A Policy Revolution and a Regime Change



Elga Bartsch
Managing Director,
Head of Macro Research
BlackRock Investment
Institute

Jean Boivin
Head of BlackRock
Investment Insitute

Philipp Hildebrand
Vice Chairman
BlackRock Investment Insitute,
Member of BlackRock's Global
Executive Committee

ABSTRACT

The macroeconomic policy revolution accelerated by Covid-19 implies that central bank policy rates and nominal bonds yields will be less responsive to rising inflation pressures over the medium-term. The potential for higher consumer price inflation over the medium-term is still underappreciated, we think, because the new central bank policy frameworks and global cost pressures are not fully reflected in private sector inflation expectations. Neither is the shift towards a closer coordination between monetary and fiscal policy. Combined with the fact that bond yields remain close to their effective lower bound and that authorities need to rely to a greater extent on fiscal policy, the role of government bonds in investment portfolios as a hedge against risk-off events such as the one in March 2020 is increasingly challenged. In contrast to past inflation episodes, less-responsive nominal interest rates and bonds yields mean that government bonds are also becoming less effective as store of value.

Introduction

Covid 19 ushered in a macroeconomic policy revolution, that had only been discussed hypothetically until this Spring. But in just a few months we saw a profound revolution in monetary fiscal policy coordination. Such a profound policy revolution was very much necessary to fend off a devastating crisis.

But without proper guardrails and a clear exit strategy, we might find ourselves on a slippery slope in terms of the inflation regime. After decades of lowflation during which central banks were struggling to meet their inflation objectives, we believe that shift in the inflation regime will result from the combination of the policy revolution and number of other secular shifts accelerated by Covid-19.

The scale of the fiscal policy response surpassed the global financial crisis (GFC) in terms of discretionary fiscal stimulus and government guarantees. Fiscal policy mobilization on such a scale has not been seen since World War Two. And in some cases, the fresh round of emergency stimulus comes on top of already sizeable budget deficits and steep upward trajectories in public debt.

The policy response during the GFC also forced policy innovations that were seen as revolutionary at the time: forward-guidance, quantitative easing (QE), negative interest rates, and funding-for-lending programs to bolster bank lending. These unconventional policies still worked mostly by lowering short- and long-term interest rates – and they also worked through the financial system, affecting the non-financial private sector only indirectly.

Some of these policies started to blur the distinction between fiscal and monetary policy. Examples include the funding-for-lending programs (UK), central bank purchases of equity (Japan) and corporate debt (euro area) – as well as the introduction of yield curve control, targeting a range for long-term yields (Japan). Yet this blurring still only occurred at the fringes of the policy envelope.

New tools in the box

Major central banks policy tools

Central banks and policy tools	US	Euro area	Japan	UK
FX swap lines	✓	✓	✓	✓
Regulatory forbearance	✓	✓	✓	✓
QE – government bonds	✓	✓	✓	✓
QE – credit	✓	✓	?	✓
QE – equity	X	X	✓	X
Negative policy rates	X	✓	✓	?
Direct lending to public authorities	✓	X	X	✓

Source: BlackRock Investment Institute and central banks, June 2020. Notes: The table shows which major central banks have adopted or are considering different "unconventional" policies. FX swap lines are an agreement between two central banks to exchange currencies. Regulatory forbearance is where central banks state that commercial banks may eat into capital and liquidity buffers to boost liquidity. Direct lending to public authorities is direct cash transfers from the central bank to government to finance spending.

Blurred boundaries due to Covid-19

In the wake of Covid-19, the policy revolution has taken on a new dimension, with global policy frameworks being redesigned in real time as specific needs arise both on the monetary and to some extent also on the fiscal side. Alas, so far there not much thought seems to have given to an institutional framework for the coordination between monetary and fiscal policy area. This increased coordination was needed for three reasons:

First, the nature of the Covid-19 shock required a policy bridge that directly replaced lost incomes. Lowering rates and easing financing conditions would not have been sufficient to stem the pandemic's damage, especially to services activity. Direct financing – even through credit – is fiscal in nature.

Second, the outbreak of Covid-19 caused an economic shock unprecedented in peacetime. Even though the cumulative shock is probably going to be relative short-lived compared with the GFC, provided adequate policy support prevents scarring of productive capacities, a shock of this magnitude requires full involvement of both fiscal and monetary authorities.

Third, in the wake of the GFC there has been very limited monetary policy space due to interest rates already being at or near their effective lower bounds. As a result, fiscal policy needed to become much more actively and aggressively involved in providing policy support at the current juncture.

