T20 SAUDI ARABIA 2020
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POLICY BRIEF

MONETARY POLICIES, STRATEGIES, AND THE COVID-19 CRISIS

Task Force 8

INTERNATIONAL FINANCIAL ARCHITECTURE

Authors

FRANCO BRUNI, JOSÉ SIABA SERRATE

موجز السياسة

استراتيجيات السياسة النقدية وأزمة كوفيد-١٩

فريق العمل الثامن

الهيكل المالي العالمي

المؤلفون

فرانكو بروني، خوسيه سيابا سيرات

ABSTRACT

The COVID-19 pandemic has caused the postponement of the strategic reviews that major central banks were planning to use to redraw their policies and move toward a “new normal” that incorporated the lessons of their unconventional reactions to the Great Financial Crisis. Subsequently, these new exceptional times require new extraordinary measures. The current challenge is to design the best monetary policy reactions to the pandemic that consider the main reasons for the postponed reviews. A three-phase strategy is proposed that emphasizes monetary, prudential, and fiscal policies, and the crucial role of international coordination and the Group of Twenty (G20).

تسـببت جائحـة كوفيـد- ١٩ فـي تأجيـل المراجعـات الاسـتراتيجية التـي كانـت البنـوك المركزيـة الرئيسـية قـد خططـت لاسـتخدامها مـن أجـل إعـادة رسـم سياسـاتها والانتقـال إلـى "طبيعـة جديـدة" تدمـج الـدروس المسـتفادة مـن تفاعلاتهـا غيـر التقليديـة مـع الأزمـة الماليـة الكبـرى؛ ومـن ثـم فـإن هـذه الأوقـات الاسـتثنائية الجديـدة تسـتلزم تدابيـر اسـتثنائية جديـدة. ويتمثّـل التحـدي الحالي فـي تصميـم أفضـل سياسـات تفاعليـة نقديـة مـع الجائحـة بمـا يراعـي الأسـباب الرئيسـية للمراجعـات المؤجلـة. والمُقتـرح اسـتراتيجية مـن ثـلاث مراحـل تُبـرز السياسـات النقديـة والتحوطيـة والماليـة، والـدور الحيـوي للتنسـيق الدولـي ومجموعـة العشـرين.

CHALLENGE

When the COVID-19 crisis hit the world, the main global monetary authorities were planning wide-ranging reviews of their strategies.[1] The exceptional measures they had adopted to cope with the Great Financial Crisis (GFC) of 2007–08 and its appendixes, including the euro area crisis of 2010–12, needed a careful evaluation and 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-19 financial shock has once again precipitated exceptional times, requiring the postponement of efforts toward 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. Monetary authorities need to devise a true medium-long term anti-COVID-19 strategy that goes beyond one-off special decisions. The pandemic has pushed monetary 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 shape the new strategic posture, avoid past mistakes, minimize the risks of financial instability, and facilitate the gradual design of a new normality that hopefully will come when the financial damage from COVID-19 is being repaired. The challenge is, therefore, to determine how to inspire future monetary policy strategies, taking into account both the experience of the GFC[2] management and the specific needs of coping with the financial shocks from the COVID-19 pandemic. In this way, conceptual points must be translated into practicable proposals that the Group of Twenty (G20) can help to implement.

1. Major reviews had been initiated by the Canadian central bank, the US Fed (see Brainard 2019), and the ECB (see ECB 2020a); they all involve academic conferences and interaction with the general public.
2. For a comparison between the GFC and the COVID-19 crisis, see, for instance, Breitenfellner and Ramskogler (2020).

PROPOSAL

To develop 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 for monetary policies in both phases to take into account the main reasons to rethink the monetary strategies that were under consideration by academics and policymakers before COVID-19. A schematic list of these reasons is included in the Appendix, together with references to relevant data and the discussions that were flourishing as central banks were beginning their strategic reviews. The list is comprehensive, and our proposal is focused on the points that are highly connected to the problems of COVID-19 crisis management. Finally, the list is briefly reconsidered as part of the core aspects of Phase 3, which is the long-run strategic review that central banks will have to resume once the COVID-19 crisis ends.

