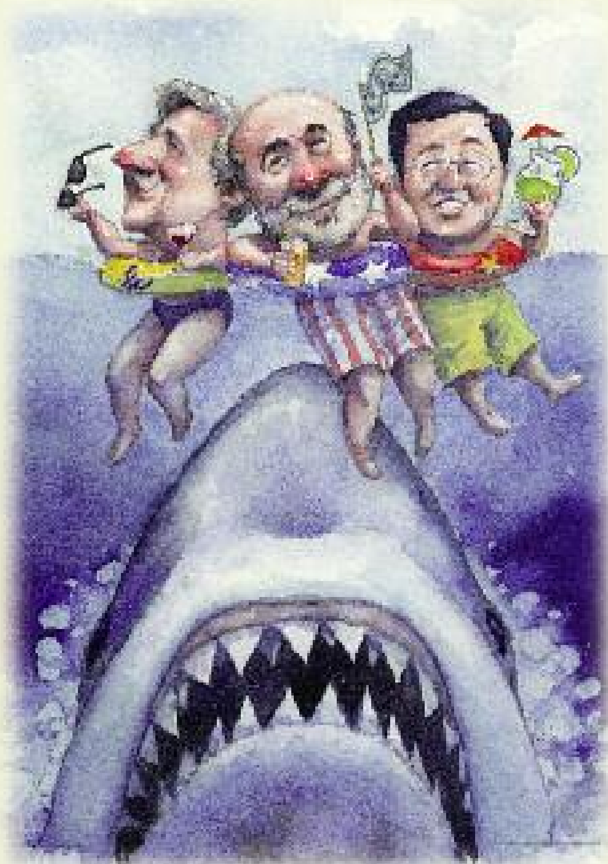

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With Sovereign Debt, Can Governments And Central Banks Have It All?

Is there a limit to the amount of public debt global central banks can purchase? Or are central bankers the new debt purchasers of last resort? If so, what are the short-term and long-term consequences of a situation in which the world's sovereign and agency debt approaches 100 percent of GDP, yet short-term interest rates remain relatively low as a result of central bank targets? Will the long-term result be global hyperinflation? Or will an extended policy of central bank purchases prove to be contractionary, perhaps producing a crowding-out effect? Or can governments and central banks have it all in the sense that the effect from such debt purchases will be relatively benign, perhaps because of the relative short-term nature of the purchased debt?

Fourteen experts share their thoughts.

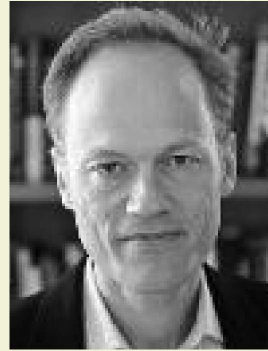
Yes, but only if we quickly return to normalization.

JÜRGEN STARK
Member of the Executive Board, European Central Bank

Governments and central banks in advanced economies resorted to unprecedented measures in response to the financial crisis. The purpose was to avert a meltdown of the international financial system, a global economic depression, and sustained deflation. This goal has been achieved—but the costs and side effects of rescue measures are becoming increasingly visible. If maintained for too long, the same measures that stopped the economic freefall in the midst of the crisis will sow the seeds for renewed imbalances down the road. The time has come to return to normal.

In the euro area context, the roadmap is clear. In a nutshell, the European Central Bank needs to take appropriate action to ensure price stability in the medium term; governments need to consolidate public finances and enhance the competitiveness of their national economies; and financial regulators and supervisors need to decisively strengthen the resilience of the financial system. If action by all policy actors—each one in its own domain—is determined and comprehensive, then governments and central banks can indeed have it all: price stability, fiscal sustainability, balanced economic growth, and financial stability.

