Special Series on COVID-19

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Monetary and Financial Policy Responses for Emerging Market and Developing Economies[1]

This note provides an overview of appropriate central bank policy responses to the severe economic and financial impact of the COVID-19 pandemic in emerging market and developing economies (EMDEs). It covers monetary, exchange rate, and macroprudential policies, as well as capital flow measures (CFMs). The note does not discuss liquidity operations that aim to ensure market functioning—these are covered in a separate MCM note.

KEY POINTS

- The pandemic represents a massive, unprecedented global economic and financial shock that is having a deep impact on EMDEs, with many facing acute strains from large-scale capital outflows.
- Central banks play a critical role in cushioning economic and financial impacts. Given the multi-faceted nature of the shock, there is a strong rationale for deploying multiple tools.
- For EMDEs with credible policy frameworks, the advice echoes that for advanced economies. Exchange rate adjustment and additional monetary easing will be appropriate in EMDEs with flexible exchange rates, credible monetary policy regimes, and low inflation.
- In some EMDEs with weak policy credibility, the scope for loosening will be limited, given the risk of disorderly exchange rate adjustment, surging inflation, and financial stability implications.
- Macroprudential policies and CFMs can play important complementary roles and help safeguard financial stability and enhance the effectiveness of monetary policy.

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OVERVIEW

The COVID-19 pandemic and related adverse confidence effects are having severe negative impacts on global economic activity and pose an imminent threat to financial stability. EMDEs are facing a sharp sudden stop in capital inflows, with the attendant high risk of currency crises. The impact of the shock is complex (and in many ways unprecedented) and involves several elements:

- **Domestic health crisis.** The COVID-19 outbreak is a health shock, exogenous to the economy and the financial system. Countries will need to deal with domestic disruptions, increased health spending, and other wide-ranging aspects of the shock.
- **Supply impact:** Production, trade, and travel disruptions are slowing the delivery of intermediate goods and foreign labor/expertise, and impact activity in EMDEs that are tightly integrated into global supply chains. At the same time, a decline in the supply of labor from sick workers and from efforts to contain the spread of the disease through lockdowns and quarantines will lead to a drop in capacity utilization.
- **Demand and terms-of-trade (ToT) impacts:** Loss of jobs and income, fear of contagion, and heightened uncertainty is reducing spending globally. The impact is particularly pronounced for commodity exporters and EMDEs with large tourism sectors, who are faced with a large, negative ToT shock in addition to a plunge in remittances from abroad. In addition, worsening consumer and business sentiment can also lead firms to reduce their investment, further exacerbating the demand contraction.
- **Impact on financial conditions:** A sudden deterioration of investor sentiment and flight to safety is contributing to a tightening of financial conditions globally, with a resulting sharp reversal in EMDE capital flows in the early phases of the crisis dwarfing earlier episodes. The ensuing pressure on EMDE exchange rates and credit spreads raises the likelihood of credit defaults, financial distress, and macroeconomic instability.

There is large uncertainty around the duration of the shock. Some effects may be longer lasting.

Given the simultaneous sharp tightening of financial conditions, collapse in many key EMDE export markets, and quarantine or confidence-induced falls in domestic demand, there is a strong rationale for deploying multiple tools. Monetary and macroprudential policy tools, exchange rate intervention, and outflow CFMs, can be used in a complementary and integrated mix, calibrated to country-specific conditions, to provide accommodation and preserve macroeconomic and financial stability.

The shock is global in nature. This implies that the effectiveness of some measures could potentially be strengthened or diminished if several countries took them at the same time. The pandemic's broad reach across many countries, the extensive cross-border economic linkages, and the large confidence effects impacting global markets also underscore the desirability of coordinated, international responses, where feasible.

