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Concerns about excessive money printing are overblown

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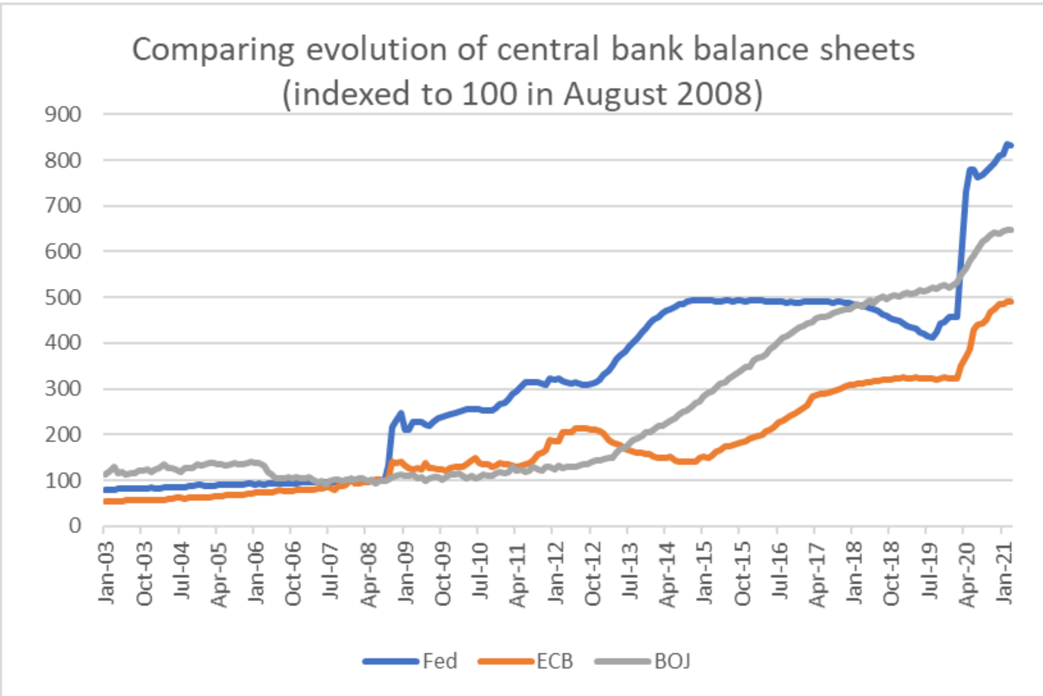
An economic Rip Van Winkle, waking from a twenty-year slumber, would be amazed at what had happened to the balance sheets of major central banks in the interim. The Federal Reserve, the ECB, the Bank of England, the Bank of Japan and several others are all engaging in some form of large-scale "quantitative easing" (balance sheet expansion) (see chart). The current Covid-19-triggered round of QE is the third, after that triggered by the Global Recession and the BOJ's pioneering QE of 2001-2006, and each time more central banks are joining in. Such widespread, large-scale and apparently never-ending "money printing" is raising concerns that this grand monetary experiment is bound to end badly. These concerns, while legitimate ones to raise, are way overblown; they underscore more a need to rethink our intellectual and operational frameworks than fundamentally change monetary and fiscal course.



Concerns about the current course of monetary and fiscal policy are of at least three kinds. One is that such large-scale money printing is bound to end in runaway inflation, if not worse:

hyperinflation and a breakdown of the entire monetary system. A second is that it will lead to asset price bubbles, the inevitable bursting of which will wreak havoc on financial systems and economies, as happened in Japan in the 1980s and 1990s and in the housing boom and subprime crisis of the 2000s. A third set of concerns center on “exit strategies”: the further central banks venture into this uncharted territory the harder it will be to extricate themselves. Each of these variants has in common the idea that policy actions taken today, aimed at treating one sets of problems, are storing up even bigger problems for the future.

These concerns are not compelling and rest on some fundamental misconceptions.

