

# The economic crisis: How to stimulate economies without increasing public debt

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Despite years of applying conventional and unconventional policy instruments many economies are still anaemic, and some are sliding into depression. GDP, manufacturing output and exports are weakening in the Eurozone, the US, the UK, Japan, and elsewhere. Housing sectors have yet to recover in many countries. Banking sectors remain fragile.

Partly as a consequence of the policy responses to the earlier global economic recession, fiscal deficits have risen and, as a consequence mainly of the 'bond financing' of these deficits, public debt is now much higher than in 2008 at the beginning of the global economic crisis. At the same time, generally, QE policies have run their course, as in many countries policy interest rates are at their zero bound or at historical lows.

The macroeconomic policies that have been adopted over recent years have failed to restore the levels of sustainable growth needed to substantially reduce unemployment and to prevent the public debt burden spiralling upward.

The current difficulties are most acute in the periphery countries, where new debt is being added to existing debt in what must ultimately prove to be a self-defeating exercise as a means to buy more time. In that region there is a possibility that financial crises could occur simultaneously across a number of countries, with Greece, Italy and Spain possibly falling into this category. Simultaneous crises would complicate the policy response, increasing risks to the global economy.

It cannot but be clear to all that in many of the Eurozone periphery countries public debt, which is already excessive, is set to go higher. The 'new government bond' financing of ongoing budget deficits will ensure that this is so. The need to rollover maturing debts, and potential private capital outflow, will also bring additional debt stress, and will probably place additional demands on northern taxpayers.

In most periphery countries, gross general government debt as a proportion of GDP is already significantly above 100% and debt burdens are rising as GDP falls, as new government bonds are sold to finance ongoing budget deficits. As the public debt crisis deepens and spreads into private commercial operations and across borders, economic conditions will become even more unstable under current policy settings: interest rates will periodically surge higher, financial markets will be further destabilised, and deflationary tendencies will gain momentum. These forces will further add to public debt burdens.

Currently, multiple economic problems are affecting different countries.

The two central macroeconomic problems are deficient aggregate demand, and high and rising public debt.

High and rising unemployment is also a problem in many countries, but this is mainly a reflection of deficient aggregate demand. The high interest rate problem evident in periphery countries is essentially a consequence of bond-financed budget deficits, high public debt and associated risk premia. Banking sector problems remain of concern.

Some periphery countries have an 'international competitiveness' problem, due in large part to the relatively rapid growth of their unit labour costs and prices. In many countries, declining productivity growth has contributed to poor supply-side and competitiveness outcomes since the beginning of the global economic crisis. The poor productivity performance of the UK is striking, particularly in comparison to that of Spain. The persistent weakness of productivity is not a normal feature of financial crises (Hughes and Saleheen, 2012). Particularly in some European countries, rigidities are widespread because structural reforms have not been sufficiently broad-based or progressed rapidly enough over recent decades.

Returning, however, to the central macroeconomic problems, insufficient aggregate demand and high public debt.

Aggregate demand deficiency can be proxied by unemployment rates. On this basis (and considering only Eurozone countries and major industrial countries) Spain, Greece, Portugal and Ireland have the greatest demand deficiencies.

The public debt burden (general government gross debt as a proportion of GDP) is highest in Japan, Greece, Italy, Portugal, Ireland, and the US. While estimates may differ, Padoan et al. (2012) estimate that once a country breaches a 106% public debt to GDP ratio threshold it can no longer on its own escape from a 'bad equilibrium'. All the countries mentioned above have gross debt to GDP ratios in excess of 106%. Separate analysis (Reinhart et al., 2012) suggests that, historically, the average duration of a debt episode is around 23 years. The Bank for International Settlements is reported to have concluded that "...in most advanced countries, the fiscal budget excluding interest payments would need 20 consecutive years of surpluses exceeding 2% of gross domestic product just to bring the debt-to-GDP ratio back to its pre-crisis level" (Plender, 2012).

