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Making central banks serve the real economy

Abstract: The challenge is to redirect central bank money into the real economy and to the needs of society. If new money is issued to expand the productive capacity, there is no reason for inflation. Long-term financing could become available at an affordable price. Central bank money must not replace a sound tax system and the distribution of income and wealth, but complement it. The remaining task, apart from the financing of real needs, is the prevention of speculative asset price inflation. For this, central banks and regulators should install debt brakes for the financial sector. Furthermore, independent monetary policy calls for capital account management. It enables national central banks to find space for the conduct of their own policies in an interdependent global economy. Coordination between central banks and governments might increase as policies combine monetary, fiscal and regulatory facets. The future role of central banks should particularly lie in their insights regarding capital flows and leverage cycles and in their ability to create and withdraw money, depending on economic conditions.

“A crisis is a window into the soul of the economy, like Plato’s republic was the soul writ large. If non–standard policies saved the economy during the crisis, they surely should play a role in normal times.”¹

Central banks shall supply money for the economy by supplying money for banks. The paradox here is that they lack influence on what banks do with the money. The problem with low key interest rates is that they are not targeted. Quantitative easing measures (QE), such as the purchases of securities by central banks, can help the financial sector in systematic liquidity and solvency problems. QE can also reduce government debt servicing costs by lowering the sky–high interest rates of state bonds. That has, for example, been the case with the European Central Bank’s bond–buying programme for struggling member states. However, the current QE has not been targeted towards stimulating real economic activity. It has failed to spur real economic lending and securities emissions. The monetary transmission mechanism did not work: the central bank money has remained in the financial sector itself. That is why it risks feeding leverage–driven asset bubbles in the financial sector instead of funding real needs.² As Dominic Lawson points out³:

“If the real assets remain unimproved either by investment or by advances in productivity, and all that happens is that their monetary value on the markets increases in nominal local currency terms, this is merely the classic recipe for a financial bubble.”

Hence the challenge is to redirect central bank money into the real economy and to the needs of society. Whereas taxes refer to the re–distribution of money, the task here tackles its pre–distribution.

1 Central banks should contribute to the funding of real needs

Central bank money should not solely be used to fund private banks; it shall also engage in the financing of public investment expenditures. Renewable energies, public transport, communication infrastructure, public health and climate protection: the world is full of

unfulfilled investment needs. Not everything suits the profit-orientated expectations of private investors. Or if you make it to fit them by increasing the profit through higher consumer prices and spreading the risks via excessive securitisation, the price may be social exclusion and financial instability.

For example, research in Alzheimer's disease might take 20 years; and some parts of that research may yield inconclusive results. Yet that is human life, and we need sustainable finance for it. We should not stand and watch the pharmaceutical industry prioritise more lucrative botox research. Central banks should use their ability to create new money and channel it into meaningful investments. They can also finance the retraining of employees in the fossil fuel industry to enable them to carry out similar work in the renewable energy sector. At the global level, the UN Green Climate Fund was established in 2010 and planned to raise US\$100 billion, but is still out of money. Central banks could cooperate with the International Monetary Fund and development banks in order to employ monetary financing to break this funding deadlock.

Among the proponents of a broader mandate for monetary financing are Adair Turner, chairman of the Financial Services Authority in the UK, and Martin Wolf, economic journalist of the Financial Times.⁴ Wolf argues that it is impossible to justify the conventional view that monetary financing should operate almost exclusively via today's system of private borrowing and lending.

The benefits of such monetary financing will be substantial:

- Long-term financing will become available at an affordable price. Partnerships between government, financed by new central bank money, and long-run institutional investors like foundations, insurance companies and pension funds are also possible. New government money can, for instance, act as a catalyst during the start-up phase of long-term infrastructure projects. By contrast, private-equity funds aim at above-average returns up to super returns. Thus, it

often turns out that they are unsuitable as sponsors for sustainable development. Additionally, their high consultancy fees and special dividends can even hamper investment.

- The deleveraging process of private banks can be accompanied by new central bank money. Thus a credit crunch can be avoided.
- New central bank money can contribute to overcoming austerity. This will promote social equity too. Poorest people suffer the most from austerity because they can barely afford the better equipped private hospitals and private schools.
- This will also strengthen democracy, as austerity is a means to exert power. New central bank money can end governments and the real economy being held hostage by unreliable financial markets. It can end unreliable conditions of structural adjustments, be it through the International Monetary Fund towards its poorer member states or through the Troika in Europe.
- Finally, instead of waiting any longer, socially and environmentally required investments could be put into practice. Every necessary investment, which is not taken today, goes at the high expense of present and future generations. This ranges from neglected safety standards for public transport to environmental consequences and public education.

Consequently, the widespread taboo of monetary financing should be broken. The key is always where the money goes to and on what terms – in times of stress as well as every day.

2 ... but what about inflation?

Monetary financing of governments is still a taboo, though. This is not without reason as economies have been affected by hyperinflation like in Brazil, Germany and many African countries.

