

Observations on central banks in the center and the periphery: secular stagnation and external constraints

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Abstract

Historically, central banks have been instruments of economic development, yet in developed countries their position as guardians of macroeconomic orthodoxy and price stability has taken a predominant role. In an interconnected world, this limits the ability of central banks to play the same role in developing countries that their peers in developed countries played in the past. This article discusses the limits of modern central banks in the context of supposed secular stagnation, and the renewed external problem that some developing countries are facing as the commodity price supercycle ends. Recently, however, all of this has been complicated in the short term by the coronavirus (COVID 19) crisis.

Keywords: central banks; center periphery; development instruments; secular stagnation; Latin America.

1. INTRODUCTION ¹

Central banks originally came about as semi-public banks to manage the public debt of new merchant states in the transition towards capitalism (Vernengo, 2016).² The first more formal banks which preceded central banks were the *Taula de Canvi* in Barcelona, founded in 1401, and the *Casa di San Giorgio* in Genoa, founded in 1407, to name two famous examples.³ Next came the issuing banks, which are generally recognized as the precursors to central banks, in particular, the Bank of England, the oldest of the central banks in operation today, dating back to 1694.

It is clear that the invention of public debt at the end of the European medieval period forced the formation of banks which operate as fiscal agents for the government. This allowed, contrary to what one might imagine, a considerable increase of the public debt, but in a sustained manner in the majority of cases. The increase of public debt in turn can be found in the roots of what is known as the Fiscal-Military State (Brewer, 1989), which was key in the development of the British Industrial Revolution, and more recently in modern capitalism.

Once the industrialization process which lies at the heart of the development process gained strength in the hegemonic center of capitalism, separated from the rest, the so-called periphery, an international division of labor took shape, with central countries producing manufactured goods and those in the periphery producing commodities in general. As Chang (2002) points out, not only the free market was transformed into a dominant ideology, in order to avoid the lagging countries from using the same development methods as advanced nations, but the role of central banks also changed. It was after this that they would become the guardians of the value of currency and be solely concerned with inflation. This is what Goodhart (2011) calls the Victorian era of central banks.

The job of central banks as guardians of currency in the modern world essentially remains. Nevertheless, the global crisis of 2007-2009 forced central banks to use unconventional policies such as the notorious quantitative easing and have a more active role in financial regulations. In particular, the slowing down of growth in the center of what Summers calls secular stagnation (2014), presented the possibility for thinking of central banks as instruments of development (Epstein, 2007).

This work discusses the possibility of using central banks as instruments for growth and development in the center and periphery. It does not pretend to be an original theoretical contribution, much less an exhaustive analysis of the literature. On the contrary, it seeks an alternative theoretical approach to shed light on important limits of the dominating theory on the behavior of central banks in the center and the periphery.

The work is laid out in the following form: in the next section I argue that the reasons for the imposed limits on central banks are political in nature and related to a growing financial fragility, to use the term coined by Hyman Minsky, and not structural causes of secular stagnation, as explained by mainstream theoreticians. In the next section I discuss the limits imposed on central banks in periphery countries within the context of slowing growth in the center. In particular, we will point out the limitations or the problems in using central banks as instruments for development in Latin America. Finally, there will be a brief conclusion.

2. CENTRAL BANKS AND SECULAR STAGNATION

Even though the idea is old —dating back to Alan Hansen who was influenced by the notion of closing borders, the old West, and some Keynesian ideas— the modern concept of secular stagnation can be associated with Larry Summers, the ex-secretary of the American Treasury Department (Backhouse and Boianovsky, 2016). Summers' primary argument is that structural changes in the economy changed the balance between saving and investment, resulting in the drop of natural interest rates. This is the primary argument in Summers' version of the thesis of secular stagnation.

One of the primary arguments, which is shared by Summers, for the drop in the natural rate is the fact that the population growth rate in the United States has gone down. In this case, the reduction of the workforce brings about a greater labor-capital relationship, the greater increase in the cost of labor, and the lower cost of capital, or rather the interest rates, in accordance with the marginalist substitution principle.

