National Bank of Romania

“Revisiting limits and pitfalls of QE in emerging markets”, CBBH, Saraievo, 4 November, 2021

D. Daianu, A. Alupoaiei, M. Kubinschi

The opinions expressed in this presentation do not necessarily reflect the views of the National Bank of Romania.

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- The paper follows D. Daianu (SUERF, Sept. 2020)

1. Context

- A huge sanitary crisis has been interweaving with **severe economic and social strain** following a necessary lockdown for several months during 2020; a deep fall of economic activity, more abrupt than during the GFC

- The Pandemic shock follows the GFC, which has triggered massive unconventional operations by CBs and aid from governments – a sort of a *War economy syndrome*

- Most economies are out of the deep hole caused by *The Shutdown*, with a strong rebound → but economic recovery likely to be **difficult** as it is accompanied by significant uncertainties and contradictions, an energy price shock, supply chains disruptions, geopolitical rivalries…

1. Context

- New variants of Covid-19 maintain **uncertainty --** vaccination is the only effective weapon to stymie its destructive effects and help us overcome the sanitary crisis…..Vaccination is very low in poor countries and the Pandemic will continue to plague the global economy

- The energy shock forebodes a dramatic change in relative prices due to Climate Change, which is an existential threat…is *hydraulic civilization syndrome (Wittfogel)* looming?

1. Context

- An age of extreme events, of *radical uncertainty*

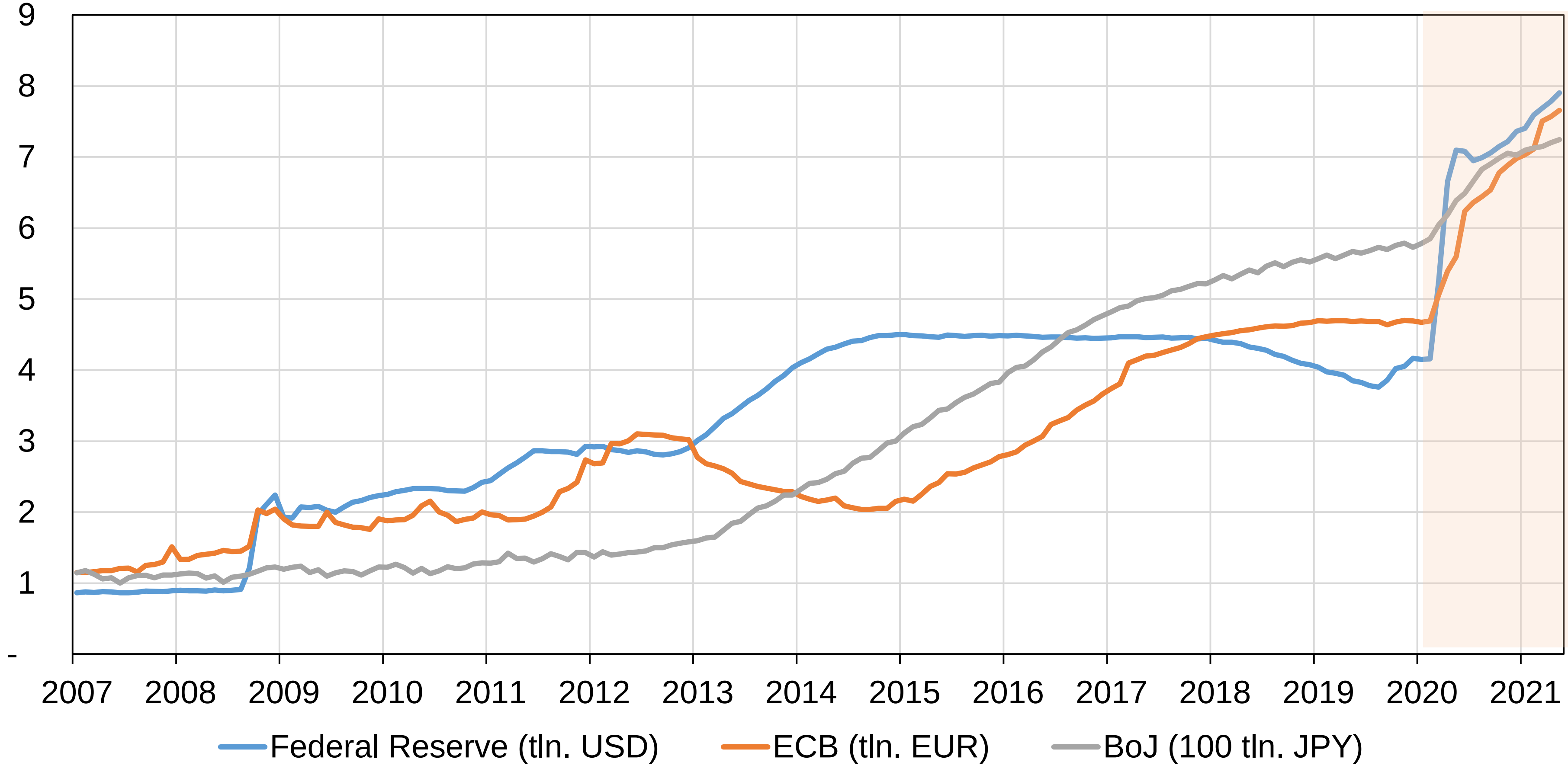
- Forecasts become increasingly unreliable…our models are questioned (not only conceptual key constructs, such as the Phillips curve)

