The new role of monetary policy in the Covid-19 crisis and its climate application

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The financial crisis of 2008 and the subsequent recession revealed several of the instruments central banks may use when economic circumstances require. The prevailing opinion was however that monetary policy should exit this 'unconventional policy' and go back to 'normal' as fast as the situation would allow, by tapering programmes such as 'quantitative easing' and raising interest rates once more.

In this regard, the US Federal Reserve at least partially succeeded in raising the federal-funds rate, which had been zero. Yet while some central banks were able to do likewise, others were stuck at record-low levels. In particular, the European Central Bank's interest-rate target still remains in negative territory. In any case, while 'normalisation' had started, interest rates remained far from their pre-crisis levels.

This was before the coronavirus spread across the world. Anyone who thought that the financial crisis had forced central banks in advanced economies to go to the limit of extraordinary measures has been disabused. Strict measures to reduce social interaction were imposed to prevent national health systems from breaking down and to minimise fatalities and humanitarian tragedies. But, in addition, to mitigate the devastating *economic* impact of supply-chain interruptions, policies unimaginable a few weeks previously began to be implemented.

Among other measures, such as grants to businesses and support for the self-employed and wage payments, governments (for instance in the UK) have provided guarantees of hitherto unseen amounts to secure commercial banks' emergency business loans, to reduce risk premia in market rates. If the health crisis does not last for too long, businesses may have a better chance of surviving the lockdowns.

Liquidity trap

Yet the most impressive policy change was presented by the US Fed in the second half of March and early April. Having cut the federal-funds rate target to zero once more, the Fed has not only been fighting the liquidity trap and high market rates by purchasing treasury bonds and mortgage-backed securities, as it had already done in 2008. Additionally, it has set up two facilities to provide credit to big companies, via the purchase of new bonds and loan issuance on the one hand and support for outstanding corporate debt on the other. By the beginning of April, the facilities were extended and an additional programme to guarantee loans to small businesses was established.

The central bank's activity is thus not limited any more to the secondary market but it directly intervenes in the primary capital market too. Beyond this, even a facility to support securities backed by student and consumer loans has been established. These facilities provide liquidity at the most favourable conditions allowed by risk and term considerations.

Hence, the current crisis has made the Fed not only circumvent commercial banks to stabilise financial markets, as it did in the last crisis by means of its quantitative-easing programmes. Now it circumvents commercial banks also to stabilise the real economy directly. The Fed's emergency facilities are *de facto* public banks aiming at a social goal—the maintenance of economic activity and employment by providing the finance required.

Highly indebted

The coronavirus crisis has not found the global economy in a healthy state. Central banks all over the world had still been struggling (in vain) to set monetary conditions back to the pre-2008 level. Now they are forced further to intensify liquidity expansion.

Moreover, we know that the private sector in most advanced economies was already highly indebted before the outbreak and a significant share of firms were only surviving as 'zombies', with with cash flows barely sufficient to service debt. Now, with prospects becoming formidable—since revenues have reduced substantially or dried up completely in most sectors for an indefinite period—a return to 'business as usual' has never appeared more remote.

It thus seems that issuance of business loans and purchase of bonds by the US central bank, despite being intended as a short-term remedy, will be a lasting arrangement. Businesses will struggle to repay the debt and no private bank will be willing to take it over.

Hence the Fed will be left with a balance sheet to manage, much like a commercial bank. Moreover, once the Covid-19 crisis is over, the recession will still be there. Monetary policy will be kept busy supporting demand and employment.

The obvious question is: why should these facilities not be used to promote economic recovery? And now that this crisis has shown that public finance is not as evil as orthodox theory tells us, why should such an in-effect public bank not be used to tackle the other, far bigger crisis—climate change?

Green investment

Since those facilities for business loans are already there—and other central banks and public banks may follow, as the Bank of England or Germany's KfW, for example, are already doing to a lesser degree—they should provide credit for green investment and hence employment stimulus, once the lockdown measures are over. And this should happen under the same favourable conditions enabled by the circumvention of the profit-making, private banking system.

For instance, there is a tremendous need for finance of renewable-energy production and replacement of fossil-fuel-driven technologies, such as in heating systems or industrial processes. Much as in the case of the coronavirus, central and public banks are needed to fight climate change—because, obviously, private banks are not doing so on their own.

Whether such credit facilities will remain embedded in the central bank or formally separated as public banks is not of high importance. What matters is the new role of monetary policy in advanced economies to create employment and reconnect supply chains, by means of financing green investment to tackle the climate crisis.

If monetary policy and governments will do for the climate what they are currently doing because of Covid-19, the transition to sustainability will be feasible.

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