECB at once. The ECB is well equipped to assess the right amount of debt to be cancelled. It could be a question of **proportioning debt write-offs according to the scale of recession on each country**. This would have the advantage of providing the euro area with a mechanism to combat asymmetric shocks. In that sense, some countries would benefit more than others from debt forgiveness, but to the extent that it would be used to finance global public goods, everyone would benefit from this action.

Perpetual QE versus debt forgiveness

If the central bank were to commit to keeping interest rates at zero and perpetually renewing the amount of sovereign securities it holds, this could be equivalent to a cancellation of government debt. What would be the credibility of such a commitment by the ECB? This question is all the more important in a context of legal fragility linked to the vagueness of the Treaties. A recent ruling by the German Constitutional Court bears witness to this fragility. There is no guarantee that the ECB will be able to continue its asset repurchase program ad vitam aeternam and if it were to be interrupted, we would probably see a rise in the rates on the public debt of certain States. In other words, **no contract can guarantee to the States that the ECB would keep a promise to renew the debt it holds in perpetuity.** To be credible, the only possibility is to tie our hands, to put in place a mechanism that prevents a flip-flop. The mechanism can only come about through debt cancellation, which the authors of the note propose as a condition for financing the ecological transition.

Three main criticisms of the proposal

- **Cancellation of debts would result in losses on the assets of central banks that states would have to compensate.**

It's a fake problem. The liabilities of a central bank consist almost exclusively of central bank money created ex nihilo with no pre-established limit. The central money it issues on its liabilities is therefore not a debt contract. The monetary liabilities of the central bank (banknotes and deposit accounts of second-tier banks) constitute the ultimate liquidity of the payment community for which it has a monopoly of issuance. A BIS report published in 2013 specifically states that central banks cannot be declared bankrupt. A central bank is not a commercial bank: it does not aim to make profit and can operate with negative capital.

- Fear of inflation

First of all, a debt cancellation does not create more money but simply prevents the money already created when the ECB repurchases sovereign securities from being destroyed when the maturing securities are redeemed.

It may be that the increase in public demand is generating some inflation. However, to the extent that parallel investments increase supply, inflation would remain moderate. Moreover, in the current recessive context, fighting deflationary pressures is more of a virtue than a vice, including from the point of view of the ECB's failure to meet its inflation target since 2013. The risk of deflation is much more dangerous economically, especially when private and public balance sheets are burdened by excess debt.

Moderate inflation would even allow for a painless reduction in debt and should be sought. It might be appropriate to revisit Olivier Blanchard's proposal to raise the inflation target to 4-5% to better counter sharp falls in activity. With higher inflation, we can have real interest rates that remain low or even negative, which makes it possible to fight the contraction of the economy. This is impossible when inflation is close to zero or negative.

Inflation is not an evil itself; it only becomes an evil if it gets uncontrolled, if it generates perverse effects on the distribution of income, which is far from being the case. If such effects exist, they are much more due to the context of secular stagnation and hyper-financialization that has prevailed for several years.

- The loss of legitimacy of the ECB

To consider that the cancellation of public debt by the ECB will destroy credibility and trust in the euro is an unfounded belief. It shows a lack of understanding of what founds trust in a fiat currency, i.e. a currency without intrinsic value, backed by no precious metal. Trust in a fiat currency is based on collective trust and in the perpetuation of the payment community.

Far from undermining the credibility of the ECB, the proposal to cancel debts, which is likely to remove the specter of the break-up of the euro zone and to arm Europe to face climate challenge risks, would, on the contrary, establish its credibility. Furthermore, we must not ignore the power of the central bankers' words. In this sense, **this proposal must be accompanied by a communication from the ECB aimed not only at the markets, but also at European citizens, so that they do not turn their backs on the European project.**

Legal obstacles to the proposal

Debt write-offs by the ECB are not credits to Member States, nor are they purchases of government debt securities on primary markets. A priori, therefore, it is not supposed to interfere with Article 123 of the Treaty on the Functioning of the European Union (TFEU), which prohibits this. It is, however, a proposal that contravenes the general philosophy of prohibiting the monetary financing of States by the central bank.

