A preliminary analysis of coordination between monetary and fiscal policies during Covid-19

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Abstract

Coordination between monetary and fiscal policy is warranted in fighting Covid-19, with the central bank responsible for addressing the liquidity issue and the fiscal authority focusing on the solvency issue. In China, two standing mechanisms serve as the platforms for the coordination of monetary and fiscal policy. In addition, the People's Bank of China (PBC) and the Ministry of Finance (MOF) coordinate on a regular basis through various channels. During the pandemic, the PBC worked with the MOF in facilitating pandemic containment and subsequently in supporting the resumption of work and production. The PBC remains committed to sound monetary policy that is flexible, appropriate and better targeted, and it will appropriately address potential risks such as the rising macro leverage ratio and non-performing loans.

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1. Covid-19 highlighted the need for tighter coordination between monetary and fiscal policies

Covid-19 and the ensuing lockdown measures have dealt a severe blow to the real economy. Coordination between monetary and fiscal policy is therefore warranted, with central banks responsible for addressing the liquidity issue and the fiscal authority focusing on the solvency issue.

First, the policy response depends on the nature of the crisis. The 2007–09 Great Financial Crisis stemmed from the financial system, which bore the brunt of the impact. Thus, central banks played a key role by pumping in liquidity to maintain financial stability. In contrast, the Covid-19 pandemic is a public health crisis, mainly affecting corporates and households. So the primary task is to provide much-needed relief to the real economy. Rather than loans from banks, troubled market entities need targeted support to tide them over difficulties. In this aspect, the role of central banks is limited, and targeted fiscal policy is more important.

Second, the economic impact of Covid-19 is uneven, calling for more targeted support through structural policies. Covid-19 has had a larger impact on the consumer-facing service sector, low-income households and the informal sector than on the industrial sector, high-income households and the formal sector. As monetary policy focuses on stimulating economic aggregates, its role in supporting specific sectors remains limited. Fiscal policy could better target specific sectors or households through tax cuts or transfer payments, and may therefore serve as a more efficient tool to cope with the pandemic's impact.

Third, with various pros and cons, monetary and fiscal policies should be combined. Fiscal policy usually has a long time lag, since several rounds of discussions are needed to determine the size, recipients and other details. With a short time lag, monetary policy can be quickly deployed in the early stage of a crisis, replenishing market liquidity and boosting market confidence.

Against this backdrop, many economies have launched an unprecedented monetary and fiscal stimulus to address downward economic pressures. According to the International Monetary Fund (IMF), the aggregate fiscal and monetary stimulus amounted to 9% and 11% respectively of GDP in advanced economies, and around 3.5% and 2% of GDP respectively in emerging market economies. There are many examples of strengthened coordination between monetary and fiscal policies. For example, in the first round of the $3 trillion rescue plan, the US Treasury allocated $454 billion to the creation of various liquidity assistance tools by the Federal Reserve.

2. China's experience of monetary and fiscal policy coordination

China has attached great importance to sound coordination between monetary and fiscal policies. On the one hand, two standing mechanisms, namely the Financial Stability and Development Committee (FSDC) under the State Council and the Monetary Policy Committee (MPC), serve as the platforms for the coordination of monetary and fiscal policy. On the other hand, the People's Bank of China (PBC) and the Ministry of Finance (MOF) carry out coordination on a regular basis through various channels, such as jointly conducting market-making for Treasury bills on the secondary market, managing the national treasury through time deposits with commercial banks and working-level communications. In addition, as the central bank of a transition economy, the PBC has multiple objectives, including maintaining price stability, supporting economic growth, promoting employment, achieving a general equilibrium of the balance of payments, promoting financial reform, and financial market development. According to the Tinbergen rule,[1] it may be difficult to achieve all these objectives by monetary policy tools alone, and so coordination with fiscal policy is very necessary.

Since the outbreak of Covid-19, coordination between monetary and fiscal policies has been strengthened to contain the spread of the virus.

First, in the early stage of the pandemic, both monetary and fiscal policies were deployed to ensure the supply of medical supplies and daily necessities. The MOF and the PBC, together with other authorities, jointly issued the *Emergency Notice on Strengthening Financial Support for Enterprises Essential to Epidemic Prevention and Control*, by which the PBC provided special central bank lending of up to RMB 300 billion to nationwide banks and local banks in severely hit regions, granting preferential loans to enterprises essential to epidemic prevention. The MOF subsidised 50% of the interest for a period up to one year, thus reducing the actual financing cost for enterprises to 1.25%. This has played a positive role in facilitating pandemic containment, as well as the resumption of work and production.

Second, RMB 1 trillion in special Treasury bills and RMB 3.75 trillion in local government special bonds have been issued in response to the pandemic. The PBC worked closely with the MOF to keep liquidity at a reasonably adequate level through multiple monetary policy operations, so as to create an appropriate liquidity environment.

