The Role of the Fiscal and Monetary Policies during the Covid-19 Crisis in Countries with High- and Lower income

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Abstract: Countries around the world are affected by coronavirus pandemic and struggle with the economic consequences of Covid-19. Based on macroeconomic data the paper analyzes how policy responses to the pandemic differ in countries of different income. It examines to what extent the macroeconomic state of an economy determines the use of the tools of fiscal and monetary policies and how economies had to change their policies to tackle the coronavirus crisis. Besides introducing the tools and measures, the research aims to answer whether recession triggered by pandemic differs from other, „normal" recessions. This paper focuses on what specific support will be necessary for countries of lower income.

Key Words: Covid-19, Recession, Fiscal and monetary policies.

1. INTRODUCTION

In 2020, all economies around the world were hit by (COVID-19). The damage of the COVID-19 pandemic to people and economy has been stronger than that of the global financial crisis of 2008. "Getting back to the pre-Covid standard will take time," said Carmen Reinhart, the World Bank's chief economist. "The aftermath of Covid isn't going to reverse for a lot of countries. Far from it" (World Bank Report, January 2021).

As for the economic consequences, countries have been affected differently.

In response, almost all major economies have adjusted their monetary policies and lowered policy rates, or introduced new targeted long-term refinancing operations. Implementing unlimited and open-ended quantitative easing or reducing the reserve requirement ratio were the commonly applied tools that aimed to give monetary stimulus to their economies. Due to the fast spread of the disease the systematic risk has increased, which affected investments adversely. In contrast with 2009, in 2020-21 low-income and emerging economies were hit harder and advanced countries suffered less by the economic crisis that the pandemic caused.

This paper aims to summarize the governments' and central banks' responses to the pandemic and the subsequent economic crisis regarding fiscal and monetary tools on a large scale. The World Bank classifies the economies of the world in four income groups: high, upper-middle, lower-middle, and low, based on their GNI per capita. Countries with high income can use the required resources and implement fiscal expansionary policies a lot easier. In addition, they have more access to external funding than others.

The challenge to the central banks in the current situation is to shape the best monetary policy responses to the pandemic, in which the lessons of their unconventional reactions to the Great Financial Crisis are incorporated.

2. MATERIAL AND METHODS

This research is based on analysing qualitative and quantitative data. Literature review and analysis have been used and data have been collected from diverse sources, including books, journals, newspapers, conference papers, reports from international organizations, government policy records and websites.

The data on national fiscal policy responses have been gathered from the International Monetary Fund's (IMF) Tracker of Policy Responses to Covid-19. The data sources on fiscal and monetary policy responses include Fiscal Monitor Database, Statista and Eurostat. The data relate to advanced economies emerging markets and developing economies. Having analysed the data and examined the countries' economic, social, political, and institutional contexts I have made comparisons of the fiscal and monetary policy responses in countries with high- and lower income and drew conclusions regarding the effectiveness of the tools applied by the economies.

Countries around the world struggle with the economic consequences of Covid-19 that has thrown both advanced and developing economies in recession, which has not been seen since the Great Depression. In April 2020, the global economy was projected to shrink sharply by -3% in 2020, a fall of 6.3% from a pre-Covid-19 projection. Governments and central banks have used fiscal and monetary tools to respond the economic crisis caused the pandemic. Nevertheless, there is a limit for the economies to use these tools. When crisis broke out, most high-income countries had historically low interest rates, 0.78% on average. At the same time their public debt levels were very high. At the end of 2019, central government gross marketable debt was estimated at 72.6% of GDP for OECD countries overall (World Bank). As the use of conventional monetary policy was limited, high-income countries implemented different unconventional monetary policy tools (UMPTs). They include central bank guarantees, asset purchase programmes (APPs), restrictions of dividend payments and relaxation of macroprudential rules. On the other hand, a country's access to credit markets or its credit rating may restrict its ability to introduce fiscal policies when short-term rates are extremely low. The pandemic has hit advanced economies differently as for number of confirmed cases and deaths**.** Higher sovereign credit ratings of these countries can facilitate their reacting to the shock with fiscal policies, while countries with lower credit ratings are limited in their use of the implementation of policies. Bernanke (2020) suggests that UMPTs may offset the effect of interest rates at their lower bound, while Summers (2014) argues that monetary policy's ability to achieve is limited in such circumstances.

