



EPOG INTERNATIONAL MASTER'S COURSES

EPOG STUDENTS AND ALUMNI ASSOCIATION

Policy Debate - Special Issue

"Policy Mix in the Eurozone facing Covid-19"

Advocating public debt forgiveness by the ECB to build the world to come

Partial public debt write-offs, held by the ECB, conditional on the reinvestment of the same amounts in "green" investments, appear to be an economic and ecological exit solution to the Covid-19 crisis.

It needs to be politically discussed.

I. ENCOURAGING STATES TO RUN INTO DEBT TO FINANCE THE WORLD TO COME, WITHOUT DISCOURAGING PRIVATE ECONOMIC AGENTS TO FOLLOW SUIT

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"The views and opinions expressed in this policy brief are those of the author and do not necessarily represent the views of the EPOG Students and Alumni Association"

Public debt levels are currently rising in many European countries, rightly taking on debt to offset the immediate effects of the Covid-19 crisis. However, while this present debt is absolutely necessary to keep today's world afloat (guaranteeing workers' purchasing power, avoiding a banking crisis and keeping the production capacity ready to resume activity quickly), it should not be a substitute for taking on the debt necessary for investing in tomorrow's world. States will need to invest in the future for two reasons. Even before the pandemic, deflation and the collapse of potential growth were symptoms of a secular stagnation, against which monetary policy, even in its unconventional forms, cannot fight alone (Acharya et al., 2019 ; Borio and Zabai, 2016 ; Elbourne and Ji, 2019 ; Jannsen et al., 2019). It requires public spending support, while many studies show that fiscal multipliers are high (Blanchard and Leigh, 2013 ; Gechert and Rannenberg, 2014). Moreover, this public expenditure is all the more appropriate as some public investments prove to be absolutely necessary, in public services, as the situation in hospitals proves, but also for the ecological transition. States may decide to move in this direction, to go further into debt after this crisis, which is itself debt hungry. Indeed, they can survive with very high debt-to-GDP levels, like Japan, so long as the economy's growth rate is higher than the interest rate paid on debt securi-

ties, and so long as financial markets allow them to roll-over their debt. This is all the more probable as the ECB makes holding public securities low-risk by fulfilling its role as an investor of last resort on these markets. The ECB buys excessively large amounts of public debt, on which governments do not pay interest, since the ECB on-lends it to them. Moreover, it is possible that the ECB postpones the repayment date of government debt indefinitely by purchasing new debt when the old debt matures. All the debt purchased by the ECB would therefore in theory be free of interest and repayment: a kind of “free” debt.

Therefore, the question is whether governments will seek to reduce their debts as soon as possible, just as they sought to do so in 2010, to cope with debt overhang. This strategy did not work as it contracted the economy and public revenues as well, as in Greece. The ECB could encourage governments to borrow, by promising to repurchase their debt securities *ad vitam aeternam*, so that they would never have to be repaid and would not charge interest. This promise, however, only commits those countries that believe in it. The ECB could stop buying back public debt, for fear that the cash issued to finance them, flooding financial markets, would inflate financial or real estate bubbles about to burst. Faced with the non-zero risk of having to repay their debt one day, are governments going to add more debt to their mountain of debt? Many political leaders and technocrats are already promising that their countries will have to repay their public debt generated by Covid-19². So, there is every chance that the Covid-19 indebtedness will wipe out any desire for debt to finance the world to come. The agreement for a European recovery plan presented by Angela Merkel and Emmanuel Macron on Monday 18 May, which provides for the Commission to go into debt to the tune of EUR 500 billion and to transfer it to the regions and sectors most affected by the coronavirus, is, however, a step in the right direction, even if the terms of repayment have yet to be determined and the European partners to be convinced.

A second problem, that of private indebtedness, unfortunately arises when the first problem, that of recovery through public debt, is “partly solved”. Economic agents could anticipate an increase in the fiscal pressure following a stimulus of public spending through debt. This is a Ricardian equivalence effect, not emerging from the expectations of perfectly rational agents, but rather of people building on the austerity experience of the past decade, and believing in the pernicious, often-hammered out idea, that they will have to suffer the consequences of their “failed states”. Faced with the increase in debt-to-GDP ratios, which were wrongly supposed to give an indication of public debt sustainability, it is possible that economic agents brake the recovery by being cautious and by increasing their savings, while governments would be trying to restart the economy. Here again, the ECB’s promise to buy back public debt *ad vitam aeternam*, i.e. to prevent State from ever having to bear the burden of its repayment, only engages private agents who would believe in it. And these are very few, since it is obvious that economic agents are attached to heuristics such as the debt-to-GDP ratio,

and do not go into the technical and accounting details of central bank balance sheets. An explicit way must therefore be found to show economic agents, even those with the least knowledge of monetary mechanisms, that the additional debt issued after the crisis will not have to be repaid. It must be anchored in their expectations that they will not have to bear the fiscal burden of the “whatever it takes” cost of the recovery. The best way to do this is to cancel the debt that the ECB holds towards governments, to avoid a short-term increase in the debt-to-GDP ratio, on which all eyes are focused. The ECB must not only promise to buy back government debt indefinitely, which in accounting terms will mean not making them pay for it, but cancelling it with great fanfare. Two accounting situations that are comparable may be perceived by economic agents in completely different ways, depending on the manner in which they are presented. Monetary policy is also about forward guidance, leading economic agents through this period of radical uncertainty. If the ECB were to decide to write off public debts once and for all rather than promising to buy them back indefinitely, it would act through communication, which is perhaps the most important way to do monetary policy. Remember that Draghi’s “whatever it takes” alone did more than half the job!

