

# Central Banking Challenges in the Post Covid Era

Kenneth Rogoff, Harvard University

ECB Conference on Monetary Policy

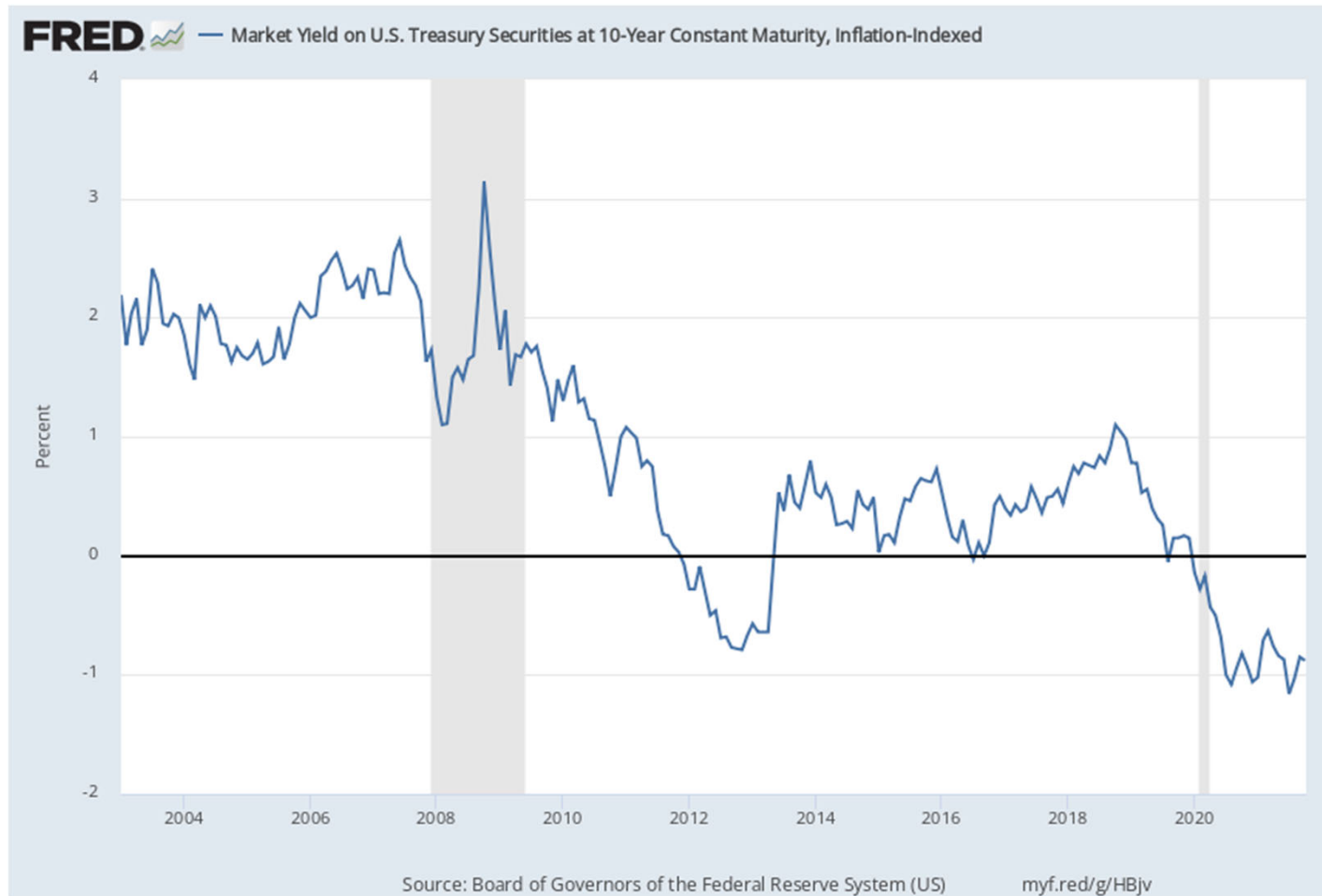
Frankfurt (online event), October 11, 2021

Draws on figures from : Kose, Ohnsorge, Reinhart and Rogoff “The Aftermath of Debt Surges” (September 2021), Iltzetski, Reinhart and Rogoff “Rethinking Exchange Rate Regimes,” September 2021, and Iltzetski, Reinhart and Rogoff “Will the Secular Decline in Inflation and Exchange Rate Volatility Survive Covid-19,” BPEA Fall 2020, forthcoming

# Overview of the talk

- The first part of the talk will focus on emerging markets where the lines of demarcation between interest rate policy and fiscal policy are significantly sharper today than in advanced economies. – for now...
- The second part of the talk will turn to advanced economies, especially the debate over expanding the role of the central bank in an era where the scope for conventional monetary policy has been quite limited (and will be until conditions for implementation of fully effective negative interest rate policy are finally adopted)