The possibilities for blocking such a decision are weaker within the ECB than within the Eurogroup. This could have made it easier to get this type of proposal through. However, it seems that the measure is exceptional enough to call for a high-level political agreement and thus an amendment of the Treaties. This can be justified if Article 123 TFEU is interpreted in sa teleological way, i.e. according to the problem it is supposed to address. At the time of its drafting, the prohibition of State financing by the ECB was seen as a necessity to guard against the risk of inflation. Today, it is no longer inflation that is feared, but deflation. If we have a teleological interpretation of Article 123, as soon as the grounds cease to exist, the article must cease to respond to the new context.

The proposal is conceived as an **axis for re-founding the European project**. The crisis is deep enough, both in its ecological dimension and in terms of the survival of the euro zone, to require excessively strong measures of this nature.

Discussion

The discussion that followed highlighted the following points:

- The proposal to cancel debts conditional on the financing of the ecological transition would constitute a real rethinking of the doctrine of central banks and their practices. It answers the question of rising debts, financing the ecological transition and tackles the public investment deficit.
- The identification of green investments is not straightforward and requires a taxonomy to be established. This is a subject that has been addressed by the European Commission. Generally speaking, these would be investments to finance the ecological transition, which would also help to facilitate disinvestment on brown assets.
- In the euro area, the investment needs for the ecological transition differ from one country to another. It would therefore not be for the ECB to decide the guidelines to be followed. For this purpose, one could imagine a sub-assembly of the eurozone countries in the European Parliament.
- The ECB is failing to achieve its 2% inflation target despite a policy of massive liquidity injections. In the euro zone, the inflation rate is not unified, and some countries have already experienced periods of deflation. Deflation must absolutely be avoided, especially in a context of very high public and private indebtedness.
- There is no mechanical link between money creation and price increases.
- There is not necessarily a financing gap in the field, but there are engineering obstacles to the arrangement of such financing, the need to produce new risk and profitability analyses.
- The cancellation of public debt held by the ECB is necessary to free up investment capacity and prevent the deterioration of public debt ratios. In this sense, it is a way of escaping the austerity temptation. The criticisms that are made against this type of proposal are much more a matter of rhetoric of inaction, of defending the status quo, than of economic argumentation.

2. Jézabel Couppey-Soubeyran, Lecturer at University Paris 1 Panthéon-Sorbonne

Jézabel Couppey-Soubeyran, "La 'monnaie hélicoptère' contre la dépression dans le sillage de la crise sanitaire", *Note from the Veblen Institute,* 17 April 2020.

In the same spirit as the cancellation of public debt, the proposal for an enlarged helicopter currency would provide a real financing alternative for public debt. More specifically, it is a proposal to **monetize public expenditure through a direct, non-counterparty transfer of central bank money to the Treasury**. This proposal, developed in a note from the Veblen Institute last April, adapts to the context of the health crisis, a proposal developed with E. Carré, T. Lebrun and T. Renault in January, in a note from the same institute, entitled: A "monetary drone" to put monetary policy back at the service of all. This note proposed to free ourselves from the broken transmission channels of monetary policy by transferring central bank money directly to households from central bank digital currency accounts.

With the health crisis, it became necessary to rethink and extend this proposal for a helicopter currency, using a direct transfer of central bank money in two phases while the crisis was being managed:

- **The rescue phase**, characterized by a monetization of public expenditure i.e. a direct transfer of central bank money to the Treasury. It is also referred to as helicopter money for the States. The aim here would be to eliminate the risk of debt unsustainability.
- **The reboot phase of the economy.** This would involve transferring central bank money directly to households and companies to increase private spending **without delay or transmission failure,** while continuing to increase public spending. This instrument would be much more effective than quantitative easing in transmitting the effects of monetary policy to the real economy. Moreover, since the health crisis has led to a double crisis, both of supply and demand, it is essential to provide joint support in the recovery phase. It is also a way to better **control the upward path of inflation that** can be associated with this proposal.