To do this, we³ propose a very simple incentive mechanism, which 1) encourages States not to run out of debt too quickly, 2) without this additional public debt being offset by a parallel debt reduction by private agents: that the ECB cancel as much old State debt, already held on its balance sheet, as States would issue new debt to finance the world to come. These investments would therefore be “free”, the debt-to-GDP ratio would not change, and yet there would be more public investment to revive the economy and finance certain strategic sectors

II. THE FAKE PROBLEM OF CENTRAL BANK SOLVENCY

The argument that the ECB would become insolvent, since it would realise losses, is not admissible. The ECB’s liabilities almost entirely consist of central bank money, which falls within its seigniorage power, i.e its ability to purchase assets by creating means of payment at will. It therefore has no debts on its liabilities side since they are composed of money which it creates itself *ex nihilo*. If the ECB were to make losses on its assets, it would not have an insolvency problem, since it is not indebted. Central banks therefore cannot become insolvent the same way as commercial banks and can survive without difficulty with assets smaller than their liabilities (BIS, 2013).

To be perfectly right, so as not to owe anything to anyone, a central bank only needs to refrain from paying interest on the deposits of commercial banks with it. This is possible, and even desirable in times of deflationary pressures, as evidenced by the negative rates on banks’ excess reserves with the ECB today. Though, debt-based investment, conditional on the ECB cancel-

ling public debt, could generate inflation by boosting public demand. It would be the role of the Central Bank, which is independent, to ensure that this does not get out of hand. The right amount of debt cancellation is a matter of proportion, and the ECB is perfectly capable of doing so. In the event of excessive inflation, the ECB would no longer be able to sell as many government securities to dry up the outstanding central bank money, since it would first have cancelled some of these securities. But if inflation were to become too high, the ECB could increase the rates at which it pays interest on commercial bank deposits with it, so that banks would raise the cost of credit. Then, and only then, would this cost something to the public sector, of which the central bank is a part. But this would mean that the central bank would have won its wager to restart inflation, by means of a public expenditure that would hopefully have already made possible an economic recovery, as well as a social and ecological transition. In the event of excessive inflation, and if the ECB did not have sufficient resources to pay interest on commercial bank deposits with it, it could always increase the non-interest-bearing reserve requirement ratios (Turner, 2013). This “financial repression” would certainly have a cost for the banking sector, but this cost would be more than offset by the fact that growth would have resumed, and that the risks of financial instability caused by the ecological transition would be lessened, phenomena which actually strengthen banks. The fact remains that it is still better to revive public demand without raising too much inflation, which makes it possible to keep this mechanism viable for as long as possible. How can this be done? By directing investments conditional on the cancellation of public debt towards the financing of productive investments by the State because the supply capacity would be expected to increase. So, there would certainly be more public demand, but there would also be an increase in production, so no necessary inflation. In this respect, the thermal renovation of buildings, the development of electrical charging networks for clean vehicles, and investments in rail infrastructure, particularly in peri-urban areas, would probably be among the most promising candidates for these “green” investments.

III. CONDITIONAL PUBLIC DEBT WRITE-OFFS, FOR WHOM AND FOR WHAT?

Should the rule of equality for public debt cancellation apply among member countries? Not necessarily, because the ECB could proportion public debt write-offs according to the magnitude of recessions countries experience, which would finally provide the euro area with a mechanism to tackle asymmetric shocks. Not all would necessarily benefit from it in the same proportions.

Ideally, the ECB should follow a Taylor rule, by cancelling more public debt in countries where inflation is too low and unemployment too high. Taking unemployment into account would require a change in its statutes. But if we stick to the framework of its current mandate, we could make debt cancellation conditional on inflation in

each country, because not all countries have the same inflation rates. Assuming that inflation is lower in euro-zone countries with weak demand, a sluggish economy and high unemployment, debt cancellations conditional on new debt investment would help to boost demand there, improving the country’s economic situation, even if it means generating some inflation.

One can guess the reluctance of some and others. If we take the example of Germany, what could be its advantage in having Italy’s debt cancelled, but not its own? Certainly, Italy would benefit from the economic gain of debt-based investment conditional on the cancellation of its public debt. However, the idea is that the social benefit of this Italian investment would serve all Europeans and extend beyond Italy’s borders. To this end, the European Parliament should set out major areas in which to invest, which would benefit everyone, wherever they are actually implemented, that is to say, global public goods.

This solution would therefore make it possible to address a triple crisis. Economic, because it would make it possible to invest in the countries that need it most. Political, because it would reintegrate into a democratic debate the issue of the allocation of the liquidity created by the Central Bank. Ecological, because it would make it possible to invest in goods whose usefulness would extend beyond the borders of the recipient country.

IV. A TREATY-COMPATIBLE IDEA?

At first glance, debt write-offs are not credits to Member States, nor are they purchases of securities on primary markets; in this respect, they are not supposed to hinder Article 123 TFEU which says that the European Central Bank is prohibited from granting “overdraft facilities or any other type of credit facility [...] in favour of [...] central government” and that “the purchase directly from them by the European Central Bank [...] of debt instrument” is also forbidden. However,

1 This policy brief is based on my ongoing PhD thesis, supervised by Laurence Scialom. See also B. Bridonneau et al. “[L’annulation de la dette publique détenue par la BCE libérerait les acteurs économiques de la crainte d’une future augmentation d’impôts](#)”, *Le Monde*, May 26, 2020 ».

2 Christine Lagarde on France Inter (radio) on 9 April: “Over time, we will have to gradually repay our debts and get back on a more stable path that is more conducive to balanced public finances, but we must not do so abruptly”. Bruno Le Maire, French Minister of the Economy, on Europe 1 (radio) on 10 April: “This debt must be temporary and we must reduce it as quickly as possible, as soon as the economy can get back on its feet” (statements that we have translated from French).