The European Central Bank will do all that is necessary to keep inflation expectations in the euro area firmly anchored in line with our price stability definition. The monetary policy stance will be adjusted as necessary and the non-standard monetary policy measures adopted during the crisis discontinued as the need for these measures vanishes. This logic also applies to our Securities Markets Programme. The action we took to help restore an orderly functioning of securities markets has not impacted liquidity creation and thus has been neutral to the determination of inflation and inflation expectations. Europe has learned its lesson from the past: under no circumstances will there be monetization of government debt in the euro area.



What we're witnessing is an unprecedented experiment.

SEBASTIAN MALLABY
Director, Maurice R. Greenberg Center for Geoeconomic Studies, Council on Foreign Relations

These are fascinating times for central bankers. The power implicit in the creation of fiat currencies is being stretched and tested more than at any time since Nixon's abandonment of the dollar-gold link in 1971. For most of the four decades since that fateful decision, to print money was to invite inflation. But since 2008, excess capacity, high unemployment, and the continued downward pressure on prices from global competition have meant that money could be printed without causing inflation. Governments have been able to conjure spending power out of thin air. The question is when this magical power will be rescinded.

So far it has not been. In the United States, the Fed has printed trillions of dollars to support quantitative easing and emergency relief for troubled financial firms. In the eurozone, the European Central Bank has ballooned its balance sheet, pumping money into the economy as it has done so. Even before the earthquake and tsunami, the Bank of Japan had been following the same script. After the tragedy, it immediately pumped out trillions of new yen to prevent a breakdown of the payment system. And yet, as of the spring, inflation was running at just 2.5 percent in the eurozone and 1.5 percent in the United States. In Japan, inflation was zero.

Money cannot be printed forever with impunity. Investors who believe that central banks will overplay their hand have taken refuge in gold, causing its price to double since late 2008. The central bankers, for their part, insist that they have both the tools and the will to stop the printing presses before inflation takes off. We are witnessing an unprecedented experiment.

There are reasons to be suspicious.

VINCENT REINHART
Resident Scholar, American Enterprise Institute, and former Director of Monetary Affairs, Federal Reserve Board

Central banks cannot have it all, but they can issue as much currency and reserves as they want. A modern monetary authority can purchase government securities by creating reserves with a few keystrokes and typically has considerable independence to do so. Consider that the U.S. Federal Reserve was able to triple its balance sheet in three years, unimpeded by the executive or legislative branch of government.

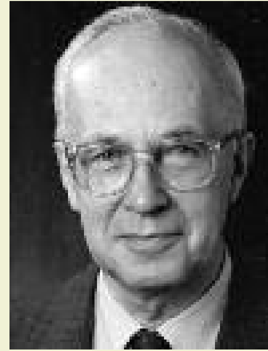
Control of its nominal balance sheet does not give the Fed unlimited license to grab real resources. As of now, the $1.5 trillion of reserves that the Fed has created mostly sit idle on domestic bank balance sheets. Were those reserves to remain for the indefinite future, they would be used and put considerable upward pressures on prices. The purchasing-power capacity of the Fed's balance sheet would contract and the borrowing cost of the federal government would balloon.

The Fed will have to raise the policy rate from its zero floor and slim its asset holdings to avoid that dire outcome. But not right now. Resources are currently slack and inflation dormant. The Fed's current job is to convince the public it will act appropriately when the time comes.

A sensible person might be suspicious for two reasons.

First, deep down, U.S. authorities would not mind a bit of extra inflation. The surprise would bolster nominal home prices and erode the real value of Treasury debt.

Second, politicians have to bend down the curve of debt issuance in the next few years. If not, foreign official investors will ultimately balk at continuing to be the buyers of first resort of U.S. debt and a reluctant Fed might become the buyer of last resort.



No, the consequences are negative if limits are exceeded.

