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SPP Roundtable Bulletin

LOW FOR LONGER: CENTRAL BANK CHALLENGES IN A COVID WORLD[1].

Introduction

We need no reminding that the Covid pandemic has profoundly affected all areas of economic, social and political activity. This has raised a number of significant issues for central banks. As providers of vital liquidity and in attempting to steer monetary policy in a low-for-long environment, central banks have confronted immense challenges.

In the short-term, the most relevant questions relate to liquidity provision, market functioning and the scope and nature of regulatory forbearance. In the longer term they relate to recovery from the economic effects of the pandemic, the sustainability of the debt that is building up and the question of when, if ever, economic growth, inflation and interest rates will recover to the levels that were earlier considered to be normal.

In many ways the pandemic sharpens issues that central banks have faced for quite some time. The accommodative stance of monetary policy in the mature economies predates the more recent Global Financial Crisis of 2007-2009 [GFC]. That crisis however led to further and deeper accommodation, providing a highly challenging backdrop to the Covid exigencies of today. These include how to conduct monetary policy in a crisis environment where real and nominal interest rates are far below their historical norms, where debt levels are rapidly becoming worryingly high and continuing to rise, and where technological change holds the prospect of radically altering payments arrangements and the financial sector more generally.

The Covid crisis – What's different? What's the same?

When evaluating central bank response to the Covid crisis, the most relevant point of reference is the GFC. Despite obvious similarities, there are important differences. Firstly, unlike its predecessor, the Covid Crisis is truly global; its direct viral effects are being felt in almost all countries and regions, albeit at somewhat different times and to varying degrees.

Secondly, the scale of the Covid crisis will be greater. We do not yet know how long and deep the recession will be, but it is safe to say that it will be deeper than any since the depression of the 1930s.

Thirdly, economically the crisis is different, too. It was not triggered by greed turning to fear or given momentum by the collapse of a house of cards built through financial engineering. Indeed, thanks to the actions taken following the GFC to raise capital standards, increase liquidity requirements, strengthen supervision and put in place arrangements to resolve large and complex financial institutions, the financial system is now stronger and more resilient.

[1] Synopsis of themes discussed at a roundtable discussion on 31 May 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 Paul Tucker, Sir David Walker and Dr Zeti Aziz. The discussions are moderated by Dr Gavin Bingham and Sir Andrew Large.

Fourthly, the Covid crisis, coming at the time of increasing trade tensions, will have a greater impact on the supply side than the GFC. Central banks are more comfortable dealing with shocks to demand or disruptions in the financial system. They leave supply side to markets or governments. Yet because they are able to respond more quickly, Central Banks, generally with Treasury backing, have stepped into the breach to support the flow of credit, which governments hope will limit the longer-term scarring of the supply side of the economy.

Fifthly, the challenges arising from ballooning sovereign debt levels will need to be addressed in very different circumstances from the last time that levels rose so high after WW2. This time growth may well be anaemic. And with interest rates low for longer, moderate inflation cannot be relied on to help to monetise the debt.

What Have Central Banks achieved?

Recognising the existential nature of the Covid crisis for human life, for the vitality of the economy and for the resilience of the financial system, central banks acted swiftly and responsibly, keeping in mind their primary and, especially, their secondary objectives.

Liquidity

In both the Covid and GFC cases, there was a massive increase in the need for liquidity and a serious threat that critical financial markets would seize up. And in both cases central banks acted with alacrity, finely-tuned judgement and well-crafted facilities. Indeed, the relatively recent experience of the GFC provided useful lessons on how best to act, most particularly when providing liquidity to short-term money markets. The Fed's actions to provide FX swap lines to fourteen central banks and the establishment of a temporary repo facility for foreign and international monetary authorities (FIMA) helped to ensure the global dollar funding markets remained liquid.[2]

In addition to ensuring core wholesale short-term money markets remain functional, central banks have provided liquidity to alleviate the hardships of those who have been hit hardest by the crisis. They have done this through multiple channels, some of them quite unconventional. For example they have provided funds to small businesses through banks (e.g. the Fed's Paycheck Protection Program Liquidity Facility). They have provided finance directly to companies by buying commercial paper (eg the Bank of England's Covid Corporate Financing Facility) and corporate bonds. And they have provided temporary short-term credit to governments. In doing so, they have arguably gone beyond their established remits.