The above suggests that the period of time needed to return the distressed economies to strong growth and full employment will be long indeed. This implies that fully articulated, coordinated, medium- to long-term policy frameworks will need to be developed by governments. However, a new short-term economic plan is also required, more or less immediately, to find a way through the current dangerous conjunctural disequilibria.

Given the gravity of the current situation and the number of problems requiring attention, policymakers will be required to consider the widest set of policy instruments to succeed. Failed orthodoxies will need to be jettisoned, and new policy paradigms developed for the new era of high public debt.

### **Simultaneous resolution of two problems: Instruments required**

Tinbergen's (1952) policy assignment principle provides an initial reference point when developing coherent macroeconomic policy frameworks. The assignment principle suggests a numerical relationship between policy instruments and policy targets. Tinbergen, and also Mundell (1960), suggest that, with appropriate analysis, it is possible to identify when an optimal combination of instruments will be achieved in order to address given policy targets. Tinbergen argues that each

policy target must be assigned at least one policy instrument.

Based on Tinbergen's conceptual analysis, it is highly likely that at least two policy instruments will need to be deployed to resolve today's dual problems of deficient aggregate demand and the high public debt. These instruments may be applied independently, or they may be coordinated and combined if synergistic efficiencies can be identified. Other instruments will be needed to address other problems.

### **Dissociation**

In the field of macroeconomics, it is often required that policymakers and politicians have to deal with more than one problem at a time. In the 1980s, for instance, many governments had to deal with stagflation – i.e. high and rising inflation and high and rising unemployment.

In such situations politicians in particular often battle with dissociation. The ability to resolve two or three macroeconomic problems simultaneously using different policy instruments can be difficult, and implementation of policies discordant. With stagflation, for instance, when inflation spiked upward politicians focused their main policy responses on that problem, tightening monetary policy. But when unemployment data releases later pointed to sharp rises in unemployment (which grabbed the headlines) politicians then quickly turned to efforts to solve the unemployment problem, ignoring the need to continue to address inflation at the same time. Their various policy actions sometimes conflicted with each other, and were not always conducive to solving both unemployment and high inflation simultaneously.

The dissociation risk today arises in respect of the dual problems of inadequate demand and high and spiralling public debt. Efforts to solve the public debt problem with sharp austerity measures – aimed at achieving budget surpluses in order to lower public debt – run the risk of worsening the problem of inadequate demand. Equally, as unemployment increases as a consequence of austerity, attempts to change course and quickly address the inadequate demand problem by bond-financed fiscal stimulus measures would further raise public debt. Such a response in the midst of the unfolding crisis would represent a policy misjudgement of colossal magnitude.

The art of macroeconomic policymaking in these circumstances is to identify a coordinated policy response that addresses both problems simultaneously – that is, without action on one front worsening the outcome on the other.

In this context, as we will argue below, coordinated monetary and fiscal policy actions can lead to better outcomes than in circumstances where fiscal and monetary policies are determined independently in separate silos: fiscal policy by the ministry of finance, and monetary policy by the independent central bank.

## Monetary and fiscal policies: The Eurozone case

### Monetary policy

In Europe, creating new money to periodically buy up excess periphery-government bonds in order to lower resurgent interest rates (whenever the interest rates on government bonds rise above a threshold level – 6% or 7%, say) is a purely ‘reactive and defensive’ strategy; one that, as the abovementioned historical results suggest, could go on for two decades or more.

In attempting to stop interest rates rising excessively by purchasing government bonds on the secondary market, risky bond accumulation is increasingly destabilising the central bank balance sheet (particularly if *pari passu* applies: that is, that the ECB accepts equal ranking with other creditors). Any new issuance of government bonds in periphery countries – to *finance* their forecast ongoing deficits into the future – will continually re-ignite the public debt problem, and trigger the need for further bond purchases on the secondary market by the European Central Bank. The current monetary policy does nothing to extinguish the source of the debt fires or lower government debt, let alone establish the conditions needed for the restoration of economic growth.

