A new policy paradigm from the LSE Maryam Forum: 2. Rethinking finance and the global financial architecture

As governments and central banks have worked to prop up the economy through fiscal stimuli, the relationship between the two has become blurred. Financial markets are being impacted by scaled-up quantitative easing. And a new international financial architecture is in the making. Central banks are revising their mandates; fiscal authorities are adjusting to constraints and upgrading cooperation with central banks; and international institutions are caught by the retrenchment of multilateralism. ***Franklin Allen, Ricardo Reis, Piroska Nagy-Mohácsi, John Gordon (LSE)*** *and the* ***LSE Maryam Forum Rethinking Finance and the Global Financial Architecture working group*** *propose ways to rethink finance and the global financial architecture.*

The pandemic has triggered radical changes in both national policies and the global financial architecture. Fiscal policy has provided large stimuli to prevent major economic depressions, reduce inequalities, and deal with large and rising private debt. Monetary policy has scaled up its support for fiscal policy, with quantitative easing (QE) increasing in size, and purchases that target new market segments. The lines between government and central bank policies have become even more blurred. Central banks like the Federal Reserve, the ECB and the People's Bank of China have expanded their swap and repo lines. Emerging market policies have also changed in radical ways. Due to positive spillovers from advanced country monetary policies and their own improved credibility, emerging market central banks also have been able to conduct QE for the first time, without immediate impact on inflation and the exchange rate.

Meanwhile, financial markets have also been reacting to changes in monetary policy, with implications for the monetary transmission mechanism, market structures and ultimately financial stability. Less understood, but critically important, is the interaction between monetary policy and financial market structure, and ultimately financial sector resilience.

Masks on sale in Lagos, Nigeria. Photo: Ebun Akinbo/ International Monetary Fund via a CC-BY-NC-ND 2.0 licence

Central bank swap lines complemented the role of international financial institutions (IFIs), but also blurred the lines between these types of institution – notably with the IMF's mandate on reserve and exchange rate policies.

A new international financial architecture is in the making. Central banks are revising their mandates; fiscal authorities are adjusting to constraints and upgrading cooperation with central banks; and international institutions are caught by the retrenchment of multilateralism. But all this has risks. A lot can go wrong when central banks are monetising debt without apparent limits, when sovereign and corporate debt levels reach historic highs with rising default probabilities, and when superpowers increasingly ignore international organisations.

Recommendation 1: Don't stop stimulus now, but watch out for QE tipping points

QE has played a much-needed role in financing fiscal expansions, and it should be continued to help economies bridge to the post-COVID world. However, monetary and fiscal authorities should watch out for potential QE tipping points – in particular, the risk of inflation, and the capacity of the central bank and the fiscal authority to each service the interest payments on their debts.

Continued low interest rates create additional debt service capacity for governments which borrow in their own currency. But risks are higher for corporates and in emerging markets, where governments borrow significantly in foreign exchange. Given the exceptional times, debt (in local currency and held by the local central bank) could be issued at very long maturities to eliminate rollover risks.

The lower interest rates induced by QE create risks. As returns on 'safe' assets are low, banks and other asset holders may seek higher risks to compensate. Low spreads could make banks unprofitable and hence more fragile as they seek out higher risks. And although rates are low now, they may not be in future, and governments may struggle to service their debts and put pressure on central banks to keep rate low.

Many emerging markets have been able to perform larger-scale QE, but in the developing world, this has not been an option, and countries need scaled-up IMF. Central bank swap lines have proven helpful on a temporary basis but may not be the appropriate mechanism to help with foreign exchange finance on a permanent basis, except for the liquidity needs of cross-border entities operating in multiple currencies across various jurisdictions.

Recommendation 2: Central bank mandates should be periodically reviewed

Central banks and governments should conduct periodic, pre-announced reviews of central bank mandates. Some already are: in 2020, the Federal Reserve has published its first-ever comprehensive and public review of the monetary policy framework and concluded that it would do the same roughly every five years. The ECB will complete the second review in its history in mid-2021.

Transparent reviews help realign society's preferences for what central banks should do and reduce the perceived democracy deficit. They can help central banks adapt to emerging challenges and assess the impact of their policies, especially those that go beyond the monetary domain (e.g. sectoral allocations resulting from corporate asset purchases).

