The case against quantitative easing and for Overt Money Financing (OMF) in the eurozone by Thomas Fazi

It’s a well-known fact that since the financial crisis the Federal Reserve and the European Central Bank (ECB) have pursued rather different monetary policies: the Fed has engaged in large amounts of quantitative easing (QE) – purchases of mortgage-backed securities and other securities such as government bonds –, while the ECB, until recently, has relied on more conventional monetary policies (the lowering of interest rates and long-term refinancing operations or LTROs). The ECB’s measures, though, for reasons that we will see, have failed to get banks in the currency area to start lending again – let alone revive the economy. Partly as a response to this, and under pressure from all corners to take more vigorous action against the threat of deflation – by early 2014 a consensus was setting in even at the mainstream level that the ECB should engage in a US-style programme of quantitative easing to stem the deflationary tendencies in the currency area –, in June 2014 Mario Draghi made the controversial decision of imposing a negative interest rate on deposits (i.e., funds placed on deposit at the ECB by private banks, also known as ‘excess reserves’), subsequently raised in September. Even though the mainstream media generally described the move as ‘radical’ and ‘aggressive’, various commentators noted that negative interest rates amount to a further ‘squeeze on the margins of already-damaged banks’ and are thus ‘intrinsically contractionary’. ¹ The events would prove them right, with the eurozone’s economy contracting once again in the second quarter of 2014 (thus landing it officially in stagnation and on the verge of the third recession in seven years), leading Draghi to finally announce in early September that the ECB was ready to engage in a form of ‘quantitative easing lite’ through the purchase of private sector credits, including asset-backed securities (ABSs) and covered bonds. Most commentators reacted enthusiastically to the news; along with a number of experts, they attribute the fact that the US has recovered much better, in economic terms, than the EMU to the more expansionary monetary policy pursued by the Fed, and thus conclude that QE is the solution to Europe’s woes. This paper argues that this is a gross and dangerous simplification.

How money works

There’s growing evidence that QE in the US has had almost no effect on the real economy and economic recovery: loans to American businesses and households are still well below pre-crisis levels, despite the massive increase in ‘base money’ (central bank reserves).² This is because QE – or better, the idea that QE is the optimal tool to revive an economy in recession – is based on a fallacious view of how monetary system works.

The monetarist or quantitative theory of money asserts that banks need excess reserves before they can loan out deposits (according to the so-called ‘money multiplier’) and thus that central banks can directly, or exogenously, control the money supply by influencing the minimum reserve requirements of banks or by increasing reserves through QE. The economic corollary to this theory is the so-called ‘wealth effect’, a variation on the classic (and blatantly disproven) ‘trickle-down theory’. This is the belief that virtuous economic cycles don’t begin with increased demand but rather with increased equity prices, with rising asset prices leading to beneficial effects in consumer sentiment, retail spending, along with corporate capital expenditure and

² Manuel Hinds, ‘We’ll finally see that the Fed has done nothing to help Main Street’, Quartz, 24 December 2013.
As post-Keynesian theory explains, though, the causality actually works in reverse: when a bank makes a new loan, it simply taps some numbers into a computer and creates brand new money ‘out of thin air’, which it then deposits into the borrower’s account. Only then, if it has insufficient reserves, does the bank turn to the central bank, which is obliged to provide reserves on demand. Pre-existing deposits aren’t even touched – or needed, for that matter. In other words, bank lending is not ‘reserve constrained’.

The ECB itself debunked the myth that banks need reserves before they can make loans, in its *Monthly Bulletin* for May 2012. In considering whether ‘a large increase in central bank liquidity… necessarily implies rapid broad money and credit growth’, the ECB said:

> The occurrence of significant excess central bank liquidity does not, in itself, necessarily imply an accelerated expansion of… credit to the private sector…. In sum, holdings of central bank reserves are thus not a factor that limits the supply of credit for the banking system as a whole. Ultimately, the growth of bank credit depends on a set of factors that determine credit demand and on other factors linked to the supply of credit.

The Bank of England also recently rejected the idea bank lending is constrained by prior reserve holdings. They conclude that the ‘reality of how money is created today differs from the description found in… economics textbooks’. Banks do not ‘receive deposits’ and lend them out. Rather, ‘bank lending creates deposits’.

In short, the money supply is *endogenously* demand-driven and largely controlled by private banks, not central banks. Central banks can only hope – at best! – to indirectly influence it by adjusting their key interest rates. This is why in the face of weak demand (even in the ‘recovering’ US), where the economic and profitability prospects offered by the real economy are dim – not to mention in a deflationary-recessionary context such as the one that the eurozone finds itself in, in which balance sheets are being repaired (in the face of a rapidly-growing volume of non-performing loans), household and business demand for credit is weak, corporate insolvencies are on the rise and credit intermediation channels are impaired –, credit dries up, regardless of the amount of QE that a central bank engages in (especially if the zero-bound on central bank interest rates has been reached, as is the case in both the US and the eurozone). This is known as a ‘credit trap’.