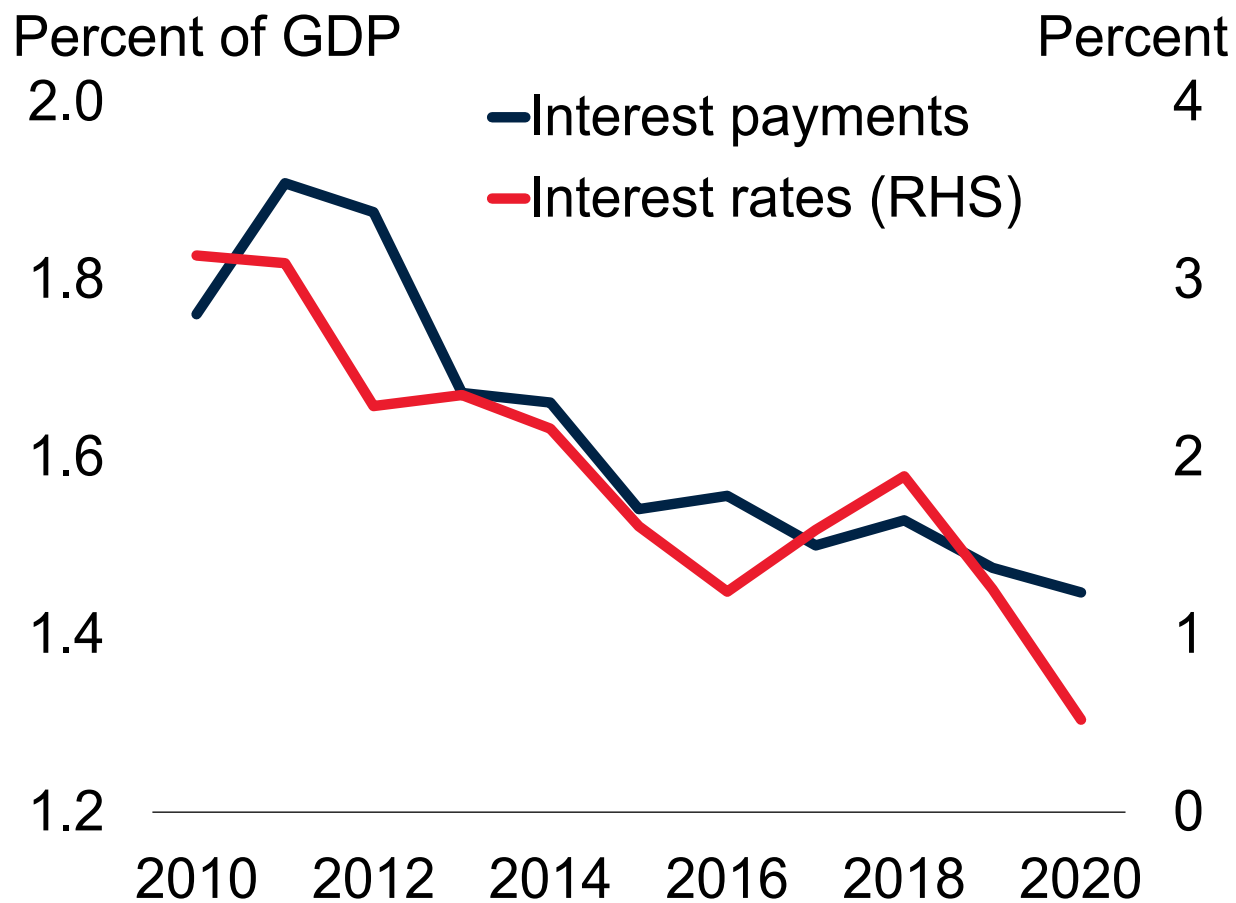
THE SHARP FALL IN REAL INTEREST RATES OCCURRED ONLY AFTER THE FINANCIAL CRISIS



# The debate in emerging markets is quite different than advanced economies

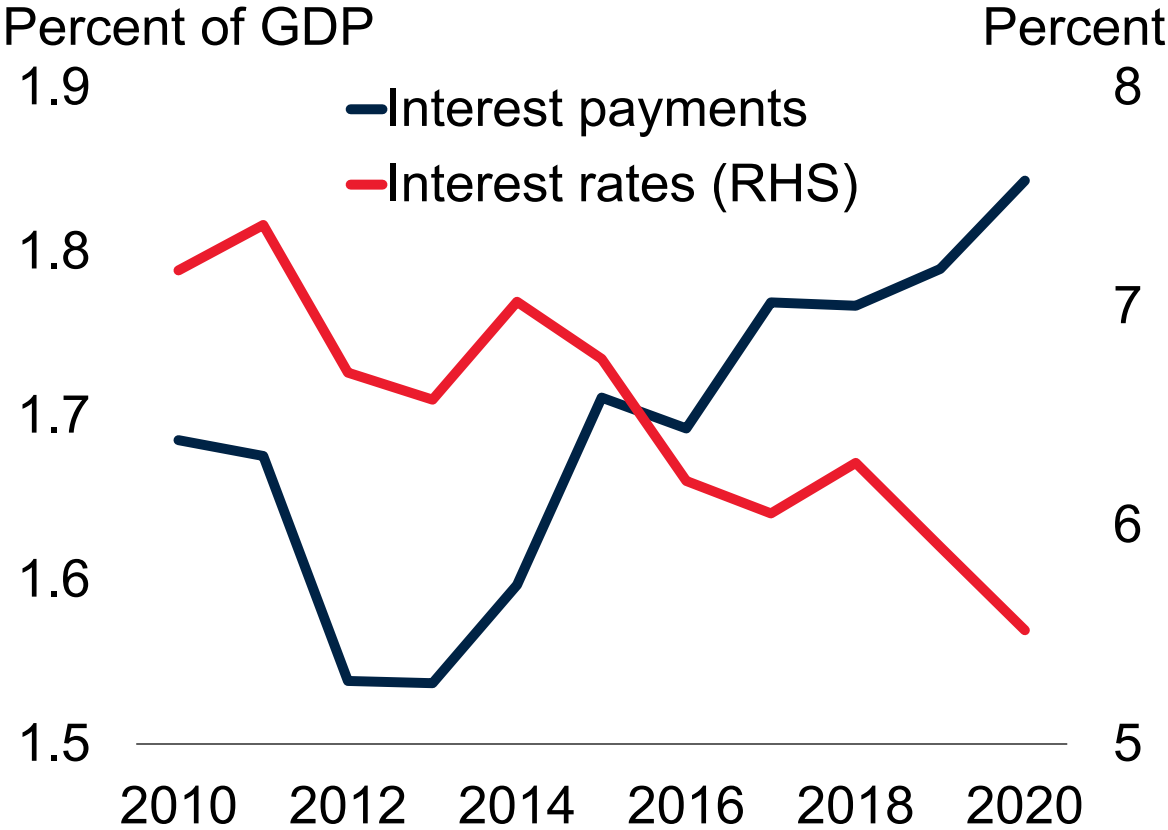
- Emerging market are not facing the problem of the zero bound (effective lower bound)
  - Some EM central banks are already raising rates
- Emerging markets have vastly less fiscal space, a few are already in default (as are a great many less developed economies)
  - The interest burden of debt is rising, not falling, and a higher share is owed to foreigners
- Financial fragility is much more acute after the pandemic
  - The 2008-09 crisis did not hit EMs nearly as hard and consequently they did not institute the same degree of banking reform
  - “Hidden debts” are large given more state-controlled companies, and extensive dollar borrowing by domestic non-financial corporates
  - Emerging markets have employed some of same policies as advanced economies (e.g., rent moratoria) that could put pressure on banks