Summers suggests, in a more viable manner,⁴ albeit with the wrong mechanism, that the worsening of income distribution, by increasing the propensity for savings, has also resulted in a drop in natural interest rates. The last element in the explanation of the drop in interest rates as claimed by Summers is the stockpiling of dollar reserves by central banks in order to face the international financial instability. As for Eichengreen (2015), he makes a similar argument in suggesting that the reduction in the price of capital goods has reduced the demand for investment.

In other words, Summers' argument is that the natural interest rate, a concept which had been cast aside by central bankers after the Keynesian revolution, persistently dropped in part because a contraction of the investment curve and, in part, due to an increase in the savings curve, in what is a traditional argument for the loanable funds doctrine.⁵

We find this in Summers' last arguments on the increase in savings which occurred in his debate with Bernanke, ex-president of the Federal Reserve (Fed). The ideas on excessive global savings in some way complement the conventional ideas on global causes for secular stagnation (Bernanke, 2005). Both Bernanke and Summers agree that secular stagnation is related to dollar reserves, or what Bernanke himself calls the global savings glut. Bernanke (2015) nevertheless supposes that at a global scale there is no problem, if financial liberalization spreads, once the global investment opportunities which exist, in conjunction with the increase in capital flow, lead to an increase in the natural interest rate and the marginal capital productivity curve expands outwards.

Furthermore, in Bernanke's opinion, with the free movement of capital there will come a capital drain in the United States, a depreciation of the dollar, an appreciation of the yuan, and a rebalancing of the instability of global current accounts, especially in the US deficits. The optimism of elasticity implies that a depreciation would eliminate or reduce considerably the American current account deficit, the Chinese surplus; the excessive reserve stockpiles of the latter would also fall. In other words, the global instability which is seen as part of the problem would tend to disappear. It is worth noting that for some the Chinese savings glut and a low interest rate are behind the excessive American debt and that of other advanced countries, which would make it partly responsible for the last global financial crisis. Either way, Bernanke's argument allows him to suggest that the way out is more financial liberalization.

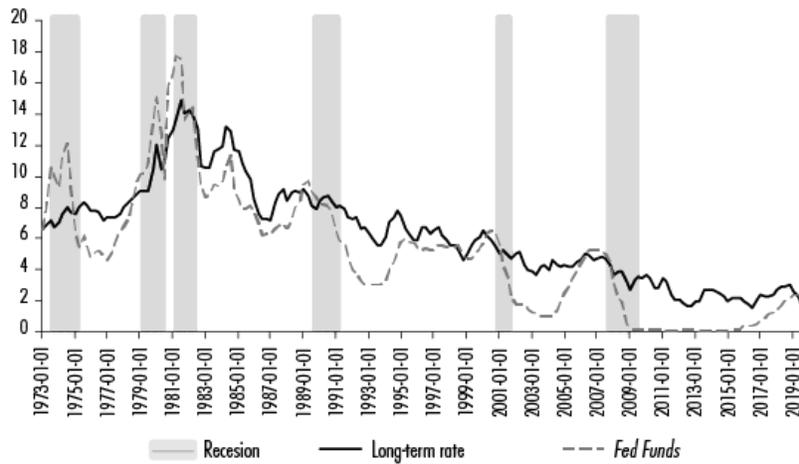
Summers (2015) is skeptical about the possibility that the depreciation of the dollar would work. Furthermore, he also has an understanding of the role of the dollar as a reserve currency, partly because of its connection to Wall Street. For him, the solution is that surplus countries increase consumption. Some heterodox authors see a rebalancing and increased spending in surplus countries in the current account as a re-vindication of Keynes's ideas in Bretton Woods. Along these lines, it is worth remembering that Summers recently acknowledged that the post-Keynesian ideas on the possibility of equilibrium with unemployment for example, as analyzed by Palley (2019), would be important for understanding the crisis.⁶

Nevertheless, the solution, when the hegemonic role of the United States is considered, is the international expansion of central countries with a strong currency. In other words, more than rebalancing, what is needed is an expansion of global imbalances, once an American expansion generates, if everything else is constant, greater trade deficits. The trade war between the United States and China, along with a slowing of global trade, in fact make one think of a world where central countries, especially the United States, are not a driving force for global recovery. And now that the crisis caused by the coronavirus (COVID-19) seems to be serious, the global economy is in recession; solutions which reduce the connections between global production chains to stimulate the economy seem to be even more necessary.