In such a context, continuing to inject vast amounts of new money (via quantitative easing) into the financial system is almost certainly bound to be ineffective – or worse, dangerous. If we look at the US, not only has the money not ‘trickled down’ to those that need it the most; by inflating the prices of assets (such as government bonds), QE has almost exclusively benefited the wealthiest members of society who control the overwhelming majority of those assets, thus leading to even higher levels of inequality compared to pre-crisis levels (as Krugman writes of the US, ‘95 per cent of the gains from economic recovery since 2009 have gone to the famous 1 percent’) and encouraging risk-taking and new bubbles in the stock, housing and CDO markets (with stock indices coming close to – or wildly exceeding, in the case of the US – pre-

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crisis levels, in a telling example of the yawning disconnect between financial markets and the real economy). As Australian economist and long-time Treasury consultant Richard Wood writes:

Those players in the real economy that most needed financial support, the unemployed, low-income households and the disadvantaged (all with high marginal propensities to consume) were not recipients of the new money provided under the asset purchase program: that new money never reached the ‘real economy’ in significant volumes…. Those who did receive new money under continued quantitative easing were commercial banks, traders, speculators, financial investors, high wealth individuals and hedge funds.6

As a consequence, the impact on consumer prices (the aforementioned ‘wealth effect’) was negligible – despite the chorus of naysayers in the US who predicted that the Fed’s monetary stimulus would lead to runaway inflation, while ignoring the real risk posed by QE: asset price, not CPI, inflation.7 As Frances Coppola writes, for all the reasons outlined above, ‘it is abundantly clear that there is no clear relationship between the quantity of monetary base and the price level’.8

QE as a monetary vs. monetary-fiscal tool

So what is the United States’ improved recovery attributable to, if not to QE? In the immediate aftermath of the financial crisis (2008-10), both currency areas resorted to deficit spending to finance the holes in public budgets that resulted from unemployment benefits shooting up and tax revenues falling. From a social and economic standpoint this made a lot of sense. It functioned as a circuit-breaker and allowed the European economies to recover rather swiftly from the post-crisis crash, as testified by the mild growth rates registered in the 2010–11 period. In fact, temporary economic stimulus was ‘probably the most important reason we didn’t have a full replay of the Great Depression’, Paul Krugman writes.9

Then, in 2010, the trajectories of the two economies started to diverge dramatically: as Europe succumbed to the budget-slashing dogma of austerity, internal devaluation and ‘structural adjustments’, the post-crisis stimulus policies were dramatically reversed and the continent plunged back into recession (as various economists had predicted); the US, on the other hand, kept running large deficits all through to last year (when the government started cutting back on public spending). Herein, to a large degree, lies the explanation of the improved performance of the US vis-à-vis Europe. Of course, the expansionary fiscal policies pursued by the US government were made possible by QE, which kept US sovereign borrowing costs down. In this sense, QE did work, but only to the extent that it allowed the US government to run fiscal deficits without incurring higher debt-servicing costs (unlike what happened in Europe, as we know).

This exemplifies one of John Maynard Keynes’ greatest lessons: monetary policies are not sufficient to fight recessions; they have to be combined with stimulatory fiscal policies. In 1933, in an open letter to US president Roosevelt, the British economist described the idea of raising output and income by increasing the quantity of money in circulation as akin to ‘trying to get fat by buying a larger belt’. What was needed, he said, was for the government to ‘be called in aid to create additional current incomes through the expenditure of borrowed or printed money’. In other words, economic growth requires that money be spent into the economy, not stored in bank reserves. What Keynes understood was that the problem was one of deficient demand, not supply. The same is true today, especially as far as the eurozone is concerned, as even the staunchest defenders of austerity are now being forced to acknowledge. In a recent article on *VoxEU*, none other than Francesco Giavazzi – one of the fathers of the infamous ‘expansionary austerity’ theory – and fellow orthodox economist Guido Tabellini stated that ‘the main challenge currently faced by the Eurozone is a lack of aggregate demand’ and that ‘this is much more important than internal imbalances or lack of competitiveness in the periphery’.

What this means is that, when speaking of QE, it is important to differentiate between QE as a purely monetary tool and QE as a monetary-fiscal tool: *i.e.*, an expansionary monetary policy meant to facilitate an expansionary fiscal policy. The two are radically different. Yet, it is not always easy to discriminate between the two. Given that monetary policy always has a fiscal component, by influencing bond yields, establishing the extent to which the ‘fiscal outcome’ of QE reflects the intention of the central bank, and thus the degree of collaboration between the monetary and fiscal authorities, is also not easy.

