NRI

lakyara vol.324

Post-pandemic global monetary policy

Masaya Sasaki

14.August.2020

Nomura Research Institute, Ltd.

Executive Summary

Masaya Sasaki
Senior Economist
Strategy Planning Department

Fiscal deficits are rapidly growing amid the global COVID-19 pandemic. Considering monetary policy normalization's potential impacts on equity and bond markets, central banks will likely use some version of the BOJ's yield curve control as their primary means of post-pandemic policy normalization.

Central banks' role amid pandemic

With the global COVID-19 pandemic yet to abate, the battle raging since January between mankind and SARS-CoV-2 will almost certainly be a long one. Although the risk of contagion persists, countries around the world have started to gradually reopen economically and socially following stringent lockdowns.

The imperative of figuring out on the fly how to best navigate the pandemic naturally extends even into the realm of economic policy. Governments worldwide have been forced to ramp up fiscal spending in unison to provide relief to households and companies. Meanwhile, central banks have resorted to a succession of highly unconventional policies, including de facto monetization of incremental fiscal deficits through aggressive purchases of government bonds.

The IMF's latest World Economic Outlook[1], released on June 24, projects that even under a baseline scenario that assumes steady recovery in economic activity from mid-year, the overall general government fiscal deficit will jump to 13.9% of global GDP in 2020 from 3.9% in 2019, an increase equivalent to one-tenth of 2019 global GDP.

The IMF's projection means that new government bond issuance in 2020 will equal last year's new issuance plus 10% of global GDP. The last big surge in the global aggregate fiscal deficit occurred in 2009, during the GFC, but the deficit's 2009 increase was only 4.9% of GDP, half its projected 2020 increase.

Historically, surges in government bond issuance have tended to knock supply and demand out of balance and drive rates up (bond prices down). This time, by contrast, rates have actually declined in most major developed countries.

NOTE
1) https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020

©2020 Nomura Research Institute, Ltd. All Rights Reserved.

While their decline seems to have been driven partly by growth in sovereign bond demand from investors anticipating a deep pandemic-induced recession, the predominant driver is that numerous central banks swiftly unleashed a flood of liquidity, including through government bond purchases, in response to the pandemic.

This torrent of liquidity restrained the spike in junk bond yields, steep equity market selloffs and EM capital outflows triggered by initial reports of the virus's spread to Europe and North America. A major financial crisis was consequently averted, unlike in 2008. In fact, even though the real economy has suffered drastic deterioration, financial markets have managed to regain composure by virtue of central banks' massive liquidity injections, in response to which equities have rallied to valuations that cannot be justified by company fundamentals alone.

However, with fiscal deficits set to balloon to a mid-teens percentage of global GDP even under the aforementioned optimistic scenario, they could swell even further if headwinds such as a major second wave of the pandemic or longer-than-anticipated wait for a vaccine were to hypothetically emerge. In such an event, central banks may assume a commensurately bigger role.

Post-pandemic monetary policy

Conversely, the current harmonious coordination of ultra-expansionary monetary and fiscal policies could abruptly come to a screeching halt once the pandemic endgame is clearly visible in the form of, e.g., widespread availability of a newly developed vaccine. Monetary and fiscal authorities would then no longer need to continue their expansionary policies (undertaken in a state of panic). They may make a U-turn toward post-pandemic policy normalization through fiscal consolidation and/or shrinkage of central bank balance sheets.

Even worse, such policy normalization could unfold in globally synchronous fashion, just as ultra-expansionary monetary and fiscal policies were rolled out at roughly the same time globally.

When central banks were looking to wind down QE during the post-GFC recovery of the early 2010s, the Fed was the first to start normalizing monetary policy. It did so in response to an endogenous factor, namely domestic economic conditions, though not without unintentionally provoking a "taper tantrum" in long-term rates.

©2020 Nomura Research Institute, Ltd. All Rights Reserved.

The BOJ and ECB subsequently followed the Fed's lead.

This time, however, the catalyst that triggers policy normalization will likely be an exogenous one: subjugation of the pandemic. If so, governments could very well start clamoring en masse about the need for fiscal consolidation through tax hikes and/or spending cuts at the same time that central banks start to likewise turn their attention to policy normalization to scale their balance sheets back down to the pre-pandemic norm. Monetary and fiscal authorities would have to plan in advance how they will transition from expansionary policy to austerity to minimize the adverse repercussions of doing so.

