BIS Bulletin

No 71

Fiscal and monetary policy in emerging market economies: what are the risks and policy trade-offs?

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29 March 2023

BIS Bulletins are written by staff members of the Bank for International Settlements, and from time to time by other economists, and are published by the Bank. The papers are on subjects of topical interest and are technical in character. The views expressed in them are those of their authors and not necessarily the views of the BIS. The authors are grateful to Agustín Carstens, Hyun Song Shin, Claudio Borio, Alexandre Tombini, Benoit Mojon, Jon Frost, Fabrizio Zampolli, Deniz Igan, Fiorella De Fiore, Aaron Mehrotra, Daniel Rees and Marco Lombardi for the helpful comments, and to Louisa Wagner for administrative support.

The editor of the BIS Bulletin series is Hyun Song Shin.

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ISSN: 2708-0420 (online)
ISBN: 978-92-9259-644-6 (online)

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Key takeaways

- *Since 2021, monetary policy has tightened globally in response to the surge in inflation. Fiscal policies have generally remained expansionary, notably as governments put in place subsidies and transfers to insulate households, first from the pandemic and then from higher energy and food prices.*
- *Such fiscal support increases governments' funding needs at a time when tighter monetary policies raise the cost of servicing debts. Financial markets may reassess fiscal sustainability, request higher risk premia or reduce their holdings of sovereign bonds.*
- *Although such effects could affect both advanced and emerging market economies, the latter have historically been most vulnerable to a rise in the cost of international financing and a weaker exchange rate.*

In late 2021, inflation surged to levels not seen in more than 20 years. Policymakers responded by increasing rates and by providing fiscal support and subsidies to lessen the impact of higher energy and food prices. As a result, fiscal deficits – although lower than during the Covid-19 pandemic – are still large in many economies. Both rising rates and large fiscal deficits – even if the optimal response in the short run – affect financial markets and could worsen policy trade-offs going forward, especially in emerging market economies (EMEs).

EMEs are more vulnerable to changes in financing conditions, especially external borrowing. Financing costs have already increased in line with higher interest rates worldwide. Still, concerns about the lack of sufficient fiscal consolidation – and a possible de-anchoring of inflation expectations – may lead to higher sovereign risk premia, currency depreciation and tighter domestic financial conditions. In addition, fiscal concerns may exacerbate the domestic impact of tighter international financial conditions and raise the risk of a sudden stop in capital flows.

These potential developments would worsen the trade-offs faced by fiscal and monetary authorities. For monetary policy, financial channels of fiscal imbalances put pressure on the exchange rate, pushing inflation higher and affecting its dynamics. For fiscal policy, higher interest rates increase debt service costs and weigh on public debt.

Going forward, interest rates will probably continue increasing and remain high as central banks commit to bringing down inflation. Fiscal authorities need to balance providing support, on the one hand, and keeping debt at manageable levels, on the other. Expansionary fiscal policy needs to be perceived as sustainable, with a clear exit strategy that leads to consolidation in the future. It should be temporary, targeted and tailored. So far, it has been extended, extensive and expanded.

This Bulletin assesses the financial risks of EMEs' fiscal and monetary policy stances in an environment of tighter financial conditions, heterogeneous growth across countries and high inflation. It also explores the policy trade-offs and side effects that would prolong the disinflationary process forecasted by central banks.

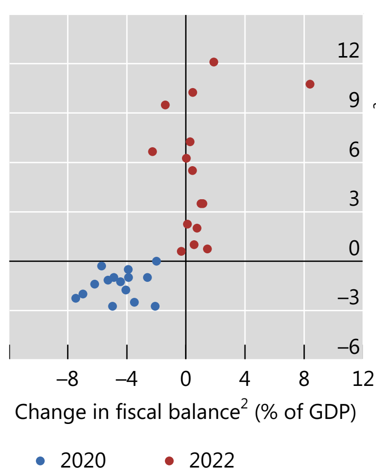
Fiscal and monetary policy stances in EMEs in the aftermath of the pandemic

At the onset of the Covid crisis, fiscal and monetary policies acted together and complemented each other (Aguilar and Cantú (2020) and Graph 1.A, blue dots). In the aftermath, the recovery has been heterogenous. Output gaps in most EMEs have closed and, in some countries, they have become positive. But a strong demand and a large supply shock have widened inflation gaps abruptly and have led to different responses from monetary and fiscal authorities.

