Central Banking in the Time of Covid

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Things are different in a crisis

- Merriam-Webster dictionary: a ***crisis*** is "an unstable or crucial time or state of affairs in which a ***decisive change is impending***, *especially* one with the distinct possibility of a ***highly undesirable outcome***."
- The pandemic posed:
  1. A public health crisis **X**
  2. An economic crisis ***√***
  3. A *potential* financial crisis **√**
- #2 and especially #3 got people thinking about central banks riding to the rescue.
- The central banks generally performed well.

Improvisation was/is imperative.

- Perfection was not achievable, nor even well-defined.
- There was no manual to consult. The new "rules" had to be made up on the fly.
- A short (and only slightly exaggerated) summary of this lecture: ***Take everything you ever learned about best central banking practices… then multiply it by minus one!***

"*When the facts change, I change my mind - what do you do, sir?*"
— John Maynard Keynes

A roadmap

1. Act fast (CBs normally take their time developing consensus.)
2. Solve the identification problem quickly: Is it a demand shock or a supply shock?
3. Go big (CBs normally move cautiously and incrementally.)
4. The wall between the CB and the Finance Ministry had to be breached. (involving large, multiple violations of CBI)
5. As LOLR, go beyond Bagehot. (CBs normally stick to Bagehot.)
6. Don’t rush to the exits.
   - Moral hazard concerns can wait.
   - Inflation concerns can wait.

1. Speed kills

Since a crisis hits fast and hard,…

- You have had no chance to "foam the runway."
- You start out "behind the curve," playing catch-up.
- Conventional interest rate weapons operate with long lags. So…
  - Monetary policy should cut interest rates to the floor—*immediately.*
    - And signal that they will remain low for a long time
    - Having built up credibility previously helps.
  - Monetary policy may have to take a back seat to fiscal policy.
  - Must identify instances of poor liquidity or weak spots in credit markets quickly--and then move to shore them up.
    - In a crisis, it's hard to tell illiquidity from insolvency.
    - In 2020 USA, knowing that the Fed "was there" may have been enough.

2. The identification problem(s)

- Q1: Is the shock ***primarily*** to aggregate demand or to aggregate supply?
  - If it's AD, do whatever you can to boost demand.
  - If it's AS, the CB faces the standard stagflation dilemma.
  - How can you tell—esp. when it certainly has elements of *both*?
    - Watch inflation (it fell)
    - Watch the disequilibria in markets (sellers were scrambling for buyers)
- Q2: Is the crisis [financial → real] or [real → financial]?
  - 2008 (patch ups) vs. 2020 (fire walls)
- Q3: Is it mainly an illiquidity crisis or an insolvency crisis?
  - CBs are better at the former.

3. The loss function is strongly asymmetric.

- The CB won't be able to hit the bull's-eye.
- The loss function is not close to: $L=(\Pi-\Pi^*)^2 + \lambda(U-U^*)^2$
- Doing too little → big losses
  - Massive U, bankruptcies, likely hysteresis effects
- Doing too much → small losses
  - Some inflation, some bad investments, overleveraging
- Conclusion: Go big!
  - Contrasts with usual advice: Don't overdo it.

4. Take down that wall.

- This may be the most dramatic departure from norms.
- CBI is normally considered sacrosanct—for good reasons. But in a crisis…
- The problem is likely to be too big for either the CB or the Treasury to handle alone.
  - In some countries, other financial supervisors will be involved.
  - In a crisis, “all correlations go to 1.” → need for coordination
- Need for fiscal support (esp. in quasi-fiscal actions)
  - But only the CB can serve as the lender of last resort.
- The CB and the finance ministry *must not* be seen to be disagreeing in public.

5. On beyond Bagehot

- In a crisis, LOLR role is likely to be far more important than interest rate reductions.

- Every central banker knows Bagehot's dictum by heart:
  - "lend freely, at a penalty rate, against good collateral"

5. On beyond Bagehot

Some modifications for crisis times:

- “lend freely”?: certainly!
- “at a penalty rate”?: not obviously a good idea
  - Can worry about moral hazard later
  - Pandemic risk does not create much moral hazard
- “against good collateral”: sure, but maybe not *superb* collateral
  - *Someone* probably must take losses *somewhere*.
  - Treasury can/should back the CB.

6. Heading for the exits

- Not too soon: The Scarlett O'Hara principle: *"I won't think about that now. I'll think about that tomorrow."*
- Normally, this would be terrible advice to a central banker. But in a crisis…

6. Heading for the exits

- Not too soon: The Scarlett O'Hara principle: *"I won't think about that now. I'll think about that tomorrow."*
  - Moral hazard worries can wait.
  - Inflation worries probably can wait.
- Another big asymmetry: Exiting too soon vs. exiting too late
  - Hysteresis, "scarring"
  - Try to keep your exit strategy/schedule under wraps until you're ready. (a violation of transparency)
- In sum: enter quickly, exit slowly
- And don't forget to get that independence back!

Last words

- A lot of this is universal:
  - Go fast
  - Solve the identification problems(s)
  - Go big
  - Don’t exit prematurely
- But some of it depends on a nation’s wealth, its political environment, etc.
  - Can/will the fiscal side step up with support?
  - Will lending beyond Bagehot open a political pandora’s box?
  - Can a cooperative CB get its independence back?