POLICY BACKGROUNDER

There is a history of central banks intervening positively in crises without significant inflation. The reason for this is simple: when incomes and revenues have collapsed, bringing those incomes and revenue back to where they were restores spending power. It does not increase it.

Almost all instances of hyperinflation are due to a country owing money in another currency. What makes the difference is changing exchange rates. A country whose currency is dropping in value has to spend more and more to keep buying foreign currency to pay debt.

1) Last week, the Bank of England started directly financing the UK governments.

https://www.theguardian.com/business/2020/apr/09/bank-of-england-to-finance-uk-government-covid-19-crisis-spending

2) Here is the Financial Times' endorsement of the use of "Helicopter Money" and Central Bank financing of government

https://www.ft.com/content/fd1d35c4-7804-11ea-9840-1b8019d9a987?sharetype=blocked

3) The Bank of Canada used to provide finance to governments as well as business

A history of the Bank of Canada's monetary financing is available here:

http://www.levyinstitute.org/pubs/wp_848.pdf

Is Monetary Financing Inflationary?A Case Study of the Canadian Economy, 1935–75

by Josh Ryan-Collins – October 2015

"Historically high levels of private and public debt coupled with already very low short-term interest rates appear to limit the options for stimulative monetary policy in many advanced economies today. One option that has not yet been considered is monetary financing by central banks to boost demand and/or relieve debt burdens. We find little empirical evidence to support the standard objection to such policies: that they will lead to uncontrollable inflation. Theoretical models of inflationary monetary financing rest upon inaccurate conceptions of the modern endogenous money creation process. This paper presents a counter-example in the activities of the Bank of Canada during the period 1935–75, when, working with the government, it engaged in significant direct or indirect monetary financing to support fiscal expansion, economic growth, and industrialization. An institutional case study of the period, complemented by a general-to-specific econometric analysis, finds no support for a relationship between monetary financing and inflation. The findings lend support to recent calls for explicit monetary financing to boost highly indebted economies and a more general rethink of the dominant New Macroeconomic Consensus policy framework that prohibits monetary financing."

4) Nouriel Roubini – A Greater Depression? Project Syndicate, March 24, 2020

"…governments need to deploy massive fiscal stimulus, including through "helicopter drops" of direct cash disbursements to households. Given the size of the economic shock, fiscal deficits in advanced economies will need to increase from 2-3% of GDP to around 10% or more. Only central governments have balance sheets large and strong enough to prevent the private sector's collapse.

But these deficit-financed interventions must be fully monetized. If they are financed through standard government debt, interest rates would rise sharply, and the recovery would be smothered in its cradle. Given the circumstances, interventions long proposed by leftists of the Modern Monetary Theory school, including helicopter drops, have become mainstream."

https://www.project-syndicate.org/commentary/coronavirus-greater-great-depression-by-nouriel-roubini-2020-03

5) **Adair Turner – Former Former Chairman, United Kingdom Financial Services Authority**

https://www.ineteconomics.org/perspectives/blog/demystifying-monetary-finance

"Discussions of "helicopter money" – the direct injection of cash into the hands of consumers, or the permanent monetization of government debt – have, as a result, become more widespread. In principle, the case for such monetary finance is clear.

If the government cuts taxes, increases public expenditure, or distributes money directly to households, and if the central bank creates permanent new money to finance this stimulus, citizens' nominal wealth will increase; and, unlike with debt-financed deficits, they will not face increased future taxes to pay off the debt incurred on their behalf. Some increase in aggregate nominal demand will inevitably occur, with the degree of stimulus broadly proportional to the amount of new money created."

6) Stephanie Kelton - Professor of public policy and economics at Stony Brook University in New York

https://www.bloomberg.com/opinion/articles/2019-03-07/deficits-mmt-and-a-green-new-deal

"Every economy has its own internal "speed limit." There are only so many workers, machines, factories, raw materials and so on that can be brought online to produce our economy's goods and services. This is our "potential GDP."

In a depressed economy, say, the U.S. economy of 2008-2009, there are plenty of idle workers and businesses that are producing well below their full capacity. In that environment, the government can easily expand its deficit, spending more money into the economy, without risking an inflation problem."

