What more could the central banks do to deal with the crisis?

By Christophe Blot and Paul Hubert

The return of new lockdown measures in numerous countries is expected to slow the pace of economic recovery and even lead to another downturn in activity towards the end of the year. To address this risk, governments are announcing new support measures that in some cases supplement the stimulus plans enacted in the autumn. No additional monetary policy measures have yet been announced. But with rates close to or at 0% and with a massive bond purchase policy, one wonders whether the central banks still have any manoeuvring room. In practice, they could continue QE programmes and increase the volume of asset purchases. But other options are also conceivable, such as monetizing the public debt.

With the Covid-19 crisis, the central banks – the Federal Reserve, the Bank of England and the ECB – have resumed or amplified their quantitative easing (QE) policy, to such an extent that some are viewing this as a de facto monetization of debt. In a recent *Policy Brief*, we argue that QE cannot strictly be considered as the monetization of public debt, in particular because the purchases of securities are not matched by the issuance of money but by the issuance of excess reserves. These are distinct from the currency in circulation in the economy, since they can be used only within the banking system and are subject to an interest rate (the deposit facility rate in the case of the euro zone), unlike currency in circulation.

Our analysis therefore makes it possible to look again at the characteristics of QE and to specify the conditions for monetizing debt. It should result in (1) a saving of interest paid by the government, (2) the creation of money, (3) being permanent (or sustainable), and (4) reflect an implicit change in the objective of the central banks or their inflation target. The implementation of such a strategy is therefore an option available to central banks and would allow the financing of expansionary fiscal policies.
The government, in return for a package of fiscal measures – transfers to households or health care spending, support for businesses – would issue a zero-coupon perpetual bond, purchased by commercial banks, which would credit the account of the agents targeted by the support measures. The debt would have no repayment or interest payment obligations and would then be acquired by the central bank and retained on its balance sheet.

Monetization would probably be more effective than QE in stabilizing nominal growth. It would reduce the risk to financial stability caused by QE, whose effect depends on its transmission to asset prices, which could create asset-price bubbles or induce private agents to take on excessive debt.

Monetization has often been put off because of fears that it would lead to higher inflation. In the current environment, expansionary fiscal policy is needed to sustain activity and to prepare for recovery once the pandemic is under control. A pick-up in the pace of inflation would also satisfy the central banks, and insufficient demand should greatly reduce the risk of an out-of-control inflationary spiral. Monetization requires stronger coordination with fiscal policy, which makes it more difficult to implement in the euro area.