- CBs and their new mandate: price stability and financial stability; climate change; distributional effects of QE, etc

- Much tougher rides for CBs owing to huge challenges for economies

2. Policy response in advanced economies

Central Banks' balance sheet dynamics (2007-2021)



Source: Federal Reserve Economic Data (FRED), ECB Statistical Data Warehouse (SDW) and BoJ

2. Policy response in advanced economies

- In advanced economies (AEs), governments and central banks have unleashed massive support programs, similar to the response to the Financial Crisis

✓ "*In three months, the Fed 'printed' as much high-powered money as it did over the first 100 years of its history, from 1913 to 2013*" (Orphanides, 2021)

✓ the ECB has extended its non-conventional operations, through the Pandemic Emergency Purchase Programme (PEPP) in 2020, amounting to 1.85 trillion euro

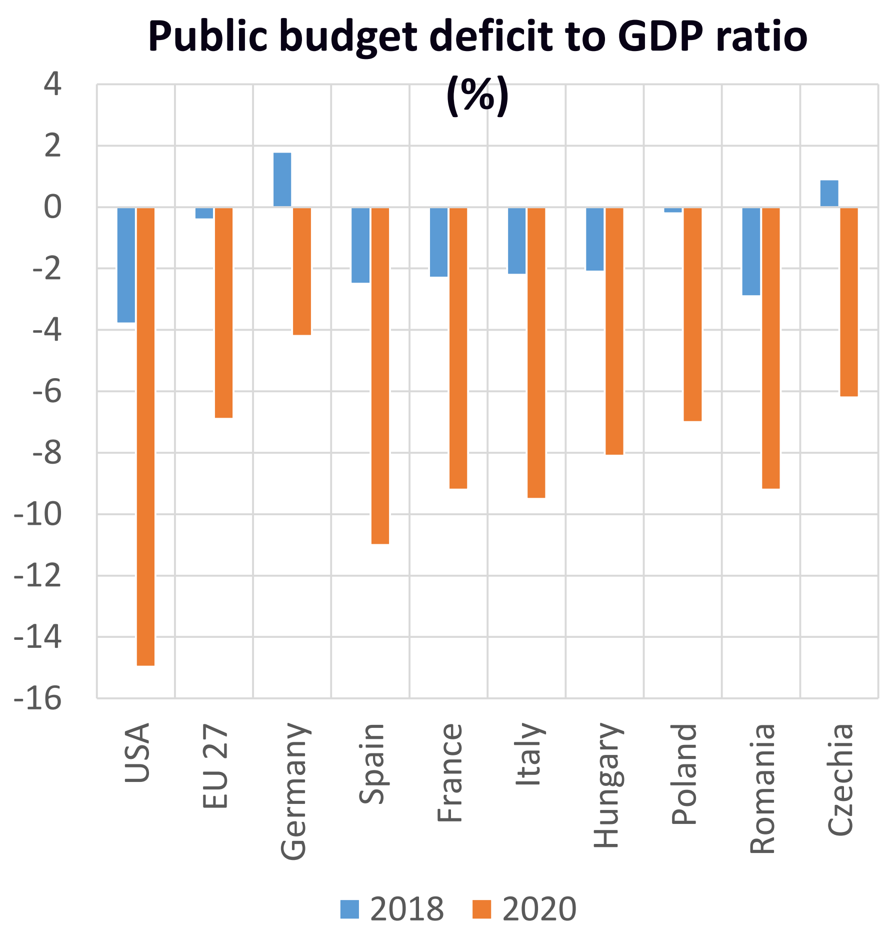
✓ On the fiscal side, a Recovery plan of 750 billion euro supplements the EU budget for 2021-27. It is a sanitary crisis response + an Industrial Policy (climate change, competitiveness)