Nevertheless, if global stagnation is not the cause of low interest rates in the last few years, the question remains unanswered. Borio, *et al.*, (2017) noted that the relationship between the determinants of savings and investment on the one hand and interest rates on the other, is weak. These authors suggest that the proper response to low interest rates are monetary policies. The argument seems to be reasonable, and the evidence that the decisions regarding monetary policy would be decisive, seems irrefutable.

In order to understand this point, it is worth analyzing the data carefully. As such, Figure 1 shows the interest rates in the long-term, which remunerates 10-year bonds from the American Treasury Department, along with the short-term rate determined by the Federal Open Market Committee, the known rate of Fed Funds. The periods highlighted in gray identify recessions, and one can see that in general, when the short rate is below the long-term rate, or in other words there is an inverted yield curve, there is a recession. With the advent of Bretton Woods, when capital controls were eliminated and exchange rates were left floating in relation to the dollar, the rates were low, but in the late 1960s, with the elevated inflation due to the impact of oil and wage resistance, the rates were already high. One can see that the rate of long-term bonds, a proxy for the natural interest rate in the literature on the subject, was what accompanied and situated the decisions on economic policy.

Figure 1. Short and long-term rates in the United States

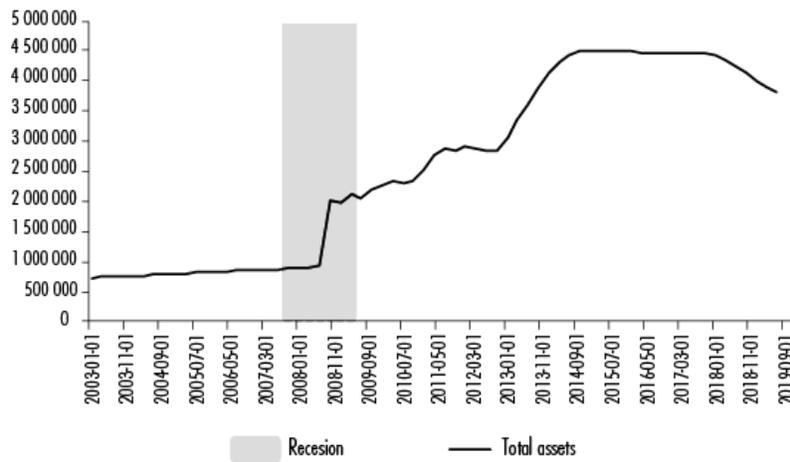


Source: created by the author based on FRED ECONOMIC DATA, St. Louis FED (2019).

Slowly, starting in the 1980s, the rates started dropping from very high levels until, after both the dot-com and real estate bubble burst, the base rate dropped to rock bottom. In this context, what forced the Fed to take a political stance of lowering rates is precisely the financial deregulation and the collapse of the bubbles. The instability which put aside the lowering of rates also led to the growth of the Fed's portfolio. The problem is financial fragility, to use Hyman Minsky's term in describing the rise of financial speculation, and not secular stagnation.

It should be noted that during a period of crisis, as with the period after the Lehman Brothers crisis in September 2008, the Fed intervened to determine short-term interest rates, but also affected the long-term rates. In fact, the growth of the Fed's asset portfolio (see Figure 2), can be largely attributed to the increase of long-term bonds and real estate assets, going from a little more than \$1 trillion USD to close to \$4.5 trillion USD. This also explains the drop in the long-term rate, which was the objective of the policy, and which allows financing fiscal policy with a more stable foundation, as is well known by debt dynamics.⁷

Figure 2. FED Asset Portfolio (USD)



Source: created by the author based on FRED ECONOMIC DATA, St. Louis FED (2019).

It is important to be aware that even though the Fed declared, and for some time attempted, the reduction of its portfolio starting in 2018, the program was suspended. It should be perfectly clear that it is impossible to increase short-term rates at the same time as reducing FED assets without causing a problem for the actual economy. This suggests that one can expect low rates to continue for the foreseeable future in advanced countries, in some cases even negative in real terms; this could have important ramifications for monetary and fiscal policies, as well as foreign exchange policies in the periphery, once it allows keeping rates low without running the risk of asset drains, with which it would be possible to finance fiscal spending and reduce rates without the risk of a foreign crisis. Or at least that was the case before the coronavirus.

