THE CENTRAL BANK AND POLICY INTERACTIONS POST PANDEMIC

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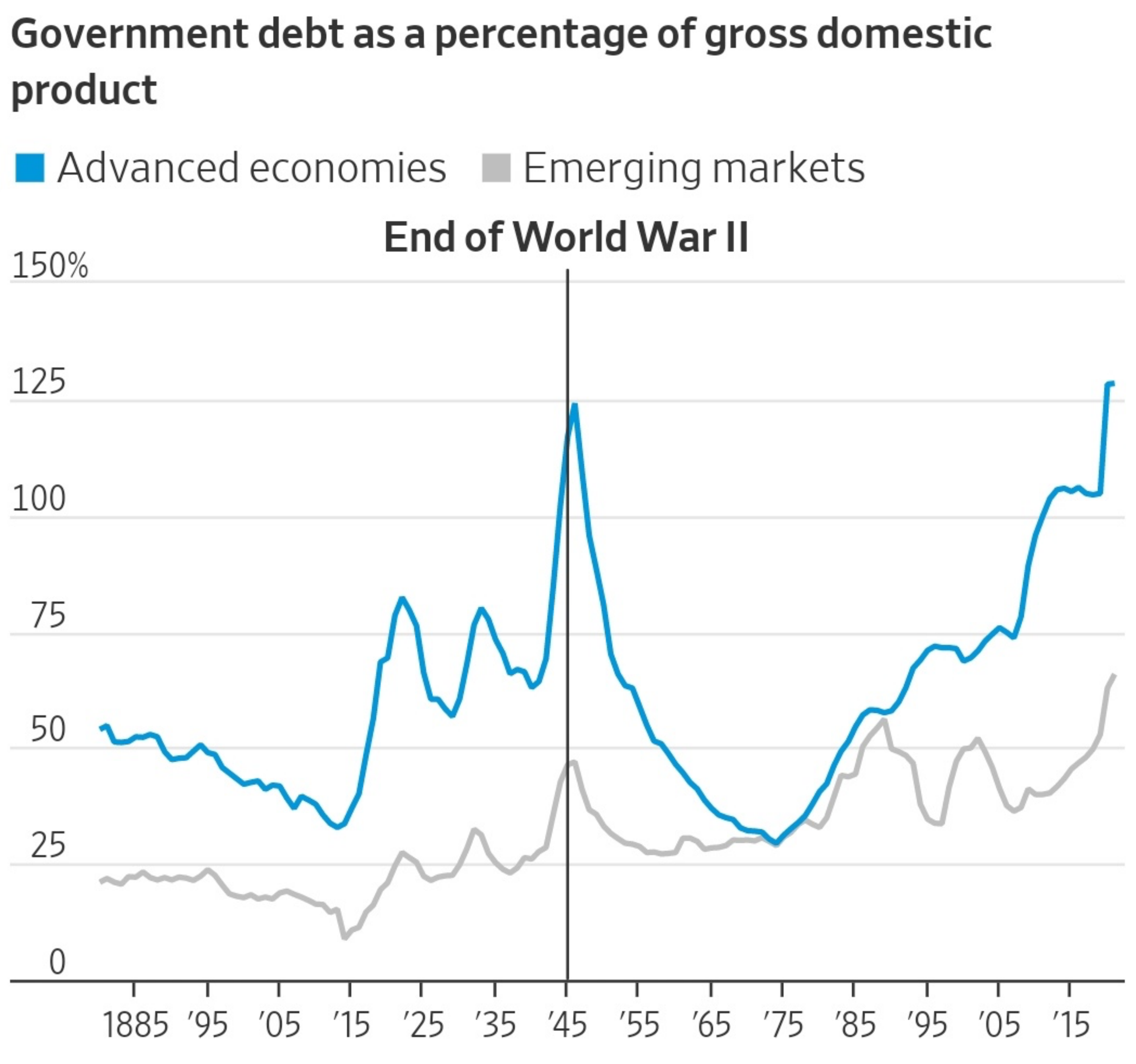
Bank of Canada, online

