Maintaining sound money amid and after the pandemic

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Introduction

I would like to thank the Progress Foundation for inviting me to the 50th Economic Conference. It's a great honour to be here today at this round anniversary. Let me mention that we too are marking a round anniversary this year, the BIS's 90th, and we are grateful to the Swiss community for all the support you have given us over the years. The BIS has evolved over time to become a hub for central banks, with the overall goal of promoting global monetary and financial stability. Put differently, we aim to promote sound money worldwide. As the title of the conference suggests, sound money is a noble goal under constant fire and it is a continuous challenge for central banks to defend it.

For a long time, bringing inflation down and keeping it from rising was the main challenge faced by central banks. More recently, however, a new challenge has emerged: fighting persistently low inflation and economic stagnation in a low interest rate environment. The Covid-19 shock has massively compounded this challenge.

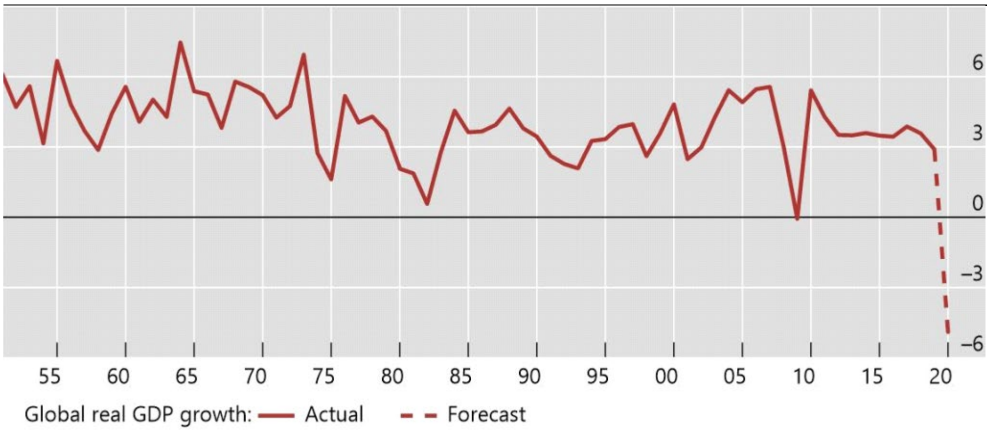
Central banks' response to the pandemic

The pandemic has been a threefold shock: a public health crisis, an economic sudden stop and, initially, a short-lived but acute financial crisis. The consequence is, according to current forecasts, the most severe global economic downturn on record, at least since World War II (Graph 1). The IMF currently expects global real GDP growth in 2020 to fall by 5%, with an 8% contraction in advanced economies and a 3% recession in emerging and developing economies (IMF, *World Economic Outlook*, June update).

These numbers factor in the buffering effects of the unprecedented policy reaction. Governments have launched massive fiscal stimulus programmes. Central banks were again at the forefront, cutting policy rates where possible and launching large-scale balance sheet measures. A defining feature of the crisis response has been far-reaching direct support for households and businesses to limit social distress and avert unnecessary bankruptcies that could hold back the recovery.

The coronavirus recession

In per cent | Graph 1



Sources: IMF, *World Economic Outlook*, June 2020; Maddison Historical Statistics; BIS calculations.

The pandemic's economic repercussions were propagated globally through large swings in capital flows and exchange rates. Emerging market economies (EMEs) confronted large-scale capital outflows and currency depreciation, contributing to a tightening of financial conditions and forcing many central banks to intervene supportively in currency and domestic bond markets. By contrast, safe haven capital flows have led to strong appreciation pressures on some advanced economy currencies, in particular the Swiss franc, forcing the Swiss National Bank (SNB) to intervene to stabilise the exchange rate.

Central banks' responses were instrumental in avoiding a financial meltdown and buffering the recession both domestically and globally. But difficult challenges loom large going forward. In the following, I would like to highlight two such challenges. The first consists in the prospect of interest rates staying very low for a very long time in major advanced economies. The second is the strengthening of the fiscal-monetary nexus brought about by the policy response to the pandemic.

