Institute for Innovation and Public Purpose

Monetary-fiscal policy coordination during Covid-19: lessons for the green transition

Post-Keynesian Economics Society Annual Conference, SOAS, 13th June 2024

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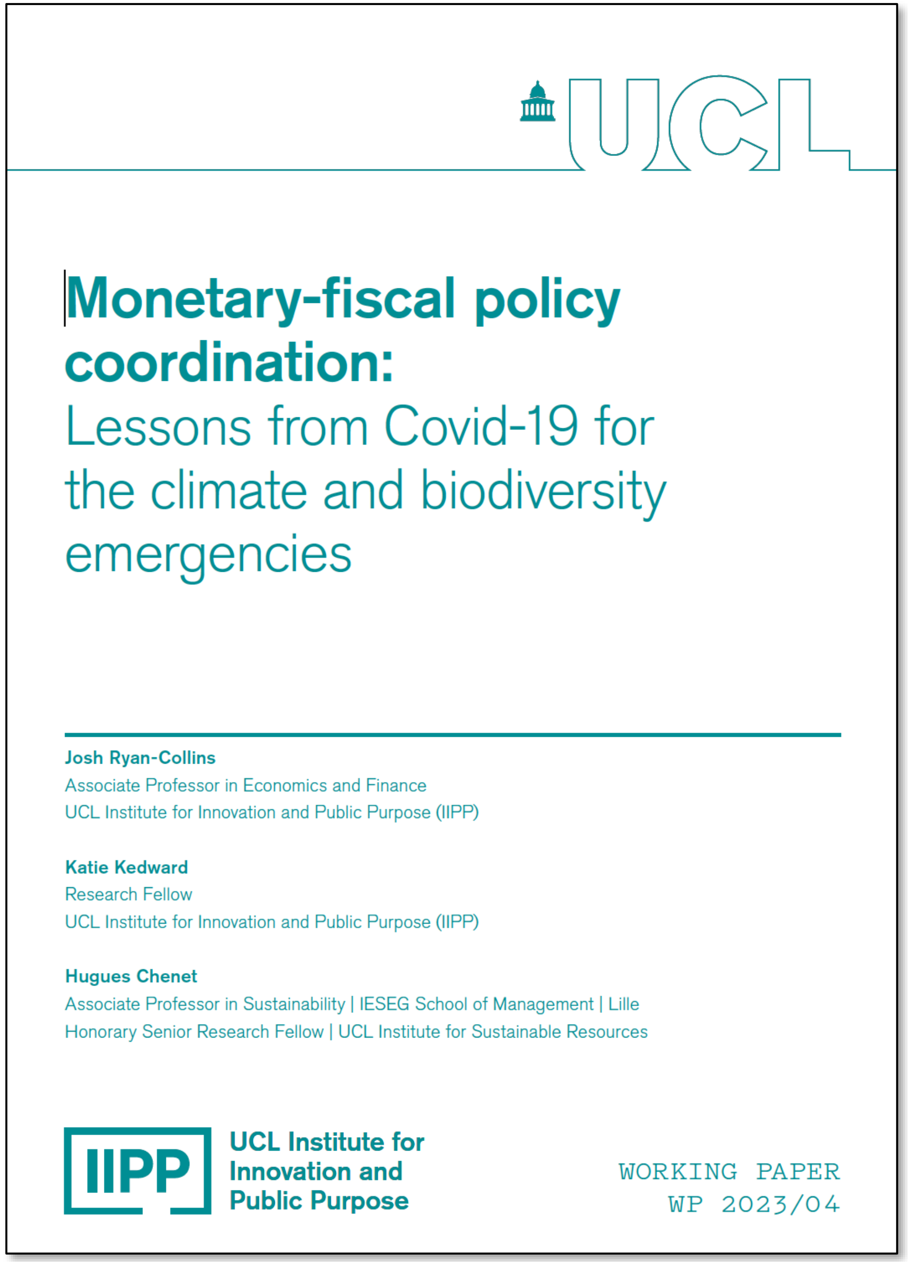
Summary

- **Examine two forms of monetary-fiscal policy coordination during pandemic:**
  - Monetary policy to create fiscal space: QE, yield-curve control, reserves policy, monetary financing
  - Liquidity interventions to support real economy sectors in need (a form of ‘credit guidance’).
- Sources:
  - IMF policy tracker database ‘Policy responses to covid-19’ & BIS’ ’Global database on central bnaks monetary reponses to Covid 19’ (Cantu et al 2021)
  - analysis of individual central banks’ documentation
  - other media
- Discussion of climate and nature crises and why M-F coordination ended post-pandemic



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Monetary-fiscal policy coordination:
Lessons from Covid-19 for the climate and biodiversity emergencies