Four challenges

1. Record high public debt



Source: International Monetary Fund

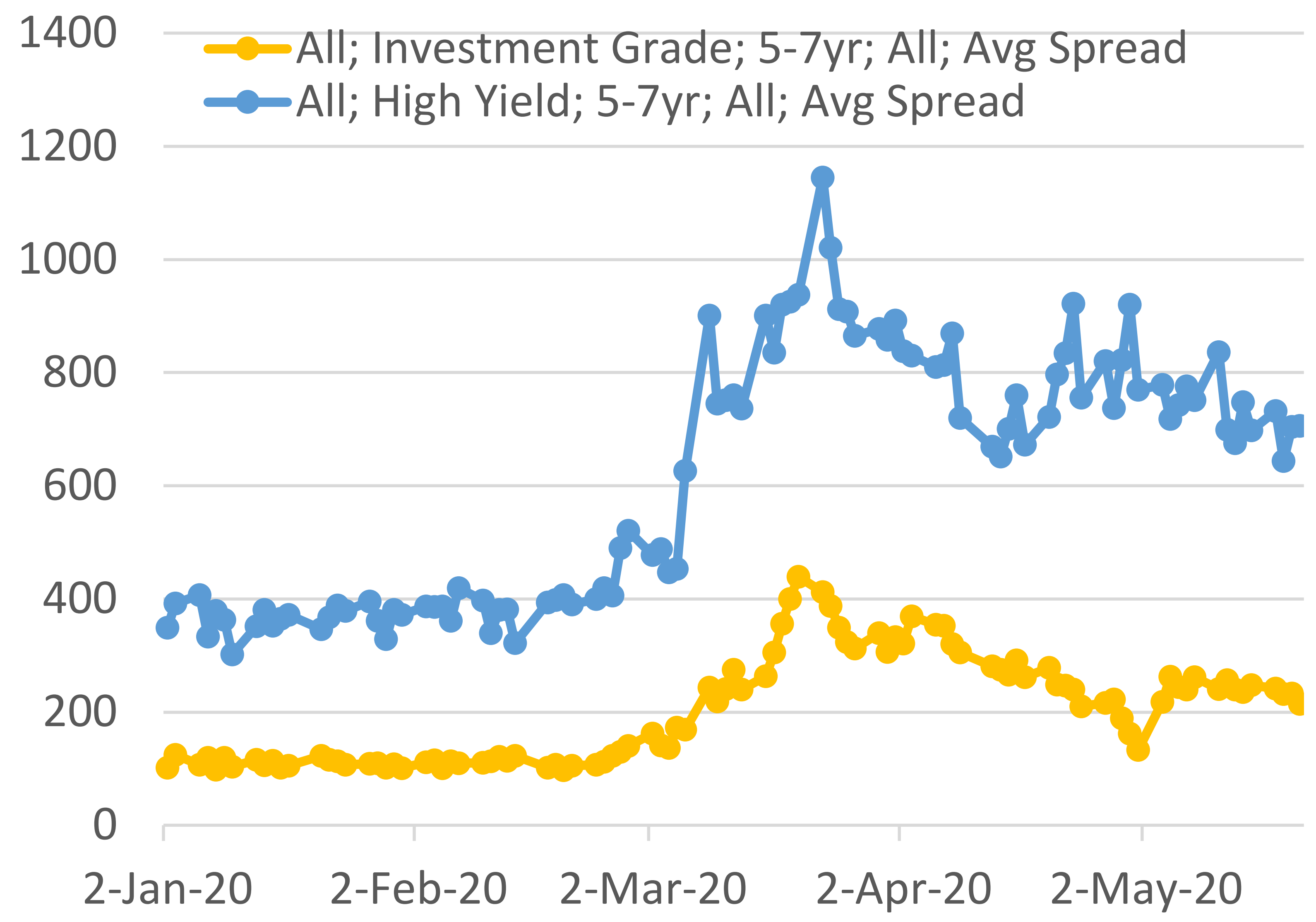


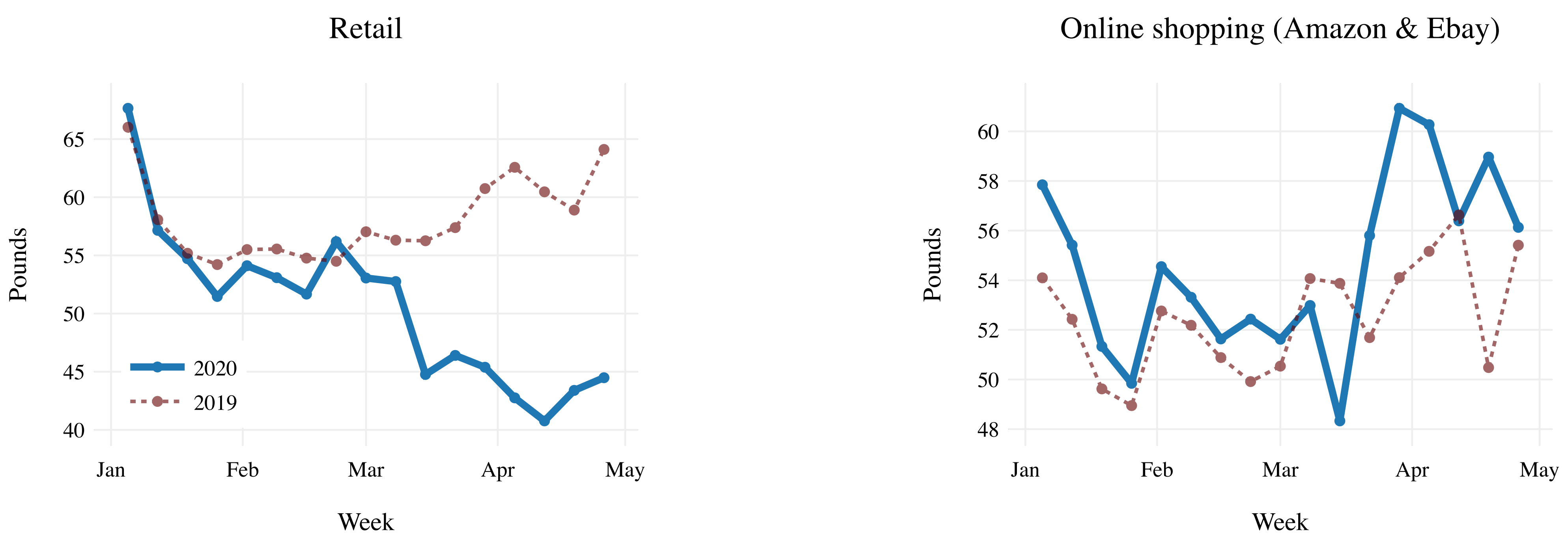
Figure 6. High Yield and Investment Grade Corporate Bond Spreads