Helicopter money is not a new form of central bank money

To manage the crisis, central banks are issuing astronomical amounts of central bank money. If all this has a magical side, it is because central bank money is created ex nihilo by the central bank. Helicopter money doesn't change that: **it's not a new form of central bank money, it's just another way of distributing it, of getting it to the real economy.** It is a way of freeing monetary policy from the dysfunctional banking and financial transmission channels. They do not, or not enough, move central bank money to the real economy. Emancipating from them would ensure that the central bank money created constitutes almost entirely and almost immediately a spending capacity in the real economy.

Avoiding the risk of debt unsustainability and austerity blackmail

Helicopter money in its broadest sense, as a direct and without counterparty transfer of central bank money, would not be in line with fiscal policy. On the contrary, it would make it possible to fully articulate monetary policy and fiscal policy, to give fiscal policy the greatest possible room for some marge of error. By financing public spending without increasing debt, or in other words, by monetizing public spending, the helicopter currency proposal would remove the **risk of debt unsustainability**.

It would also rule out the **risk of a further blackmail of austerity** in the coming years, when public debt-to-GDP ratios deteriorates. While technically there seems to be no limit to this ratio, in practice when this ratio deteriorates, it is instrumentalized and used to orchestrate austerity.

Moreover, a deterioration in public debt ratios could generate **financial panic**. Indeed, financial markets are cyclothymic: They ask for new sovereign debt issuance and may very well want to sell these same assets tomorrow if they observe a deterioration in public debt ratios. Perhaps the central bank will be there to buy them back, but it still needs to make a very long-term commitment. This commitment ad vitam aeternam is not very credible and if it is credible at all, it raises other problems.

Problems in the transmission of monetary policy

What has been mobilized by central banks to manage the health crisis is nothing more than what they have already mobilized to manage the financial crisis of 2007-2008, but on a larger scale, namely :

- Refinancing of banks at extremely accommodating conditions
- The purchase of assets, including government debt instruments, in secondary markets as the ECB does or in primary markets as other central banks do.

To do this, central banks issue massive amounts of central bank money. Commercial banks then find themselves with large reserves in their central bank accounts, but at the same time there is so little increase in credit for business investment and just a discrete recovery in growth and inflation. Since 2015, the ECB's extremely accommodating monetary policy has not made it possible to attain its inflation target or to sustain growth and its determinants. **The same policy conducted on a larger scale to manage the health crisis is unlikely to produce different effects.**

Two relationships that are supposed to be at the heart of monetary policy seem totally dysfunctional:

- **The relationship between the central bank money issuance and money supply.** An increase of central bank money make commercial bank money increase more than proportionally. Helicopter money would re-establish this link since central bank money would be poured directly into the real economy.
- **The relationship between the amount of money in circulation in the economy and inflation of the prices of goods and services**. This is all the truer in highly financialized economies where money circulates in a loop in the banking and financial sphere. This raises the price of financial assets but not the price of goods and services. Helicopter money, on the other hand, would make central bank money circulate in the real sphere and make it possible to combat deflationary pressures. The transfer of central bank money, by supporting both business supply and household demand, would make it possible to control the inflationary trajectory. Stopping the transfer as soon as the inflation target is reached would also be a way to avoid inflationary slippage.

The arrangements for implementing this proposal

Initially, during the rescue phase, States would benefit from direct and without counterparty transfers of central bank money. They would then be able to carry out their expenditure and, if they wish, target this expenditure on health, environment, etc. This could easily be done by reactivating the Treasury account on the balance sheet of each national central bank. While Article 123 TFEU prohibits the ECB from doing so, some central banks operate differently. The Bank of England has recently reactivated the account of the English Treasury and allowed the government to transfer central bank money as a repayable loan.

In a second phase, during the economic recovery phase, helicopter money would be given **uniformly to** households and businesses. Specifically, individuals over 15 years old on the one hand and businesses on the other would each receive an identical transfer. The uniformity of the transfer is due to the fact that it is not for the ECB to decide what each individual may receive. The ECB could possibly only decide this in close consultation with the States, which would completely undermine the ECB's independence. This would be an even more radical development than simply considering helicopter money as a crisis management device, an alternative monetary instrument.

