Debt and money illusion

Today there are countless calling on us to solve the problems arising from excessive debt by using the means of monetary creation.

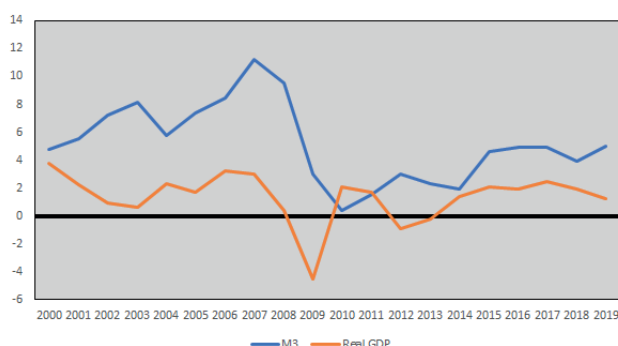
Before discussing this, it is useful to ask a fundamental question: where do these massive debt problems come from?

For many, it is the result of years of "easing", feasting, not famine: instead of "living within our means" and limiting new debt to financing activities that would fuel future economic growth, too often we have resorted to using debt to finance consumption.

If we look at a country like France, we see that much of its public debt has been used to pay for current expenditure (personnel costs, administration, social system deficit...). This drift explains the fact that debt keeps growing with the passage of time: not being a creator of future wealth, it is difficult to repay it and expensive to serve; it accumulates.

This phenomenon is synthesized in the following graph concerning the EU but is valid worldwide.

Real GDP growth against M3 growth in the euro area, %



We can see in the diagram that credit growth – which has consistently outpaced economic growth since the early 2000s – has been at the root of "over-financing" the world and is the resulting cause of financial crises (in previous periods, economic growth and credit growth were moving more or less in tandem).

Continuous recourse to debt has led – to the indifference of the monetary "authorities" – to trends and figures that are historically unbelievable.

Thus, in 2019, before the pandemic hit, global debt – public and private- reached a peacetime record of 230% of world GDP. The increase in debt in 2019 compared to the previous year was almost 15%, out of all proportion to the rate of economic growth (3,2%).

We have ended up getting used to this "financialization", which has the merit at least for some operators in the financial sector, of ensuring them exorbitant remuneration.

In short, these are the results of thirty years of monetary laxity. Worth noting that over the last twenty years, Central Banks have actively kept key real interest rates in negative territory for eighteen years...

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It was in this explosive and deteriorating economic and financial environment that the coronavirus occurred. The economic crisis associated with the pandemic is to a very large extent a supply-side problem : where the unpreparedness of public authorities to deal with the health situation has been the most evident, governments have been obliged to strictly and indiscriminately confine populations and shut down a significant part of economic activity. Because of the lack of patient testing, everyone was ordered to be confined, authorized activity was kept in line with the number of beds available and the maximum daily capacity of the hospital system to treat serious cases...

The problem of debt and the public accounts have been greatly aggravated now by the additional spending to tackle the containment-induced unemployment. The halt in production, forecasts of European growth being down in some countries by 10% or more this year and the need to support employment explain the explosion in public debt ratios, most of which were already problematic even before the health crisis.

So, what can be done?

We cannot and must not go down the wrong road again.

Basically, two approaches can be considered.

The first is to deal with the problems, the second is to deny them and to try to "circumvent" them.

What are the advantages and disadvantages of these two approaches?

1. A "classic" and rational approach

a) According to this view, past excesses must be redressed, to ensure that they do not recur, with public finances better managed by focusing on future investments and reducing the least useful current expenditure. In France, as in many other countries, a primary surplus (without debt servicing costs) will have to be gradually built up, which will make it possible to start the desirable – and necessary – process of gradually reducing public debt levels. The mere fact of having made this effort – which was necessary in any case even before and independently of the pandemic – would have positive effects on the perception of the quality of national debts as perceived by foreign investors in particular.