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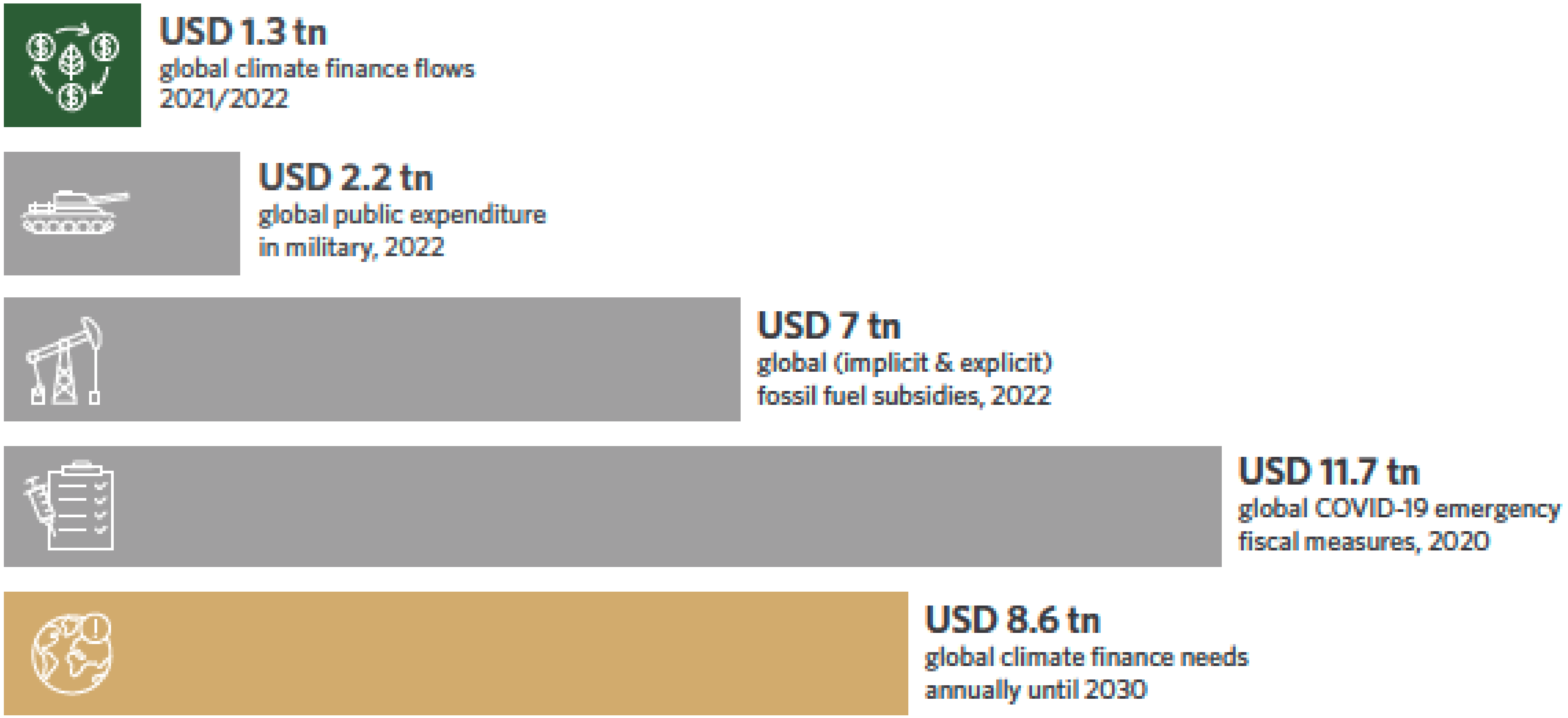
WORKING PAPER
WP 2023/04

The green finance challenge vs Covid measures



Source: Climate Policy Initiative (2023) Global Landscape of climate finance 2023, p8 https://www.climatepolicyinitiative.org/publication/global-landscape-of-climate-finance-2023/

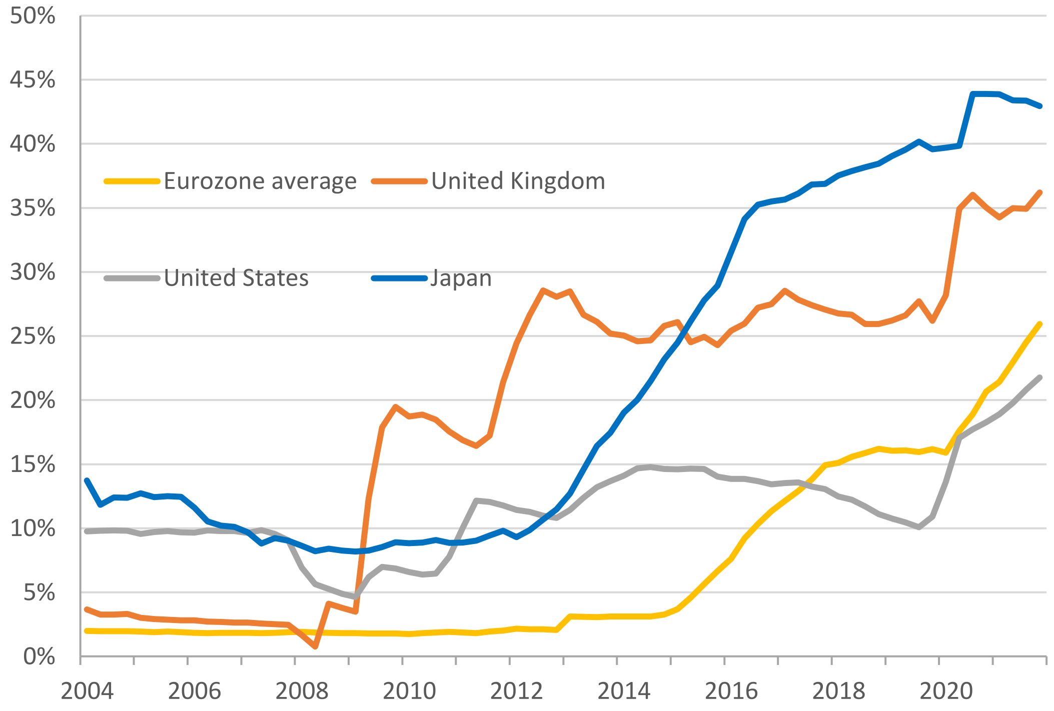
Monetary-fiscal policy coordination: historical backgournd

- **1930s-1970s:** monetary policy, financial regulation & credit policy coordinated with govt. economic policy objectives (Wade 1990; Amsden 2001; Bezemer et al 2021)
- MoFs lead but CBs actively supported economic development (Epstein 2006; Goodhart 2011; Vernengo 2016) esp. with credit policies (Monnet 2018), exchange rates via cap controls & debt management to support fiscal expansion (Roubini and Sala-i-Martin 1992; Reinhart et al 2011; Ryan-Collins and van Lerven 2018). CBs held 1/5th of govt. debt until 1960s.
- **1970s** distortion critique (McKinnon 1973; Shaw 1973) & government driven inflation (Friedman)
- **1980s – 2007** New Consensus macro – separation of policy spheres (Arestis & Sawyer 2002); Macro policy concerned with fin. & economic stabilization, not supporting structural change/growth/employment. CB key role is short-run adjustments to interest rates to align economy with natural rate and inflation targeting (Blanchard and Gali 2007); .