Third, to improve the access of micro and small businesses to finance, in June 2020, the PBC launched two facilities directly targeting the real economy, namely the loan repayment rollover facility and the uncollateralised lending facility for micro and small businesses. Specifically, the PBC and MOF jointly funded the establishment of a special purpose vehicle, which conducts interest rate swaps with commercial banks to encourage them to extend loan and interest repayment for SMEs. With the support of these policies, the balance of inclusive small and micro loans reached RMB 15.1 trillion at the end of 2020, a year-on-year growth rate of 30%. The interest rate for new inclusive small and micro loans stood at 5.08% in December, down 0.8 percentage points from a year earlier.

At the early stage of the pandemic, some people were arguing for monetary policy 3 (MP3) and modern monetary theory (MMT) in China. However, this did not become a mainstream concept and gradually faded away. There are many challenges in the design and implementation of MP3 and MMT. First, the monetisation of fiscal deficits is the last resort when in extreme situations, such as during wars or an economic crisis. Second, some of the suggestions are not easily implemented, making the expected results rather elusive. Third, such measures may give rise to hyperinflation and economic chaos. Fourth, MP3 and MMT are faced with strict institutional constraints. Fifth, MP3 and MMT would blur the boundary between monetary and fiscal policies, and violate the principle of central bank independence.

[1] For each policy objective, at least one policy instrument is needed.

In general, China has ample monetary and fiscal policy space. With the support of both policies, China's economy has been recovering steadily, with annual GDP growth posting 2.3% in 2020. Therefore, there is no need for China to implement unconventional monetary policies.

3. China will conduct a normal monetary policy for as long as possible, keeping the fiscal deficit and public debt under control

The PBC is well positioned to maintain a normal monetary policy and has no need to deploy unconventional measures such as large-scale domestic asset purchases. The Chinese economy still has huge growth potential, and its endogenous growth momentum continues to strengthen. Monetary policy transmission remains smooth and policy space is adequate. As of December 2020, one-year and five-year LPR rates were 3.85% and 4.65% respectively, higher than the interest rates in advanced economies. In addition, the reserve requirement ratios for large banks and small- and medium-sized banks stood at 12.5% and 9.5% respectively, with some room for a further reduction. In general, conducting a normal monetary policy and maintaining positive interest rates should help provide economic entities with positive incentives, promote sustainable social and economic development and make RMB-denominated assets more attractive for foreign investors, supporting the "dual-circulation" development pattern.

In general, China's government debt remains at a reasonable level. Although China's fiscal deficit and public debt has risen since the beginning of 2020, the current government debt ratio is lower than the 60% threshold. Given that China's GDP growth rate has been higher than the real interest rate and has remained so for a long time, government debt is sustainable and will not threaten macroeconomic and financial stability.

The PBC remains committed to a sound monetary policy that is flexible, appropriate and well targeted, and will properly address the following risks.

First, the risk of a rising macro leverage ratio. Efforts to stabilise the macro leverage ratio have made considerable progress since 2017. China's leverage ratio increased at a slower rate, namely by 8.1 percentage points annually between 2017 and 2020, whereas the average annual growth in the period of 2008–16 was 11.4 percentage points. However, the macro leverage ratio temporarily rose in 2020, as stimulus policies were rolled out to support the real economy. In addition, many new local government officials will take office in 2021, and the impulse to expand credit may further push up the macro leverage ratio. Therefore, while maintaining continuity and avoiding "cliff effects", monetary policy should also be designed to prevent the macro leverage ratio from rising too fast.

Second, the risk of rising NPL. Since the outbreak of Covid-19, many enterprises have suffered from a lack of funding, and some of them have even filed for bankruptcy, putting downward pressure on the quality of bank credit. Given the time lag before NPL risks materialise, as well as the repayment extension policy adopted during the pandemic, the NPL ratio is expected to increase in the future. In 2020, the PBC conducted a three-year stress test (2020–22) on commercial banks. The results show that the NPL ratio will rise in 2020, and peak in 2021 before declining in

2022. In response, the PBC has instructed commercial banks to make contingency plans to cope with the increase of NPLs and increase pre-emptive provisioning and write-offs.

Third, external risks. The impact of the second wave of the pandemic should not be neglected. Vaccine nationalism could affect the distribution of vaccines. The pandemic may also accelerate the process of deglobalisation, as many multinational companies expedite the diversification of supply chains, shorten the overseas industrial chain, change their procurement arrangements and even move some factories back home, exerting possible downward pressure on exports. If the pandemic persists, the risk of renewed volatility in the global financial market cannot be ruled out, which would have a bearing on the Chinese market and create uncertainties in the balance of payments and cross-border capital flows. Financial risks have been on the rise, as the performance of financial markets disconnect from the real economy, and the vulnerabilities of non-bank financial institutions are exposed and the quality of banks' assets deteriorate. Additionally, given the increasing global leverage ratio and high levels of both private and public debt, the risks of excessive debt should not be underestimated .

Although there is still huge uncertainty about the evolution of Covid-19, China's sound economic growth fundamentals will remain unchanged, backed as they are by a resilient economy and a vast domestic market. Going forward, China's macroeconomic policy will maintain its continuity, stability and sustainability. Proactive fiscal policy and prudent monetary policy will be more targeted, seeking to improve economic efficiency in supporting the recovery and avoiding any sharp policy reversals.