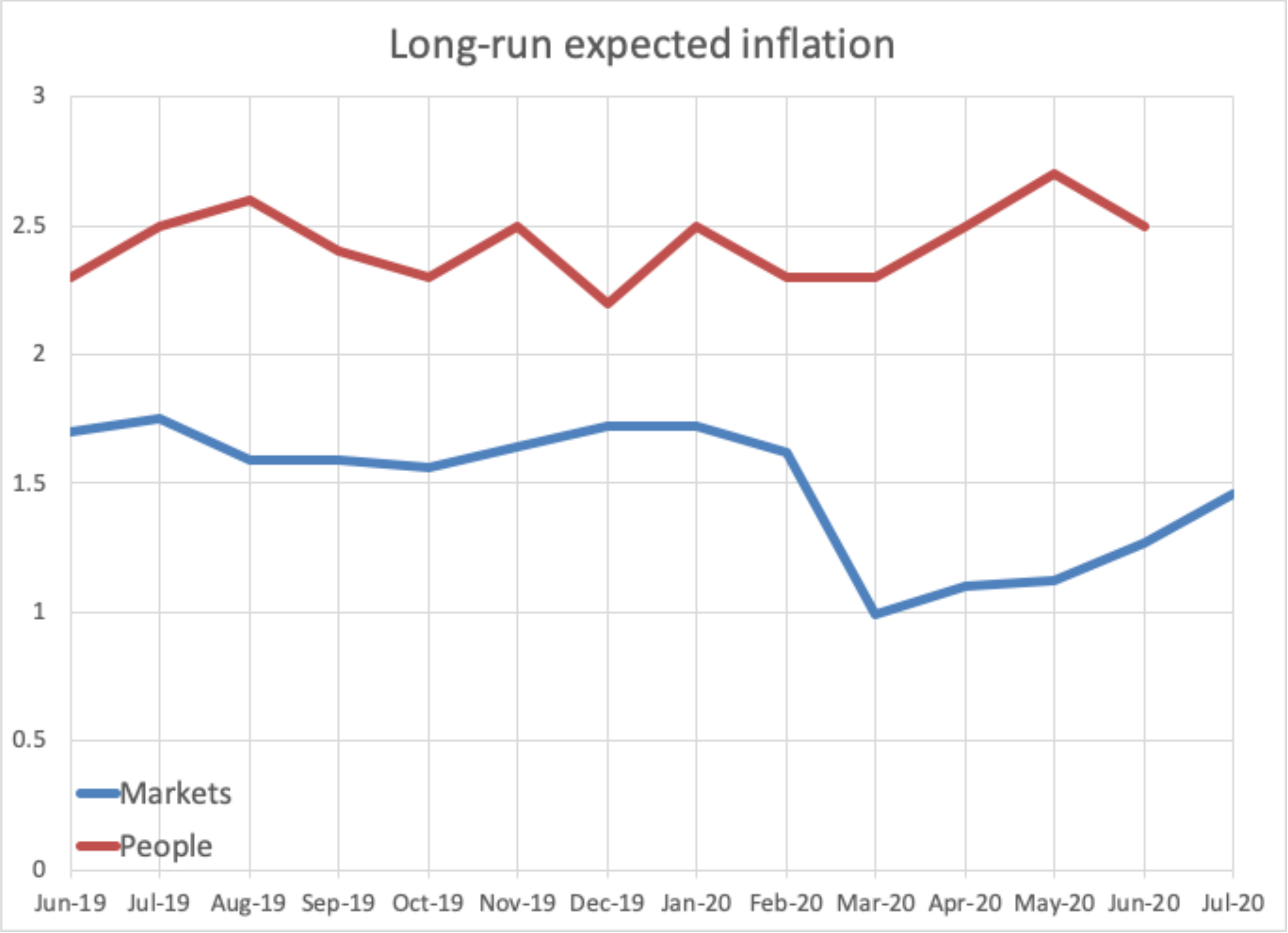
Source: JP Morgan

2. Private default in the horizon

3. Digital payments on the rise

Figure 2: Average weekly expenditures by sub-categories





4. Will get inflation, deflation, stability?

Sources: Wall Street Journal (2020), Surico, Kaenzig Hacioglu (2020), Brunnermeier Krishamurthy (2020), Reis (2020)

1. The high public debt: footprint

The fiscal footprint of monetary policy

- How much does government budget constraint tighten following policy?
- Direct effect of conventional and unconventional policy

Figure 2: Effect of conventional monetary policy

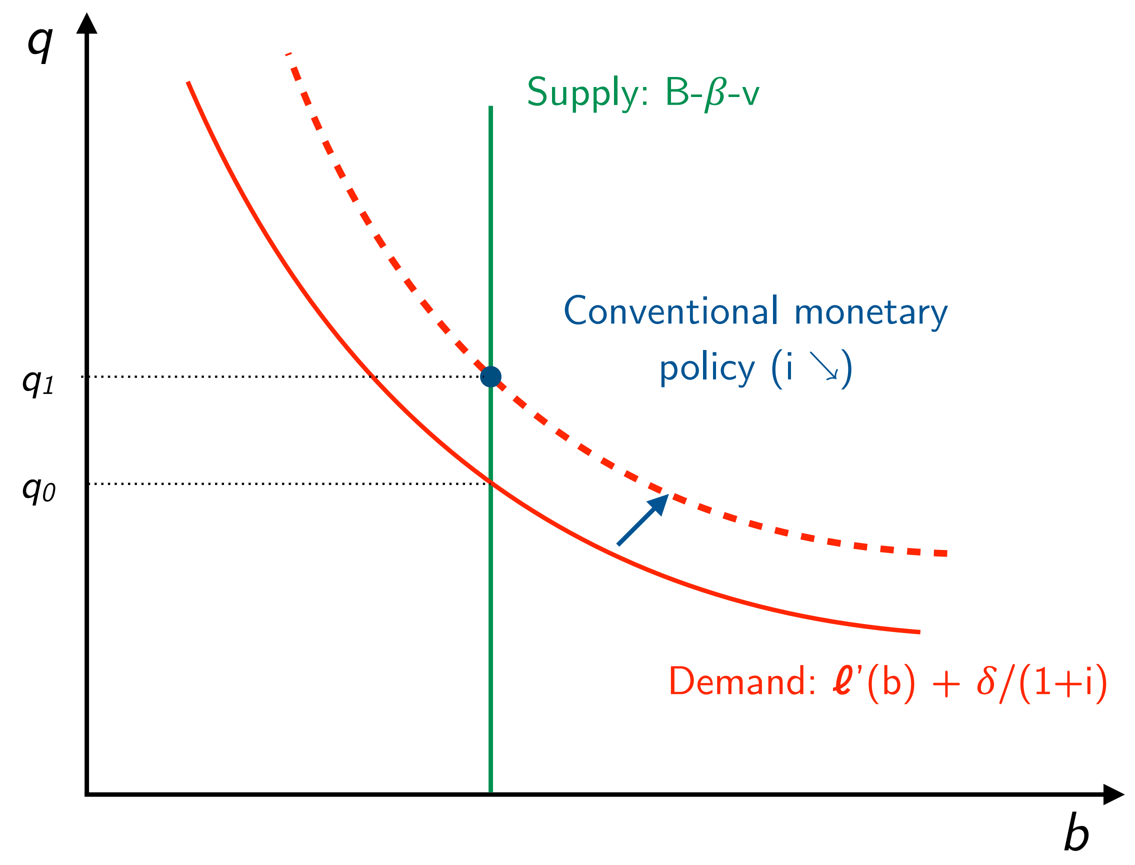
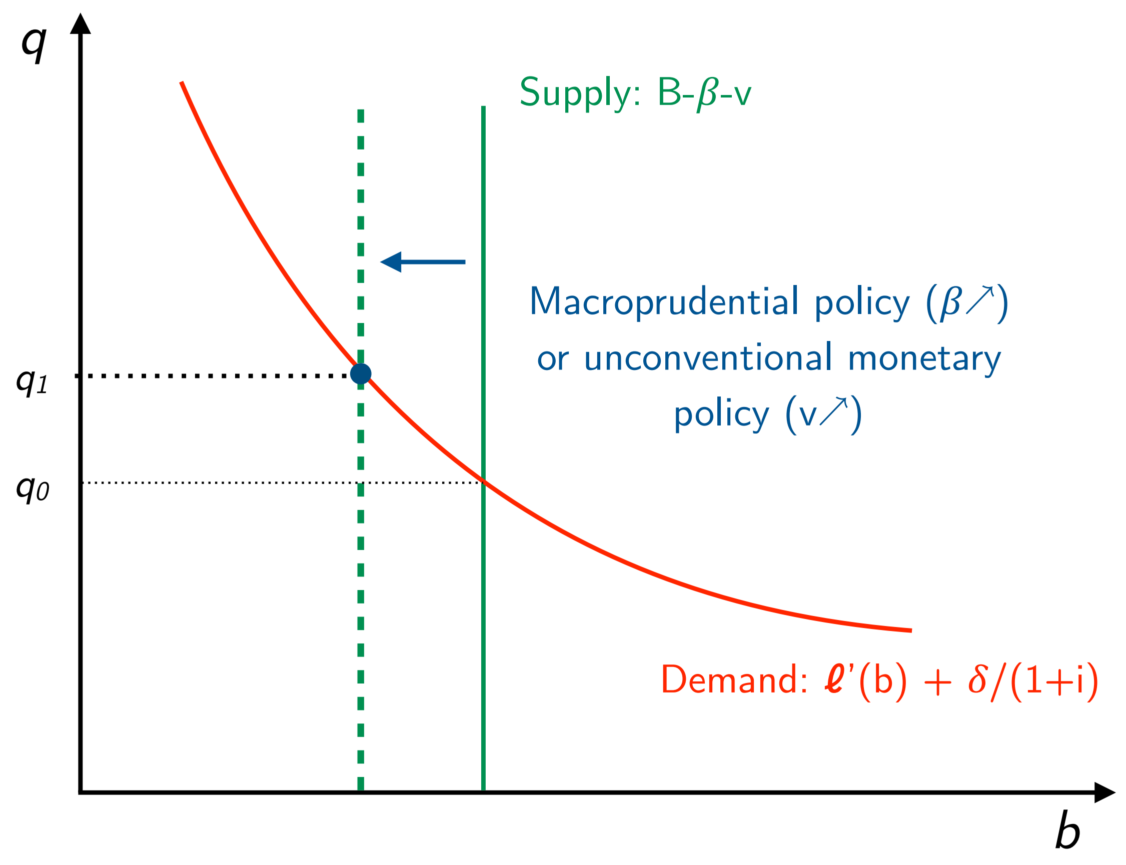