HELMUT SCHLESINGER
Former President, German Bundesbank

The short answer is no. There are limits, and if these are exceeded, the consequences are quite negative. For example, John Law, who served as financier for France's King Louis XV, invented the notion of financing state expenditures with massive issues of paper money. The scheme ended badly. The president of the German Reichsbank during and after World War I, Rudolf von Havenstein, financed the post-war hyperinflation, and died three days after his successor had stabilized the mark. And the man in the same position during World War II, Walther Funk, helped to finance the war with central bank money and was condemned to jail by the Nuremberg tribunals.

The result of these and other experiences was to introduce legal limits for state financing in the laws of certain central banks such as the Bundesbank. The Maastricht Treaty forbids central banks in the European Union from granting credit to the state and from directly purchasing state bonds. In other words, the purchase of state bonds "out of the market" is allowed. This exemption is currently used by the European Central Bank. The Bank of England (also under the EU Treaty) has created a daughter company as a middleman to be able to buy a large but limited amount of gilts. The European Central Bank carefully explains that the central bank money, created by its purchases of government bonds, is "sterilized" by not more than eight-day term deposits. This caution shows these are steps into a dangerous area.

Three points are important. First, the clear separation of responsibility between government finance and an independent central bank is in danger. Nothing is more attractive for finance ministers than to know a source of credit which *de facto* does not cost interest because that interest, paid to the central bank, comes back with the profits of the bank, and one can be sure that the credit, when it must be redeemed, will be renewed. This diminishes the need to restrain government expenditures and increases both outstanding debt and the political pressure against the central bank.

Second, central bank financing of government expenditures is—in the longer run and in the case of larger amounts—an historic source of inflation. If inflation is measured as the increase of consumer prices at the beginning, it is a slow-going process and therefore does not alarm the public immediately. But the consequences of inflation may come later, especially if private savings are low and the exchange rate devalues as a consequence of a relatively low interest level and a deficit in the balance of payment.

Third, it is my observation that most proponents of government financing by central bank money do not take care against the repercussions on the external position of a country. If the country is not the country which issues the most-used reserve currency, high and growing government debt deteriorates its financial status with all the negative consequences. The reserve currency country can—and is prepared to—neglect the external consequences of its government debts and its financing. It can do this for a long time, but not forever. In every respect it would be helpful to accept legal limits on the magnitude of government debt and strong restrictions for central bank financing.

It depends on credibility.

RANDALL S. KROSZNER
Norman R. Bobins Professor of Economics, University of Chicago Booth School of Business, and former Governor, Federal Reserve System

The key, as usual, is central bank credibility. If the debt purchases by the central bank are perceived as a limited response to the threat of deflation or negative economic shocks, then the debt purchases can be effective in warding off those negative consequences. Central banks generally have the tools to "sterilize" their expanded balance sheets through, for example, the payment of interest on reserves and repurchase agreements, to avoid a high inflation outcome. But will the central banks act and will people believe that they have the resolve to do so? The answers will vary considerably around the globe. In countries with less independent central banks and more recent bouts of high inflation, the answers are more likely to be "no." Once the markets perceive that a central bank has crossed the line to become simply the purchaser of last (and, in some cases, first) resort, the game is up—inflation expectations rise, interest rates move higher, and stagnation can result. Only deep and sustained fiscal consolidation and reform can then restore both central bank and fiscal credibility.

Collateral damage is likely to be massive.

HANS-JOACHIM DÜBEL
Founder, Finpolconsult.de

Central bank bond market intervention is the main tool to manage the deleveraging of highly indebted (sub)sovereigns, banks, and households. Fiscal and directed credit options have been sought as an alternative but remain small. While the narrow objective of stabilizing bond markets has been reached in this way, collateral damage is likely to be massive and reputation loss permanent.

First, a central bank can go bankrupt. For the European Central Bank, credit risk is high in *de facto* subsovereign or mortgage bonds bought from the eurozone periphery, which has already prompted calls for a recapitalization. The Federal Reserve avoids sub-sovereign bonds, but is highly exposed to long durations in sovereign and sovereign-guaranteed mortgage bonds. Both entities shy away from mark-to-market accounting that could reveal the risk.