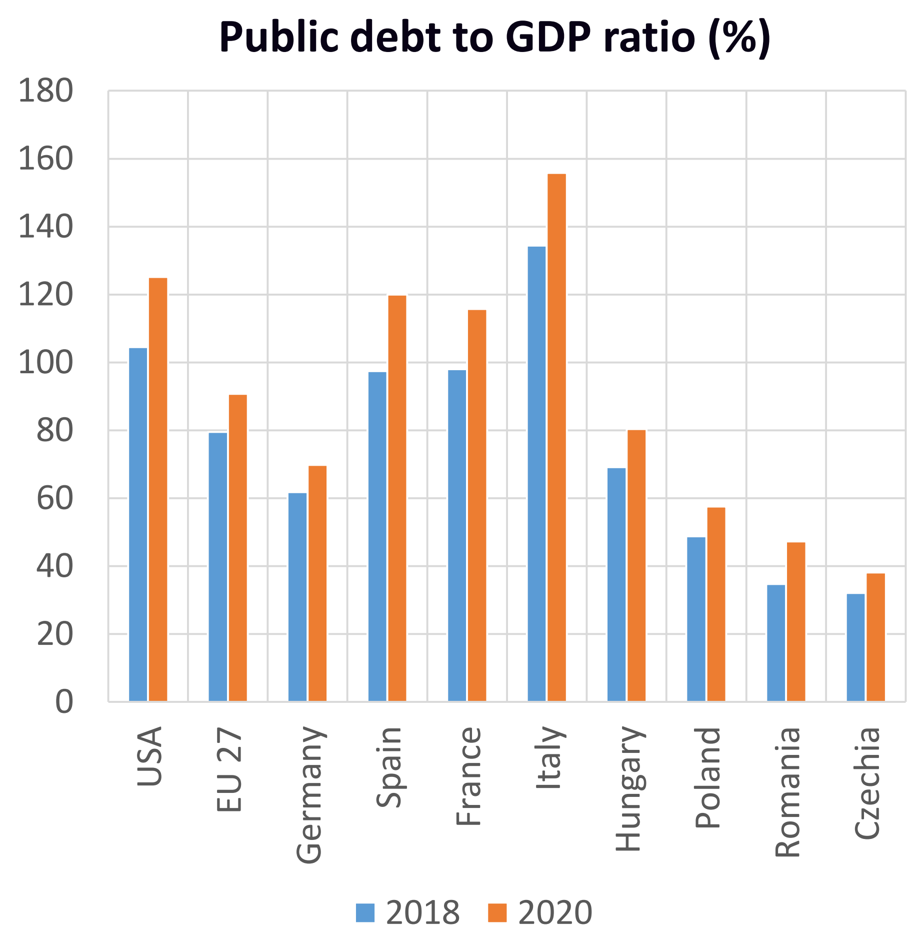
2. Policy response in AEs

An enabling intellectual environment:

- Ultralow interest rates, due to structural factors (*secular stagnation*)
- A new “policy normal” (Blanchard, 2019)…Rogoff favors deeply negative real interest rates (instead of QE)
- This view gets more nuanced lately…a *debt trap*?

2. Policy response in advanced economies





Source: Eurostat, Federal Reserve Economic Data (FRED)

3. Limits of QE in Emerging Economies (EEs)

- Some EEs launched APPs in Spring 2020: Chile, Colombia, Hungary, India, Poland, Romania, South Africa, Thailand, Turkey and others – mostly geared towards ensuring the **smooth functioning** of financial markets

- CBs in AEs expanded their balance sheets at rates reaching double digits (10 – 20% of GDP) ↔ CBs in EEs hardly went above a few percentage points

- „**Free riding**” on the wave of QE in AEs and worldwide low interest rates (the fall of *natural interest rates*)

➔ **But QE in emerging economies can be pretty tricky and littered with pitfalls**

3. Limits of QE in Emerging Economies

Bottom line – significant **differences** between AEs and EEs:

