Monetary and fiscal policy interactions in the wake of the pandemic

Saudi Central Bank

Abstract

The outbreak of the Covid-19 pandemic in 2020 has had a significant impact globally, resulting in a severe economic contraction in most economies. Moreover, oil-exporting economies faced additional shocks as a result of the substantial decline in oil prices earlier that year. These developments have forced countries to use a policy mix to safeguard their respective economies. However, their policies have varied, depending on the available monetary and fiscal space, as well as other macroeconomic and structural factors. Coordination between monetary and fiscal policies has been essential to achieve the desirable objectives, and an integral factor in supporting economic recovery. Actions taken by the Saudi Central Bank have played an essential role alongside the fiscal response by enabling the financial system to complement the government's efforts in combating the pandemic and mitigating its financial and economic impact, especially on the private sector.

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In the Kingdom of Saudi Arabia, the National Financial Stability Committee (NFSC) is the main channel for coordination between the fiscal and monetary authorities. The NFSC's primary objective is to identify, monitor and coordinate between the regulatory authorities These are the Capital Market Authority, the Ministry of Finance, the National Debt Management Center and the Saudi Central Bank. The NFSC charter serves as a formal guideline for processes and procedures. Although it is not a decision-making body, the committee provides a platform for the discussion and monitoring of potential risks to financial stability and for enhancing coordination between the regulatory authorities with a view to maintaining financial stability.

The NFSC notably aims to promote financial stability in Saudi Arabia by enhancing the formation of a shared assessment regarding the financial system's ability to manage internal and external shocks.[1] The NFSC's members meet on a quarterly basis in normal circumstances. However, due to the Covid-19 developments, the implications for financial stability and the ensuing need for more coordination, the NFSC met more frequently and on an ad hoc basis in the course of 2020.

The global economic shock caused by the outbreak of Covid-19 sparked a deterioration in risk sentiment, with adverse global growth implications, resulting in a severe economic contraction as well as rising debt levels. In addition, the substantial decline in oil prices deepened the burden on oil-exporting economies such as Saudi Arabia. Different countries have used varying forms of policy mixes to combat the crisis, depending on the depth of their domestic recession, the available monetary and fiscal policy space at the start of the downturn, and private and public debt conditions.

The policy mixes applied by advanced economies (AEs) differ from those of emerging market economies (EMEs). The fiscal response to the pandemic in EMEs has been smaller than in AEs, owing to their more constrained fiscal space. For commodity-exporting countries, fiscal space has been limited due to the fall in commodity prices. Moreover, gross government debt had risen in EMEs prior to the outbreak of the pandemic, further limiting their fiscal space.

Most countries around the world, nonetheless, used similar fiscal policy tools, deploying measures such as credit guarantees, social support, one-off payments and temporary standstills in fees and payments. In terms of monetary support, central banks have resorted to tools such as lending and credit provision at lower cost in addition to funding and liquidity operations, and specific market tools to maintain market functioning. A number of EME central banks have broken new ground by introducing asset purchase programmes for the first time.

In Saudi Arabia, both the monetary and the fiscal policy authorities have reacted promptly and decisively by deploying a wide range of tools to mitigate the unprecedented shock to domestic economic activity. The measures deployed by the central bank included, but were not limited to, the Deferred Payments Program, the Funding for Lending Program, and the Loan Guarantee Program in addition to the direct injection of SAR 50 billion to support the banking sector's liquidity. Moreover, the approved fiscal measures included an allocation of SAR 50 billion via the unemployment insurance system (SANID) to expedite payment of private sector dues as well as extending the deadlines for filing tax returns and offering a 30% discount for two months on utility bills for the commercial, industrial and agricultural sectors.

1 See IMF, *Saudi Arabia Financial System Assessment*, Financial Safety Nets, 2017.

The swift and effective response through these measures has helped mitigate the impact of the shock by reducing the cash flow burden on the private sector and providing credit provision as well as liquidity support. The fiscal and monetary authorities each did their utmost to combat the negative effects of this unprecedented shock to the economy. Additionally, coordination at the international level, as the G20 ministries of finance and central banks made a joint commitment to undertake measures under an agreed G20 Action Plan, has amplified these effects and induced a positive spillover.