Once the policy interest rate is taken down to its zero bound – a desirable step when aggregate demand is falling – there is little evidence that the further application of ‘quantitative easing’ (QE), aimed at pulling bond interest rates back below 6% or 7% or whatever, could permanently address rising risk premia or sufficiently raise investment and demand. Commercial banks already have large excess reserves, housing stocks remain excessive in some countries, confidence has collapsed and, with QE, the new money does not reach the unemployed, the disadvantaged, or other potential consumers generally. In terms of its likely effectiveness, it probably matters little whether the central bank itself buys the bonds or whether it provides a banking licence to the EU rescue fund to enable it to do so.

### Fiscal austerity

A budget deficit in itself does not raise public debt. The main source of the spiralling levels of public

debt in Europe, and elsewhere, is the issuance of new government bonds by governments to finance their ongoing budget deficits.

The sharp fiscal austerity solution currently being applied in periphery countries reduces demand, government revenues and GDP, raises the budget deficit, and increases the ‘public debt’ burden. Fiscal austerity policy aims, *inter alia*, to lower public spending and raise taxation as a means to lower the magnitude of the fiscal deficit, and eventually provide for fiscal surpluses. By lowering the magnitude of the fiscal deficit it is hoped that there will be smaller upward movements in public debt, and later budget surpluses would work to lower the public debt burden.

The main problem with this crude strategy, however, is that its basic aims are not being achieved because the policy is procyclical in the current circumstances of falling aggregate demand, impotent monetary policy and a liquidity trap. Austerity lowers growth or causes recession/depression, and as output weakens then tax revenues decline and public expenditure is increased. As a consequence, the budget deficit, the public debt, and interest rates are all higher than might otherwise be. The heightened budget deficit is unhealthy as it is due to income destruction lowering tax revenues rather than being due to healthy cuts in income tax rates. In such circumstances in the 1920s, the US president Herbert Hoover tried to eliminate the deficit by raising taxes; a policy which is inimical to the objective of raising private demand.

Austerity, it is argued, results in internal deflation – falling output, incomes and prices – and, in that way, works over a long period to improve the international competitiveness of periphery countries. But deep austerity is not the only way to achieve lower wages and prices: that could be achieved much more efficiently (see later) by prices and incomes policies in periphery countries without creating crippling unemployment.

Austerity demonstrably results in growing popular opposition, not only to austerity policies but also to structural reform policies that, to most, cannot be separated from the austerity process. Resistance to structural reform grows. This ‘austerity fatigue’ thus further complicates longer-term growth possibilities.

### Bailouts

The ‘debt bailout/firewall/loan solutions’ potentially add new debts on top of existing excessive debts, creating additional burdens for the future.

## Eurobonds

The 'Eurobond solution' would require uncertain political compromises, and would mainly address symptoms rather than causes.

## Fiscal union

The 'euro fiscal funding union solution' would be ambitious but cannot be quickly arranged, and remains uncertain in its structure and application.

## Monetary union

The 'monetary union solution' seems sensible if the Eurozone is to survive, but may not be rapidly agreed or implemented in full, and would not solve all difficulties, particularly those which might develop in the short-to-medium term.

## Inflation

Inflating one's way out of the debt trap is not on the agenda of the ECB. While modest inflation may be beneficial, high inflation would be disastrous as one set of macroeconomic problems would be replaced by another.

## Does new money create a liability for the money-issuing authority?

Before considering new policy options — involving the use of new money creation — it is necessary to establish that the issuance of new fiat money does not add to public debt. If it did so, then it would be pointless proposing solutions that rely on new money creation.

In an elegant article, Willem Buiter (2003) formalised the proposition that new fiat money is not a liability to the issuer. Buiter demonstrates that the issuers of fiat money have no obligation greater than that of exchanging national currency notes for other national currency notes of the same value. No real liability is created by new fiat money creation, and therefore public debt does not rise as a result.

The authors of a recent IMF Working Paper (Benes and Kumhof, 2012) support this conclusion.