## Interest rates and payments in advanced economies



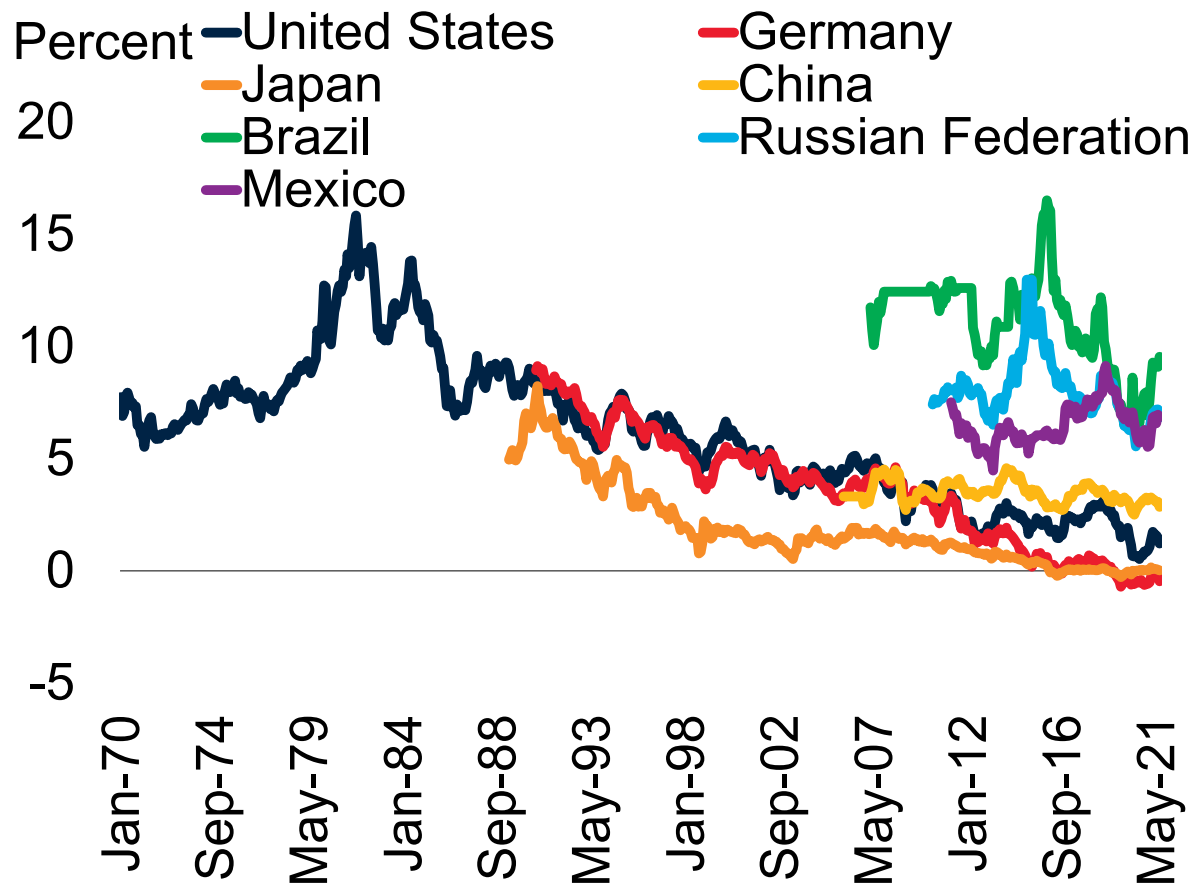
Source: Kose, Ohnsorge, Reinhart and Rogoff (2021)

# Interest rates and payments in Emerging Markets and Developing Countries



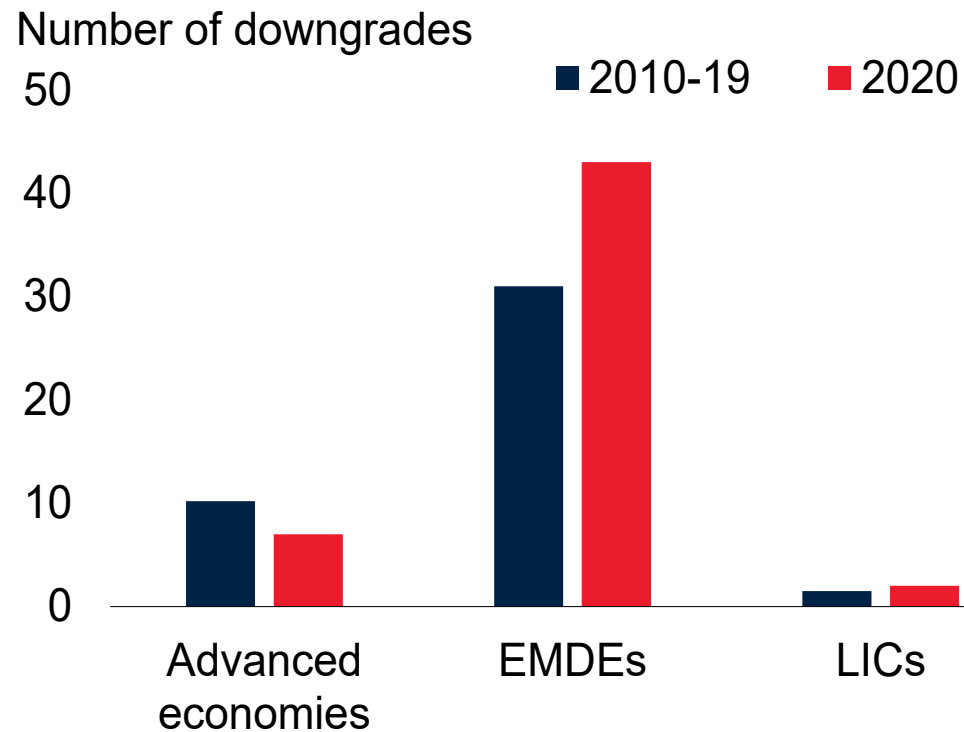
Source: Kose, Ohnsorge, Reinhart and Rogoff (2021)

## Ten-year government bond yields



Source: Kose, Ohnsorge, Reinhart and Rogoff (2021)

