Review of the IMF wp “Some Alternative Monetary Facts”

Some considerations on new monetary and fiscal policy scenarios

by Reforming.it (www.reforming.it, info at eforming.it)

This working paper of the International Monetary Fund arrives in perfect timing, just as, especially in Europe, the debate on new scenarios of the post-COVID-19 monetary policy of the Euro Area is deepening.

Reforming.it has already expressed some brief considerations in the Note "New old balances between Money and Financial statements" and even earlier in the Note "Budgets, Debt, Money". Here it is our equally short review, with the impressions aroused by the IMF document.

It rarely happens to read documents of the Fund that end with an invitation to finance the economic policy measures with the issuance of debt.

Of course, the invitation is relative, and probably concerns only countries that have a tradition of bankruptcy and little trust with the currency (those of South America, for example, or other developing countries) and not the West of early industrialization. This can be understood from the various references to the degree of maturity of the public debt securities markets and to the improvement of debt management techniques obtained in recent times. A better distinction should be made.

The invitation is also relative because the IMF does not suggest tout court to spend, of course, but points out that those who have to take extraordinary measures to revive the post-COVID-19 economy would do well, in the current market conditions, to take advantage of the low yields requested by investors and to avoid innovative extraordinary monetary policies.

Such a generalized suggestion (every country, every currency, every degree of indebtedness, etc.) is normally questionable, but I this case it is even more because the reasons for staying away from extraordinary monetary policies are not fully clarified. The clearest argument is limited to saying that the issuance of public debt collects resources in exchange for securities that are then marketable by everyone (banks, companies, private savers) both on the domestic market and on international markets, while the choice to credit resources in the deposits held by commercial banks at the Central bank, to give greater range of action to bank credit, is a leverage that remains limited to the national banking circuit (depending also on the institutional and regulatory framework of the country): *"[...] fungible treasury securities [...] can be held by investors worldwide and used as collateral in global capital markets [while] deposits held at the central bank [are] tradeable only among banks authorized to hold such accounts* ". The point may be correct, but it compares the issuance of public securities, to finance economic policy measures, only with one of the modalities, albeit the most widespread

and in some ways the standard one, with which expansionary monetary policy can be configured. Since at least ten years, other modalities of conductions expansionary monetary policies have been observed, non-standard and not necessarily depending on the banking system.

The paper states that it is not with continuous monetary expansion that long-term growth can be sustained: "*[…] the "neutrality" proposition" [of money] has almost universal acceptance […]*" (page 24, top). One cannot disagree, it would be the biblical multiplication of loaves and fishes, but this is not the point on which the paper apparently would like to shed light, which instead concerns the possible role, even extraordinary but temporary, of monetary policy as leverage to obtain real effects otherwise precluded or difficult to achieve with other policy tools. This is the basic question.

Almost all the rest of the arguments against effectiveness of monetary expansions focuses on the relationship between the quantity of money and the price level, between the rate of change of monetary aggregates and inflation. This relationship, which in other historical phases various currents of thought (neo-Keynesians, monetarists, ultra-rationalists, the various Phillips, Fisher, Friedman, Lucas, etc.) have tried to define in the direction of causality (the more money expands the more prices rise) and in the estimation of the parameters (differentiating the short term from the long term), it now seems to have become fluid and unstable, as a consequence of the technological innovation in the guarantee and payment systems that creates a growing decoupling between the monetary policy choices of the Central banks and monetary means endogenously (already) present in the economy (including the various forms of credit between national and non-national subjects). If the means of payment are endogenous (bitcoin and cryptocurrencies included), money is no longer a lever that can be controlled by the Central bank and verifiable in its effects.

To tell the truth, it must not be just technological innovation, given that the paper gives the example of Japan, which in the last ten years (since 2012 to today, since the beginning of Abe's mandate) has been a natural large-scale experiment of quatitative easing, and in the eyes of many it has raised definitive doubts both on monetarist causality as well as on Keynesian and neo-Keynesian causality linking monetary aggregates to prices and growth. Despite the massive and continued expansive direction of monetary policy, there has been no significative consequence on inflation rate, as Monetarists would have expected), neither any kind of reflection on the real economy, growth and employment (Japan is still stagnating), as even moderate Keynesians would have expected.

