# Centrality of Central Banks During the Covid Era[1]

## Presentation by William White

I want to thank the Institute for International and European Affairs for the invitation to make this presentation to an Irish audience. I have one grandfather for sure that came to Canada from Cavan, and another great grandfather from Ireland. Sadly, I am not able to say from where exactly. The theme of my short presentation today is also well expressed in an old joke about Ireland.

"A tourist is totally lost in the little lanes of Ireland. He sees an old man in a field and asks him how he can get to Dublin. And the old man replies: "If I were you, I wouldn't start from here". We are where we are, and that is the problem.

I will begin with a few words about the role played by central banks during the pandemic which began last spring. Then, I will go on to evaluate whether that role was appropriate or not. My conclusion is that they had to do what they did, but it has left us with even more severe problems than we had prior to the pandemic. In a nutshell, easy money over many decades has encouraged a succession of credit "boom and busts". This has led to a buildup of debt that is now the elephant in the room: think Ireland in 2008, but now at a global level. And the pandemic has made the debt problem much worse. As I said above, if I were you, I wouldn't start from here.

Finally, I will spend a few minutes on how we might deal with that debt problem on a more permanent basis. Some routes out are less dangerous than others, but there are no magic bullets available. As an aside, I will say a few concluding words about maintaining central bank "independence".

**What did central banks do during the covid crisis?**

As the seriousness of the pandemic became evident in March, including in the US, financial markets panicked and almost ceased functioning. As the real economy started to contract under the influence of the pandemic, credit spreads rose very sharply, equity prices fell, measures of volatility rose and the dollar strengthened.

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These are all classic signs of “Risk Off” when all investors are trying to cover themselves and are retreating into less risky assets. However, this time there was an important exception. In most such periods, the yields on US Treasuries decline as everyone strives to buy the safest asset of all. This time, however, the financial disruption was so great that the US Treasury market also threatened to fall apart. It was like after the failure of Lehman Bros in September 2008, but even worse.

The response of AME central banks, especially in the US, was massive and immediate. Policy rates were lowered still more and central banks announced their intention to intervene in financial markets in various ways to restore their functioning. The Fed announced, with the support of the US Treasury, a whole host of new facilities to provide credit to sustain spending. Moreover, the Fed announced a number of new “swap” agreements that helped foreign central banks to get access to dollars that they could lend to their own nationals that needed dollars to meet their financial commitments.

There were also a number of announcements that this new state of easing would continue for a number of years into the future. Finally, once order had been re-established in the financial markets of AMEs, implying lower interest rates, many central banks in EMEs also announced unconventional programs to ease monetary policy.

What central banks did was judged to be consistent with their two primary objectives, maintaining financial stability and maintaining price stability. That the first was threatened was obvious. However, the threat to price stability was more of a judgement based on the belief that the pandemic would cut aggregate demand more than aggregate supply.

**Was it the right thing for central banks to do?**

In terms of its immediate effects, the answer must surely be yes. Financial markets did stabilize and order was restored. Credit was made available to help support demand in the economy.

Yet, it is significant that what the central banks did in response to the pandemic was just a more extreme version of the policies that they had followed earlier in response to other kinds of threats. There have been successive “booms and busts" since the late 1980's, with each "bust" eliciting a central bank response that encouraged the next "boom". A look at that history makes this clear

In the decades **prior to the Great Financial Contraction** of 2008, interest rates were eased aggressively in the face of whatever shock seemed to threaten: 1987 (Green span "put"), 1990 (property bubbles burst), 1995 (SEA crisis), 1998 (LTCM), 2000 (MMT stocks). Moreover, in the subsequent upturns, rates were never raised as much as they had been lowered earlier. So, by 2008, interest rates had ratcheted down to near zero in many countries.

In and **after the Great Financial Contraction**, the central bank response was essentially "more of the same". However, with so little room to cut policy (short) rates, they embarked on ever more experimental ways to ease monetary policy: forward guidance, Quantitative Easing, negative interest rates on deposits held with central banks etc..

During the **pandemic** the experimentation has continued. Perhaps most important, the central banks have intervened in markets in ways that make it clearer than ever that they consider themselves the "market makers of last resort" rather than just Lenders of Last Resort to financial institutions as had previously been the case. In short, the safety net continues to widen.

Why should we be concerned that the post pandemic policies have essentially been "more of the same"? It is because those earlier policies were already showing some bad attributes before the pandemic, and "more of the same" will only make those problems worse.

