Monetary Policies Strategies and the COVID-19 Crisis

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This Policy Brief is offered to the Saudi T20 process, as a recommendation to the G20 in 2020.

The Covid-19 shock caused the postponement of the strategic reviews that major central banks were planning to redraw their policies and move towards a "new normal" incorporating the lessons of their unconventional reactions to the Great Financial Crisis and its appendixes. New exceptional times require new extraordinary measures. The challenge is to design the best monetary policy reactions to the pandemic taking into account the main reasons of the postponed reviews. A strategy in three phases is proposed emphasizing the need of a joint action of monetary, prudential and fiscal policies, the crucial role of international coordination and of the G20.

Challenge

When the Covid-19 crisis hit the world, monetary authorities of the main countries were planning wide ranging reviews of their strategies [1]. The exceptional measures they had adopted to cope with the Great Financial Crisis (GFC) of 2007-8 and its appendixes, including the euro area crisis of 2010-12, needed a careful evaluation, a deeper understanding of their limits and undesired side effects. The idea was to gradually define and implement a "new normal" strategy learning from a decade of unconventional policies.

The Covid shock has precipitated again the world in exceptional times requiring the postponement of efforts towards any "normality" and the adoption of new extraordinary measures. Moreover, while the health aspects of the shock will probably be relatively short lived, its economic consequences are bound to last much longer, requiring monetary authorities to devise a true medium-long term anti-Covid strategy, going beyond one-off special decisions. The virus pushed their policy design from one decade of exceptionality to a new period of necessarily abnormal strategic attitudes.

However, some of the lessons from the past decade can help in shaping the new strategic posture, avoiding past mistakes, minimizing risks of financial instability and facilitating the gradual design of a new normality that hopefully will follow the fixing of the Covid damages. The challenge is therefore to single out a few main points that should inspire the coming monetary policy strategies, taking into account both the experience of the GFC management and the specific needs of coping with the new tremendous shock. Conceptual points must then be translated into practicable proposals that the G20 can help to implement.

Proposal

To make proposals on how the G20 can influence and coordinate the optimization of the coming monetary strategies, we start from Phase 1, the immediate measures required by the shock; we then proceed to synthetically discuss Phase 2, the medium-long term strategy to repair its wounds. We propose ways to obtain that in both phases the anti-virus monetary policies take into account the main reasons to rethink monetary strategies that were under consideration of academics and policy makers before the Covid shock. A schematic list of these reasons is in the Appendix together with some references to relevant data and to the discussions that were flourishing while central banks were starting their strategic reviews. The list is long and comprehensive but our proposal is focused on the points that are highly connected to the problems of the Covid crisis management. Finally, the whole list is briefly reconsidered in sketching the core aspects of Phase 3, the long run strategic review that central banks will have to resume once the Covid crisis ends and the search for a new normal will make sense again.

Phase 1

In Phase 1 the task of monetary policy is to provide liquidity to the economy where a supply shock – the sudden blockage of productions, caused by health precautions and illnesses – also triggers a severe demand shock interrupting cash flows and upsetting the payments system. To contain the deaths of firms and the increase in unemployment, that would be inefficient and unjustifiable in a medium term perspective, the central bank measures must be framed in such a way as to push commercial banks [2] to lend to households and firms where the cash-flow process is disrupted. Besides an appropriate technical framing of the monetary measures, including interest rate incentives for banks, the success of such a vast credit support, which is essential for SMEs, requires immediate coordination with prudential measures and fiscal policy decisions [3]. On the prudential ground the crucial aspect is the treatment of bad loans that will inevitably result: forbearance in classifying the quality of loans could cause lasting damages to transparency while a temporary easing of the relevant capital requirements is inevitable and coherent with their countercyclical role [4]. As for fiscal policy, the government should guarantee a relevant part of the loans making room in its budget for the appropriate amounts. Liquidity is also needed on the open market, where security prices are troubled by a frightening phase of risk-off. Fast central bank purchases of private and public bonds and commercial paper are required to buy time for taming the epidemic and avoid the financial meltdown of the economy. International cooperation in the provision of liquidity is key in this phase and should be carefully stimulated and monitored by the G20: a wide network of swap arrangements [5] centered on the major global currencies should pay special attention to EMEs and LDCs where blockages of global trades, foreign currency denominated debt and sudden capital outflows can cause “the economic devastation arriving before the epidemic itself” . We propose that the G20 promotes the establishment of a multilateral swap line managed by the IMF that could be reached by EMEs and LDCs, or an alternative financing arrangement, dedicated to the Covid-related emergencies. A special new issue of SDR could be a source of financing for this facility.