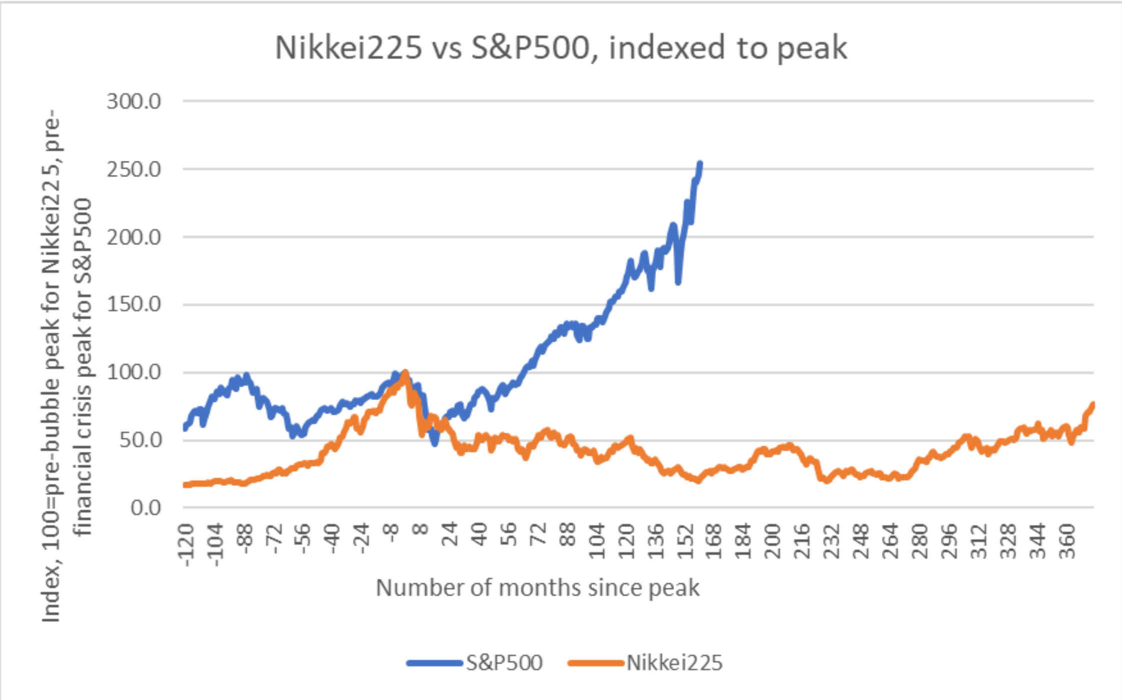
The notion that large-scale QE is bound to lead to runaway inflation in the future rests on several misconceptions. The context in which central banks are doing QE and governments are running large budget deficits needs to be considered. Coming a little more than a decade after the Great Recession and with market and policy interest rates already very low in much of the developed world, Covid-19 dealt economies one of the largest negative shocks in modern history. Real GDP in the US fell 9.0% (non-annualized) in Q2 2020 from the previous quarter, and the unemployment rate went up by 11.2 percentage points in just two months. Japan’s real GDP fell by 8.3% and the euro area’s by 11.8%. Even with the recovery in the second half of the year, real GDP in the US stands 2.5% below its Q4 2019 level; Japan’s is 1.1% below and the euro area’s is 5.0% below. Economies still need policy support.

The idea that QE is money printing on a grand scale and therefore bound to trigger inflation is simplistic and wrong. QE, by exchanging one dollar or one yen of central bank money for one dollar or one yen of government debt or other asset, is like an asset swap; it does not inject any net purchasing power into the economy. QE just substitutes one form of asset in the private sector’s portfolio for another; hence the idea that its stimulus effect comes via the “portfolio rebalance effect.”

Some worry that it is the blowout in budget deficits and piling up of government debt that will stoke the inflationary fires. Left unchecked, this could happen, but again context matters. The national accounting identity shows that, for the world as a whole, or to a large extent for individual countries given “stickiness” in current account balances, a recession-driven increase in private savings relative to private investment must necessarily result in a corresponding increase in the budget deficit. Government debt levels should not be viewed as policy targets but rather as part of the adjustment mechanism by which economies recover.

The second concern that monetary and fiscal expansions risk fueling asset price bubbles also needs to be approached critically. There is a difference between a full-fledged asset price bubble, whereby price rises are driven by a self-fulfilling process untethered from underlying fundamentals, and asset prices that rise as part of the monetary easing process and that reflect a much improved outlook produced by the monetary and fiscal policy easing.

Particularly in the case of Japan it would be wrong to view the recent run-up in the stock market as presaging a 1980s-style asset price bubble. As the chart shows, Japanese stock prices finally seem to be escaping from its multi-decade doldrums, consistent with the country finally shaking off its entrenched deflationary mindset. The puzzle in Japan is why this took so long, not why it is happening now.



Policymakers do need to be vigilant about genuine asset price bubbles, particularly ones fueled by bank credit growth, creating a mismatch between bank deposits on one side of the financial system's balance sheet and bubble-inflated risk assets on the other. This is half the story of Japan's bubble; the other half is the failure to mark non-performing loans to market and quickly mobilize enough public money to recapitalize the banking system when the bubble burst. If asset price bubbles are a concern, the appropriate policy response is not to overburden monetary policy with more targets than available tools but to use new macroprudential policy tools and ensure that banks and other systemically important institutions are adequately capitalized.

The third concern about “exit strategies” is also misplaced. The goal of monetary and fiscal policy is not to have healthy-looking monetary and fiscal metrics but to have a healthy economy, one that grows in line with its potential while maintaining price stability. If the government needs to run large deficits and the central bank needs to do a lot of QE, so be it. If these policies lead to the economy starting to overheat and inflation picking up, a desirable outcome from the current vantage point, fiscal and monetary policy can both be appropriately tightened. Calibrating policy settings to progress towards achieving policy goals *is* the exit strategy.

For fiscal authorities, that means raising taxes and cutting expenditures, not “to pay for” an aging society or to pay down government debt, but rather to drain purchasing power that would otherwise cause the economy to overheat. Central banks that have cut policy rates to zero or below and have done QE, and can pay interest on reserves, have two margins of adjustment: raising policy rates and shrinking their balance sheets. They can be as aggressive as they deem necessary on either or both margins.

None of this is to suggest that policymakers could not make a policy error. Monetary policymaking is all about making forward-looking judgments; the risk of making an error goes with the job. The question is whether policy errors can be detected and corrected. There is no reason to believe they cannot.

With economies still operating in the dark shadow of the Covid-19 pandemic, now is not the time for policymakers to let up. Macroprudential authorities need to remain vigilant. With governments suppressing economic activity to quell the pandemic, fiscal policy needs to play a significant social insurance role by providing income support to households and small business. And, the more that monetary policymakers show their determination to achieve their inflation target by implementing aggressive QE and other “unconventional” policies when they are struggling to do so from below the target, the more credibility they will have when it comes to fighting inflation. Rip can sleep easy.