Opinion **Central banks**

Monetary financing demands careful and sober management

It is simply another policy tool, neither the royal road to hyperinflation nor a cure-all

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Bank of England governor Andrew Bailey initially claimed the bank would not engage in monetary financing of government © Neil Hall/EPA/Shutterstock

Martin Wolf YESTERDAY

Desperate times demand desperate measures. Among those measures might be monetary financing of government or transmission of money to members of the public from the central bank, via "helicopter money". So what does monetary finance really mean? Does it ever make sense? How dangerous is it? How and by whom should it be managed? These questions demand sober answers, not hysteria about the onset of hyperinflation.

Just this week, Andrew Bailey, governor of the Bank of England, writing in the Financial Times, insisted that the bank was not engaging in — and would not engage in — "monetary financing" of government. Yet, just a few days later, the Treasury announced that the bank would directly finance its ballooning operations. The Treasury also stated that this was to be "temporary and short-term". But the decision on when this operation is to be reversed rests with the Treasury.

So the bank can still claim that this is not "a permanent expansion of the central bank balance sheet with the aim of funding the government", condemned by Mr

Bailey. But the bank does not, as he asserted, "remain in full control of how and when . . . expansion is ultimately unwound". The Treasury does.

Much in this discussion consists of intellectual sleights of hand. One hinges on whether direct monetary financing is fiscal or monetary policy. The economic answer is that it is both. If one focuses on which institution is in charge, then it could be either. Another sleight of hand hinges on the tricky word "permanent". For policymakers, that is about intentions. If they do not intend it to be permanent, then it is not monetary financing. This is how the Bank of Japan pretends that it is not engaged in monetary financing, despite the huge scale of its holdings of government bonds.

Fine words butter no parsnips. What matters is not intentions, but actions. Supposedly temporary purchases of government bonds, or the direct monetary financing now imposed by the UK Treasury, might well become permanent. Indeed, in the case of the expansions of central bank balance sheets over the past 12 years, it probably has. This is an embarrassing truth that dares not speak its name. Yet supposedly irreversible monetary financing might ultimately be reversed. As the French say, "*Il n'y a que le provisoire qui dure*." ("Only the temporary endures.")

The real question is whether a policy of large-scale monetary expansion in support of the government's policies may sometimes make sense. The answer is "yes". In exceptional circumstances, such as times of war, deep depressions or pandemics, it is the job of the central bank to support the overriding need for the state to protect people's lives and livelihood. Only the craziest libertarian would disagree. As an organ of the state, the central bank must help. Its independence, while normally desirable, is a means to an end, not an end in itself. Even price stability is not overriding in all circumstances. Other things matter.

This is not to deny that monetary financing brings dangers. Uncontrolled, it may lead to irresponsible spending, concealed taxation that takes the form of high inflation via the excessive creation of base money, or even hyperinflation. Fighting these dangers might then force central banks to curb bank lending via regulations, including higher reserve requirements. This might throttle development of the private sector.

Yet, in a situation like today's, direct monetary financing can help a government to do whatever it needs to do to sustain people's incomes and the economy through a crisis. The alternative of debt financing would reduce the desired expansionary effects, partly because it would be expected to end up with another painful round of austerity.

The question is not whether intentionally-permanent increases in central bank money can be justified. They can. The question is rather how to manage them, institutionally and technically.

The Israeli economist Eran Yashiv argues that the institutional solution is to create a funding arm for a time-limited programme of what is intended to be irreversiblemonetary financing of Covid-19-related programmes, in support of health and people's livelihoods. Its governing committee could include representatives of the finance ministry, the central bank and outside experts. If such arrangements do make the policy more visibly under control, this idea makes sense.

Yet there are also questions about how the policy is to be operated. Suppose that there is indeed a very large increase in the monetary base. Suppose, too, that commercial banks seek to expand their lending dramatically, partly because they find themselves with what they think of as "excess reserves". Then the central bank may have to raise interest rates by more than it would otherwise have had to do. It may also have to raise the interest it pays on reserves, which is costly. Alternatively, it may have to tax banks by imposing higher requirements of unremunerated reserves. It may feel obliged to let inflation rip. Or it may simply have to mop up excess reserves, as normal, through open-market operations.

The employment of supposedly irreversible monetary financing is just another policy tool. It has pros and cons, specific to the circumstances. It is neither the royal road to hyperinflation nor a panacea for today's contraction of the real economy. Right now, when government deficits are exploding in the midst of a huge crisis, it is an obvious mechanism. Use it. Work out ways to manage it. Above all, make sure we get through this. That is our chief aim.

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