Elements of the policy revolution

The policy revolution has three main elements. First, the new policies are explicitly attempting to "go direct" – bypassing transmission through the financial sector by finding more direct pipes to deliver liquidity to a larger set of entities. These include businesses, households and foreign central banks. This liquidity is provided in return for a broader set of collateral, such as corporate bonds and bank loans – up to and including the Fed's Main Street facilities.

The ECB and the Bank of Japan had already made baby-steps in that direction, but all major developed market central banks are now moving into unchartered territory. The U.S. and UK fiscal authorities are explicitly backing this type of central bank lending and in turn are starting to rely on direct borrowing from the central bank at the local government level. In the euro area, the main innovation is the Pandemic Emergency Purchase Programme (PEPP) that allows the ECB to buy government debt with a greater flexibility in terms of pace and composition than the traditional purchase programs foresee.

One consequence for financial markets: going direct relies less on lower interest rates, portfolio rebalancing and inflating asset price values to deliver stimulus. Hence, on its own, this policy revolution is unlikely to be the prelude of a decade-long, policy-fueled bull market for risk assets as we saw after the GFC.

Second, the policy revolution is blurring the boundaries of fiscal and monetary policies. Some of the new monetary policy instruments, notably the various credit facilities offered by the Federal Reserve under 13(3) all involve credit risk that is explicitly backed by the U.S. Treasury. This is fiscal policy delivered through a Fed instrument.

Boundaries have also been blurred in the use of monetary policy to keep interest rates low – buying government debt as fiscal spending surges. Aside from the few places where it is explicitly presented as yield curve control, large or even unlimited asset purchase programs are tied to maintaining low government bond yields. Temporary monetary financing has been made explicit in the UK.

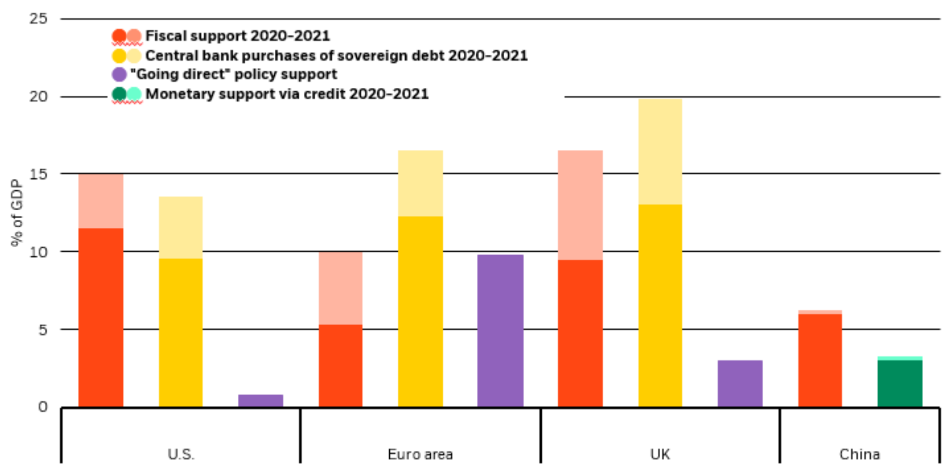
Third, the policy revolution has also rung in stringent conditionality around dividend payouts, share buybacks and executive compensation imposed on companies taking government support. This opens the door to unprecedented government intervention in financial market functioning and corporate governance.

Fiscal policy also has undergone major shifts. Not only has the response been faster and the scale greater than at any moment in peacetime history, but central banks are absorbing a considerable share – if not all – of the net issuance through the expansion of their balance sheets. On our estimates this phenomenon is set to continue in 2021 as well.

Fiscal and monetary policy support set to continue into 2021

Ongoing support remains vital to prevent permanent economic scarring. The U.S. faces risks of policy fatigue. In the euro area, monetary policy remains accommodative with fiscal support expected in H2.

Fiscal and monetary support, 2020-2021



Source: BlackRock Investment Institute, with data from Haver Analytics, December 2020. Note: solid orange bars show estimates of the discretionary fiscal measures in 2020 implemented in response to the Covid-19 pandemic. The light orange bars show the equivalent support for 2021, based on a range of estimates of measures from internal and broker sources. The green bars show the estimated impulse of monetary growth in China measured via total social financing (TSF), the broadest gauge of credit, stripping out local government debt purchases. The purple bars show the direct central bank support via programs such as the Term Funding Scheme for Small and Medium-sized Enterprises in the UK and the Targeted Longer-term Refinancing Operations in the euro area aimed at ensuring flow of credit to banks in return for greater bank lending to the private sector.