3 Bridonneau B et Scialom L. (2020a), Crise économique et écologique : Osons les décisions de rupture, Avril

http://tnova.fr/system/contents/files/000/001/955/original/Terra-Nova_Cycle_Covid-19_Crise-ecologique-et-economique-osons-les-decisions-de-rupture__020420.pdf?1585843205

Bridonneau B et Scialom L. (2020b), Des annulations. De dettes publiques par la BCE : lançons le débat, Avril

http://tnova.fr/system/contents/files/000/001/982/original/Terra-Nova_Cycle-Covid19_Des-annulations-de-dettes-par-la-bce_170420---.pdf?1587132547

er, it is understandable that the spirit of this article may significantly exceed its letter, and that public debt write-offs by the ECB may be subject to legal challenges.

So are these cancellations of public debt by the ECB legal? It is difficult to say beforehand: the legal interpretation of treaties is not just a simple act of knowledge, which the interpreter has no choice but to make. The interpreter has a certain margin of freedom in interpreting. There is no pre-existing meaning, before the Supreme Judge has provided his interpretation, on which all members of the political body would agree and which would have to be discovered. The true spirit of a law only becomes apparent when the supreme judges render their conclusions. For example, it was not really possible to know whether the ECB had the right to buy securities on secondary markets until the Court of justice of the EU issued its conclusions in the Gauweiler and Henrich Weiss rulings in 2015 and 2018, long after the contested acts had been put in place.

Yet, rather than leaving the supreme judges responsible for interpreting ambiguous treaties, the most transparent solution is to politically amend the treaties. According to Jürgen Habermas (1997), treaties, like any fundamental law, must be a project in perpetual updating, a substance that each generation refreshes. It is all the more important that the European treaties can now be seen to face deflationary tensions and ecological challenges, where they were clearly designed to cope with inflationary pressures and without any particular consideration for the environment. The best solution would therefore be to find a political consensus to amend Article 123 TFEU and make these conditional public debt forgiveness by the ECB explicitly legal, in order to finance the world to come.



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Public debts in times of coronavirus

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The COVID-19 outbreak has strengthened two trends in recent monetary developments: the rise in public debts and the low level of interest rates. In all advanced economies, governments have implemented huge measures to support businesses and households. The resulting rise in public deficits was easily financed at very low interest rates in most countries. Will higher public debts be a problem in the future? Several proposals have been made to cancel or to monetize public debts. Are they realistic?

THE RISE IN FISCAL DEFICITS WAS FINANCED

The COVID-19 sanitary crisis led to a sharp rise in deficits and public debts in all advanced economies. According to the IMF (World Economic Outlook, 2020), the average output loss in advanced economies will be 8% in 2020, leaving a gap of 5.5% compared to the pre-crisis trend in 2021. Public deficits would increase on average by 7.6 percentage points of GDP in 2020 (public finances would bear 75% of the output fall in 2020), of which 2.4 percentage points would remain in 2021; the debt-to-GDP ratio would increase by 16 percentage points.

In modern monetary economies governments should always be able to finance their deficits. The Central Bank commits to refinance banks at a refinancing rate that it set. Banks commit to buy all bonds issued by the government, knowing that they can always place them at the Central Bank, if they fail to place them with public or other financial institutions. The

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Government has, in fact, an unlimited right to draw on the Central Bank, at a rate close to the refinancing rate.

Financial markets currently anticipate neither a strong economic recovery, nor the acceleration of inflation, nor generally sovereign default risks. Therefore, they expect interest rates to remain low. Thus, governments have been able in 2020 to issue short-term and long-term bonds at very low rates. Once again, the rise in public debts and deficits in times of economic depression, is accompanied by a fall and not by a rise in interest rates.

In the euro area, since the COVID-19 outbreak, most governments have been able to issue bonds at negative interest rates up to 10-year maturities. In 2020-21, the French government is expected to borrow around € 300 billion (net, excluding interest payments), at near zero interest rates from financial institutions. Hardly a “debt wall” which should be broken.

Conversely, the Italian sovereign risk premium has widened until 2 percentage points. Markets are not worried at all about the US public debt (despite Trump), the UK public debt (despite Brexit) or the Japanese one (which has reached 240% of GDP). Markets have fears about the Italian debt because it is not guaranteed by the ECB. They remember the Greek debt crisis in 2012: a crisis leading Italy to leave the Eurozone cannot be totally excluded, especially since markets may fear their own self-fulfilling prophecy. Once again, the health crisis shows that the Eurozone is a fragile building.

THE MAGIC SOLUTIONS

The health crisis has led public debt to increase while private agents overall have accumulated financial assets. The risk is that demand remain sluggish for a long time. Uncertainty will weigh on households' spending and on business investment. Support for activity will remain necessary. In this situation, how to manage public debts? Three innovative solutions have been proposed.

The first proposal consists in cancelling part of the public debts, to the expense of their holders. However, government bonds' holders are not the richest. The latter hold a variety of assets outside government bonds, either in real estate, in riskier, higher-yield financial instruments, or in they own company. Public debt owners are middle-class households (through life insurance, pension funds or investment funds assets). They have trusted the French government by buying bonds at very low rates without a risk premium: they are ready to buy bonds again. France is not bankrupt, it cannot seriously claim to be unable to service its debt. The government bonds holders would complain to French or international courts of justice and would win. Finally, raising the possibility of partial debt cancellation could frighten savers, cause interest rates to rise, and generate a debt crisis. Public debts would no longer be considered safe assets; this would require banks to tie up capital to hold it. Countries that have carried out such

operations would find it difficult to borrow again to finance the ecological transition.

Some suggest, more modestly, that the government issue perpetual bonds, solely requiring interest payments. George Soros suggests the EU should issue such bonds at a 0.5% interest rate¹. But why would financial institutions buy such bonds, which they would never be able to sell without a huge loss if interest rates rose? The EU would have to offer much higher rates or indexed rates, which would strongly reduce the attractiveness of the proposal.