## Sovereign credit rating downgrades

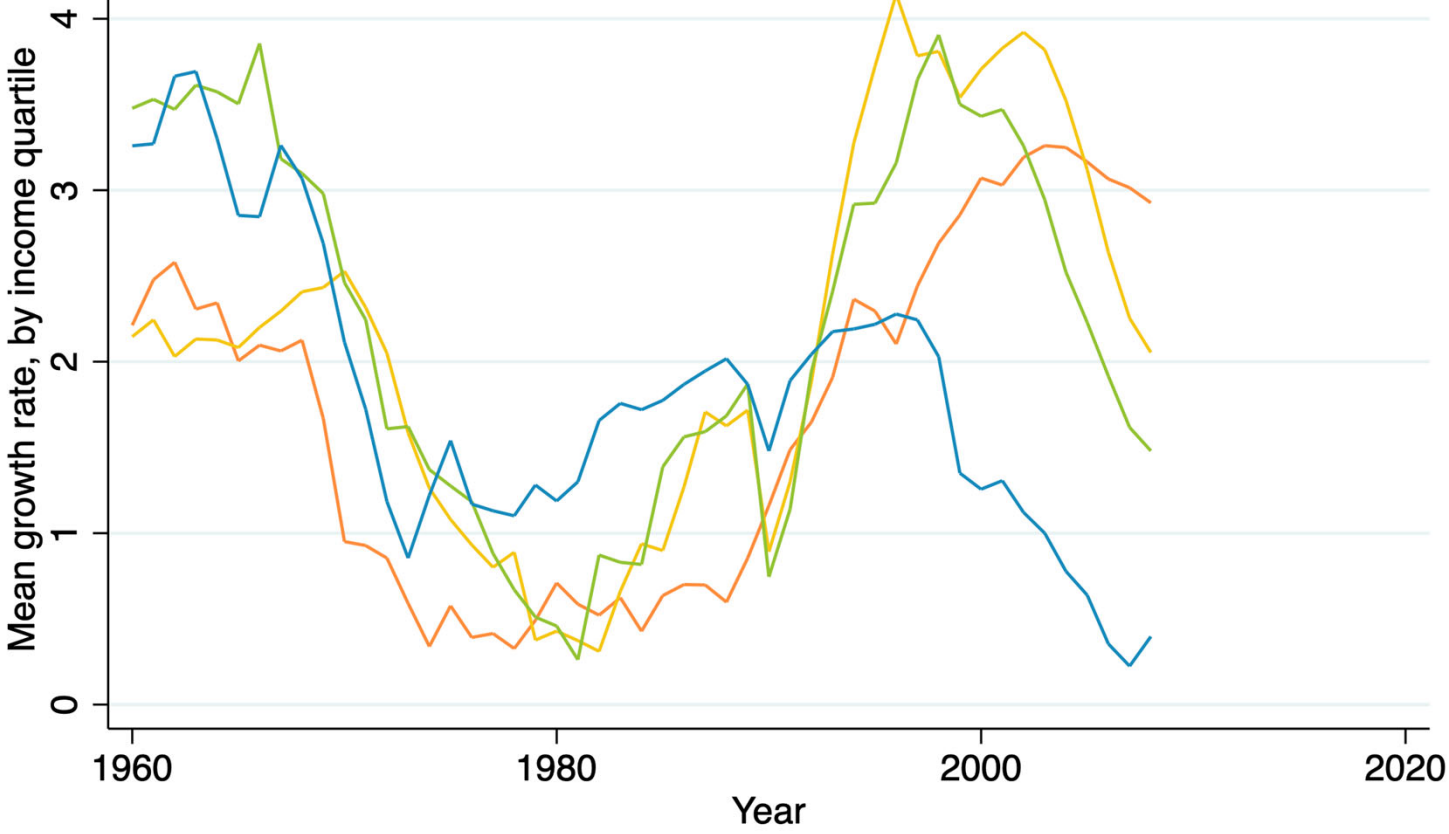


Number sovereign credit downgrades during 2010-19 (average per year) and in 2020. Includes 151 countries, foreign currency long-term sovereign debt ratings.

Source: Kose, Ohnsorge, Reinhart and Rogoff (2021)



UNITL COVID19, RICHER COUNTRIES (4<sup>th</sup> Quartile) HAVE GROWN RELATIVELY SLOWLY IN 21<sup>st</sup> CENTURY



Kramer, Willis and Yang, April 2021

# Advanced economies are in a different place

- ...For now. (Albeit it is important to recognize that the “advanced” “EM” distinction is more of a continuum as the European debt crisis illustrated.)
- Impact of the zero bound on central banks’ is profound
- Central banks are forced to rely on instruments that heavily overlap with tools available to fiscal authorities, and to other regulators, and often the central bank is very much the junior partner.
- Absent the ability to conduct normal monetary policy, central banks nevertheless are able to draw on accumulated credibility for their technical expertise, often missing elsewhere in the government.
  - But risk being asked to weigh in on areas that, at least until now, are only thinly related to their mandate and expertise.