7) Mariana Mazzucatto – Capitalism's Triple Crisis

https://www.project-syndicate.org/commentary/covid19-crises-of-capitalism-new-state-role-by-mariana-mazzucato-2020-03

"When it comes to households, governments should look beyond loans to the possibility of debt relief, especially given current high levels of private debt. At a minimum, creditor payments should be frozen until the immediate economic crisis is resolved, and direct cash injections used for those households that are in direst need.

8) Bank of Canada debt, because it is lower interest, can have a much better impact than private borrowing:

   Ari Andricopoulos wrote:
   A 10% of GDP increase in private sector debt corresponds to a 0:16% reduction in GDP for every year going forward. Government debt, which would also have a higher positive multiplier when taken out, has less of a negative impact in the future. A 10% of GDP increase in government debt corresponds to just a 0:07% reduction in future GDP growth. The purpose of the DBCF model is to propose a mechanism that would explain this phenomenon. The lower cost of government debt would almost certainly be related to the lower real interest rate paid.
   This suggests that government debt is vastly more efficient at stimulating demand than private sector debt. Using an assumption of $\propto$ on government debt of 0.8% to real GDP (as opposed to NGDP), makes government debt 18 times as efficient in terms of future cost for the same level of stimulus' (Andricopoulos 2016, 18).

9) In 2016, William White wrote that the world was even more in debt than in 2007, and that the next recession could be accelerated and made worse because private and public debt are both much higher. In 2003, he warned Alan Greenspan in person that ultra-low interest rate policies would lead to a crash.

   White is currently a Senior Fellow at the C.D. Howe Institute. He is a former chairman of the Economic and Development Review Committee at the OECD, former Economic Adviser to the Bank of International Settlements. He worked at the Bank of the England and is a Former Deputy Governor of the Bank of Canada.

   In December, three months ago William White delivered a speech in the UK.

   He said:

   "Both public sector and private sector debt ratios are at uncomfortably high levels in many countries. With growth likely to be impeded by the headwinds of debt and demographics, it would be unwise to assume that we can simply grow out of any associated problems. Higher inflation might also be a solution, but it would be imprudent to suppose that this might not easily get out of control. Moreover, generating more inflation through ultra low interest rates only contributes to the undesired side effects referred to above.

   If these alternative solutions to unserviceable debt requirements are not available, much more reliance must be put on debt restructuring. Disorderly debt defaults, without the cooperation of creditors, involve much greater costs than orderly defaults in which creditors and debtors work together. Unfortunately, recent work by the OECD (2013), the IMF (2016) and the Group of Thirty (2018) makes it clear that the laws and judicial procedures for restructuring debt continue to be highly unsatisfactory.

   This applies to private non-financial debt (households and corporations) in many countries and still more to private financial debt (especially banks that are too big to fail). Above all, it applies to

> sovereign debts where there are no agreed criteria for the need to restructure, nor any international treaties to force action.
>
> Dealing with these problems is a challenge that governments should start to deal with now. It is a dangerous delusion to suppose that central banks can somehow mitigate [through ultra-low interest rates] this need for action by governments."

Further background

Since the 2008-09 global financial crisis, the role that private, personal debt poses to the economy has come to the fore. At the root of that crisis was the decision of central banks to run ultra-low interest rates, and that risky mortgages were packaged up into investments that were presented as safe.

While there are occasional articles about how Canadians owe more than 170% of their annual income, or $2.2-trillion in mortgages, student loans and credit cards, the impact of private debt as a whole is not recognized.

Private, personal debt is usually seen as just that - private and personal. However, especially since the financial crisis of 2008, which resulted in a global financial meltdown, the role of private debt is being recognized as being a major driving factor in the business cycle, as well as recessions and depressions.

This is from evidence of the 2008 financial crisis, the banking crisis in Japan in the 1990s and the Depression of the 1930s.

Current Macroeconomics theories - "neoclassical" economics that replaced Keynesian policies in the 1970s do not include money, banks or private debt in their modelling.

In our current neoclassical macroeconomics, private debt cannot possibly be a problem because it does not exist, because banks are seen as intermediaries.

Modern Monetary Theory takes a different approach. It argues that money is not just created by governments, but that banks create money in the act of lending – they "write up both sides of the balance sheet at once" and create money, mostly for mortgages. This "private money creation" is why banks can lend so much, while their reserves are so small.

After the 2008 crisis, there have been major reassessments of economics in the countries that were hit the hardest, especially the UK, the EU, the US and elsewhere. Canada engaged in a huge bank bailout but was saved in part by soaring oil prices.