*'In this context it is critical to realise that the stock of reserves, or money, newly issued by the government is not debt of the government. The reason is that fiat money is not redeemable, in that holders of money cannot claim repayment in something other than money. Money is therefore properly treated as government equity rather than government debt, which is exactly how Treasury coin is currently treated under US*

*accounting conventions (Federal Accounting Standards Board, 2012).'*

## Monetisation of spending

We are now ready to identify two options in the general policy zone of monetisation of spending.

Option A is a pure 'helicopter drop' of new money by the central bank into private bank accounts. Option B is the creation of new money to directly finance the budget deficit.

Option A does nothing to resolve the 'public debt' problem arising from ongoing budget deficits, and that, along with the difficulty of appropriately targeting the drop, is probably its main weakness.

In contrast, Option B provides for targeted fiscal stimulus possibilities without increasing public debt. Under Option B new money can be transmitted through established fiscal policy channels to areas where it is most needed – the unemployed, those adversely affected by economic depression, those suffering from falling house prices (a consequence of early policy failure), public infrastructure activities, and so on – and where marginal propensities to consume and spend are greatest.

Under Option B it is first required that a money-issuing authority creates new money and, second, that the new money is made available to the treasury. This operation needs to be done in a way that does not increase 'public debt': public debt is conventionally measured by 'general government debt'.

In the US, for instance, if the Fed created new money and sought to pass it to the US Treasury (so that the Treasury could finance the deficit) then 'public debt' would increase. This follows because, in exchange for the provision of the new money to the US Treasury, the Fed would need to receive new government bonds from the Treasury, and this transaction raises general government debt, the measure of 'public debt' relied on by credit rating agencies. This is so for two reasons: 1) because the Fed is defined as an outside investor, and 2) because credit rating agencies 'look through' and see that government bonds held by the central bank could be sold to public at any time.

In the UK the accounting conventions also treat the debt held by the central bank as part of general government debt. The author is uncertain about how the relevant accounting standards operate in the Eurozone area, but presumably they are similar, if not identical.

## The deficit monetisation proposal

Under deficit monetisation, new money would be created to finance budget deficits.

In the US, Japan and the UK, deficit monetisation could be applied instead of resorting to new rounds of quantitative easing. The further application of QE is of doubtful value and declining utility. QE policies benefit bond traders and add to unproductive reserves held by commercial banks at the central bank. Additional QE would distort the yield curve further – distorting risk taking, encouraging investment in risky assets, causing stock market bubbles, and denying income to the elderly, insurance companies, superannuation funds and others who rely on low-risk investment options to provide them with safe incomes.

In the Eurozone, deficit monetisation could displace the need to create new money to purchase excess periphery-government bonds. Fiscal policy could be adjusted by moving away from deep fiscal austerity towards a relatively more expansionary, pro-growth fiscal stance where the new money is redirected and used to finance the budget deficit.

When achieved, deficit monetisation would result in a stabilisation of levels of public debt. Public debt would stop spiralling upward and interest rates would not be periodically resurgent: the risk of a financial crisis would be avoided. The credit rating agencies would be under much less pressure to downgrade credit ratings of distressed periphery countries. Under deficit monetisation the slide toward depression would be arrested. Pessimism, and the current sense of hopelessness in periphery countries, would be defused by the enhanced fiscal stimulus, and the better prospects for employment and the resumption of economic growth.

In a monetary/exchange rate union the issuance of new money is usually the responsibility of the union's central bank, which in the case of the Eurozone is the ECB. For the ECB to print new money, and provide it to the governments (ministries of finance) of periphery countries in order for them to finance their ongoing budget deficits, it is necessary that the periphery governments issue new government bonds to the ECB. This raises the general government debt of the periphery countries (assuming conventional accounting standards apply).

Consequently, in order to avoid this increase in public debt, and credit downgrading by credit rating agencies, it may be necessary for the governments (ministries of finance, not central banks) of individual periphery countries to create new money, and directly finance their deficits with that new money.

