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SPP Roundtable Bulletin

THE COVID CRISIS, CENTRAL BANKS AND THE FUTURE[1]

The Covid crisis: support had to be given.
So far, a good news story…..
….but with significant underlying issues….
….leading to several consequential concerns….
….and leading too to concerns about central banks….
….with the major issue of finding an exit strategy from the debt….
….and questions as regards the future for central banks.

1. The Covid crisis: support had to be given.

The pandemic allowed no option but for Governments to spend, for central banks to supply liquidity, and for both to be on massive. The need to address and contain the health impact of Covid, together with the need to sustain economies and keep them standing for an eventual exit demanded nothing less.

Central banks in both emerging and mature economies responded to the 2020 pandemic swiftly and responsibly. Their prompt and proportionate operations in their own money markets, together with the rapid establishment of a network of fx swap lines, buttressed domestic and international liquidity during a global crisis of a scale unseen for more than half a century.

2. So far, a good news story…..

In a sense we are left with a good news story. Economies have suffered hugely: but they are in better shape than if this had not been done. Governments have used the money they have borrowed to alleviate human suffering and to provide life support for the economy. Despite demands for more liquid assets on their balance sheets for regulatory reasons following the financial crisis of 2007-2009, banks have not been constrained by a shortage of liquidity and have been able to meet large and unexpected credit needs to tide businesses and households over a period of great uncertainty.

[1] Synopsis of themes considered at roundtable discussions on 31 May and 1 October 2020. The views expressed do not necessarily reflect those of the participants. Roundtable discussions take place semi-annually. Participants have included Vitor Constancio, Stefan Ingves, Jacques de Larosière, Erkki Liikanen, Donald Kohn, Guillermo Ortiz, His Highness Mohammed Sanusi II, Andrew Sheng, Masaaki Shirakawa, Sir David Walker and Dr Zeti Aziz. The discussions are moderated by Dr Gavin Bingham and Sir Andrew Large.

And central banks have played a key role through supplying liquidity to public and private sectors, in both orthodox and unorthodox ways.

This meant that financial constraints did not hinder efforts to combat the pandemic or alleviate its adverse economic consequences. Their decisions, along with those of other regulatory authorities, to apply flexibly the stronger regulatory standards put in place since the Great Financial Crisis enabled the financial system to respond to those in need for credit.

Developed country central banks had to act to calm markets (enabling governments to borrow) at a time when their traditional policy tools – interest rates – had long been exceptionally low. It is an academic question whether they were at or near the reversal rate, normally in negative territory, where the effects of policy action "invert" so that further lowering of rates depresses economic activity rather than simulating it. In any case, with interest rates near or below zero, the only way that central banks could seek to cope with the impact of the pandemic was to extend massive amounts of credit to banks, governments or the private sector, directly or indirectly.

3. ….but with significant underlying issues….

However, we are left with serious underlying consequences. The low for long environment remains in place in much of the developed world, with distortional impacts on asset prices and risk appetites. These permit borrowers to service higher debt levels and give central banks little choice but to implement monetary policy through quantitative easing (QE) and similar asset purchase programmes. The wealthiest 1% have benefitted from rising asset prices buoyed up by the crisis measures. Despite the fact that many who would have been unemployed have benefitted too and are still in employment, perceptions of rising inequality have encouraged populism. At the same time sovereign debt has risen to post WW2 levels, from which the exit routes are far from clear.

4. ….leading to several consequential concerns….

In turn this leads to several consequential concerns both for emerging and mature economies where experience suggests that when the New Normal arrives - hopefully ushered in by the breakthroughs in vaccine development and delivery - a day of reckoning will occur as we are all tested by a number of unknowns and uncertainties. These include the questions whether

- the debt that has been assumed can be repaid in time and in full;
- economic growth will revive, and to what level;
- interest rates will remain at such low levels;
- inflation will return;
- the perceived increase in the skewness in the distribution of income and wealth will provoke still greater populism;
- the financial system and central banking will be fundamentally altered by the digital revolution; and
- nation states will have the capacity to cope with existential threats such as climate change.

Firstly, will sovereign debt be sustainable?

Public and private debt has risen dramatically both in nominal terms and relative to income and continues to rise. Amongst the G20 countries Japan, Italy and the United States now have public debt ratios of roughly 240, 140 and 120 percent of GDP. While most emerging market economies have lower ratios, many can expect them to rise by 20 percentage points or more in less than a year. . The need to cope with the Covid pandemic is the proximate cause, but other factors too have been significant, including actions to stimulate demand prior to the crisis and the low level of interest rates.

As for sustainability we may not have the answer, but we do know that the level will be time and state dependent. When the New Normal arrives investors may start to worry about how the debt is to be serviced, particularly if sentiment is impacted by higher levels of tax, or the realisation that private debtors are stretched as well. Ultimately, however, the answer will depend on the relationship between economic growth and interest rates. Debt structures also matter: the longer the maturity and lower the rate of the interest, the greater the sustainability of the debt.