Therefore, some conditions must be met:

First, if new money is issued to expand the productive capacity, there is no reason for inflation. At the same time, there is no necessity to limit central banks' support of governments' financing needs to times of crisis. Rather it can contribute to public finance on a regular basis. Turner, among others, proposes that central banks allow a defined amount of monetary financing as a percentage of the gross domestic product. Matthias Kroll of the World Future Council recommends, depending on economic trends, up to five percent.⁵ Since this will be a decision by the central bank, not the Treasury, the independence of central banks can be maintained. In doing so, central banks should take democratically agreed criteria as the basis, including the degree of the utilisation of production capacity. Whether central banks adopt the amount of monetary financing before any one budget year, the Treasury can take this into account and balance it with fiscal measures such as taxes and debt. Provided the amount of new central bank money is in pursuit of the gross domestic product level, it can also be spent on dance performances, theatre plays and on the funding of foundations.

Second, although appropriate timing and sequencing is a sensible job, exit strategies are implementable when economic conditions are boosted. For that, central banks have various tools. They can, for instance, increase minimum reserve requirements. Japan in the early 1930s, namely under Finance Minister Takahashi Korekiyo, provides a remarkably good example for the use of new central bank money combined with a well-tailored exit strategy. In order to escape from the Great Depression, spending increases were financed with government bonds which were underwritten by Japan's central bank, the Bank of Japan. Thereby new central bank money was channeled into government

spending. Later, to prevent inflation in a boosting economy, the Bank of Japan sold – part of – these bonds to private financial institutions. This was the appropriate exit strategy to suck off money by transforming it into liabilities. Furthermore, the Japanese government employed its rising tax revenues to keep its debt at a sustainable level.⁶

Third, new central bank money must not replace a sound tax system and the distribution of income and wealth, but complement it. While new central bank money can be used in a certain corridor without being inflationary, taxes are the basis of public finance.

Yet, the remaining task, apart from the financing of real needs, is the prevention of speculative asset price inflation. For this, central banks and regulators should install debt brakes for the financial sector.

3 Debt brakes for the financial sector

Leverage within the financial sector plays a primary role in creating asset bubbles as well as in making financial institutions too big and too connected to fail. It is nearly impossible to close highly leveraged financial institutions without systemic consequences. Moreover, and most crucially, leverage can be more important to asset prices than interest rates. As leverage cannot be stopped by increasing interest rates, it must be managed directly.⁷ Thus, central banks should focus on leverage cycles and the overstretching of collateral. To a great extent, money creation takes place in the shadows, namely banks interacting with non-banking financial institutions such as investments funds, hedge funds, private equity funds, endowments and insurances.

Policies to be developed as debt brakes for the financial sector:

- An effective policy regarding the overstretching of collateral would be a preventive testing of financial innovations – a finance TÜV⁸. The purpose of some financial innovations – such as collateralised debt obligations and credit default swaps – is to stretch the available collateral further. Securitisation can be useful up to a point;

savings banks use it to diversify regional risks. However, re-securitisation is not needed by the real economy and should be prohibited. Other financial innovations should be bound by specific conditions such as position limits for certain derivatives.⁹

- A further form to overstretch collateral is the re-pledging of securities in long credit intermediation chains. This clearly has to be limited. Otherwise, the liquidity illusion is everywhere.
- The value of collateral is also subject to cyclical volatility. Thus, central banks and regulators should focus on the value of that which serves as collateral: in the case of overvalued assets, they should curb the permitted value of these assets as collateral. Regulating leverage based on loan-to-value ratios (asset-based leverage) rather than solely according to debt-equity ratios of banks (investor leverage) will include the whole financial sector. A central bank or regulator should, for instance, say¹⁰: *“You cannot loan at two percent down on houses.”*
- Furthermore, leverage from mergers and acquisitions (M&A) should be constrained. Pavan Sukhdev proposes that the capital structure of M&A transactions which exceed a given transaction amount – such as US\$10 billion – ought to be reviewed by central banks.¹¹

These policies are crucial to avoiding fictitious liquidity and leverage-based asset bubbles. They go beyond the potential leverage ratio in the framework of the Basel Accord for capital requirements which refers only to banks. There will be resistance from the financial sector, as decreasing leverage means a decreasing return on equity. However, the real economy and society need sustainable wealth, not permanent fragility. This real need has to be the priority.

4 Central banks can conserve the taxpayer's money

Differently from private companies, central banks cannot default as they can create their own money in their own currency. Their privilege is thus that they need no fiscal backing from the government.¹² Central banks can finance tax cuts in a recession as well as debt cancellation for the benefit of present and future generations. In an historical review, published by the Bank for International Settlements, Charles Goodhart writes¹³:

"For over three centuries (1694–1997) a prime function of the Bank of England was to manage the national debt. But as the debt declined, both as a percentage of GDP and in relation to the size of the financial market, debt operations became simpler, falling into a routine pattern. Much the same happened in other countries. But now many countries face the prospect of rising debt levels. During the coming epoch of central banking, they should be encouraged to revert to their role of managing the national debt."