Unconventional monetary policy

With interest rates "low for long" at the outbreak of the pandemic, the most significant monetary policy action that central banks have taken is the provision of huge amounts of financing across the maturity spectrum through quantitative easing and its various cousins. The more traditional route of using the policy rate has become fraught with the complexities of dealing with the zero bound, the unknown point at which lower interest rates become contractionary, and the impact on the banking system as deposits find other homes.

[2] The central banks participating in the fx swap arrangements and eligible for FIMA are: the Reserve Bank of Australia, the Banco Central do Brasil, Bank of Canada the Danmarks Nationalbank (Denmark), the European Central Bank, the Bank of Japan, the Bank of Korea, the Banco de Mexico, the Norges Bank (Norway), the Reserve Bank of New Zealand, the Monetary Authority of Singapore, the Swiss National Bank,the Sveriges Riksbank (Sweden) and the Bank of England.

While the specifics of the mechanisms in relation to credit provision differ, they are similar in character to the ones used after the GFC and in the case of Japan for much longer. One consequence is a huge increase in the size of central bank balance sheets.
These actions undoubtedly have positive effects. They have helped to support economic activity. Prices have for the most part remained stable, with neither inflation re-appearing nor deflation becoming endemic. Prior to the pandemic unemployment had been low too, though this was in part because of low productivity growth and a reduction in participation rates.

Appropriateness of central bank actions

So overall central bank actions in the face of the pandemic have been appropriate. Lockdowns were necessary, and people and firms had to be supported with income to survive. This has implied huge budget deficits everywhere. As in war, such exceptional actions were necessary. All the rest was secondary.

Still, the collateral effects and trade-offs need to be understood and managed. Acute crises, especially when they result from an act of nature, do not warrant overwrought concern about moral hazard. But how to deal with the undesirable secondary consequences has to come after the essential policies have been implemented. That time is now upon us.

Challenges

These are significant and it is useful to consider the challenges posed by the pandemic that central bankers and policy makers now face under four rubrics:

1. *Debt.*

The expansion of central bank balance sheets through credit injection raises a number of issues. Firstly significant accommodation of government financing needs by the central bank facilitates the build-up of debt by the sovereign, unfettered by the need to provide a compelling story to financial markets or the public at large. The fact that QE-type activity has now spread from the mature economies to significant emerging economies such as Brazil and Mexico is cause for further discomfort, accompanied as it has been by a reversal from painfully won fiscal discipline.

Of course as long as debt is sustainable, it does not constitute a material threat to financial stability. Central banks focus intently on the question of the sustainability. Their collateralization policies are conservative and they often have government guarantees for their lending. In addition, they deal primarily in secondary markets, thereby acquiring and selling seasoned assets whose prices are set by the interplay of supply and demand. While these arrangements help to ensure the quality of individual items entered into central bank accounts, they do not guarantee that the debt in the aggregate will be sustainable.

Arguments that continued low rates justify the expansion of debt because of low service costs are surely circular and possibly self-serving. It is not only the size of the indebtedness that is of concern. It is also the use to which the funds have been put and the distribution of the debt burdens. Household debt is not evenly distributed, which increases fragility.

2. *Distribution, distortions and disintermediation*

Central banks' unconventional policy actions, and particularly the necessarily selective provision of credit to the private sector, affect differentially the welfare of individuals, companies and entire sectors. Naturally, the same can be said about conventional short-term monetary policy operations. Any change in policy rates affects different sectors in different

ways (e.g. housing, consumer credit vs. corporate credit). However, the effects of conventional monetary policy operations are transient. Phases of easy money are offset by periods of tight money. Any residual impact on income distribution or resource allocation is the by-product of seeking to achieve the widely accepted and legally mandated core objectives of price and financial stability.

Prolonged monetary easing lasting decades implemented through unconventional policy measures is different. Large purchases of long-term public and corporate debt may have a lasting impact on distribution and resource allocation. By seeking to manage the yield curve or providing an unpriced Greenspan put, they risk distorting (or at least affecting) asset prices.

The low and sometimes negative interest rates accompanying QE also add momentum to the process of bank disintermediation potentially leading to instability. Households and companies are tempted to turn to Fintech competitors for increasingly competitive payments services. In turn this squeezes margins, which are already under pressure, and may add to risks within the system. They also prompt search for higher yields, causing people to adjust their risk tolerance, with the potential for unwanted herd behaviour as risk assessment adjusts.