Second, intervention displaces institutional and international investor credit supply. The Fed owns more U.S. bonds than China, and the European Central Bank is the largest creditor in Ireland and Greece. Measured in the currency of the bond market—duration—displacement is even greater. The failure to deal with credit losses at their source via resolution with haircuts for the directly responsible investors has deterred other investors. Losses are indiscriminately socialized through zero interest rate policy, performing borrowers are confronted with balloon-

ing spreads, and taxpayers are asked to foot the remainder. The political dictate to avoid resolution has rendered monetary policy powerless to reduce capital market rates and stimulate growth. A permanent deformation of the investor structure is likely, or at least a protracted exit.

Finally, inflation. Once private investors have been replaced by official ones, is a sufficiently fast exit from keeping leverage high and rates low politically feasible? Can the European Central Bank act against the interests of median voters in the periphery who are highly indebted in variable-rate mortgages? Will the Fed resist an inflation strategy made easier by cutting ties with international investors in order to solve the debt problem? Politicized as central banks have become during this crisis, the likely answer to all these questions is no.

Yes, under certain circumstances.

RICHARD N. COOPER
Maurits C. Boas Professor of International Economics, Harvard University

Of course a central bank can finance government deficits without limit. They simply "buy" government bonds, or lend to the government, against credit created by themselves, which they can do without limit. The key issue is not the technical possibility, but the economic consequences of central bank lending to the government. We have many examples of countries that have done this, the most notable recent example being Zimbabwe, where official foreign exchange reserves have been exhausted, inflation runs into thousands of percent annually, and residents seek to flee from the domestic currency by buying greenbacks or other currencies of stable value in terms of goods and services.

Thus, the appropriate question is when is it desirable for central banks to lend to governments (or buy their bonds) in moderate amounts? The answer is when an economy has lots of unemployment and unused productive capacity, and when it has a flexible exchange rate, that is, circumstances similar to those of the United States today.

Yes, but there are risks.

JOSÉ DE GREGORIO
Governor, Central Bank of Chile

A crisis is a rare event. The unconventional policies applied in many countries to deal with the zero lower bound of interest rates were fully coherent with both price and financial stability. Those types of policy interventions included government bond purchases aimed at reducing market interest rates.

Nevertheless, during a crisis, the central bank risks facing fiscal pressure to deviate from the goal of price stability in order to obtain more resources. This is especially important in developing countries. A commitment to an inflation target, where deviations are explicitly announced to the public together with the strategy for achieving the target, can mitigate this risk. The second risk is related to budget. Whereas the treasury is restricted by budgetary concerns, the central bank is not. This adds flexibility during periods of turmoil, and hence, rather than a risk it may turn out to be an advantage. However, the misuse of this ability may undermine credibility and weaken monetary policy. Therefore, a clear mandate on price stability and an independent central bank should minimize this risk.

The significant increase in the balance sheets of central banks necessary to finance unconventional policies has been pointed out as a source of inconsistency with future price stability. Increasing interest rates to secure price stability in the future will require undoing those operations, which could threaten financial stability. But central banks that are facing this challenge have the ability to pay an interest rate on those reserves different from the monetary policy rate. This additional instrument should secure a smooth exit from their current situation without affecting price stability. Again, price stability and *ex post* financial stability are mutually consistent.

Finally, some analysts have argued that if some unconventional policy interventions have been too extended, price and financial stability may not be consistent from an intertemporal perspective. In effect, some dimensions of unconventional monetary policy, in particular credit policy, involve a fiscal dimension. Although

these concerns are relevant, I think that the key solution to them will be strengthening independence of central banks and generating a more resilient financial system.

We're nowhere near any risk of hyperinflation.