Next, we will discuss the central banks of the periphery, particularly in Latin America.

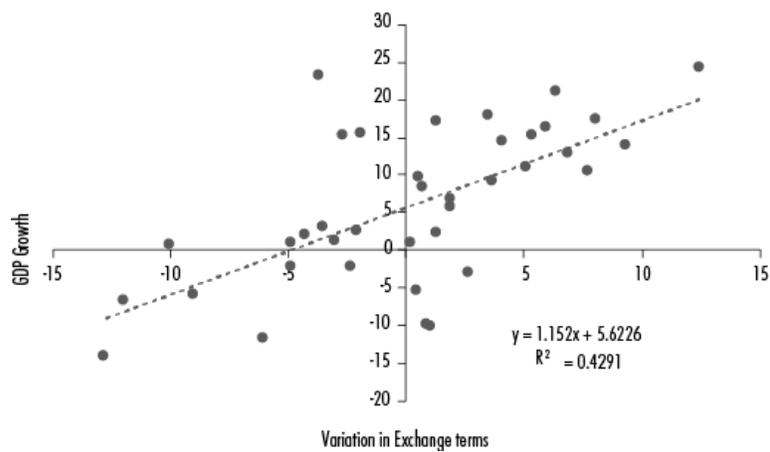
3. FOREIGN RESTRICTIONS AND CENTRAL BANKS IN LATIN AMERICA

Latin America is a peculiar region beyond a doubt. The levels of inequality are higher than what one would expect based on the average income levels. In general, it is a region of mid-level average incomes, but with a high rate of inequality, comparable to the poorest regions of sub-Saharan Africa. Furthermore, during the 2000 boom, contrary to global trends, the income distribution —measured by the Gini index— improved, and in many countries, especially in South America, wherever there was a leftist government, real wages grew (Cornia, 2014). On the other hand, the raw materials price boom which many associate with Chinese growth, albeit barely in the case of metal raw materials, clearly lost strength after repeated international crises, thereby complicating the regional situation.

The region establishes itself with a dual global integration, with South America exporting farming, mineral and energy commodities; while Central America and Mexico have gone on to depend on “maquilas”, exporting goods with little added value, imported technology, and a great number of production imports (Pérez Caldentey and Vernengo, 2010). In other words, the exports depend on natural advantages, or rather the proximity to the American markets and low wages, characteristics which make their integration not very dynamic and make it difficult to approach the income levels of central countries. The pattern of growth depends on the price of commodities, as well as on the growth of the economy of developed countries, especially that of the United States which, as we saw, for reasons of financial fragility grows at moderate rates.

There is a clear positive correlation between the exchange terms and GDP growth in Latin America (see Figure 3),⁸ but it is dangerous to accept simple correlations between the two variables. The correlation is actually stronger starting in the year 2000, (Pérez Caldentey and Vernengo, 2010). The rise of raw materials between 2003 and 2008, and after a collapse, until 2014, allowed among other things the lifting of foreign restrictions and created a space for redistributive policies, the increase of some social transfers and of the minimum wage in the region.

Figure 3. Growth and exchange terms

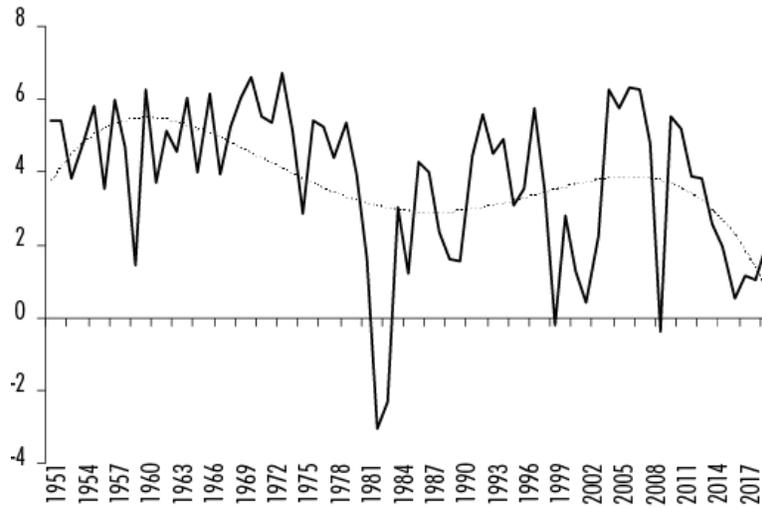


Source: created by the author based on data from CEPAL (2019) and the World Bank (2019).