The second would be to print money or to monetize public debt. But, what is money printing in 2020? The question is not: “Can the State give money to households and businesses in times of crisis”? As we have seen, the State can distribute any amount of money it wants², but this money is neither distributed nor held in the form of banknotes. So, there is no need to print any money, but there are also no additional resources at guaranteed zero interest rates.

Let us assume that the government gives 100 billion euros to precarious households who will spend it entirely³. This will have a multiplier effect on output if the economy is underemployed. Let us assume that the average households' savings rate on their current income is 0.7 and that the tax rate on production is 0.3. Then the Keynesian multiplier is 2, output will increase by 200 billion and therefore tax revenues by 60 billion. Ex post, the public deficit will increase by 40 billion, as will households' savings. The effect on the public deficit is much smaller than the initial shock. But these 40 billion will not be held in cash. For example, 20 billion will be held in bonds (through life insurance in particular) and 20 billion will be held in remunerated bank deposits. Banks have no reason a priori to increase lending to the private sector and will therefore be able to buy the 20 billion bonds issued by the government. Ex post, the public debt will necessarily be 40 billion higher in long-term or short-term bonds. Knowing how much of that 40 billion is monetary funding is a question that makes no sense.

With interest rates currently at 0, increasing public borrowing is not an issue. If interest rates rise in the future, interest payments will increase. However, interest rates will rise only in the event of strong economic growth and inflation, therefore with higher tax revenues and a relatively low interest rate corrected from growth. Consequently, the situation of public finances will not be necessarily difficult.

If the Central Bank buys 100 billion government bonds, directly or from banks, banks' refinancing decreases by 100 billion, which could encourage banks to increase lending. This implies that the amount of public bonds held by the central bank should not be too large, as it could reduce excessively banks' refinancing and could weaken the Central Bank's control on credit supply.

Some believe that Treaties should allow the Central Bank to directly finance States. But who would have the

initiative? The Central Bank - in which case it would be like today where the Central Bank guarantees that the government may issue as many bonds as they want and can buy back long-term debt - or governments - but at what interest rates and up to what limits? There is a difference between a situation where the Central Bank can decide to buy government bonds, directly or indirectly, to stabilize long-term interest rates and a situation where the Central Bank would be forced to finance a public expenditure programmed, without having a say on its amount. This could prevent the Central bank from controlling banks' refinancing or constrain it, on the contrary, to run a too restrictive refinancing policy.

The Central Bank is owned by the State, and gives its profits to the latter. When It buys public bonds, it earns interest payments on public debt, but loses interest payments on bank refinancing. Financing government at zero interest rates would amount to squeezing the Central Bank's profits (which in itself is of little importance since the Central Bank's profits are given back to the State, except that it would be contrary to the Central Bank's autonomy if the State could reduce its profit in a discretionary manner). It is therefore legitimate that the State pays a risk-free market rate for the public debt that the Central Bank holds.

Debt monetisation therefore means for the whole "State + Central Bank" financing borrowing at the refinancing rate, which should be compared to borrowing costs via bonds, at long-term, risk-free rates, which reflect market expectations on the evolution of short-term rates. Thus, when long-term interest rates are at zero as they currently are, the government may prefer to borrow via long-term bonds, rather than be financed at the money market rate, and thus be protected against the risk of higher interest rates. Conversely, the Central Bank may buy government bonds to lower long-term interest rates, which may be helpful if markets are worried about a rise in interest rates.

According to some economists, if the Central bank owns government securities forever, the State will not have to repay. Certainly, but this is true for all public debt, if it is guaranteed by the Central bank. At each period of time, the government is ensured to be able to refinance the maturing debt. The State is eternal: there will always be savers who want to hold safe financial assets. There will not be a D-day when the State has to repay the entire public debt. Each month, the government reimburses the maturing loans, but most of the institutions being reimbursed immediately buy government bonds again. The government only has to keep control of its debt; it must be able to lower it if government borrowing generates excessive demand in relation to production capacity.

The third solution would be to have the public debt born by the Central Bank. Some suggest that the Central Bank cancel the public bonds it already owns or that it holds them until the end of times at a nil interest rate, which is the same thing. In fact, this operation is purely internal to the "State + Central Bank" entity and would have no effect on other agents and so no macroeconomic impact. Let us assume that the Central

Bank cancels 400 billion of public debt it owns. Public debt falls by 400 billion, but the "Central Bank + State" debt remains unchanged. This would not give public finances an additional 400 billion room of manoeuvre both in terms of the short-term equilibrium and of debt sustainability⁴. With interest rates at zero today, interest payments do not matter. But if interest rates increased, the central bank would have to borrow from banks at the refinancing rates and its current account would be unbalanced. As the Central bank is owned by the State, the savings made by the government on interest payments on the cancelled debt would be offset by the loss of dividends from the Central bank and probably by the obligation to subsidize it. The Central Bank's independence would be weakened.

Some suggest to use helicopter money to provide a certain amount of money to each household⁵. But the Central Bank's role is not to run fiscal policy, but to run monetary policy, and therefore to control credit and to guarantee banks and public debts. A bank lends; it does not pay benefits. In the euro zone, each member state has already taken measures to support its economy as well as possible, it would be a waste to add a transfer to all, the richest as well as the poorest, to pay money to civil servants or to retirees who did not see their incomes fall ; assistance needs differ for countries with or without a minimum income and a satisfying unemployment insurance system.

Let's go back to our example. Let us assume that the Central Bank paid 100 billion to precarious households. Ex post, the Central Bank will run a deficit of 100 billion; the government will be able to cut its deficit and debt by 60 billion, but the central bank will see its refinancing to banks cut by 100 billion. On the whole, for the "Central Bank + State" entities," the evolution of net debt will be the same as for a State-financed operation, money supply will be the same, nothing will be changed for private agents, but the financing will be ensured by banks' refinancing and not by bonds.

