

Green Money without inflation

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Introduction

- To what extent can money created by the central bank be used to finance investments in the environment?
- The ECB has created 2,600 billion euros of new money since 2015 in the context of its quantitative easing (QE) program.
- It added another 915 billion euros in the context of PEPP-programme initiated during pandemic.
- All that money has gone to financial institutions that have done very little with it.
- Why can't the ECB inject the money into environmental investments instead of pouring it into the financial sector?

Basics of money creation

- Money is created by the central bank when that institution buys financial assets in the market.
- The suppliers of these assets are financial institutions.
- These then obtain a deposit in euros at the ECB in exchange for relinquishing these financial assets.
- That is the moment when money is created.
- This money (deposits) can then be used by the financial institutions as the base to extend loans to companies and households. This is why it is also called “money base”.

- There is no limit to the amount of financial assets that the ECB can buy.
- In principle, the ECB could purchase all existing financial assets (all bonds and shares, for example),
- but that would increase the money supply in such a way that inflation would increase dramatically.
- To avoid this, the ECB has set a limit: it promises not to let inflation rise above 2%.
- That imposes a constraint on the amount of money that the ECB can create
- So far, the ECB has been successful in maintaining the 2% inflation target.

- There is also no restriction on what types of assets the ECB can buy.
- Since 2015 when it started its QE-program, the ECB has mainly bought government bonds, but also corporate bonds from financial institutions and bonds from international financial institutions such as the EIB.
- The ECB could, however, also purchase bonds issued to finance environmental investments.
- The only restriction on these purchases (again) is that they do not endanger the 2% inflation target.

What are the options for the ECB?

- The ECB has bought approximately 3,500 billions of government and corporate bonds since 2015.
- These purchases have not fueled inflation, which has remained below 2% in the Eurozone.
- The ECB has announced that when these government and corporate bonds come to maturity, new bonds will be bought in the market so as to keep the money stock (money base) unchanged.
- It is unclear at this stage how long it will do this.
- I will come back to this point later.

- The existence of a large portfolio of government bonds on the ECB's balance sheet creates a "window of opportunities" for the ECB.
 - It could replace the old bonds with new "environmental bonds", i.e. bonds that have been issued to finance environmental projects.
 - ECB would not create new money.
 - It would only reorient money flows towards environmental projects.
 - As the total amount of money would remain the same there would be no risk of additional inflation.

First Objection

- If the ECB buys these "environmental bonds", it will be involved in the decision-making process about which environmental investments should have a priority.
- For example it would have to answer questions such as:
 - How much public and private investments must be made?
 - Should it be renewable energy or nuclear energy?
 - Should the priority be given to public transport?
- These are all questions that have to be settled by political authorities, and not by the central bank.

One way out

- The European authorities give a mandate to the European Investment Bank (EIB) to finance, for example, 1000 billion of environmental investments.
- The political authorities add guidelines for the EIB about environmental priorities.
- The EIB issues bonds to obtain the resources necessary to fund these investments.
- This is the moment the ECB can step in by buying the EIB-bonds at a pace dictated by the expiration of the old bonds on its balance sheet.
- This way the ECB creates “green money” without fueling inflation.
- At the same time, as the ECB buys EIB bonds, it creates the possibility for the EIB to increase its borrowing in the capital markets without endangering its AAA-status.

Second objection

- When the ECB buys green EIB bonds to replace maturing government bonds, national governments will face the fact that a higher share of their outstanding bonds will be in the hands of the private sector.
- This means that these governments will have to pay interest on these bonds.
 - As long as government bonds are on the balance sheet of the ECB they carry no interest burden for the government because the interest paid out on these bonds is returned to the government by the ECB.
- This means that green money creation is in fact equivalent to financing green investment by the issue of new national government bonds.
- It would probably be best to use that avenue of financing green investment.
- Unfortunately, this is made impossible by the EU-mandated fiscal compact which forbids the financing of public investment by the issue of debt.
- Thus, the proposed creation of green money can be interpreted as a way to circumvent a self-imposed unintelligent fiscal rule.

How long can the ECB pursue this strategy of creating “green money”?

- That will depend on the question of how long the ECB intends to keep the 3,500 billion of bonds on its balance sheet.
- The latter also depends on the future inflation.
- If inflation were to accelerate a lot, the ECB would be forced to sell part of its stock of government bonds, thereby reducing its capacity to finance green investment.
- I take it, however, that this point is sufficiently far away so that the ECB could add a significant amount of green bonds on its balance sheet without endangering its commitment towards a low inflation.

Conclusion

- Given the existential nature of the degradation of the environment, including climate change,
- priority should be to use the ECB's money creation capacity towards the support of environmental investments.
- This can be done without creating inflation.