Monetary policy impacts

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It is time to expand macroprudential framework in the non-banking sector

In the view of many investors, the low and even negative interest rate environment (LIRE) has slowly become the most prominent risk that threatens the stability of the financial system in the EU. It has, perhaps, even become the new normal as depressed interest rates marked the entire decade. Although these developments are somewhat lagging in Croatia, as interest rates are relatively higher compared to other EU countries due to national idiosyncratic reasons, they are highly relevant because both banking and non-banking financial sectors are heavily exposed to domestic government bonds, whose long-term yields are rapidly converging towards zero. Insurance companies and pension funds are especially vulnerable to LIRE risks due to their business profiles, which are characterized by negative duration gaps, particularly those that issue products with guaranteed rates and defined benefit pension plans.

While direct risks that negatively affect stability of the financial system are notable, what is more important is the indirect effect that LIRE has on the system through its negative effect on economic activity, which continues to be subdued more than ten years after the global financial crisis. There is a growing consensus that current environment characterized by low interest rates and anemic growth is more determined by structural factors (declining productivity of companies and falling profitability that hinders new investments and contributes to the accumulation of the excess savings, increasing social inequalities, negative demographic trends and risk aversion) than cyclical factors (relaxed monetary policy, over-indebtedness of private and public sectors).

Therefore, the discussion regarding the LIRE should be broadened to emphasize its effect on real economic activity, which eventually impedes the profitability of financial institutions. In order to successfully restart the economic and financial progress in the EU, organized collective effort of all policyholders is needed, such that would focus on long-term and broad-based goals. More specifically, long-term view should take into account sustainability and environmental impact of long-term investments, while broad-based view should be socially sensitive and inclusive. Some steps in the right direction have been made to reach these goals, but majority of the road still lies ahead.

Since we are finding ourselves in uncharted waters, growing emphasis is, and will continue to be, placed on unconventional policy, more specifically on macroprudential policy actions. Therefore, policymakers should utilize the present relatively stable environment to further improve macroprudential regulation focusing on cross-border and cross-industrial harmonization of macroprudential rulebook. Even though macroprudential regulation in banking sector has made significant leaps following the global financial crisis, progress in non-banking sector is still lagging, which creates possibilities for regulatory arbitrage. The significance of closing this regulatory gap is even more highlighted by the rising importance of the EU non-banking sector as (investment and pension) funds and insurance companies are steadily increasing in size, are becoming highly connected (directly and, more importantly, indirectly) with the rest of the financial sector and are strengthening their relevance as a source of funding for the real economy.

> *We are swimming in uncharted waters and growing emphasis is being placed on macroprudential policy.*

In other words, policymakers should work proactively to improve their macroprudential toolboxes, following the banking example but also taking into account industries' specificities and the current macroeconomic and financial environment (LIRE), while simultaneously improving the resilience of financial system in order to support sustainable long-term investments. ●

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For a new Bretton Woods

The coronavirus pandemic beyond its health aspects, will profoundly disrupt the economies of the planet for a long time to come.

The brutal and widespread recession in the global economy this year will trigger a worldwide wave of public spending to limit the social effects of the recession such as unemployment or the disappearance of cash flow in many companies. It will however increase public and private indebtedness, which risks accelerating imbalances in indebted economies and slowing down structural reforms that have not yet been carried out, while new sources of imbalances are emerging with the violent fall in oil prices, the probable fall in the price of certain raw materials, the financing needs of an inevitable energy transition and the negative effects of geopolitical conflicts such as the Sino-American strategic conflict.

The European Central Bank and Member States have already implemented significant and timely monetary and budgetary measures to deal with this global crisis and to ensure there is ample liquidity across the EU. But Europe must fight the tendencies towards fragmentation accentuated by the national egoism visible in the health crisis. At the moment the EU is facing one of its biggest economic challenges, it needs to make a collective effort in favour of a " shared sovereignty" on the political, economic, industrial and health levels if it wishes to exist in the face of pressure from a China that is filling the void left by the American weakening that has been perceptible since long before the Trump mandate.

More generally, it is the entire system of international economic relations that needs to be the subject of in-depth review because the problems and solutions are cross-borders. Even if this perspective may seem optimistic or even utopian, this crisis is an exceptional opportunity to make progress towards the implementation of stabilization mechanisms that take into account the major challenges common to the entire planet. Fortunately, elements of such a consultation have already been initiated, particularly in the climate field.