# Caveat

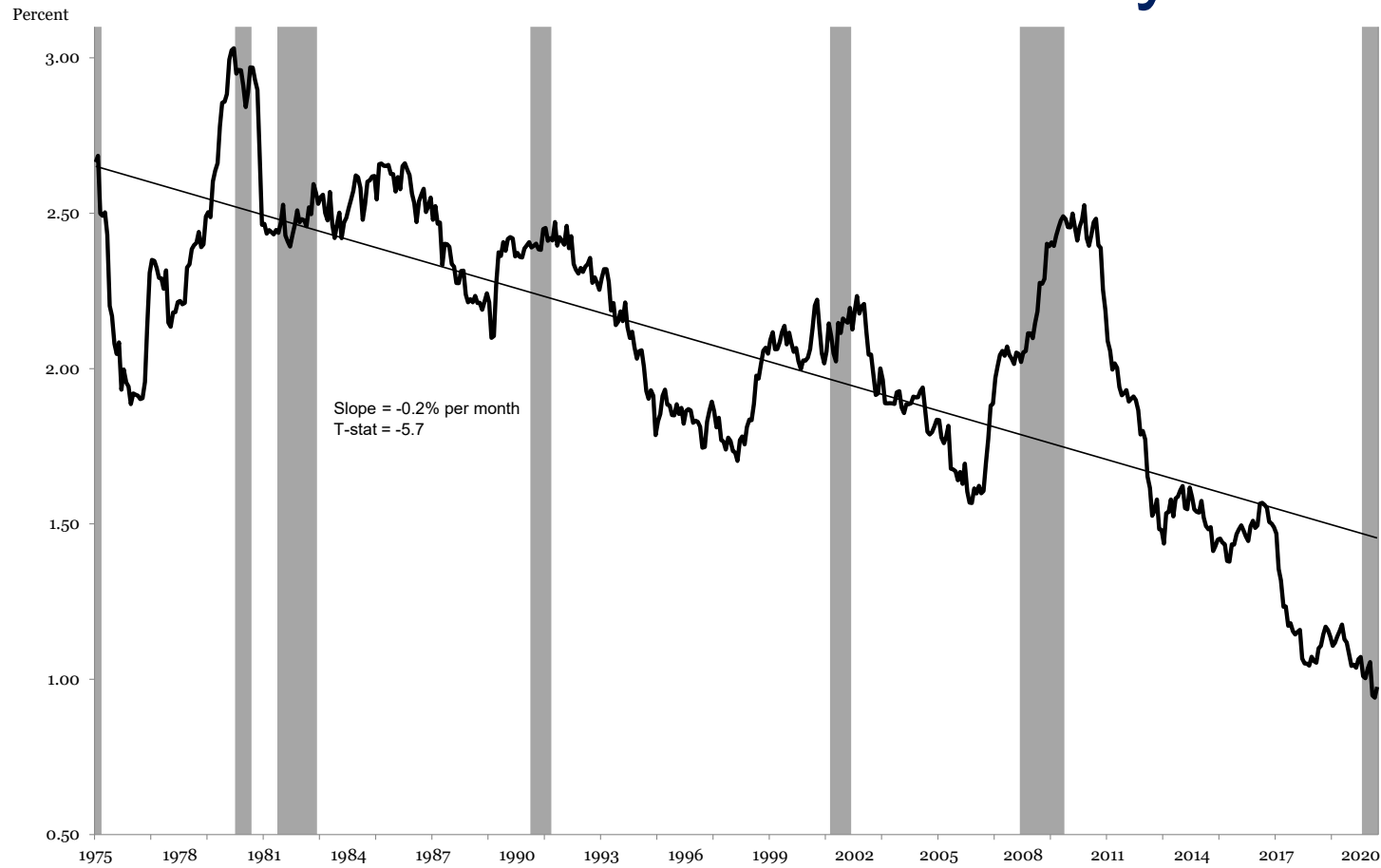
- The ECB is unique among advanced economies in that there is no corresponding unified fiscal authority

# Impact of zero bound on central bank independence

- Claim: At the effective zero lower bound on interest rates, central bank independence loses a great deal of its meaning, particularly in “normal” times.
  - Thesis of my 2019 presentation to this conference, also Rogoff (2016) Curse of Cash, Rogoff (2017 (JEP)) and Lilley and Rogoff (2019)
  - In pure QE, the central bank is a junior partner to the treasury
  - Fiscal QE (buying private debt) can be a powerful intervention in a crisis when the government is too slow to act, but in normal times, credit subsidies to the private sector should mainly be the domain of democratically elected authorities, or delegated agencies with clear supervision.
  - Forward guidance mainly about what happens if zero bound period ends
- The loss of their key instrument exposes central banks to enormous political pressures that threaten the long-term independence of central banks
  - This could be a problem if inflation ever rises significantly on a sustained basis.

One piece of evidence on how dormant normal monetary policy has become is the remarkable decline in exchange rate volatility at the core of the international system

# US Dollar-Euro Volatility



Note: Absolute value of month on month exchange rate change, 4 month moving average. USD-DEM pre-1999  
Source: Iltzetski, Reinhart and Rogoff, Brookings 2020

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# US Dollar-Yen Volatility

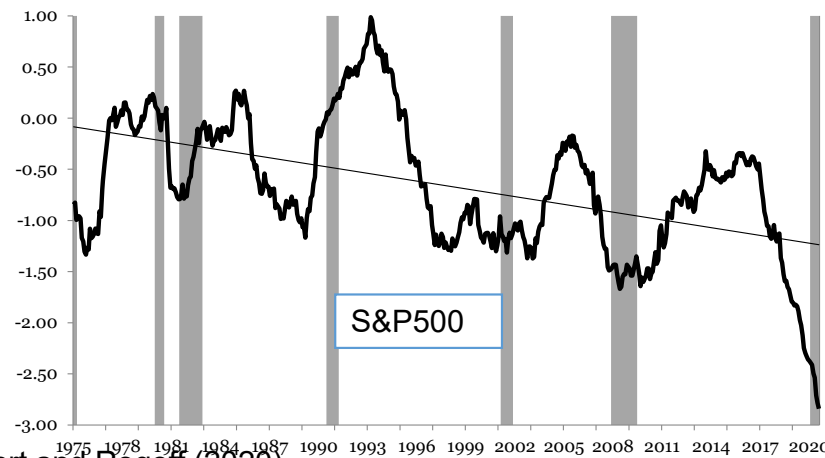
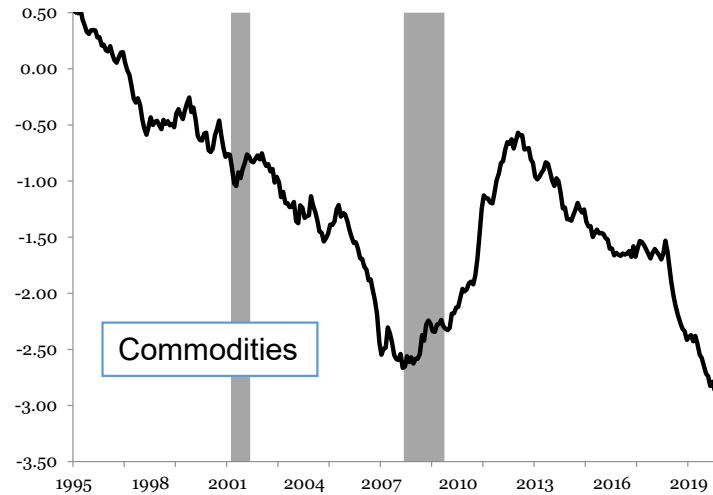
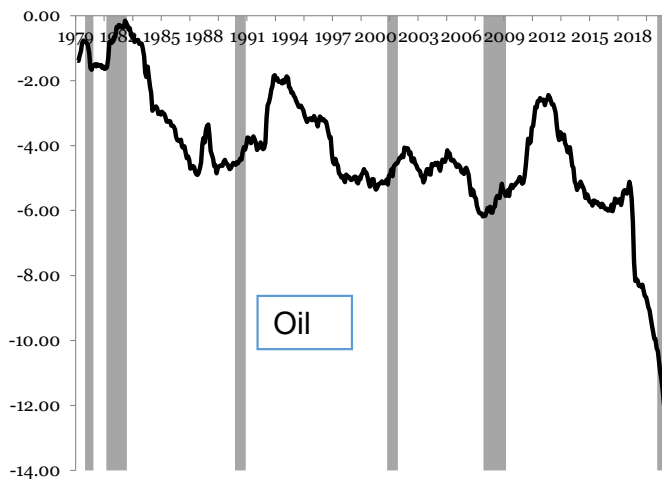


Note: Absolute value of month on month exchange rate change, 4 month moving average.

