T20 SAUDI ARABIA 2020 THINK

POLICY BRIEF

THE ROLE OF MONETARY POLICY IN WORLDWIDE SOLIDARITY IN THE FACE OF COVID-19

Task Force 11

COVID-19: MULTIDISCIPLINARY APPROACHES TO COMPLEX PROBLEMS

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موجز السياسة

دور السياسة النقدية في التضامن العالمي في مواجهة كوفيد-١٩

فريق العمل الحادي عشر

جائحة فيروس كورونا المستجد (كوفيد-١٩): نُهج متعددة التخصصات لمعالجة المشكلات المعقدة

المؤلفون

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ABSTRACT

The COVID-19 pandemic has created an unprecedented symmetric shock worldwide. The main challenge is promptly addressing the reduction in incomes and jobs in order to reduce the short-term losses and to compensate for missing income and growth in the future.

We present three proposals:

1. To establish an exceptional financial instrument, for economies worldwide, which is a special emission of a 1,000 billion special drawing rights distributed to the International Monetary Fund (IMF) member countries. This special emission is aimed at financing the eventual imbalances of the balance of payments of the poor and emerging market countries.
2. A special national issue of bonds is launched and subscribed by the major Central Banks of IMF countries, worth 10% of world gross domestic product (GDP), with a 99-year maturity and 0.01% interest. They are guaranteed by the signature of the Group of Twenty (G20), which shall provide the world and the international financial community the necessary impetus for the required solidarity to face the COVID-19 pandemic.
3. To establish a global coordination mechanism among central banks, aimed at avoiding global spill over problems. The G20 might be a good forum to achieve global coordination among central bank policies.

تسببت جائحة كوفيد-١٩ في صدمة عالمية متساوقة غير متوقّعة. ويكمن التحدي الرئيسي في سرعة معالجة انخفاض الدخول والوظائف من أجل تقليل الخسائر قصيرة المدى وتعويض خسارة الدخل والنمو في المستقبل.

ونقدم ثلاثة مقترحات:

1. تأسيس أداة تمويل استثنائية للاقتصادات على مستوى العالم، تكون مصدرًا خاصًّا لحقوق سحب خاصة بمقدار ١٠٠٠ مليار موزعة على الدول الأعضاء بصندوق النقد الدولي. ويهدف هذا المصدر الخاص إلى تمويل الاختلالات المحتملة لميزان المدفوعات في أسواق البلدان الفقيرة والناشئة.
2. إصدار سندات وطنية خاصة تدشنها وتشارك فيها البنوك المركزية الرئيسية ببلدان صندوق النقد الدولي، بقيمة ١٠% من الناتج المحلي الإجمالي العالمي، واستحقاق لمدة ٩٩ سنة، وفائدة ٠٫٠١%. وتكون مضمونة بتوقيع مجموعة العشرين التي تزود مجتمع التمويل العالمي والدولي بالحوافز الضرورية للتضامن المطلوب لمواجهة جائحة كوفيد-١٩.
3. تأسيس آلية تنسيق عالمية فيما بين البنوك المركزية، تهدف إلى تفادي انتشار المشكلات العالمية. وقد تكون قمة مجموعة العشرين منتدى جيدًا لتحقيق التنسيق العالمي بين سياسات البنوك المركزية.

CHALLENGE

The COVID-19 pandemic has created an unprecedented symmetric shock worldwide, causing a GDP decline and reduction in economic activity more severe than any other short-term fluctuation or crisis ever experienced since the World Wars. The entire world has been shocked with the unprecedented stress on the healthcare system. In many countries, the number of peak treatments for the COVID-19 pandemic at the beginning of the crisis was forecasted to exceed the available number of beds per thousand inhabitants. As a response, emergency construction of last-minute hospitals has been executed in China, Europe, and many other countries.