It is possible that the amounts transferred may not be fully spent by their beneficiaries, particularly wealthy households, but in general they would still be largely spent. Empirical studies of fiscal transfers show multiplier effects ranging from 2 to 5. If we refer to them, assuming that the amounts paid out are only half spent, a payment of 1,000 of central bank money would lead to an expenditure of 500. If we then consider a multiplier effect of 2, which is fairly small compared to the range from 2 to 5, the expenditure of 500 would be multiplied by 2, so that 1,000 of central bank money paid out would give 1,000 circulating in the real economy. This would have a positive effect on inflation, which is quite desirable in a deflationary situation and which is perfectly controllable.

Discussion

The discussion that followed highlighted the following points:

On the non-sustainable and uniform nature of the helicopter coin scheme

- Helicopter money for households and businesses is not intended to be a sustainable system. It is a crisis management mechanism designed to boost the effects of monetary stimulus by freeing itself from broken transmission channels.
- **The monetization of public expenditure, on the other hand, could well be redeployed as part of the financing of the ecological transition.** We need to make the link between today's health crisis and tomorrow's environmental crisis.
- Proposals for debt cancellation, conditional on financing the ecological transition and monetization of public expenditure, are solutions that could well serve to prevent and manage the environmental crisis.
- The transfer of central bank money to households and businesses must be uniform and not targeted. This is a prerequisite to avoid monetary policy walking on the fiscal policy bandwagon.
- The monetization of public expenditure, however, leaves the possibility for States to target their spending and, in particular, to direct spending towards the ecological transition. Monetization in this sense would be a way of financing the ecological transition without weighing on public finances.
- In a helicopter money scheme, it is not the provision of central bank money that will determine the need. It is the identification of a need and, above all, the need to free oneself from faulty transmission channels that leads to the direct payment of the central bank money. Helicopter money is not based on a particular conception of exogenous versus endogenous money.

On the development of central banking

- The debate on how central banks should act is eminently political. Referring to economic theory gives a cover of scientificity, but in the end it is always a political position that prevails.
- Proposals that occupy the public space do not sufficiently challenge the problematic foundations of the system. There is no guarantee that we will not face the same situation in the years to come.
- At the heart of the debate is whether it is appropriate for a central bank to claim to be independent and neutral.
- The multiplicity of instruments available to central banks in the 1950s and 1960s has been lost in the name of economic theories with a technicist approach to money, the same one that prevailed at the creation of the euro and which today undermines monetary union.
- **Depending on the central banking regimes, the subordination relationship between the state and the central bank is more or less great.** Since the 1980s and the era of market supremacy, this link has been apparently broken. However, as soon as a crisis occurs, the sovereign reappears through the currency. There is **no act of sovereignty more important than the act of the lender of last resort that contravenes the sanction of the market by an off-market act.**

On the nature of the criticism of these proposals

- This criticism is political. The arguments put forward are economically ill-founded. The same applies to the constitutional argument that the Treaty prohibits. Debt cancellation is not explicitly prohibited by Article 123 TFEU. As for monetization, in a way quantitative easing already circumvents it.

- The inflationary argument does not hold for debt forgiveness. A debt write-off does not create money, it just prevents the destruction of money. It can possibly have an inflationary effect if we take advantage of it to contract new debts that will have a ripple effect on the economy.
- There is a stronger inflationary effect structurally associated with monetization since the monetary base is poured directly into the economy. Again, if supply and demand are jointly supported, there is no reason for this to go out of control.
- If the central bank wants to meet its objectives, it would have to achieve more inflation. The proposals put forward would allow the central bank to better meet its objectives of monetary stability, economic stability and financial stability. Continuing with its current strategy will not achieve this.
- Quantitative easing only makes it possible to support the debt on condition that it is done ad vitam aeternam (see T. Philippon's argument on the subject). There is no guarantee that this is possible, and if it were, the central bank could certainly rule out the risk of unsustainable public debt, but it would no longer meet its monetary, economic and financial stability objectives.
- Thus, either it removes the risk of unsustainability but does not meet its objectives and therefore will lose credibility in the long run. Or it seeks to better fulfil its objectives and then it must change its instruments, its doctrine.
- The argument that the aggregated balance sheet of the State and the central bank should be considered must be deconstructed. Considering the net assets of the State and the central bank implies perfect homogeneity between the two, it is not relevant.
- Nor does it make sense to think that government debt is the result of poor public management in the current context. Part of the debt is the consequence of the socialisation of the private sector's losses during the 2007-2008 financial crisis. The fault is not budgetary but rather a lack of control over finance, an excess of private debt. It is also difficult to see the health crisis as the result of poor public management.