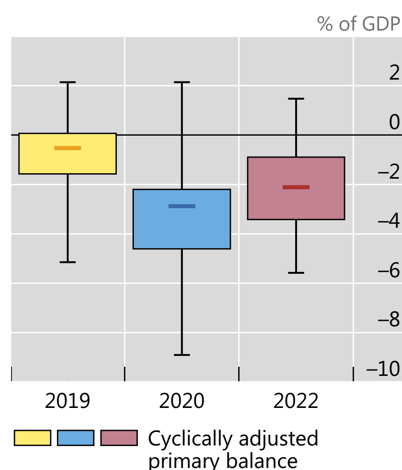
The global monetary response in 2022 was forceful and highly synchronised as the surge in inflation was of a global nature (BIS (2022) and Graph 1.A, red dots). Thus, not only have central banks withdrawn monetary stimulus but most EMEs have taken real policy rates to positive territory. In some cases, real rates have reached levels higher than those before the pandemic.[1]

EMEs' monetary policy tightened while fiscal policy remained expansive — Graph 1

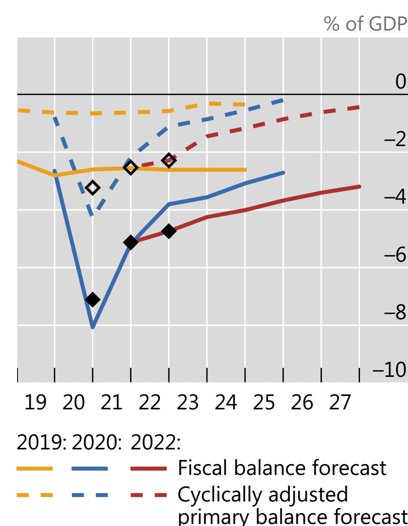
A. Monetary policy tightened and fiscal deficits narrowed...[1]



B. ...but the fiscal stance remains expansionary...[4]



C. ...while fiscal consolidation keeps getting pushed back[4]



[1] EMEs include: BG, BR, CL, CO, HU, IN, ID, MY, MX, PE, PH, PL, RO, TH and ZA. [2] Change in fiscal balance from 2019 to 2020 and from 2021 to 2022. [3] Change in policy rate from Feb 2020 to Dec 2020 and from Aug 2021 to Dec 2022. [4] Considers 23 EMEs. Median figures for panel C. Dots denote observed balances for 2020 and 2021 and forecast figures for 2022.

Sources: IMF; national data; BIS.

The response on the fiscal front has left the policy stance relatively expansive. After the strong recovery from the pandemic, governments hardly reduced their fiscal deficits in 2022 (Graph 1.A, red dots). The severe surge in energy and food prices that started in mid-2021 derailed consolidation plans and kept the discretionary fiscal stance expansionary – at least more than before the pandemic – in almost all EMEs (Graph 1.B). Governments lessened the effects of the loss of real income inflicted by these shocks – especially to segments of the population where food and transportation represent a large share of their consumption basket. As shown in Graph 1.B, the 2022 cyclically adjusted deficits remain sizeable.

While EMEs' governments should aim for a tailored, targeted and temporary ("triple-T") response, the current approach has been perceived by markets and analysts as expanded, extensive (broad-based) and extended ("triple-E"). EME governments' response to limit the pass-through of energy and food prices expanded beyond price subsidies to include suspension of import duties and reductions in value-added taxes and excises (Amaglobeli et al (2022)). These policies were not explicitly tailored to low-income households as they were extended to the whole economy. For some oil exporters, these policies would completely offset the government's revenue gains from high oil prices. Other policies did not target

[1] An analysis with ex ante real interest rates confirms a tightening in monetary policy.