For those who know about the 2008 crisis, the general story is that "subprime" mortgages were bundled up into investments, which were then sold to unsuspecting investors, and against which enormous insurance contracts were sold.

The mortgages were bad, the investments were bad, and the unregulated insurance contracts (default credit swaps) were not regulated or backed by adequate reserves. Banks and other companies would buy "default credit swaps" against one another, which linked all the risk together in a dangerous chain.

While the people who took out mortgages were blamed, it is important to know that there was an enormous amount of fraud related to the mortgages, because mortgage brokers received more money if they lent out a bigger mortgage. Hundreds of thousands of individuals had their mortgage contracts forged and altered, especially black and hispanic borrowers. A black family making $200,000 would get the same credit score as a white family making $40,000. These were bundled up into collateralized debt obligations (CDOs) which were rated triple-a - the same rating as a US government bond. Overseas banks, especially in Europe, started selling off sound bonds and bought these ones instead.

In the US, when the housing bubble popped, it started a cascade of disaster, in the US and around the world. As the housing market collapsed, and defaults grew, banks found out their capital reserves were worthless. Suddenly, there was no money available to lend, even in overnight "repo" markets, which are supposed to be the lowest risk markets in the world. No-one was willing to lend to help companies cover payroll, and the reason GM collapsed was because its financial wing was obliterated.

In the U.S. the government had to intervene to prevent a complete lockup and meltdown of the global financial system. A program called "TARP" the troubled asset relief program was rolled out, in which the Federal Reserve and U.S. government bought up assets of banks in order to make sure they had enough money on hand to keep from going broke.

Canada's banks were not immune. We have been told that we have a resilient bank system, but Canada's bailout of our banks was larger than the US, relative to the size of our economies. For a period, Canada's banks liabilities exceeded their assets - meaning they were technically insolvent. The Bank of Canada and the Government of Canada stepped in with $114-billion in assistance, $66-billion of which was a purchase of mortgages by CMHC, with money printed by the Bank of Canada.

It is important to say that the Harper Conservatives loosened mortgage rules and introduced 40-year mortgages in imitation of the US.

A similar situation played out in the EU.

What happened was a "financial crisis" in that many banks went broke.

There is a known pattern of financial crises - that they drive extreme politics. In an examination of 140 financial crises, a study showed that people became both more socialist and more nationalist.

One of the major responses on the part of central banks was "unconventional monetary policy" including "quantitative easing" or having central banks create money and using it to buy assets from banks, with the hope that the banks would lend the money forward. To date, about $20-trillion has been printed. The money has not gone into new businesses, which are risky, but it has inflated the stock market as well as real estate markets in various "global cities" - Vancouver, Sydney, Toronto and others.

DEBT-DEFLATION: Why things don't get better

While people talk about the concerns of inflation, deflation is also a problem. Inflation has many problems, but rising prices and wages erode the value of existing debt.

For this reason, when people bought houses or had debt in the high inflation of the 1970s, it was possible to pay it down more easily.

Deflation - when prices and wages drop - makes it harder to pay down debts.

After a crisis, while some people are driven bankrupt or lose their jobs, not all do. But in recessions, and especially in depressions, prices and wages drop.

For traditional economists, this is seen as a necessary part of rebalancing the business cycle. It is the goal of austerity: eventually, when prices drop enough, people start buying and hiring again.

What is missing from this model is debt. Inflation makes debt easier to pay off, but deflation makes it harder to pay off.

This also happened in Japan in the 1990s. At one point in the late 80s, Japan was worth 50% of all the real estate in the world. When the bubble burst, banks failed. The companies and people who survived still had incredible debts, which have contributed to several decades of stagnation. It is a so-called “balance sheet recession”.

In the US Depression and in Japan in the 90s, governments embarked on stimulus programs. As long as the stimulus continued, the economy limped along. As soon as it stopped, it sank into recession again. Stimulus alone was not enough- the debts have to be reduced either through growth, inflation or debt cancellatiion.

WHY WE HAVE SO MUCH DEBT

It may seem shocking that we have so much debt. The fact is there is a generational difference in experience because the economy was run in completely different ways.

From 1945-75 there was a focus on full employment and job stability that ended in the 1970s with stagflation, when the policy changed to low inflation, tax cuts, deregulation and monetarism.