As a lender of last resort, it belongs to the job of central banks to buy troubled assets or to accept them as collateral. The purchasing of bonds with long-term maturities – for example in the secondary market – can even lower long-term interest rates.

5 Independent monetary policy calls for capital account management

The monetary policy of systemically important economies affects capital flows and borrowing costs in the global financial system. The mere announcement that the Federal Reserve Bank might exit its bond-buying programme has led to capital flight and currency crashes in emerging economies like the "Fragile Five" – Brazil, India, Indonesia, South Africa and Turkey. It made borrowing costs jump up in the euro periphery such as in Greece, Italy and Spain, too.

Hélène Rey aptly describes the transformation of an old macroeconomic trilemma (impossible trinity) into a new dilemma (irreconcilable duo)¹⁴:

"Whenever capital is freely mobile, the global financial cycle constrains national monetary policies regardless of exchange rate regime. For the past decades, international macroeconomics has postulated the "trilemma": with free capital mobility, independent monetary policies are feasible if and only if exchange rates are floating. The global financial cycle transforms the trilemma into a "dilemma" or an "irreconcilable duo": independent monetary policies are possible if and only if the capital account is managed."

Capital account management enables national central banks to find space for the conduct of their own policies in an interdependent global economy. It includes the management of capital inflows and outflows. Some countries, for instance Israel, Korea and Thailand, have an already active management of capital account.

Additionally, excessive trading which causes systemically risky volatility should be addressed. That is, apart from raising revenues, the purpose of a financial transaction tax. For this reason, the tax rate should be scalable; it would enable the tax to efficiently contribute to preventing price bubbles. A scalable tax rate has already been suggested by economist Paul Bernd Spahn in 2002 in his report commissioned by the German Federal Ministry for Economic Cooperation and Development.¹⁵

To conclude, coordination between central banks and governments might increase as policies combine monetary, fiscal and regulatory facets. This concerns even the financial transaction tax which involves fiscal and regulatory aspects, along with cyclical trends if the tax rate is scalable. The future role of central banks in these exercises should particularly lie in their insights regarding capital flows and leverage cycles and in their ability to create and withdraw money, depending on economic conditions.

¹ Geanakoplos, John (2011a); What's missing from macroeconomics: endogenous leverage and default, Cowles Foundation paper, no. 1332, p 225.

<http://cowles.econ.yale.edu/~gean/art/p1332.pdf>

² For more details see: Putnam, Bluford H. (2013); Essential concepts necessary to consider when evaluating the efficacy of quantitative easing, in: Review of Financial Economics 22, p 1-7.

<http://www.sciencedirect.com/science/article/pii/S105833001200064X>

³ Lawson, Dominic (19/5/2013); Coming soon: credit crunch 2 – and this time it's personal, in: Sunday Times.

⁴⁴ Reichlin, Lucrezia, Adair Turner, Michael Woodford (20/5/2013); Helicopter money as a policy option, on: VoxEU.

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Wolf, Martin (12/2/2013); The case for helicopter money, in: Financial Times.

<http://www.ft.com/intl/cms/s/0/9bcf0eea-6f98-11e2-b906-00144feab49a.html>

⁵ Kroll, Matthias (2008); Monetäre Stabilität und die Finanzierung von Staatsdefiziten durch Zentralbankkredite bei endogener Geldmenge, Berlin, p 68f.

⁶ For more details see: Kroll, Matthias (2013); Takahashi Korekiyos Wirtschaftspolitik als Grundlage einer "Best Policy" zur Rezessionsüberwindung, World Future Council policy brief.

<http://bit.ly/18biZxK>

⁷ Geanakoplos, John (2011b); Incorporating financial features into macroeconomics, Cowles Foundation paper, no. 1331, p 4.

<http://cowles.econ.yale.edu/~gean/art/p1331.pdf>

⁸ TÜV is German name for road safety tests.

⁹ For more details see: Reiners, Suleika (5/4/2013); Introduce precautionary principle for financial products, or they will fail us, on: EurActiv.

<http://www.euractiv.com/euro-finance/introduce-precautionary-principi-analysis-518903>

¹⁰ Geanakoplos, John (2011a), p 224.

¹¹ Sukhdev, Pavan (2012); Corporation 2020, Washington, p 157f.

¹² For more details see: De Graume, Paul & Yuemei Ji (14/6/2013); Fiscal implications of the ECB's bond-buying programme.

<http://www.voxeu.org/article/fiscal-implications-ecb-s-bond-buying-programme>

¹³ Goodhart, Charles (2010); The changing role of central banks, Bank for International Settlement, working paper no. 326, p 25f.

<http://www.bis.org/publ/work326.htm>

¹⁴ Rey, H el ene (2013); Dilemma not trilemma: The global financial cycle and monetary policy independence, London Business School.

<http://www.kansascityfed.org/publicat/sympos/2013/2013Rey.pdf>

¹⁵ Spahn, Paul Bernd (2002); On the feasibility of a tax on foreign exchange transactions, Bonn.

<http://www.wiwi.uni-frankfurt.de/professoren/spahn/tobintax/>