And if it is true that the quantitative theory of money (including its most recent elaborations) comes more battered out of the Japanese case, also for the Keynesian approach it is difficult to avoid contradictions and to say that Japan could correspond to the extreme Keynesian case of vertical LM curve, because a "liquidity trap", continuous and lasting for a decade, is something that also the Keynesian approach is not able to explain (indeed, something it does not even treat, concentrated as it is on the short to the maximum medium term). Of course, we will never know how it would have turned out if there had not been the prolonged Japanese QE, because it must be recognized that a real effect is also that one, that mans what was avoided and would have happened if there had not been such stubborn monetary support, even if ex-post apparently ineffective or even at risk of being counterproductive.

On this long part of the paper that deals with the relationship between money and prices, two weaknesses can be glimpsed, one of a more technical nature and the other more about the overall key-readings.

As regards the first, the correlation between monetary aggregates and prices is investigated without clustering across countries and without using any control variable. When the panel is large, to include countries quite different in economic structure, monetary attitudes and even cyclical phases that they go through, putting everything in a big cauldron dilutes the detection of possible causal relationships, which is not surprising in fact they are weak and variables also in the sign.

Still on a technical level, the choice of the sub-periods over which to evaluate the M-P correlation remains questionable, because it aggregates very different historical phases. An example above all: the period 1960-1989 brings together the "very Keynesian" roaring '60s (in which the expansionary monetary policy seemed to work well in direct support of the expansionary fiscal policy) and the' 70s and '80s dominated by monetary instability and inflation which necessitated monetarist remedies and tighter controls of monetary aggregates. Also from this point of view, putting everything in a large temporal cauldron disturbs the detection of possible causes.

But, beyond the most technical aspects, there is a basic consideration that is perhaps more important in the light of the purpose of the paper. Even once it has been demonstrated that the relationship between money and prices is weak and unstable (it changes according to the monetary aggregate considered), this evidence does not lead to any definitive results on possible uses of monetary policy, above all when in acts in extraordinary ways, to obtain real effects, for example as a counter-cyclical measure or to support investments at well-defined times or to provide financial coverage for sectoral supports. Indeed, one might say, it is right when the connection between monetary aggregates and prices is weak and slow that a monetary stimulation has more chances not to stop to only superficial nominal effects but to change the course of reality, if introduced for the most suitable channels and used for the most durable and productive uses.

This immediate and strong impact on prices is, without sufficient arguments and without any empirical support, traced back to the direct monetary financing of economic policy interventions (purchase of government bonds directly by the Central Bank, Treasury financing on a special current account at the Central bank, and the like): "*The difference between Central bank direct liabilities created trading it in the open market for other government liabilities and money created by giving it away to finance fiscal expenditures is central to understanding why monetary augmentation has little impact on prices in the former context and significant immediate and lasting impact on prices in the latter* ".

This last is another questionable attestation in its vaunted generalization, not only for what the case of Japan has shown us, but above all in the aftermath of the massive interventions that the ECB has carried out, increasingly from 2008 to today, to contrast the crises, first the financial one (the so called double-dip of 2008 and 2012) and then that caused by COVID-19. The ECB has pushed itself to the limits of its mandate, has bought public securities in derogation of the capital-key rule, has also bought private securities on the primary and secondary market, has constantly announced the continuation of the monetary stimulus / support and more recently has also announced the commitment to finance the NGEU and the Recovery Fund (with the purchase of what can be defined first examples of Eurobonds) and also special funds for sectoral projects linked to the green and digital transition. As you can see, this is reinforced monetary toolbox, much more varied than the standard measure of increasing reserves at the Central bank available to commercial banks that IMF paper always seems to refer to. All of these monetary efforts happened (I still happening) as inflation disappeared (is still under targets) from the Eurozone horizon. Even the recent (early 2021) rise in price indices in Europe and in the US is for the time being interpreted as a transitory phenomenon

(due to post lock-down misalignments between orders and stocks, production processes and availability of raw materials and semi-finished products) and in any case a rise far from being an inflationary flare-up.

In short, the impression that remains to the reader is that in this paper IMF "eats its tail" and ends up inconclusive. After many arguments to refute a string causation between the growth of monetary aggregates and inflation, which is one of the limits and risks (not the only one) of the recourse to monetary expansions, IMF suggests financing the anti-crisis and recovery measures with the issuance of public debt, staying away from, or in any case limiting as much as possible, the use of extraordinary monetary policies.

IMF probably fears that the monetary lever could be abused, a bit like it happened in the 70s and 80s, laying the foundations for future instability in the financial and real estate markets and, in a chain, in the real economy. Considering the role that the Institution has always played, we should not be too surprised that, even in an academic-like papers as this one, it launches warning messages: When anti-crisis expenditures are finance with debt, there is an evident and formal trace of the expansionary policies and, above all, the market-floating debt is a constant thermometer reflecting widespread assessments of the state of the economy and its leadership; on the other hand, with monetary financing expansionary policies find less external resistance, and it is more a matter of out-of-records relationships between the Treasury and the Central bank.