Insufficient or mistaken action in Phase 1 could trigger serious financial crisis that would transform Phase 2 in a mayhem, with a Lehman-type crisis joining the Covid shock. A key initial difference is that while the Lehman crisis was a banking crisis, the Covid shock has not hurt banks upfront and they have capital and liquidity cushions to utilize further down the road. However, the risk of a disastrous outcome, with the two types of crisis joining forces, is higher if one considers the high indebtedness of the global economy that still remains a decade after the explosion of the GFC , the many fault lines that caused that crisis and are still waiting to be adequately cured , the fact that during the last couple of years geopolitical tensions have increased and the weaker EMEs and LDCs have met with new difficulties generated by the threat of de-globalization and of sudden stops and inversions in international financial flows. The world (and the G20) should be well aware of this avoidable risk and be prepared to act accordingly.

Phase 2

In spite of the measures taken in Phase 1, even if a disastrous financial crisis can be avoided and after the health aspects of the crisis have been substantially scaled down and production and commerce resume, serious wounds will remain in both the real and financial sector of the economy; uncertainty will keep being an obstacle for investment, consumption and growth; unemployment and firms closures will have created mismatches and disorientation in the normal resource allocation process. Phase 2 will then be devoted to cure the wounds and relaunch normal growth. The length of the second phase will most probably be much longer (2-3 years?) than that of the first. Here monetary and fiscal policies must swap their roles: the latter becomes crucial while the former must assist it without pretending to be able to act alone. Central banks must coordinate with fiscal authorities providing technical and quantitative support to the financing of their policies.. Any insistence in relying of monetary expansion to fix the real problems of the system would prove ineffective, unsustainable and dangerous. Among the dangers one should include excessive inflation, a problem that has been gradually forgotten along the last two decades. High inflation could result from the overabundance of money and credit coupled with planned fiscal expansions and with the persistence of the negative supply shocks from Covid as well as with additional supply restraints coming from the disruption of value chains, from trade protectionism and various geo-political frictions that could limit the elasticity of productions. Resuming multilateral economic coordination under the auspices of the G20 is therefore key also in this respect.

The role of fiscal policies in Phase 2 cannot be specified in this paper. It obviously consist both in redistributive measures and in major debt financed public expenditures, transfers and tax reliefs. The quality of fiscal measures and of their implementation is as important as their size. Increases in public debt should in part substitute unsustainable private debts helping firms and households to deleverage and reconstruct the capital stock eaten by the Covid shock and by its consequences. Monetary policy must help the placement of the new public debt, monitor banks' liquidity, keep the general level of interest rates credibly low, neutralize speculative and distortive shapes of their term structure as well as excesses of the spreads between interest rates of different countries and debtors. However, the illusion of super-low interests rates forever must not be nourished, the size of central bank balance sheets must find a limit and excessive flattening of risk premia must be avoided to defend financial markets' efficiency in allocating resources. Eventually, when the end of Phase 2 approaches, expectations must be allowed to gradually incorporate the advent of Phase 3, when a plan of monetary "normalization" will start.

The task of monetary policy in Phase 2 is linked to that of macro and micro prudential measures. The target of both policies is to preserve financial stability and its sustainability in a period of major increases in public debts and speedy restructuring of private firms and finance. Monetary stability becomes a component of financial stability, much more than the usual vice-versa. Macro-prudential tools should not be conceived as emergency means to check exaggerations in the monetary financing of public deficits: they should be actively used to reinforce the otherwise insufficient impact of purely monetary techniques.

International coordination of monetary and prudential policies (as well of fiscal policies!) is also important in this phase. The need to expand public debt will be shared nearly everywhere in the world and financial help to satisfy it must show solidarity to reflect this commonality. Central banks cooperation, promoted by the G20 and monitored by the IMF, should favor stable exchange rates and vigorously combat any sliding into currency wars.

International solidarity is the rational reaction to Covid-19 : the shock, while looking symmetric, it is rather asymmetric as far as its consequences are concerned: the timing of its health and economic wounds can be very different as are the reactions of the different countries and, most importantly, their financial and structural weaknesses when the shock came. Moreover, solidarity is compatible with national interests as in a second round global interdependencies will generate spillovers and spillback of each country's sufferings .