The Bank of England, for example, has presented QE as a purely monetary policy tool that sustains economic growth in the face of necessary and desirable fiscal consolidation. The Federal Reserve’s position, on the other hand, has been more ambiguous. Fed vice-chairman Stanley Fischer, like former chairman Ben Bernanke, has stressed that premature fiscal consolidation can hold back the post-crisis recovery. Thus, it would appear that the Fed has implicitly viewed QE in part as a tool to ensure that rising bond yields do not offset the beneficial impact of large deficits. While the Fed’s policies were most likely not aimed at an increase in fiscal deficits, Ben Bernanke made it pretty clear that he would not get in the government’s way (barring runaway inflation, which was extremely unlikely given that the Fed was fighting off deflation in the aftermath of the crisis). This shows that the Fed is much less ‘independent’ than often assumed; as Bernanke recently stated, ‘of course we’ll do whatever Congress tell us to do’: in other words, if Congress is not satisfied with the Fed’s actions, it can always tell the Fed to behave differently. In this sense, the US government’s decision to cut back on spending (see last year’s decision to cut food stamp benefits to more than 47 million people) – despite continued QE – appears like an entirely political choice, in which the central bank had little or no say (unlike in the EMU). The same can be said for the UK government’s austerity programme, also pursued in the face of massive purchases of government bonds by Bank of England.

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13 See his statement here: http://www.youtube.com/watch?v=a7XV3vS1hAM.
It could be argued that the ECB’s Outright Monetary Transactions (OMT) programme – activated in August 2012 and aimed at reining in speculation against the periphery countries of the eurozone by announcing that the central bank was ready to engage in ‘unlimited’ purchases of government bonds if the ‘appropriate monetary policy transmission and the singleness of the monetary policy’ was threatened – also acted as a monetary-fiscal tool. By providing a lender of last resort-style backstop, it had the immediate effect of lowering bond yields in Italy and other countries (which by late 2014 remain relatively low, though they are still high compared with non-euro countries that present similar economic fundamentals) – and thus undoubtedly had a significant ‘fiscal outcome’. Yet, it cannot be considered a monetary-fiscal tool in the way that it is intended in this paper: i.e., an expansionary monetary policy meant to facilitate an expansionary fiscal policy. Firstly, it is not an ‘expansionary policy’ since the ECB has yet, as of late 2014, to buy a single government bond under the programme. Moreover, not only are euro area member states straightjacketed by the EU’s extremely restrictive fiscal and budgetary rules (most notably the Stability and Growth Pact or SGP, further tightened by the Fiscal Compact), and thus cannot engage in expansionary fiscal policies, regardless of the interest rate paid on government bonds; the OMT programme itself comes with a lot of strings attached. As the ECB’s press release states, a ‘necessary condition for Outright Monetary Transactions is strict and effective conditionality’.14 Intervention is attached to an ESM structural adjustment programme including a host of economic and social reforms (liberalisation of labour markets, reduction of labour costs: the usual agenda) on the macroeconomic level, and cost-cutting reforms on the fiscal level. In other words, governments in crisis or under attack by speculators will be offered the minimum help necessary to keep their bond yields below an unacceptable level, but in exchange will be forced to implement recessionary troika-style austerity programmes. This is the exact opposite of the monetary-fiscal policy pursued by the Federal Reserve in the US. Thus, the plan falls very short of transforming the ECB into a ‘real’ central bank. Rather than a lender of last resort, it effectively makes the ECB a ‘dealer of last resort’, with the power to exploit the economic difficulties of countries to blackmail them into implementing neoliberal and austerity-driven reforms, as EU policy analyst Protesilaos Stavrou notes.15

What options for Europe?

What does all this mean for Europe, and what options does the continent have to escape its deadly mix of near-zero inflation, stagnation (or outright recession in various periphery countries) and growing unemployment and inequality? One option, as mentioned, is for the ECB to engage in QE. But mainstream proponents of QE – and especially Mario Draghi –, unfortunately, don’t view this as a way to increase fiscal deficits in the EMU but as a purely monetary tool. This is evident in the fact that Draghi’s QE plan doesn’t even cover government bonds – a necessary prerequisite for QE to act as a monetary-fiscal tool! Such a plan, for the reasons outlined above, would have almost no impact on the real economy. This policy option should thus be avoided: QE as a purely monetary tool is part of the problem, not of the solution (especially if we consider that Draghi’s ABS-geared QE will provide a huge incentive for banks to engage in the same process of securitisation that caused the subprime crisis).


As post-Keynesian theory explains, and as the United States’ example proves, monetary policies alone – even unconventional monetary policies such as QE (Draghi has said that he doesn’t rule out sovereign government bond purchases as an option going forward) – are not sufficient to fight recessions; as said, they have to be combined with stimulatory fiscal policies. As we all know, though, the Maastricht framework – further tightened by the Fiscal Compact – severely limits the fiscal autonomy of member states, especially those with ‘high’ levels of public debt, effectively sentencing them to ‘permanent austerity’. Technically, of course, the ECB could allow individual members states to pursue a debt-funded deficit increase by activating a non-conditional bond-buying programme (unlike the OMT programme) – thus becoming a full-fledged lender of last resort – to keep borrowing costs down. But we all know that is unlikely to happen, at least in the short term, since it would effectively imply abandoning the Stability and Growth Pact. As for the notion that the ‘flexibility’ contained in the SGP already offers all the fiscal leeway that governments need, see my article on the subject.16 Moreover, a debt-based stimulus at the national level would send the debt levels of crisis-stricken countries such as Italy and Greece through the roof, even by Keynesian standards – which in turn would put further strain on the integration process and core-periphery dynamics.