Figure 1: The market for government bonds



- Indirect effect: on output and fiscal surpluses

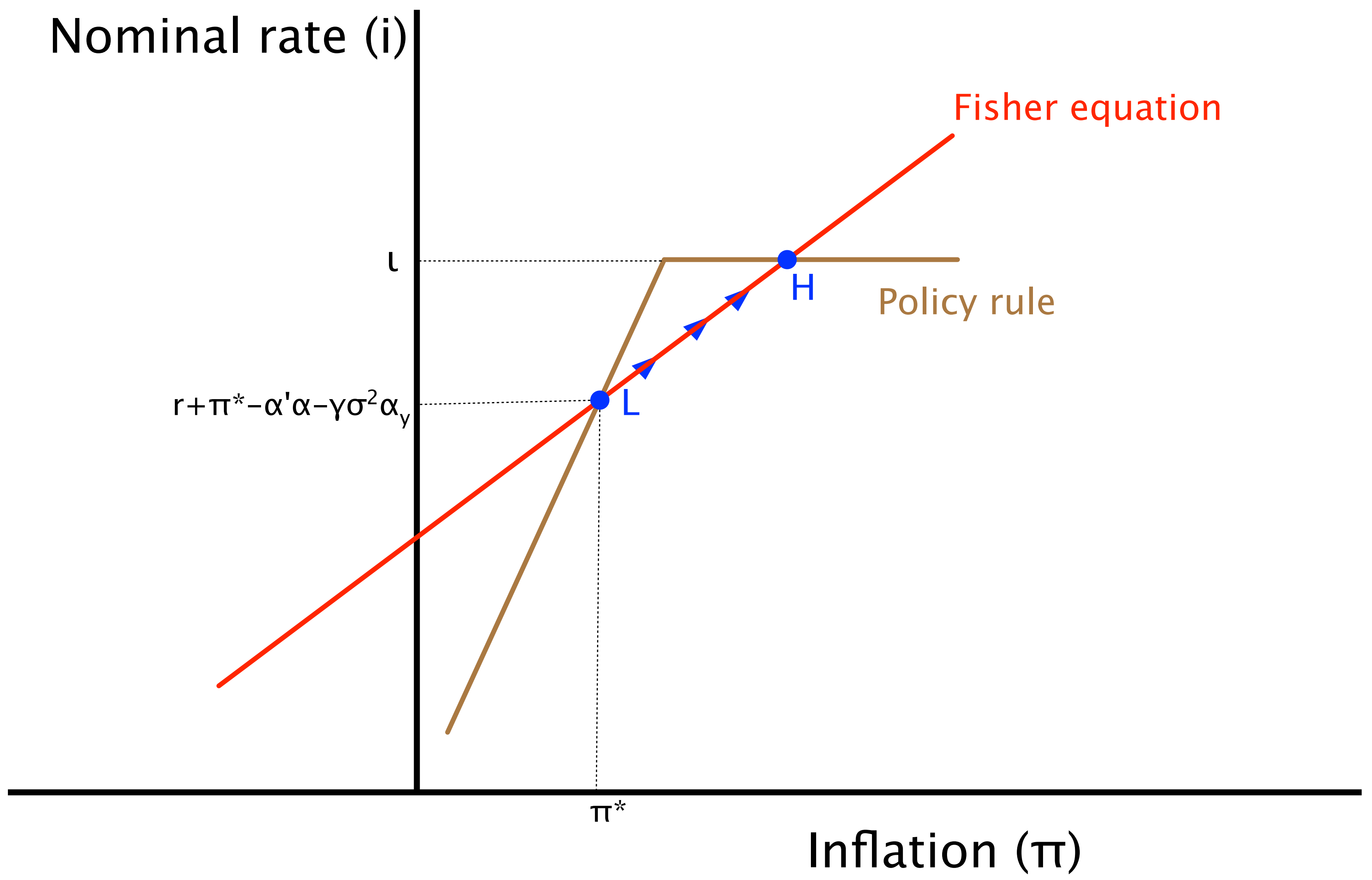
Footprint is higher when public debt is high

Source: Reis (2020) The Fiscal Footprint of MacroPrudential Policy

1. The high public debt: interest-rate ceilings

US monetary history of the 1940s

- Federal Reserve, 1942-51: ceiling of 2.5% for 10-year yield. Ready to buy.
- Yield 2.37% in 11/47, and 2.45% in 12/47. Volatile inflation until 1951 accord
- Theory:



Ceilings mean lose control of asset composition, eventually bind, inflation de-anchored

Source: Reis (2019) Central Banks Going Long

1. The high public debt: financial repression

If you're not lucky to grow out of it, how to you pay for war-level debt?