CB balance sheets during GFC & Covid-19

- GFC saw first shift towards M-F coordination with QE programs from 2008 in UK & US in particular
- Notable lack of unwinding in post GFC period
- Covid-19 saw even greater balance sheet expansion

Proportion of total government debt held by domestic central banks in major high-income economies, 2004-2021

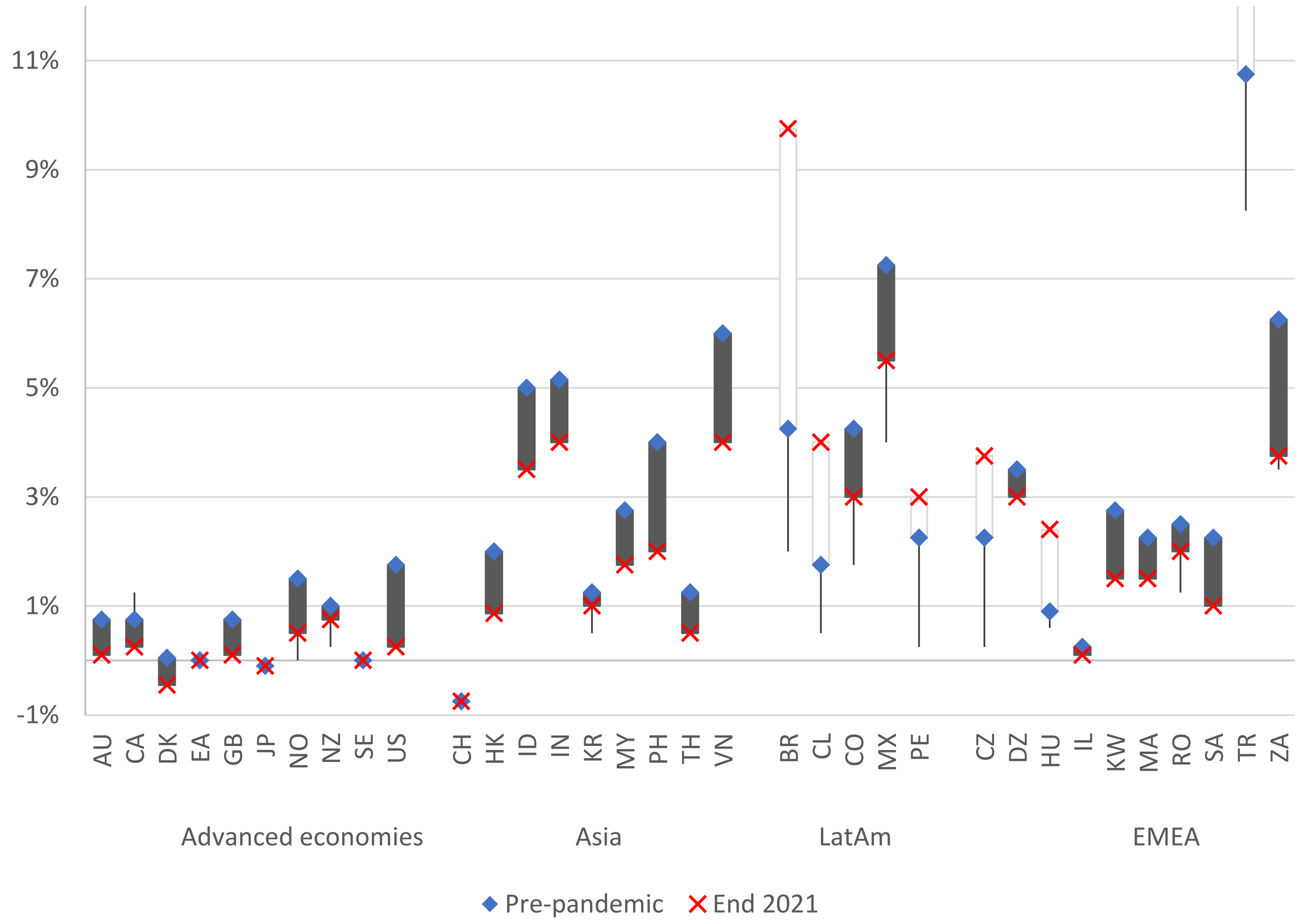


Source: IMF Sovereign Debt Investor Base for Advanced Economies (April 2020 update), available at https://www.imf.org/~/media/Websites/IMF/imported-datasets/external/pubs/ft/wp/2012/Data/_wp12284.ashx; (original paper: Arslanalp and Tsuda (2014))

Covid-19 interventions I: Monetary policy support for fiscal expansion

- Sharp falls in policy rates and huge asset purchase programs (far in excess of GFC) ensured public borrowing costs declined across most economies
- Explicit yield curve targeting on govt debt:
  - March 2020: RB Australia committed to holding 3-year yields at 0.25%, later 0.1% (RBA 2020).
  - March 2020: ECB Pandemic Emergency Purchase program
- Supported on average 9% increase in fiscal deficits