Governments have responded with administrative measures to limit personal mobility, impairing normal economic activities. Despite the introduction of smart working, not all economic activities can be handled remotely. The consequences of this reduction in productive activities became immediately evident in the reduction of energy demand on the electric grids of major countries (recorded downturn in the order of -20% to -30% worldwide, with peaks up to -50%). Car manufacturers experienced decline in sales of almost 100%, airline traffic was almost completely stopped, and the entertainment industry came to a standstill. Forecast from major institutions indicate a world GDP loss of around 5% in 2020.[1] Long-term responses in different sectors of economic activity are yet to be ascertained, due to the propagation and spiraling effects on business closures and bankruptcies.

The consensus among most economists is that countries should "act fast and do whatever it takes" (Baldwin and Weder di Mauro 2020). The key argument is that while the medical shock is transitory, the economic damage could be persistent. Without a strong response from governments and central banks, many firms might go bankrupt, many jobs may have disappeared when the recession passes, and banks and national balance sheets could be severely impaired.

1. The IMF's World Economic Outlook Update of June 2020 projects Global Growth in 2020 at -4.9%, 1.9 percentage points below the April 2020 World Economic Outlook (WEO) forecast. The OECD Economic Outlook of June 2020 projects the average growth rate of OECD countries to be between -9.3 and -7.5 %.

Most governments worldwide have responded with strategic monetary and fiscal policies. The fiscal space, the institutions and the ability of governments to raise resources, however, are acutely asymmetric across countries. The COVID-19 pandemic is likely to have much harsher effects in developing and emerging market economies. These are not only very vulnerable in terms of public health, but also less resilient to global shocks and shifts in capital flows. The early macroeconomic signs are particularly concerning. Commodity prices have plummeted (World Bank 2020). Emerging market economies have started to experience unprecedented portfolio outflows in terms of both size and speed, large increases in credit spreads, and large depreciations of their currencies (IMF 2020b and 2020c; OECD 2020b and Appendix 2). These are factors that tend to precede financial crises and default waves in emerging market economies (Reinhart and Rogoff 2009).

The liquidity crisis and the related collapse in operator confidence require bold choices on the part of policy makers, especially central banks. The latter, by providing the economic system with all the liquidity necessary in a coordinated action, are able to restore the confidence of financial operators. This generates a rise in stock market prices and reduces interest rate fluctuations on the interbank and credit markets, thus reducing the harmful effects linked to credit rationing.

The main challenge is prompt response to the reduction in incomes and jobs in order to reduce short-term losses and to compensate for missing income. Moreover, it is imperative to immediately compensate those small businesses that are at risk of permanent closures or bankruptcies due to lack of revenue.

We note that, with a few exceptions, this point has been neglected in the major political announcements thus far. They have focused on providing immediate income and launching long-term infrastructure plans and new environmental policies (such as the new Green Deal and the Recovery Fund of EU). These measures will have a medium to long-term effect. However, small businesses engaged in seasonal activities, such as fashion, tourism, holiday sites, and cultural festivals, will suffer a loss for the entire year.

The missing link has two facets: (i) preventing the closure and the bankruptcies of economic activities that have suffered the economic downturn due to the worldwide lockdown, and (ii) preventing poor and emerging countries from suffering income loss due to the slowdown of international trade.

A new positioning of the monetary policy in response to the COVID-19 pandemic is required as an evolution of the shifts in monetary policy paradigms, along the lines depicted in the short historical review in the Appendix. The brief historical review suggests that there is no single cause or policy prescription for a shift in monetary policy priorities. Rather, historical economic challenges faced in different time periods are reflected in dominant central banking paradigms and central bank policies. For instance, an inflation-targeting monetary policy regime was a reaction to the surges in the inflation rates starting from the 1960s. On the contrary, macroprudential measures to ensure financial stability were a reflection of the global financial crisis that exposed the missing link between the macroeconomy and the financial system. Thus, the experience of the COVID-19 pandemic, disruptions in economic activity, slowing of economic growth rates, and surges in unemployment rates and poverty require a re-examination of the inflation-targeting, financial stability oriented central banking paradigm that became prevalent after the global financial crisis.