For the economists who propose to transfer the public debt to the Central Bank, being the ultimate source of liquidity, the Central Bank's balance sheet can be unbalanced without problem. But this reasoning applies

1 <https://www.project-syndicate.org/commentary/finance-european-union-recovery-with-perpetual-bonds-by-george-soros-2020-04>

2 Which allows one to say, according one's mood that the Modern Monetary Theory is right, or that it knocks on an open door.

3 To make the reasoning simpler, we assumed that this is a closed economy.

4 Contrary to what believes Laurence Scialom (2020) : <http://tnova.fr/notes/des-annulations-de-dette-publique-par-la-bce-lancons-le-debat> and Gaël Giraud (2020) https://www.lepoint.fr/postillon/gael-giraud-cette-crise-est-une-epreuve-de-verite-pour-les-collapsologues-romantiques-25-04-2020-2372847_3961.php

5 As Aurore Lalucq and Jézabel Couppey-Soubeyran (2020): <https://www.nouvelobs.com/economie/20200330.OBS26781/tribune-la-monnaie-helicoptere-ou-le-desastre.html>

similarly to the State, whose public debt, guaranteed by the central bank, can also grow without limit. The equivalence between public debt and possibly a Central Bank debt is macroeconomic and financial. To assess the fiscal stimulus, one must account for government and Central bank's deficits. This is where some economists suggest creative accounting. They think that financial markets and European Authorities may be fooled, that they will look at the fall in public debt and not at the stability in the total "public + Central Bank" debt. This is an illusion. If governments tried to cancel part of their debt in their Central bank's balance sheet, financial markets and international institutions would quickly take this into account to assess debt sustainability.

There is no magic monetary creation that could allow unlimited funding at nil interest rates of universal income, guaranteed full-employment, ecological transition, and now the health crisis. As concerns the equilibrium of goods and services markets, an increase in public expenditure must be financed by taxes in full employment periods. Its increase is necessary in times of unemployment; it must be financed by deficit, i.e. by borrowing. The delicate point is to draw the line between these two situations.

WHAT TO DO WITH PUBLIC DEBT?

Public debt is necessary. It satisfies households' and financial markets' wish to hold a safe financial asset. It is legitimate that it finances public investments. Fiscal deficits should increase in times of weak activity, once interest rates have been cut to their minimum. Public debt is only excessive when it induc-

es excessively high interest rates and inflation rates. Obviously, this is not currently the case. The recent increase in public debt corresponds partly to households' involuntary savings resulting from the impossibility to buy goods and services in the lockdown. It would be counterproductive to reduce this savings through taxes, while demand needs to be sustained. It would be socially unjustifiable.

In the short term, the priority is for activity to resume; public debt should be cut only by lower excess savings and by inflation; above all, European authorities should not reintroduce the 60% of GDP limit for public debt, 3% of GDP limit for the deficit and the objective of medium-term public balance in equilibrium. The ECB should guarantee public debts while the European budget should support the countries most affected by the pandemic. In the medium term, public investments and ecological transition financing should be facilitated by the development of a public financial system offering safe financial investments, at low rates, off-markets, and protected from inflation. In the longer term, public debt reduction will be facilitated by a tax on high wealth, by the fight against tax competition and optimization, and above all by the reduction of income inequalities induced by neo-liberalism.



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Policy Debate - Special Issue

"Policy Mix in the Eurozone facing Covid-19"

Euro Treasury, Job Guarantee and MMT: Time for a Fiscal Theory of Economic Stabilization

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*"The views and opinions expressed in this policy brief
are those of the author and do not necessarily
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Restarting the European economy with mere monetary policy will not work. If demand is to be increased, it will have to be through government spending. To that end, Dirk Ehnts proposes a public Job Guarantee to combat both unemployment and low demand across the European Union.

The Coronavirus has created economic and social havoc. In what macroeconomists would label an "exogenous shock" - while admitting in private that globalization surely would have something to do with it - we have seen thousands of victims all over Europe. Parts of Europe's population have been under lockdown, some briefly, others for quite some time. GDP growth in the first quarter of 2020 is down by 3.8% and 3.5% in Eurozone and EU, respectively. From a macroeconomic perspective the big issue is how to restart the economy after a shock to both the supply and the demand side.

The traditional kick-starter is out of service and will not be available: monetary policy. A five percent interest rate drop would take the main refinancing operations rate of the ECB deep into negative territory. Even if that would happen, it would surely not stimulate economic demand. With conventional wisdom out of the window, the Eurozone and the EU will have to be creative if they want to survive politically. The Eurozone, built in the neoliberal era which has now come to an end, puts up quite some roadblocks with respect to fiscal policy (see Wray 2012, p. 169-184). Assuming that trade policy is out - neither US nor China would take another round of Quantitative Easing (QE) without retaliation - and that no changes in other variables are imminent, fiscal policy is the only game in town. If demand is to be increased, it will have to be through government spending.

THE EUROPEAN RESPONSE TO THE CRISIS

That must mean higher public deficits and higher public debts. The European Commission has acted in mid-March and activated the general escape clause of the Stability and Growth Pact (SGP). “Excessive” deficits are not a problem anymore. The other problem that we remember from the Euro crisis that started in 2010 is rising yields and hence rising interest rates on government bonds of crisis countries. This time around, the ECB has acted swiftly and created a Pandemic Emergency Purchase Programme (PEPP) to ensure that all Eurozone governments - including that of Greece - will be able to spend as much as they wish. The program, following that proposed by Ehnts (2016, p. 200) - “any default risk of sovereign securities would be a thing of the past” - comes with no actual limits in terms of size and time. “Whatever it takes” is what the ECB said. These two policies were enough to not repeat the Euro crisis of 2010. Austerity, at least for the moment, is off the table. Member states have regained fiscal sovereignty in the sense that they are free to set the level of government spending as they wish.