This could be achieved in a number of ways. For instance, the Greek government could print new drachma and immediately exchange it at the ECB for euros. This would avoid drachma circulating alongside the euro in Greece. Alternatively, of course, new drachma could be used to finance the budget deficit and thus enter into circulation, and be traded alongside the euro. There are many instances, currently and historically, where two currencies are in circulation simultaneously. There may be other options: the ECB could conceivably license the governments of periphery countries to print euros.

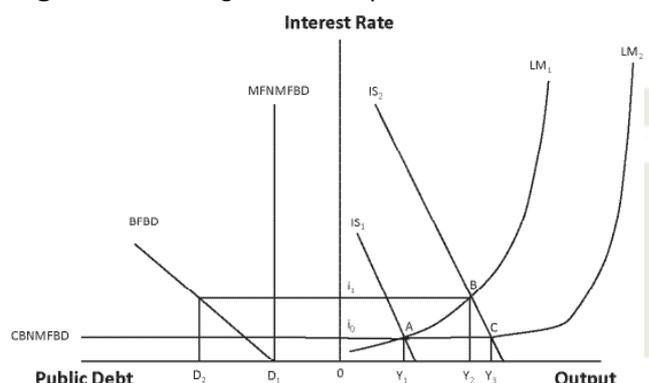
Figure 1 illustrates the main mechanism. Assume the economy is at point A. At A, public debt is  $OD_1$ .

Assume a bond-financed fiscal stimulus is applied. This moves the IS curve outward and takes the economy to point B. Interest rates rise and public debt increases by  $(D_2 - D_1)$  to reach  $OD_2$ . Assume QE is then applied. Interest rates return to their former level. This takes the economy from point B to point C, but *debt remains at  $OD_2$* .

Assume the central bank sought to create new money to finance the budget deficit. In that case the economy moves to point C, but, as the government has to sell new government bonds to the central bank in exchange, *public debt rises to  $OD_2$* .

Alternatively, assume that deficit monetisation is applied to the economy initially at point A. The budget deficit is increased, financed by new treasury money. The economy moves to point C, but *public debt remains at  $OD_1$* .

**Figure 1.** Financing deficits and public debt



LM: Liquidity preference/money supply equilibrium schedule  
 IS: Savings/investment schedule  
 BFBD: Bond-financed budget deficit schedule  
 CBNMFBD: Central bank new money-financed budget deficit schedule  
 MFNMFBD: Ministry of Finance new money-financed budget deficit schedule  
 Source: Chart reproduced from 'Delivering Economic Stimulus, Addressing Rising Public Debt and Avoiding Inflation', Journal of Financial Economic Policy, April 2012.

## The inflation concern

Underpinning the current German economic philosophy is a concern that if the central money-issuing authority financed budget deficits with new money there would be a rise in inflation, and hyperinflation would follow. This view is based on the German experience in the 1920s.

During the 1970s and 1980s many governments precluded the use of deficit monetisation. This was not inappropriate during the era of high inflation.

However, the 1920s experience in Germany was somewhat unique, and occurred in circumstances which were fundamentally different from today's. One key difference is the fact that the central bank in Germany at the time was a private central bank, unlike the ECB of today.

A recent IMF paper (Benes and Kumhof, 2012) reports from a book released in 1969 by the German Reichsbank President (H. Schacht) at the time:

*'Specifically in May 1922 the Allies insisted on granting total private control over the Reichsbank. This private institution then allowed private banks to issue massive amounts of currency, until half the money in circulation was private bank money that the Reichsbank readily exchanged for Reichsmarks on demand. The private Reichsbank also enabled speculators to short-sell the currency, which was already under severe pressure due to the transfer problem of the reparation payments pointed out by Keynes (1929). It did so by granting lavish Reichsmark loans to speculators on demand, which they could exchange for foreign currency when forward sales of Reichsmarks matured.'* (Page 16, emphasis added)

The IMF paper goes on to conclude that:

*'This episode can therefore clearly not be blamed on excessive money printing by a government-run central bank, but rather by a combination of excessive reparations claims and of massive money creation by private speculators, aided and abetted by a private central bank.'* (Page 16, emphasis added)

*'...it answers the somewhat confused claim of opponents of an exclusive government monopoly on money issuance, namely that such a system would be highly inflationary. There is nothing in our theoretical framework to support this claim. And as discussed in Section II, there is very little in the monetary history of ancient societies and Western nations to support it either.'* (Page 56)

Based on this IMF analysis, it does not necessarily follow that the mistakes and excesses that led to

the German hyperinflation in the 1920s would be repeated today.