A more ‘realistic’ option is that of the much-debated eurobonds, whereby the EMU would raise money as a whole, at a single interest rate, and then forward it to individual governments, each of which would be fully liable for the entire issuance. This would be a desirable solution – so long as the ECB commits to purchasing eurobonds as part of its standard monetary policy and is willing to cooperate with the EMU’s fiscal authorities –, since an increase in the ‘European public deficit’ as a whole, rather than that of individual member states, would have a much more favourable overall economic impact, boosting demand and employment across the entire continent. The trouble with eurobonds is that they would require the existence of some form of ‘European government’ (or political union) that at present doesn’t exist. And Germany has made it quite clear that it is opposed to any form of debt mutualisation in the near future.

The case for OMF

So – barring an ‘exit and default scenario’ – what immediate options does that leave us within the context of the EMU? As it turns out, not all hope is lost. There is in fact a ‘radical’ solution that is gaining increased support even in mainstream circles: ‘overt money financing’ (OMF), or what renowned journalist and financial economist Anatole Kaletsky calls ‘quantitative easing for the people’.17 It basically consists in handing out newly created money, debt-free, directly to governments instead of banks.

OMF is very different from standard QE, where the Treasury is expected to buy the bonds back from the central bank at some point. Under OMF, the bond purchases are never intended to be reversed, and thus effectively amount to ‘free money’. They are explicitly aimed at an overt increase in the government’s fiscal deficit (without, though, adding to the overall debt) through expansionary policies, thus implying a cooperation between fiscal and monetary authorities; and they are subordinated to employment- and/or growth-related targets, as well as inflation targets. In short, if QE consists of injecting liquidity into the banks in the hope that this will percolate into the wider economy, OMF consists of bypassing banks altogether and

17 Anatole Kaletsky, ‘How about quantitative easing for the people?’, Reuters, 1 August 2012.
injecting this money into the non-financial economy of consumption, investment and jobs, either through direct cash hand-outs to citizens (in the form of an unconditional basic income, for example) and tax cuts, or even better, by financing public investment. The central bank would in effect be financing the government’s expenditures by ‘printing’ money. As Biagio Bosson and Richard Wood write, recent analyses of alternative policy options demonstrate that OMF ‘offers to deliver the most powerful stimulus possible without increasing interest rates or public debt’. Just as OMF can be used to finance new deficits, it can also be used to write off (part of) the national debt, in a process is known as ‘debt monetisation’.

Although most people, even among the left, would balk at the idea of printing money and giving it away to governments debt-free – because it is so removed from the current economic and monetary doctrine, especially in Europe – this is not a new idea. OMF has been defended in the past by such eminent and diverse economists as Henry Simon, Irving Fisher, John Maynard Keynes, Abba Lerner and Milton Friedman. In fact, from the 1930s up to the neoliberal counter-revolution of the 1970s, it was one of the few practical points on which Keynesians and free-market economists agreed upon. In 2003, then-Federal Reserve chairman Ben Bernanke argued that Japan, facing deflation, should increase public expenditure or cut taxes, funding the operation by printing money rather than issuing bonds. This, he argued, was bound to increase national income, because the direct stimulative effect would not be offset by concern about future debt burdens.

Interestingly, the case for OMF was recently made by none other than Adair Turner, member of the UK’s Financial Policy Committee and former chairman of the Financial Services Authority, and one of the most influential financial policy makers in the world. In a truly taboo-breaking speech, Turner acknowledged that not only has the standard form of monetary policy – cutting interest rates – failed to kick-start the economy; unconventional forms of monetary policy such as QE have also failed to live up to expectations. He thus argued that we should ‘take the possibility of OMF out of the taboo box’ and ‘consider whether and under what circumstances it can play an appropriate role’.

OMF cuts straight to the heart of one of the main challenges that we face as a society: the need to reassert the primacy of politics, democracy and the state – or supra-state – over markets (and especially finance). It has been argued by a number of scholars, including myself, that democratic institutions need to reassert their control over markets first and foremost through clear rules and regulations, but also to a certain extent by regaining the levers of economic, industrial and investment policy – thus reclaiming their right to a certain degree of central planning. This is already a huge taboo-breaker in itself.