But if we want true global collaboration, we must also reorganize the international monetary system. Indeed, the "non-system"; in which we live has a great disadvantage: The absolute freedom that reigns in the exchange rate area raises suspicion. The easing of monetary policies by some countries is often seen as a disguised way of depreciating their exchange rates. In fact, since the end of the war, we have never been so close to the situation in the thirties ("beggar thy neighbour").

> *It is time for the major dominant economies to understand that a minimum of stability is in the common interest.*

Consideration must be given to the future pivot of the future system in order to stabilise exchange rates: should we envisage a return to gold, or to a revisable basket of raw materials - which would undoubtedly be better adapted to today's multipolar world, or to Special Drawing Rights additional to the rights stemming from a Monetary Fund with revised quotas? It is also necessary to work on the means of organising and monitoring, around the IMF, effective surveillance of the new system.

This work could be entrusted to a small 'Group of wise men" including experts and representatives of the major international financial institutions: BIS, IMF, Central Bank of China, Central Bank of Russia, etc. , in order to take stock in a forward-looking manner of the possible options and possible timetables.

It is time for the major dominant economies to understand that a minimum of stability is in the common interest. ●

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Helicopter money: Panacea, shell game or Faustian pact?

Since the GFC, proposals for economic stimulus through the recourse to helicopter money have multiplied. Recently, the measure has been associated with the issuance of a central bank digital currency or the fight against the Covid-19 epidemic. It is thus seen as a panacea. This piece is meant to be factual. It describes the concept and the advantages it is supposed to bring, to show that it is more akin to a shell game, if not a Faustian pact.

The concept of helicopter money

The concept of helicopter money is old. It already appeared in Friedman's essay *The Optimum Quantity of Money* (1969). Friedman describes it as a "thought experiment" in which a helicopter flies over a society that has reached a state of economic equilibrium and drops bills that are hastily collected by members of the community. He shows that the measure has no long-term effect on the level of output, only on the level of prices. In the short to medium term, output can rise or fall, due to opposite effects on demand (part of the helicopter money is spent) and supply (labour supply is reduced).

Only much later did Bernanke (2003) suggest that Japan could combat deflation by pursuing a policy of public deficits financed by permanent purchases of public securities by the central bank. Bernanke (2003) stresses that the central bank's balance sheet is protected, since it holds a claim on the Treasury. However, this protection precisely prevents the measure he suggests from being regarded as helicopter money *stricto sensu*. Indeed, helicopter money is a gift on the part of the central bank: bills are dropped from the helicopter without the central bank acquiring a counterpart and thus correspond to a loss on its books. The gift approach has been rationalized by many, eg Caballero (2010), within a monetary and fiscal policies coordination framework.

Helicopter money and public finances

On public finance side, public debt does not increase. In accounting terms, that is true but, since the aim is to have a public deficit financed by the creation of central bank money, it is the total made up of the general government and the central bank balance sheets that must be taken into account. Indeed, the increase in the Treasury's account at the central bank in the first instance, and the increase in banks' accounts at the central banks in the second instance, following expenditure by the Treasury, increases the liabilities of the central bank by the amount of the creation of helicopter money (Cecchetti and Schoenholz, 2016). The consolidated debt of the central government and the central bank thus increases.

Furthermore, the money created has no cost for public finance. Again, that is accountingly true, at least in the very short term. However, the seigniorage of the central bank, and thus the profits it can pay to the State, are permanently reduced. Indeed, the increase in reserves held by the banks entail a fall in banks' refinancing and/or an increase in banks' excess reserves, which are remunerated. To do otherwise, the interest rate on the excess reserves (the deposit facility rate in the case of the Eurosystem) would for example have to be set permanently at zero, which would be tantamount to abandoning any monetary policy (Borio et al. 2018).

It therefore seems that presenting helicopter money as having no impact on public debt and deficit boils down to a shell game. It is the "free lunch" where Borio et al. (2016) see an illusion.

Helicopter money and the central bank

On the central bank side, helicopter money would first circumvent banking intermediation. This seems self-evident but it would clearly be a "second best" compared to relying on the banking system. Indeed, banks have a better knowledge of their customers' finances than public authorities have of their taxpayers'.