20% of Manitobans have not seen an increase in their incomes since 1978.

One of the single greatest changes in policy was that instead of governments raising taxes and spending to stimulate the economy or hire people, central banks were supposed to stimulate the economy using changes to interest rates.

Banks and credit cards were deregulated, and the idea that debt was risky was changed entirely to an expectation that private individuals and consumers should shoulder the burden of stimulating the economy.

Two things happened that are similar. At one point, credit cards required a higher percentage to be paid back. A consultant approached the companies and explained that if they reduced the minimum payment, they could make more money.

Let’s say the credit limit is $1000 and the minimum payment is 10%, or $100. If you change the minimum payment to 5%, it doesn’t mean that you can now pay $50 - it means the credit limit goes up to $2,000. Credit cards make their money from people who rack up balances and just pay the minimum.

This model has transferred over to mortgages. At a monthly payment of $2,000 a 30-year mortgage at 8% will buy a house worth $275,000. If interest rates are 4%, it doesn’t mean people will pay less: instead, it can finance a mortgage of $550,000.

In Manitoba’s schools, a bank-sponsored curriculum teaches children how to apply for credit cards.

When interest rates were higher, it meant that house prices were often lower.

Over 30+ years, interest rates have been dropping and house prices and debt have been soaring. Low interest rates have the perverse effect, not of saving money, but of driving up the prices of property and existing assets.

This is a deliberate policy on the part of central banks to stimulate the economy, but it has real downsides.

Some decades ago, it was possible to buy a house with a year’s worth of income. Now it is virtually impossible.

This is generally seen as entirely positive, because it is seen as adding to wealth.

There are several serious downsides.

While houses are seen as “investments” they do not generate revenue on an ongoing business. One of the purchases investments in a person’s life, usually funded by debt, is not a “productive investment” like investing in a business.

As a result, the vast majority of debt being taken out if for housing and real estate, not for productive investments - borrowing money with interest on a purchase that does not generate revenue to help pay for it. This is very risky.

Another is that ever-increasing cost of real estate raises the cost of living and the cost of doing all business. High rent is the reason small businesses can’t survive and there are empty shopfronts in downtowns.

Real estate is overhead, for people and businesses alike. Because the effect of borrowing is so large, it drives up the costs of real estate, rent products and services for everyone, whether they are in debt or not.

The price of real estate goes up much faster than wages. People born earlier who bought low benefit enormously.

However, people born later into the cycle - or newcomers to Canada cannot possibly buy a house without taking on a multiple of their salary. Renters do not escape. Apartment buildings are converted to condos, which benefit from increasing prices, reducing in a shrinking apartment stock, as rents increase.

The result is that we have created a generational pyramid scheme, based on inflating asset prices. The people who got into the game early did very well. The people who join later do less, and lose everything. And when pyramid schemes collapse, they do not “return to equilibrium”

THE BIG PICTURE

We are in an extremely difficult position. If a real estate bubble pops, cheaper property would seem welcome. However, all the people who bought that property at the peak will still have debt - more debt than their property is worth. They will be underwater. Even if they sell, they will be homeless and still have debt to pay.

Right now, in Alberta and Saskatchewan, property prices have dropped dramatically, along with job losses and increased unemployment. The suicide rate is rising as a consequence.

Except for real estate, Canada is already in recession, and despite record low unemployment, insolvencies are at a ten-year high. Canada’s real estate sector is now 20% of GDP.

Now, Coronavirus is having further impacts on the real economy - oil, travel, manufacturing, and more.

The usual measures here are the ones we are all familiar with:

- Austerity: liquidating and shrinking the public sector - education, health, and infrastructure. The real consequence of austerity is to shift public debt onto private individuals. It will deepen and extend a recession, and private debt gets worse.
- Taxing / borrowing / and spending to stimulate the economy, increase employment and inflation. When the government borrows to put people to work and they pay down their debts, the private debt is transferred to the public sector - so governments end up with more debt.
- When the debt overhang is colossal, if the fiscal stimulus ends so will growth. That happened in Japan and the Depression.

We are in a trap: because huge amounts of debt are at low interest rates, if inflation goes up, investors will lose. If interest rates rise, there will be mass bankruptcies.

There is a third option, which is some kind of debt relief. Some of it can be debt restructuring - write downs, refinancing, payment arrangements and crackdowns on predatory lending.