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Limits and pitfalls of QE in emerging markets*

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The pandemic caused by COVID-19 has shocked the whole world and is another huge blow to the world economy after the financial crisis that erupted in 2008. A sanitary crisis is interweaving with a very severe economic and social crisis. Although most economies seem to have got out of the deep hole caused by *The Shutdown*, a steady recovery is likely to be difficult and painful, surrounded by big uncertainties and contradictory effects. Much of economic activity is badly hit, not a few companies may not be able to survive, unemployment has been growing rapidly[1], and repair efforts will be time consuming.

* This is an expanded English version of the article "QE in emerging economies: beware of traps", which was published in Romanian by *Opinii BNR*, 1 July 2020. The views expressed do not necessarily represent the position of the institutions the author is affiliated with.

[1] An acute social problematique is unfolding, that will be reinforced as temporary relief measures for jobless workers will end. "Kurzarbeit" type schemes may not be sufficient to mitigate the social impact of this crisis (see also Carmen Reinhart and Vincent Reinhart, "The Pandemic Depression. The Global Economy will Never Be the Same", Foreign Affairs, September/October, 2020). This explains why some countries (Finland, Germany, etc) experiment with minimum guaranteed incomes. The social dimension of the Covid-19 crisis is recurrently highlighted by the managing director of the IMF, Kristalina Georgieva; this dimension should be examined in relation with an ever more skewed income distribution in recent decades, the erosion of the middle class, the declining power of labor (see Anna Stansbury and Lawrence Summers, "The declining worker power hypothesis", NBER Working Papers No.27193, May 2020), declining social inclusiveness, the impact of artificial intelligence. In poor countries things will get ever worse because of the crisis, and IFIs and the international community need to step in to prevent sovereign debt crises in a row (see also Joseph Stiglitz and Hamid Rashid, "How to prevent the looming sovereign debt crisis", Project Syndicate, 31 July, 2020).

In advanced economies (AEs), governments and central banks have unleashed massive support programs. In the US, for instance, the fiscal and monetary support goes beyond that seen during the *Great Recession*. The Fed's intervention in markets is stunning in its depth and breadth, with its balance-sheet jumping from over 4 trillion to over 7 trillion USD this year, and more is probably to come; even junk assets, *fallen angels*, are liable for acquisition. In Europe, the ECB has extended its non-conventional operations, while a European recovery plan that amounts to 750 billion euro, will supplement the EU budget for the period that starts in 2021. As a novelty, the Plan will be funded by the issuance of collective EU bonds. All in all, budged deficits have skyrocketed worldwide, like during war times (a *war economy* syndrome).

Apart from the dire conditions entailed by the pandemic and the economic crisis, an intellectual context favors rising fiscal support. The apparent decline of the natural interest rates in recent decades[2] and very low inflation after the financial crisis seem to prompt governments to rethink allegedly dangerous thresholds for public indebtedness. Kenneth Roggof and Carmen Reinhart's upper level of 90%[3] may no longer be seen as a discouraging barrier. Olivier Blanchard talks of a new normal (a *new regime*) for monetary policy by considering lower debt servicing costs when interest rates are inferior to economic growth rates[4], a view that is echoed by Paul Krugman[5] and others. Kenneth Rogoff argues in favor of deeply negative policy rates as an alternative to large scale QE, which itself is a form of financial repression; he says that such a policy would be a huge blessing to EMs that are plagued by falling commodity prices, fleeing capital, high debt and weak exchange rates.[6] Proponents of the New Monetary Theory argue openly for monetizing fiscal deficits provided inflation is under control[7]; their line of reasoning can be bolstered by the desire to reverse very low (or declining) inflation expectations (the threat of debt deflation) and the extraordinary nature (once in a lifetime) of the coronavirus shock and the related economic and social crisis.

This is the context which made some to examine the feasibility of QE[8], the injection of base money against financial assets, even monetization of budget deficits in emerging economies/markets (EMs). As a matter of fact,

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[2] Mervyn King and David Low, "Measuring the World Real Interest Rate", NBER Working Paper, No.19887, 2014; Kathryn Holston, Thomas Laubach and John Williams, "Measuring the Natural Interest Rate: International Trends and Developments", Journal of International Economics, 108, January 2017 (by using the model used by Thomas Laubach and John Williams (2003) they show that the rate seems to have fallen close to zero in the US during the financial crisis and stayed there since 2016); Rachel Lukasz and Thomas Smith, "Secular drivers of the global interest rate", BoE, Staff WPs No.571, 2015. See also Larry Summers on secular stagnation, "Reflections on the New Secular Stagnation Hypothesis", in C. Teulings and R. Baldwin, "Secular stagnation: facts, causes and cures", VoxEU.org EBook, CEPR Press.