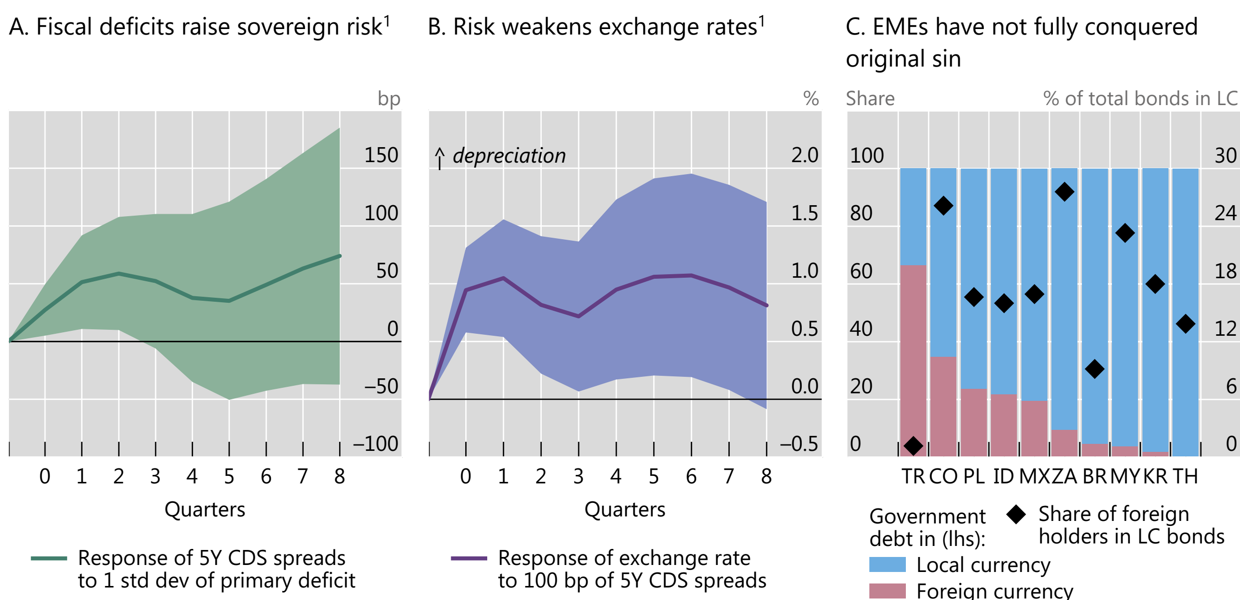
specific prices but instead expanded income, for example, direct cash transfers and lower income taxes. Finally, despite a desire for temporary policies, some support programmes were extended past their original expiration date – even after the original shock had reverted.

The current fiscal stance and high levels of debt stress the need for a fiscal sustainability plan, but the actual fiscal deficit figures and forecasts have continued widening since 2020 (Graph 1.C). This implies that the expansion has been larger than expected and that the fiscal consolidation has been postponed for a couple more years. The fiscal support has diverged from the triple-T approach that would guarantee an exit strategy and lead to consolidation once the shock has passed. Instead, the triple-E approach makes consolidation harder and negatively affects the debt outlook. Moreover, higher deficits pile up on already high debt-to-GDP ratios. In an environment of higher interest rates, debt issuance is expensive, and refinancing costs are higher. It also makes overall financial resources more costly in an already tight market.

What are the financial risks?

High levels of debt and deficits can trigger adverse financial market reactions. In a context of tighter global financial conditions, a lack of clear signs of fiscal consolidation can put pressure on fixed income markets, especially for sovereign bonds, and push up sovereign risk premia. EMEs' access to international funding markets is particularly vulnerable when there are worries about debt increases (Reinhart et al (2003)). When governments announce big spending packages or large tax cuts without a clear commitment to future fiscal discipline (eg through a fiscal rule), financial markets may react negatively. At the same time, negative market signals from sovereign credit ratings, government bond yield differentials and sovereign credit default swaps (CDS) spreads could significantly constrain fiscal policy.[2] In a worst case scenario, an expansionary policy could end up being not expansive but contractionary.

Loose fiscal policy raises the risk premium and puts pressure on the exchange rate — Graph 2



[1] See annex for details.

Sources: Institute of International Finance; BIS.

The sovereign risk premium is a key channel that connects financial markets with fiscal policy. Governments face stringent lending conditions in international markets as public debt expands and concerns about fiscal sustainability grow. This is because investors require a higher yield on their

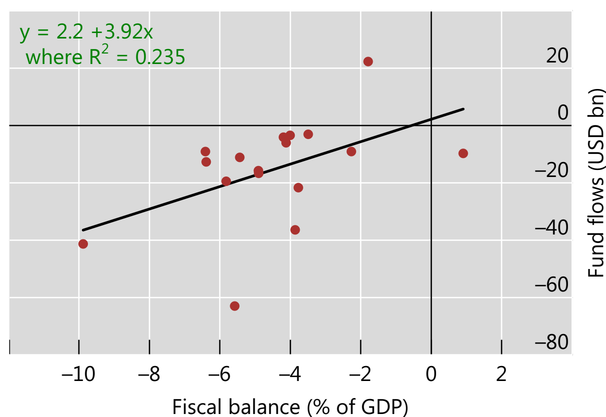
[2] A recent episode that shows that advanced economies are not immune to these effects was the "mini-budget" incident in the UK (Greene (2022)).

investment if they perceive the probability of a sovereign default to be higher. An empirical exercise provides evidence of this channel. A panel estimation for 19 EMEs shows that a rise in the primary deficit raises sovereign risk. On average, a one standard deviation expansion of the primary deficit increases the five-year CDS around 50 basis points (Graph 2.A). Hikes in sovereign risk premia tend to put pressure on the exchange rate. A higher risk premium raises the compensation to foreign investors and reduces their demand for domestic assets, thus causing the domestic currency to depreciate (Aguilar et al (2022)). Based on the same empirical model, a 100 basis point rise in five-year CDS spreads could cause a depreciation of local currencies against the US dollar of around 1% (Graph 2.B).