PROPOSAL

The most effective way to counteract a symmetric shock is to act in a unified and coordinated way from the point of view of both fiscal policy and monetary policy. Hence, the pandemic should be tackled at a supranational level with rapid interventions, endowed with a capacity of resources proportionate to the fall of the GDP, which is projected to collapse by around 5% at the global level (IMF 2020a).

Without immediate intervention, the symmetric shock is at the risk of turning into an asymmetric shock: the shut-down of economic activity puts producing firms at the risk of closure, which will turn very soon into bankruptcies. Once production is abandoned, the goodwill, investment, and the ability to acquire income for workers associated with the companies that close down are lost. This has been the typical recession pattern that we have already experienced during the Great Depression of 1929, with a domino effect for the whole world economy.

Therefore, exceptional and generous measures are needed with a spirit of collaboration and of international cooperation. This calls for the design of exceptional monetary and fiscal stimuli, for all economies worldwide.

It is true that the US and many European economies have launched important plans for domestic support, but there has been a lack of interest and coordination in providing support for the emerging countries at the international level.

The typical economic policy instrument launched and adopted in the industrialized world has been essentially to call for more national (or supranational, as in the EU) debt, to be financed by purchases of the central bank in the secondary market. This is the plan of the US government with the Federal Reserve. This is the plan of the European Monetary Union with the European Central Bank.

This debt is aimed at providing support for national and supranational plans launched by individual governments, US Treasury, and the EU to deal with the emergency, such as liquidity to individual incomes, and support to small and large businesses, airlines and transportation, hospitals and education, and third sector businesses, among others.

The EU has recently discussed supporting national governments' recovery plans with a more structured recovery fund based both on loans and grants to members, according to the conditionality rules usually adopted for the Structural Funds (European Regional Development Fund or ERDF and the European Social Fund or ESF).

We present three proposals:

1. To establish an exceptional financial instrument for all economies worldwide.
The International Monetary Fund (IMF) issues a special emission of a 1,000 billion special drawing rights (SDRs) distributed to IMF member countries based on their shareholding. These instruments should be used to finance the eventual imbalances of the balance of payments of the poor and emerging countries. SDRs represent unconditional liquidity aimed at supplementing existing reserve assets. Thus, they can be funneled by rich recipients to emerging countries to allow them to conduct expansionary monetary policies that can accommodate the secondary market with their anti-cyclical fiscal policies.

The problem is the distribution of SDRs (currently, with the existing rules, two thirds are allocated to advanced economies), which can be handled as follows. According to this proposal, a common political decision—not dissimilar to the EU commitment to the recovery fund—is adopted by the IMF countries to pool this special emission and direct it to poor and emerging countries, flipping the above proportion.

The proposal is to agree that two thirds of the special emission is allocated to emerging economies and one third to advanced economies. This requires a strong political will, but quite a simple procedure, with a favorable vote of 85% of the members. The Group of Twenty (G20) endorsement of this proposal can be conducive to a rapid and successful decision.

In other words, there will be a new worldwide coordinated response to the consequences of the COVID-19 pandemic shock. The political commitment allows, in practice, to establish a grant equivalent to one third of the special emission flowing from the advanced economies to the emerging market countries. This instrument has the advantage of being readily implementable and providing immediate relief to the international payment system. In addition, this instrument will allow for the conduct of the monetary policy in emerging countries along the business cycle in coordination with the fiscal policy. Contrarily, the external constraint arising from international trade and capital movements is dealt with by using resources borrowed from countries with surpluses of balance of payments.

2. The G20 promotes and guarantees political commitment to a special national issue of bonds in the amount of 10% of world GDP. These bonds are launched by the governments. Each country has the right to launch bonds in proportion to its GDP. The bonds are subscribed by the major central banks of IMF countries.

The special bonds are issued either by the national or supranational governments and have a 99-year maturity and 0.01% interest. They are guaranteed by the signature of the G20, which will provide the world and the international financial community the necessary impetus for the required solidarity to face the COVID-19 pandemic.