- Financial regulation forces institutions to hold long-term government bonds: get liquidity /default/regulatory premium when sell.
- A little bit of extra inflation, for a long time, lowers real payments.
- History: 1950-80s Radcliffe credit policy, US in 1970s and deposit ceilings, Latin America in 80s through reserve requirements.

Result 1: if present-biased, do more as under-state future contraction in lending

Result 2: if financial crisis, do more as justified to lower bailout costs

Result 3: unpleasant fiscal arithmetics, forced to do more

Source: Reis (2020) The Fiscal Footprint of MacroPrudential Policy

2. Corporate defaults and bank trouble

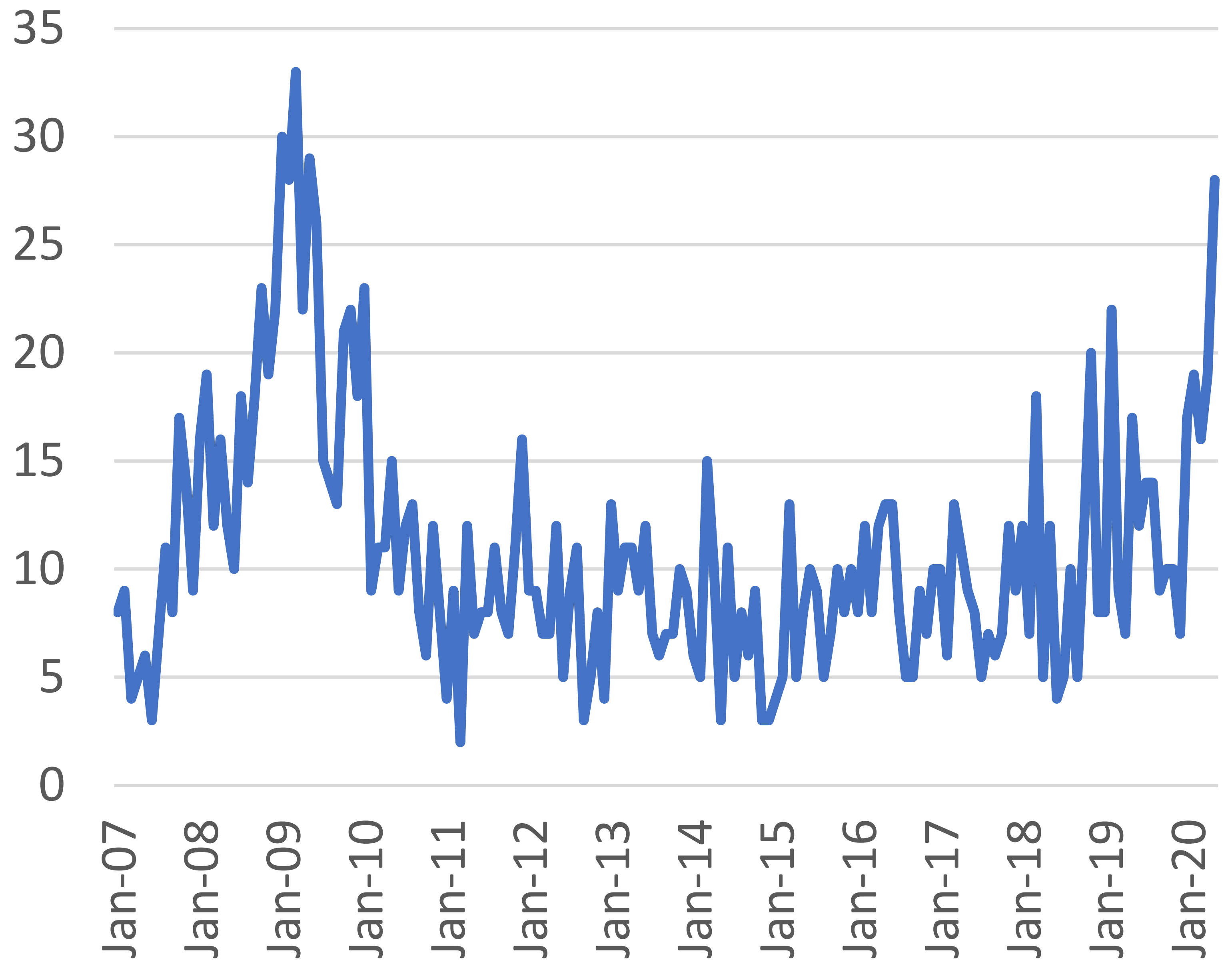


Figure 8. Bankruptcy Filings Monthly Count, Jan 2007 to May 2020

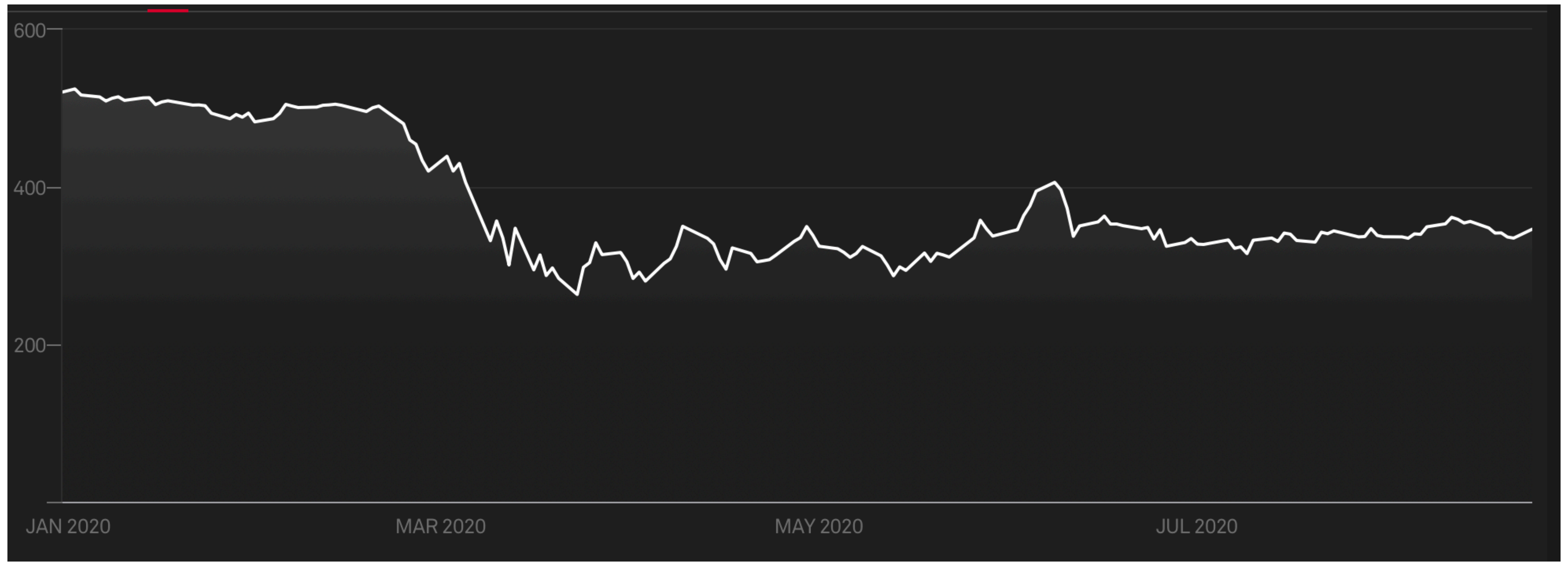
Source: Bloomberg BCY

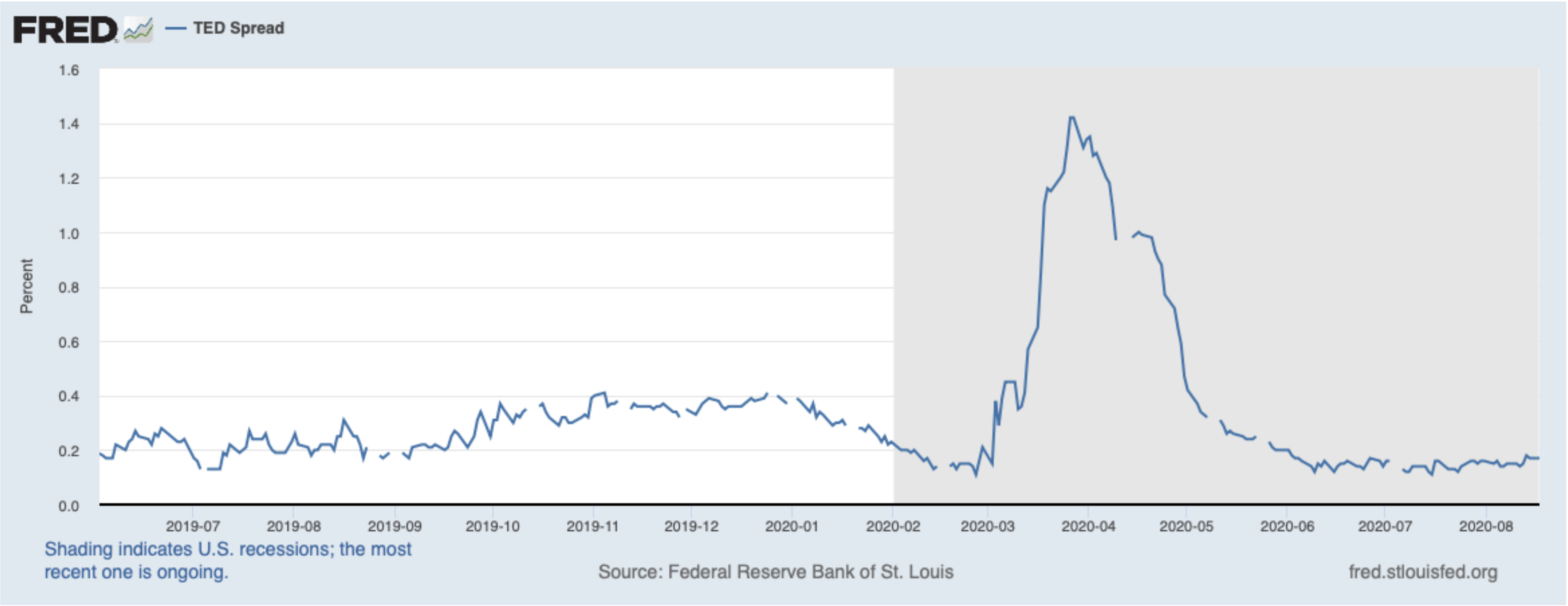
Consumer Discretionary	40.82%	52.25 billion
Energy	16.33	20.90
Financials	10.2	13.06
Health Care	9.18	11.75
Communications	5.1	6.53
Consumer Staples	4.08	5.22
Industrials	4.08	5.22
Technology	4.08	5.22

Table 1: Corporate Bankruptcy Filings as of 6/1/2020

Source Bloomberg

Dow Jones U.S. Banks Index





Source: Brunnermeier Krishanmurthy (2020) Corporate Debt Overhang and Credit Policy

2. Corporate defaults: LOLR and fiscal

Fiscal theory of lending of last resort

- First stage: lend to the illiquid and solvent
- Second stage: when the illiquid become insolvent, call the Treasury
- Lending of last resort can quickly become a bailout

Fiscal - LOLR coordination in the European crisis (or lack thereof)

- Cyprus, Spain, Portugal: very costly bank resolution triggered by ECB
- Systemic crisis: joined troika, and imposed reforms