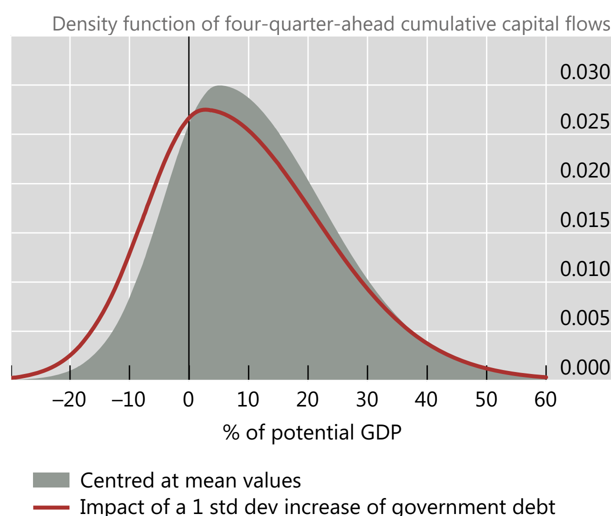
The link between the sovereign risk premium and the exchange rate hits EMEs harder if they are exposed to FX borrowing or if the share of foreign investors in local currency debt is high. Despite progress in developing local currency debt markets, there are still EMEs with a large share of debt denominated in foreign currency (Graph 2.C). Signs of fiscal unsustainability would have a double effect on foreign debt by raising both the yield required and the debt burden in local currency. A larger share of borrowing in foreign currency is correlated with higher volatility of capital flows and with lower credit ratings (Eichengreen et al (2023)). Even if debt is denominated in local currency – thus eliminating so-called original sin – countries remain exposed to abrupt changes in global financial conditions. Currency risk shifts to international investors holding local currency debt who respond more aggressively to changes in international financial conditions – so-called original sin redux (Carstens and Shin (2018)). International lenders find it harder to hedge currency risks as EMEs tend to have shallow domestic financial markets and lack a robust domestic investor base.

Unsustainable public debt can reduce capital inflows — Graph 3

A. Fiscal deficits and fund flows during 2022[1]



B. Higher debt raises the probability of reversals in capital inflows[2]



[1] Total portfolio flows during 2022 for EMEs. [2] See annex for details.

Sources: Aguilar et al (2023); EPFR.

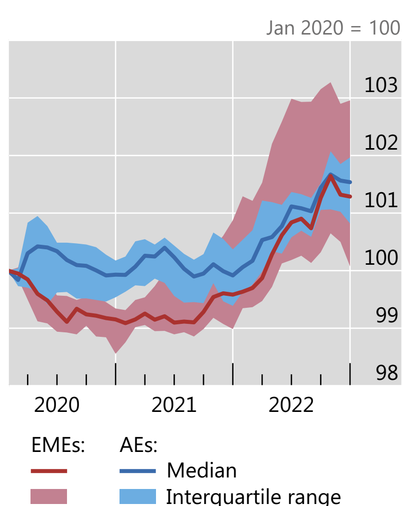
Fiscal imbalances also have a negative effect on capital flows. One important driver of capital flows, especially banking flows, is country risk (Koepke (2019)). Public debt can affect capital flows through its impact on investor confidence and perceived risk. For instance, capital may stop flowing into a country if investors seek safer investment opportunities elsewhere. Also, investors could retrench their flows at minor signs of domestic vulnerabilities. In 2022, a larger fiscal deficit was positively correlated with negative portfolio flows (Graph 3.A). Finally, recent empirical evidence shows that higher debt could shift the future distribution of capital inflows, by shifting the left side of the density curve further to the left, implying a

higher probability of capital flows reversals. This shift is consistent with a greater probability of capital stops (Graph 3.B) (Aguilar et al (2023)).

