April 27, 2009

Concept Note prepared for the Shadow Gn meeting, May 6 and 7, 2009, Rome

Debt, Monetary Policy and Inflation

Nelson Barbosa*

Debt and Monetary Policy

1. The reduction in short and long interest rates is a necessary step to facilitate the recycling of bad assets and to reduce the cost of the increase in public debt needed to do it. The success of monetary policy depends more on the restructuring of private balance sheets through quantitative easing and risk mitigation than on interest rates, which are already at minimum levels in many advanced economies.

2. Quantitative easing must be based on purchases of both public and private bonds in order to recycle troubled assets. The capacity of the Fed to drain liquidity out of the system depends on the pace of the recovery, since this is what will ultimately determine the market price of the troubled assets on the its balance sheet, as well as the need for the Treasury to issue or not to issue more public debt.

3. In the favorable scenario the US economy recovers, inflation accelerates, the private bonds on the Fed's balance sheet becomes profitable, and excess liquidity can be drained by selling such bonds back to the private sector. In case the market for the Fed-owned bonds is too thin, another alternative would be to transfer the private bonds to the Treasury, at a profit for the US taxpayer, in exchange for more liquid public bonds that can then be used to drain liquidity from the system.

* Secretary of Economic Policy at the Brazilian Ministry of Finance and Professor at the Federal University of Rio de Janeiro. E-mail: nelson.filho@fazenda.gov.br.

4. In the adverse scenario the US economy stagnates, the private bonds on the Fed's balance sheet lose value and cannot be used to drain liquidity. However, it should be noted that in such a context there will probably be no need to drain liquidity from the system because inflation will be low. If anything, it would probably be necessary to inject more money in the system, and this would be achieved by buying the very own public bonds issued to cover the taxpayers' losses.

5. The main risk of the current US strategy is not the incapacity of the Fed to drain liquidity out of the system if and when that becomes necessary, but actually the asymmetric incentives given for private investors to participate in the public-private special purpose vehicle created by the US government to bid up prices of troubled assets.

<u>Monetary Policy and Inflation</u>

6. So far the main risk for the US continues to be deflation. In the short run a sudden acceleration of inflation is only possible if there is a massive run on the US dollar. However, given the lack of alternatives to the US currency for holding financial wealth, such an extreme situation is not probable in the near future.

7. Moving the world economy, a simultaneous run on all main reserve currencies can only occur through a global capital flight to real assets. Such a thought experiment is also very unlikely to happen in the real world. On the one hand, the slow growth of the world economy does not justify speculative investment in commodities. On the other hand, the record-high level of idle capacity in manufacturing also indicates that a boom in the demand for capital goods is far from happening. Finally, the global increase in unemployment and the losses in labor income tend to keep the demand for real estate at a low level until the economy shows strong signs of recovery.

8. The main danger of inflation would have to come from a sudden and global acceleration of income growth. For this to happen the recent actions by national governments must be too successful in jumpstarting

the world economy, which so far doesn’t seem to be the case. The most probable scenario today is a slow and gradual recovery of the world economy, which in its turn would give central banks plenty of time and instruments to react to inflationary pressures.