Monetary and fiscal policy interactions in the wake of the pandemic

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Abstract

The impact of the pandemic and subsequent lockdown measures on incomes and growth was unlike economic shocks before. Heightened coordination between monetary and fiscal authorities was a critical element of a comprehensive policy response. However, several potential risks arose from the heightened level of interaction. For central banks in particular, questions on central bank independence and fiscal dominance gained attention. This article explores the preconditions and processes that allowed the risks associated with heightened monetary and fiscal coordination in Malaysia to be managed. Specifically, this paper offers insights on the processes and safeguards to ensure that monetary and fiscal policy complementarities can be maximised, while limiting the risk of impediments to respective authorities in achieving their mandates.

JEL classification: E58, E62, E63, H12.

Keywords: monetary and fiscal policies, coordination, institutional coordination, robust policies.

Introduction

The Great Financial Crisis (GFC) almost saw the collapse of the modern financial system and required significant policy responses and the exploration of unorthodox policy tools. Many advanced economies implemented various types of unconventional monetary policy (UMP), some of which inadvertently require closer interactions with the fiscal authorities. In 2020, the world faced another unprecedented challenge: a global pandemic. Lockdown measures that were essential in dealing with the pandemic had a direct negative impact on incomes and growth. Countries implemented months-long lockdowns to contain the spread of the virus, as experts advised.

As public debt continues to accumulate and monetary policy approaches its effective lower bound globally, more countries (including emerging market economies (EMEs)) have resorted to unconventional policy measures, eg central bank purchases of government bonds) to support the economic recovery. Once again, the interactions between monetary and fiscal policy are at the forefront, raising concerns about monetary policy independence, and suggesting that . steps should be taken with caution. Upending the delicate balance of how monetary and fiscal policies operate, which itself is an outcome of "a long history of trials and errors",[1] could lead to several unintended outcomes (eg fiscal dominance).[2] This paper will look at Malaysia's experience regarding the interaction between monetary and fiscal authorities. The overall goal is to emphasise that this balance can be retained while still providing a multifaceted approach in addressing the economic impact of the pandemic.

Part A: Monetary and fiscal policies as complementary tools

Traditionally, a monetary authority's primary goal is to ensure short-run price and macroeconomic stability, mostly expressed in quantitative targets for inflation, unemployment or growth. Meanwhile, the fiscal authority plays its role in the economy via taxation and expenditure by affecting aggregate demand, the distribution of wealth and the economy's capacity to produce goods and services.[3] Given the reduction in conventional policy space available to central banks recently, many countries have either resorted to unconventional monetary policies or heightened monetary and fiscal coordination.[4]

1 Bonatti et al (2020).

2 Schnabel (2020) defines fiscal dominance as a condition when high government debt leads to a central bank deviating from its monetary policy objectives, such that monetary policy targets are geared towards ensuring government debt sustainability rather than other economic targets such as inflation, growth or employment.

3 Kopcke et al (2006).

4 Benmelech and Tzur-Ilan (2020) argue that AEs with lower policy space in the lead-up to the pandemic were more likely to pursue unconventional MP, while Bonatti et al (2020) highlight examples from the ECB such as the asset purchase programme and the Pandemic Emergency Purchase Programme.

In either case, it is imperative that central banks be wary of two issues. The first issue is the challenges in unwinding these types of policies.[5] These could be avoided by embedding exit mechanisms and strategies at the onset of policy implementation. The second issue is the impact these changes could have on the central bank achieving its mandate. Here, self-interest is the key challenge to be wary of,[6] especially with regards to the risk of asymmetric fiscal responses to shocks. Due to political considerations, fiscal authorities are by nature less (more) inclined to reduce (increase) deficits during upturns (downturns). These asymmetric preferences could result in an imbalance where monetary policy builds policy space during good times[7] while fiscal policy does not.[8] This imbalance can result in an overburdening of monetary policy to provide support to growth if the economy experiences another major economic shock. Resorting to various unconventional monetary policies, especially those with links to fiscal policy,[9] could be a source of concern. If clear exit mechanisms are not established under these programmes at inception, unwinding them could prove challenging, which complicates the strategy and implementation of monetary policy. The next section of this article assesses the preconditions for a more effective monetary-fiscal nexus to avoid unravelling complementarities.