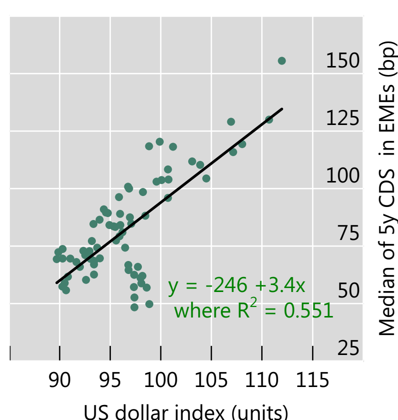
Risks related to the fiscal stance tend to be higher when global financial conditions are tighter. Interest rates have risen in sync in EMEs and advanced economies (AEs) as central banks tackle inflation and financial conditions tighten (Graph 4.A). Episodes of tighter financial conditions could fuel the sovereign risk premium channel. Higher international rates and a strong dollar could boost country risk due to significant shares of public debt in foreign currencies – even if reduced lately – creating a feedback loop (Graph 4.B). In addition, push and pull factors that explain capital flow movements (eg international and domestic monetary policy rates) seem to be related to a stronger dollar, thus creating a strong association between the probability of outflows and tighter financial conditions (Graph 4.C).

Tight financial conditions compound financial risks of fiscal policy — Graph 4

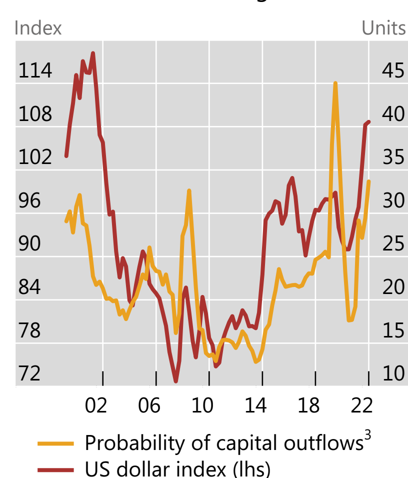
A. Financial conditions are tight[1]



B. US dollar appreciation correlated with higher sovereign risk premium[2]



C. Historical probability of outflows associated with a strong dollar



[1] Goldman Sachs financial conditions indices. EMEs = BR, CL, MX, ID, IN, KR, MY, PH, TH, CZ, PL and ZA. AEs = AU, CA, GB, EA, US, NO, NZ and JP. An increase of indices denotes a tightening of financial conditions. [2] Five-year CDS spread median values considering BR, CL, CO, MX, PE, ID, IN, KR, MY, PH, TH, CZ and ZA since 2017. An increase of the US dollar index denotes an appreciation. [3] See annex for details.

Sources: Aguilar et al (2023); Bloomberg; IHS Markit; BIS.

What are the policy trade-offs?

An expansionary fiscal stance appears particularly unsuitable at the current juncture. First, fiscal expansion stimulates domestic demand, which works at cross purposes to central bank efforts to rein in inflation. Second, large fiscal deficits may trigger repricing by financial markets. Doubts about public debt sustainability will weaken domestic currencies, which may in turn push inflation higher, especially in countries with a more vulnerable position (Banerjee et al (2022)). Both sovereign risk premia and capital flows explain this effect. Moreover, eroding investors' confidence may constrain governments' access to international funding markets, calling for larger fiscal consolidation and further monetary policy tightening – implying a higher cost in terms of economic activity. Finally, higher risk premia can put pressure on the neutral rate of interest (r*) since in EMEs the risk-free rate in most cases is considered to be the US government bond yield plus the country's credit risk premium (Cavallino and Sandri (2019)). Thus, in the medium term the current fiscal stance complicates bringing inflation to target. Persistent inflation and upward revisions to inflation expectations may call for even tighter monetary policy and for rates to stay high for longer.

The monetary policy reaction to high inflation could complicate life for fiscal authorities, but it would be even worse if there were no monetary policy response. Tight monetary policy reinforces the costs of

expansionary fiscal policies. The policy reaction would push up debt service costs and raise public sector financing requirements. The rise in interest payment costs would increase fiscal deficits. Finally, higher costs of servicing debt would further accelerate the need for consolidation, in an environment where it may be resisted in some EMEs. Still, higher fiscal costs should not distract central banks from their fight against inflation. Without a strong monetary policy response, the costs in terms of growth and risk premium would be higher.

The general picture highlights the importance of striking the appropriate balance between fiscal and monetary policy at a time when central banks are trying to tame inflation. More pressing is the risk that sustained fiscal deficits tie central banks' hands, where they cannot increase interest rates because it would undermine public debt sustainability. This would endanger the credibility that most EME central banks acquired thanks to their independence, the adoption of inflation targets and a track record of low and stable inflation. To avoid this risk – which could, in turn, constrain fiscal policy to consolidate abruptly in episodes of large capital outflows – fiscal authorities should secure sound fiscal accounts (Reis (2019)).

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