Phase 1

In Phase 1, the task of monetary policy is to provide liquidity to the economy where a supply shock, which in the case of COVID-19 was the sudden production problems caused by the pandemic, also causes a severe demand shock that interrupts cash flows and upsets the payments system. To contain bankruptcies and increases in unemployment that are inefficient and unjustifiable in a medium-term perspective, the central bank measures must be framed in such a way as to push commercial banks to lend to households and firms[3] when the cash-flow process is disrupted. In addition to an appropriate technical framing of the monetary measures, such as interest rate incentives for banks, the success of such vast credit support, which is essential for small and medium-sized enterprises, requires immediate coordination with prudential measures and fiscal policy decisions.[4] For prudential reasons, the treatment of bad loans that will inevitably result is crucial: 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.[5]

3. An example is the US Fed lifting Wells Fargo's asset cap so it can help lend to small businesses. See Cox (2020). For the ECB, see the request for banks not to pay dividends until at least October 2020 (ECB 2020c).
4. 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), which will supply $30 billion in equity to these facilities.
5. See the first measures taken along these lines by the US Fed (Financial Times 2020a) and by the ECB (2020b).

For fiscal policy, the government should guarantee a relevant part of the loans making room in its budget for the appropriate amounts (Baudino 2020). Liquidity is also necessary on the open market, where security prices are troubled by a risk-off phase.[6] Fast central bank purchases of private and public bonds and commercial paper are required to buy time and avoid the financial meltdown of the global 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[7] centered on the major global currencies should pay special attention to Emerging Economies (EMEs) and Less Developed Countries (LDCs), where blockages of global trades, foreign currency-denominated debt, and sudden capital outflows can cause "the economic devastation arriving before the epidemic itself"(Financial Times (2020b); see also, Okonjo-Iweala et al. 2020; Daly, Grafe, and Gedminas 2020). We propose that the G20 promotes the establishment of a multilateral swap line dedicated to the COVID-19-related emergencies, managed by the International Monetary Fund (IMF) that could be accessed by EMEs and LDCs, or an equivalent financing arrangement. A special new issue of SDRs[8] could be a source of financing for this facility.

Insufficient or mistaken action in Phase 1 could cause a serious financial crisis that would transform Phase 2 and could result in a Lehman-type crisis in addition to the COVID-19 pandemic. A key initial difference is that while the Lehman crisis was a banking crisis, the financial problems from the COVID-19 pandemic have 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 remains a decade after the GFC (Tanzi 2020); the many fault lines (Rajan 2010) that caused that crisis that are still waiting to be adequately cured;[9] the fact that geopolitical tensions have increased during the last few years; the weaker EMEs and LDCs have met with new difficulties generated by the threat of de-globalization; and the 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.

6. Risk-on risk-off is an investment paradigm, framed in a behavioral economics analysis, under which asset prices are dictated by changes in investors' risk tolerance. In risk-off situations, investors become more risk-averse and sell assets, sending their prices lower as they tend to maximize the liquidity of their portfolios. See, for example, Hayes (2020).
7. The Fed has established dollar swap lines with 15 central banks in the EU, Canada, the United Kingdom, Swiss National Bank, Japan, Australia, Brazil, South Korea, Mexico, Singapore, Sweden, Denmark, Norway, and New Zealand (as of end March 2020).
8. Special Drawing Rights. See, for example, IMF (2020).
9. "The question that regulators and central bankers are asking themselves now is whether the measures they took in recent years to crisis-proof the banking system will be enough to prevent a credit crunch, bank failures, and a financial meltdown with global ramifications" (Ewing 2020).

Phase 2

Despite 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 problems will remain in both the real and financial sectors of the economy. Uncertainty will remain an obstacle for investment, consumption, and growth, and unemployment and bankruptcies will have created mismatches and disorientation in the normal resource allocation process. Phase 2 will then be devoted to solving these problems and relaunching 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 without pretending to be able to act alone. Central banks must coordinate with fiscal authorities and provide technical and quantitative support for the financing of their policies. Any insistence in relying on monetary expansion to fix the real problems of the system would prove ineffective, unsustainable, and dangerous.

The dangers include excessive inflation, a problem that has been gradually forgotten over the last two decades. High inflation could result from the overabundance of money and credit accelerated by the adoption of some form of "helicopter money."[10] Price levels increases could start accelerating following continuous monetary expansion coupled with planned fiscal expansions and with the persistence of the negative supply shocks from COVID-19 as well as with additional supply restraints coming from the disruption of value chains, from trade protectionism, and various geopolitical frictions that could limit the elasticity of production. Resuming multilateral economic coordination under the auspices of the G20 is, therefore, vital in this respect.