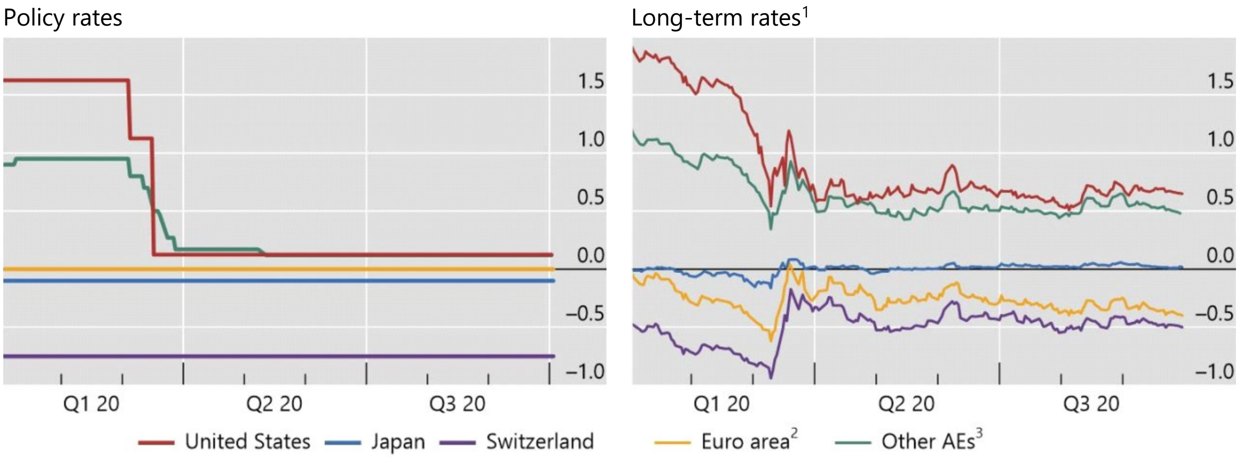
Low for very long

The pandemic has reinforced the low interest rate regime that has prevailed in advanced economies over the past decade. Short- and long-term rates are now at or near zero, or even below, in all advanced economies (Graph 2). After interest rates fell towards zero or below in Japan and in most European advanced economies over the past decade, they have now "zeroed in" across the board, including in the United States.

Low interest rates across advanced economies

In per cent

Graph 2



[1] Ten-year government bond yields. [2] For long-term rates, simple average across DE and FR government bond yields. [3] Simple average across AU, CA, GB, NO and SE.

Sources: Bloomberg; national data; BIS calculations.

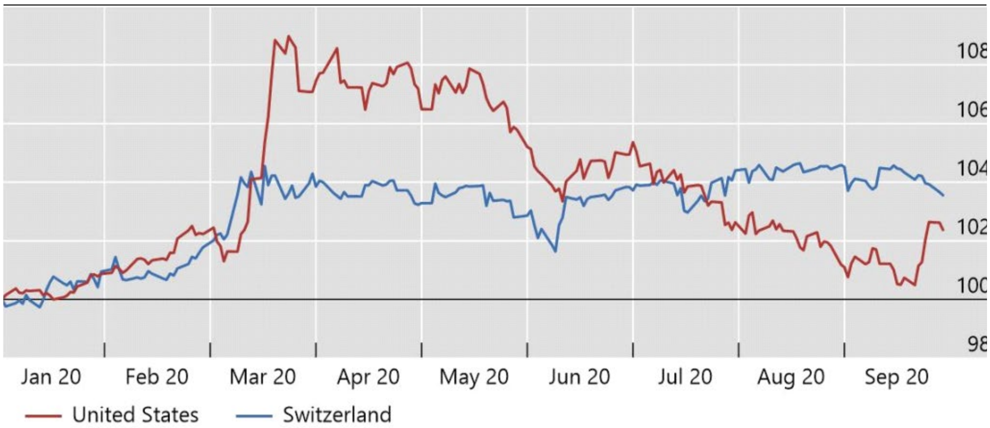
Forward guidance from central banks signals that, in the major economies, policy rates will remain low for years to come. In line with this forward guidance, and reflecting the currently bleak economic prospects, financial market prices suggest that both short- and long-term interest rates will remain at very low levels for the foreseeable future. The pandemic thus seems to have pushed the advanced economies from a low-for-long into a low-for-very-long interest rate regime. But this does not mean that central banks have run out of ammunition with both their conventional and unconventional tools. With their pandemic responses, central banks have shown that they can overcome the limits posed by very low interest rates and provide additional stimulus through innovative balance sheet policies, such as purchasing corporate bonds, or even by directly lending to firms.

At the same time, even when long-term government bond yields are very low, this does not mean that central bank bond purchases cannot provide additional accommodation. During the pandemic, large-scale purchases by central banks helped to keep long-term bond yields low when the bond supply increased massively in the wake of the fiscal support. Without central bank purchases, bond yields would likely have risen, tightening financial conditions amid the pandemic.