Whether the resulting higher government deficits and debts become a problem depends on the development of the following three dimensions: deficits, debt and interest rates/yields. The deficit question is easy to answer. As long as the general escape clause is activated, deficits do not matter. When will it be deactivated? Well, not before 2022 for sure. So, if economies are back on track by 2022 they will have the deficits they had in 2019 and the situation will be the same as before. With respect to public debt there is almost no problem at all. Somewhere in the European Fiscal Compact there is a 60% debt to GDP limit. The structural deficit can be 1% for countries that have less public debt and 0.5% for those that have more. Given that most Eurozone countries' public debt is well above 60% of GDP it probably does not matter whether, for instance, Italy's public debt to GDP ratio has reached 130% (2019) or 170% (say, 2022). The ratio most probably won't fall below 60% for as long as the Euro lasts.

LEARNING TO LOVE PUBLIC DEBT

Baptiste Bridonneau and Laurence Scialom have recently argued that we should think about “a cancellation of national government's debts” in proportion to their green investments (Link). This proposal seems well-intended, but it reinforces the neoliberal framing of government debt as inherently “bad”. Why should one

cancel government debt? Government normally cannot run out of its own money and in case it occurs, why not change the rules regulating the monetary system to ensure that the government can always sell bonds to investors? For those who think that interest rates on government debt are the driver of inequality: think again. Public debt is increasing since the 1980s, but interest rates have been falling. They are pretty much zero now or even negative. Still, this has not led to a decline in inequality.

Now let us turn to the interest rate on new government securities and the yield on existing ones. Since the PEPP is in operation, the feared “spread” - the yield differential with respect to German government bonds - will not be a problem. However, PEPP is not a permanent feature of the Eurozone - yet. The ECB's governing council will determine whether this happens. Assuming that during the next quarters, Eurozone governments will increase government spending to prop up their health care systems and fight unemployment, public debt in the Eurozone will probably go up by 20% or 30% on average. Some countries will see their public debt go up by perhaps 50% in two years. It will be clear to everyone that the ECB is the buyer of last resort of those countries' government bonds, and that without the PEPP the countries would not be able to sell their bonds and hence use their national central bank to help with the actual spending. Yields would skyrocket and spell the end of the Euro.

The ECB has a clear mandate, and that is to maintain price stability. Letting a big country drop out of the Euro means that the ECB will have a problem with its inflation target of close to, but below two percent. Returning to a national currency, the former Eurozone member will depreciate its currency (if it is not Germany that leaves). That would make imports from that country cheaper in Euros and hence create a deflationary impulse. Usually, those are unwanted as the ECB has struggled for more than ten years to achieve its inflation target of close below two percent. So, there would be a justification of making PEPP permanent.

The German constitutional court will probably have a say about an arrangement like this but it will take years to get there. If a German court finds itself competent to watch over supranational institutions and the European Court of Justice, then the whole construction of the European Union as a supranational state is in danger, not just the ECB bond purchasing programmes.

THE FUTURE OF THE EUROZONE

When the economic recovery is complete, a new fiscal theory of economic stabilization must rule. The ECB's interest rates have been hovering around zero for almost a decade. A fall in the interest rate is not possible without moving heavily into negative territory. Even if it would happen, private investment will very likely not react to that. Since the 1980s we have seen a falling level of private investment and falling interest rates going hand in hand. That is not a coincidence. It is the lack of private investment that leads to a weak labor demand, which then causes slower wage growth and hence lower inflation. To that, the central bank reacts with lower interest rates. This strategy has failed. There will not be any "normalization". A policy rate of zero is the new normal. In the background, productivity growth has reduced the demand for labor. It would be important to reduce the regular working week to four days with full wage compensation such that more workers participate in the economy. Full employment is not attainable without the reduction in working hours.

How should fiscal policy be organized to deal with business cycles? Old school Keynesians would argue in favor of discretionary spending, but that is not acceptable to many politicians on the right. They would fear that the government would use its spending to create jobs for its supporters, thus leading to inefficiency and waste. While this is surely overdrawn, there are alternatives that neutralize at least some of the concerns. A Job Guarantee rooted at the level of communities and financed by the federal government would create space between those in power and those who receive the jobs. The idea is simple: Those that want to work but cannot find employment are offered a job by the local government. They can choose from a menu of jobs that should suit their skills and knowledge.

The Job Guarantee pays a living wage that supports a family, including health care, pension plan and other social benefits (see Tcherneva 2018 for the application in the US). It would thus act as a minimum wage in countries and sectors where none existed before. The Job Guarantee puts pressure on employers to offer good and well-paid jobs. The offer of jobs would be determined locally. A variety of options should be available for all: full positions (probably based on a 32-hour workweek), part-time work, summer jobs, short-term contracts, etc. The Job Guarantee comes on top of all other institutions and does not replace unemployment benefits or other institutions. One might still be unemployed and not want to work. Only those who are unemployed and would not like to continue to be unemployed are of-

fered a job. Since our societies care for the unemployed anyway, making sure that they are fed, clothed, have a roof to sleep under, there is no fundamental change at work. It still pays to move to a better-paying job in the private or public sector, so workers should be motivated to transfer out of the Job Guarantee jobs and into regular employment in good times.

The federal government would pay for the Job Guarantee jobs. In the Eurozone, Cruz-Hidalgo et al. (2019, p. 101-102) propose to create a Euro Treasury that pays for the fiscal costs of that program:

In short, what we propose is for the Euro Treasury to establish a new fiscal institution that would issue sovereign securities. For simplicity, we call these eurobonds. The eurobonds would be eligible as collateral to borrow from European Central Bank (ECB) to the full extent possible. As the ECB is only prohibited to finance national governments directly, it could put its full support behind the eurobonds, meaning that it could promise to buy up as many eurobonds as necessary. Acting as a buyer of last resort it would guarantee that investors would always be able to sell eurobonds at a fair price without creating a large fall in the price of eurobonds. Thus, the ECB would ensure sufficient liquidity in the market for eurobonds. De facto, the Euro Treasury would spend first and tax later, thus removing the need to finance the European Union's budget by transferring money from the budgets of the Eurozone's member countries.