SEBASTIAN DULLIEN

Professor for International Economics, HTW Berlin-University of Applied Sciences

Fortunately, warnings of an imminent hyperinflation are misguided. True, balance sheets of major central banks have expanded strongly over the past couple of years. However, central banks have only stepped in where financial markets have failed: Monetary authorities have provided the liquidity wealth owners wanted to hold in their portfolio. While markets used to provide this liquidity (or at least liquidity illusion) prior to 2008, central banks since then have created narrow money as market liquidity has dried up.

This kind of liquidity provision does not create inflation. A hyperinflation is caused when either aggregate demand exceeds aggregate supply over a prolonged period or when investors shift their wealth out of monetary (nominally fixed) assets into real assets such as companies and real estate. With unemployment remaining stubbornly high and capacity utilization low in major economies, there is no sign of excessive aggregate demand. Real estate prices as well as stock prices have stabilized, but they are by far not exceeding their 2008 value, so there is no indication that investors are moving out of monetary assets. Moreover, central banks could easily reverse their policy, selling some government paper.

As long as central bank purchases of government debt remain an emergency measure to keep the economy from spiraling into deflation and a prolonged depression, they carry very little risk of creating a hyperinflation. Central bank purchases of treasury paper become a danger if monetary authorities are forced into them to keep governments solvent, either by keeping interest rates low even when inflation accelerates or by directly financing budget deficits. Such a scenario is still far off. While there is no consensus at which level government debt creates solvency problems, for the United States, the euro area, and Britain, the current level is safely below levels observed historically without a solvency crisis.

Yes, but a lot of things have to go right.

SUSAN M. PHILLIPS

Professor of Finance and former Dean of the School of Business, George Washington University, and former Governor, Federal Reserve System

History does not paint a very optimistic picture for the outcome of long periods of easy money and massive fiscal debt. Previous experience suggests we will see a build-up in inflation over the next several years, perhaps exacerbated by international food shortages and energy production disruptions due to political upheaval. The key to any central bank's ability to expand its balance sheet to ease monetary policy is continued confidence in that country's currency. So far, the United States has been able to handle deeper fiscal debt, some of the paper held by the Fed, because the United States is still seen as a safe haven with credible currency.

The continued move towards a more fully integrated global economy adds a new dimension for governments and central banks as they attempt to manage their debt and accompanying monetary policy. Nevertheless, countries are differently situated in terms of economic growth, access to capital, currency credibility, labor markets, productivity and economic diversification.

For the United States, there is an even chance we can work our way out of the current state of monetary ease this time without a bout of hyperinflation. But it will take work on the fiscal side to reduce the fiscal deficit. Slack in the labor markets, ample productive capacity, and generally strong corporate balance sheets and cash positions will help. The Fed's successful winding down of its various "facilities" established during the financial crisis as well as its commitment to transparency and communication bode well for the Fed's downsizing its balance sheet in an orderly fashion. Moreover, since much of their pur-

chased debt is short-term, its sale will be into a deep and liquid market, lessening the chances of market disruption. Nevertheless, this liquidation will have to be carefully managed. The United States may escape hyperinflation this time, but a lot of things need to go right. I am not ready to say that central banks and governments can have it all every time—both large public debt and easy money. Too much else has to cooperate—the private sector, financial markets, labor markets, and the global economy.

No, like coming off of drugs, reversing today's expansionary overdose will leave the patient screaming.

NORBERT WALTER
Walter and Töchter Consult, and Chief Economist Emeritus, Deutsche Bank

The Maastricht fiscal policy criteria at the start of the 1990s were designed for economies reckoned to have nominal GDP trend growth of not less than 5 percent annually. If inflation that does not undermine fiat money's acceptance in the mature world is not above 2.5 percent and the trend growth rate of the mature world is no more than 2.5 percent, then the Maastricht limit of a 60 percent debt-to-GDP ratio applies.