- EEs do not issue **reserve currencies** - this dents the efficacy and autonomy of monetary policy in dealing with severe shocks (nota bene: Helen Rey's dilemma…which reminds of the Tosowski dilemma)

- For not a few EEs there is an issue of **institutional credibility** and track record in subduing inflation and deficits

- Monetary policy efficiency can be reduced by the **exchange rate risk**, by insufficient trust in the local currency, by size…

- The **volatility** of exchange rates in EEs does matter, the more so if dollarization/euroization is high

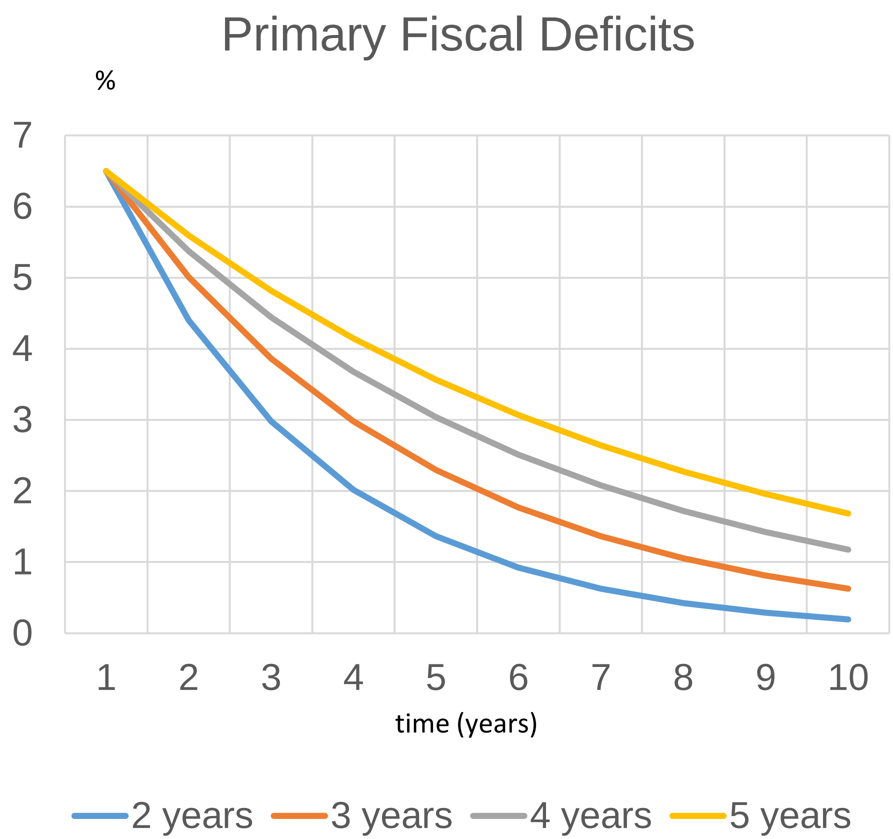
3. Limits of QE in Emerging Economies

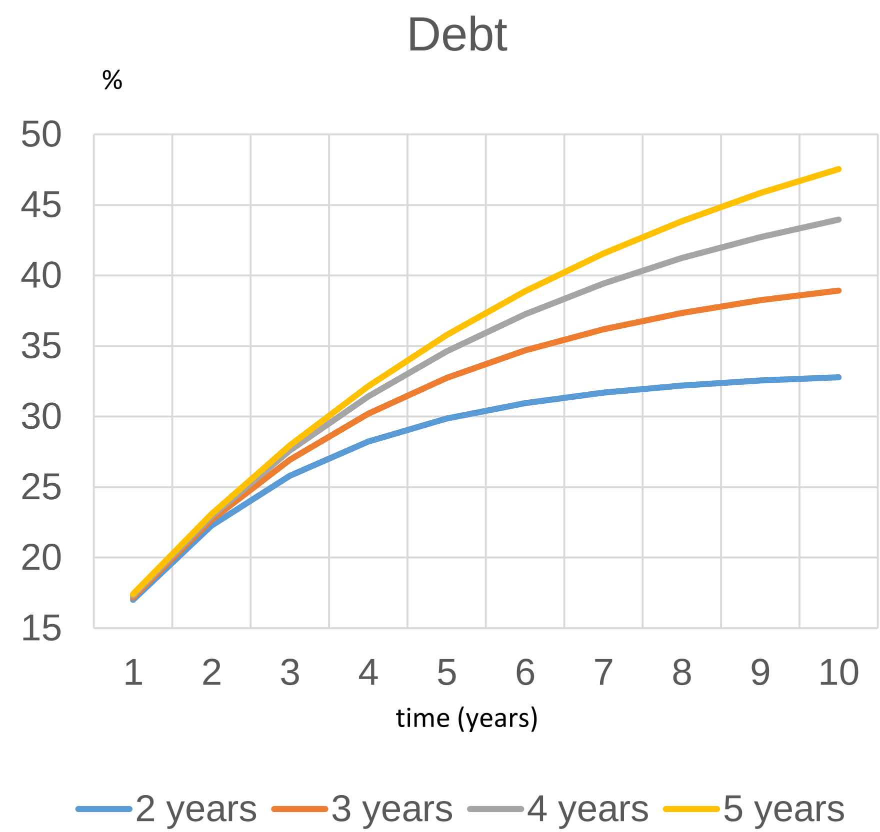
Bottom line – significant **differences** between AEs and EEs:

- Local financial markets are frequently **quite thin** and cannot absorb large issuances of sovereign debt
- Issuing debt on external markets can also be very tricky
- For the EU weaker economies, the free movement of capital is a headache in moments of market panic – **sudden stops** occur even when conditions are/seem benign
- QE in advanced economies can induce EMs to borrow too much as **hot money** is searching for higher yields
- It is not clear whether macroprudential policies to deal with large capital inflows and outflows can be effective enough

3. Limits of QE feasible in Emerging Economies

Fiscal dominance in EMs: a counterfactual exercise





Source: own estimation

3. Fiscal dominance in an EE: a note of caution

- In a macroeconomic environment where fiscal policy is dominant, delaying deficit reduction leads to higher inflation and higher interest rates over the longer run. The “optimal” level of inflation tends to increase the longer the fiscal consolidation period is.

- But rising inflation can easily entail a confidence crisis in the local currency and destabilize the economy, even if high nominal interest rates would indicate positive real interest rates (ex: remuneration rates at local deposits may be to low to encourage people to maintain their deposits in the local currency)

4. EU Emerging Economies' experience

- **Poland** - QE program that went to roughly 6% of GDP in July 2021, while the budget deficit stood at 7% of GDP in 2020

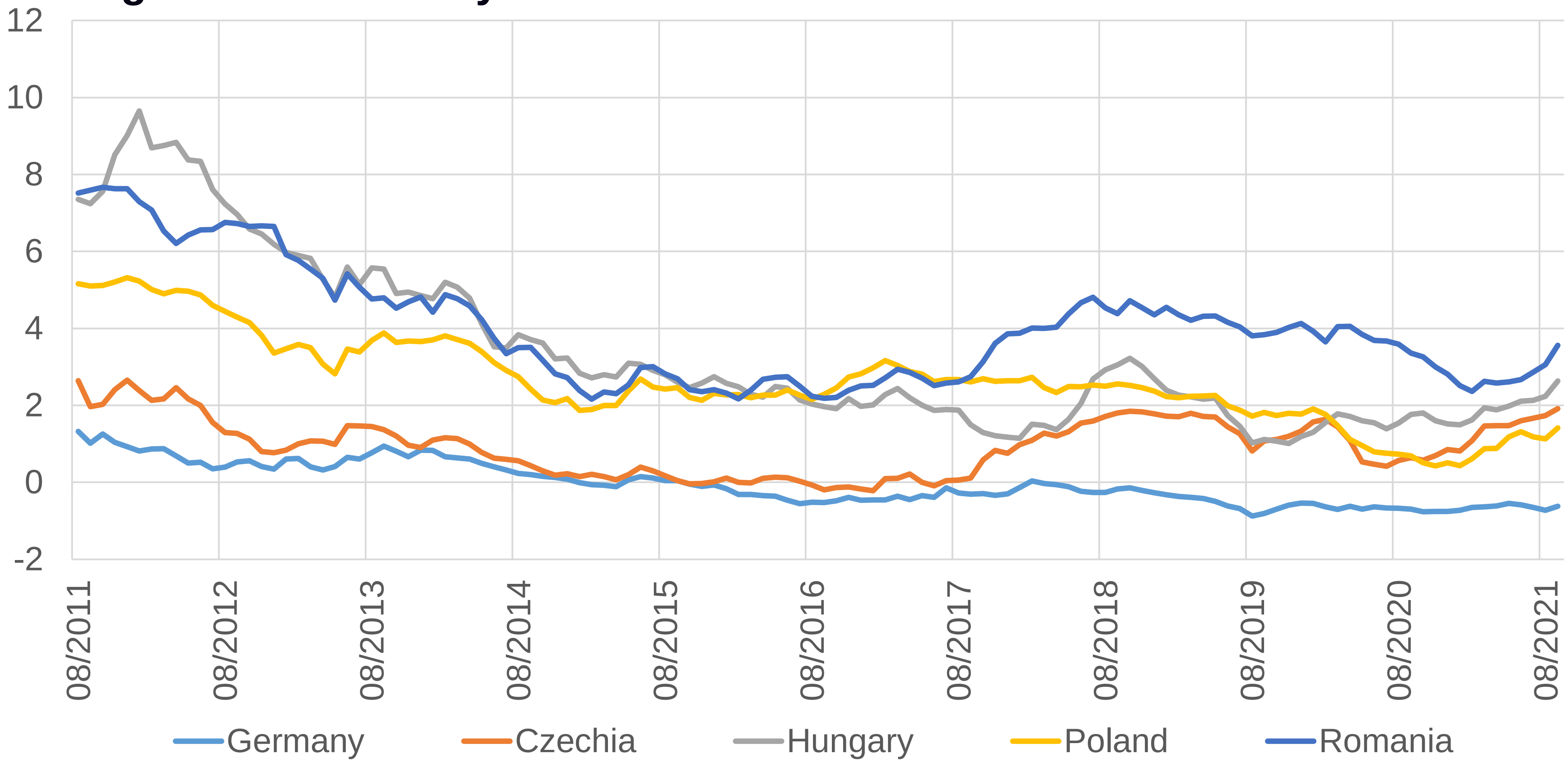
- **Hungary** - QE program for Treasury Securities amounting to around 5% of GDP (in June 2021), but NBH also purchased private securities, unlike the other CEE peers (approximately 2% of GDP, IMF)