On Excessive Private Sector Debt and the Effectiveness of Monetary Policy

- The effectiveness of quantitative easing is limited by the response of the private sector. Firms invest little or nothing when their balance sheets deteriorate. That said, it benefits large firms more than small ones. Large firms enjoy privileged access to markets and can finance themselves at very low rates.
- When private balance sheets are burdened with debt the transmission belt that does not work. After the financial crisis, we did not see the usual deleveraging of the private sector. This has to do with the authorities' management of the crisis. The response has saved the financial system without any counterparty in terms of financial regulation.
- Our economies have therefore not been purged of the dysfunctions in the financial sphere that led to the 2007-2008 crisis. Monetary policy is not directly responsible for this. On the contrary, it exacerbates and maintains this situation. Asset buybacks mainly benefit the banking and financial sector. It is not by continuing in this way that it will be possible to create the conditions for a clean-up of private sector balance sheets.

On the need to put the central bank back in the service of the State

- The proposal for helicopter money refers somewhat to the situation in France in the 1960s and 1970s, when the Treasury could benefit from direct central bank financing. Today, we are rediscovering the need to put the central bank at the service of governments when they have to make massive investments. In the context of the health crisis, this involves massive spending to support the economy, but also investments to accelerate the ecological transition.

- When the main concern is inflation, central bank independence is fundamental. Indeed, inflation preferences differ considerably between the government and the central bank. When the urgency of the moment is to get out of deflation and move towards a sustainable and inclusive growth model, there is every reason to rethink this relationship. Monetary policy must change to respond to the urgency of the moment

On messages to businesses

- Considering new modalities of central bank intervention would help to pull the economy out of the sluggishness it has experienced since the 2007-2008 crisis.
- Businesses, especially when they are burdened by debt, would benefit from an upturn in activity and slight inflation: this would devalue the real value of their debt.
- The leeway that would be created to make green investments or to help brown assets run aground would directly benefit businesses. Businesses are stakeholders in the structural reconversion of the industrial fabric that is being announced to complete the ecological transition.
- The current monetary policy will not be able to manage the health crisis. It certainly makes it possible to facilitate the financing of States, but it does not rule out the risk of debt unsustainability. States are in a situation of total dependence on the decisions of the central bank.
- The situation will only be sustainable if the central bank continues to pursue its extremely accommodating ad vitam aeternam policy, but in that case it will not meet its objectives. That is why we need to change it and consider possible alternative solutions.
- Criticism of such proposals is very political. They aim to defend the status quo, the interests in place and in particular the interests of the banking and financial sector.
- The cancellation of debts or the direct payment of central bank money to governments, households and businesses are possible solutions. **They are technically feasible and institutionally possible as soon as the community can convince itself of their necessity.** There is a need to stimulate public debate in order to make the need for these alternatives clearly understood.
- These measures are part of a reflection on the structural transformation of our economies and capitalism. **This only makes sense in a broader perspective of reducing hyper-financialization, of a more regulated finance, more at the service of society and less at the service of itself.**

On the likelihood of implementation of these proposals

- Europe is making headway on the brink of the abyss. If these proposals are unlikely to apply tomorrow, when the day comes to resolve them, the debate will already have been given, the ideas will have been cleared up.
- There is a progression of ideas that challenge the orthodoxy of central banks.
- We need to create epistemic communities, to infuse these proposals into the world of business and intellectual circles.