What is the alternative? Agreeing passively, without reacting, to go from 100% of Debt/GDP to 120% at the end of 2020 and thereafter, continuing, as we have been doing for decades, to add deficits and increased public spending every year thereby registering a continuous increase in our debt? We hear this murmur, this whisper of easing on both sides: "We have reached a new debt level but let us not change out habits". This would be the worst solution. It would be tantamount to setting in stone bad habits, refusing to consider intelligently the real challenges, including inter-generational equity to be fair to our children and grandchildren.

Or, to use the budget as an engine of growth and progress and not as an untouchable, inflexible monument serving the existing bureaucracy. This approach requires rational questioning and examination of the least useful public expenditure and drawing up a prioritized plan for the future.

Is the second approach above irresponsible "austerity"?

Some say yes. But this is forgetting that a country like Germany - which for the past ten years has reduced its public debt burden from 84% to 60% of its GDP – greatly benefited from this policy when the coronavirus crisis hit:

- The debt margin created by so-called "austerity" has assisted German to be much less affected by the crisis than France (-6,5% GDP decline in Germany expected in 2020 compared to -10% in France). Germany was able to decide on a much more vigorous recovery program than those of many of its European partners who are tackling the crisis without sufficient margins and with debt ratios at the limits of sustainability. It should not be forgotten that the effectiveness of the Keynesian multiplier depends very much on the degree of indebtedness at the start of the programme.
- The rigorous, far-sighted and long-term management of the German budget has made it possible to target public spending more wisely : at a cost equal to 9% of GDP; the hospital system in Germany faced with the pandemic proved better equipped (tests, respirators…) and was more able to react efficiently (integration of private clinics into the common effort, systematic use of town medicine, good governmental structures…).

b) The second aspect of this approach consists of addressing, through negotiations, the problems of the unsustainability of Governments' debt

A debt is defined a contract between the debtor and the creditor. Since the beginning of time, negotiated solutions of wisdom have been used in cases of serious debt difficulties. If the debt becomes unsustainable because it is no longer compatible with the debtor's earning capacity, both parties renegotiate the contract to take into account the new reality.

In the current situation which has been massively exacerbated by the effects of the pandemic, it would seem advisable to rely, in the most acute cases, on this case-by-case negotiation procedure. The financial world has experience of these negotiations, which should be conducted in the spirit of serene cooperation, considering all the realities and the prospects of a return to better fortunes in the debtor countries. The IMF has acquired expertise in this area and creditors – albeit even numerous ones - know how to coordinate action in the order appropriate bodies (e.g. the Institute of International Finance).

2. The approach of denial

The classical approach I have just outlined seems to have few supporters:

- It involves budgetary efforts and a strategic vision of the future. The advocates of "facility" would like people to believe that any elimination of a useless public expenditure would be decrease of sustainable growth and prosperity. The truth is the contrary, that such actions are key for growth because they would free resources for productive investment in the future.
- It involves delicate restructuring

Other ideas emerged as well, the inspiration of which could be summed up as follows: "Why go through so much trouble, in an uncertain and troubled situation, when depression threatens, when money creation can fix everything at no cost?" The temptation is general, enticing but it can be demolished intellectually in various ways:

- Helicopter money is in vogue. Rather than going through normal channels - Central Bank - commercial banks - customers, a channel made uncertain by the difficulty of forcing an already weakened banking system to lend - it would be more efficient to allocate free money created by the Central Bank to citizens in the hope that they will spend it on consumer goods.
- The problem of new bond issues by already highly indebted states would no longer arise if the Quantitative Easing (QE) policy were pushed far enough. The markets, which buy these bonds, must avoid discriminating between issuers and applying spreads to the securities issued that reflect the risks incurred by each issuer. To counter this risk, Central Banks can buy government securities for considerable amounts (sometimes without limit as in the USA and UK). This has the effect of reducing spreads and making it easier for States to issue at very low rates. In this way, whatever the starting level of public debt (60% of GDP in Germany, 100% in France, 125% in Italy…) new issues – in a way guaranteed by QE - will be at almost equal rates. The risk premium will, in fact, have disappeared to the great benefit of the most vulnerable borrowing States. And to ensure that the interest burden on existing debt is not too heavy, the Central Banks set their key rates at very low levels in real terms, or even at negative ones. But, obviously, this policy must be extended over time to stabilize expectations and avoid volatility; in fact, the Central Banks communicate by anchoring in the public mind the idea that rates will remain low for an indefinite period.
- But what about the stock of existing debts? It benefits, in part, from the QE insofar as the refinancing of old maturing debts also gives rise to issues and repurchases on the market by the Central Bank. But some would like to go further and deal with all the stocks that amount to astronomical amounts at once. Could we envisage that the Central Banks might buy back at par the totality of the public debt of their States? Some recommend transferring existing public debt held by investors to the Central Banks. In this way, after the debt has been acquired by the Issuing Institutes, it could be cancelled, and the States would find themselves … without debt. A less radical version of this proposal would be for central banks to cancel their QE holdings (the ECB has just rejected this idea).