Several suggestions have been made in considering debt sustainability.

Firstly, the Japanese experience over the last 20 years suggests to some that sustainability levels may be higher than we think. Against this several features distinguish Japan from other mature economies. On the one hand Japan is a net creditor internationally and much of its public debt is to domestic residents, who may be less inclined than foreigners to seek out other options for their assets. In the background is the fact that any eventual restructuring would essentially be an internal intergenerational issue: social expenditure on e.g., pensions can be - and to some extent is being - adjusted. And on the other debt could be reduced since there is capacity for taxes to be increased: VAT at only 10 % is far lower than in other industrial countries.

Secondly, certainly in the major mature economies, several key ingredients which helped mitigate the debt burden after WW2 – the last time that sovereign debt levels were so high – are absent today. Economic growth was robust after the war, thanks to the high productivity of investment. The latest technologies, some of which had been developed during the war, could then be embodied in the plant and equipment that replaced those that had been destroyed or made obsolete by the shift from military to civilian production. By contrast, underlying growth has been rather weak for the last 10 years or more (at least relative to the 10 years pre-GFC), and productivity growth has been weak despite the dawn of the digital age. Liquidity made available by the official sector at that time could be used for into reconstruction and investment. The suspicion today is that less finds its way into 'productive' uses as more liquidity is retained by traditional banks in line with post GFC regulatory demands.

Thirdly moderate levels of inflation after WW2 helped to reduce the debt, even if it had other less desirable consequences. Today, despite efforts by central banks in particular over recent years, inflation does not appear to be a near time prospect. With worries that when it does come, any rise in interest rates could cut off the growth, and perhaps lead to instability.

5. ….and leading too to concerns about central banks.

Concerns too arise for central banks. They have rightly been praised in the Covid crisis for the swift, well-executed and appropriate liquidity provision learnt from experience in the GFC of 2007-9. However, in the public – and political - mind many see them as part of the problem rather than the solution.

They were once viewed as saviours ("masters of the universe") and rewarded with expanded mandates that they often had not sought. Now however they are in danger of being regarded as the villains. They are accused of failing to meet inflation targets, and some hold them responsible for 'low for long' with its resulting perils.

The actions they have taken are also seen politically as leading to other, less salutary consequences, including the ballooning of asset prices - unrelated to underlying productivity growth - that further skewed the distribution of income and wealth towards the ultra-rich. Despite the positive impact of these measures on employment, their contribution to the increase in the wealth of the one percent seems to have fuelled populism. Populism in turn spawns partisanship that hinders rational discourse and reasonable policies.

The accusations fly. Central banks are said to have failed to instigate growth while engaging in covert monetary financing so that governments can borrow without the discipline of the market.

There are concerns too that they may exercise forbearance when inflationary pressures resume and suggest the need for interest rates to rise. Governments, to which many central banks are now more answerable in today's zero lower-bound world where monetary and fiscal policies are hard to disentangle, will not want them to risk growth, and they may be afraid of instability as asset prices fall. They are in a sort of trap, perhaps made worse because, with such large balance sheets, mark-to-market losses could provide an excuse for greater direct government controls on their activities.

6. …with the major issue of finding an exit strategy from the debt.

A real worry even for major mature economies has to be that the sustainability threshold will one day change. Today's high debt levels are tolerated because there has been no real choice. More normal attitudes to debt can be expected when times become more normal.
Holders of debt instruments will then find values compromised. In turn as indulgence of foreign investors towards emerging markets becomes weaker, pressures would mount on emerging economies with the danger of restructuring and default. And indebted reserve currency countries could also come under strain. These would be all the ingredients of herd behaviours leading towards instability.

The preferable exit path would of course be for debt to be serviced in full and on time as a result of a resumption of environmentally sustainable economic growth. Equally, modest inflation, even if controversial, can help make debt sustainable.

So, what are the prospects for growth?

Growth rates have not responded to monetary accommodation as expected over the past decade or more. Low interest rates have not (and arguably could never have) solved the structural problems. Investment in productive capacity has been restrained by low productivity growth and increasingly mercantilist policies, in both industrial and emerging market economies, in an environment where multilateralism has been trumped by trade war. And fiscal response in the major market economies to help develop the supply side has been anaemic even if, with such low interest rates, it might have been more effective than monetary policy. Such have been the dangers of the calls for austerity, which developed political focus. Growth might occur spontaneously if the much vaunted digital, AI and bio- and nanotech revolutions finally begin to bear fruit in the form of greater productivity, but this at least until now has not happened.

