Sovereign Money Creation for a Post-growth Economy

Discussion Paper

SUMMARY

A finite planet cannot sustain an ever-growing economy, and the effects of environmental degradation are already becoming alarmingly manifest. There are several factors that drive governments to think growth is both beneficial and essential, and to think that a number of social and economic problems would arise if we didn't pursue economic growth at all costs. We take a detailed look at one source of growth dependency: the role of the current monetary system in creating high levels of private and government debt. High levels of public and private debt create the pressure for ongoing economic growth. But if governments are to be persuaded to abandon the pursuit of endless economic growth as an overriding policy objective, it will be necessary to find other, non-growth solutions to these problems. To this end we propose the adoption of a new monetary tool: Sovereign Money Creation (SMC). SMC entails that money is created by the central bank and credited to the government's account to be spent into the economy without an increase in private sector debt levels. This tool will also disrupt the idea that 'there is no money' for the things society needs, like social housing, healthcare, and building infrastructures for a low-carbon economy.

For background information on this discussion paper, refer to the following publications:

Sufficiency: Moving beyond the gospel of eco-efficiency (Friends of the Earth Europe)
http://www.foeeurope.org/sufficiency

Escaping Growth Dependency (Positive Money)
http://positivemoney.org/publications/escaping-growth-dependency/

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Authors: Robert Macquarie, Riccardo Mastini

If GDP Goes Up, Nature Goes Down

For every euro that makes GDP grow, raw materials and energy are used, and waste and pollution is generated. Hence, all economic activity has a real impact on the environment. There is now widespread consensus that an absolute decoupling of GDP growth from environmental impact is not possible. Given the current overshoot of several planetary boundaries and the fast-shrinking carbon budget, it is urgent to wean our economic system off its growth dependency. It's important to recognise that abandoning the pursuit of endless economic growth does not mean accepting poverty and a miserable life for citizens. There is no shortage of ideas for ways to significantly improve quality of life without GDP growth – in fact, the pursuit of growth in GDP at any cost can even lead to lower levels of wellbeing for citizens.

The Role Of The Monetary System In Creating High Private And Public Debt

Our current monetary system creates high levels of private and government debt. But as long as the economy grows at a faster pace than the level of debt, this outstanding debt becomes smaller relative to GDP. Consequently, governments are incentivised to pursue GDP growth to make high levels of public and private debt more manageable. This locks us into a vicious cycle of endless economic growth and ecological destruction only to keep up with our mounting pile of public and private debt.

But why does our current monetary system create high levels of debt? Notes and coins make up little more than 2% of the total money supply in the Eurozone, with the vast majority of money existing in the form of bank deposits at commercial banks. New money is created when banks make loans. When a customer takes out a loan, the bank credits their bank account with a deposit. This is a liability on the bank's balance sheet; it also adds a corresponding asset – that is, the obligation to repay the loan (debt).

As the money supply grows, so too does the sum of debt in the economy. Banks are profit-seeking businesses, and loans are the main product that they sell. They use incentive schemes and targets to encourage their staff to 'sell' (lend) more, whilst using marketing and sales strategies to encourage households to 'buy' (borrow) more. They do so because they reap the private benefit of creating money, in the form of interest on the loan. Banks are encouraged to create too much private debt for the wrong things by the protection against failure they receive from governments. Unwilling to let the monetary and payment system collapse in a recession, states are committed either to bail out distressed banks or to assume their liabilities via deposit insurance schemes. Most lending does not flow to the productive economy, but instead flows to pre-existing assets, especially property. Therefore, the burden of this debt (and, crucially, of corresponding interest payments) relative to society's income worsens over time.

When customers pay off their loans, money is 'destroyed' and can no longer be spent, so is no longer part of the 'income stream' of the economy. If debt levels become too high, some borrowers will become unable to pay the interest due. This can lead to bank runs and financial crises. If enough economic actors try to deleverage (pay off their debt) all at once, the money supply shrinks and the economy tips into a 'balance sheet' recession. Banks themselves can exacerbate the downturn by restricting new lending and calling in risky loans.

The higher the levels of private debt following a crisis, the harder it is to recover from recession, because households and businesses that are already highly indebted and have an uncertain outlook on the economy are not willing to take on more debt to spend or invest.

This all results in a highly pro-cyclical and unstable monetary system, with too much money being created during boom times (fuelling the boom and funding speculation), while too little is created in the aftermath of a bust (worsening the recession).

Furthermore, recessions and/or financial crises inevitably lead to a rise in public (i.e. government) debt, because:

• bank failures and rescue packages increase government expenditure;
• recessions cause tax revenue to fall;
• and recessions cause government welfare payments to rise.