2.1. Unconventional monetary policy tools

The support provided to money, securities, and FX markets is based on the central bank mandate, where price and financial stability objectives have priority.

The target of unconventional measures is different from that of conventional monetary policy, which targets short-term interest rates. They were designed to affect term spreads or, long-term risk-free rates, while other UMPTs targeted influencing liquidity and credit spreads or interest rates on different non risk-free instruments. The aim of other UMPTs were to ensure liquidity and restore asset valuations to support the monetary policy transmission mechanism (BIS, 2019).

Advanced economies deployed asset purchases to a great extent at the time of the Global Financial Crisis, which resulted in a significant increase in the size of central bank balance sheets in recent years. During the pandemic, central banks in many advanced economies launched large-scale APPs. The Federal Reserve (Fed) for instance, purchased US Treasury debt and mortgage-backed securities in the amount of 4.5% of GDP. The European Central Bank (ECB) started a temporary public and private securities purchase amounting €750 billion, which takes up 6% of GDP of EMU economies (IMF, 2021).

There is a trade- off between holding on to the balance sheet portfolio and increasing short-term rates. Monetary policy has come to a new stage, which is characterized by the special role of balance sheets. One leading goal for central banks in developing countries is to support financial sector development. This has been further confirmed as a reform principle for developing countries in the post-crisis era. Central bank balance sheets have got a special emphasis in their role as the new tool of monetary policy instead of interest rates. It does not mean giving up tightening by hiking short term rates even if it has special implications due to the post crisis economic environment. In addition, it is the central bank's option whether to sell longer-term securities and affect the term structure of rates or to raise short term rates.

Furthermore, by designing UMP interventions central banks have successfully implemented a number of actions that can reduce side effects that may limit the effectiveness of their measures. For instance, extensive APPs are effective in lowering long term yields and generate a scarcity of high-quality assets in repo markets at the same time. The issue was addressed by the introduction of securities lending facilities.

When liquidity in money markets dries up, central banks respond by initiating measures to facilitate financial institutions' access to liquidity. For instance, central banks increase the frequency of repo auctions, provide funds at longer maturities, create new liquidity facilities or increase the range of collateral accepted. They can expand the set of eligible direct counterparties and enhance the availability of central bank liquidity indirectly. Nevertheless, in situations where liquidity is abundant with interest rates extremely low for a long period, the efficiency of allocation funds may be at risk. Financial resources may become misallocated in favour of less-productive companies An important intermediate objective of central banks during a crisis can be reducing or slowing deleveraging.

UMPTs are not the only tools implemented to tackle the financial and economic contraction during crises and their aftermaths. Effective fiscal, structural, microprudential and macroprudential policies are also necessary to introduce. The effectiveness of fiscal expansions has often been associated with the ability of central banks to commit to low-for-long policies. (Woodford, 2011).

The effectiveness of UMPTs mostly depends on several factors, such as the credibility of the central bank; whether public perceive the tools are effective and implementable, as UMPTs to a great extent operate through the expectations of financial market players. UMPTs are more effective when accompanied by appropriate policies and function in a broader policy framework.

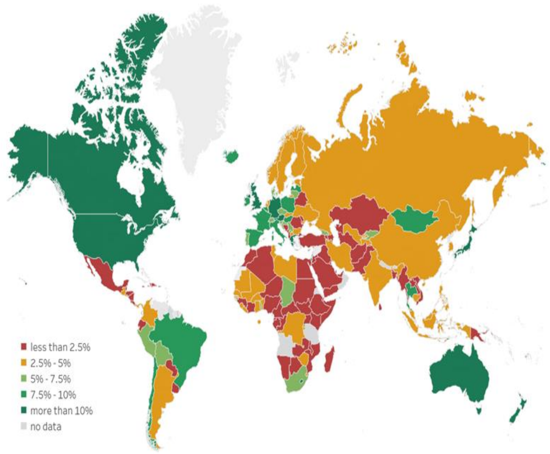
2.2. Other policies supporting monetary policy