At the same time, demographic shifts have boosted saving and reduced the attractiveness of capital investment. Taken together, these factors can explain low growth and low interest rates and inflation, and why efforts by central banks to alleviate them, first by lowering policy rates and then through asset purchases, have failed.

A number of issues are at play, some of which relate to central banking. Firstly, in efforts to secure solvency of firms through the pandemic, it has been impossible to discriminate in favour of those who will be viable when the new normal appears from those who will be zombies. This drags down innovation whilst adding to debt.

Secondly sustained policy easing maintained over years or decades may, paradoxically, reduce economic growth. Conventional and coordinated monetary policy easing operates by shifting demand into the present by reducing savings and increasing borrowing. There is however a limit on the amount of private demand that can be moved forward. If easy monetary policy is prolonged, it will gradually cease to stimulate demand. Moreover, the need to repay debt and build savings back up will sap demand in the future. The economy could settle into a state of high debt and slow growth similar to the one that Japan has experienced in the last two decades.

What is clear is that such matters should be debated openly and decided upon politically, rather than being left to central banks - essentially technocratic as opposed to political institutions - charged with maintaining price stability and fostering financial stability.

Basically, short of citing the inadequacy of supply reforms, fiscal response and investment in e.g., infrastructure, training and education, it is difficult to say what has held growth back. Some even ask whether whether low for long itself may have discouraged investment by flattening the yield curve and making long-term instruments used to finance productive investment less attractive. The one thing that we can be sure about is that to achieve growth we need innovation. Digital technology has not achieved this so far: but could AI be successful? Will supply side reform take place? Central banks can play a part as thought leaders and facilitators in all these areas: but responsibility for policy in these areas rests with governments.

And what are the prospects for inflation?

The conventional wisdom is that inflation is a long way ahead. But there remain many poor countries with inflation problems, and the demographics of ageing and the movement of China up the food chain may cause inflation sooner than we think in the richer countries as the demand for labour once more outweighs supply. If inflation were to re-emerge unexpectedly, it could help to alleviate the debt burdens. This would put central banks in a quandary. Statutes, modern precepts of central banks and public interest would compel them to take up arms against rising prices, yet they would do so in the knowledge that modest and non-accelerating inflation would help to reduce debt burdens that could give rise to financial instability.

If debt instability does loom, what measures could be taken, not just in vulnerable emerging economies but also mature economies?

Financial repression – which was practiced after WW2 and is still seen in some emerging market economies – could be a way out even though rolling back financial development would be difficult and costly. Exchange controls, limits on interest rates and the types of financial instruments that can be offered as well as restrictions on entry into the financial industry can all be used to deflect the flow of saving into public or other debt. Following World War II this made it possible for governments to remain current on the debt that had accumulated during the war and the reconstruction period. But today the technique would seem to be neither desirable nor likely.

If growth and/ or modest inflation - perhaps assisted by some repression - does not make debt sustainable, default in one of its many guises might then loom, even as regards major economies. In such cases negotiated settlement would almost always be superior to outright repudiation or clandestine expropriation: assisted perhaps by much improved understandings and processes for effective resolution mechanisms. These can allocate losses in a fair and predictable manner without leading to moral hazard that distorts the operation of financial and product markets.

The principles for the resolution of financial institutions in distress developed following the GFC provide a touchstone for negotiated settlements that seek to achieve in a practical way both fairness and future efficiency.[2] In cases where the default takes the form of changing the social contract by adjusting pensions, medical coverage or other social payments, it is fairest to do so at the margin, where the changes are not imposed ex post and apply only to new recipients. Such "grandfathering" is fair and consistent with the need to maintain predictability. However, it works only slowly and, if it is not applied consistently over time, can lead to tension between the young and the old. It is therefore best to start it early.

Sovereign debt restructuring has historically provided governments with a way out once debt becomes unsustainable. Sovereign defaults can take a number of forms that have differential impacts on different creditor classes. Currency reform tends to affect residents when the debt

[2] See: https://www.fsb.org/work-of-the-fsb/policy-development/effective-resolution-regimes-and-policies/key-attributes-of-effective-resolution-regimes-for-financial-institutions/ Accessed 9 November 2020

is dominated in local currency. Debt moratoria and exchanges and reprofiling of debt denominated in foreign currency tend to affect foreign holders. The fact that different approaches affect different creditor classes in different ways is the single greatest obstacle to achieving a negotiated settlement. The pie will be smaller than expected! The key is to achieve a settlement that leads to bigger pies in the future. For example, the suggestion by the US President that the United States should repudiate US government debt held by China would constitute strategic default for political ends. It is unlikely to increase the size of the pie.