It is unclear whether the drop in prices of raw materials was the only, or even the primary, cause of the bad performance in the region during the last few years, although it has certainly played a relevant role. In many cases, the countercyclical macroeconomic policies play an important role. For the countries in the region with programs from the International Monetary Fund (IMF), austerity has also played a role.

Nevertheless, facing the low global interest rate, foreign restrictions are not clearly valid at the moment save for a few exceptions, primarily Argentina and Venezuela for disparate reasons. The region has grown less in the last few years (see Figure 4); it grew at a rate of 5.6% from 1950 to 1981 and 2.5% afterwards. The deceleration after 2014 is clear. It should be noted, in part, that the reduction in growth is owed to macroeconomic policies adopted in the region. As Pérez Cladentey *et al.*, (2014) note, a characteristic of the region is relatively weak expansions, compared to the depth of the crisis and expansions in other parts of the world.

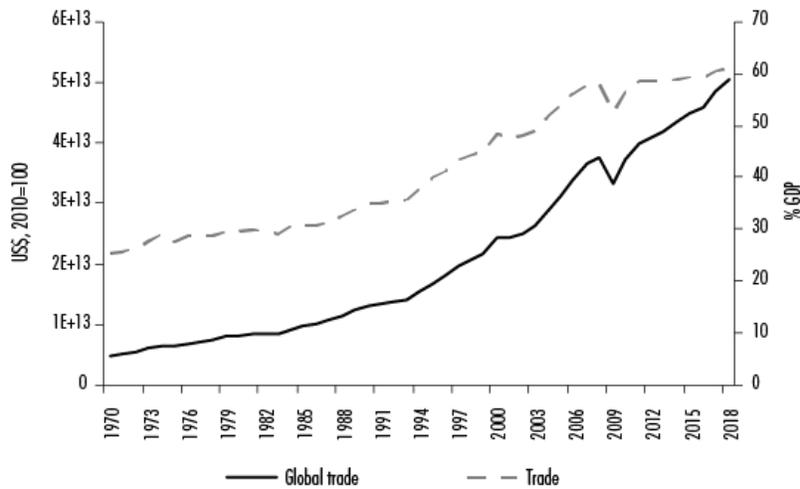
Figure 4. GDP growth in Latin America - 1951-2019 (%)



Source: Total Economic Database, Conference Board (2019).

But it is reasonable to suppose that the global situation, as much the low growth in the center as the slowing growth of global trade, have played an important part. Figure 5 shows world trade as a share of global GDP in billions of dollars. It should therefore be clear that while world trade grew at rates greater than the GDP, especially since the 1990s until the global crisis in 2008, the relationship between trade and global product has then been relatively stagnant at around 6%.

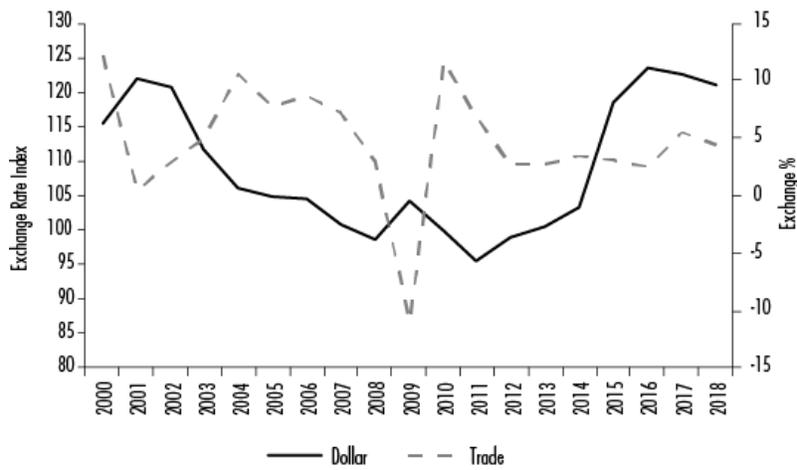
Figure 5. World trade



Source: created by the author based on data from the World Bank (2019).