Such proposals raise obvious and serious objections:

- Normally, if the Central Bank buys government debt securities, it intends to obtain from the issuing government all the rights attached to these securities and in particular the servicing of interest and repayments. In the event of unsustainability, potential losses should be recognized in due course. But the pure and simple cancellation of debt instruments after their acquisition would be a major fiscal act in favour of the States, a decision which would go beyond the most elementary accounting rules and the statutes of the Central Banks.
- The purchase, by monetary creation, of all public debt would represent the equivalent of world GDP. This would obviously make no sense and could have serious inflationary consequences. And what alternative investments would investors who have agreed to sell their sovereign securities to Central Banks focus on? In fact, it is likely that holders of good quality public securities will wish to keep them as risk-free investments for reasons of liquidity and portfolio diversification. They would therefore only sell to Central Banks, according to this scheme, problematic securities, which

would be a piecemeal way of dealing with the problem of public debt that has become unsustainable by transferring it to the Issuing Institutes. This solution is far from obvious, indeed flawed.

- If the Central Banks were to buy doubtful securities at par, they would suffer an undue loss; they would therefore have to negotiate a realistic purchase price and thus replace the usual restructuring negotiations.
- As for the risk taken by the Central Banks in the event of such a transfer of debt, it would undoubtedly generate definitive losses on their balance sheets in the long term and would therefore, according to some, oblige the States to strengthen their equity capital. The Member States would therefore ultimately find themselves responsible for, and financing, the debt transfer operation.

Despite these objections, the fact remains that the proponents of the thesis of total or partial repurchase of existing debts caress this idea as an almost mythical way of reducing the debt to a level close to zero in order to get humanity back on track ... without having to deal with budgetary problems or structural reforms.

Unfortunately, this new world view that money creation would solve all the problems of today and tomorrow is based on a profound illusion.

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The fundamental problem with this “vision” is that fiat money is not the equivalent of wealth. Money created ex-nihilo is only effective if it is part of a healthy and vigorous ecosystem.

The reality is that most of these so-called “new ideas” have the particularity of giving with one hand while taking away with the other. Let me explain.

A Central Bank can buy existing debt instruments on the market through monetary creation. In doing so, these bonds are transferred from a holder to the Central Bank. The owner of the security has therefore changed: it is now the Central Bank, which can offer advantages in times of crisis (because of the potentially almost unlimited scale of its purchases, the Issuing Institute, as a stable buyer, can raise the value of these securities and at the same time lower their interest rate, which will facilitate the financing of the budgets of the most vulnerable States). But what must be understood is that the debt represented by the title is still there and that the State must continue to service it according to the legal contractual provisions. This would only be different if the Central Bank could cancel the value of the debt thus purchased. But as we have seen above, such an act, which would amount to the Central Bank taking a major fiscal decision (the financial consequences of which, moreover, would ultimately be borne by the State concerned), and is not in line with the division of tasks and responsibilities in our democratic systems[1].