MONETARY POLICY

Targeted fiscal and financial support measures will often be most suitable for addressing some of the most acute pandemic-related problems (such as alleviating capacity constraints in health services, providing relief to households and small businesses facing cash-flow problems, etc.). More broadly, EMDEs with space should expand fiscal outlays, including to avoid overburdening other policy levers. That said, monetary policy should play a critical complementary role in cushioning the macroeconomic and financial impacts of the pandemic—including in EMDEs. While lockdowns and other mitigation measures may dampen the full stimulative effect of monetary policy in the short term, early relaxation of monetary policies will also help create conducive conditions for the recovery.

In those EMDEs with flexible exchange rates, credible monetary frameworks, low inflation, and the absence of large currency mismatches, the exchange rate will be a key shock absorber. In these countries, in addition to the easing of monetary conditions implied by a depreciation, an additional lowering of policy interest rates may help avoid a credit crunch and support demand—much in the same way that accommodative monetary policies work in advanced economies.

Many EMDEs still have significant conventional policy space to loosen monetary policy. Should this space be exhausted (if rates reach the effective lower bound), unconventional tools may also be considered.[2] However, unconventional monetary policies tend to pose bigger risks in EMDEs where safe assets are often in short supply and where governance risks can be considerable. In all cases, a relaxation of monetary policy is advisable only if longer-term inflation expectations remain aligned with central bank targets.

EMDEs with less-credible monetary frameworks and weak fundamentals may find themselves between a rock and a hard place. In these countries, 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 inflation if inflation expectations are poorly anchored and pass-through from the exchange rate is high. Moreover, in some countries, large unhedged balance sheet exposures can imply that sharp exchange rate movements could have severe contractionary effects. Under such circumstances, the scope for monetary policy loosening is limited given the need to mitigate capital account pressures and contain inflation.

As mentioned, targeted fiscal measures will generally be most appropriate to alleviate specific bottlenecks in the economy, lessen credit constraints, and support aggregate demand, especially if the downturn persists.[3] However, central banks may need to step in to help provide funding to market segments where liquidity has dried up, or where monetary transmission has become impaired. Possible tools could be funding-for-lending schemes, where central banks provide collateralized long-term funding to banks to aid monetary policy transmission through the banking system, and to support provision of new credit to bridge financing needs of specific sectors. However, before recommending such tools, careful consideration should be given to the potential financial risks to central bank balance sheets, the operational readiness of such tools, potential distortions and spillovers, and the importance of transparency and accountability in the use of such instruments. Fiscal guarantees for central banks' exposures resulting from such measures should be provided ex ante.

Fiscal challenges may complicate monetary policy responses, especially in countries with already high public debt. Constraints may become rapidly more binding if fiscal positions in EMDEs deteriorate owing to spending to fight the COVID-19 pandemic, potentially presenting difficult tradeoffs going forward.

FX INTERVENTION

Exchange rate intervention can play a role in muting excessive volatility, particularly in countries with shallow foreign exchange markets—provided that the authorities have adequate foreign exchange reserves and interventions do not obstruct necessary adjustments in the exchange rate. Under the same proviso, in some countries where large unhedged balance sheet exposures could pose immediate threats to domestic demand and financial stability, interventions (in combination with tighter monetary policy) may curb damaging volatility and help smooth out exchange rate adjustment over a longer time frame, giving economic actors time to hedge

[2] The scope for unconventional monetary policy and respective measures and tools is discussed in more detail in a forthcoming note.

[3] Targeted fiscal measures often include, e.g., cash transfers, wage subsidies, credit guarantees, unemployment benefits, and tax deferrals.

and unwind positions. Any such interventions should be planned on the basis that the pressures arising from the crisis could persist for a longer period.

Countries with fixed or tightly managed exchange rate regimes may face a difficult choice. If foreign exchange (FX) reserves are sufficient, maintaining the peg may make sense in the short term (although larger than normal FX sales may require domestic currency lending, to prevent illiquidity in the domestic markets). FX intervention, however, will likely need to be supported by monetary policy tightening and under certain conditions by CFMs (see below). However, given the severe tightening of global liquidity, these EMDEs could continue to face very substantial outflow pressures and reserve losses that may prove to make their pegs untenable. The pressures are particularly acute for oil and commodity exporters.