The coordination and internal communication between fiscal and monetary policy authorities have been pivotal in supporting economic recovery since the outbreak of Covid-19. In Saudi Arabia, both the central bank and the government continue to implement their respective policy agendas to support the economy and maintain monetary and financial stability. Indeed, in the context of Saudi Arabia's Vision 2030 programme, the central bank, in coordination with the Finance Ministry and the Capital Markets Authority, are implementing the Financial Sector Development Program (FSDP), with the aim of creating a thriving financial sector. The implementation of the FSDP has not slowed down as a result of the pandemic. On the contrary, the pandemic has underscored the importance of some of the FSDP targets, among them a faster pace of financial sector digitalisation. The FSDP's overall aim is to arrive at a more developed, inclusive, digitalised, efficient and diversified financial system, which will include a sound domestic capital market with robust infrastructure.

Fiscal position in Saudi Arabia

Fiscal policy space in Saudi Arabia has generally been adequate, given its large reserves and relatively low debt levels. This enabled the authorities to cope immediately and decisively with the unforeseen economic shock caused by the outbreak of Covid-19.

Given that government spending is the main driver of the Saudi economy, the fiscal position has a direct and an indirect impact on output, financial system liquidity and economic activity. Consequently, this should reflect on local consumption and demand for imports.

At present, Saudi Arabia's public debt remains within a stable range, commensurate with the size of the economy and its absorptive capacity. Saudi Arabia also ranks high among a group of developed and developing economies with the lowest public debt-to-GDP ratio (32.5% of GDP in 2020). In addition, external debt represents about 41.1% of the total public debt or around 13.4% of GDP.

Despite the negative impact of the pandemic on economic activity, the Saudi economy was found to be resilient. The government has undertaken a plethora of economic measures aimed at supporting economic growth while also keeping public debt in check. The government was able to maintain fiscal stability and sustainability by shifting public investment spending, reorienting expenditures and raising spending efficiency, as well as increasing revenues (via, for example, VAT rates, which increased from 5% to 15%). This fiscal stability will, in turn, assist in fostering the appropriate investment climate needed for the economic recovery and achieving the diversification objectives of Vision 2030.

Together with other Vision Realization Programs working towards that end, the Fiscal Balance Program is a key component of Saudi Arabia's Vision 2030. It offers a fiscal framework that allows the Kingdom to follow flexible fiscal and economic policies that keep pace with local and global developments and seek to maintain fiscal discipline by controlling the deficit and public debt in order to achieve sustainable economic growth.

Monetary policy in Saudi Arabia and its fiscal ramifications

The Saudi Central Bank is committed to maintaining its pegged exchange rate regime, which has supported economic growth since the mid-1980s. The Saudi Central Bank aims to maintain monetary stability primarily through a wide range of tools

With the fixed exchange rate regime as its policy anchor, the Saudi Central Bank's monetary policy has worked well, even in the post GFC environment when major central banks in AEs adopted unconventional QE. The Saudi Central Bank's monetary policy consists of interest rate and market operations, in addition to reserve requirements. The combination of passive interest rates and active liquidity management is effective in preserving exchange rate stability, in line with the central bank's objectives of maintaining monetary and financial stability as well as supporting the country's economic growth. In 2020, the Saudi Central Bank announced the enhancement of its Open Market Operation framework to enrich its liquidity management apparatus. In addition, a working group including bank representatives has been established to develop a legal and operational framework for the interbank repo market in order to establish country-specific guidelines suited to local and international investors and compatible with both sharia and conventional standards.

As indicated by the development of Saudi Arabia's credit markets, credit to the private sector recorded an increase of 14.8% year on year by Q1 2021. The non-performing loans of the banking sector in Q1 2021 remained stable at 2.2%, indicating strong financial soundness. In addition, the loan-to-deposits ratio was 77.6 in Q1 2021, well below the central bank's guideline, reflecting banks' ability to extend further credit.

The Saudi Central Bank's foreign exchange reserves reached USD 453.7 billion in December 2020, representing 79% of the aggregate money supply (M3). According to the IMF's reserve adequacy metric, the Saudi Central Bank's foreign exchange reserves remain adequate.[2]

To conclude, the scale and severity of the pandemic presented the Saudi economy with an unprecedented challenge. However, the well coordinated policy mix of the Saudi Ministry of Finance and Central Bank have dampened the impact of the economic shock, mitigating its toll on businesses and individuals. Moreover, the strong macroprudential framework has maintained the stability of the financial system and paved the way for the recovery in the coming years.

[2] See IMF, *External Sector Report*, August 2020.