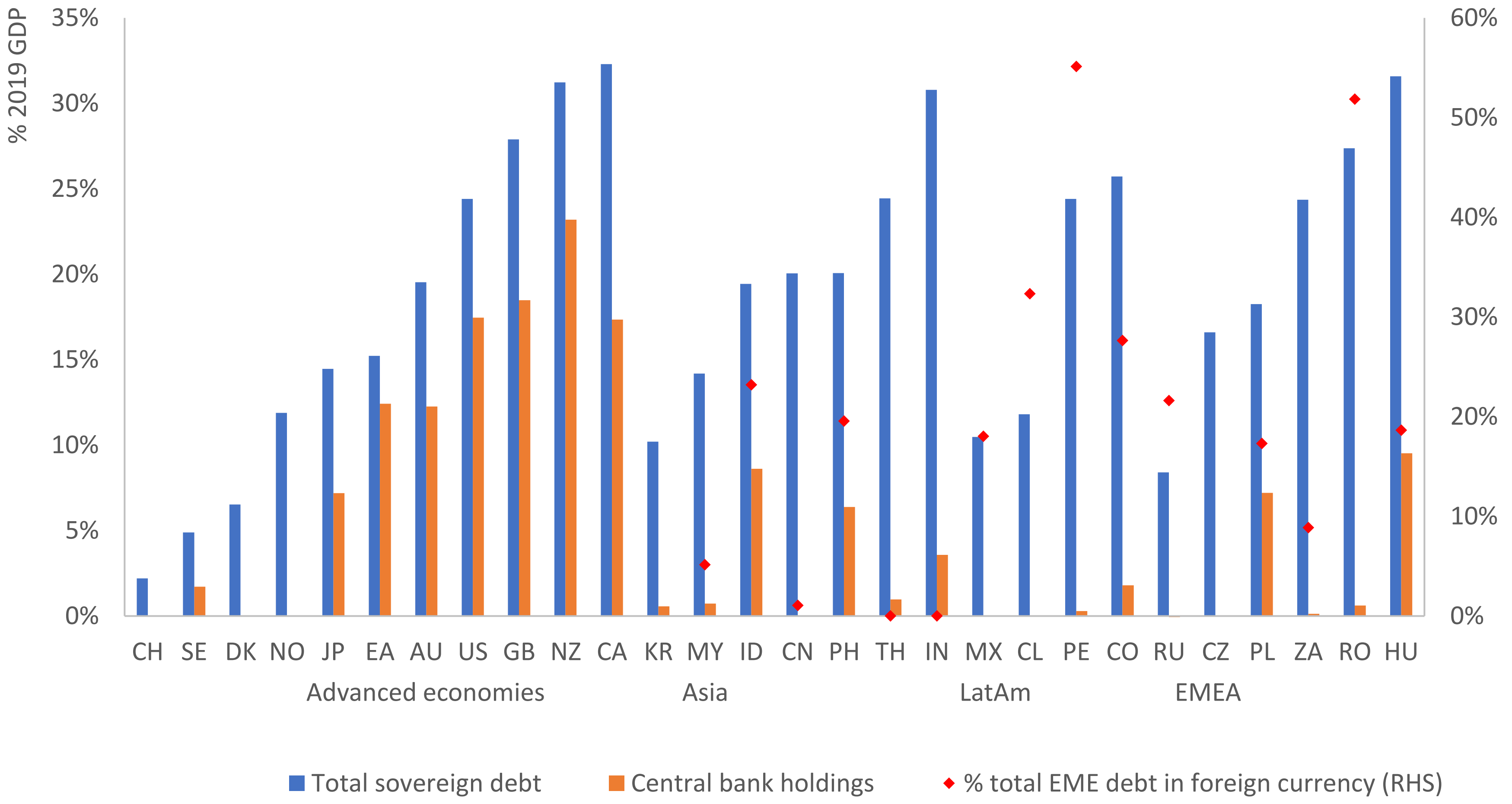
Change in policy rates, pre-pandemic (Q4 2019) to Q4 2021



Source: BIS Data; own analysis. Note: excludes Argentina (policy rate ended 2021 at 40%). Turkey's policy rate reached a high of 19% and finished 2021 at 16%.

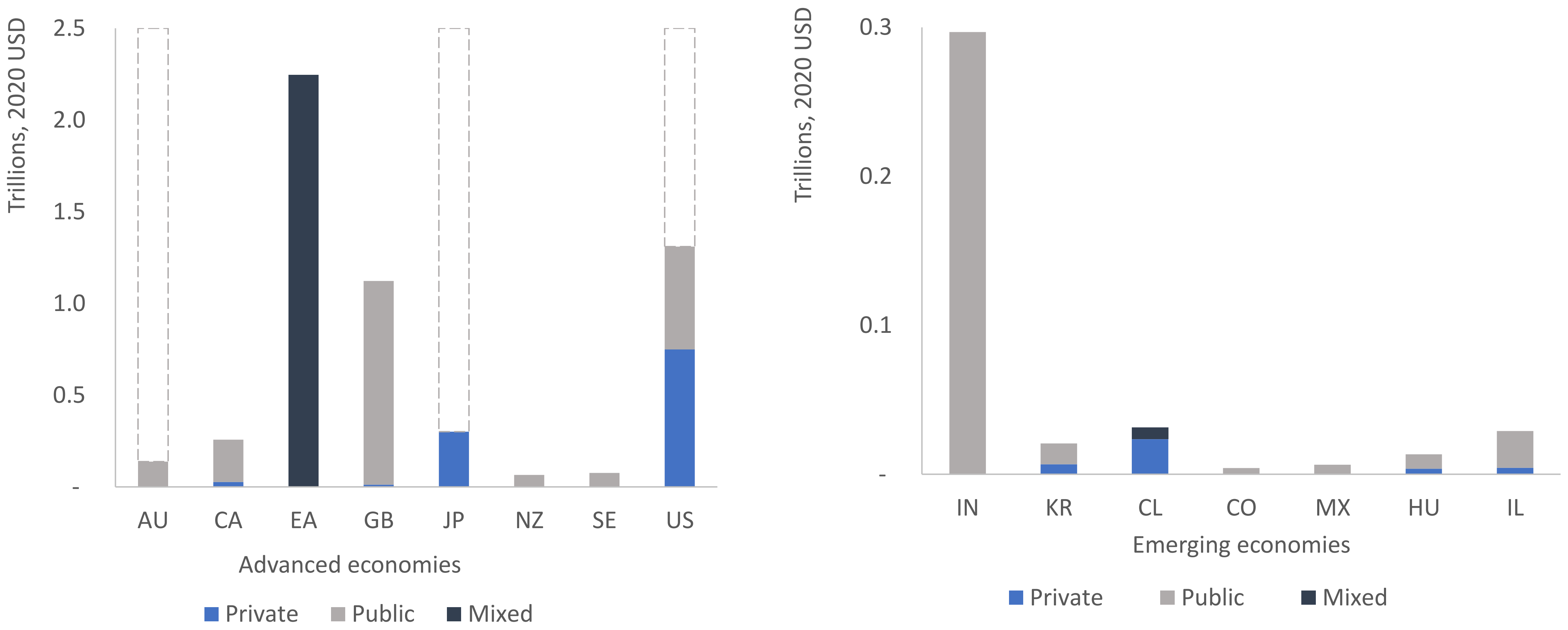
Sovereign debt & CB balance sheet expansions during pandemic