Both conventional and unconventional monetary policy can stimulate the economy more effectively if they are supported by other policies. Prudential policies, for instance, strengthen resilience in the financial system, thus monetary policy can address financial stability risks without having to use its interest rate tool. Appropriate micro and macroprudential policies can ensure that UMPTs do not result in excessive risk-taking by financial intermediaries. Responsible lending is ensured by bank regulation under favourable lending operations. In addition, macroprudential policy can strengthen the stimulating effects of monetary policy by releasing countercyclical capital buffers. So do fiscal authorities when using automatic stabilisers or discretionary policy actions at critical phases of the business cycle.

2.3. Fiscal policy responses

The Covid-19 crisis underlined the significant role of national fiscal policies in increasing employment levels, maintaining the living standards of people and economic development. Each economy needs to implement fiscal policies which are appropriate to its specific circumstances. Aggregate fiscal packages consist of both budgetary and non-budgetary measures. Budgetary measures include spending on health care, transfers to firms and households, wage and unemployment subsidies and tax cuts or deferrals. They have a direct negative impact on fiscal balances. The non-budgetary part comprise funding and credit guarantees, which do not have an immediate impact on the fiscal balance. Funding means loans by governments to firms, particularly to small and medium-sized enterprises or providing equity to strategic firms. Government credit guarantees, including fiscal backing for central bank programmes, aim to maintain the flow of credit to the economy. Governments have responded to the pandemic using a wide variety of fiscal policy tools (Cavallo and Cai 2020). The role of fiscal policies mainly focuses on changing taxes or fiscal spending on various programs or projects. Cavallo reveals that low-income economies have fewer fiscal tools and policy options to combat the damage to their economies. On average, high-income countries deployed fiscal policies that amount to 6.8% of GDP compared to 3.1% in low-income countries (Benmelech - Tzur-Ilan, 2020). In addition, economic and fiscal conditions are important factors that determine the capacity and room for fiscal policy. Economies with higher income and larger room for these policies can raise and allocate resources swiftly and adopt expansionary policies. Furthermore, due to their higher sovereign credit ratings, they have more access to external funding than emerging markets or low-income developing countries. (Alberola et al. 2020; Benmelech and Tzur-Ilan 2020).

Figure 1: Budgetary fiscal support to people and firms across countries



Source: IMF

3. RESULT AND DISCUSSION

In this part, monetary and fiscal policy responses of particular economies are presented and discussed.

3.1. Monetary policy response in the U.S.

The negative economic impact of the covid-19 crisis hit the U.S. economy concentrated in March and April 2020. The Fed reacted quickly and significantly. In the initial phase of the crisis in March, financial market stress rose drastically. The St. Louis Fed Financial Stress Index[1] reached its peak perceived since December 2008. The world's deepest and most liquid market, the U.S. Treasury market, showed signs of stress and illiquidity.

The Federal Open Market Committee (FOMC) reduced the target range for the federal funds rate by a total of 1.5 percentage points since March 3, 2020, to a range of 0% to 0.25%. As it is the

[1] The St. Louis Fed Financial Stress Index (STLFSI2) measures the degree of financial stress in the markets and is constructed from 18 weekly data series, all of which are weekly averages of daily data series: seven interest rates, six yield spreads, and five other indicators. Each of these variables captures some aspect of financial stress. (Federal Reserve Bank of St. Louis, 2021)

rate banks pay to borrow from each other overnight, the federal funds rate is a benchmark for other short-term rates, and affects longer-term rates as well. Other interventions included temporarily relaxing regulatory requirements, emergency lending and asset purchases— some of them went beyond the scale of measures taken under the global financial crisis (GFC) of 2007-09. For instance, the corporate bond market was not included in programs during the financial crisis regarding backstop funding, which indicates to investors that the Fed will be a participant of last resort, thus ensuring these markets continue trading. Through Term Asset Backed Securities Loan Facility (TALF**)**, the Fed supported lending to households, consumers, and small businesses. It means lending to holders of asset-backed securities collateralized by new loans. The TALF would initially support up to $100 billion in new credit. To encourage banks to lend the Fed lowered the overnight rate to banks from 2.25% to 0.25%, lower than during the GFC, and extended the terms to 90 days.