But the growing number of mainstream advocates of OMF argue that we should go even further, and reclaim (a degree of) democratic control over monetary policy itself. This does not mean putting monetary policy at the service of the short-term interests of governments and politicians. Rather, it means rethinking the priorities of monetary policy in order that they serve the interests of the wider economy, and society at large. After all, when talking of OMF, we

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19 Ben Bernanke, speech given at the Japan Society of Monetary Economics, 31 May 2003.
20 Adair Turner, ‘Debt, money and Mephistopheles: how do we get out of this mess?’, speech given at the Cass Business School, 6 February 2013.
should always keep in mind that states already create money out of thin air. The only difference is that under the current system they give that money away to private banks (which also create new money themselves in the form of loans).

Such a shift would of course require a degree of coordination between fiscal and monetary authorities. Given the evolution of our monetary and financial systems, this is inevitable. We have already seen how the money supply is largely controlled by private banks, not central banks. If, to a certain degree, this has always been the case (at least since the 17th century, when banks started issuing paper receipts), today it is truer than ever. In an in-depth study on the evolution of credit in the macroeconomy, economists Moritz Schularick and Alan Taylor identify ‘two eras of financial capitalism’. In the first era – which the authors call the ‘era of money’, running from 1870 to 1939 – aggregate credit was closely tied to aggregate money. In this era, money and credit were volatile but, over the long run, they maintained a roughly stable relationship with each other and with the size of the economy measured by GDP. In the second era – the ‘era of credit’, which began in the postwar period but truly took off in the 1970s – credit started to decouple from broad money, resulting in an unprecedented expansion in the role of credit in the macroeconomy. This was largely a result of the process of financial deregulation and liberalisation which began in the 1970s. An oft-quoted example is the practice mortgage securitisation, which gives banks the power to create a potentially infinite supply of money, fuelling massive credit bubbles. As Hyman P. Minsky wrote, ‘securitization implies that there is no limit to bank initiative in creating credits’.

This has determined a situation in which central bank have effectively ‘lost control over private and international financial markets’, and thus over the money supply, as Ann Pettifor writes. This doesn’t just point to the need for a broad process of financial re-regulation, including limits to the ability of banks to create money; it also means that ‘we must either re-unify monetary and fiscal policy or resign ourselves to central bank impotence…. Attempting to enforce separation of monetary and fiscal policy renders the central bank powerless’, Frances Coppola writes.

Money-financed versus debt-financed stimulus

At this point it would be legitimate to ask: if the stated aim of OMF is to inject money directly into the economy through expansionary government spending, why not do this by means of traditional Keynesian revenue- and debt-funded fiscal stimuli? From a technical standpoint, advocates of OMF acknowledge that there are circumstances in which a conventional funded fiscal stimulus – provided the country in question has a central bank capable of keeping, and willing to keep, borrowing costs down (as a standard policy, and not, like the ECB, under the threat of ‘conditionality’) – could be appropriate. They simply consider a debt-free, OMF-

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24 For a radical proposal in this direction, see Martin Wolf, ‘Strip private banks of their power to create money’, _Financial Times_, 24 April 2014.
funded stimulus to be an even better (and in some cases necessary) option.

From an economic standpoint, advocates argue that OMF is always better than a conventional funded fiscal stimulus because the impact of the stimulus is not offset by public awareness of future debt burdens, self-fulfilling (albeit unfounded, from an OMF standpoint) concerns about future debt sustainability and future taxes and/or spending cuts that will be necessary (from an orthodox standpoint) to reduce the fiscal deficits and debt levels. This is most evident in the eurozone, but also in the US and Japan, where the large bond-financed fiscal stimuli needed to address collapsing demand in the aftermath of the financial crisis added substantially to the size of the public debt in those countries, prompting regular (and regularly unfulfilled) predictions about the impending disasters that await them for running high debt-to-GDP ratios.

As Richard Wood writes:

When the global financial crisis hit it was natural, perhaps, for policymakers – many schooled predominantly in the finer points of rational expectations, market efficiency, liberalisation, bond financing and the latest general equilibrium models – to not even consider whether orthodox bond financing would continue to be appropriate. Had policymakers had sufficient understanding of what was about to happen to public debt burdens they may well have adopted a different policy approach to deficit financing.26

None other than Milton Friedman, one of the founding fathers of neoliberal economics, argued in the 1940s not only that government deficits should sometimes be financed with fiat money, but that they should always be financed in that fashion, on the basis that such a system would provide a surer foundation for a low-Inflation regime.27

Moreover, in some cases – such as those in which a country’s debt-to-GDP ratio has reached very high levels, even by Keynesian standards – OMF might be the only option. An oft-cited example is Japan: with a debt-to-GDP ratio of 230 per cent and rising, many economists, while acknowledging that large Japanese government deficits were, and still are, necessary to avoid a 1930s-style Great Depression, argue that even according to Keynesian theory there is no persuasive explanation of how Japan will ever contain or reduce the growth of its public debt burden relative to GDP – except through monetisation or debt restructuring/repudiation.28

Furthermore, in circumstances such as those outlined above, the danger is that the level of OMF required to reduce the debt-to-GDP ratio might be so high that it would result in unacceptably high inflation. This leads to the conclusion that if there are conditions in which OMF will eventually be required, it is better to deploy it early and in small amounts, than to allow fiscal debt as a percentage of GDP to accumulate to ‘unsustainable’ levels. Thus, given the fact that, relative to national income, government debt is now larger in many countries than at any point since the Second World War, and is projected to grow relative to income for years to come, there are good reasons to believe that it is a good time to use OMF – both to fund the deficit and to write off (part of) the existing debt.