➔ Both countries have started the war against the COVID-19 pandemic with **much smaller domestic and external imbalances** and significantly lower euroization of their financial systems than in Romania

➔ The role of repo and swap arrangements in supporting QE

4. EU Emerging Economies' experience

Benchmark Government Bond yields (5-year maturity, %) in the CEE region and Germany



Source: monthly averages based on daily data from Reuters

5. Romania’s case

- The issue is not the stock of public debt (cca. 35% of GDP at the end of 2019) → it is **a flow problem**, that is rooted in a large structural deficit (cca. 5% of GDP start of 2020) and a large primary deficit (above 3% of GDP start of 2020)

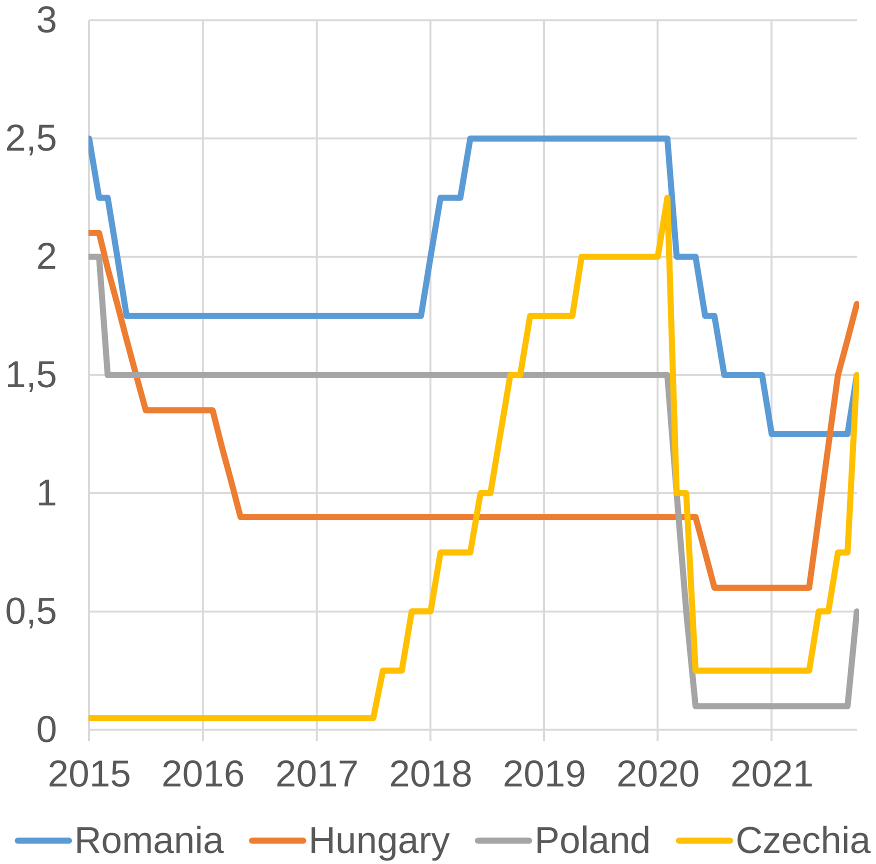
- **A twin deficit problem** - quite singular in the region - considerable depreciation pressures on the exchange rate which enhance inflationary expectations