[3] Kenneth Rogoff and Carmen Reinhart, "This Time is Different. Eight Centuries of Financial Follies", Princeton University Press, Princeton, 2011.

[4] Olivier Blanchard, "Public Debt and Low Interest Rates", American Economic Review, 109(4): 1197-229. Basically, the argument is that when economic growth rates are higher than interest rates, governments can run primary deficits without endangering the state of public finance and welfare as long as public debt as a share of GDP stabilizes; this can be summed up as (r – g) being negative, where (r) is the interest rate and (g) is the economic growth rate (both rates can be in nominal, or real terms). See also O. Blanchard, A. Leandro, and J. Zettelmeyer, "Revisiting the EU fiscal framework in an era of low interest rates", 30 January, 2020. For a much less sanguine view on this scenario see Charles Wiplosz, "Olivier in Wonderland", CEPR, VoxEU, 17 June 2020.

[5] Paul Krugman, "The Case for Permanent Stimulus", VoxEu, 10 May 2020.

[6] Kenneth Rogoff, "The Case for Deeply Negative Interest Rates, Project Syndicate, 4 May, 2020.

[7] William Mitchell, Randall Wray and Martin Watts, "Macroeconomics", London, Red Books, 2019. See also N. Gregory Mankiw, " A Skeptic's Guide to Modern Monetary Theory", American Economic Review, May, 2020, pp.141-45.

[8] QE is not to be equated with normal capital markets operations, as they take place in EMs as well.

elements of QE are practiced in a series of emerging economies. In Colombia, Indonesia, Poland, Hungary, Thailand, among others, central banks do it. But the size of their programs is significantly smaller than what the Fed, BoE, the ECB and BOJ, etc.[9] Why is it so? The crux of the matter ist that QE in emerging economies can be pretty tricky and littered with pitfalls. The view that a „silent monetary policy revolution" is taking place in emerging economies, in the sense of undertaking QE like in advanced economies is an overblown assertion.[10] Where QE is done in EMs, it takes place as a sort of „free riding" on the wave of QE in AEs, but not without limits and risks.

There are basic differences between emerging and advanced economies, which asks for caution in judging QE in the former:

- Emerging economies do not issue reserve currencies. This dents the efficacy and autonomy of monetary policy in dealing with severe shocks;
- For not a few EMs there is an issue of institutional credibility and track record in subduing inflation and deficits;
- Monetary policy, as a plus in a policy-mix framework, can be weakened by the exchange rate risk, by insufficient trust in the local currency;
- The volatility of exchange rates in emerging economies does matter, the more so where dollarization/euroization is high[11]. A flexible exchange rate can help in correcting imbalances, but it can also do harm when a massive depreciation entails substantial wealth and balance-sheet effects, intensifies currency substitution, and may cause inflation to get out of control. A brutal drop of the local currency value can cripple financial stability;
- Local financial markets are frequenly quite thin and cannot absorb large issuances of sovereign debt. The exposure limits of commercial banks to local governement debt are to be considered as well.
- Although issuing debt in local currencies is preferable[12], a small size of local financial markets can force the issuance of bonds on external markets. And this creates a major vulnerability related to exchange rate dynamics. In addition, unless deficits are not perceived by financial markets as reasonable, their funding can be drastically limited and sudden stops can ensue;

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[9] An IMF document says that "Among the 81 economies classified as EMs, 55 took measures to support financial markets during the COVID-19 pandemic…as central banks aimed at easing pressures in short-term funding markets. However, EMs intervened more in FX markets than AEs reflecting partial dollarization and capital outflows. EMs seldom intervened in securities markets, reflecting the bank-centric nature of their financial systems"("Central Bank Support to Financial Markets in the Coronavirus Pandemic", IMF, MCMCO, 2020, p.6).

[10] Piroska Nagy-Mohacsi, "The Quiet Revolution in Emerging Market Monetary Policy", Project Syndicate, 18 August, 2020.