Pre-announced periodic reviews can help reduce the expectations about their outcomes. *Ad hoc* reviews can feed expectations that important changes to interest rates would be announced, leading to volatility.

For reviews to be an integral part of accountability mechanisms, they need to be open and involve representation from both government and the legislative branch.

However, reviews may be risky for countries where central bank independence is fragile, particularly if there is political involvement.

Recommendation 3: Conduct cost-benefit analysis of any proposed new area for central banks

When central banks are asked to move into new areas, or decide to do so, they should carry out a cost-benefit analysis of the change and communicate it to the public. This would help identify the skills required, support the delivery of the bank's mandate and better align its aims with those of government. On the other hand, there is a risk of putting central bank independence at risk, diverting resources away from other priorities, and intervening in the market excessively. Crisis-induced activity must be clearly distinguished from the rest, and time limits may be appropriate.

The QE policies and other instruments launched since the global financial crisis have often had knock-on impacts on financial and economic issues. Sometimes these have had little impact on inflation and may not be worth pursuing if the side effects are too great. Cost-benefit analysis would help to formalise these deliberations.

Many central banks have moved beyond the role of "lender of last resort" to "market-maker of last resort." This raises questions about potential crowding out and the balance between government (broadly defined) and markets. In some countries the corporate bond market is growing, thanks to central bank purchases. Proportionality is an important principle, and should be a central consideration.

Several central banks actively consider the climate emergency as part of their mandate, and others are considering doing so. Greening financial sectors and lending is a very important societal objective, but may be best handled by central banks within their financial stability mandate (where it exists) or by other institutions concerned with financial risks in the economy. More broadly, the benefits and downsides of the climate policies deployed by central banks would benefit from proper assessment. It may well be that the priority of governments in coming years is not climate change or inequality, but rather keeping the high levels of debt affordable.

Recommendation 4: Define the rules of the game for monetary and fiscal authority cooperation and introduce a periodic review of their policy mix

Catastrophic events like the pandemic have highlighted the crucial importance of cooperation between monetary and fiscal authorities. During these crises, central banks necessarily become less independent to help enlarge the country's policy space by directly or indirectly financing governments. Often, they also help with the design of fiscal packages. Calls for monetary policy to align with government objectives are becoming increasingly loud, particularly given the climate emergency.

We need to lay down the rules of monetary and fiscal cooperation. This might jeopardise cherished central bank independence. But should we not accept that central banks can be less independent in the face of catastrophic events? The issue is what the right accountability mechanism for today's era would be.

Greater monetary and fiscal cooperation raises two broad issues. It should not compromise the primary objective of price stability, and the independence of central banks that enables it. And if central banks are to venture into the fiscal or political domain, they need to have the appropriate legitimacy and accountability mechanisms to do so.

Moreover, we need to differentiate between developed and developing countries. For the latter, what matters is not only how developed the financial markets are, but how strong their institutions are. Countries with fragile institutions may not want to risk independence, and could opt for less intrusive cooperation mechanisms.

There is increasing attention to the interactive impact of monetary and fiscal policies – the so-called policy mix. In our view, there should be periodic reviews of the policy mix that a country pursues.

Recommendation 5: QE necessitates better regulation of non-bank entities

Although monetary policy has not raised inflation, QE has sustained increasing asset prices. This has led asset management firms and other non-bank financial institutions to become increasingly large, concentrated and overall systemic, even if they do not take household deposits. What systemic risk do non-bank entities pose and how should they be regulated? Central banks may be reluctant to do it as it is may not be their area of expertise, but this large hole in regulation needs to be addressed.

Recommendation 6: The global financial safety net needs a reality check

So far, the global economy has reacted reasonably well in the face of the COVID shock. But this is in spite of the current global financial architecture, rather than because of it.

The role of the IMF and IFIs in the crisis has been limited, despite many proactive efforts. Instead, emerging markets have been able to conduct QE without inflation and exchange rate risks, thanks in part to positive spillovers from developed countries – QE and expanded currency swap lines. The role and impact of these swap lines and repo operations deserve further research.

Additionally, the role of the US dollar as the international currency may be set to decline, but no other major currency is in a position to take over. This also carries risks and needs heightened policy attention.

This post represents the views of the authors and not those of the COVID-19 blog, nor LSE. It is the second of six sets of recommendation from the LSE Maryam Forum. Read the first here.

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