Cruz-Hidalgo et al. (2019, p. 107) stress that the Job Guarantee would be an automatic stabilizer:

If Europe were to institute a standby policy of hiring the unemployed at all stages of the business cycle at a base (non-competitive) wage, the Job Guarantee pool would expand with recessions as people are laid off and enter the program. The expenditure of employing them is the very stimulus that resuscitates the European economy. As the private sector recovers, the program helps JG workers transition to better-paid private sector employment opportunities. Macroeconomic and price stabilization are achieved in a similar way as with the NAIRU except by a fluctuating pool of public service sector workers.

This would solve the unemployment problem that we have seen so far in the Eurozone. Government spending has been too low all of the time. This led to mass unemployment in the Eurozone that has been unnecessary. It also solves the political problem associated with government spending, namely that those who get jobs

vote for the party that gave them the job. Now, it is a job that is guaranteed to the workers and administered on a local level. The wage is fixed, and so are the other terms of employment.

ECONOMIC POLICY FOR THE 21ST CENTURY

The other step that needs to be taken is to address what we do with the increase in government spending. Addressing climate change, we should reduce the workweek to four days and start a socio-ecological transition as described in the Green New Deal for Europe (Adler and Wargan, 2019). We should also reregulate the financial sector as proposed by Mosler (2009). This is not the time to “return to growth” or “stabilize the economy” - it is time to move forward and start rebuilding our societies.



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"Policy Mix in the Eurozone facing Covid-19"

An essay of rejoinder: searching for a consensus on the new macroeconomics

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This policy brief intends to highlight the consensual points between the contributors to the three previous policy briefs #10, #11 and #12. In particular, we point out what the authors do not want, and on the contrary what they want for the future in the domains of fiscal policy and monetary policy.

1. PRELIMINARY REMARK: THE GOAL

The 'mission' that was assigned to me is to discuss the three contributions. Make a synthesis would be too pretentious because questions are too complex, and most of the authors' arguments seem right, even if authors sometimes disagree. It also could be judged arrogant to pretend to give the good and bad points to one or the other. Pretending to go beyond the three contributions would also be highly pretentious, and I have too much respect for the authors to do that. So, what I propose to do is to try to find a core of heterodox macroeconomics they all agree on. I will be positive and highlight the consensual points between the contributions.

All the policy briefs share the same goal: escaping from the current crisis and the gigantic crisis which is coming. This goal is not restricted to heterodox economics: New Classical or New Keynesians also want to achieve that. What is heterodox is how to do that: the rejection of the usual mainstream way. In the three policy briefs, I see a consensus, a common ground that can be proposed as an alternative to mainstream macroeconomics. I will first present the 'negative' consensus: what the contributors do not want. Then I will highlight the 'positive' consensus, what I consider that they all propose.

2. THE CONSENSUS IN NEGATIVE: WHAT THEY DO NOT WANT

All the contributors agree on what is not relevant. They agree that we cannot use the traditional New Classical way of doing, based on anti-Keynesian expansionary fiscal contraction à la Alesina (2012). They all agree that fiscal consolidation and the austerity fiscal criteria (3%; 60%) and the European Stability and Growth Pact are not the solutions. We do not need fiscal adjustment. We need a revolution compared to what has been done in Europe with the public debt criteria. We need something different. We need change, urgently.

All the contributors agree that the critique of fiscal policy, but also the critique of its corollary public debt, should not continue. The contributions are more or less clear on that point, but it seems that the basic idea is that we should reject the hypothesis that high debt levels lead to a) inflation and b) low growth. To be clear, the simplistic idea of Reinhart and Rogoff (2010), and their big mistake, should not continue to be the doxa of fiscal policy. The corollary is that we should not follow the idea that the debt to GDP ratio is a good indicator of future growth or financial instability. On the contrary, a basic idea of the policy briefs seems to be that we should reverse the mainstream proposal: we need fiscal policy (deficit, debt) to avoid a) deflation and b) secular stagnation.

On the monetary policy side, they all agree that central bank independence à la Alesina and Summers (1993), and monetary policy austerity are not the solution. We do not need a conservative central banker à la Rogoff (1985) that is obsessed with fighting inflation, notably because now the main risk is the opposite: deflation. It implies that we need to go beyond inflation targeting. The contributors all agree that we cannot escape from the crisis with central bank communication alone: we need action. We cannot escape from the crisis just simply with fine words, contrary to what the New Keynesian expectations management and “open mouth operations” recommend (Woodford, 2003). A lesson from the subprime crisis is that central bank communication without intensive actions is not the right policy; it is a “flash in the pan”. Who can pretend that we can escape from a severe crisis with only ‘forward guidance’? It can be useful, but it is not enough. Identically, we cannot escape the crisis with some kind of technical targeting by the central bank, such as the price level targeting recommended by New Keynesians (Eggertson and Woodford, 2003). We cannot continue to simply conduct monetary policy by following a Taylor rule, augmented of financial stability or not. Indeed, to deal

with the Covid-19 crisis, central banks use massively not only their interest rate instrument, but also their balance sheet instrument; and more generally the Taylor rule is not enough compared to the challenges we face.