There are obviously regional differences in the trend growth rate. However, a 100 percent debt-to-GDP ratio is unsustainable even for the United States with its higher trend growth rate than Europe or Japan. It is patently obvious that the 200 percent-plus debt-to-GDP ratio of Japan is paving the way to old-age poverty. Europe is not in as bad a situation as Ireland and Greece—according to the capital markets—but its public debt situation is definitely also unsustainable.

While current fiscal policies and central bank actions at macro level are unsustainable, the particular sin of purchasing junk assets is unforgiveable for central banks since it undermines trust in the quality of paper money. If a bailout is necessary, it ought to be done with taxpayers' money and with the open approval of government and parliament. A central bank stepping in to provide more than liquidity on a temporary basis is unacceptable. It only feeds illusions.

While the Federal Reserve, Bank of England, Bank of Japan, and European Central Bank are all sinners in this respect, the largely short-term nature of the liquidity provision to banks still allows excess liquidity to be reduced before inflation starts to get out of hand. The pain inflicted by higher central bank rates—or even more so in high-tax economies by cuts in government spending—will prove sufficient to topple more than one government and this will undoubtedly occur.

After the folly of an expansionary policy overdose, it is coming off the drugs that will leave the patient screaming.

For the ECB, these concerns are unfounded.

YVES MERSCH
President, Luxembourg Central Bank

The purchase of public debt by major central banks in the course of the financial crisis gave rise to concerns that the precarious situation of public finance could lead to accelerated inflation as governments might try to "inflate away" their debts. In the case of the euro area, these concerns for various reasons are completely unfounded.

From a legal standpoint, monetary financing is strictly forbidden in the euro area. Article 123 of the EU treaty explicitly prohibits primary market purchases of government debt. Secondary market purchases of government bonds in order to circumvent that monetary financing prohibition are not allowed either.

The European Central Bank and the national central banks of the euro system have always complied with these rules. Since May, we have intervened in the euro area public and private debt securities markets, under the Securities Markets Programme. These interventions were deemed necessary as the tensions observed in the financial markets at that time threatened to impair the effective transmission of monetary policy. This put the European Central Bank's primary mandate of price stability at risk.

The SMP therefore has been implemented to restore a proper functioning of the monetary policy transmis-

sion mechanism. No primary market purchases of EU government debt were made, and the secondary market purchases conducted in the context of the SMP cannot be assimilated to primary market purchases. Hence, the SMP was not designed to finance the government's deficit at a time of financial distress.

From an economic standpoint, the European Central Bank did not embark on any form of quantitative easing. No economic stimulus was created; the size of the total balance sheet of the European Central Bank was not affected as the purchases were sterilized. Moreover, the magnitude of the SMP was relatively small.

Amid the rules of the treaty, the clear mandate of the ECB, and its institutional independence, the monetization of public debt in the euro area is out of question. As the fiscal situation, however, is still precarious, national governments must live up to their responsibilities and bring back public finances back on a sustainable track.

There are serious potential costs.

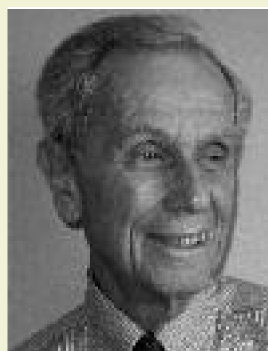
MICHAEL J. BOSKIN
Tully M. Friedman Professor of Economics and Hoover Institution Senior Fellow, Stanford University, and former Chair, President's Council of Economic Advisors

The major central banks—the U.S. Federal Reserve, the European Central Bank, the Bank of Japan, the Bank of England, and the People's Bank of China—hold substantial power and a variety of instruments available to affect economic and financial conditions. But their power to do so is fundamentally limited by economic, financial, and political factors, especially in a global economy with mobile capital. The balance sheet of the central bank is expected eventually to be consolidated with that of the government. There is an upper bound to the fraction of wealth private citizens and the institutions that manage their wealth are willing to hold in government bonds for prudential and diversification reasons, that is, due to the fear of future inflation and/or currency depreciation (PIMCO's flagship Total Return bond fund no longer holds Treasuries).

