EDITORIAL

DOES QUANTITATIVE EASING REPRESENT A FREE LUNCH FOR GOVERNMENTS?

In recent decades, the experience in many countries has been that the decline of the public debt ratio during expansions did not compensate for the increase during recessions. This could end up creating concern about sovereign risk and influence the borrowing cost. Under the assumption of permanent reinvestment of maturing paper, significant holdings by the central bank of government paper as a result of quantitative easing, could limit this risk. This depends on the interest rate on excess reserves and on whether such a policy ends up generating higher inflation and/or inflation expectations.

One of the major economic consequences of the Covid-19 pandemic is the significant increase in public sector debt as a percentage of GDP. This is related to the drop this year of the denominator and the jump in the numerator due to the role of automatic stabilisers and, sometimes massive, discretionary measures taken to soften the blow to the economy.

Experience in recent decades shows that in many, if not most, countries, the decline of the public debt ratio during expansions does not compensate for the increase during recessions. It implies that recessions create a stairway of public debt. High and rising levels of public indebtedness imply increased sovereign risk and, a priori, one would expect that this would end up influencing the borrowing cost. In parallel, since the global financial crisis, we have seen the emergence of quantitative easing as a key monetary policy tool considering that the official interest rates offer little or no leeway for more accommodation. We have thus reached a stage of de facto coordination between monetary and fiscal policy. By directly increasing final demand, the latter increases the effectiveness of an expansionary monetary policy, a point that is often emphasized by central bankers. Purchases of government bonds by central banks facilitate the financing of the fiscal stimulus.

Should these trends continue, it would mean that, eventually, a rather considerable part of public debt could end up on the balance sheet of the central bank. Some commentators have argued that this part should not be taken into account when analysing debt sustainability. The rationale is that the coupons received by the central bank would be paid back to government as dividends and that maturing debt will always be reinvested by the central bank. On the latter point, it is unlikely that a central bank would ever announce that such a policy would be maintained forever, because it would be perceived as monetary financing, hit its credibility and possibly create a jump in inflation expectations. However, for the pricing of sovereign risk, such an announcement is not strictly necessary. It is sufficient that the likelihood of reinvestment is sufficiently high. This seems to be the case. The US experience of quantitative tightening[1] has shown how difficult it is to reduce the size of the balance sheet. Moreover, more quantitative tightening is a substitute for policy rate hikes. If a central bank wants to reduce its recourse to QE during a future easing cycle, it should privilege increases in official rates during the expansion in order to create leeway to cut them subsequently. This implies that government bonds, once bought, could remain on the balance sheet for a very long time. Still, this does not mean that QE creates a free lunch for governments. Asset purchases are mirrored on the liability side of the central bank's balance sheet by reserves held by the banking system, which acts as an intermediary between the end investors and the central bank. Under the assumption that coupons are fully paid back to government in the form of dividends, the effective cost of funding is the interest rate paid on excess reserves of the banks with the central bank. We have grown accustomed to this rate being very low or, in the case of the ECB, being even negative. However, one would hope that this is a temporary situation and that eventually it should rise because the neutral rate of interest increases. Another reason behind such a rise would be an increase in inflation and inflation expectations that could follow from an ever bigger role of the central bank in financing the budget deficit. To conclude, under the assumption of permanent reinvestment of maturing paper, significant holdings by the central bank of government paper would imply that sovereign risk is priced in function of the debt held by other investors than the central bank. However, in simulating the long-term dynamics of deficits and debt, the overall debt level should be taken into account, at least if the interest rate on excess reserves is positive. Moreover, a growing role of the central bank in financing public deficits could end up generating higher inflation and/or inflation expectations and influence the cost of borrowing.

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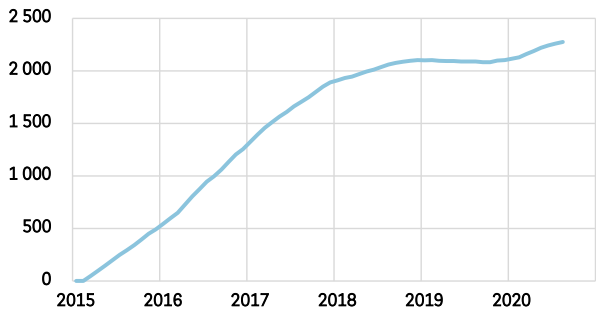
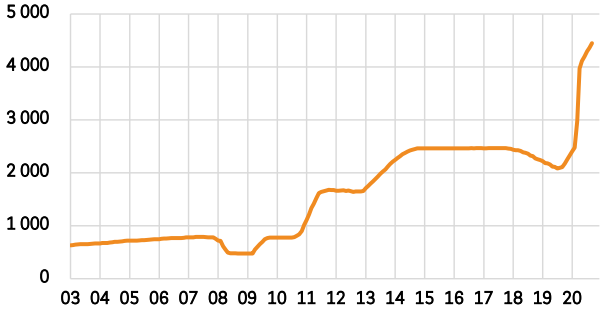
1. This refers to the balance sheet normalization policy whereby maturing securities were no longer re-invested. This policy began in October 2017 and ended in August 2019 (source: Federal Reserve).

ECB: HOLDINGS UNDER THE PUBLIC SECTOR PURCHASE PROGRAMME (BN EUR)



SOURCE: ECB, BNP PARIBAS

FED: SECURITIES HELD OUTRIGHT, TREASURY SECURITIES (BILLION USD)



SOURCE: FED, BNP PARIBAS