Recent monetary expansions through QE in the US, Japan, the UK and the Eurozone have not resulted in substantial inflation or hyperinflation.

And, in any event, a legislative cap could be placed on the policy in advance to preclude significantly higher inflation.

But even more importantly, under the deficit monetisation proposal outlined in this article, there would be no risk of high inflation as, once the fiscal stimulus is financed, delivered and the multiplier is operating, the new money could be sterilised (removed from the economy) if excess liquidity ever became a problem. The sole purpose of monetising the deficit is to finance the first round of stimulus, once that has been achieved the new money has served its main function. The new money could then be safely withdrawn from the economy – if that ever became necessary to address excess liquidity – and destroyed.

However, it is not obvious that sterilisation would prove necessary, as fiscal stimulation would raise GDP, creating a need to retain the increased money supply to avoid a shortfall in liquidity.

The world successfully dealt with the era of high inflation and unemployment. Things have now moved on to an era of high public debt and demand deficiency. Because of the radically changed circumstances, deficit monetisation now has a legitimate role to play and could contribute to economic stabilisation and recovery.

## Effects: Economic growth, no increase in public debt

The main benefit of deficit monetisation is that economic stimulus can be provided without further raising public debt or interest rates. This policy could help to reduce risk premia, restore confidence and avert an even deeper financial crisis.

Deficit monetisation (as proposed in this article) is aimed at rescuing nation states from a short-term crisis, but it does not solve all the longer-term fiscal difficulties. Public debt and public spending as a proportion of GDP will still remain too high. These problems will need to be addressed over the medium- to long-term, including by steady and appropriately timed fiscal consolidation.

## Deficit monetisation is not radical

Many among the current generation of economists and journalists view the helicopter drop or deficit monetisation as representing 'radical approaches'. However, Maynard Keynes, Abba Lerner, Milton Friedman, Ben Bernanke and, most recently, Max Corden, Richard Wood, Willem Buiter and Anatole Kaletsky have all advocated consideration of this general approach for use in appropriate circumstances.

Since the Middle Ages, money-issuing organisations used reserves (e.g. gold or other legal tender) to purchase financial assets, creating money in favour of some borrower, either other banks or the government.

*'More often than not, this borrower was the government'. 'Over the centuries money-issuing organisations have chiefly supplied credit directly to the state; and even when loans to the banking system have become predominant, central banks have often accorded them provided that the banking system would, in turn, redirect at least part of them to the government'. 'Historical evidence suggests that neither changes in the organisational model of central banks nor government deficit monetisation should necessarily be seen as evil'. (Ugolini 2011)*

Deficit monetisation has had both successes and some much-publicised failures (due in part, to the policy being taken to excess, particularly by private central banks). 'Sometimes it ended in catastrophe, but on many occasions it did not'. (Ugolini 2011).

In his letter to President Roosevelt in 1933, Maynard Keynes identifies the main factors that would cause an increase in output:

- i. an increase in confidence;
- ii. a lower rate of interest; or,
- iii. 'public authority must be called in aid to create additional current incomes through expenditure of borrowed or *printed money*', (emphasis added).

Keynes proposed bond financing of the deficit, as public debt was low in the US at the time. However, if Keynes were advising today he may well propose printing money to finance the fiscal stimulus given the high levels of public debt.

