CENTRAL BANKING

A vaccine for the global economy

Olivier Blanchard, Peter Praet and Daniel Alpert discuss shorter- and longer-term actions to tackle the flaws exposed by the Covid-19 crisis

By Victor Mendez-Barreira, Frankfurt

As Covid-19 inflicts the worst hit the global economy has suffered in decades, former policy-makers and senior financiers reflect on the short-term responses, as well as the longer-term transformations, that are needed to reinforce the international monetary system.

Olivier Blanchard, International Monetary Fund chief economist from 2008–2015, Peter Praet, European Central Bank chief economist from 2012–2019, and Daniel Alpert, author and founding managing partner of Westwood Capital, highlight the need for bold monetary and fiscal action to mitigate the immediate impact of the pandemic.

Nonetheless, they also stress repeated bouts of market volatility are exposing an overdependence on the US dollar to fuel the global monetary system, reflected in the sharp appreciation of the greenback over the last two weeks. This reveals a major fault line, which requires the completion of the eurozone capital markets union to reinforce the euro as an alternative to the dollar.

"Firstly, we have some major market disruption, especially in the bond market. What we're finding is an enormously high liquidity preference for hard cash, particularly the US dollar" says Daniel Alpert, author of *The Age of Oversupply: Confronting the Greatest Challenge to the Global Economy.*

Due to the dollar's predominant role in key financial transactions worldwide, and the economic paralysis created by Covid-19, international companies and banks are trying to get hold of as many dollars as possible to honour short- and medium-term costs.

For instance, "when European international banks want to lend somewhere in the world, they basically lend in dollars, but their source of funding is in euros," says Peter Praet. "They usually resort to currency swaps via US money market funds, but as there is dollar scarcity the rates they need to pay for this are sharply rising."

This has forced the Federal Reserve to reinforce dollar liquidity globally through swap lines with the European Central Bank, the Bank of England, the Bank of Japan, the Bank of Canada, and the Swiss National Bank. From March 20, these lines now offer seven-day maturity operations on a daily basis, and they will continue to hold 84-day maturity operations once a week.

On March 19, the Fed extended more limited swaps to a wider range of countries, including Brazil and Mexico.

The need to deploy these tools "shows the euro has to play a bigger role internationally. Because there's too much dependency on the dollar today," adds Praet. He cautions "emerging markets are likely to experience a big shock due to hefty sovereign as well as corporate bond issuance in dollars."

In addition to liquidity shortages, bond price volatility, and dollar appreciation, "there's enormous collateral volatility in the existing repo market," Alpert points out. "As you get to zero nominal rates across the curve, investors have less of an interest buffer to protect their principal."

This is compounded by highly leveraged international participants, whose income is not dollar-based. The sharp dollar appreciation puts pressure on the collateral they are pledging.

Recent actions by the Fed, including the swap lines, and today (March 23), the expansion of quantitative easing to be essentially unlimited, appear to have taken some of the pressure off. The DXY dollar index shows the US dollar reached a peak on March 19 and has since plateaued.

But the tension in US markets reflects how important is for European policy-makers to accelerate their efforts to complete the eurozone, adds Praet. Over the last decade officials have repeatedly highlighted the region needs to develop more liquid capital markets, completing the banking union with a common deposit insurance scheme, and reducing the dependence on banks as the almost sole providers of funding.

Such a framework would also need a common fiscal instrument to co-ordinate counter-cyclical policies across the region, and a shared debt instrument.

"We would be in a better position if we had Eurobonds," says Blanchard, now a senior fellow at the Peterson Institute. "That's fairly obvious, but they are not there, and there isn't time now to launch it to deal with this crisis."

Limits to central banks' actions

Over the last few weeks, central banks have led the response to the economic crisis. In addition to dollar swap lines, the Fed, BoE, BoC, RBA, RBNZ have all cut rates to record lows. Additionally, although the ECB did not cut its policy rate, it joined these institutions creating new lending facilities for banks to support businesses, and launching new asset purchase programmes.

Nonetheless, due to the nature of the crisis, a double hit to both supply and demand, some observers warn monetary policy is only part of the solution.

"I think the Fed response was the right one, I don't think that it makes an enormous amount of difference to cut interest rates in this context. But it is symbolic, it shows that you care, and it cannot do harm," says Blanchard. "It's much more important to provide liquidity to firms that are going to be in trouble because they can't sell or they cannot get the goods and produce. Additionally, liquidity provision to markets that are dysfunctional, will remain very important."

Alpert points out that beyond the obvious limitation that lower rates have to stimulate consumption when most people cannot leave their homes, the Fed's accommodative efforts are hampered by some of the measures introduced after the financial crisis. "One of the difficulties is the Fed paying interest on excess reserves. That's bouncing up against the reduced policy rate, sort of creating a disincentive for banks to lend," he says.

In 2008, the Fed started paying banks interest on their excess reserves. The Fed argues the mechanism allows it to place a floor on the federal funds rate because depository institutions are unlikely to lend at rates below the interest rate on excess reserves. As a result, it can keep "the federal funds rate closer to the FOMC's target rate than it would have been able to otherwise," says a document published by the Federal Reserve Bank of San Francisco.

"I am not advocating that they shouldn't have cut the policy rate," says Alpert. "But I do think that we need to explore whether or not the systemic support provided by interest on excess reserves is actually worth it."