Percentage increase in sovereign debt and central bank holdings, Q4 2019 to Q4 2021 and % share of of foreign currency denominated debt for emerging market economies at end Q4 2021 (RHS)



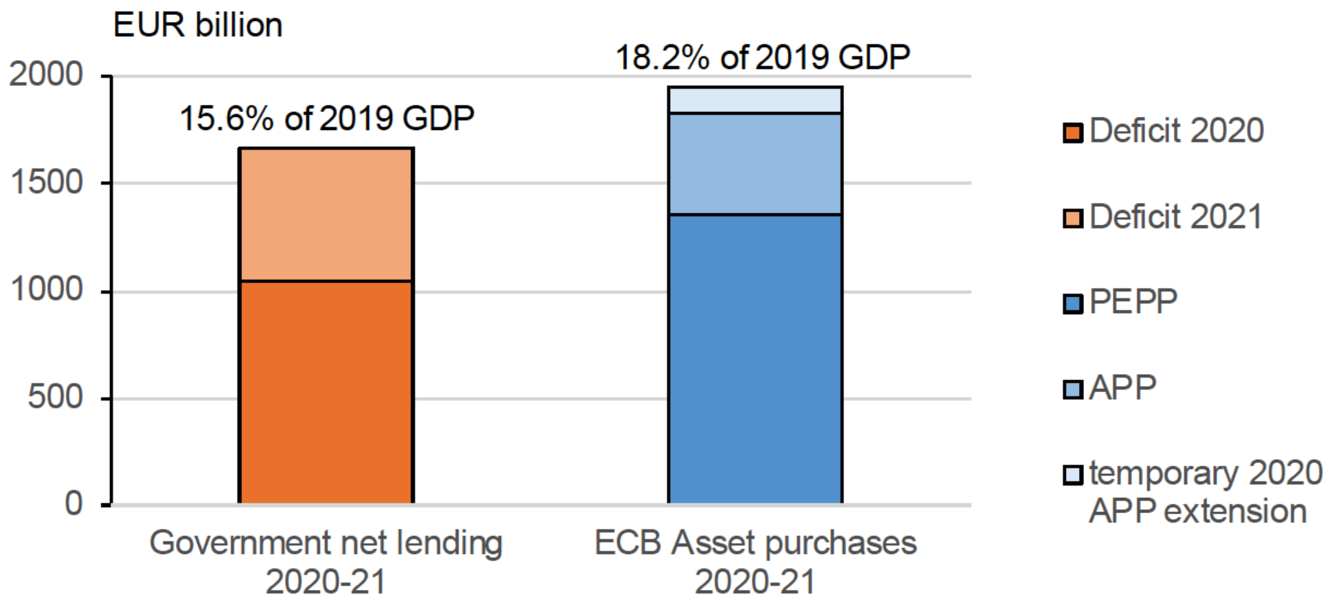
Source: IMF Sovereign Debt Investor Base database, IFS statistics, own analysis

Announced size of asset purchase facilities



Source: BIS Data; own analysis. Note: EA = Euro area. Australia, Japan, and the USA announced programmes unlimited in size

ECB financing of debt expansion in the Eurozone



"Governments in the euro area issue additional bonds of immense volumes (on primary markets), and the Eurosystem simultaneously purchases bonds of almost the same volume and duration (though on secondary markets). What follows is that, in some sense, monetary financing is effectively carried out already, even though it is not called so officially, and even if the actions can convincingly be explained and justified by central bank communication with different reasons and arguments, e.g. "… to effectively stave off risks to the smooth transmission of monetary policy." (ECB 2020a).