[11] Agustin Carstens, the head of BIS, notices that "…emerging market economies have a quasi-managed floating exchange rate regimes where central banks lean against swings in the exchange rate, both on the way up and on the way down….this approach is one where the practice outruns the theory and it is arguably the theory that needs to catch up". This is because "…the behavior of the exchange rate can fundamentally affect the dynamics of inflation and the capacity of monetary policy to produce the expected results"(Exchange rates and monetary policy frameworks in emerging market economies", Lecture at the London School of Economics, London, 2 May 2019.

[12] But even issuing debt in the local currency and selling it to non-resident investors can create an implicit debt-rollover risk", named as the original sin 2.0." During periods of higher risk aversion, when local currencies are under pressure and domestic assets are sold off, foreign investors are likely to reduce their exposure and might not roll over maturing positions("Managing volatile capital flows in emerging and frontier markets", Reinout De Bock et.al., VoxEu, 19 August 2020).

- For the EU weaker economies, the free movement of capital can be a headache in moments of market panic. This has been glaringly shown by substantial flow reversals during the euro area crisis, when money took a flight from South to North; or outside the euroarea, when capital sought to flee New Member States, which was a reason for the *Vienna Initiative* to be enacted in 2009.
- Sudden stops can take place in emerging markets even when global financial conditions are relatively benign.
- QE in advanced economies can induce EMs to borrow too much as hot money is searching for higher yields. And when conditions change, larger debts may find their servicing jump quite highly and turn very costly.
- It is not clear whether macropudential policies to deal with large capital inflows and outflows can be effective enough. As a mater of fact, a paradox operates here: QE in AEs may foster a temporary more benign global environment that helps ease monetary conditions in EM too. But this can easily turn out to be a nuisance in disguise to the extent there is much overborrowing (like after the Great Recession) and capital flows reversals harm weaker EMs[13].

The features highlighted above indicate constraints for monetary and exchange rate polices in EMs and, consequently, for QE programs. Emerging economies that have been quite successful in reducing dollarization/euroization of their domestic transactions, where internal and external deficits are under control, with considerable sovereign bonds issued in local currency and plentiful foreign exchange reserves, can be more daring in practicing QE. They could also benefit on back ups, such as swap and repo lines arranged with reserve currency issuers, like the Fed and the ECB. This room of manuever concerns the flow of liquidity on domestic markets and preventing excessive yields demanded by foreign lenders/inevstors (via asset purchases by local central banks on secondary markets), the easing of policy rates and of overall monetary conditions when interest rates fall in the global economy.

<u>But QE and monetization of deficits are fraught with major risks wherever deficits are large, external debts are considerable, and trust in the local currency is not sufficient</u>.

The case of EMs in the EU deserves attention for some of them have undertaken parts of QE. Among New Member States which joined the EU in 2004 and 2007, Poland has announced a QE program that could go up to 5-6% of GDP this year, while the budget deficit could reach more than 8% of GDP. Hungary has a significatly smaller QE program as the budget support for its economy relies extensively on guarantees. Both these countries have started the war against the COVID-19 pandemic with much smaller domestic and external imbalances and significantly lower euroization of the the financial system than Romania. The Czech Republic is quite a peculiar case for the high trust the crown enjoys among its citizen. Sovereign ratings illustrate macroeconomic situations[14], and the cost of issuing debt is indicative of national economic circumstances. Thus, Romania pays almost double for issuing debt in local and external markets, as compared to Hungary and Poland, not to mention the Czech republic; CDS term premia are also telling in this regard. Hungary and Romania have repo arrangements with the ECB, whereas Bulgaria and Croatia benefit on swap lines as they entered ERM2 in June

[13] Andrea Presbitero and Ursula Wiriadinata rightly argue that although interest rate-growth differentials (r – g) have turned negative in many countries, which may facilitate fiscal expansions, there can also be (r-g) reversals when public debts grow massively and much of these debts are denominated in foreign currencies. Clearly, the specter of substantial currency depreciation, the exchange rate risk, is involved in such dynamics ("The risks of high public debt despite a low interest rate environment", VoxEU, 5 August 2020).

[14] The Czech Republic has AA-, Poland has A-, Hungary has BBB, while Romania is rated BBB- by S&P.

this year. These arrangements are a plus in dealing with possible liquidity squeezes in financial markets. The EU budget funds, together with the European recovery plan, help considerably the fight against COVID-19 and economic reconstruction.