26 Wood, ‘Europe, USA and Japan: Recent Macroeconomic Policy Errors and a Way Forward’.
28 Turner, ‘Debt, money and Mephistopheles’.
This holds particularly true in a number of European countries, leading financial experts Pierre Pâris and Charles Wyplosz to conclude that ‘the only way we can end the crisis’ is to ‘bury the debt forever’ through partial debt monetisation; this would free up resources currently devoted to the debt service, allowing governments to pursue a (limited) stimulus even within the constrains of the current budget rules and without adding new debt. The same conclusion was reached by Carmen Reinhart and Kenneth Rogoff in a recent IMF paper, in which they claim that advanced economies are wrong to pretend ‘that debt sustainability can be achieved through a mix of austerity, forbearance and growth’; the historical track record of most advanced economies shows that past debt overhangs can only be resolved by resorting to ‘the standard toolkit of emerging markets, including debt restructurings and conversions, higher inflation, capital controls and other forms of financial repression’. As historian Nicholas Crafts writes, history shows that both in the aftermath of the Great Depression as well as after the Second World War, those countries that managed to successfully reduce their debt overhang were able to do so only thanks to a mix of ‘subservient central banking’, capital controls and financial repression (and, of course, the rapid catch-up of growth as a result of massive public investment in the economy). For an overview of the various proposals for debt restructuring in the eurozone, see the article ‘Whither Europe? The Modest Camp vs the Federalist Austerians’ by James Galbraith and Yanis Varoufakis.

More importantly, though, arguments in favour of debt-free rather than debt-based fiscal stimuli are also underpinned by a strong (albeit largely unspoken) ethical-ideological logic. If ‘OMF is bound to be at least or more stimulative than an increase in funded fiscal deficits’, as Adair Turner writes, why should the burden of the stimulus fall on the shoulders of future taxpayers (through the servicing of the debt) if this can be avoided? This is especially so if we take into account that this burden amounts, in most cases, to nothing more than a shift from the private sector to the public sector.

**OMF as the best policy option for the eurozone**

Given the current economic fundamentals of the eurozone – stagnant or negative growth rates, very low or negative inflation rates, high debt ratios, etc. –, as well as the limits posed by its institutional framework (first and foremost, the unwillingness of Germany to engage in debt mutualisation), there are good reasons to believe that OMF is the best policy option for the eurozone, at least in the short term. Interestingly, Richard Wood and Biagio Bossone have

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29 To be fair, the authors are keen to stress that in their plan the ECB would borrow on financial markets the money necessary to acquire a portion of existing public debts rather than use newly created money, and thus technically there would be no monetisation involved. See Pierre Pâris and Charles Wyplosz, ‘PADRE: Politically Acceptable Debt Restructuring in the Eurozone’, Geneva Special Report on the World Economy 3, ICMB and CEPR, 2014; and Pierre Pâris and Charles Wyplosz, ‘To end the Eurozone crisis, bury the debt forever’, *VoxEU*, 6 August 2013. A similar argument was also made by Roberto Perotti in Roberto Perotti, ‘Eurozone recovery: there are no shortcuts’, *VoxEU*, 13 September 2014.


31 Nicholas Crafts, ‘The Eurozone: if only it were the 1930s’, *VoxEU*, 13 December 2013


33 Turner, ‘Debt, money and Mephistopheles’. 
argued that it could even be implemented without violating Article 123 of the Lisbon Treaty, which prohibits so-called monetary financing, since the use of new money created by the ECB could be transferred to individual governments in the eurozone using non-debt financial instruments. This could be done through the existing Emergency Liquidity Assistance (ELA) facility: the ELA allows the ECB to provide ‘central bank money’ to any solvent financial institution ‘facing temporary liquidity problems, without such operation being part of the single monetary policy’. While the rules prohibit the ELA being used to provide ‘overdraft facilities for official bodies’ or to purchase ‘government bonds’, the authors note that there are precedents in the current crisis (for example, Belgium, Ireland and Greece) where the ELA facility has been used as a source of additional bailout funding, and thus conclude that by extending its legal interpretation of the ELA, the ECB could use it as a ‘last-resort demand management tool to fight local recessions and preserve monetary and financial stability in the eurozone’ without violating the existing Treaties. Other economists are not so optimistic about the possibility of using the ELA to implement OMF without a Treaty change. Ultimately, it boils down to a question of political will: since the start of the crisis, the ECB has not hesitated to bend the rules whenever it has deemed it necessary.