The G20 in Phase 1 and 2

Looking together to Phase 1 and 2 at least three points seem particularly relevant in the agendas of the monetary policy strategic reviews that were under consideration before the Covid shock. First, monetary and prudential policies must act jointly and their main preoccupation must be financial stability. Second, after Phase 2 the degree of indebtedness of the world, which was already very high before the shock, will be significantly increased and will include higher levels of private and public cross border debts. Therefore, financial fragilities will gradually become a dominant theme and plans to reduce leverages in Phase 3 must be timely prepared and preannounced in the framework of an internationally coordinated action. The third point is a generalization of the second: international multilateral cooperation must be very active and creative in most of the policy reactions to the Covid-19 shock: in his respect the general tone of international relations must immediately and quickly change, abandoning the trend towards nationalisms and geo-political zero-sum games and hostilities that has been recently prevailing. Very obviously in each of the three points the role of the G20 is crucial. It is alarming that in fact, relative to the situation in the Lehman crisis where the G20 was elevated to the status of main political and economic forum, the Covid crisis has experienced a retracement to a lower level of international cooperation and the US favouring more visibility for the G7. The G20 should intensify its work and increase its ambitions.

We propose a pragmatic way to start as soon as possible the deepening of the engagement of G20 in Phase 1 and 2 of the battle against Covid-19. Learning by doing will then shape global cooperation in more detail and favor its continuation in Phase 3. Our proposal is coherent with we suggested in past T20 policy briefs .

Our proposal is to adopt a method – also using the Global Monetary Policy Coordination Meetings (GMPCMs) proposed in our T20-2018 brief – similar to the IMF's "multilateral consultations" organized in 2006 to correct global unbalances . The G20 should recommend that the four central banks issuing the major currencies (Fed, ECB, BoJ, PBoC) should jointly agree with the IMF on a selected group of measures specific to the jurisdictions of each of them to be adopted in the short-medium term. The measures should reflect the lines of action suggested above for Phase 1 and 2 of Covid crisis management. Specific moves should also be agreed with the monetary authorities different from the "big 4". The IMF should also care to involve and represent the wider community of EMEs and LDCs. The gist of the agreed measures would be announced to the markets thus anchoring expectations and reassuring on the existence of a coordinating procedure to cope with the Covid-19 crisis. Like in the IMF's "multilateral consultations" of 2006, the "meeting" convened to agree on the starting measures should decide to call other meetings to check and monitor their implementation and reach new sets of decisions.

Phase 3: towards a "new normal"

The process will gradually spillover into Phase 3, where central banks will be in the position to resume their plans for reviewing their strategies in the medium-long run as they were ready to do at the end of 2019. The concept of "normalization" will appear again reasonable and feasible even if a "new normal" will have to be designed taking in to account the problems emerged in the past decade (as summarized in the Appendix). Again, the G20 will be a valuable help to stimulate and coordinate the process.

We propose to stress two main pillars of the "new normal", i. e. the strategy that should prevail at the end of Phase 3. First, coherently with the strategic postures of the previous phases, central banks should go beyond the idea that "monetary policy should focus squarely on inflation and that financial stability is a task better left to prudential regulation" . Financial stability should be explicitly included in monetary policy targets and monetary and prudential policies must be continuously coordinated . The task isn't easy as measuring financial stability is a controversial exercise and financial stability can sometimes require monetary policies that do not favour price stability; moreover, financial stability depends heavily on factors that are far from being controlled by monetary authorities, like fiscal policy; finally, financial stability issues are often heavily politicized and could endanger the independence of monetary policy. However, there are ways to overcome these problems and inflation targeting has also proven to be very difficult as inflation targets have been missed in a systematic way, year after year, by the majority of the central banks. De facto, the attention of many central banks during the last decade has been devoted to prevent financial instability.

We propose that the following IMF post-GFC statement is officially adopted by the G20: "The mandate of monetary policy should include macro-financial stability, not just price stability" . The G20 should then monitor the appropriate implementation of the dual target of monetary policies.