Lerner (1943) states:

*'When taxing, spending borrowing or lending (or repaying loans) are governed by the principles of Functional Finance, any excess of money outlays over money revenues, if it cannot be met out of money hoards, must be met out of printing new money, and any excess of revenues over outlays can be destroyed or used to replenish hoards'. (Emphasis added)*

Milton Friedman (1948) later proposed that the main function of the monetary authorities could be:

*'...the creation of money to meet government deficits or the retirement of money when the government has a surplus'. 'Under the proposal, government expenditures would be financed entirely by either tax revenues or the creation of money...'. (Emphasis added)*

Milton Friedman (1969) later proposed the 'helicopter drop'. This is a temporary tax cut, increase in transfer payments or boost to exhaustive public spending (including infrastructure investment), financed through a permanent increase in the money base.

Ben Bernanke (2002) proposed the helicopter drop for Japan in 2002 and for economies at zero-bound interest rates.

Max Corden (2010) raises the prospect of a new money-financed fiscal deficit arguing, *inter alia*, that:

*'When the central bank lends to the government, and the government then spends the funds, the government is simply substituting for the private sector. The government provides an alternative channel for money and credit to flow to the real economy. By simply avoiding a decline in aggregate demand and thus possibly deflation (or counteracting a decline that has already taken place) the effect is not necessarily inflationary. One is not causing a flood by hosing down a fire'.*

Richard Wood (2012) argued that if the Ministry of Finance (not the central bank) printed new money to finance the budget deficit, economic stimulus could be delivered without an increase in public debt.

Willem Buiter and Ebrahim Rahbari (2012) argued that the helicopter drop (including for Europe) is 'perhaps the most effective form of stimulus currently'. They also argue for greater coordination between monetary and fiscal authorities.

Anatole Kaletsky (2012) suggests that quantitative easing for the people may now be possible.

Based on the above, and recalling the Tinbergen policy assignment principle mentioned earlier, there is a strong basis for considering deficit monetisation as the most likely optimal macroeconomic policy paradigm needed to simultaneously address both falling demand and rising public debt. When policy interest rates approach their zero bound, deficit monetisation represents perhaps the only combination of monetary and fiscal policy instruments that could deliver a stimulus – that is, economic growth – without increasing public debt. Such a formula is urgently required for periphery countries, whether they remain in the Eurozone or not.

The case for deficit monetisation is greatest in current circumstances where there are two concurrent problems: high public debt and deflation/inadequate demand. Using new money to finance public deficits is no more radical than using new money to finance banks and increase their reserve accounts at the central bank (as with QE).

Macroeconomic policy planning and coordination must get ahead of the unfolding crisis and work to resolve high public debt and inadequate aggregate demand problems. Public demand must fill the void until private demand picks up.

### **Northern burden sharing minimised: Germans under less pressure**

The German government and taxpayers have recently shown that there are limits to their willingness to go on bailing out periphery countries.

In this context ‘deficit monetisation’ should be seen as a potential godsend. Public debt in the periphery countries would stop rising immediately after the policy is implemented. As a consequence, Germany would no longer be under such pressure to bail out the southern countries. Deficit monetisation would immediately take pressure off German taxpayers and the German government.

### **Is deficit monetisation the same as QE plus bond financing of budget deficit?**

It is widely believed, particularly by central bankers, that central banks already effectively achieve the objectives of deficit monetisation by deploying 1) the policy of quantitative easing to operate in conjunction with 2) the government’s policy of new bond-financed budget deficits. This argument is spurious because under policy 2) new government bonds are issued and this raises general government debt (that is, public debt). Under the proposed deficit-monetisation policy

there is no issuance of new government bonds and, consequently, public debt does not increase.

Alternatively, it might be thought that the central bank could simply credit the government’s account with new money. However this does not overcome the problem created by new bond financing as crediting the government’s account at the central bank would create a liability for the government and raise public debt as currently measured.

### **To address periphery-country problems a more differentiated monetary policy is needed: One size does not fit all**

Without a fiscal union among Eurozone countries it is difficult for countries running fiscal deficits to be assisted by a central Eurozone authority. Currently, each part of the EZ runs its own fiscal policy. As a consequence mainly of policy responses to the global financial crisis, EZ treaties and the ‘one size fits all’ policy interest rate implemented by the ECB, the central policymakers are forced into defensive tax-funded bailouts as a means to assist distressed regions.