Source: Ilizetski, Reinhart and Rogoff (2020)

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# Dollar/Euro Volatility Relative to...

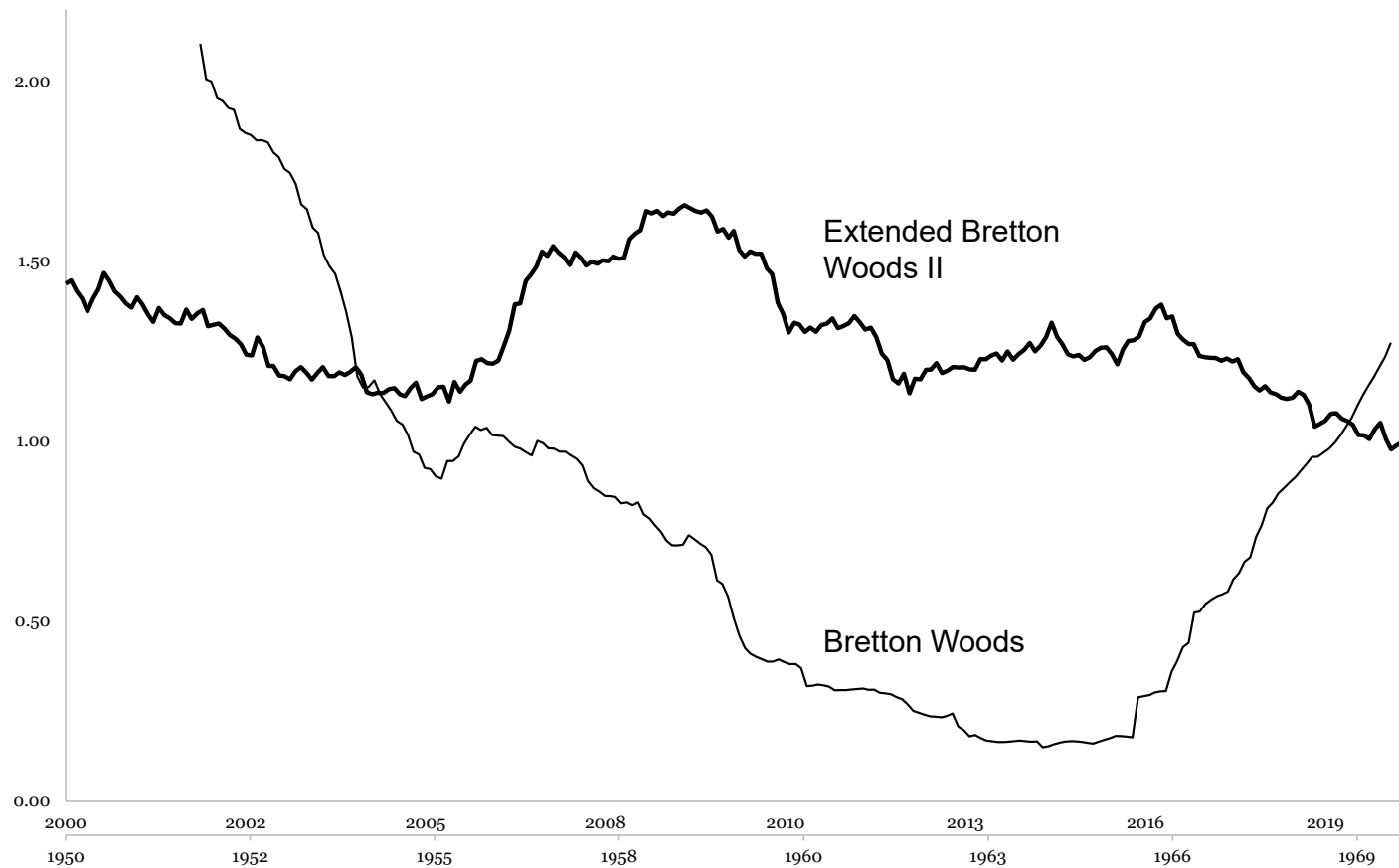


Source: Ilzetski, Reinhart and Rogoff (2020)

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# G4 Currency Volatility in Bretton Woods I and II



Bretton Woods I G4: US, UK, Germany, France. Bretton Woods II G4: US, China, Euro, Japan

Source: Iltzetski, Reinhart and Rogoff, 2020

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[Return](#)