Two dangerous approaches which have been suggested for mature economies to handle or wish away debt problems should be avoided. The first of these is extensive *monetary financing* whose proponents suggest might now be appropriate to both the fund the government and generate rising prices. This would contravene an axiomatic precept of central banking of banning monetary financing of the government. The issue is difficult since semantics and fine distinctions can get in the way of the economic realities. Since money is fungible, the distinction between providing credit to the government by granting overdrafts or other loans and buying government securities in the secondary market is nugatory. In both cases, net funding is provided to the government. The first is often barred by legal provisions. The latter is a standard element of open market operations. The former is viewed as monetary financing; the latter is not.

One argument against monetary financing is that it amounts to covert and unlegislated taxation. Indeed, the rationale for giving central banks responsibility for monetary policy is that it reduces the risk that governments will engage in clandestine operations that affect resource allocation and wealth distribution.

Underlying the issue today is the fact that QE has altered the relationship between central bank officials and government mandarins. When central banks engage in QE, central bank asset managers and government debt managers need to confer about what they intend to do. If they come to an agreement - written or unwritten - that the CB will regularly buy government debt in the secondary market, this affects issuance and pricing of government debt. It is tantamount to monetary financing.

Earlier inflation sometimes reduced debt burdens. However apart from failed states such as Zimbabwe and Venezuela, it has not done so in recent decades. This is partly because general levels of inflation have fallen, and partly because it represents a form of covert taxation which is seen to be illegitimate and to have adverse consequences for the efficiency of resource allocation and for income and wealth distribution. Antipathy to these consequences explains why central banks were given monetary policy autonomy. If governments decided to rescind this, it would undermine the credibility of governments and trust in central banks.

The second quagmire to avoid is *Modern Monetary Theory*. This “theory” calls for a central bank to print money for the government so that it can spend, unchecked by market or regulatory disciplines. The basis of this proposition is that sovereign debt does not matter because governments can control inflation by altering taxation.

Its claim is that governments should not be worried about borrowing in their own currencies. If debt cannot be issued, print money. If excess expenditure leads to inflation, increase taxes. This “theory” ignores the fact that hyperinflation and social or political breakdown occur if lenders lose confidence in the ability of the sovereign to repay. Indeed, this happens with depressingly regularity (Argentina, Greece, Venezuela, and now Lebanon). MMT is not "modern": the proposals were first aired more than a century ago. It is not monetary because it is about financing fiscal deficits. And it is not a theory because it is not grounded in analysis of how people actually behave. It is essentially a polemical assertion clothed in academic garb, that governments rather than central banks, should decide on the amount of money that is created.

7. ….and questions as regards the future for central banks.

In turn this leads to the question as to the future of central banks.

The Covid crisis has demonstrated both what central banks can do and what they cannot. The current precepts of central banking, which see their primary function as maintaining price stability and fostering the soundness of the financial system, may well be in question post-Covid. This challenge comes on top of those wrought by disruption through digitalisation and the difficulty of conducting monetary policy when both growth and real interest rates are low for reasons beyond central banks' control.

If inflationary pressures return to more normal levels, monetary policy carried out independently from the political cycle, will be necessary both to ensure credit flows into the economy but also to keep inflation within tolerable bounds.

The essential ingredients of the success of central banks have been their twin capacities for swift action and the ability to take a long-term perspective. No other public institution has similar capabilities for handling rapid and massive interventions at times of danger and crisis. Often crises require rapid responses ahead of any parliamentary process and so depend on modes of operation pre-agreed with government. On the other hand, central banks are almost unique amongst public authorities in their ability to handle long-term financial issues which go beyond electoral cycles.

It was the ability both to act quickly with massive amounts of funds, and to take longer term views that served as the original grounds for the decision to give central banks responsibility for monetary and financial stability. It was based on the conviction that neither price nor financial stability should be sacrificed to narrow, short-term political interests.

The coexistence of very short-term and long-term capabilities lies at the heart of why central banks are unique and important. So, it would be wise, when attempting to overcome today's opprobrium, for them to focus on these two areas, both to ensure that they are well understood, and to able to act effectively in both of the two temporal domains.

So, for central banks there is no silver bullet. To retain their roles in future when they will be sorely needed, they will need to tread familiar but treacherous paths. They should avoid insisting on independence from governments for its own sake. For example, independence of monetary policy is vital. But central banks cannot act independently of government as regards financial stability or crisis handling where the roles of the central bank and the ministry of finance are necessarily intertwined.

They should focus on careful communication policy so as not to raise expectations beyond what they can deliver. They should demonstrate their commitment to the long term: for example, the whole green revolution requires a long-term approach where central banks can play a role. Above all they need to redouble efforts at handling relationships with governments and the public: supporting and helping to facilitate policies that will lead to longer term improvement.

The need for the qualities that only central banks possess will never be greater. Their future will depend on the success they have in being seen as far-sighted thinkers and policy makers, accountable institutions that discharge their policy mandates effectively over time. This is after all what is expected of them. Independent of government, not entirely. Independent within government, probably not. But independent in thought to pursue their mandates, certainly.