- Quick **rebound** in 2021 → GDP growth is forecast to exceed 7% of GDP (IMF and EC forecasts)

- External events + energy price shock → raised abruptly **inflation (**likely above 7% at end this year**)**

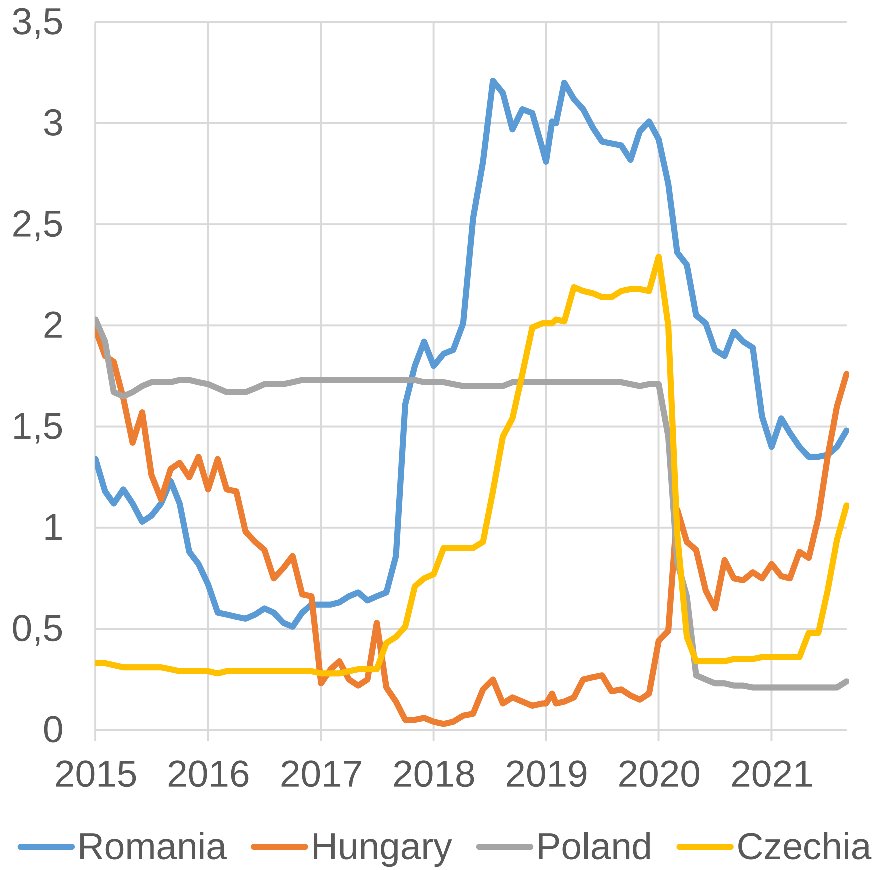
5. Romania's case

Reference rates (%) in CEE economies



Source: central bank websites

MM Rates (3M, %) in CEE economies



Source: Eurostat

5. Romania's case

- **Large structural budget deficit** correction → **gradually** - so that it does not cripple an economic recovery after the Lockdown – it has to play a critical role in reducing macroeconomic imbalances