Yet, the three policy briefs propose more than a simple negative consensus. They make positive proposal

3. THE CONSENSUS IN POSITIVE: WHAT THEY WANT

There is a positive consensus on what should be done and how it should be done, even if it is not a perfect consensus. All the contributors agree that fiscal policy and monetary policy should work together: they all agree on a real policy-mix. Monetary dominance should not continue: fiscal policy must be active. Inside the eurozone, fiscal policy should be active not only at the national level but also at the supranational level. It is implicit in the three contributions that various forms of fiscal federalism are required in the euro area, and the level of the euro area federal budget should be much higher. Albeit an old proposal, it is even more relevant in times of crisis (financial crisis or Covid-19 crisis) and ecological transition. This fiscal federalism would alleviate the debt constrain of euro area countries. More generally, an expansionary fiscal policy is required for two other reasons. First, because it is now commonly admitted that the fiscal multiplier is higher in crisis times (Creel et al., 2011). Secondly, it is now established that the path of economic growth can be lower after a severe crisis, without automatic return to the previous path, so a form of hysteresis. This suggests that public expenditures could reduce this growth gap. Yet, fiscal policy would have some difficulty in solving a post-Covid depression alone. Fiscal policy needs the help of monetary policy.

Regarding monetary policy, I agree that in theory, the central bank can set an infinitely negative interest rate to help the recovery of the economy, but that in practice it is debatable to cut the interest until it reaches the Marianas pits. Identically, there is a priori no limit to the increase of central bank balance sheets. In three months, from March to June 2020, the European Central Bank's (ECB) balance sheet has increased by more than 900 billion of euros, an increase of about 20% to deal with Covid-19. If this rhythm continues, the balance sheet of the ECB will be around 3,000 billion euros bigger by the end of 2020. These liquidity injections are welcome in trying to limit the risks of deflation and recession following the Covid crisis. Unfortunately, we had no alternative than using intensively monetary policy because the Stability and Growth Path blocked fiscal policy in Europe. Unconventional monetary policy was one of the few emergency

solutions we had. Yet there are reasons to think that there are decreasing returns, rather than increasing returns, to this central bank balance sheet increase (Goodhart and Ashworth, 2012). There are also potentially negative redistributive effects of the unconventional monetary policy that I will discuss later (Montecino and Epstein, 2015). The central bank can do a lot, as stressed by the contributions, but it cannot do everything alone. The resulting stimulus of the economy could be more massive and efficient if fiscal policy played its full role. Researchers working on monetary policy should re-think its links with fiscal policy, and change the hierarchy between them if necessary.

All the contributors agree that we need a liberal central banker injecting money liberally. We all agree that the central bank should support fiscal policy. Hence, we all agree that one of the main transmission channels of unconventional monetary policy is the “fiscal channel” (Bernanke et al., 2004): the central bank buys government’s bonds so that their yields is decreasing (the cost of public debt is decreasing), and that there is a buyer of public debt in last resort. All contributors suggest that the liberal central banker should not be restricted to a couple of months. We do not want just a lender of last resort à la Bagehot (1873) that injects liquidity only during the financial panics. The ecological transition is long, so the central bank should support fiscal policy in the long-run. In this area, we have a lot to learn from the Japanese experience of the 1990s-2000s, as we want to avoid the so-called ‘Japanese scenario.’

Therefore, all contributors agree that monetary and fiscal policy should focus on the goal of ecological transition. However, it should not be just a long-run objective. The fiscal authorities should take advantage of the room of maneuver given by the central banks in the current situation to accelerate the ecological transition. This is a typical Keynesian investment policy, a ‘Green Deal’ to use the wording of the New Deal. Hence, the money support allocated to the State by the central bank should go to green investment. And we should not be scared of using a New Classical argument: State investment in green infrastructures is good for growth according to endogenous growth theory (Barro, 1990). Green investment should be presented as a positive investment, like all the positive investment highlighted by the endogenous growth theory (public infrastructures, education, R&D, etc...). And we have to go further. It is not explicitly said in the three contributions, but it is in the air: We need an industrial policy for ecology that goes beyond green fiscal policy. Industrial policy is not a taboo, a swear word or a thing from the past. The Covid-19 crisis has shown the importance of industrial policy. We need real ecological planification, not the market setting the priorities. We

need to define democratically the industrial priorities, as was shown by the Covid-19 crisis.

All the contributions agree that we need to use a political economy approach to make all this sustainable from a political, democratic, and social justice point of view. We all agree that we should tackle the redistributive effects of unconventional monetary policy, and of the policy mix. Once again, researchers on monetary policy should work harder. Hence, we all agree that we need to come back to income policy and a really redistributive fiscal policy à la Piketty (2013). We all agree that expansionary unconventional monetary policy should not lead to increasing wealth inequalities¹. To connect with the previous point, we all agree that fiscal policy should use part of the room of maneuver given by the central bank, via the “fiscal channel”, to reduce inequalities. Of course, this means that we should think even more about the link between the ecological transition and inequalities. For instance, some of the contributors of the policy briefs deals with employment. Why not linking ecology, education, unemployment, and inequalities? They could be combined by providing ecological work training to the people who are put at the margins of the society by markets mechanisms, and to unemployed too. This is a big education plan for the State and the local authority that are stressed as important actors for employment in one of the three policy briefs.

Finally, what else could make consensus in the policy briefs, and that we should develop even more? Maybe we need to use more history of economic thought and economic history than we do now. They will help us to make assumptions based on historical grounds that would strengthen our theory and proposals. We need to use the history of debt (Charles V, 16th century), the history of financial crises and financial cycles (Venice crisis in the 14th century, Great Depression), and the history of pandemics (plague) and their economic consequences. We need to re-read works on the land banks in Scotland in the 17-18th centuries. We need to re-read Tooke, Thornton or Fullarton and the 19th-century monetary controversy, and also the economic history of secular stagnation. We need to understand the periods of deflation such as the Great Deflation of the end of the 19th century. Finally, we could be inspired by the economic history of the industrial revolution to deal with the ecological transition; with all the books (Kindleberger notably) and articles available online, we are, more than ever, dwarfs on the shoulders of the giants.

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