Buying longer-term Treasuries with excess reserves which are perfect substitutes for T-bills on the balance sheets of financial institutions already stuffed with excess reserves is equivalent to a shift in the maturity structure of the federal debt, a fiscal operation. Buying the bulk of Treasury issuance, the Fed risks being perceived as more likely to monetize debt in the future, given the government has made too many promises it cannot meet.

While they have the tools to forestall inflation and inflationary expectations, the judgment to do so has in the past sometimes eluded the Fed and other central banks. It is certainly the intention of Mr. Bernanke and his colleagues to do so. Exiting is going to be doubly tricky: shrinking its balance sheet and raising rates in some sensible, predictable combination. And, given its dual mandate, political pressure is likely to be intense well beyond the time when the Fed should be normalizing policy.

While the headline nominal commitments in facilities, bailouts, TARP, QE1, and QE2 were always an exaggerated upper bound on potential losses (even the Resolution Trust Corporation got back 80 percent of the shutdown cost from savings and loans), getting "paid back"—whether the Fed or Treasury—is a very limited, and not always sensible, measure of success. Among the costs it ignores is the potential pressure on the Fed—also on fiscal policy—to react aggressively to even minor economic problems in the future and the moral hazard that creates for private investors and financial institutions in the expectation it will happen. Central banks have substantial power and influence, but these are neither costless nor unlimited.



No, there are limits.

STEPHEN H. AXILROD
Author of* Inside the Fed: Monetary Policy and Its Management, Martin through Greenspan to Bernanke, Revised Edition *(MIT Press, 2011)

No, they cannot have it all, and yes, there is a limit to the amount of public debt global central banks can purchase. However, since no theoretical limit

to a central bank's balance sheet expansion is readily apparent, what I have in mind is a practical limit to the amount of public debt central banks should or can safely purchase.

Among global central banks, that limit is reached when the expansion of the bank's credit and associated private sector liquidity strongly arouse inflation expectations or, more subtly, run the risk of doing so (perhaps even before becoming clearly evident in market indicators). The effort of global central banks to continue adding debt beyond that practical point will do little, if anything, to expand the real economy (possibly even an underemployed one), and could well lead to a worsening later on.

That's all easily said; the trick of course is to realize when the limit is approaching. There are no clear statistical guidelines or magical econometric formulas. It's a matter of sound central banker judgment, and most importantly, having the political possibility, clout, and nerve to exercise it. Judging from behavior during the recent credit crisis in the United States and the remaining one in Europe, the exercise of good judgment on a timely basis has been far from a given.

While the United States now seems to be beyond the crisis, the Fed faces crucial judgments about its balance sheet in the recovery period. The Fed is now embarked on further acquisitions of longer-term securities to help fortify the economy—termed QE2 in the press, though I do not recall the phrase "quantitative expansion" in the Fed's official statements. Nonetheless, the extremely high, ahistoric total of Fed credit has been rising gradually further since the recent policy was adopted. It looks as if the Fed feels it is not at a limit to its credit expansion from government debt.

I would argue that it is at a limit, and perhaps beyond. It is better to be early rather than late in realizing the inflationary potential in current circumstances, especially in light of the huge amount of liquidity remaining in markets from the crisis period—just as it would have been better to be early rather than late in realizing the potential for a drastic credit crisis. That does not mean the Fed cannot buy more long-term bonds if it wishes. It merely means that the purchases should not be monetized. They should be offset by other operations to reduce bank reserves. Also, I suspect one can begin cutting into the more than $1 trillion in excess reserves currently in the banking system without, up to a point, significantly affecting the near-zero federal funds rate. Rather deep cuts will have to be made sooner or later. Why not begin sooner? ◆