The Fed has tried to ensure the financial system doesn't strengthen the shock to the economy. Its measures proved successful as levels of financial stress seems to have been declining and are now back to pre-pandemic levels January and February 2020.

3.2. Fiscal policy response in the U.S.

The scale of fiscal package during the Covid-19 crisis has been much larger than the fiscal package in 2009. It aimed to compensate those who are most adversely affected.

Therefore, U.S. fiscal policy was designed to keep the pandemic under control and maintain people's living standard. Households and businesses were compensated by supplemental unemployment insurance benefits, pandemic unemployment assistance for workers who would not be eligible for unemployment insurance under normal programs. Small businesses are provided forgivable loans through the Paycheck Protection Program.

Congress has passed the USD 2,200 bn Coronavirus Aid, Relief and Economic Security Act (CARES), a fiscal stimulus package that is the equivalent to 10% of GDP or 50% of the annual federal budget. (BNP Paribas)

3.3. Monetary and fiscal policy response in the EU

The economic policy response of EU member states was quite similar to that of the U.S. in terms of maintaining liquidity debt and guarantees, ensuring households can delay payments, and workers receiving pay-checks. The response aimed at preventing mass insolvencies, providing cash flows to firms, particularly small businesses (Buti – Papaconstantinou, 2021). Crisis relief first, recovery second. There are differences in member states regarding their economic and fiscal conditions, thus in their policy instruments as well. Nevertheless, the differences were less significant than during the eurozone crisis. Liquidity provisions added a €2 500 billion-response to the fiscal of €500 bn in 2020 (IMF, 2020).

In an environment of low interest rates, the ECB aimed at ensuring the crisis did not spill over to financial markets, and stabilised markets for sovereign debt. It expanded its targeted and non-targeted refinancing operations, expanded its accepted collateral and eligibility as well as renewed and expanded its asset purchases programme. The central bank implemented Pandemic Emergency Purchase Programme (PEPP), a temporary asset purchase programme of private and public sector securities. The amount of the initial €750 billion was increased by €600 billion in June, and by a further €500 billion in December 2020. Under the existing asset purchase programme (APP) as well as under the PEPP, all asset categories are eligible (ECB, 2021).

The early activation of the general escape clause in Stability and Growth Pact (SGP) rules enabled member states to employ large scale fiscal relaxation estimated at about 8% of GDP, in addition to liquidity schemes of about 19% of GDP in the eurozone. This was supplemented by measures for liquidity provision to firms as the relaxation of state aid rules allows the activation of national guarantees.

The European safety nets – SURE to mitigate unemployment risks, the EIB Pan European Guarantee Fund, and the ESM Pandemic Crisis Support – complement national responses.

The ECB ensures that all sectors of the economy including households, firms, financial institutions and governments can benefit from financial support.

3.4. Responses in advanced and emerging market economies

The size and composition of fiscal packages greatly depend on structural factors. Due to their higher level of development and income, advanced economies (AEs) can react more effectively to the shock, as it is easier for them to allocate resources appropriately and timely. In addition, wealthier economies can buffer unexpected shocks better, owing to their economic and institutional framework. In the context of the income level, strength of the social safety nets and automatic stabilisers also determine fiscal packages. Deeper financial markets and broader social safety nets would require a more limited discretionary fiscal response. For emerging economies (EMEs), it is the the living standards that are the main determinants of fiscal responses. Fiscal policy room is another important factor. International investors are more sensitive to EMEs' fiscal fundamentals and less tolerant as for their debt levels. Their fiscal response is constrained by higher financing costs and their reduced access to external financing. Financing costs are measured by ten-year local currency government bond yields. Their level was on average 5.7%[2], in EMEs, and 0.7% in AEs February 2020. (Bis, 2020). For those with higher bond yields and worse sovereign debt ratings, fiscal packages have been smaller. Another fact is that fiscal policy is procyclical in EMEs, which means governments' increasing spending and reducing taxes during an economic expansion, but reducing spending and increasing taxes during economic downturns. Foreign financial flows may be shifted away from these economies thus financing conditions have become tighter, which is reflected by the rising CDS spreads.