Crossing the Rubicon

The policy revolution was inevitable given that the monetary policy space was insufficient to respond to a significant, let alone a dramatic, downturn. We discussed this in our paper *Dealing with the next downturn* in August 2019. But now we seem to have crossed the Rubicon in terms of fiscal and monetary policy coordination. As central banks are increasingly implementing fiscal policies, they are becoming even more vulnerable to political pressure in an age of rapidly rising debt levels and deepening political divisions – up to and including outright populism.

Without proper guardrails and a clear exit strategy, it is unclear how policymakers are going to put the 'genie back into the bottle'. There will already be a need for central banks to absorb much of the debt issued by governments for some time to avoid an uncontrolled rise in long-term yields once the economy recovers and inflation moves back – and eventually above – inflation targets. And at that point, it is not clear what will prevent governments from financing new spending in the same way.

In fact, the Fed's new policy framework explicitly states its intent to become more tolerant of inflation in the future. Not only is the Fed willing to let inflation overshoot its 2% target to make up for past undershoots with average-inflation targeting approach, it will also look beyond any warning signals coming from the labour market at or beyond full employment. That's because its new approach only considers shortfalls from full employment in monetary policy decisions. This could potentially open the door to uncontrolled deficit spending with commensurate monetary expansion – and ultimately a higher inflation regime.

In need of an institutional framework

A clearly defined exit strategy from the crisis induced monetary fiscal coordination is required. One approach we laid out is a Standing Emergency Financing Facility (SEFF), a framework in which the exit from the joint monetary-fiscal policy effort is explicitly determined by the inflation outlook. A practical approach would be to stipulate a contingency where monetary and fiscal policy would become jointly responsible for achieving the inflation target. Without an ex-ante commitment to a governance framework, an orderly exit could be very difficult. And to be credible, the exit decision will need to be independently controlled by the central bank.

The contours of a such a framework could include the following elements:

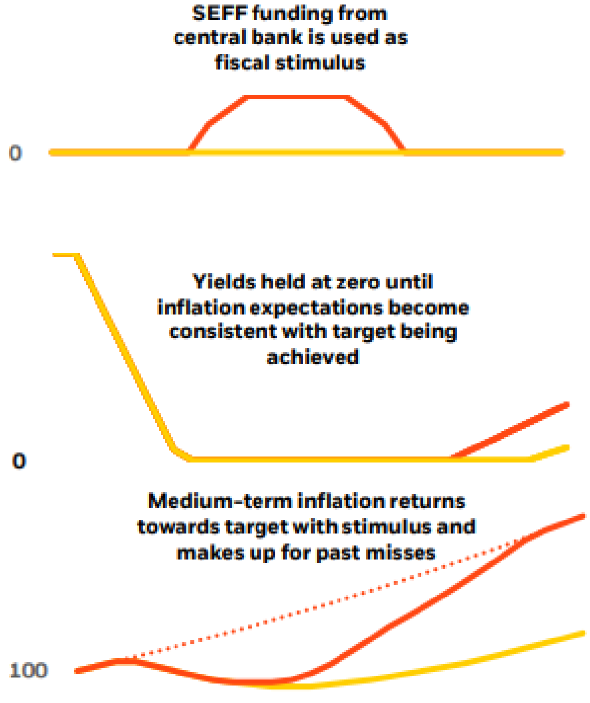
- An emergency fiscal facility – such as the SEFF – would operate on top of automatic stabilisers and discretionary spending, with the explicit objective of bringing the price level back to target.

- The central bank would activate the SEFF when interest rates cannot be lowered and a significant inflation miss is expected over the policy horizon.
- The central bank would determine the size of the SEFF based on its estimates of what is needed to get the medium-term trend price level back to target and would determine ex ante the exit point. Monetary policy would operate similar to yield curve control, holding yields at zero while fiscal spending ramps up.
- The central bank would calibrate the size of the SEFF based on what is needed to achieve its inflation target.

This proposed framework could include Ben Bernanke's temporary price-level target where the central bank commits to not only reach its inflation target but make up for past shortfalls (see Bernanke 2017). Importantly, it complements it by specifying the mechanism – the SEFF – to push inflation higher. This is inspired by Bernanke's 2016 proposal for a money-financed fiscal programme**.**

In action

Stylized impact of SEFF on yields and prices



Sources: BlackRock Investment Institute, August 2019. Notes: These stylized charts show the hypothetical impact of a temporary increase in fiscal stimulus financed by the central bank, as reflected in the SEFF funding (red line in top chart). The other red lines show the impact on the inflation trend relative to the inflation target (dotted line on bottom chart) and on the long-term sovereign bond yield (middle chart). The yellow lines show the hypothetical outcome if there is no stimulus. For illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

Post-COVID Normalisation

At the current juncture many of these policy-related risks would be mitigated if the economy and markets quickly return to a more normal environment. The vaccine news is encouraging in this respect as it underscores that policy is building a bridge to somewhere, providing reassurance that the risk of material scarring productive capacities is limited. The availability of several effective vaccines strengthens the political arguments for providing temporary policy support.