Yield differentials for sovereign bonds and CDS term premia show that markets discriminate among EM, despite the easing of monetary and financial conditions worldwide. Therefore, caution must operate when contemplating dealing with the pandemic and the economic crisis by resorting to large fiscal stimuli and aggresive easing of monetary policy, to QE and monetization of deficits. The countries that have fiscal space can be more daring in this regard, but not without caution. In the EU, fiscal rules are temporarily suspended, but markets do discriminate and judge economies according to their robustness, the capacity to absorb shocks, whether back ups (as safety nets) are available. In the euro area, the debt servicing costs for more fragile economies hinge basicaly on the ECB support, which has saved the single currency via its unconventional oprations, including QE. In the global economy, instead, there is no automatic support, in spite of massive operations undertaken by the IMF to support emerging and poor economies.

In the Romanian case, the issue is not the stock of public debt, that was cca. 35% of GDP last year. It is a flow problem, that is rooted in a large structural deficit (above 4% of GDP at the start of 2019) and big pressures to increase permanent public budget expenditure while fiscal revenues are pathetically low (cca. 27% of GDP); there is also a twin deficit problem involved here. This creates a big policy conundrum since, on one hand, the room of maneuver to combat the Pandemic is severely curtailed and, on the other hand, there can be considerable depreciation pressures on the exchange rate which enhance inflationary expectations (as the pass-through effect is non-trivial). A significant rise in permanent budget expenditure would worsen even more the structural budget deficit, it would imperil Romania's investment grade rating and entail a significant rise in the cost of debt service, in the public debt[15]. This would invalidate a key assumption of the new normal for monetary policy in the Blanchard logic (see footnote 3), namely a low interest rate (r) level. And if the economic growth rate (g) falls significantly, apart from an allegedly temporary impact of the pandemic[16], and in conjunction with a sizeable primary (and structural) budget deficit, one ends up with a reinforced invalidation: while (g) comes down, (r) goes up when the primary deficit is considerable and on the rise.

A correction of macroeconomic imbalances has to be undertaken in Romania in the next few years, which will be a pretty tough operation in view of the impact of the sanitary and economic crisis. This situation explains why the Romanian central bank cannot be as aggresive in reducing its policy rate as its peers in the Region, and why it cannot embark on a QE program per se[17]. For it may undermine the trust in and trigger a run on the local currency, ultimately damaging financial stability. If markets would perceive that there is monetization of the budget deficit on a large scale, a crisis of the local currency would be quite inevitable. The correction of the large structural budget deficit, be it done gradually (so that it does not cripple a tenous economic recovery after the Lockdown) has, therefore, to play a critical role in reducing macroeconomic imbalances. This correction can be much facilitated by EU funds that can uphold public expenditure and help fund external deficits.

[15] Eurostat figures show that, before the Pandemic stroke, Romania was the only EU member state where public debt as a share of GDP was rapidly growing in the absence of fiscal consolidation measures: from cca 35% in 2019 to 62,3% in 2025 and to 91,2% in 2030 ("Debt Sustainability Monitor 2019", European Commission, Brussels).

[16] More likely is that the COVID-19 crisis and the related economic and social crisis will reduce potential economic growth in most economies.

[17] As a matter of fact, the NBR has become a net creditor of the banking sector since March this year, via irreversible operations as a means to stem depreciation pressures on the Leu (the local currency). But the loss of net foreign assets could not continue indefinitely, which shows why fiscal consolidation is a must in the not too distant future.

Is financial repression the exit out of the current situation with rapidly growing public debt worldwide as Carmen Reinhart and Belen Sbrancia suggested by referring to the second world war period and its aftermath in the US and Europe?[18] *Prima facie*, this seems to be the case in view of the staggering rise in public and private debts following the financial crisis and, currently, because of the Pandemic. QE is a form of financial repression as governments try to control the yield curve by purchasing sovereign bonds (and, thereby, by reducing the cost of budget funding) and other financial assets, by going beyond what can be seen as market-making (repair) in periods of distress. But even in AEs financial repression may be difficult to achieve when inflation is very low, which would imply negative nominal interest rates. And how sustainable are negative interest rates over the longer term is an open question, although Japan provides food for thought in this respect (as well as to the secular stagnation thesis, the *Japanization* syndrome). In some New Member States, which have experienced labor markets strains for years now (due to massive labor emigration), where the Balassa-Samuelson effect may be larger than some suspect, and where exchange rate dynamics have probably also played a role, inflation is quite considerable – between 3-4% lately in Hungary, Poland, Romania, etc. When inflation is substantial and currency substitution is an issue, capping interest rates may be risky. The bottom line ist that rapidly increasing public debts should not leave us unnerved, be the natural interest rate much lower than a few decades ago[19]. QE may have merits as a means to avoid a lasting depression and, in the euro area having helped to save it, but it is unclear whether it can be the final solution to debt sustainability.