# To regain greater degree of independence without significantly raising the inflation target

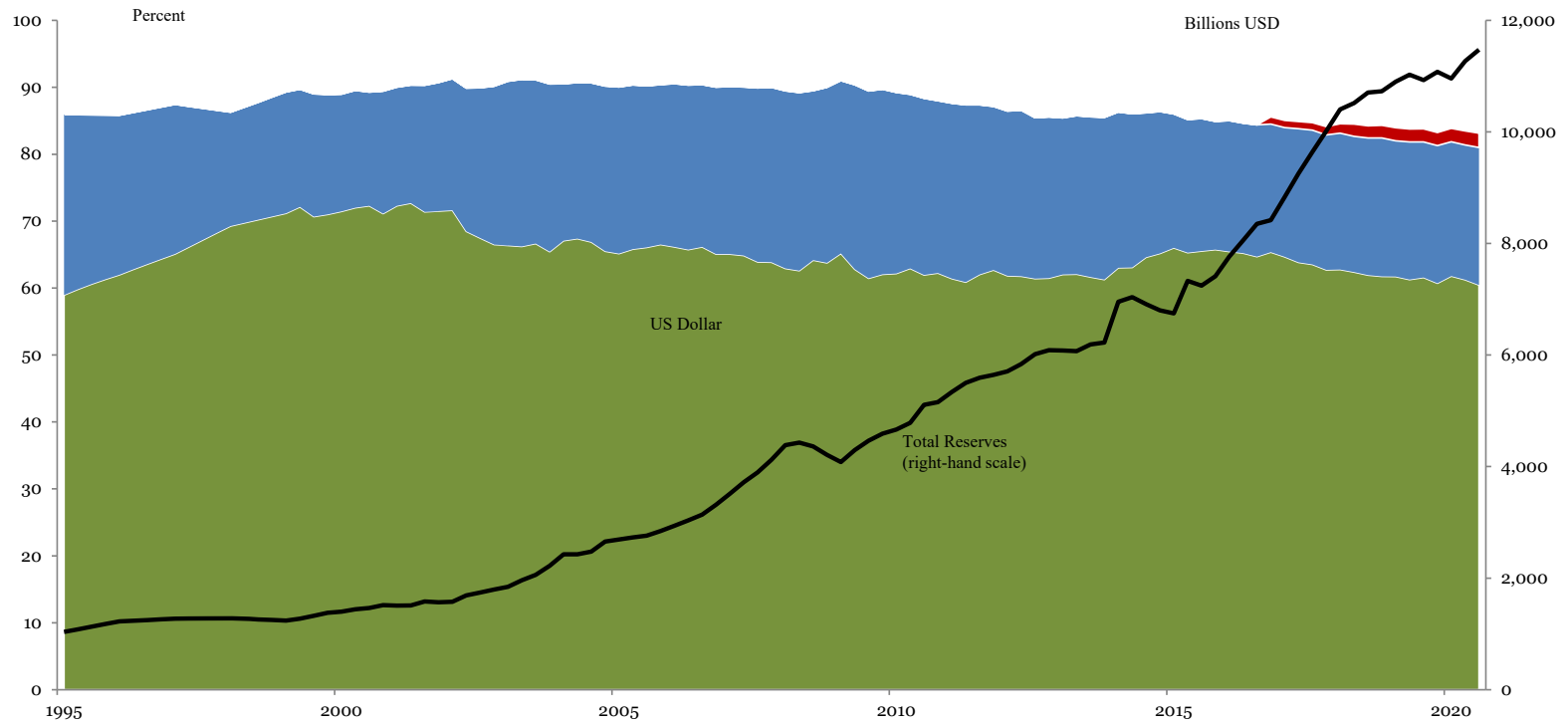
- By far the most elegant approach is to take the necessary steps for open ended short-term negative interest rate policy
- Introducing an exchange rate between bank reserves, paper currency is the cleanest approach.
- Phasing out large denomination notes would go a long ways towards reducing incentive for hoarding, and make the transition smoother.
- CBDCs can make the transition easier technically and politically
- Other legal, institutional and tax issues can be dealt with straightforwardly (Rogoff, 2016)

# ECB is very different

- For central banks associated with a single country government, there is a sharp distinction between “pure QE” and “fiscal QE”
- In the Eurozone, there is no equivalent to “pure QE”
  - In United States, the central bank does not (normally) buy state and city debt (albeit a historic – if very limited -- exception was made the pandemic.)
- ECB thus has a governance role far more significant than other central banks.
- But democratic accountability is nevertheless indirect compared to parliament, or national treasuries that report directly to respective central governments.

The Euro (and far more so) the Dollar are Unique

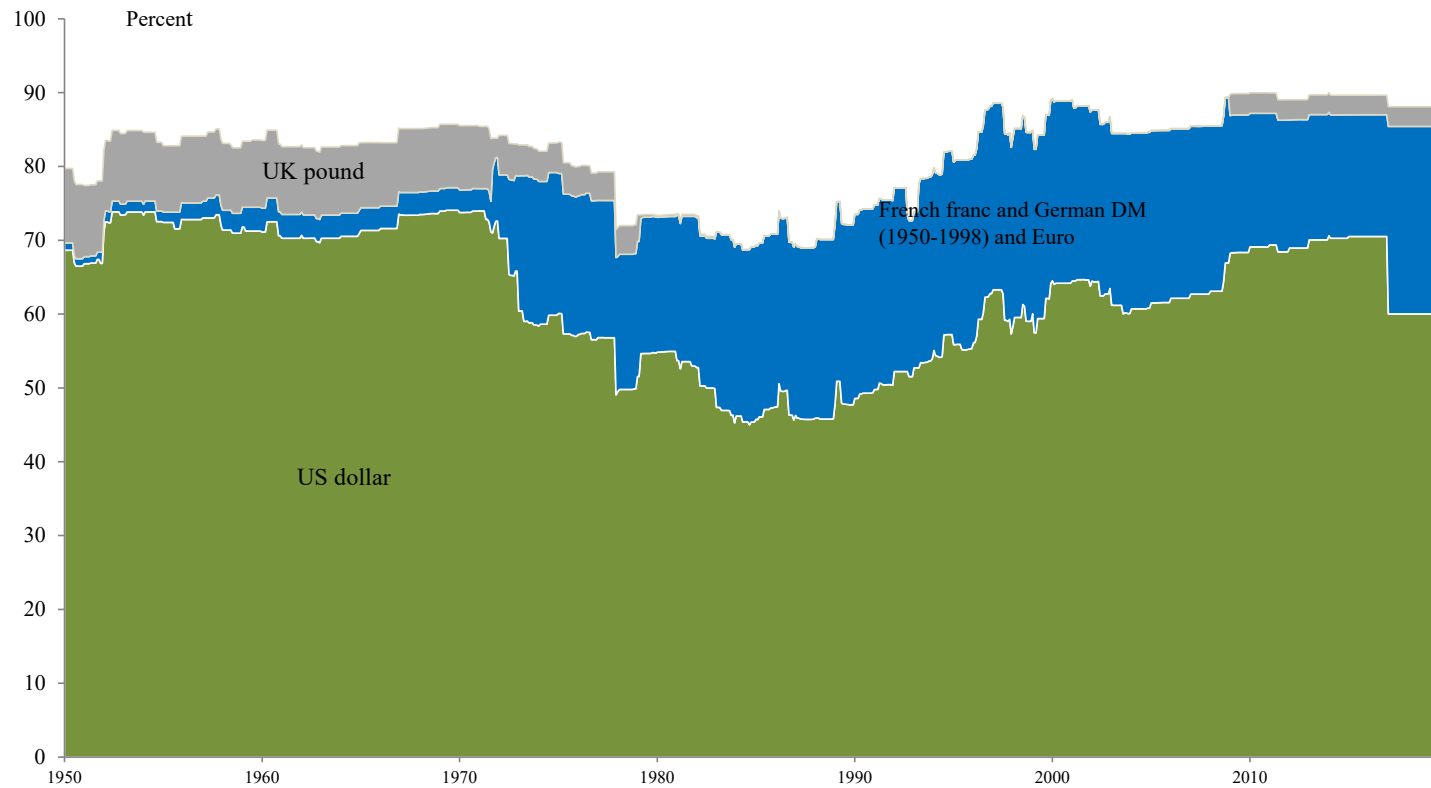
## CENTRAL BANK FOREIGN CURRENCY RESERVES