3. *Longer term consequences for the market economy*

Growth rates have not responded to monetary accommodation over the last ten or more years. 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.

When central banks substitute for markets by buying and holding huge amounts of government and other debt rather than making markets by buying and selling, they risk converting the hard budget constraint into a soft budget constraint. Purchases by central banks of government debt tend to lower interest rates in general. When central banks buy and hold corporate debt, their operations reduce risk premia. Both types of action are intended to stimulate economic activity, and firms with sound business plans should find it easier to expand. At the same time, however, firms with poorly conceived or poorly implemented business models (“zombies”) will also find it easier to continue to operate. For this reason purchases by central banks of private debt should be temporary and kept at reasonable levels. So far this seems to have been the case, the ECB has a portfolio of EUR 212 bn corporate bonds in a market of several trillion, and the FED has also kept their purchases and holding of private debt to a low level relative to the stock outstanding.

Sustained policy easing maintained over years or decades may, somewhat paradoxically, reduce economic growth. Conventional monetary policy operates by altering the strength of demand in over time. In periods of easy monetary policy it shifts demand into the present by reducing savings and increasing borrowing. In periods of monetary restraint it works in the opposite manner. 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. Growth in turn will be adversely affected. 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.

There might be positive effects in the form of lower ecological load and greater social harmony, but the decision to opt for stasis over dynamism is profoundly social and political. Such matters should be debated openly and decided upon politically, rather than being the result of actions of a technocratic institution charged with maintaining price stability and fostering financial stability.

Then there is the question whether the large indebtedness could lead central banks to monetize unsupportable burdens and even cause inflation. The fact that QE and its cousins have not led to inflation in industrial countries may be because they have had, initially at least, a greater impact on asset prices than on the prices of goods and services. Ultimately, however, the prices of assets are determined by the discounted present value of the revenue they generate. We cannot exclude the possibility that goods and service prices may surge after some years.

4. Populism and MMT

Not all of the issues above are exclusively or primarily a result of central banks' crisis management actions. However, in the minds of populists and polemicists, central banks may be easy targets given their prominence in recent decades as 'Masters of the Universe', particularly if they are seen to be supporting equity prices and 'bailing out Wall Street', following a decade-long increase in the share of the top 1 % in total wealth.

Populism is inimical to the reasoned discourse of policy action practiced by central banks. And yet changes in the distribution of income and wealth for which they are perceived to have been accomplices can actually lead to it.

The efforts to deal with the pandemic might have been expected to encourage a coming together of its potential victims and to temper populist extremism. Experience has so far been disappointing. Positive signs of coming together within the EU are more than balanced by nationalistic assertion of the nation state and steps to withdraw from the international scene by the US and UK amongst others. Central banks have been spared from the vitriol as the focus has been on Covid. However, once the pandemic is passed, populist attacks on central banks may re-appear.

Modern Monetary Theory provides a cloak of intellectual respectability for such urges and treats debt as a residual rather than a potential determinant of behaviour. But MMT it is not "modern", "monetary" nor a "theory". It is not modern since 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 based on rigorous analysis, e.g. choice-theoretical analysis of the behaviour of economic actors. 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.

Secondary objectives often enshrine the need for central banks to support government policies, usually those for growth and employment, without being specific as to how that is delivered. It would not necessarily need changes in legal mandates to call those secondary objectives into play.

What might lie ahead?

Prior to the pandemic it was difficult enough to see how central banks could attempt to engineer an exit from very easy monetary policies and seek to restore their balance sheets to sizes that correspond to their policy responsibilities. The present crisis clearly puts any question of exit from these policies off into the future. In the meantime vulnerabilities will keep rising.

We have already seen with low-for-long that this had been difficult, as the monetary policy environment elides more closely with the fiscal. The present crisis makes this elision all the greater, and the likelihood of monetary financing or close look-alikes increasingly possible.

Having examined the basics of how central banks have fared, we next intend to review two key subjects: Firstly, the deep uncertainties surrounding the impact of and withdrawal from likely unsustainable sovereign debt, and the danger of potential re-emergence of inflation as a result of massive monetary financing.

And secondly the prospect of a fundamental change in the role and nature of the central banks themselves. There seems to be an inevitable change of their status as they become closer to governments. Will their independence survive? Should it? And if not, will they be agents of government, or independent within it?