In the eurozone, on March 19 the ECB unveiled the Pandemic Emergency Purchase Programme (PEPP) through which it will buy $750 billion in sovereign and corporate debt this year. This amount will be on top of the €120 billion envelope for 2020 unveiled in the last policy decision on March 12, and the open-ended €20 billion the ECB has purchased per month on average since November 2019. This means the central bank will buy over €1.1 trillion in assets this year.

The governing council also said it was willing to increase this package "by as much as necessary and for as long as needed" in a bid to close the spreads between German bund yields and those of other countries in the eurozone, especially Italy.

"Whatever you can do to basically limit the increase in rates, I think it should be done to support Italy, but the same argument applies for Spain, Portugal or Greece," says Blanchard

Praet considers the ECB action an excellent decision, but he worries it may remove pressure from governments to keep working on a joint fiscal solution. In particular, it could reduce the feeling of urgency around a common debt instrument.

"Europe is not only the ECB," says Praet. "These measures buy time again. But there must be a political decision to put in place a fiscal structural mechanism."

Officials and analysts have discussed for weeks the possibility for eurozone governments to jointly issue a triple-A-rated Covid-19 bond to support enhanced crisis spending. An alternative would be for the European Stability Mechanism to issue these bonds at the lowest possible rates, and transfer the funds received to countries such as Italy without conditionality. This means accessing these resources without policy conditions attached.

These proposals have been traditionally resisted by surplus countries in the eurozone, including Germany and the Netherlands, because their governments are not willing to accept the risk sharing associated with joint government debt.

"I'm still skeptical," says Blanchard. "On the one hand, there's a desire to do it on the part of some countries. But there remains an unwillingness to share risk."

A fiscal response

Apart from the actions of central banks, some observers still think a globally co-ordinated monetary and fiscal action may be necessary. But this should not preclude decisive action at the national level, says Blanchard.

"Co-ordination is useful, but not essential. It seems to me, each country has an incentive to use fiscal policy. And there's not much need for formal co-ordination between fiscal policy and monetary policy, it can help but it's not essential," he says. "It's always good to talk. It's useful to have a sense of what you're going to do. It's useful to have a sense of what measures should be taken on the health front.

"Co-ordination is not essential. It's useful. But the lack of co-ordination cannot be taken as an excuse to do nothing."

Alpert warns about the magnitude of the possible economic impact of the virus on the US economy. "We have now more jobs in eating and drinking establishments in the United States than we do in manufacturing," he says. He estimates over 31 million jobs are currently held in sectors which are now at risk.

Over the short term, Blanchard thinks governments first need to do as much as they can to help the health system. "The main priority is to increase the number of hospital beds, the number of tests. That is a focus for fiscal," he says. "The next step is to take care of firms that are going to be in trouble, providing as much liquidity as possible to limit lay-offs."

Over the medium term, the former IMF chief economist anticipates lower demand. "We're going to see a lot of precautionary saving. In order to address this, we'll need fiscal responses such as a reduction in income taxes. We will see a decrease in demand, which will probably come later, but we have to be ready now."

An epochal shift

In order to adequately respond, Alpert thinks it essential to implement a fiscal policy U-turn in the US and abandon most of the theories underpinning public policy in the country since the 1980s.

"In terms of the relationship between government and the economy, we need to consider the same sort of epochal shift that the US went through in 1932, and again in the 1980," he says. These periods saw radical change, the first being dramatic increases in public spending following the Great Depression, and the second tighter monetary approaches adopted by the Fed to curb higher inflation during the 1970s.

"The notion that government deficits drive capital away from private investment, or create confidence problems, has been proved completely wrong over the last 30–40 years," Alpert adds.

He argues ever lower interest rates in the US reflect the fact that there is no credit risk implied in US government debt. This is partly due to the fact that the US prints the undisputed global reserve currency required to repay that debt.

Nonetheless, he points out the key to understand lower rates in the US, UK, Europe or Japan is the imbalance between a larger global supply of capital and insufficient demand for it.

In his view, this balance has been upended by the emergence of the post-socialist economies, plus China, India and other emerging economies. "This has exacerbated global excess labour, excess production, and excess capital capacity. That can't be put to good use because demand is so much lower than supply," says Alpert. "You've created the perfect storm following this policy of trying to shrink government's role in the economy, while at the same time there has been a build-up in global oversupply."

Additionally, investors lack alternatives. There is an insufficient supply of sovereign risk-free jurisdictions among the currency-printing countries. "You have a handful of countries that print and finance their debt in hard currency," he adds. "So the only determinant of interest cost in those countries is perceptions of inflation. There is no risk premium."

In this environment, regardless of record-low rates, capital inflows into these core jurisdictions persist. "Even at zero to negative rates, [investors] will buy sovereign debt because you know, it's just expensive to store cash."

An infrastructure plan

A way to restore some balance would entail generating much greater demand in the US and across the rest of the Western world. Nonetheless, the most transformational fiscal spending measures such as major infrastructure projects take time bear fruit.

"It's never too soon to start," says Alpert. "The most important form of fiscal spending long term is to fill the order books of domestic manufacturers in heavy industries that are built around conventional infrastructure and green infrastructure. The Chinese are about to ramp up their infrastructure spending enormously."

China enjoys a situation in which it has a currency that is neither freely exchangeable nor convertible, plus the core of its banking system is state-owned. And it can print currency without limits.

"Trying to confront that with an ideology that's totally based around the private sector is ridiculous, you can't even hope to do it," says Alpert.