The second pillar of the "new normal" implies the most difficult and important task of Phase 3: the deleveraging of the global economy, burdened with debts in the preceding two phases. Gradual increases in interest rates will have to be targeted by monetary policies while assuring good liquidity conditions for bank lending; prudential regulation should in the meantime increase minimum capital ratios and decrease the maximum unweighted leverage of banks imposing also limits to the leverage of firms that borrow from them. Coherent fiscal measures should be decided to gradually reduce public debt and a long due reform should invert tax incentives of debt versus equity financing. Dangerous, stressing periods during this deleveraging phase should be carefully monitored and assisted by jointly easing liquidity conditions and prudential constraints.

We propose that Phase 3 resorts to GMPCMs to move along the lines of its pillars under the coordination and monitoring of the G20.

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Appendix

Agenda for central banks' strategic reviews (before the Covid-19 crisis)

The following is a schematic list of the problems that, just before the beginning of the Covid-19 crisis, were suggesting to reconsider central bank strategies .

(i) Problems concerning the relationship between money and prices. Price stability has been for long the dominant strategic target of monetary policies. However, expansionary monetary policies preceding 2007, while allowing excessive increases of credit and asset prices, did not result in a self-disciplining inflationary alarm . More recently, efforts to increase inflation by expanding liquidity and lowering interest rates, were largely unsuccessful , weakening central banks' credibility and forward guidance. The impact of money on inflation looks increasingly non-linear and asymmetric, with long variable lags, while globalization, technological changes and frequent supply shocks cause structural changes in the behavior of prices. The same definition of price stability, with the widely adopted target of 2% yearly increase in prices, becomes controversial and enters in different and inconstant ways official and de facto reaction functions of central banks.

(ii) Monetary vs "natural" interest rate. The power of monetary policy to exert a durable impact on the general level of interest rates has been questioned by arguing that the latter was dominated by the relationship between global savings and investments, with the monetary interest rate being a mere follower of its "natural" level . Therefore, the feasibility of a strategy of sustainable "normalization" of interest rates, advocated by some, is denied by many scholars and policy makers.

(iii) Financial globalization. Financial globalization and the emergence of a global financial cycle increases the interdependence of monetary policies and the importance of their spillovers and spillbacks. Therefore, central banks' mandates focused on purely domestic objectives become debatable. The strategic relevance of problems of global monetary coordination grows and requires considering also the participation of EMEs in the governance of the global monetary stance.

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(iv) Undesired effects of unorthodox monetary policies. A "new normal" monetary strategy could admit as orthodox some of the extraordinary measures and tools that followed the GFC . However, a wide set of problems arise with the side effects of these measures, such as the impact of QE on income and wealth distribution, the risk of fiscal dominance and of loss of central bank independence from pressures by securities markets, the flattening of the structure of risk premia that deteriorates resource allocation and market discipline.

(v) Central banks' targets and financial stability. There is growing evidence that monetary and prudential policies have cross effects on their respective main targets: monetary (price) and financial stability. The GFC followed the disregard for financial stability of monetary policies during the Great Moderation which caused credit and asset prices booms. Monetary impacts of prudential policies include the often bewailed restrictive effects of Basel III: authorities are aware of these effects and reacted to the Covid-19 shock relaxing capital ratios in parallel with liquidity injections. An explicit strategic relationship between monetary and [macro]-prudential policies should be considered where the latter cannot be only the remedy (the "Maginot line") to undesired side effects of the former and central banks systematically resort to both policies in the same direction. Considering also points (i) and (ii) one could even conclude that financial stability should become again the dominant target of central banking as for decades until mid-20th century.

[1] Major reviews had been started by the Canadian central bank, the US Fed – see Brainard (2019) – and the Ecb – see ECB (2020) – also involving academic conferences and interaction with the general public.

[2] An example is the US Fed lifting Wells Fargo's asset cap so it can help lend to small business: see Cox (2020), https://www.cnbc.com/2020/04/08/the-fed-is-lifting-wells-fargos-asset-cap-so-it-can-help-lend-to-small-business.html ; as for the ECB see the request to banks not to pay dividends until at least October 2020: https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200327~d4d8f81a53.en.html

[3] An example of coordination is the US Fed announcing several new programs to provide credit to employers, consumers and businesses for up to $300 billion in new financing, using the Exchange Stabilization Fund (ESF), that will supply $30 billion in equity to these facilities: https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm

[4] See the first measures taken along these lines by the US Fed (Financial Times (2020a)) and by the ECB (https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200312~43351ac3ac.en.html).

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