MACROPRUDENTIAL POLICY

A relaxation of macroprudential tools can help the financial system absorb the impact of the shock and ease a credit crunch that might otherwise amplify the effect on the real economy. However, such a relaxation is possible only if macroprudential buffers are in place, and useful only if the relaxation of the available buffers is expected to relieve stress or remove binding constraints on the provision of credit to the real economy (IMF 2014, 2017).

Relaxation of different types of tools can relieve a range of stressors, if conditions allow: [4]

- Where the countercyclical capital buffer (CCyB) has already been activated, it can be relaxed to support the flow of credit to the economy, by providing additional capacity to lend through a period of increased credit risks. Where the CCyB is not available, banks should be encouraged to use the capital conservation buffer (CCB). Consideration can also be given to a relaxation of systemic risk buffers that are designed to protect against macroeconomic risks.
- Banks should be able to make use of their high-quality liquidity assets under the liquidity coverage ratio (LCR), when needed to counter liquidity stress in local currency.
- A relaxation of reserve requirements (in domestic currency) can help alleviate liquidity pressures in banks. Foreign currency reserve requirements can be relaxed to mitigate FX funding pressures. Where countries have introduced additional LCR requirements in FX, they can allow banks to use the buffer, or relax the requirement.
- A relaxation of sectoral tools (such as caps on loan-to-value ratios) can also be considered, where prevailing settings of such tools is tight and a relaxation useful to support the provision of credit to households and firms.

By reducing the effects of the shock on credit and output, a macroprudential relaxation can serve as a useful complement to a monetary policy response. It can enhance the ability of monetary policy to support economic activity in a manner consistent with its mandate, by removing regulatory constraints that may otherwise impede transmission of the desired monetary policy accommodation. In countries that need to tighten monetary policy (e.g., to limit the inflationary effects of an exchange rate depreciation), a simultaneous relaxation of macroprudential policy can help reduce potential stresses from the domestic tightening.

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[4] A forthcoming dedicated note offers a fuller discussion of the macroprudential tools that can be relaxed.

CAPITAL FLOWS MEASURES

In the face of an imminent crisis, a situation that many countries may currently be confronting, a temporary use of capital flow management measures (CFMs) can help prevent a free fall of the exchange rate and provide breathing space while necessary policy adjustments are implemented. By mitigating exchange rate pressures and giving central banks more scope to ease policy (or tighten less), such tools can potentially enhance monetary policy effectiveness. Where capital inflows are restricted, their careful relaxation can mitigate net outflow pressures, provided conditions for such liberalization are met. Introducing outflow CFMs should be part of a broad policy package with sound macroeconomic policies. CFMs cannot substitute for, or avoid, warranted macroeconomic adjustment.

CFMs on outflows should generally be broad-based to be effective. They may include a wide range of measures, such as restrictions on residents' investments and transfers abroad, and repatriation and surrender requirements on export proceeds. If nonresidents' retrenchment is a significant driver of outflows, minimum holding periods, caps and other limitations on nonresidents' transfers abroad could be considered. Such measures should be implemented with due regard to the country's international obligations, in a transparent manner, be temporary, and lifted once crisis conditions abate. To the extent possible, as long as the measures are equally effective, preference should be given to those that do not discriminate on the basis of residency. To avoid circumvention and remain effective, CFMs will likely need to be adjusted on an ongoing basis.

INTERNATIONAL SUPPORT

The challenges faced by EMDEs can be eased by supportive actions from advanced economies and the IMF and other international financial institutions**.** Indeed, given the evaporation of dollar liquidity during the early phases of the COVID crisis, dollar swap lines were highly instrumental in stabilizing EMDE economies (even indirectly, insofar as swaps improved the liquidity position of foreign banks lending to EMDEs). Of course, the IMF also plays a critical role in providing financial support—including through its rapid financing instruments, such as the new Short-term Liquidity Line (SLL)—and policy advice and capacity development.

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