The role of fiscal policies in Phase 2 cannot be specified in this paper. They consist of redistributive measures and major debt-financed public expenditures, as well as transfers and tax reliefs. The quality of fiscal measures and their implementation is as important as their size. Increases in public debt should, in part, substitute unsustainable private debt (Draghi 2020),[11] helping firms and households to deleverage and reconstruct the capital stock losses from the COVID-19 pandemic and its consequences. Monetary policy must help the placement of new public debt, monitor banks' liquidity, retain credibly low interest rates, neutralize speculative and distortive shapes of their term structure, and reduce the excesses of the spread between the interest rates

10. Blanchard and Pisani-Ferry (2020) see no reason to panic forecast inflation and monetization. They also discuss the definition of "helicopter money," which was proposed and analyzed by Galì (2020).
11. "Much higher public debt levels will become a permanent feature of our economies and will be accompanied by private debt cancellation" (Draghi 2020).

of different countries and debtors. However, the illusion of super-low interest rates in the long-term 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 begin.

The task of monetary policy in Phase 2 is linked to 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 debt and the effective restructuring of private firms and finance. Monetary stability becomes a component of financial stability, much more than the usual vice-versa. Macro-prudential tools[12] should not be conceived as an emergency means to check exaggerations in the monetary financing of public deficits. Instead, they should be actively used to reinforce the otherwise insufficient impact of purely monetary techniques.

International coordination of monetary and prudential policies (as well as fiscal policies) is also important in this phase. The need to expand public debt will be shared nearly everywhere in the world, and financial assistance must reflect this commonality.

Moreover, the global monitoring of the soundness and transparency of financial transactions should be intensified in a period of tumultuous financial activity, and compliance with international financial standards should be strictly checked. Among the numerous important requirements, it is worth stressing the careful identification of the legal entities that engage in financial transactions (including the issuance of government bonds) through GLEIF.[13] Central bank cooperation, promoted by the G20 and monitored by the IMF, should favor stable exchange rates[14] and vigorously combat any sliding into currency wars.

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12. For a definition, see IMF (n.d.).
13. The Global Legal Entity Identifier Foundation, tasked in 2014 by the Financial Stability Board (FSB) to support the implementation and use of the Legal Entity Identifier (LEI), was endorsed by the G20 in 2012. Several FSB countries are still not fully complying with LEI as issuers of government bonds. See: https://www.gleif.org/en/about/this-is-gleif, https://www.leiroc.org, FSB (2019), and https://www.anna-web.org/anna.
14. Quick activation of dollar swap lines by the US Fed is proof that dollar nominal stability was a tacit goal agreed by central banks. International portfolios have a well-known dollar mismatch (a net short position) that would have been exacerbated by turbulence and increased risk aversion putting upside pressure on the dollar nominal exchange rate. In the two weeks to April 1st, swaps worth $326 billion were created, and no significant dollar appreciation was observed (Federal Reserve n.d.).

International solidarity is the rational reaction to COVID-19: the financial shock, while looking symmetric, is instead 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 at the time of the financial shock. Moreover, solidarity is compatible with the national interest, as a second-round of global interdependencies will generate spillovers and spillback of each country's financial problems (see Kohlscheen, Mojon, and Rees 2020).

The G20 in Phases 1 and 2

Looking together at Phase 1 and 2, at least three points seem particularly relevant to the monetary policy strategic reviews that were under consideration before the COVID-19 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 and rising before the shock, will be significantly increased and will include higher levels of private and public cross border debt.[15] 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 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 financial shock. In this respect, the general tone of international relations must immediately and quickly change to abandon the trend toward nationalism and geopolitical zero-sum games and hostilities that had been recently prevailing. In each of the three phases, the role of the G20 is crucial. It is alarming that relative to the Lehman crisis, where the G20 became the main political and economic forum, the COVID-19 crisis has led to a lower level of international cooperation. The US has favored more visibility for the G7. The G20 should intensify its work and increase its ambitions.

We propose a pragmatic way to start the deepening of the engagement of G20 in Phase 1 and 2 as soon as possible. Learning by doing will then shape global cooperation in more detail and favor its continuation in Phase 3. Our proposal is coherent with the suggestions in past T20 policy briefs (see Bruni, Serrate, and Villafranca 2019; Bruni and Lopez 2019).

15. Recent data and forecasts on global debt by country, region, and sector are exposed in Tiftik et al. (2020).

We propose 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 (see Bruni and Lopez 2019, 5–6). The G20 should recommend that the four central banks issuing the major currencies (the Fed, ECB, BoJ, and PBoC) should jointly agree with the IMF on a selected group of measures specific to their jurisdictions to be adopted in the short-medium term. The measures should reflect the lines of action suggested above for Phase 1 and 2 of the COVID-19 crisis management. Specific action should also be in agreement with monetary authorities other than the "big 4." The IMF should also be involved 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 providing assurance from the existence of a coordinating procedure to cope with the COVID-19 crisis. Like in the IMF's "multilateral consultations" in 2006, the "meeting" convened to agree on the starting measures should determine other meetings to verify and monitor their implementation and reach new decisions.