Source: Ilzetski, Reinhart and Rogoff, 2021

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## ANCHOR CURRENCY CLASSIFICATIONS (IRR, 2019, 2021 UPDATE )

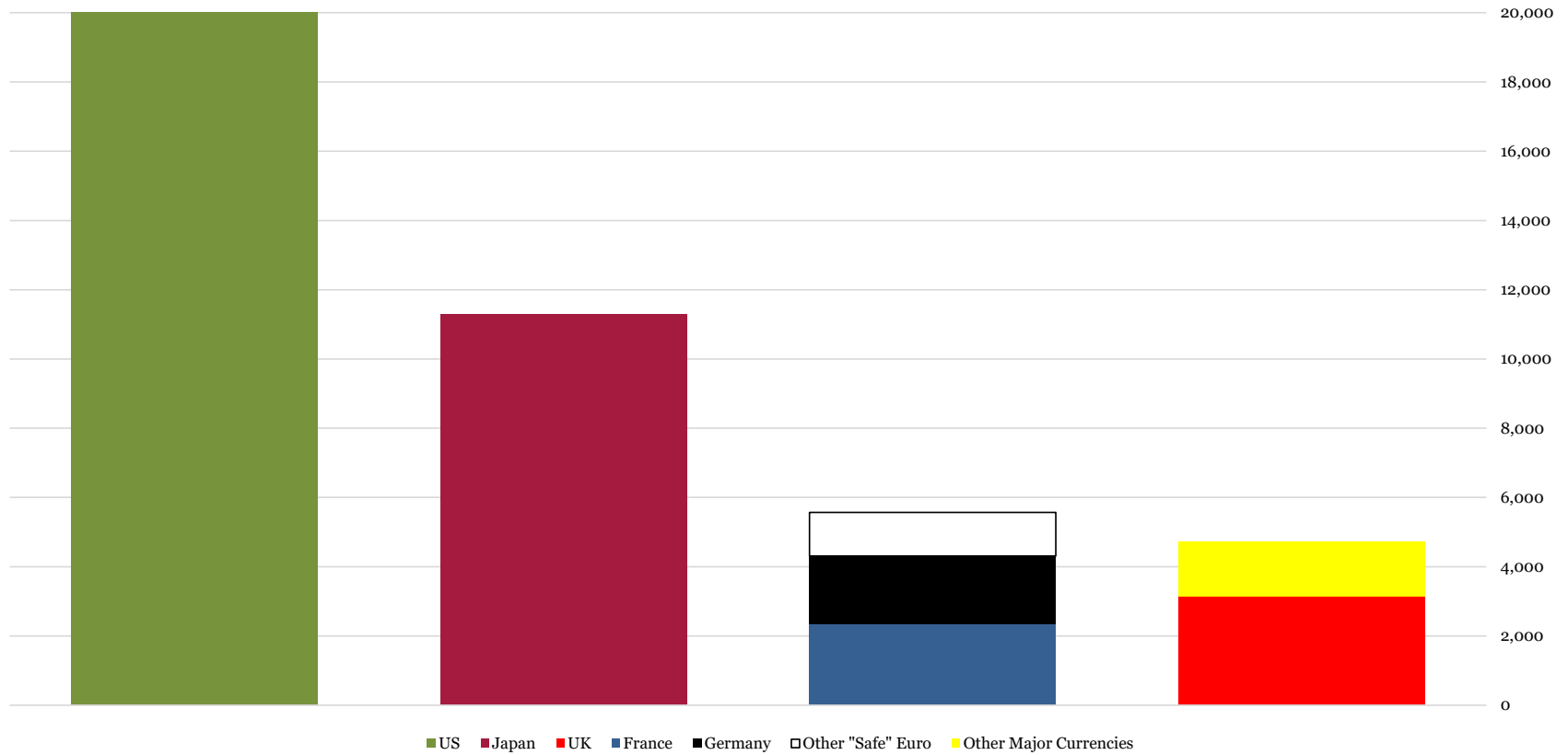


*Number of countries weighted by their share of world GDP, 1950-2019*

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Source: Iltzetski, Reinhart and Rogoff, 2021

## SOVEREIGN BONDS OUTSTANDING END-2020 (MILLIONS US DOLLARS)



Ilzetski, Reinhart and Rogoff (Brookings, 2020, updated)

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# Should central banks instead expand their targets?

- There is nothing in principle wrong with using the central bank's regulatory authority to advance clearly defined and widely agreed social goals that are determined by democratically elected authorities.
- More problematic for central banks to be setting objectives in areas outside their expertise, particularly when there is only a very tenuous connection to central bank mandate and competencies, e.g., environment
- However, as leading institutions, central banks do need to project to the world that they are fully supportive of imperatives such as these. But first and foremost in making sure their policies smooth out macroeconomic problems that arise.



Central banks' primary role in climate change should be in dealing with elevated *short-term* volatility

- The Green Transition could breed periodic bottlenecks, shortages, imbalances
- Central Banks can help stabilize along the way, build macroeconomic resilience
- Central Banks are best equipped to steer the ship, not to choose the destination

The idea that central banks should take the lead in addressing inequality is even more problematic

## Crypto-currency regulation is a case where there is a strong case for having central banks take the lead

- In most countries, many different regulators have hand in governing crypto (securities and exchange commission, commodities and futures market regulators, tax authorities, etc.)
- But there needs to be considerable centralization since ultimately key issues have to be negotiated internationally
- Digital currencies clearly falls in the domain of central banks, though treasuries can also offer digital accounts (as the US Treasury already does).
- As the financial heft of the crypto world grows, so does its political influence, and here central bank independence could prove a valuable bulwark.

THE END