That said, in a low rate regime, providing monetary stimulus is certainly harder. The exchange rate will, explicitly or implicitly, take on greater prominence in the transmission process and in policy deliberations. Indeed, since the outbreak of the pandemic, we have already seen large swings in global exchange rate constellations (Graph 3). In particular, the US dollar has fluctuated widely. It first appreciated sharply as panic spread in March, and then depreciated significantly when the pandemic's first wave ebbed.

Exchange rates amid the pandemic[1]

1 Jan 2020 = 100 Graph 3



[1] BIS nominal effective exchange rate broad index. A decline indicates a depreciation of the currency in trade-weighted terms.

Source: BIS.

The outlook of prolonged low interest rates across all major advanced economies implies an environment of ample global liquidity amid high economic uncertainty. This combination may intensify the volatility of capital flows and exchange rates as market sentiment oscillates between risk-on and risk-off. For many EMEs, the main challenge will be the amplifying impact of capital flows and exchange rates on domestic financial conditions and the risk that inflation will become unanchored through large depreciations in the event of sudden capital outflows.

In small open economies with safe haven currencies, such as Switzerland, capital inflows during risk-off phases can quickly flood the country. Such floods can overwhelm the financial system's absorption capacity and lead to excessive appreciation pressure. If excessive appreciations drive the currency's value well above fundamentally justifiable levels, the economic consequences can be very damaging. They can sap exports and hence growth and employment, and they may even curb long-run growth potential if the viability of the productive export sector is undermined. At the same time, by depressing economic activity and weighing on domestic prices through the exchange rate pass-through channel, excessive appreciations can unanchor inflation towards the low side.

Clearly, in a situation when exogenous financial factors in the form of safe haven inflows threaten to push the currency far above its fundamental value, the central bank of a small open economy has no choice but to intervene to stabilise the exchange rate. With such FX interventions, the central bank is just following its mandate to safeguard price and financial stability.

Switzerland has been exposed to recurrent appreciation pressures since the Great Financial Crisis as safe haven inflows have shot up in several instances. The Swiss economy has weathered these pressures quite well so far. Inflation has been low and at times negative, but inflation expectations have not de-anchored from the SNB's target range. At the same time, the Swiss economy has continued to grow and unemployment has stayed low.

This resilient performance is in large part attributable to the SNB's determined and pragmatic unconventional policy response. This has centred on negative rates to discourage capital inflows and FX intervention to directly address excessive appreciation pressures. Like many other central banks, the SNB also faces criticism for the side effects of its policies, but I think everybody has to realise that these measures have been necessary to fend off material risks to the Swiss economy. In the end, negative rates and high FX reserves clearly appear to be the lesser of two evils, as compared with an unhindered appreciation of the Swiss franc, which would wreak havoc on the Swiss economy. Given the outlook of a prolonged period of very low rates in the major advanced economies, unconventional policies of this type will probably continue to be necessary in the coming years.

The fiscal-monetary nexus

Let me now turn to the second longer-term challenge for central banks brought about by the pandemic which I would like to highlight, the significant strengthening of the nexus between fiscal and monetary policy.

Central banks have launched renewed large-scale purchases of government debt as part of their crisis response, motivated by the stabilisation objectives within their mandates. As already mentioned, these purchases have coincided with massive increases in public debt on the back of the massive fiscal response. Hence, they have helped to smooth the impact on bond markets of a sudden ramp-up in fiscal spending.

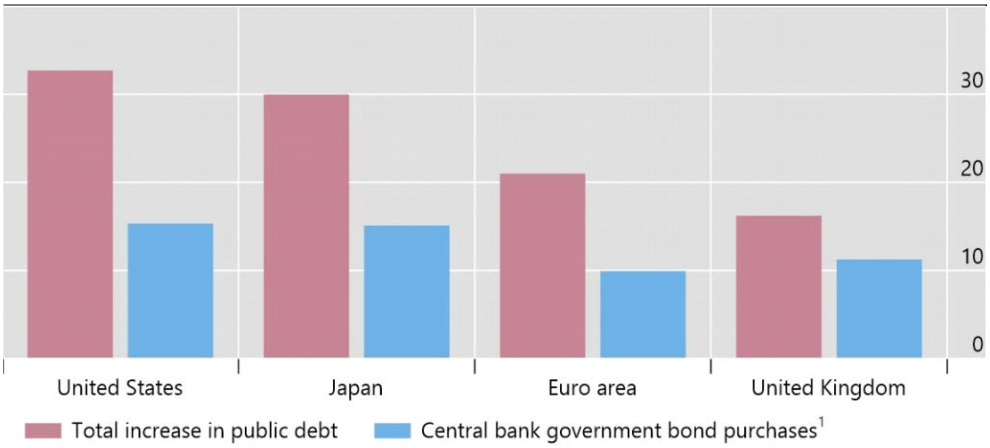
However, these purchases have also resulted in a significant increase in central bank holdings of government debt. According to current forecasts, a large part of the new issuance of government debt in major advanced economies is matched by central bank bond purchases (Graph 4). Thus, while they are grounded in central banks' stabilisation mandates, the purchases have strengthened the fiscal-monetary nexus.