Some analysts would consider this to be the result of an inverse relationship between the value of the dollar and world trade (e.g., Shin, 2019). In effect, Figure 6 shows a slight negative relationship between the real exchange rate index (measured as a price apart from the dollar, as such a drop is a depreciation) and the growth rate of global trade.

Figure 6. Exchange rate for the dollar and global trade



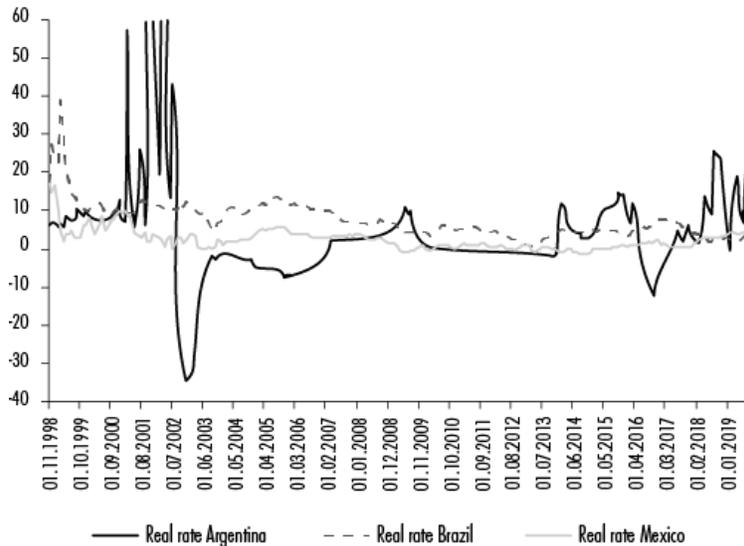
Source: created by the author based on data from the World Bank (2019), and FRED ECONOMIC DATA, St. Louis FED (2019).

The explanation would be that the appreciation of the dollar and the relative depreciation of currencies in periphery countries, would be related to monetary conditions less restrictive in the United States, and more restrictive in the periphery, which in turn would reduce the dynamism of demand in less developed countries with a negative effect on global trade (Bruno, *et al.*, 2018).

In other words, the depreciation would be contractive in the periphery with negative effects on trade. It is worth pointing out here the contractive effect would be exclusively due to the effects of monetary policy, and higher rates in the center, on the level of activity, in contrast with older structuralist literature which would suggest that the devaluation was contractive because it had distributive effects. A depreciation increases the earnings of exporters and reduces the wages of workers if the Market Basket has imported goods and, as the former group would have a propensity to spend less, the net effect would be negative.

It is along these lines that the effect of unconventional policies in the center and the excessive global liquidity, and of the resulting search for the performance of speculative capital would be a more unstable environment, as well as lower global trade growth rates. Nevertheless, this explanation loses sight of other elements of central banks' policies in the periphery. Figure 7 illustrates real interest rates in three Latin American countries.

Figure 7. Real interest rates in selected Latin American countries



Source: BIS (2019) and the author's own calculations.

The interest rates are higher than those of the United States, but aside from the case of Argentina (which was intermittent during the default crisis of 2002), they are not excessively high. This allows the three countries to stockpile significant reserves in dollars. In the case of Argentina, the rates during the crisis went from exorbitant to negative and only became positive again sporadically, when the capital drain forced the Central Bank to take action. Actually, the case of Argentina is the only one that conforms directly to the suggested analysis, in which volatility in capital flow, associated in great part with global liquidity, affected the functioning of the local economy. In actuality, the period of unconventional monetary policies in the center allowed for

the central banks in a large part of the periphery to accumulate reserves and, as Carstens indicates (2019), the sustaining of a flexible but controlled exchange rate, where dramatic variations were avoided.

In the majority of cases, the public debt in foreign currency was reduced. In this regard, Argentina—at least until the presidency of Mauricio Macri at the end of 2015—, reduced the debt in dollars (DeLucchi and Vernengo, 2019). Nevertheless, the possible financial fragility of the periphery countries is related to the increase of debt in the nonfinancial private sector (Chui *et al.*, 2016). In other words, globally liquidity and low interest rates in the center in a deregulated world allows nonfinancial companies in the periphery to produce goods for the domestic market, thereby generating income in the domestic currency, while acquiring debts in dollars, creating an imbalance between income and liabilities which could be harmful in the case of a devaluation of the domestic currency. The financial fragility in the center has created the conditions for financial fragility in the periphery, which has now been augmented with the coronavirus crisis which could lead to a new great debt crisis in the periphery, in particular if national governments, as is often the case, take over the debts of companies who owe in dollars.