In addition, public finances in some EMEs are dependent on commodity export revenues to a great extent. The sharp fall in oil demand and prices further narrows the fiscal space in oil producing countries.

The size of the fiscal stimulus reached 4.6% of GDP for the G-20 countries by May 2020, while funding support takes up 1.7% and credit guarantees 3.4% of GDP (IMF, 2021).

Monetary policy can complement fiscal policy in these turbulent times. EMEs had more room to cut policy rates than AEs and they have been able to use this tool. At the beginning of 2020, policy rates in EMEs were on average 4.9%[3], while 0.4% in AEs. Higher policy rates indicate investors' higher yield expectations that compensate them for a higher risk. In spite of that EMEs have managed to loosen monetary policy they have cut policy rates by around 114 basis points[4] compared with 40 basis points in AEs (IMF, 2021).

3.5. The economic and social fragility of low-income developing countries (LIDCs)

Falling demand and consumption level as well as restrictions on the moving of people and business shutdowns destruct global trade. In LIDCs, there is lower productivity in operations. Foreign financial flows may be withdrawn from countries affected by the virus. Their domestic capital and labour is not utilized sufficiently. Global supply chains that LIDCs are excessively exposed to, have been disrupted. For instance, economies that are strongly dependent on textile product exports, but due to a shortage of raw materials, their factories have to close down. Commodity-dependent suffer from shrinken public budgets as a result of falling commodity prices. Those who get most of their national income from tourism and its services have been severely affected as well.

The G-20 economies, the World Bank, the IMF and development banks of the low-income regions can play a vital role in providing aid and assistance to LIDCs with their efforts to respond the current crisis.

4. FINDINGS

Discretionary Fiscal Response to the COVID-19 Crisis in Selected Economies[5]
(Percent of 2020 GDP)

Figure 1: Advanced economies

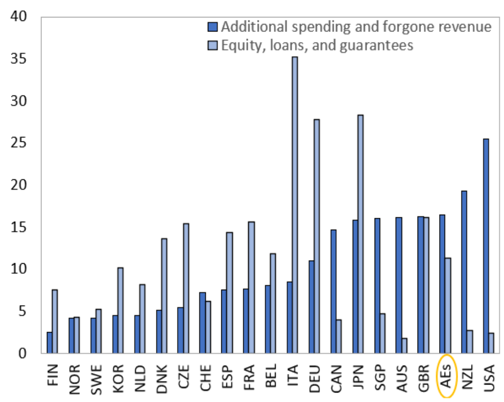


Figure 2: Emerging markets

AEs = advanced economies; EMs = emerging markets; LIDCs = low-income developing countries.

[2]Excluding Argentina

[3]Excluding Argentina

[4]Excluding Argentina

[5] Estimates as of March 17, 2021. Numbers in U.S. dollar and percent of GDP are based on April 2021 World Economic Outlook Update unless otherwise stated. Country group averages are weighted by GDP in US dollars adjusted by purchasing power parity.