Governments use the liquidity obtained from the bond emission to finance their recovery process. To ensure that the money is used in the "right" way by the governments, we propose that government plans must be finalized to public investment and formation of public capital and not to current expenditure. A special review by the IMF according to the provisions of Article IV consultations will be conducted. Upon successful completion of this procedure, the central banks of IMF countries are authorized to subscribe to these bonds, according to their share in the IMF. Periodic monitoring by the IMF under the provisions of Article IV consultation should guarantee that the funds received with these special bonds are used by governments according to their commitments. Governments that fail to get the periodic approval by the IMF lose the possibility to issue other tranches of these special bonds.

The maturity of the special bonds impinges on a very delicate intergenerational equity issue. The shorter the maturity of the bonds in facing the COVID-19 crisis, the more the burden on the current generation. The longer the maturity, the higher the burden on future generations. However, in an equitable perspective, if we want to really rescue the world and ensure a better life for future generations, longer maturity is a way of showing a political will to share with future generations the commitment to enhance the prosperity for all.

In this way, monetary policy is accommodative because it is conducted in close coordination with fiscal policy. Policies promoting coordinated monetary actions worldwide are needed, and they are beneficial for global cooperation, peace, and sustainable development. In the past, speaking of international solidarity, in June 1963, the Germans listened to the American President Kennedy say, "I am a Berliner." Now, like Kennedy, how nice it would be to hear all the G20 leaders say today to the poor and deprived citizens of the world, "I am simply human: a citizen of the Earth!"

3. To establish a global coordination mechanism among the central banks.

We propose implementing a global coordination mechanism among central banks, which aims at avoiding global spillover problems. This is a new forum, which is promoted by the G20, to create a new strategy to achieve global coordination among central bank policies. The G20's leading role in this respect would be exemplary with regard to the consensus built around macroprudential and financial stability-oriented measures in the aftermath of the global financial crisis.

As Milton Friedman (1962 and 1892, p.100) emphasized decades ago, experiences, not theory, have shaped the current central banking practices. The COVID-19 pandemic requires re-examining pre-pandemic conceptions of central bank independence and mandates.

First, many countries require central banks to take employment, poverty, and economic growth concerns seriously in addition to inflation-targeting. The Federal Reserve's dual mandate is a good example in this respect.

Second, monetary policy should be executed in coordination with other critical policy areas such as fiscal, trade, and industrial policies. Financial Stability Committees established in many countries as a response to the global financial crisis to ensure financial stability should extend their mandates to take into account poverty, unemployment, and economic activity to ensure economic resilience in the post-COVID-19 era. The coordination mechanism might differ for each country depending on the political system, the organization of the bureaucracy, and the strengths and weaknesses of public organizations. It would be helpful to identify a leading public organization to steer the coordination mechanism, set the agenda, and seek result-oriented deliberations. Only with a united front in policy cohesion can countries tackle the unprecedented challenges posed by the COVID-19 pandemic.

Third, emerging and developing economy challenges for monetary policy might differ from advanced countries in different respects (Yagci 2020). This would require carefully considering the international and domestic political economy dynamics in implementing monetary policies. Fourth, the conduct of monetary policy should comply with transparency and accountability measures in addition to independence. This would ensure that public resources are utilized for the benefit of social welfare, and the credibility and effectiveness of central banks would be strengthened.

According to this proposal, the new forum can stem from the Financial Stability Board, which can take an active role by expanding its mandate beyond financial stability concerns to tackle poverty, unemployment, and economic growth at a global scale. Within this Forum central banks can also work toward addressing global challenges such as climate change, rising inequality, and digital technologies (currencies) in a coordinated manner, and the G20 can act as a platform for addressing these concerns.

In conclusion, policies promoting coordinated monetary actions worldwide are needed and would be beneficial for global cooperation, peace, and sustainable development.