But the combination of low interest rates in the center and the new trade war with China, which is also important in order to understand the slowing of global trade, creates a space for policies fostering industries in the periphery, and opens up the possibility for renewed growth in the region. Likewise, the coronavirus crisis presents the possibility for rethinking the need for planning, and a greater governmental role in the economy. Along these lines, if one goes beyond managing the base rate, the credit policies of central banks in the region, support of fiscal policy, keeping up moderate rates and lower differentials between the base rate and that of long-term bonds, it could be relevant in promoting development in the region.

As such, capital controls, as long as it is politically viable to introduce them, are an important instrument which we should not lose sight of. Here there is an opportunity for central banks to regulate and restrict loans taken out by private agents in foreign currency. Controls would facilitate, in cases where there is a significant stockpile of reserves, maintaining a controlled exchange rate, thereby avoiding foreign crises which have been recurrent since the end of the Bretton Woods system in the 1970s. Although it could be difficult after the current coronavirus crisis. Within this context, central banks would help to create a setting more favorable to economic development and financial stability.

4. CONCLUSION

Central banks are created as institutions needed to promote the accumulation of capital. In particular, central banks were fiscal agents for the State, allowing the management of public debt. Throughout history their role has changed and the current notion of a central bank independent of the treasury, and whose primary concern is inflation, came about at the end of the 19th century and was taken up anew in the neoliberal period of the 1970s. At that time, in both the center and the periphery, central banks tend to be independent and follow a regime governed by inflation goals.

The financial crisis of 2008 created a space where we can rethink the role of central banks. In some spheres they speak of abandoning the idea of independent central banks, and more importantly, discussions have started regarding which alternative policies could be used when faced with the so-called secular stagnation. Here I have suggested the idea that negative rates, based on the theoretical idea of a natural negative interest rate, will bear little fruit. The problems related to financial fragility deem the reasons for low interest rates to be others, not real, related to demography, rather than policies connected to the necessity of rescuing financial and nonfinancial entities from speculative excesses. The coronavirus crisis can lead the economies to a recession and cause various financial and nonfinancial overindebted entities to default and possibly the same for some peripheral countries, yet the crisis also presents the opportunity to rethink the role of central banks. The reregulation should be on central banks' agenda.

Likewise, I recommend that central banks can and should be rethought in the periphery, with the objective of transforming them into what they once were: instruments of development. In particular, capital controls and the accumulation of significant reserves in dollars are a prerequisite for any alternative policy in developing countries.

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¹ This text was presented at the Institute of Economic Research, UNAM, at the conference "Developmental challenges in the current context" (*Los retos del desarrollo en el contexto actual* in the original Spanish), in September 2019.

² On the evolution of monetary policy and central banks in Latin America see Pérez Caldentey and Vernengo (2019).

³ After these came the banks of Venice, the *de Rialto* and the *el Giro* and one in Amsterdam, see Roberds and Velde (2016).

⁴ The lack of viability of the aforementioned, beyond the tenuous connection between population growth and interest rates, comes from the fact that the debate on capital clearly showed a logical inconsistency in the marginalist substitution principle. On the capital debates see Kurz (1987).

⁵ Keynes explicitly states in his most famous book, that the concept of natural interest rates should be abandoned. The concept was brought back by Friedman in the late 1960s, in his discourse on the natural unemployment rate with which it was related. More recently, central banks have tried to calculate the natural, sometimes referred to as neutral or equilibrium, interest rate. See, among others, Laubach and Williams (2003) on the lowest natural interest rate.

⁶ For more on Summers' argument that post-Keynesian authors are correct, see Summers and Stansbury (2019).

⁷ See, for example, Blanchard (2019) for a recent explanation, although this has been known since the 1940s thanks to the functional finance theory. It should be noted that this will change dramatically with the current coronavirus crisis.

⁸ Preliminary estimations suggest that the current correlation is economically and statistically significant.