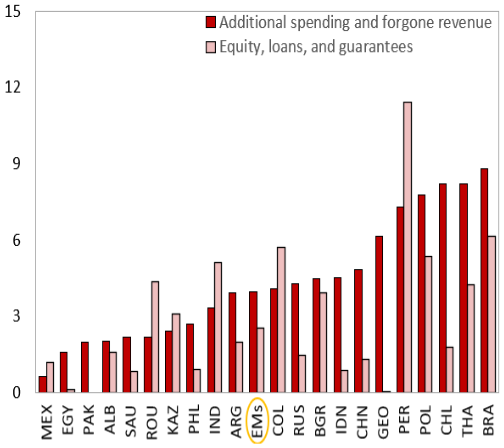
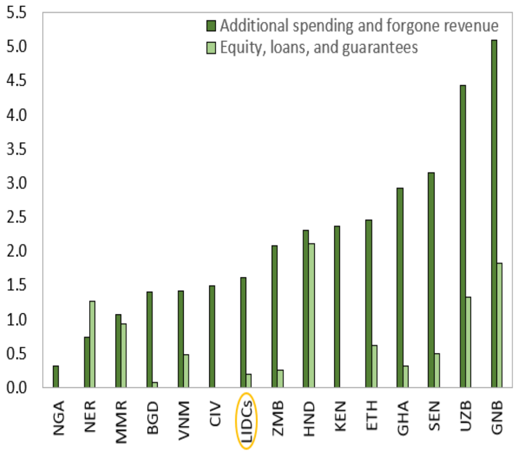
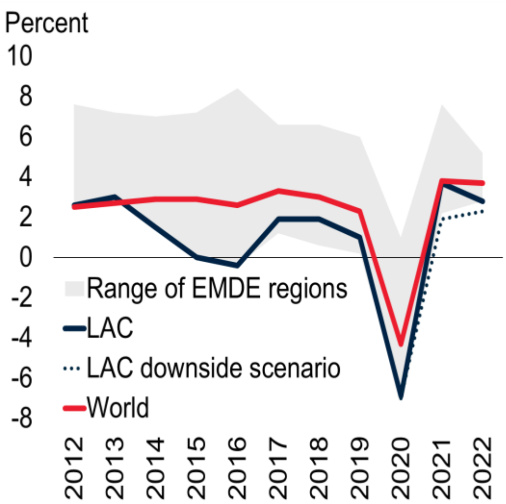


Figure 3: Low-income developing countries



Source: Fiscal policies database (IMF)

Figure 4. Growth

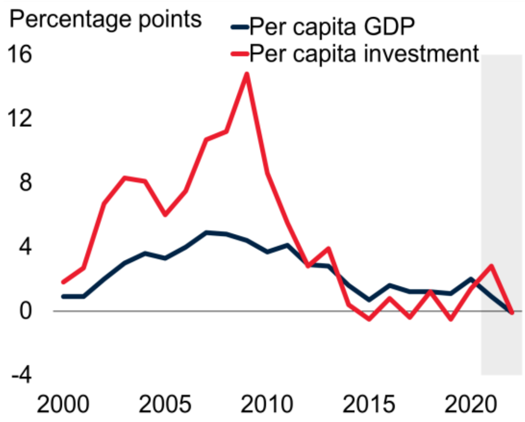


EMDE: Emerging Market and Develping Economy

LAC: Latin America and the Caribbean

Grey area shows minimum and maximum GDP growth in the six EMDE regions

Figure 5. Difference in EMDE and advanced-economy per capita investment and GDP growth



Source: World Bank

6. CONCLUSIONS

One key conclusion regarding AEs in the EMU is that successful response requires fiscal and monetary policy measures that can create room for each other. Favourable borrowing conditions provide space to the treasury with high debt. To ensure the monetary stimulus to be effective, however, the central bank must provide a credible monetary backstop to government debt. On the other hand, the treasury offers a backstop to the central bank balance sheet, to prevent monetary policy from facing the risks of losing control of inflation Both authorities can succeed in pursuing the level of stimulus if they „create a mix", and shape the responses together.

Another conclusion is that LIDCs won't be able to tackle the current crisis by appropriate responses without the assistance and aid of global institutions.

Finally, international economic cooperation is essential to ensure that the global economy is restored, and the long-term costs from the pandemic crisis are minimised. Global problems can be addressed only by taking a cooperative approach and coordinating the national measures, which may strengthen confidence in financial markets and investors as well.

International cooperation is the only way to ensure that vulnerable, low-income countries are not left behind so that all the parties will benefit.

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