26 April 2016
Asset management

Print prescription

Economist Insights

Increasingly extreme monetary stimulus measures are proving remarkably ineffectual at breaking the economy out of the low growth, low inflation cycle. So should central banks simply print money and pass it directly to governments or households? Monetisation may be contentious, but is it any more worse than QE? It could be a more equitable solution. But can our central bankers and politicians be trusted to use it wisely? The experiences of hyperinflation still haunt, and cloud, policy-makers' thinking.

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Have central banks run out of ways to cure the illnesses that afflict the economy? This has become the constant fear: zero rates were tried, forward guidance attempted, quantitative easing (QE) was implemented, and negative rates appear to be approaching their natural limit. Yet growth remains moderate at best and inflation expectations look ridiculously low.

So now attention is turning to the 'nuclear option' of 'helicopter' money. What if the central bank prints money and simply gives it straight to the government? Giving it to the government would allow for tax cuts or higher spending, hence helicopter money is often referred to as monetary financing, or simply monetisation.

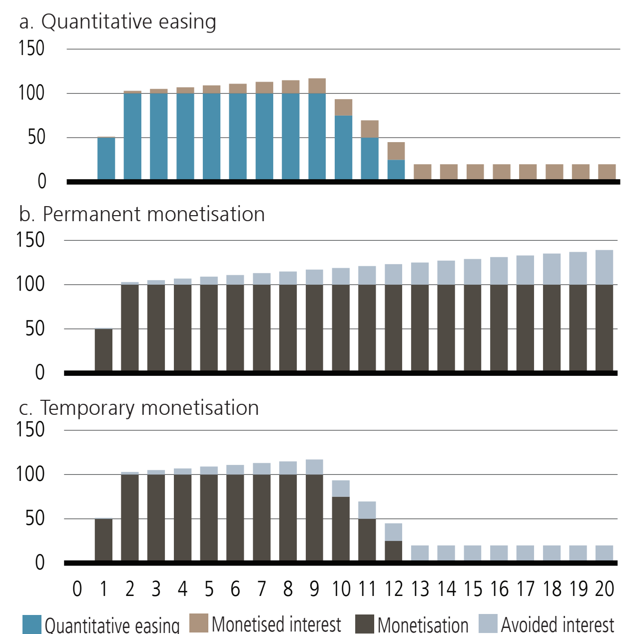
Monetisation is not a revolutionary concept. Of course there are the historical precedents that led to hyperinflation in Germany, Zimbabwe and elsewhere. But in fact, monetisation already happens every year in almost every country. As the economy grows the money supply needs to be increased in line with that growth to keep inflation positive. Who benefits from this newly created money? The government. This is known as seignorage, but QE also generates some monetisation because the central bank pays the interest back to the government (QE is like an interest free loan). The Fed transferred about USD 100 billion back to the US Treasury in each of the last two years.

So how is the rest of QE different from monetisation? Because QE is temporary, while monetisation is permanent. Suppose the central bank introduces QE by buying EUR 50 worth of bonds in each of two years (chart 1a). The stock of money is up by EUR 100 in year two and stays there until the debt starts to mature and the stock of money begins to decrease. There is some permanent effect from the money the government saved on interest payments.

With permanent monetisation (chart 1b) the increase is never reversed. That means the extra money (EUR 100 in our example) ends up in the private sector and remains in the system forever, contributing to inflation. Inflation expectations should therefore be pushed higher. The interest that the government does not have to pay is also effectively a monetisation, and that increases every year (at least compared to the base case).

Chart 1: Different dosages

Illustrative increases in the stock of money by policy type (EUR or any currency)



Source: UBS Asset Management

Will monetisation have any effect on nominal growth? Firstly, monetisation will only have an effect on nominal growth if it results in more government spending or lower taxes (rather than just reducing the level of debt). Or, if you want to be more revolutionary, monetisation will impact nominal growth if the central bank gives new cash straight to households (although you can see how that is pretty much identical to financing a government tax cut). At these extremes, the distinction between fiscal and monetary policy is blurred.

Economists will argue about almost anything, so it is no surprise that this topic is contentious. Some would argue that if the government runs a bigger deficit today, then people know that their taxes will go up at some point in the future. So any tax cuts today get saved in preparation. This is known as Ricardian equivalence, and it sounds pretty far-fetched. But what if governments have already announced the need for austerity and future tax increases? Any extra government spending today will immediately make people expect more taxation will be needed in the future.

But monetisation gets around that problem, because there is no debt to be paid back. Is this a free lunch? No, because the increase in the money supply should increase inflation expectations and, eventually, inflation itself.

Now comes another version of Ricardian equivalence: if central banks are strict inflation targeters, then they won't be happy with a permanent increase in inflation. At some point in the future, they may therefore have to reduce monetisation. If monetisation is temporary, it can end up looking identical to QE (chart 1c compared to 1a).

So when does monetisation make sense? Well, mostly if the unwanted side effect of higher inflation expectations is actually the wanted main effect. Take the example of Japan, where inflation expectations have been well below the 2% target for a long time, or the Eurozone where such expectations are in danger of falling lower. When inflation expectations are falling below target, the bold shock of monetisation may be exactly what is needed.

If you do not believe in Ricardian equivalence, then fiscal policy will work because people will not save all the tax cut today in anticipation of a likely tax increase in the future. For example, if people are credit constrained such that they cannot borrow as much as they want, fiscal policy effectively borrows on their behalf. If this is true, then you can simply use fiscal policy to boost the economy rather than monetisation. But sometimes there are political limits (as in the Eurozone), or market limits (interest rates may only stay low as long as government debt is on a sustainable trajectory). In such circumstances monetisation may be a way to sidestep the political constraints.

During a recession the effectiveness of monetisation could be even greater, because there will be more cash constrained households. And recessions are also just the time when governments may be facing budgetary pressures. During recessions, it is unlikely that additional government spending will crowd out private spending because there are so many unutilised resources. This suggests that during recessions, monetisation may not just create inflation, it could also create additional activity to help close the output gap (similar to more conventional monetary policy). In any case, even if households use the cash to save or bring down debt, perhaps because they are in a deleveraging cycle, it will bring the end of that cycle closer.

Monetisation and QE also differ in their distributional impact. These differences are important, and often ignored in macroeconomics. An important transmission channel for QE has been to push up asset prices (higher equities, lower bond yields). Higher asset prices benefit those with the most assets who are, by definition the wealthy. And people who accumulate assets have already demonstrated a high propensity to save. So they are less likely to spend from their higher wealth.

Monetisation can be targeted more equitably, giving everyone in the country the same amount. Or even progressively, so that it only goes to those with less income. Either way, more money would go to those who are cash constrained so more would end up being spent. It would also be more popular than a policy whose benefits are skewed towards the rich. When one really thinks about it, isn't it QE that is the rather odd policy?

The danger with monetisation is that it can be like a drug; it seems to answer all the difficult questions at little cost. It is like a drug that makes your heart beat faster: life-saving if your heart rate is slow, life-threatening if your heart rate is high. So like a medical drug, it is best left under the control of the doctors, not the patient. As long as the central bank uses monetisation to maintain the credibility of the inflation target it is useful; if monetisation is used by governments as a revenue-raising substitute for difficult tax-raising decisions it is not.

So central banks are clearly not out of potential cures, it is just a question of whether policy-makers can create the frameworks to overcome the traditional association with hyperinflation. Not that there are any free lunches, and in a subsequent Economist Insight we will look at the potential side effects for the banking system from this particular drug.

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