At the same time, there is an ongoing debate about the need for greater coordination of fiscal and monetary policy in an environment of reduced policy space due to persistently low interest rates, with some pundits arguing in favour of overt monetary financing. This raises the general question of how central banks can best contribute to economic growth and stability, in the current situation and in general. Is it by directly financing the government?

The growing fiscal-monetary nexus

Forecasts for 2020, in per cent of 2019 GDP

Graph 4



[1] For projection details of central bank government bond purchases, see Cavallino and De Fiore (2020).

Sources: P Cavallino and F De Fiore, "Central banks' response to Covid-19 in advanced economies", *BIS Bulletin*, no 21, June 2020; IMF, *World Economic Outlook*, June 2020; national data; BIS calculations.

I will argue that the best contribution monetary policy can make is always to maintain sound money, to focus squarely on preserving price and financial stability. Support for the government is justifiable in the pursuit of these goals. Otherwise, the risk arises of real or perceived fiscal dominance undermining central bank credibility as the foundation of sound money.

The experience of many Latin American EMEs in the 1980s and 1990s tells a cautionary tale of fiscal-monetary interactions gone wrong, ending as these did in high inflation or even hyperinflation. Exchange rates and long-term yields are key barometers for credibility risks from the fiscal side. Growing concerns about fiscal dominance could lead to exchange rate depreciation and rising long-term yields, triggering adverse macroeconomic and financial feedback loops that would severely undermine the central bank's ability to provide much needed support.

How can the spectre of fiscal dominance be kept at bay? There are two main conditions, and both need to be met.

First, governments need to safeguard fiscal sustainability. If confidence in fiscal sustainability is in doubt, central bank credibility may suffer as expectations may arise that the central bank will have to support governments through accommodative policy. Governments must therefore be prepared to take pre-emptive action to ensure fiscal sustainability.

Second, central bank policy actions need to remain credibly focused on maintaining price and financial stability, as opposed to financing the government debt. Central banks' mandates and far-reaching institutional independence are essential for them to fulfil their stabilising role. At the same time, it will be of critical importance that the measures taken by central banks are also perceived as being in line with their stability mandates. Here, the credibility capital of a central bank plays a crucial role. In advanced economies, it may be possible for central banks to temporarily cross the boundaries between fiscal and monetary policy as they can rely on a high degree of credibility built on a long track record of stability-oriented policies. In contrast, despite significant improvements over the past two decades, central banks in many EMEs are not in the same position and adverse market reactions will act as a brake.

Conclusions

Let me conclude. Overcoming the Covid-19 crisis will require us to navigate through uncharted waters, in poor visibility and with some instruments possibly not working to full effect. The initial responses of central banks to the crisis have been instrumental in fending off financial meltdown and in buffering the economic contraction. As we progress from the liquidity to the solvency and recovery phase of the crisis, the heavy lifting would normally shift from monetary policy to fiscal and structural policies. Of course, that does not mean that central banks can sit back and relax. They should be prepared to proactively supply further accommodation if adverse macro-financial feedback loops need to be forestalled.

That said, it is vital to recognise the limits of monetary policy. Monetary policy alone cannot deliver higher sustainable growth. Getting back on track will require governments to play their part. Structural reforms that raise potential growth rates are called for, as well as growth-oriented fiscal policies focused on public investment. Boosting sustainable growth is not only critical against the backdrop of the pandemic. It will also be key for getting us out of the low-for-very-long interest rate regime and for bolstering fiscal sustainability. That said, it is politically no easy task to agree and implement growth-friendly policies, and this has probably become even more difficult in the wake of the pandemic.

Sound money is the best contribution central banks can make to sustainable growth in the post-pandemic world. Maintaining it will require central bank independence and credibility to be preserved. To that end, the natural boundaries between fiscal and monetary policy need to be respected.

Finally, international cooperation is more important than ever to overcome the pandemic and its economic woes. It will also be the key to maintaining sound money. We at the BIS will continue to do our part, fostering cooperation among central banks from around the world to support the stability and soundness of the international financial system.