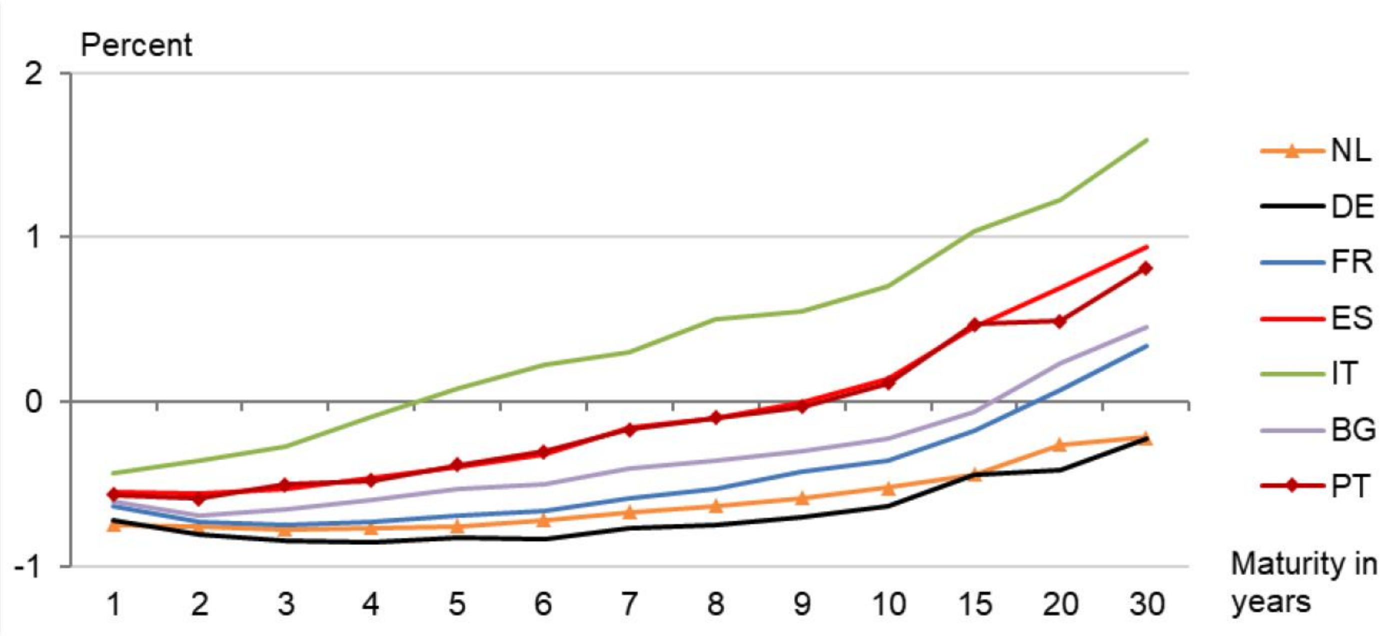
Source: European Commission (2020) 'Monetary-fiscal nexus after the crisis', November 2020, p12; note: PEPP = Pandemic Emergency Purchasing Program; APP=Asset Purchase Program

ECB forced in to yield curve control

12th March 2020:
“*The ECB is not here to close spreads”*

18th March 2020 (after launching PEPP):
“there are no limits to our commitment to the Euro”.

Eurozone negative real yields on EZ member state sovereign bonds, Oct 2020



Source: European Commission (2020) ‘Monetary-fiscal nexus after the crisis’, November 2020, p15

Covid-19 interventions II: liquidity support for real economy

- 60% of liquidity operations were non-targeted and aimed at system wide stability:
  - Lowering of refinancing rates
  - Widening eligible collateral
  - Increasing eligible counterparties
- Most economies established large programs aimed at support SMEs, often via State Investment Banks (e.g. India, Germany)
- In US, ”Main street lending program” & “Paycheck protection program” liquidity facility received large capital injections from US Treasury, establishing fiscal-monetary risk sharing.
- CB of Brazil saws 85% of emergency funding line from banks guaranteed by MF

Use of lending operations and reserve policy to target specific sectors

Country	Lending operations				Reserve policy	
	To private sector			To public sector	Private sector	
	SMEs	Strategic priority	Fiscal backing		SMEs	Strategic
Argentina	✓	✓			✓	
Brazil	✓		✓		✓	
China	✓				✓	
Hungary	✓					
India	✓	✓		✓		✓
Indonesia		✓				
Israel	✓					
Japan	✓					
Malaysia	✓	✓				
Mexico	✓					
Philippines				✓	✓	
Russia	✓					
Saudi Arabia	✓					
Singapore	✓		✓			
South Africa	✓		✓			
South Korea	✓					
Thailand	✓					
Turkey		✓				
United Kingdom	✓			✓		
USA	✓		✓			

Strategic priority sectors targeted by lending operations and reserves policy in EMEs

Country	Name of policy tool	Target sectors
Argentina	New Credit Line for MSMEs' Productive Investment and Special Treatment for Key Provincial Sectors	Agriculture, hospitality, culture and leisure
India	Special refinance facilities to specialist SIBs: NABARD, SIDBI, NHB	Agriculture, SMEs, housing
	Credit line extension to Exim Bank to enable access to USD swap lines	Exporters and importers
	On Tap Targeted Liquidity Facilities	Emergency Health, Contact-Intensive Sectors
Indonesia	Lower reserve requirements for banks financing priority sectors	Export-import sectors, hospitality, automotives, textiles, electronics, wood/paper
Malaysia	Financing facility for High Tech SMEs operating in National Investment Aspirations (NIAs) sectors	Advanced manufacturing & services sectors (e.g., aerospace), R&D in priority sectors
Turkey	Advance Loans against Investment Commitments to priority sectors	Various selected primary production, manufacturing, and advanced technology

Source: BIS data, compiled by the authors

Refinancing operations broader in high income economies but with varying conditionalities

- Bank of England/HMT Covid Corporate Financing Facility maintained market neutrality, purchasing any commercial paper within maturity & investment grade critera

- Contrast with France, Austria and Germany which implemented liquidity rescue packages for airlines with conditionalities including limitations on paying dividends, share buy backs & bonuses and policies to discourage short-haul flights

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Covid Corporate Financing Facility (CCFF): information for those seeking to participate in the scheme

This page is designed for companies, and banks acting on behalf of companies, that would like to participate in the HM Treasury and the Bank of England's CCFF.

Published on 20 March 2020

The Covid Corporate Financing Facility (CCFF):

On March 17, HM Treasury announced a number of measures designed to support businesses. The Chancellor set out a package of temporary, timely and targeted measures to support public services, people and businesses through this period of disruption caused by Covid-19.

Interpretations of differing forms of M-F coordination

- Clear evidence of CBs pursuing secondary objectives in mandates (‘supporting government policy priorities’) (Dikau and Volz, 2021)

- EME CBs maintaining ‘developmental role’ into recent times (Amsden, 2001; Epstein, 2006a).