A reference to this in the final communique will indicate that the G20 is capable of addressing the issues of human life protection and market stability worldwide with solidarity and effectiveness.

Disclaimer

This policy brief was developed and written by the authors and has undergone a peer review process. The views and opinions expressed in this policy brief are those of the authors and do not necessarily reflect the official policy or position of the authors' organizations or the T20 Secretariat.

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APPENDIX

#1

Historical challenges have paved the way for central banks to assume different responsibilities in different time periods. Thus, the COVID-19 pandemic with disruptions in economic activity, slowing down of economic growth rates, and surging unemployment and poverty rates poses an opportunity to rethink central bank priorities. This appendix offers a short review of the shifts in central banking paradigms to illustrate historical critical junctures in monetary policy conduct and to posit that we are in the midst of another critical juncture to reposition central banking.

Major events have shaped the current monetary policy paradigm. For instance, until recently, the Great Depression left a substantial mark on the monetary policy conduct. Before and during the Great Depression, the Real Bills doctrine was the most prominent central banking doctrine that advocated that monetary policy should only aim to provide sufficient credit for trade. As a result, during economic expansion periods, money stock and credit increased, whereas during recessions they declined (Meltzer 1976, p. 455).

In their popular work, Friedman and Schwartz (2008) argued that the Federal Reserve's dependence on the Real Bills doctrine during the Great Depression turned a financial crisis into a depression. Specifically, the Federal Reserve allowed the stock of money in the economy to decline and did not supply liquidity to the financial markets. Friedman and Schwartz's (2008) explanation of the reasons behind the Great Depression was influential in the adoption of unconventional measures in the aftermath of the global financial crisis (Bernanke 2002).

Following the rebuilding of economies after World War 2, starting from the 1960s the world economy witnessed a surge of inflation rates in many countries. One of the key thinkers of the monetarist central banking paradigm, Milton Friedman proposed that only effective monetary policy could tackle the surges in inflation rates and his famous dictum summarized his argument: "inflation is always and everywhere a monetary phenomenon" (Friedman 1996, p. 11). This proposition and the diffusion of neoliberal ideas starting from the 1970s influenced central banking practices, and the monetarist premise that "the long-run objective of monetary policy must be price stability" was increasingly accepted worldwide (Friedman 1982, p. 100). This general agreement on the monetary policy strategy emerged as a result of experiences rather than theoretical developments as suggested by Friedman himself (1982, p. 100). The central bank independence norm with a single mandate of inflation-targeting for many central banks diffused around the world with this background.

In the aftermath of the global financial crisis, the macroprudential turn with the prioritization of the financial stability objective in addition to price stability became accepted by many central banks (Baker 2013; Galati and Moessner 2013). Unconventional monetary policy measures, such as reducing interest rates to zero or below zero levels and engaging in quantitative easing in advanced countries, increased the fundamental role central banks played in national economies (Borio and Disyatat 2010; Borio and Zabai 2016).

As a response to the COVID-19 pandemic, national economies need to adopt monetary policy measures in coordination with other policy areas such as fiscal, trade, and industrial policies to address rising unemployment, poverty, and declining economic activity. Of particular note is that in addition to the coordination challenges, the political economy context within which countries are embedded will be critical in shaping the monetary policy responses to the adverse impact of the COVID-19 pandemic.

Thus, central banks should pay increased attention to the global and domestic political economy context to devise their policies. The COVID-19 pandemic, as a critical juncture, offers an opportunity to reposition central banking for the benefit of maximum social welfare and, in this respect, it is exemplary of historical shifts in central banking.

#2

This Appendix reproduces a few figures that show the dynamics of selected macroeconomic variables in emerging market economies. Figure 1 shows that the COVID-19 pandemic caused widespread declines in commodity prices in February and March 2020. Figure 2 documents the massive portfolio outflows experienced by many emerging market economies. Figure 3 shows the sharp currency depreciations experienced by most emerging market economies. See also, for example, World Bank (2020) and OECD (2020b) for additional data and information.