1. Increasingly ineffective in stimulating Aggregate Demand
2. Showing many unintended consequences
3. And proving increasingly difficult to reverse (the "exit" problem).

Let us look at each issue separately.

**Some downsides of repeated monetary easing**

Repeated resort to monetary easing leads to it becoming less and less **effective** in stimulating aggregate demand. It works effectively at the beginning by inducing people to spend earlier what they might have spent only later. This is largely done through credit expansion, which involves a buildup of debt. If the money spent is spent on productive investments, the return on those investment covers the cost of interest. However, if the money is spent on consumption or non-productive investments (malinvestments), the burden of debt service (the "headwinds" of debt) slow future spending. That is where we are today.

IIF published a while ago its estimates of global debt ($228 trillion) to GDP in 2020Q1.This rose to 331%. For AMEs was 392% and for EMEs 230%. The increase between 2019Q4 and 2020Q1 was "the largest quarterly surge on record" and has been accelerating since March under the influence of the pandemic.
This is not a new trend. The global debt ratio as of 2020Q1 was 50 percentage points higher than in 2008, with most off the increase occurring in EMEs, especially China (335% of GDP). Looking back further, to the early 1980s (when interest rates began to decline after the Volcker shock) the total debt ratio has increased abut 2 ½ times, while the ratio of government debt has almost tripled. The ratio of government debt to GDP is about at the level it was at the end of WW2.

Moreover, the quality of that debt has also been decreasing: ie the expected losses have been increasing. The quality of corporate debt, as measured by rateing agencies, has been falling for ages and especially over the last decade. Moreover, the pandemic has led to a massive increase in corporate borrowing by companies just above investment grade. Within that debt total, $11 trillion of debt has been issued in dollars by issuers who do not earn dollars.

The "headwinds" of debt are not the only reason to question the effectiveness of easy money in stimulating aggregate demand. If people fear the central bank knows more than they do, might they not just hunker down? If savings cumulate more slowly, might not people save more (not less) to achieve a retirement saving goal? Keynes in the General Theory revealed his concerns when he said: "If we are tempted to assert that money is the drink that activates the system, we had best remember there may be several slips between the cup and the lip".

As for **unintended consequences**, monetary easing might actually increase *financial instability* over time. The immediate effects, like in September 2008 and in March of this year, were clearly to reduce financial instability. Not least, as monetary easing led to capital gains in financial markets, banks' capital increased as did their willingness to make loans. But over time, lower rates mean squeezed margins (Brunnermeier's "reversal interest rate") and then this effect goes in to reverse. Moreover, the same negative effect on earnings hits pension funds and insurance companies even more seriously. When debtors cannot pay, creditor financial institutions go under.

As well as the effect on financial institutions, lower rates affect capital markets more directly. Asset prices get bid up to levels that have little relationship to underlying fundamentals, and lead to crashes: look at US equity prices since the pandemic began. Price discovery disappears and market functioning is impaired: look at "flash crashes" in the last decade or so and the persistence of market "anomalies". Finally, the search for yield (together with the implicit promise of a central bank "put") encourages imprudent behaviour of all sorts: look at the amount of investments in recent years in "Unicorns" that have no profits and no clear prospect for profits (Uber, We Work, Netflix, Tesla etc.).

This leads directly into another unintended consequence, that of *reducing supply potential* over time. Malinvestments do not just threaten financial disorder, when the music stops, but are a drain on future growth. Real resources that might have been used productively are used unproductively. Moreover, it is not just new firms that should never have been born that are a problem. Old firms that are not allowed to die also tie up real resources that might have better used. A lot of research by the OECD, BIS and IMF shows how weak banks in particular make "evergreen loans" that keep such "zombie" companies alive. Since the pandemic struck, the number of corporate insolvencies has plummeted due to (often indiscriminate) government support. Moreover, the amount of funds raised in bond markets, by firms just above investment grade, has been remarkable. In short, easy money may not have been effective in increasing aggregate demand, but it seems ever more effective in reducing aggregate supply.

This leads on to the *"***exit problem***"* or the "debt trap problem". As unserviceable debts and other negative side effects build up, it becomes more obvious that monetary policy should be tightened to prevent these problems from becoming worse. However, given the extent to which these problems have already built up, any tightening would trigger the crisis that the easing was intended to avoid. The result, no tightening and an ever worsening situation.