Some may argue that nothing seems to be like before, that economics enters a new „stage" and that old tools are no longer reliable, that emerging economies should do whatever advanced economies do policy-making-wise. But this is hardly a convincing argument. The size of public and private debts, of structural deficits do matter yet, as do economic fundamentals, degrees of wealth and robustness (vs. fragility), policy track records, availability of back ups and „friendly" neighbours, or membership in clubs like the EU and the euroarea. Balance of payments crises will not disappear, and defaults will continue to take place, especially among EMs. Sudden stops can also occur. This is why 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.[20] 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".[21]

A final thought on QE: QE may be useful, indispensable, wherever avoiding a collapse of economies (of financial sectors) is aimed at. But to claim that this is the way to remake the toolbox of central banks radically, for the long

[18] Carmen Reinhart and M. Belen Sbrancia, "The Liquidation of Government Debt", IMF Working Paper, January, 7/2015.

[19] See also Anne O. Krueger, "Financial Repression Revisited?", Project Syndicate, 20 August 2020.

[20] "QE appears to be a viable macroeconomic policy response to COVID-19 for countries with a credible institutional framework in which the central bank operates a floating exchange rate regime and the sovereign issues debt in its own currency" (G. Benigno, J.Hartley, A. Garcia-Ferrero, E. Ribakova, "Credible emerging market central banks could embrace QE to fight COVID-19", VoxEu, 29 June, 2020. But this assertion has to be qualified when structural deficits are large and currency substitution is significant (the issue of trust in the local currency).
"When hit by a crisis, economies with less credible monetary frameworks and weaker fundamentals my find themselves between a rock and a hard place. Capital outflows can put heavy pressure on the exchange rate, with the twin risks of a disorderly adjustment (currency crisis) and a persistent upsurge in prices (if inflation expectations are poorly anchored and pass through from the exchange rate is high"(Gaston Gelos, Umang Rawat and Hanqing Ye, "COVID-19 in emerging markets: Escaping the monetary policy procyclicality trap", VoEU, 20 August 2020.

[21] Agustin Carstens, "Countering Covid-19: The nature of central banks' policy response", BIS Speech, Zurich, 27 May 2020.

haul, is a bold statement. As a matter of fact, QE is more like „kicking the can down the road"', and it reflects, arguably, an inability to tackle fundamental issues related to resource allocation[22], taming the global financial cycle, overfinancialization of economies and feeble restructuring (zombification of many parts of economies), increasing income inequality, etc. If this is the case, QE in EMs cannot be but a pale side of this state of affairs and can, in no way be an actual breakthrough in policy making. Moreover, QE, as sort of prolonged crisis management component of monetary policy, has to be examined in a deeper sense: how economies can be remade in order to become more robust/resilient, more inclusive and fair, with an overhauled financial sector that should cater more to the needs of the real economy, antitrust laws that impede abusive concentration of market power, effective fight against tax evasion and avoidance, revamped tax systems that are more equitable, reinstating a sense of genuine ethical conduct in the corporate world, combating climate change which has become an existential threat to mankind, and avoiding a complete collapse of multilateral arangements in the global economy.

[22] As BIS experts stress, The Great Moderation years hid huge resource misallocation (Jaime Caruana, "Stepping out of the shadow of the crisis: three transitions for the world economy", BIS Speech, 29 June, 2014). Overburdened monetary policies during the past decade can be compared with monetary policies in post-command economies. Following the collapse of the command system and a dramatic change in relative prices, many enterprises became unprofitable. Massive and rapid resource reallocation was impossible. Thence the need to subsidize firms and even sectors involving monetization of quasi-fiscal deficits. Firms themselves created an own pseudo-money via inter-enterprise arrears (Daniel Daianu, "Inter-enterprise arrears in post-command economies, IMF Working Papers, 74, 1994 and "Resource misallocation and strain. Explaining shocks in post-command economies", William Davidson Institute WP, No.96, 1997)". The quasi-fiscal task of central banks during the initial stage of post-command transition is to be compared with QE practiced by major central banks in advanced economies – where a similar fiscal dominance takes center stage. But inflation is very low in AEs, whereas money printing after price liberalization in post-command economies created high inflation (after years of suppressed inflation and considerable money balances). This is due to an overwhelming liquidity trap and low inflation expectations.

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