Phase 3: Toward 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 again appear reasonable and feasible, even if a "new normal" will have to be designed to take into account the problems that emerged in the past decade (as summarized in the Appendix). Again, the G20 will be valuable in stimulating and coordinating the process.

We propose to stress two main pillars of the "new normal," that is, the strategy that should prevail at the end of Phase 3. First, together 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" (IMF 2009, 2). Financial stability should be explicitly included in monetary policy targets, and monetary and prudential policies must be continuously coordinated.[16] The tasks are not easy, as measuring financial stability is a controversial exercise, and financial stability can sometimes require monetary policies that do

16. "Price and financial stability are closely related. They are fundamental properties of a smoothly functioning monetary system. They are both ways of safeguarding the value of money, by protecting against default, erosion of purchasing power, or a dysfunctional payments system. Accordingly, central banks have always been key players in safeguarding stability. This was true under the gold standard, when they were the guardians of convertibility. It has been even more so in recent times." Borio (2019, 11).

not favor price stability.[17] Moreover, financial stability depends heavily on factors that are far from being controlled by monetary authorities, such as 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 systematically, 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 preventing financial instability.

We propose that the G20 officially adopts the following IMF post-GFC statement: "The mandate of monetary policy should include macro-financial stability, not just price stability."[18] 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 while also imposing limits to the leverage of firms that borrow from them. Coherent fiscal measures should be determined to reduce public debt gradually and long overdue reform should invert tax incentives of debt versus equity financing. Measures should also be enacted to correct the enormous unbalances in income and wealth distribution that are among the causes of the increase in macroeconomic debt.[19] 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.

17. For example, when providing extra liquidity to defend the stability of the banking system during a period of inflationary pressures that would exclude monetary expansion.
18. IMF (2009, 1). The statement continues: "To the extent that the build-up of systemic risk can portend a sharp economic downturn, and to the extent that regulation cannot fully prevent such a build-up, it is now clear that policymakers cannot neglect asset-price and credit booms. That said, prudential measures provide a more targeted and less costly policy solution than interest rate changes and should be a central element of an integrated policy response".
19. Wolf (2020) examines the increase in global debt and the data on global debt and proposes some corrective measures.

Disclaimer

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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, suggested that central bank strategies needed to be reconsidered.[20]

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 (Taylor 2009). More recently, efforts to increase inflation by expanding liquidity and lowering interest rates, were largely unsuccessful (see IMF 2018), weakening central banks' credibility and forward guidance. The impact of money on inflation looks increasingly non-linear and asymmetric, with long variable lags. Furthermore, 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 a 2% yearly increase in prices, becomes controversial and causes different and inconstant official and de facto reactionary measures by central banks.

ii. Monetary vs. "natural" interest rates. The power of monetary policy to exert a durable impact on the general level of interest rates has been questioned as the latter has been dominated by the relationship between global savings and investments, with the monetary interest rate being a mere follower of its "natural" level.[21] Therefore, the feasibility of a strategy of a sustainable "normalization" of interest rates, advocated by some, is denied by many scholars and policymakers.

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 focusing on purely domestic objectives become debatable. The strategic relevance of problems of global monetary coordination grows and requires the participation of EMEs in the governance of the global monetary stance.

20. The vision behind this list is coherent with part of the agendas for discussion as planned by major central banks at the end of 2019 and with the policy briefs contributed by the authors to the T20 2018 and 2019 (see footnote 21 above).
21. Borio, Disyatat, and Rungcharoenkitku (2019) argue against this view and cite the relevant literature.

iv. Undesired effects of unorthodox monetary policies. A “new normal” monetary strategy could include some of the extraordinary measures and tools that followed the GFC (see Committee on the Global Financial System 2019). However, a wide set of problems arise with the side effects of these measures, such as the impact of quantitative easing on income and wealth distribution, the risk of fiscal dominance and the loss of central bank independence[22] 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 the 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 by 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” (Papadia 2018)] to undesired side effects of the former and central banks systematically resort to both policies in the same direction. By considering points (i) and (ii), one could even conclude that financial stability should become the dominant target of central banking, similar to the decades before the mid-20th century.

22. See Borio (2019) and the vast literature cited in the paper.

AUTHORS

Franco Bruni
Italian Institute for International Political Studies

José Siaba Serrate
Argentine Council for International Relations