Debt Monetization, QE, Inflation, Deflation and Expropriation

Central Bank Large Scale Asset Purchases, by which is meant the buying of government or agency debt, is intended to ensure demand for such bonds and to keep borrowing costs low for the government and any other debt issuer whose cost of debt is correlated or benchmarked to government bond yields. Large Scale Asset Purchases, or QE, as they are popularly called, are meant to be a boost to the economy. The experiment has worked in the US, to a certain extent. Lower borrowing costs have certain allowed corporate bond issuers to liquefy their balance sheets. Lower mortgage rates have spurred a rebound in housing prices which have led to healthier household balance sheets. The follow on impact from businesses to labour and employment has been slow.

QE directly funds government whereby a central bank buys bonds issued by the government. The central bank's assets rise by the value of the bonds it has bought, and the liabilities rise by the same amount as it issues liabilities to fund the purchases. These can take the form of cash in the government's reserve or cash accounts. It is convenient if the bonds are sufficiently highly rated that they consume no capital. It is hoped that central banks are thus able to help governments refinance themselves and buy enough time to return to fiscal balance and thus more attractive to private lenders. A growing economy is necessary, but not sufficient, for a government to improve its fiscal position through improving tax receipts. Fiscal profligacy can confound even a growing economy and rising tax receipts. It would appear that debt monetization cannot go on indefinitely if the government's financial position is steadily deteriorating. Note that a constant budget deficit or a constantly rising level of debt has been

demonstrated to be sustainable whenever there was sufficient domestic savings to fund this debt. It helps if the savers have no option but to fund this debt. In the absence of a such private funding there is debt monetization by central banks. The result, however, is an ever inflating balance sheet as more debt is issued to central banks in return for more printed money. This type of creative accounting can be quite persistent.

If rates rise and the bond prices fall, the central bank can either not mark them to market arguing that they will be held to maturity, or, they can mark them as available for sale and mark them to market. At that stage, any loss incurred by the bank will impact its equity. If the issuer, that is the government, buys back these bonds at below par, they will have made a profit equal to the loss incurred by the bank. The government could then recapitalize the bank by precisely the loss it had incurred in the first place. The value of the bonds, therefore, once in the hands of the central bank, are immaterial. This is pure money printing.

The government’s reserves with the central bank do not count as the money base. A government that is printing money is, however, likely not to leave too much money in its reserve account but to spend it quickly. The money thus finds its way to the commercial banks and becomes part of the money base. The money base is the multiplicand to which the velocity of money is multiplier in the identity that equates to nominal output. A sufficiently large money base makes an economy vulnerable to inflation or hyperinflation. Hyperinflation is usually a consequence of loss of confidence rather than a continuous process and will require more than an over inflated money base to trigger. But, persistent inflation can lead to a loss of confidence at some point.

Inflation aggregates domestic and external purchasing power. The measure of the external purchasing power of a currency is its exchange rate. Where debt monetization results in acute currency weakness, external inflation is already underway. This can impact headline inflation through imported goods and inputs.

In many ways, inflation is a signal rather than a lever. Targeting inflation religiously can distract policy from underlying causes. Disinflation can either be a result of productivity gains or deficient demand, or both. Persistent QE and low inflation can be a sign of an acutely weak economy as efforts at supporting sagging demand only just compensate for natural weakness. If the currency is also weak at the same time, it could signal that price support from rising costs were being compensated by substitution in a flexible economy with high productive efficiency which was also operating below capacity.

Where a country has financed itself in a foreign currency and or with foreign capital, as many emerging markets do, the ability to borrow is limited. Countries can default on debt not denominated in their own currency. The risk of default limits the demand for ever increasing issuance. Countries are not compelled to, but may choose to default on debt denominated in their own currency. Venezuela (1998), Russia (1998), Ukraine (1998), Ecuador (1999), Argentina (2001) are some examples. The ability to choose not to default, come hell or high water, on local currency debt, comes at a price, being the external value of that debt, thus the currency bears the brunt, and a de facto default occurs with a recovery rate equal to 100% less the depreciation of the currency relative

to the bond holders base currency. Where the bond holders are hapless domestic investors, forced to lend to the government, no default de facto or technical occurs. Such investors would behave rationally if they save more to make up for the debasement of their forced saving and invest abroad as far as possible to compensate for the de facto expropriation. This can result in lower demand and deflation. Governments of such countries have to spend more to compensate for this demand deficiency, worsening their balance sheet and necessitating further debt monetization or de facto expropriation.