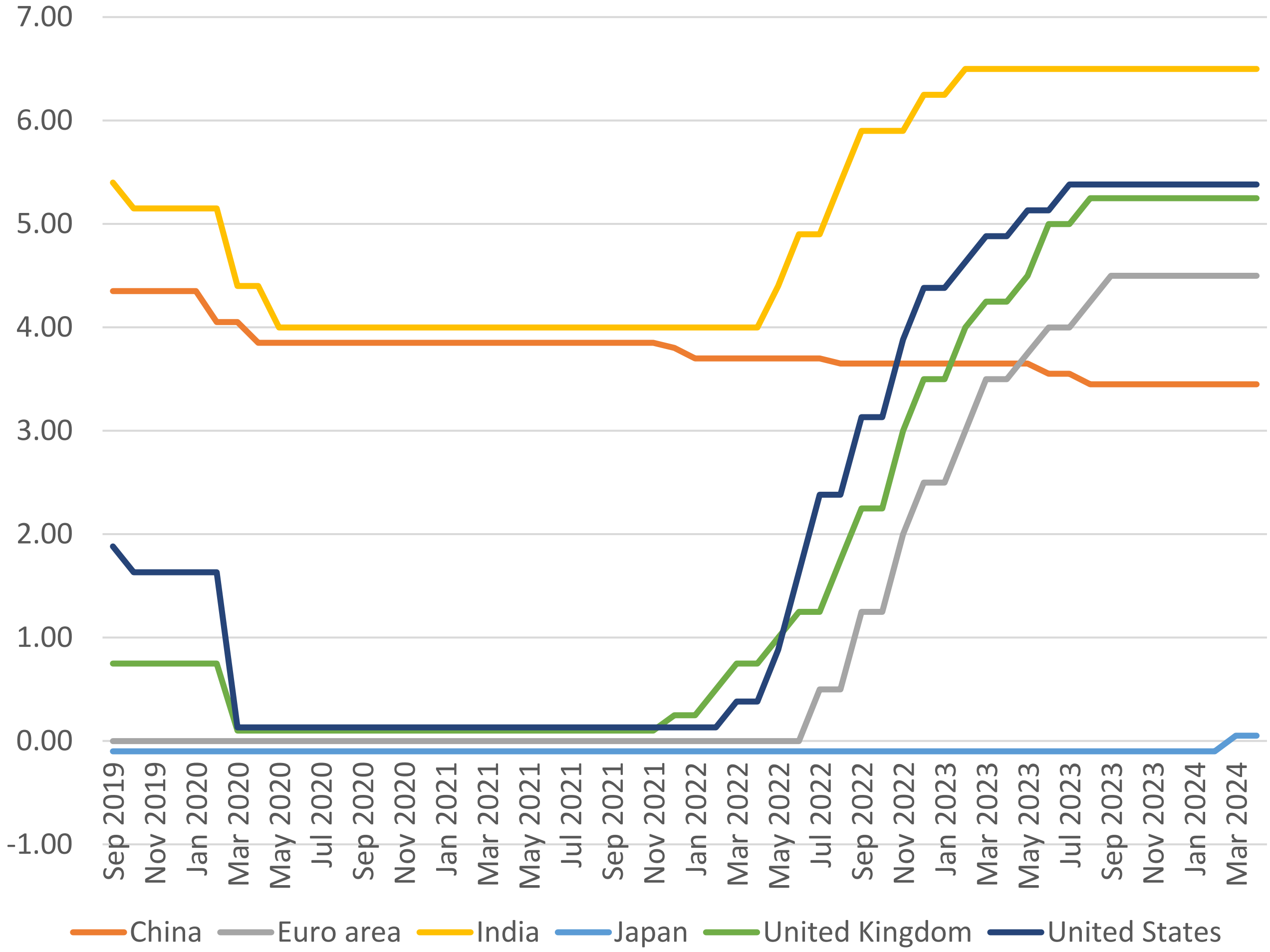
OR

- Importance of smoothly functioning asset markets for broader macroeconomic stability in advanced economies with collateral-intensive financial systems (Gabor, 2016; Dafermos, Gabor and Michell, 2021).

- Nevertheless, presence of large-scale targeted lending operations across a variety of high income & emerging economies, most of which provided extensive support to SMEs, shows that the principle of coordinating fiscal and monetary policy to target specific sectors is possible under present mandates. Sector selection remains a policy choice.

Post-covid – return to separation of spheres?