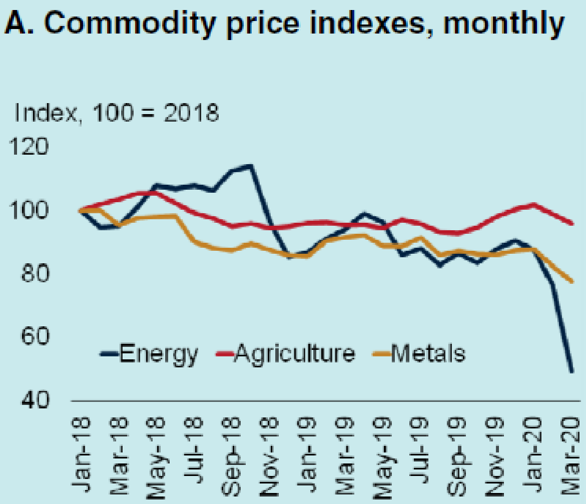

Figure 1: **Commodity Market Developments**

Source: **Reproduced from World Bank 2020, "Commodity Markets Outlook, April", p.2**

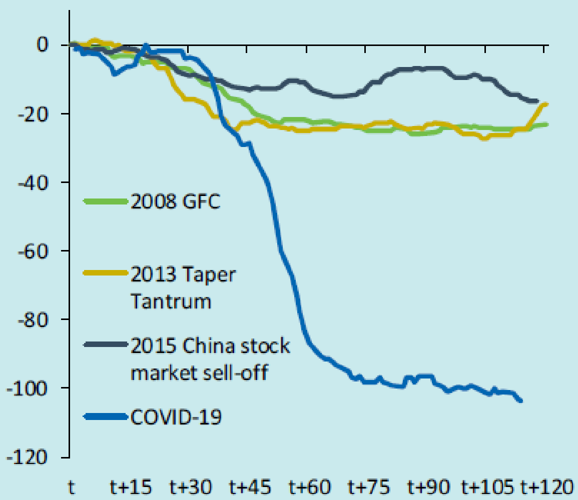

Figure 2: **Emerging Market Portfolio Outfl ws during the COVID-19 Crisis Versus Past Episodes**

Source: **Reproduced from OECD 2020b, "COVID-19 and Global Capital Flows", p. 4**

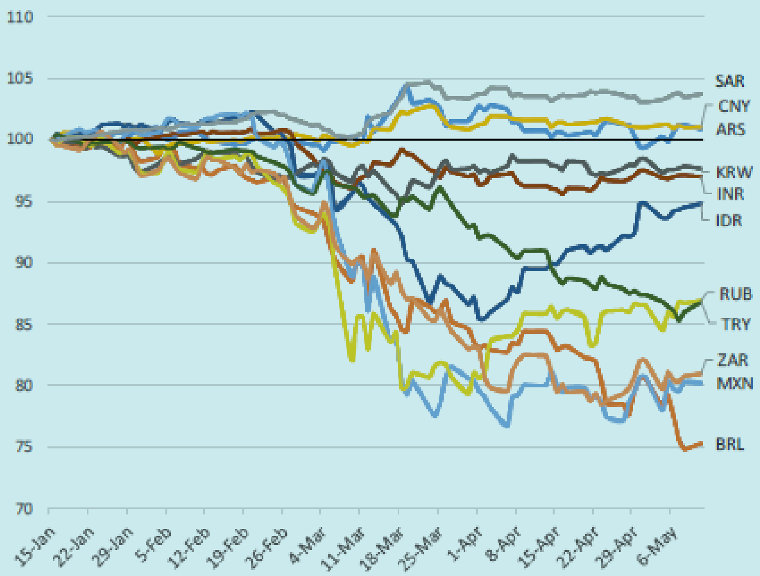

Figure 3: **Currency Depreciations in Emerging Market Economies**

Source: **Reproduced from OECD 2020b, “COVID-19 and Global Capital Flows”, p. 4**

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