Part B: Preconditions for an effective monetary policy-fiscal policy nexus

It is important to have preconditions to pre-emptively avert fiscal dominance. The first precondition for an effective monetary-fiscal nexus is clearly defined legislation and mandates.[10] Central banks rely on legislation for the legitimacy and independence of their operations. Central bank acts (CBAs) around the world set "the rules of the game", ensuring that though monetary authorities are able to act independently, they carry out actions within specified rules expressed in their mandates. The Fed, for example, looks to achieve its dual mandate of "maximum employment and stable prices". These mandates limit external political influence in monetary policy decision-making. In addition, many central banks in advanced

[5] Jones (2017), for example, argues that unwinding policies is more complicated than implementing them, given the need to avoid disruptions to sovereign debt markets and excessive volatility.

[6] Hallet (2008) argues in favour of coordination without explicit cooperation between fiscal and monetary authorities to achieve optimal outcomes to output and inflation. Since there is no separation of the effects of policies to the targets of both entities, self-interest on either end could prove disruptive.

[7] While there are criticisms that interest rates tend to be too low for too long, which may suggest asymmetry, it is primarily following unequal effects of monetary policy. Barnichon (2017), for example, finds that contractionary monetary policy shocks raise unemployment more strongly than expansionary shocks to lower it. Panetta (2020) notes asymmetric policy reaction can also be due to the asymmetry in risks.

[8] While this generally tends to be the preference, fiscal authorities have also shown commitment to fiscal consolidation. For example, in Malaysia the fiscal deficit narrowed by half between 2009 and 2019 from –6.7% of GDP to –3.4% of GDP.

[9] This includes, among others, large-scale asset purchase programmes.

[10] This refers to all laws related to the central bank and its operations that are passed by the legislative body of a country (eg parliament). Most countries have a Central Bank Act which specifies the mandate of the central bank.

economies (AEs) also specify certain definitions of their mandate via quantitative targets, which further solidifies the independence of the decision-making process.[11] With well defined objectives and limitations, the incentives can allow for long-term independent conduct of monetary policy. These legislative mandates are a formal expression of the role that the central bank plays in the economy and in responding to shocks.

In addition to the legislative infrastructure, explicit terms of reference for the interaction of monetary and fiscal authorities are needed. Similar to the benefits of having clear legislative limitations, the explicit rules specified under the terms of reference provide guidance to entities represented in these committees. Guided by these terms of reference, there are two goals for communication. The first allows the creation of concerted responses, especially when a specific remedy for a unique shock is needed (eg the Fed initiated emergency lending programmes to ensure continued credit flow in 2020 in response to the credit tightening).[12] The backstop provided by the US Treasury to absorb potential losses from defaults was a key feature of some of these programmes. The cooperation seen in establishing these facilities is an example of how concerted efforts from various facets of government can ensure optimal implementation. The second, having established and lasting platforms beyond those for emergency circumstances, would also help in ensuring smoother interactions. This can only be fostered if clearly defined rules are set. In many countries, this channel of interaction is often via committees at both the high and technical levels. It is through these committees, whether set up under normal circumstances or to respond to specific shocks, that information-sharing and discussions of policy responses can happen. These committees should be specific in their objectives (and therefore cross-agency representation), decision-making processes and frequency of meetings, often clarified via the terms of reference.

Part C: Policy coordination in practice

Similar to most countries, the nature of monetary-fiscal interactions in Malaysia is primarily in the areas of macroeconomic stabilisation policies, debt management activities and developmental and growth-promoting policies. The Central Bank of Malaysia (Bank Negara Malaysia, BNM) functions as the economic and financial adviser to the government and is mandated to promote monetary and financial stability. These interactions allowed BNM to cultivate a relatively healthy relationship with the Ministry of Finance (MOF). The key to fostering the relationship has been open communication in addressing economic issues through the various interagency policy platforms of which BNM and MOF are members. BNM leverages platforms such as the Economic Action Council (EAC) and the Fiscal Policy Committee (FPC) to provide policy advice to the government. The advisory role includes various matters ranging from policy best practices to risk mitigation. Further, working-level platforms

[11] This is more complicated for EMEs. Building long-term credibility could be emphasised prior to adopting inflation targeting. For example, Fraga et al (2004), highlight that central banks in EMEs have this focus due to generally higher external vulnerabilities and weaker institutions than AEs. Frequently missing the target (due to factors which AEs may generally not face) could impede on this credibility-building process.

[12] These include the Municipal Liquidity Facility, Main Street Lending Programme and Commercial Paper Funding Facility.

ensure information-sharing occurs at all levels. BNM representatives attend the Cashflow Management Committee (CMC), chaired by the Secretary General of the Treasury, so that BNM can assess risks emanating from fiscal policy like debt management issues and adequacy of fiscal space.