In the absence of a fiscal union, monetary policy could still become more differentiated and applied more flexibly, to achieve the objectives that a fiscal union could otherwise seek. This could be achieved by adopting the ‘deficit monetisation’ proposal outlined in this article. Under this proposal new money could be provided in required proportions to individual periphery countries to provide the required fiscal support. Should such a procedure require revisions to EZ treaties, the sooner the better.

### **How to address the periphery country ‘international competitiveness’ problem**

A country’s international ‘competitiveness’ is determined by many factors: innovation, the quality of human and physical capital, relative cost and price levels, resource availability, etc. Unit labour costs figure prominently in the determinants of a country’s competitiveness.

Many Eurozone periphery countries have overvalued real exchange rates and substantial current-account deficits. Prices and unit labour costs in most periphery countries remain relatively elevated. Broadly speaking, recent calculations suggest that unit labour costs would need to fall by between 18% and 30% in periphery countries to restore unit labour cost competitiveness with Germany.

Except perhaps for Ireland (with its high tech sectors and more flexible wage system), and to a lesser extent Spain (where recent nominal wage restraint has combined with increasing hourly labour productivity to lower unit wage costs), labour markets are highly sclerotic in European periphery countries. Reflecting entrenched labour market rigidities, wage adjustment in most periphery countries has been slow despite the large increase in unemployment.

Adopting austerity policies – in order to push up unemployment and to force wage levels and unit labour costs to fall – is fraught with difficulties in the face of persisting labour market rigidities. In such circumstances, austerity and market forces will, at best, be very slow-acting, and result in massive unemployment.

In such circumstances, individual periphery countries facing severe ‘competitiveness’ problems could consider the merits of a two-pronged policy approach:

- a. take stronger actions to remove labour market rigidities and to increase price competition; and,
- b. develop an incomes policy to achieve the required reduction in wages and prices.

### A potential role for wages and prices policies

A wages and prices policy may be used for various purposes. Such policies could be designed to lower excessive real wage levels. Alternatively, they could be used to lower high nominal wages and prices in tandem. The latter option would be relevant in circumstances where there is an imperative to increase international competitiveness but where real unit labour costs are at appropriate levels (consistent with adequate business profitability).

Consequently, before designing a wages and prices policy, individual periphery country governments would need to establish whether business profitability is adequate or not. If business profitability were judged inadequate (real unit labour costs being excessive) then the design of the wages and prices policy would need to take two objectives into account: a) to reduce real unit labour costs and, simultaneously, b) to lower price levels.

It may be possible to consider restricting the operation of a prices and incomes policy to the traded goods sector, but this would need careful consideration beforehand.

The risks associated with uncoordinated wage and price movements (relying, say, on austerity and market forces) are already evident in Greece. Private-sector wages in Greece are reported (Dalton, 2012) to have fallen 14% from their peak in 2010. But inflation has remained higher than expected, as Greek businesses have not been passing through lower wages into prices. Real wages and incomes are collapsing as a consequence, but the ‘international competitiveness’ benefits are not coming through. Clearly, domestic competition policy efforts have not done enough to force prices to fall in tandem with wages.

If a wages and prices policy, and accompanying supportive domestic price competition policies, could be designed successfully, the ‘international competitiveness’ problem could be resolved with much less pain, lower unemployment, less political upheaval and in a relatively short space of time in the affected periphery countries, and certainly much quicker than under the crude austerity/market forces plan.

### Conclusions

Many countries in the world are suffering from inadequate aggregate demand and high debt. Quantitative easing has run its course and structural reform policies could not be relied upon to boost aggregate demand in the near term. It is the thesis in this article that current macroeconomic policies, if continued, will compound current difficulties. It is argued that aggregate demand needs to be stimulated without raising public debt. With interest rates at zero bound, fiscal policy can achieve that result if budget deficits are financed by new money creation.

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