In terms of monetary policy, central banks that are purchasing government bonds to rectify supply-demand imbalances due to surging government bond issuance would have to gradually phase out their purchases to restore market principles in government bond markets. They can do so in one of two ways. First, they can provide forward guidance on planned changes in government bond purchase quantities and allow the market to set long-term rates (bond prices), as the Fed did when exiting QE in the 2010s. Second, they can set floors/ceilings on medium/long-term rates (bond prices) and let the market determine how much government bonds they will end up purchasing, as the BOJ et al. are currently doing.

Today, however, fiscal deficits are burgeoning across virtually all countries/regions in the wake of radical fiscal expansion as already noted. Even under the IMF's aforementioned baseline scenario, global public debt is projected to end 2020 at 101.5%, more than a full year's worth, of global GDP[2]. If central banks were to allow long-term rates to rise sharply against the backdrop of such a debt burden, not only would the resultant increase in interest expense strain many countries' fiscal budgets, higher rates would pose serious concerns in terms of their impact on normalization of the real economy as well as potential side effects such as severe asset price deflation.

2) Global public debt at year-end 2019 was 82.8% of global GDP.

The risk of such adverse consequences is exemplified by the aforementioned taper tantrum in the US. When the Fed signaled it was getting ready to taper QE in 2013, the 10-year UST yield shot up from the vicinity of 1.5% to 3%, roiling equity and other markets. While the taper tantrum was partly caused by suboptimal Fed communication with markets, it was mostly attributable to the Fed opting to allow the market to set rates (bond prices) in exchange for control over the quantity of its UST purchases during its exit from QE.

©2020 Nomura Research Institute, Ltd. All Rights Reserved.

In light of such, we believe many central banks are more likely to pursue post-pandemic policy normalization by controlling rates at both the long and short ends of the curve, thereby limiting side effects on fiscal policy and financial markets, like the BOJ is now doing[3]. Whether such policy normalization proves permanent, however, is a another question.

3) The minutes of the Fed's April 28-29 FOMC meeting reported that a few participants proposed purchasing USTs on a scale sufficient to cap yields at short- to medium-term maturities for a period of time. Additionally, the New York Fed's Liberty Street Economics blog published an assessment of the effectiveness of the BOJ's yield curve control (YCC) on June 22. The post notes that YCC has enabled the BOJ to keep long-term rates stably low without resorting to large-scale JCB purchases, though it has failed to lead to attainment of the BOJ's inflation target.

©2020 Nomura Research Institute, Ltd. All Rights Reserved.

about NRI

Founded in 1965, Nomura Research Institute (NRI) is a leading global provider of system solutions and consulting services with annual sales above $4.8 billion. NRI offers clients holistic support of all aspects of operations from back- to front-office, with NRI's research expertise and innovative solutions as well as understanding of operational challenges faced by financial services firms. The clients include broker-dealers, asset managers, banks and insurance providers. NRI has its offices globally including New York, London, Tokyo, Hong Kong and Singapore, and over 13,000 employees.

For more information, visit https://www.nri.com/en

The entire content of this report is subject to copyright with all rights reserved.
The report is provided solely for informational purposes for our UK and USA readers and is not to be construed as providing advice, recommendations, endorsements, representations or warranties of any kind whatsoever.
Whilst every effort has been taken to ensure the accuracy of the information, NRI shall have no liability for any loss or damage arising directly or indirectly from the use of the information contained in this report.
Reproduction in whole or in part use for any public purpose is permitted only with the prior written approval of Nomura Research Institute, Ltd.

Inquiries to : Financial Market & Innovation Research Department
Nomura Research Institute, Ltd.
Otemachi Financial City Grand Cube,
1-9-2 Otemachi, Chiyoda-ku, Tokyo 100-0004, Japan
E-mail : kyara@nri.co.jp

https://www.nri.com/en/knowledge/publication/fis/lakyara/

©2020 Nomura Research Institute, Ltd. All Rights Reserved.