Technical and economic considerations aside, one of the aspects that makes OMF particularly indicated for the eurozone is the fact that it doesn’t raise any issues of mutualisation, since present and future taxpayers, including those in core countries, wouldn’t run any risk of having to pay for future losses, bail out insolvent states or incur higher debt-servicing costs. Unless, of course, one believes that a the ECB can ‘run out money’, in which case national central banks (and, ultimately, the taxpayers) would be forced to recapitalise it. This was one of the main arguments underpinning the German Constitutional Court’s ruling that deemed the ECB’s OMT programme illegal under EU law: according to the court in Karlsruhe, if the governments whose bonds are bought by the ECB were to default, the bonds would lose value and the ECB would incur a loss that could wipe out its equity, forcing the governments of the member countries to use taxpayers’ money to recapitalise the ECB. As Paul De Grauwe explains, though, this is not how the ECB, or any other central bank, operates:

A first thing to note is that a central bank cannot default as long as it has the monopoly power to issue money. Money is the ‘debt’ of the central bank but the central bank can redeem this ‘debt’ by issuing fresh money, i.e. by converting an old banknote into a new one. These banknotes do not constitute a claim on the assets of the central bank. As a result, the central bank does not need equity (in contrast to private companies). It can live perfectly with negative equity. As long as the central bank keeps its promise of price stability any amount of equity, positive or negative, is fine.

In other words, the ECB cannot ‘run out of money’.

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36 See, for example, Bill Mitchell, ‘Options for Europe – Part 67’, author’s blog, 18 April 2014.
37 Paul De Grauwe, ‘Why the European Court of Justice should reject the German Constitutional Court’s ruling on Outright Monetary Transactions’, LSE EUROPP blog, 4 March 2014.
**Arguments against OMF**

The main argument against OMF, and expansionary monetary and fiscal policies in general, is that they inevitably lead to inflation – or hyper-inflation, in the case of OMF. Advocates of OMF offer a three-pronged response.

First, the current system – in which states not only ‘print’ money and give it away to banks through QE, but the banks themselves create most of the digital money in circulation – is just as inflationary as (if not more inflationary than) OMF. More accurately, it is inflationary when it should not be, and is not inflationary when it should be. In short, the ability to create money – in effectively unlimited amounts, through securitisation – gives banks the power to engineer credit-driven booms at will, which in turn leads to soaring prices (especially in the housing market). When these booms inevitably go bust, triggering a crisis, the banks attempt to repair their over-leveraged balance sheets by engaging in excessive de-leveraging, cutting off credit when households and businesses need it the most. This exacerbates the crisis and drives the economy into what economist Richard Koo described as a ‘balance sheet recession’. When this happens, because of the way in which banks operate, no amount of QE is sufficient to get banks to start loaning again. In such a context, central banks have little influence on the rise and resolution of boom-and-bust cycles, simply because under the current system the money supply is largely out of the central banks’ control. It need not be this way, though: ‘private credit and money creation are fundamental drivers of both financial and macroeconomic instability and need to be tightly regulated’, says Adair Turner. 38

Second, there is no inherent technical reason to believe that OMF will be more inflationary than any other policy stimulus, or that it will produce hyper-inflation, since the impact on nominal demand and thus potentially on inflation depends entirely on the scale of the operation. Besides, if and when inflation did begin to rise above target levels excess liquidity can be removed. As mentioned, even Friedman believed that a system of money-financed deficits could provide a surer foundation for a low-inflation regime than a debt-based financing system.

Finally, the anti-inflation doomsayers are missing a crucial point: that (a bit of) inflation is precisely what we need, or at the very least is a means justified by the end of employment creation (while maintaining the anchor of commitment to long-term price stability). The eurozone is currently trapped in a deflationary spiral: a situation where decreases in prices lead to lower production, which in turn leads to lower wages and demand, which leads to further decreases in prices, which leads to growing unemployment, and so on. In such a situation, not only is a higher inflation rate justified by the prospect of creating jobs, it is also beneficial in itself, as it implies a higher return on investments, producing a more fertile economic environment. It also has the added benefit of alleviating a country’s debt burden by eroding the real value of the debt.

**OMF already a reality**

There appears to be a growing cognisance of this even at the mainstream level. Recently, none other than Francesco Giavazzi (of ‘expansionary austerity’ fame) and Guido Tabellini proposed

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38 ‘Turner, ‘Debt, money and Mephistopheles’.
a quasi-OMF solution for the eurozone. They write that:

Combining a monetary and a fiscal expansion is key to the success of aggregate demand management, as shown by the recent experience of other advanced countries… [but] fiscal expansion without monetary easing would be almost impossible, because public debt in circulation is already too high in many countries.\(^{39}\)