- An EDP procedure: the correction should cover 2021-2024

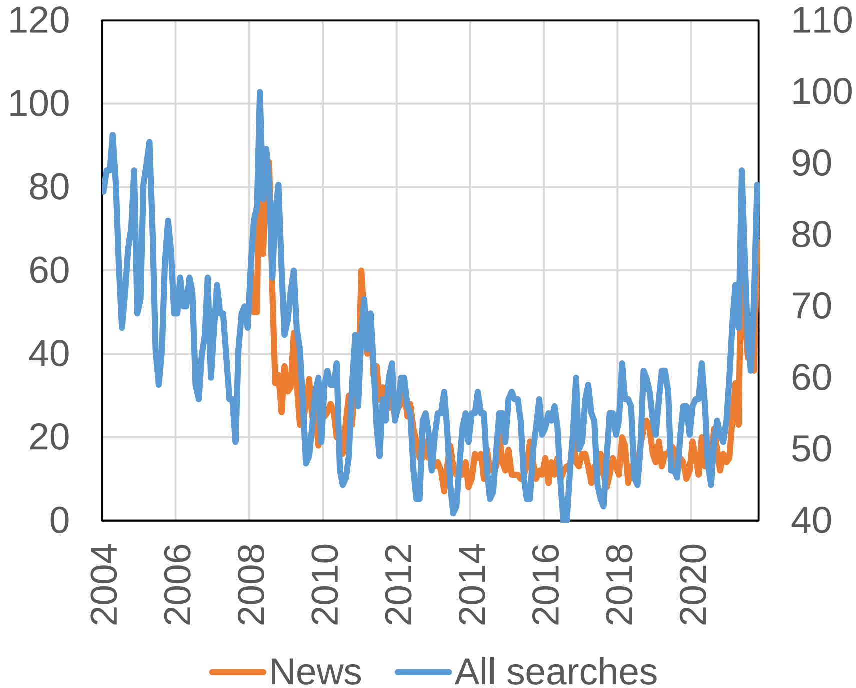
- This correction can be facilitated by EU funds that can bolster public expenditure, foster reforms and help fund external deficits

- **Euro adoption** → discipline policy, enhance structural change - entering the ERM2 and the Banking Union (by 2026?) requires correction of deficits

6. Does the inflation spike change the picture?

Most countries from the CEE region have decided to hike policy rates as inflation is already well above target levels

Google Trends search history for the term "*inflation*" worldwide



Source: Google Trends

Interest rate hikes in 2021

Country	Reference rate (Oct. 2021)	Increase	Inflation rate (Sep. 2021)	Target
Czechia	1.50%	+1.25%	4.90%	2.00%
Hungary	1.80%	+1.20%	5.50%	3.00%
Romania	1.50%	0.25%	6.30%	2.50%
Poland	0.50%	0.50%	5.90%	2.50%
Iceland	1.50%	+0.75%	4.40%	2.50%
Russia	6.75%	+1.75%	7.40%	4.00%
Brasil	6.25%	+4.25%	10.25%	3.75%

Source: central banks' websites

6. How transient is this inflation spike?

- It hinges on energy prices, supply chains bottlenecks, geopolitics
- A wage/price spiral? Labor shortages (emigration) in cohabitation with labor surpluses (remember Kornai!)
- Climate change and a change in relative prices (unless cheap energy renewables do not prevail soon)

Some final thoughts

- Is **financial repression** the exit out of the current situation with rapidly growing public debt? (Reinhart & Sbrancia)
- How sustainable are negative interest rates over the longer term is an open question – *Japanization syndrome?*
- Actually, QE are trimmed in AEs and policy rates will rise…a fallout for EEs…
- What if Goodhart and Pradhab are right regarding future inflation, and climate change would cause havoc in relative prices… Would AI (robots) offset the effect of aging?
- The existential threat posed by **climate change** is to be factored in, with huge impact on public and private budgets

Some final thoughts

- Balance of payments crises will continue to harm EEs
- Proliferating systemic risks (cyber, crypto, shadow banking)
- QE indispensable in order to avoid a collapse, but it reflects an inability to tackle fundamental issues …a massive resource misallocation (Jaime Caruana, 2014)
- QE has to be examined in a deeper sense: how can our economies be more robust and fair
- The need for a *new international policy regime –a new Bretton Woods?*

Some final thoughts

- Caution is warranted in EMs in trying to mimic QE as practiced by AEs. For emerging economies, there are limits and pitfalls in undertaking QE . As Agustin Carstens put it, „fiscal sustainability should be assured, otherwise perceptions may arise that debt can be inflated away”...and „crossing the traditional boundaries between fiscal and monetary polices, are only feasible for central banks in advanced economies with high credibility stemming from a long track record of stability-oriented policies”

Thank you for your attention!