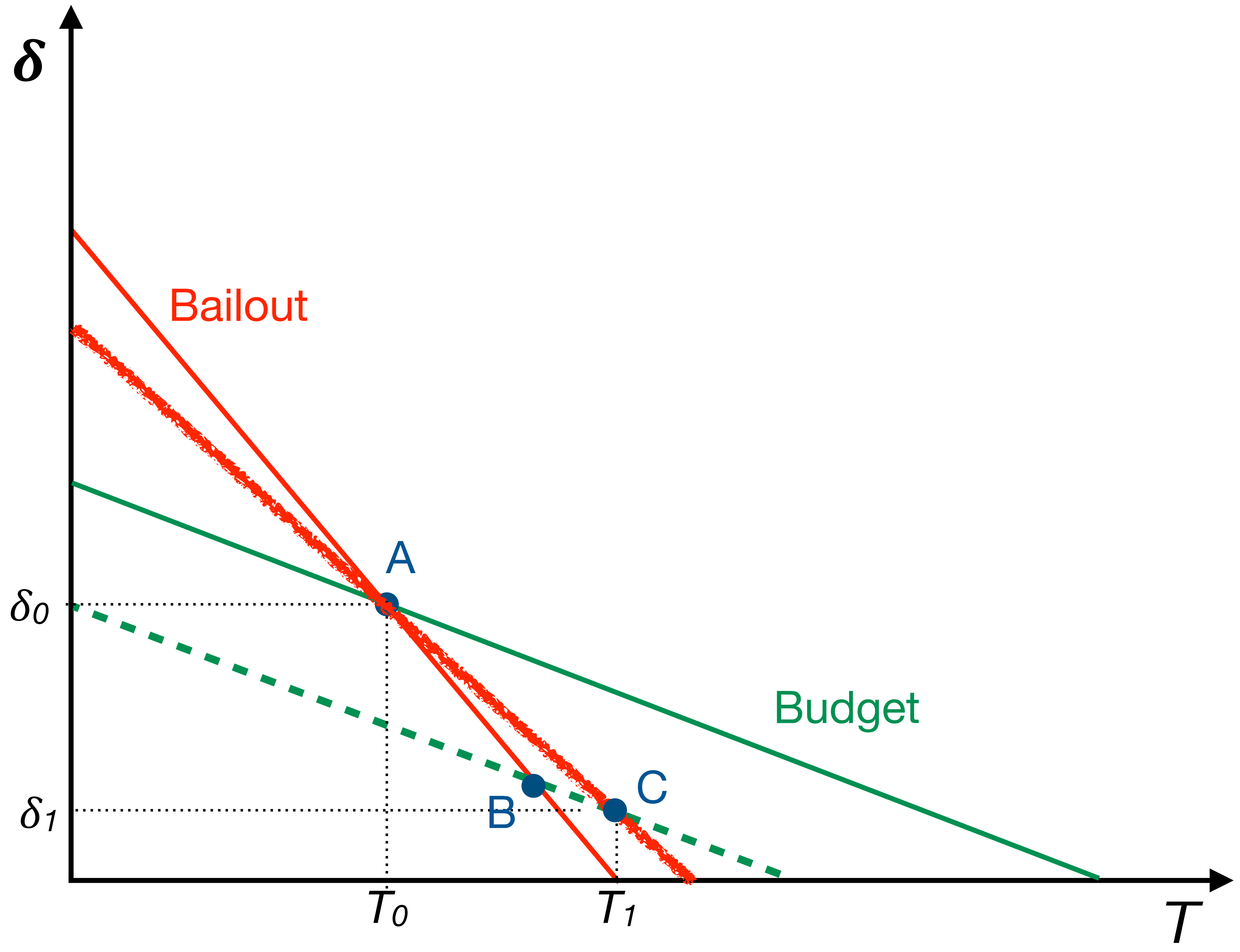
Untenable to undertake LOLR of significant scale without fiscal support

Source: Reis (2019) The Second Decade of the Euro: Old Challenges in New Clothes

2. Corporate defaults: monetary policy

QE that swaps bonds and reserved in a fiscal + financial crisis

(b) Amplification of spending shocks



<u>*Reserves special in fiscal crisis*</u>

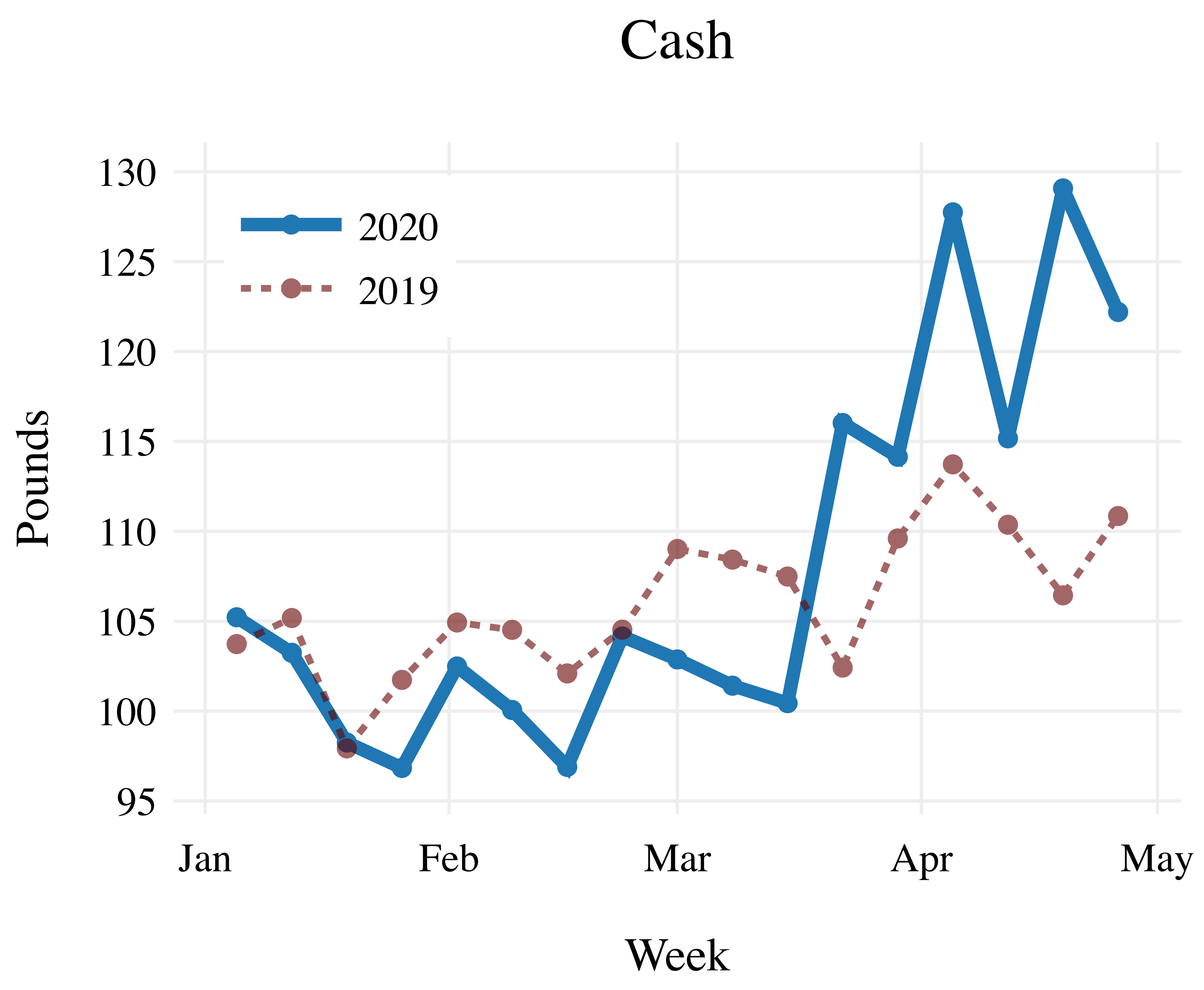
QE gives reserves for bonds
Banks insulated from government default ex post
Banks have access to safe asset ex ante
Reserves special because default-free, and only held by bank