Irrespective how understandable it could be, IMF's fears should not be generalized. If what is emerging is that the effects of monetary expansions do not respond to stable and universally valid laws, but depend on the country context, on the cyclical moment or more precisely on the historical moment (the pandemic does not mark a simple cycle but an entire historical phase with multiple deep structural breaks), a possible more pervasive role for money should be evaluated in a much more contextualized way. And, to tell the truth, this aspect emerges even if vaguely from some passages of the paper, making his logics even more contradictory. For example, there is a salient citation of Sims: "*Recent expansions of central bank balance sheets and of the levels of rich-country sovereign debt, as well as the evolving political economy of the European Monetary Union, have made it clear that fiscal policy and monetary policy are intertwined. Our thinking and teaching about inflation, monetary policy, and fiscal policy should be based on models that recognize fiscal-monetary policy interactions* ". Intertwined monetary and fiscal policies means cooperation between the Treasury and the Central bank, and a greater cooperation between fiscal (or budget) and monetary policy is what is lacking in the Eurozone, which has so far kept the two sides of economic policy completely separate, for so many reasons that cannot be reviewed now (some considerations are in in "New old balances between Money and Budget" a Note on www.reforming.it) but which broadly refer to the heterogeneity of the Member States, to the lack of sufficient trust, to time and efforts necessary for the supranational and community institutional design, etc..

For the Eurozone (at least for the Eurozone!), the issue of a more flexible combination of fiscal policy and monetary policy ("*[...] fiscal policy and monetary policy [...] intertwined*"), also with the latter putting in place forms of financing of economic policy measures based on the creation of new money ("[...] money created by giving it away to finance fiscal expenditures [...]"), remains open and this paper by IMF does not downsize it. As already noted, the paper can serve as a warning, to remind you that, especially in common currency areas, an interventionist monetary policy is a very powerful lever, that assumes many of the qualities of the fiscal lever and takes on allocative and political purposes, with possible redistributive implications between countries, sectors, geographic basins and

citizens, especially in the initial phases after the interventions. Like all powerful levers, it must be used wisely and carefully, put in action only when the future benefits are clear and agreed on.

Keynes argued that the peculiarity of money is that it is an asset that allows us to wait, to delay, to defer choices until the conditions (environmental, informative, strategic, diplomatic, or any other aspect that may affect “animal spirits”) are propitious. Among the memories of the first course in Monetary Policy at Bocconi University (Milan, early 1990s) there is also this comparison that jumped out to describe the strategic dimension of money that allows you to turn time to your advantage, exactly as it often happened in large pitched battles that changed the course of History, exactly as it happened to Quinto Fabio Massimo who earned the nickname of “Temporeggiatore” par excellence, when he decided to slow down the rhythms of the clashes with Hannibal and the Punics to allow the Romans to recover after the heavy defeat of Lake Trasimeno. It has nothing to do with the topic we are dealing with here - I know - but it is worth observing: How important it is that professors can be able to stimulate the students' imagination with examples selected in History, Philosophy, Literature! Each sign will be more lasting and more fecund.

This temporal quality of money, however, is double-sided as we pass to consider economic systems as a whole, because it implies that in times of crisis everyone tends to hoard it (including the banking system) and no one wants to make the first move to start lending, spending and investing again to help drive the recovery (the famous "Keynesian preference for liquidity").

We do not know that Keynes has ever said this (and so in some sense we are proposing this interpretation), but it also sounds very Keynesian to say that money, indeed the monetary base (the money newly created by the Central bank), also has another peculiar quality, that of acting as a bridge towards the future, opening up (with the attribution of new liquid balances) spending possibilities and fresh resources to invest that otherwise would have been foreclosed. This peculiar property is crucial precisely at times when the economy is stagnating below potential and, nevertheless, the feasibility of profitable structural changes and real broad-spectrum returns can be glimpsed.

Money allows you to wait, and at the same time can allow you to go further; money comes to the rescue of those who are afraid of the future, and at the same time it can be a tool for shaping that future. The meaning of the above-mentioned cooperation between the Central bank and the Treasury, between monetary policy and fiscal policy is exactly in this capability of shaping the future. However, we must be up to it. With great power comes great responsibility, and the step to deform into "witch doctors" of the monetary lever can be shorter than imagined.