They thus propose a large deficit-raising tax cut financed by issuing long-term public debt which ‘should all be bought by the ECB, without any corresponding sterilisation’. McCulley and Pozsar have proposed a similar solution. Considering that unconventional and radical policies such as QE and similar policies are not effective because they are ‘independent of the fiscal policy stance’, they propose what they call ‘fiscal-monetary cooperation (FMC)’, in which monetary policy works to ‘support the fiscal authority in raising nominal demand’ by funding the deficit. This easily can be done by the central bank ‘buying on the secondary market the same amount of bonds that the government has issued to fund the stimulus’.\(^{40}\)

At first glance, these authors would seem to be proposing a traditional debt-funded stimulus. But the truth is that in the strange, post-crisis, paradigm-defying phase that we find ourselves in, distinguishing between traditional QE and OMF, and between bond-financed and money-financed stimulus – and establishing exactly what policy monetary and fiscal authorities are really pursing –, is not always easy. Some commentators, for example, argue that the United States and Japan are in effect already monetising the deficit/debt. The fact is that it largely depends on whether the bond purchases prove to be permanent or not – and many believe that in fact they will, especially as far as Japan is concerned (where the central bank now owns government bonds worth 35% of GDP). As mentioned already, and as Adair Turner notes, ‘there is no credible scenario in which Japan can generate fiscal surpluses large enough to repay its accumulated debt: a significant proportion will remain permanently on the Bank of Japan’s balance sheet’ or will otherwise be written off.\(^{41}\) Likewise, if Giavazzi and Tabellini’s proposal were adopted, the result would almost certainly be some permanent increase in the ECB’s balance sheet. As Turner explains, political considerations may lead central banks and governments to choose the Machiavellian path of ‘monetiz[ing] debt while pretending not to…

As a result, even when permanent monetization occurs – as it almost certainly will in Japan and possibly elsewhere – it may remain forever the policy that dare not speak its name’.\(^{42}\)

**Conclusions**

Tectonic shifts are under way in monetary and fiscal policy theory, as a growing number of central bankers and policy makers around the world move towards flexible and/or higher inflation targets, and employment- or growth-related targets, and begin to ‘re-unify’ monetary and fiscal policy. Furthermore, some of them are starting to openly advocate, or covertly implement, overt money financing. And yet in Europe, despite the fact that the continent, like most developed countries, is clearly trapped in a credit trap and is heading into a deflationary scenario – and even more importantly, is the region that is suffering the most in economic and

\(^{39}\) Giavazzi and Tabellini, ‘How to jumpstart the Eurozone economy’.


\(^{42}\) Adair Turner, ‘Rethinking the Monetization Taboo’, *Social Europe Journal*, 19 March 2014.
social terms – the ECB has consistently refused to follow suit. Of course the ECB, lacking a unified government to back it fiscally or authoritatively, is in a much trickier position than other major central banks. From a progressive-integrationist perspective, this reinforces the need for a deepening of the integration project. But for this to succeed requires nothing less than an ideological quantum leap, in monetary as well as fiscal and budgetary terms.

• In the short term, in view of recent evolutions in monetary policy theory and the EMU’s unique economic-institutional set of conditions, the ECB should engage in OMF to finance public expenditure across the currency area without adding to the overall public debt of members states or of the currency area as a whole (and without raising issues of mutualisation). This would be the most desirable solution.

• Alternatively, governments should be allowed to pursue a debt-financed fiscal stimulus, by issuing long-term bonds which would be entirely bought by the ECB (ideally on a permanent basis). In both cases, the ECB would need to coordinate itself with fiscal and political authorities at both the European and national levels.

• At the very least, the ECB should reduce the interest payments of governments by acquiring or monetising a portion of existing public debts; and should activate a non-conditional QE programme covering government bonds as well, even though without a corresponding fiscal policy stance, as explained, this is likely to prove ineffective and potentially dangerous.

• In general terms, the ECB must be willing to support an expansionary fiscal stimulus and to this end should aim for more flexible employment- and/or growth-subordinated inflation targets, in the context of much more flexible deficit- and debt-to-GDP targets (the SGP and Fiscal Compact, and the target of ‘structural balance’ for public budgets, must be abandoned).

• In the longer term, the EMU must aim for a permanent ‘re-unification’ of monetary and fiscal policy, and the deficit-, debt- and inflation-obsessed neoliberal dogmas of austerity and over-restrictive fiscal and monetary policies must be abandoned.

It is the author’s opinion that these are necessary prerequisites for any furthering of the integration process – and for any form of ‘political union’.

Ultimately, it should be noted that the idea of OMF was recently championed even by the Committee on Economic and Monetary Affairs in a 2013 draft report on the activities of the ECB which recommended that the central bank ‘undertake an “overt money financing” of government debt in order to finance tax cuts targeted on low-income households and/or new spending programmes focused on the Europe 2020 objectives’. The proposal was ultimately struck down, but the simple fact that it was debated offers a glimmer of hope for the future. It is only by challenging the dominant and tragically flawed economic and monetary orthodoxy that we have any hope of escaping the crisis, and of rebuilding Europe on the basis of a socially and environmentally sustainable economy.