It is therefore understandable that, despite QE and its possible magnitude, the budget constraint remains. This is an important point. It should not be thought that the quasi “guarantee” of sovereign securities purchases by the Central Bank eliminates any possibility of judgment and analysis by the markets. Analysts and rating agencies will continue to examine ratios and make judgments about the quality and sustainability of public debt. This point should not be taken lightly: rating changes are an important element of an issuer’s “signature” and also a key factor in the decision to buy securities by private investors, especially non-residents. However, as they are very sensitive to the rating, they play a decisive role in the demand for public securities offered for issue. Considering that these judgements voiced by the markets do not matter, because the Central Bank will always be there to buy, is doubly inaccurate: the Central Bank will not ALWAYS be able to buy EVERYTHING, as we shall see below, and the quality of a State’s signature is an essential element of confidence that must be preserved at all costs for the country’s future.

Just as in a crisis we can use QE to reduce market spreads in order to get through the turbulence without too many hiccups, as we are doing today, it is questionable to argue that this is a permanent feature of new monetary policy.

Without even raising the problem of the likely inflationary effects of a policy consisting of monetizing a very substantial part of sovereign - or even private - issues (this discussion, in the current context of under-utilisation of production capacities, is too theoretical and does not lead to any certainty), the fact remains that a systematic and prolonged use of monetary policy to keep rates low is likely in the long term to have negative effects on the very quality of money: I have already said a word about the effects of this policy - and the budgetary slippage of which it is a corollary - on our rating, a rating that we should consider as the apple in our eye.

The current situation is curious: after decades of monetary easing, rates are at zero, or negative, so there is no room to lower them as a depression threatens. As for budgets, they have slipped into repeated deficits and often unsustainable debts. Again, there is no margin to use. The temptation is to try to get out of this double contradiction by inflating the money supply more and more.

The thesis is simple: since budgets are stretched to the extreme, let us allow governments to spend as much as they need without having to bear the cost of uncertainty - and therefore the spreads - of the markets. Central Banks will be able to triple, or more than triple, their balance sheets by buying sovereign issues at yields low enough not to impede fiscal stimulus.

As for interest rates, if they are at zero: “Never mind,” some say, “let us implement frankly negative rates and pass them on to depositors”. This view suggests that monetary policy would regain its room for maneuver by creating negative real rates despite the absence of inflation.

But, if one thinks about it, the two theses stated above contain innate fatal contradictions.

The first presupposes, in fact, that quantitative easing is permanent, since the more financial markets are shaped by monetary policy, which comes to control the entire yield curve and to guide market expectations in a detailed manner, the more difficult it is to change and normalize policy. The fear of a sudden market downturn is such that Central Banks feel obliged to maintain their accommodating policy for an indefinite period. In the fall of 2018, we saw how the Fed was forced to stop its gradual normalization effort, which had begun two years earlier.

But this resignation to never change policy poses a particular problem in the euro area. While the national central banks can

[1] The Treaty on the Functioning of the EU prohibits monetary financing (Article 123)

do practically everything within the political consensus, this is not the case for the ECB, which is a multilateral institution governed by a Treaty and where the Member States have to find common ground on the crucial issue of the divide between monetary and "fiscal" policy. Between targeted interventions - however massive - and a policy of permanent purchases leading to a major change in the balance sheet and the role of monetary policy, there is a margin that is far from obvious. The recent decision of the Constitutional Court in Karlsruhe is a warning in this respect.

Negative rates, on the other hand, are supposed to encourage productive investment, which has been in decline for more than a decade. But the reality is quite different. It has been shown that negative rates deter savers, particularly in Europe, from investing for the long term and encourage them to hold on to cash, a strong trend observed in all European countries. If the Central Banks continue to announce the permanence of zero or negative rates, it is now clear that productive investment will not resume. How can we catalyze savers to invest in future projects with their share of risk if all we are going to give lenders is zero remuneration?

A policy you cannot get out of is not a good policy. Any strategy must include an element of flexibility to respond to events.

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The current impasse is eminently dangerous: to continue indefinitely a policy of monetary easing that leads to declining growth, a decline in productive investment, rising debt, market instability, speculative bubbles and the survival of zombie companies boosted by low rates ... is a grim outlook.

If this is the price to be paid to avoid having to deal with substantive issues that have been neglected for too long, it is certainly not the right way to look at the post-crisis period.

Written by Jacques de Larosière