Second, helicopter money would have a substantial impact on demand. In fact, much would depend on how the measure is perceived by the public. In particular, if it were seen to reflect a diminished ability of public issuers to access capital markets, the public might become concerned and increase their savings. In this regard, Bernanke (2016) proposes that the central bank itself should decide, on a legislative basis, on the appropriateness and the amount of helicopter money. However, even under the difficult conditions associated with the Covid-19 epidemic, no government has considered establishing such a legislative framework, perhaps precisely for fear of damaging its reputation.

Third, seen from an ex ante perspective, it should be easy to withdraw once the economic recovery objective is achieved. But its withdrawal should then produce the opposite effect to its implementation. If the measure were to become permanent to avoid this circularity, monetary policy and the central bank's balance sheet would be permanently affected. A Faustian pact would thus have been signed. ●

This article has been co-written with Christian Pfister, Deputy Director General, DG Statistics, Banque de France
The views expressed in this article represent those of the authors and not of their institutions.

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That's one small virus for man, one giant leap for economic policy

The global economy has entered the most severe recession since the 1930s. But this is a new kind of crisis by its very nature. Comparisons with the Great Financial Crisis of 2008 or the Great Depression of the 1930s are misleading because at its source, this is neither a financial crisis (there was no bubble burst) nor a debt crisis (even though the world has entered this recession with historically high levels of private and public debts). The collapse in economic activity has not been triggered by the direct impact of the epidemic but by the global lockdowns, which have brought entire sectors of the world economy to a standstill. Half of humanity are confined to their homes, which is unprecedented in modern history.

Two essential things must be kept in mind. First, an epidemic is by its nature temporary. Second, given the characteristics of Covid-19 (low mortality rate in the labour force), potential GDP growth should not be affected in the medium run.

It was therefore necessary first to prevent the economic crisis from becoming a true financial crisis. Governments and central banks were equal to the emergency. Economic policies implemented on both sides of the Atlantic are unprecedented on both the fiscal and monetary policy fronts, with stabilisation plans equivalent to 10% to 20% of GDP (including loans and guaranties) and an expansion of central banks' balance sheets unseen throughout history.

Stabilisation programmes are being carried out in different ways on each side of the Atlantic, but the spirit is the same: the aim is to maintain macro-financial stability, compensate temporary unemployment, and avoid a full blown credit crunch with cascading corporate bankruptcies and defaults. The common goal is to protect the economy as much as possible during the recession in order to allow recovery once the epidemic is under control.

At the end of the day we are witnessing a de facto merger of central bank and Treasury balance sheets. Public debt will de facto be monetised. Debt securities will be purchased by central banks in order to keep bond yields at a very low level. The entire yield curve is now under control. Sovereign debt issuance (net of redemptions and central banks' purchases) will be negative in the major advanced economies in 2020. In the United States, it is the first time this has ever happened. Given the scale of the ongoing recession, public debts will rise very sharply, and bond yields would have soared without central banks' asset purchases. Subsequently, central banks' balance sheets will soar in tandem with public debts. Governments have become the buyers of last resort, while central banks are playing their role as lenders of last resort. Fiscal and monetary policies have become intertwined, and this is not reversible.

A crisis of this nature thus calls for a paradigm shift in terms of economic policy. Historically, economic and financial crises have always given the authorities an opportunity to equip themselves with the appropriate instruments to contain them. Indeed, it was following the crisis of the 1930s that the Fed adopted the statutes that enabled it to deal with the GFC in 2008. And it is thanks to the 2012 sovereign debt crisis that the ECB is today able to support (among other things) the guarantees provided by the governments. Most of the tools mobilised (or that could be mobilised today) in the Eurozone were put in place after 2012 to save the euro.

> *We are witnessing a de facto merger of Central bank and Treasury balance sheets.*

How long will central banks be able to monetise debts without causing a general loss of confidence? How long can interest rates be kept so low? Can inflation resurface? All these questions will likely remain unanswered for a while. The only certainty is that fiscal dominance has now become a reality among the major advanced economies. And whether we regret it or not, this process is not reversible.

For those who fear that a global debt crisis is looming, it should be remembered that debts owed to the central bank are unique in that they can be spread over time indefinitely, or even partially cancelled painlessly.

Ultimately, the policies that are put in place will inevitably shape the debate once the crisis is over. In Europe, leaders will at some point be forced to recognise that a single federal budget and a single financing instrument for the Eurozone would probably have been more efficient to manage this crisis. The birth of a European budget and a common debt will perhaps be the institutional traces that this crisis will leave in history: a forced march towards the "United states of Europe". ●