The impact of the pandemic-induced recession has further underlined the importance of seamless communication between BNM and the MOF. BNM provided policy suggestions to ensure that key issues are addressed while retaining sustainability of public finances. BNM must have assurance that the fiscal authority will not impede decisions regarding the appropriate monetary policy stance in order for the relationship to continue working.

The independence of decisions made by the Monetary Policy Committee (MPC), as accorded by Article 22 of the Central Bank Act 2009, must be upheld as the highest priority, given evidence of the effectiveness of the MPC when it is free from political influence.[13]

Three key strategies are deployed by BNM to ensure the MPC's independence will remain in the long term. First, BNM utilises proactive advisory on fiscal matters to ensure that public finances are sustainable in the long term. This proactive advisory role allows BNM to provide the government with complementing insights on how best to utilise its resources to efficiently provide fiscal impetus to the economy and also help to mitigate short-to-medium term fiscal risks. BNM's second strategy to ensure MPC independence is by ensuring the continued ability of the fiscal authority to seek financing from the financial market. The outcome sought from this policy is to avoid BNM being in a position where it is relied on for deficit financing. Over the years, BNM's role as the agent for the government's front office provides the ability to minimise risks to government issuances as well as develop facilities to manage issuances. BNM advises the government on the details of government securities issuance (eg assessment on operational risks and sequencing of issuances) and is responsible for the development of facilities to manage these issuances (eg appointments of principal dealers). Risk mitigation and the availability of private sources of financing to the government eliminate the need for the government to seek financing directly from BNM. BNM also seeks to ensure that market functioning remains orderly, particularly to prevent disruption in the primary government bond market and ensure that price discovery remains efficient. Third, legislation draws clear boundaries and limits to maintain monetary operational independence should fiscal authorities find themselves seeking longer-term financing directly from BNM. These boundaries are drawn on the amount of financing allowed, the terms of the lending and its exit mechanism (provided under Section 71 of the CBA). During times of revenue shortfall, the government can leverage this clause of the CBA to obtain financing of up to 12.5% of projected annual revenue. The lending is also to be "on terms prevailing in the market" to ensure that there are no perverse incentives to pursue this lending facility during normal periods. Finally, repayment of the financing is to be completed in not more than three months after the end of the financial year. Should there be outstanding financing yet to be repaid by this time, this clause cannot be utilised further, which provides a clear exit mechanism for BNM. These also reflect the policy preferences of BNM to avoid taking on unwarranted credit risk of the government.

[13] Arnone et al (2009) highlight the benefits of autonomous central banks empowered by a Central Bank Act on policy outcomes such as inflation.

Recently, the pandemic-induced recession presented a set of unique challenges to central banks. Specifically, the utilisation of monetary financing by several other EMEs during this crisis presents a threat, given the desire to avoid taking on unwarranted credit risk of the fiscal authority. While legislation is in place to potentially avoid this, proactive measures were taken to avoid the need to resort to such practices. Through its role as financial adviser to the government, efforts have been accorded to the development of the government bond market to minimise frictions. Complementing the market development efforts, BNM additionally allowed for financial institutions to use Malaysian Government Securities (MGS) and Malaysian Government Investment Issues (MGIIs) as part of their compliance with the Statutory Reserve Requirement (SRR). While these have ensured sufficient liquidity in the banking system to support financial intermediation activity, it has also resulted in healthy demand for government bonds.

Both longstanding and recent measures allow for assurance within BNM that the risk of direct intervention into monetary policy from fiscal authorities remains remote. However, the threat of fiscal dominance can never truly be eliminated, nor should it be, given that fiscal decisions rightfully remain under the ambit of the MOF. The primary method of mitigating this risk will be proactive engagement. Communication built on the lasting relationship between monetary and fiscal authorities will prove vital.

Broadly, the coordination between BNM and the MOF have proven useful as a way to achieve concerted policy responses to the pandemic-induced recession. The more targeted approach to containment and the rollout of the vaccine, expected to inoculate 80% of Malaysians by early 2022, will help to reduce the risk of more widespread infections and thus mitigate the need for further lockdowns. This will facilitate a more entrenched economic recovery with the existing monetary-fiscal nexus intact. The flexible and proactive nature of this engagement will continue to allow for coordinated policy responses to shocks in the future.

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