A reasonably high level of public debt will always be necessary to provide safe assets for investors, but there are several reasons why public debt at higher levels of GDP may start to cause problems for the government. High public debt limits the perceived 'fiscal space' for countercyclical stimulus in a downturn (which, as we'll see, is not a problem in itself yet does incentivise the government to reduce the debt). Interest payments may divert funding from necessary public services and drive inequality, as net recipients of interest payments represent only a small, relatively wealthy section of society. These concerns drive governments to want to limit the growth in debt and reduce overall debt-to-GDP ratios.

Because trying to pay off debt reduces expenditure on productive activity, sustained deleveraging either by the private sector or by the government is impossible without creating a recession. Therefore, most attempts to reduce debt-to-GDP ratios are much more likely to rely on increasing GDP rather than reducing the debt.

How Can High Levels of Debt Be Reduced?

The debt burden – in the form provided by official statistic agencies and scrutinised by policymakers and the media alike – is expressed as a percentage of GDP and calculated by dividing the debt by total nominal GDP (NGDP). NGDP is GDP evaluated at current market prices. Hence:

$$\textit{Total debt to GDP ratio} = \frac{\textit{Public debt} + \textit{Private debt}}{\textit{NGDP}}$$

In order to improve the debt ratio without paying off debts, NGDP must be increased. This can take one of two forms, which of course can and do occur simultaneously:
1. Inflation: meaning an increase in the prices of goods and services and wages. The overall tally of spending increases as a result, but without any increase in 'real' output.
2. Real output growth: meaning that after prices have been adjusted for inflation, the economy has grown in terms of actual output – the 'real' value of the goods and services produced. This of course implies that there has also been an increase in the input of energy and resources, and the output of pollution and waste.

Inflation can be useful to governments as it contributes to reducing the real value of debt. But there is a catch. Inflation can only reduce the debt burden in the short-term: after any protracted period of higher inflation, investors will simply revise their inflation expectations upwards and demand higher interest rates on newly issued debt, as old loans and bonds mature. It is therefore only real GDP growth, sustained over long periods of time, that can truly help bring down public debt/GDP ratios.

Yet we have already recognised the fact that growing the economy, and consequently growing our usage of energy and resources and production of waste and pollution, is incompatible with protecting the environment and ecosystems. Instead, we need to look for a way to reduce private and public debt in the absence of economic growth. In other words, we need a non-growth solution to the problem of high private and public debt.

Sovereign Money Creation For A Sustainable Economy

It is clear that the design of our current monetary system contributes to a growing debt burden and thereby to society's growth dependency. The essential problem is the reliance on private money creation, entrusted to the banking sector, to generate spending power.

The approach we propose to tackle this problem is adding a new tool to central banks' toolkit: Sovereign Money Creation (SMC).

SMC has also been called Overt Monetary Financing or QE for People. The latter references quantitative easing, the ongoing asset purchase policy central banks have been undertaking, and suggests how such a policy could be deployed differently to assist in reducing levels of private debt and promote wellbeing.

SMC entails that money is created by the central bank and credited to the government's account to be spent into the economy. There is no increase in private sector debt levels when new money is created, unlike in the current system where new money is created only when the private sector takes on more debt.

SMC would be a very effective countercyclical tool when responding to shocks, crises, and recession. The stimulus required for economic recovery would not need to be fully financed by increased government borrowing, and would therefore reduce the amount of public sector debt the government was required to take on. It would also avoid many of the issues with quantitative easing, which relies on an indirect mechanism, via the banking sector, for new public money to reach the economy.

Oversight of how this new tool is used is important. SMC needs a comprehensive and robust institutional framework to be used effectively. We suggest that the central bank should decide how much money to create, whilst elected politicians would decide how newly created sovereign money is used. In the Eurozone, this would involve new treaties to establish a new role for the European Central Bank, or national central banks working as part of the ECB system, in issuing new debt-free public currency.

Allowing central banks to create money to be spent into the economy in the public interest through SMC will disrupt the idea that 'there is no money' for the things society needs, like social housing, healthcare, and building infrastructures for a low-carbon economy. To put it more simply, the 'magic money tree' does exist.

For instance, early on in 2018 the International Energy Agency sounded the alarm over a pause in the shift to clean energy after global investment in renewables fell 7% last year. A possible solution to reverse this trend is for governments to increase investment in energy markets directly through state-owned energy companies, or by extending lines of finance to private renewables firms. SMC can be a useful tool for helping governments take a lead in the energy transition.