## Why have central banks done what they have done?

Central banks have econometric models, or at least informal analytical frameworks, that link policy instruments to desired economic results - cause and effect. Unfortunately, these frameworks suffer from a fundamental "ontological" flaw. They assume that the economy is simple and static, and therefore understandable and controllable. In reality, the economy is a complex adaptive system that is neither fully understandable nor controllable. By pursuing, relentlessly, the impeccable logic of an argument which is based on false assumptions, central bankers have been led into making many mistakes.

The most important of these mistakes has been the relentless pursuit of price stability as the primary objective of monetary policy. For over thirty years, some combination of globalisation and demographics has been pushing inflation down. This should have been allowed to happen, as was the case many times in history. Instead, central banks leaned against these trends by successively easing monetary policy with all the undesired results I have just described. The fact that their models generally contained no financial sector, nor credit, nor debt made central bankers blind to anything but the near-term implications of their actions. Even there their competence can be questioned, since most central banks (and also the OECD and IMF) overestimated growth and inflation in the next year for nine years in a row.

Central bank models said the Great Financial Contraction was impossible. They also said, that whatever the shock, the economy would quickly revert to "equilibrium" and full employment. Ten years after the GFC, prior to the pandemic, both of these propositions would seem patently false. Yet ultra easy monetary policy was being pursued up to the eve of the pandemic and now well beyond. We need what Thomas Kuhn once called a "paradigm shift" but this has not happened to date. The closest we have come is the unanimous assertion by central banks that fiscal expansion is also need to support a post pandemic recovery. No central banker has thus far admitted that monetary policy might now be part of the problem rather than part of the solution.

## Where to from here?

Debt is now the elephant in the room. It makes the economy more vulnerable in all states of nature: weak growth lowers debt service capacity while stronger growth raises interest rates and debt service requirements. The academic literature suggests four possible solutions.

First, austerity, to pay down debt. This works for a single household but not for an entire economy. We run at once into the Keynesian “paradox of thrift”. If I spend less, to save more, you have less revenue out of which to save. In the end we are all poorer and debt ratios have actually increased. Think Greece.

Second, increase real growth to gradually reduce debt ratios over time. Unfortunately, this runs into the problem of debt itself, which impedes faster real growth. Moreover, the globalisation and demographic factors that encouraged real growth over the last thirty years are now going into reverse (see Goodhart and Pradhan). Adapting to climate change and global warming will also absorb many resources that might otherwise be used for pro-growth investments.

Third, “financial repression” to inflate the debt away. After WWll, government and central banks colluded to raise inflation while keeping interest rates down. Over a few years, the real burden of the debt had been much reduced. It is doubtful this could or should be repeated. First, against a backdrop of debt-deflation, could central banks actually manage to raise inflation? Second, if this were to be the case, say against growing fears of large government deficits (fiscal dominance) could inflation easily get totally out of control? Think Latin America. Third, would it be possible in the modern world to use capital and administrative controls to keep domestic interest rates down and to prevent capital flight? Finally, since inflation and financial repression would likely hurt the middle class most, both the justice and political viability of this strategy would have to be questioned.

Fourth, explicit debt restructuring to reduce debt to levels that would be serviceable at “normal” interest rates. Restructurings would be voluntarily and designed to maintain (as much as possible) the debtor as a functioning entity. Unfortunately, their remain many impediments to this happening, for private sector non financial debtors, for financial firms (especially those Too large to Fail), and especially for sovereigns. In recent years, the OECD, BIS, IMF and Group of Thirty have all made suggestions as to how those impediments might be removed, not least by improving administrative and judicial procedures for insolvency. All countries should now be reviewing their domestic procedures with urgency. Similarly, intentional procedures urgently require attention.

**Concluding comment**

Central banks have led us down a path that is now being revealed as a dead end. The economic patient had “preconditions”, in the form of excessive debt, that now threaten his recovery and perhaps even his survival. We must deal with the debt problem directly, rather than aggravate it through still further bouts of monetary easing and regulatory forbearance. Needless to say, this will raise profound political difficulties.

Reflections along these lines will also call the “independence” of central banks into question. If they got policy so wrong, can they be trusted in the future? The growing use by central banks of “macroprudential” instruments, entwines their futures ever more closely with financial regulators. Using central bank balance sheets to finance increases in sovereign debt entwines their future ever more closely with governments. Finally, calls for central banks to conduct their policies with a view to “greening” the economy and making it more “inclusive” raises other challenges. Central banking in the future seems likely to be quite different from the past.