Central bank policy rates 2019-March 2024



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Federal Reserve Added

Fed will not become a 'climate policymaker', says Jay Powell

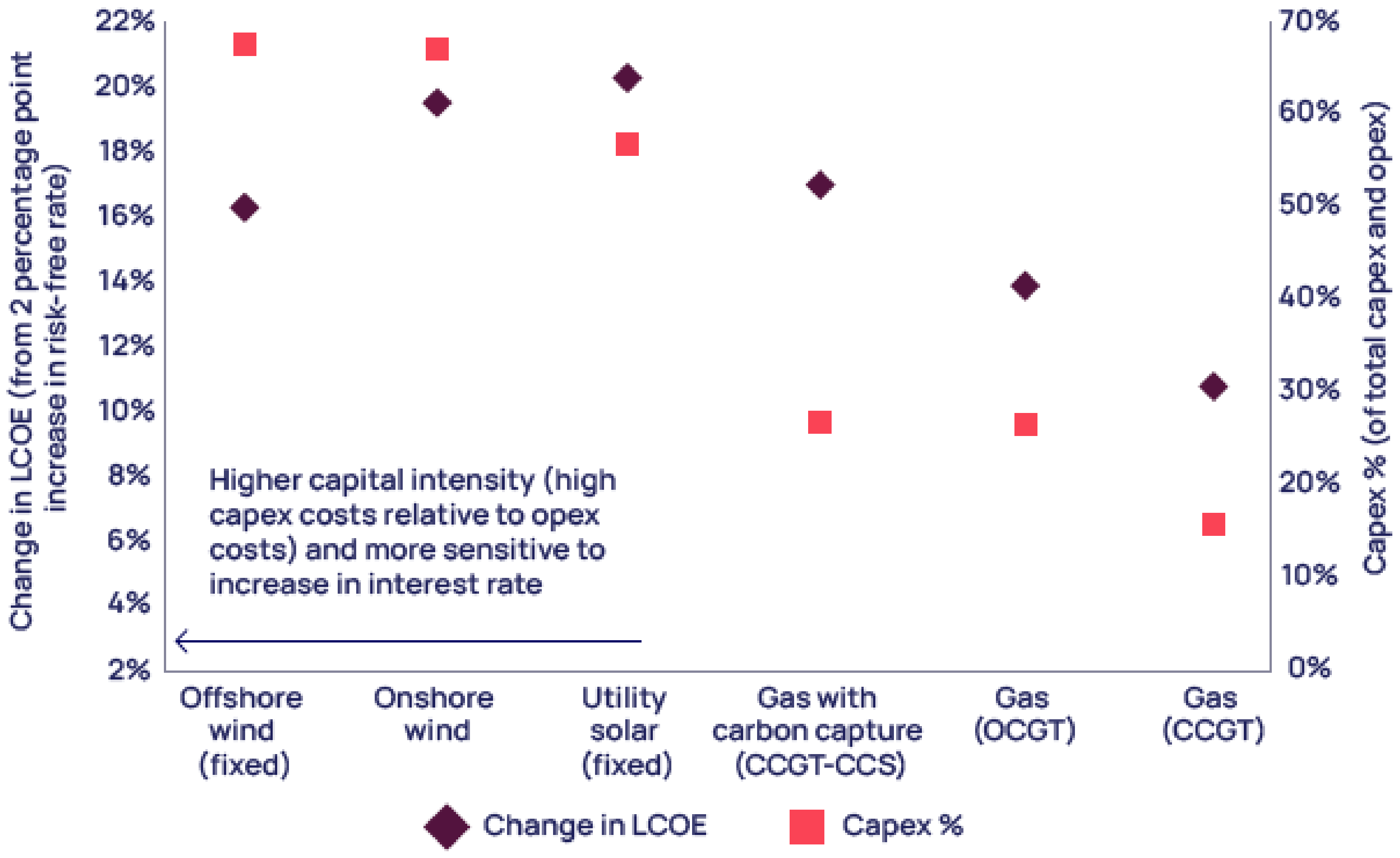
US central bank chair underscores importance of maintaining focus on inflation and labour market

Jay Powell says it is important that the Fed resists the 'temptation to broaden our scope to address other important social issues of the day' © TT News Agency/Claudio Bresciani via Reuters

Colby Smith in Washington and **Delphine Strauss** in London JANUARY 10 2023

119

Rising interest rates slowing the green transition



Assumptions: debt 55%, debt term 15 years

Definitions: levelised cost of electricty (LCOE), combined cycle gas turbine (CCGT), open cycle gas turbine (OCGT), carbon capture and storage (CCS)

Source: Wood Mackenzie

Comparison of the challenges posed by the pandemic, climate change, and biodiversity loss

- Financial materiality related to climate-related physical or transition risks has “*not yet become significant at a systemic level*” (NGFS, 2022)
- In all 3 cases timing, magnitude, and probability distribution of impacts is impossible to estimate in a meaningful sense i.e. fundamental uncertainty (Bolton et al., 2020; Kedward et al., 2022; Chenet et al., 2021).
- QE programs a clear case of policy discretion: consequences highly uncertain

	COVID-19	Climate Change	Biodiversity loss
Time scales	Immediate threat. Expectation of reversion to equilibrium over the near term.	Latent threat. Multi-decadal shifts towards unknown states, with potential tipping points. Irreversibilities.	Latent threats but with potential for sudden, near-term tipping dynamics towards unknown states. Irreversibilities.
Precedent	Historical precedent, but not recently at global scale.	Unprecedented within human history.	
Spatial scales	Global phenomena with locally specific causes and manifestations		
Probability of occurrence of adverse scenarios	High and increasing probability of another pandemic like COVID-19	Irreversible impacts already occurring and locked in; IPCC assess as ‘likely’ that emissions will exceed 1.5°C under current NDCs.[1]	Negative impacts occurring already in some locations. Further grave impacts on people from accelerating nature loss now ‘likely’.[2]
Severity of economic impacts	Very high under the worst scenarios, high potential for systemic (cascading) consequences. Estimation of loss subject to radical uncertainty.		
Evidence of financial materiality	Immediate and severe impacts on market liquidity, sovereign bond yields/spreads, and asset prices.	Emerging evidence of CRFR exposures from forward-looking scenario analysis. No clear evidence of green/dirty asset risk differentials. But no doubt from CBs and supervisors that it shall become material.	Nascent awareness of potential materiality, risk methodologies under development. But no doubt from CBs and supervisors that it shall become material.
Awareness of / preparation for potential threat by Financial institutions and authorities	None.	Increasing awareness; significantpreventative interventions obstructed by high uncertainty of risk assessment results.	Nascent awareness among selected financial institutions and central banks. No action thus far.

Discussion: challenges for monetary-financial coordination in supporting transition

- Toleration of higher short-to-medium term inflation by CBs to enable transition OR differential interest rate regime
- More expansionary fiscal policy (supported by CB bond purchases) to ensure rapid re-deployment of labour and capital to new green sectors and support just transition.
- Important role for State investment banks/off-balance sheet FIs (Gunter-Sandhu & Murau 2022)
- Sectoral price controls (Krebs and Weber 2024) & windfall taxes to insulate lower income households
- CBs need to shift from prudential to promotional institutional role (Baer et al 2021) to deal with radical uncertainty & ensure orderly greening of financial system

More information

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