The policy revolution has been key in avoiding that the Covid-19 shock doesn't morph into a full-blown financial crisis and an economic depression. But looking further ahead, a change towards a higher inflation regime is a risk in the medium term. The lack of a clear exit strategy risking a de-anchoring of inflation expectations in an environment where a rewiring of global supply chains and re-regulation could push production costs higher.

Together with a shift in central bank policy frameworks, this could pave the way towards higher inflation over the medium term. After more than 30 years, well-anchored inflation expectations are increasingly taken as a market fundamental. Yet in the past it was precisely when anchored inflation expectations were taken for granted that they became unanchored – as happened in the 1960s and 1970s.

Risk of an inflation regime shift

Without a clear framework, central banks could now find it more difficult to lean against higher inflation. The blurring of fiscal and monetary policy means the decision to start tightening monetary policy will be more politicized. When looking at the concrete debt servicing cost of tightening monetary policy, the less tangible – but no less real – risk of loosening the grip on inflation expectations will pale in comparison. And it will be harder for central banks to persuade the public of the need to lean against inflation. If it is fine to overshoot the target for some time, why not some more? If going up to 2.5% is acceptable, why not 3%?

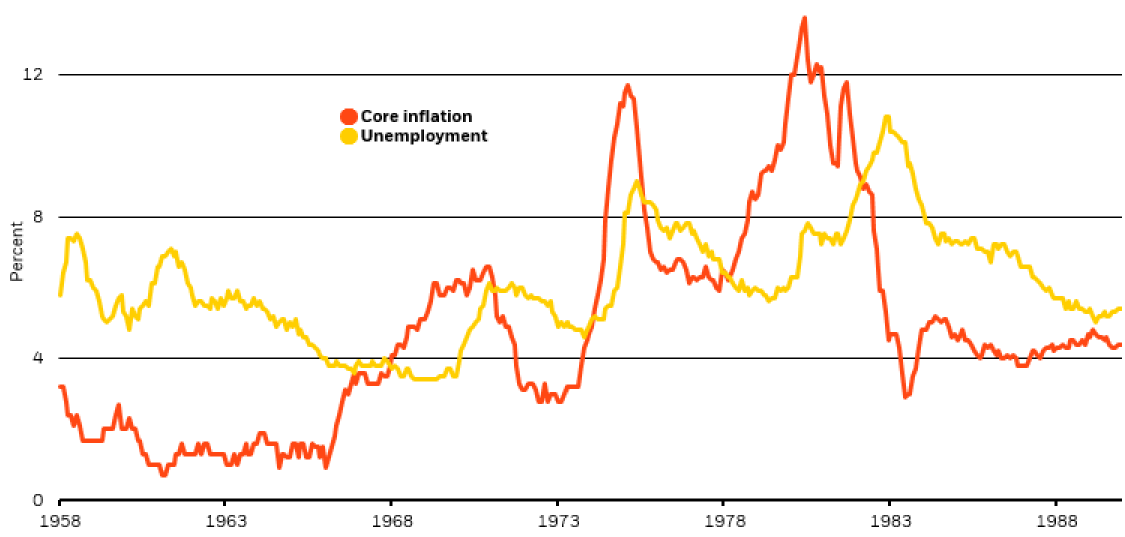
The Fed will be less able to appeal to a tight labour market anymore even if is it building inflationary pressures. This makes it harder to stave off political pressures. The underlying inflation dynamics at play, combined with perceived constraints on central banks to raise interest rates in an environment of rising and elevated debt, could raise doubts about the credibility of inflation targets. Anchoring inflation expectations is about confidence in the central bank.

Once lost, it is hard to regain – as the experience of the late Fed Chair Paul Volcker showed in 1980s. That is why we see a risk of a self-fulfilling cycle of higher inflation and inflation expectations without clear guardrails around the fiscal-monetary coordination.

The Fed could lose its grip on inflation expectations

Inflation expectations could become unanchored and keep shifting higher, as they did in the late 1960s when the Fed prioritized full employment over fighting inflation.

U.S. core inflation annual rate vs. unemployment rate, 1958-1988



Sources: BlackRock Investment Institute and U.S. Bureau of Labor Statistics, with data from Refinitiv Datastream, November 2020. Notes: The chart plots the annual change in the core Consumer Price Index against the unemployment rate.