QE diminishes the diabolic loop, and it gives banks insurance

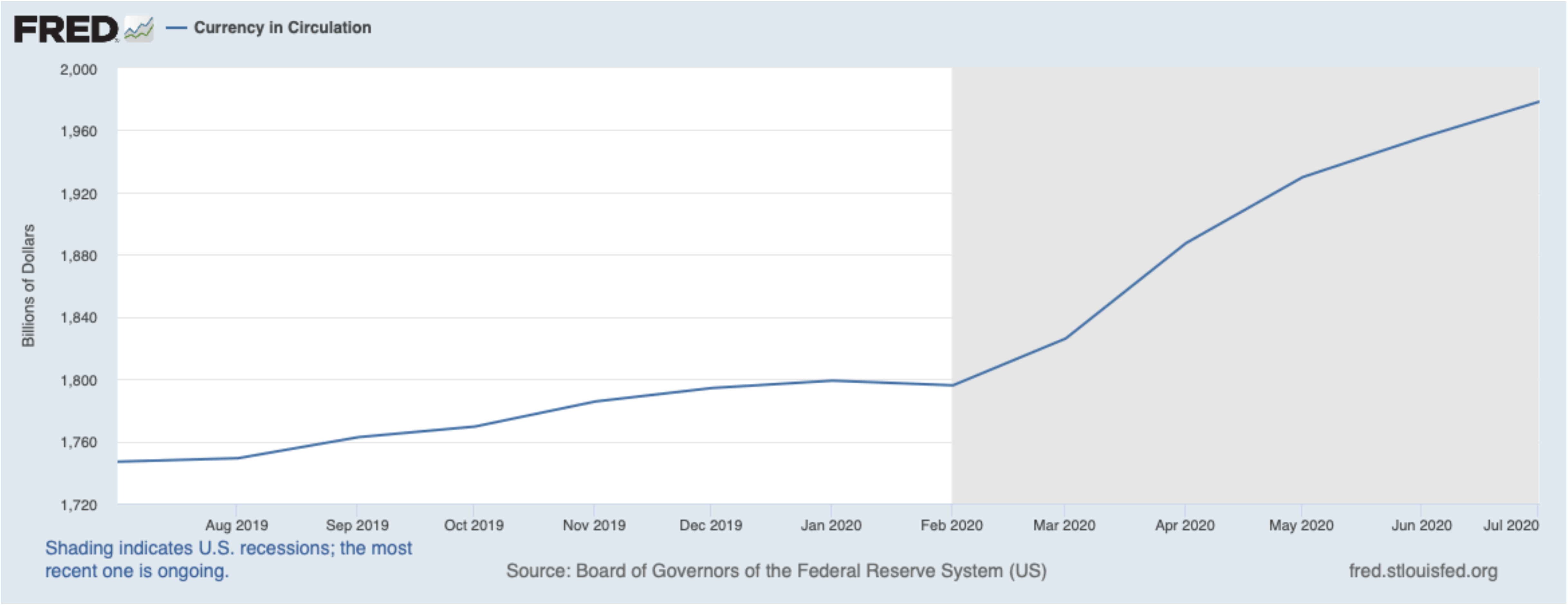
Source: Reis (2017) QE in the Future: the Central Bank's Balance Sheet in a Fiscal Crisis

3. The rise of the digital: cash is not dead yet

Figure 9: ATM cash withdrawals



United Kingdom



United States

Sources: Surico, Kaenzig Hacioglu (2020) Consumption in the time of Covid 19

3. The rise of the digital: banks, coins, CBDC

Digital payments and the new private stable coins

- Majority is using interbank settlement provided by the central bank
- Stable-coins on the rise: still USD or CAD as unit of account

But central bank so far still crucial and central

- Success of TIPS in the Eurozone: payment infrastructure and settlement
- Reserves are still the unit of account, and the store of value of last resort
- Banks are the way to access reserves
- If central-bank issued accounts: someone must still perform KYC on accounts

Competition on who can provide access to central bank. Stability vs competition

4. Inflation: three equilibria

The 2% equilibrium

- Capital built over 20 years, households inattentive, expect 2%, get 0-2%

The inflation-trap equilibrium

- High public debt, fiscal crisis needs, expect independence of monetary policy to disappear, and high inflation to be tolerated until an accord arises

The deflation-trap equilibrium

- Recession plus a rise in precautionary savings (animal spirits) decrease aggregate demand, zero lower bound prevents policy response, deflationary expectations set in.

For now in good equilibrium, dilemma on discussing the mandate

Conclusion

New challenges put pressure on strict separation of policies

- High public debt: pressure to support Treasury in paying for it, both on monetary policy and on financial regulation (fiscal-financial)
- Potential banking crisis: pressure on using QE / size of balance sheet and the lender of last resort (financial-fiscal)
- Digital economy: pressure to introduce CBDC, open access to central bank (competition-financial)
- Inflation: pressure to focus attention away from inflation (mandate)

In general, macroeconomic policy has to be coordinated. Specifically, new central banking of last 10 years closer to the future norm than the pre-2008 world.