Monetary and fiscal policy interactions in the wake of the Covid-19 pandemic

South African Reserve Bank (SARB)

Abstract

Interactions between the South African Reserve Bank (SARB) and National Treasury (NT) have been robust, even while South Africa navigated its pathway in mitigating the impact of Covid-19. Despite these interactions, central bank independence remained uncompromised and the NT's mandate to implement fiscal policy was respected. In March 2020, liquidity strains and volatility appeared in money and capital markets due to the Covid-19 pandemic. As a result, the SARB implemented several measures to provide liquidity to stabilise markets and ensure their orderly functioning. Among the measures was a programme of purchasing government bonds in the secondary market. The programme had a direct effect in restoring market functioning within the domestic bond market. While the premise of the bond purchase programme (BPP) was to smooth market functioning within the domestic bond market, it inadvertently presented the fiscal authorities with several benefits, as lower bond yields eased the government's cost of funding and resulted in increased participation in non-competitive auctions, thus leading to higher than expected proceeds.

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Session I

How did the Covid-19 crisis change the interaction between monetary and fiscal policy? Did the extraordinary circumstances make policy coordination and interaction easier? What, if any, have been sources of tension?

In March 2020, volatility in South Africa's financial markets increased significantly, largely in response to concerns about the impact of the Covid-19 pandemic, but also due to a sovereign credit rating downgrade by Moody's to sub-investment grade and the exclusion of South Africa from the World Government Bond Index. Risk aversion led to capital flight from longer- to shorter-term investments and from riskier to safe-haven assets. Liquidity in financial markets deteriorated, and banks became concerned about their ability to meet redemptions of short-term money market instruments, as well as regulatory requirements such as the Liquidity Coverage Ratio (LCR). High-quality liquid assets (HQLAs) decreased in value due to negative mark to market adjustments caused by sharp increases in government bond yields. The South African Reserve Bank (SARB) initiated several liquidity provision operations, as well as an unsterilised bond buying programme in the secondary market to ensure the continued functioning of capital markets. The government bond market is the largest and most liquid bond market in South Africa. The SARB generally does not buy bonds in the primary market, although legislation permits limited purchases. The SARB ensured that none of its liquidity interventions undermined its price stability mandate.

The SARB and National Treasury (NT) engaged robustly and frequently with each other while respecting the central bank's independence in monetary policy and the NT's mandate to implement fiscal policy. Mounting fiscal challenges affect monetary policy insofar as they impact lending rates, risk premia and overall macroeconomic stability. Rising government debt and poor economic performance continue to stoke challenges to the SARB's independence. There were public debates on whether the SARB should be doing more to support the economy and whether it should expand bond purchases to reduce the government's cost of borrowing. However, the SARB continues to pursue its constitutional mandate with integrity and focus.

The SARB and NT discussed the requirements, roles and responsibilities of the two institutions in providing the Loan Guarantee Scheme to the private sector in response to the pandemic. The Standing Committee on Banking and Financial Markets (SCBFM)[1] met more regularly to monitor market developments, share market intelligence and better understand the financing needs of NT and how this would impact the operations of the central bank in the money market. The Macro Standing Committee also met regularly to share information and perspectives on the economy's performance and outlook.

The SARB is responsible for conducting government bond and treasury bill auctions and managing the country's foreign exchange reserves. The receipt of large-scale USD loans from international financial institutions (IFIs) required frequent consultation, so these conversions could be timed to meet government's cash flow needs while also minimising distortions in foreign exchange markets. The SARB and NT maintain a cooperative, collaborative and transparent relationship, despite

[1] A joint committee of the SARB and NT to deliberate on matters related to financial markets, banking, public debt management and foreign exchange reserves.

occasionally having differing views regarding the management strategy of common objectives.

What were the key factors that led to central bank large-scale domestic asset purchases?

The SARB must ensure that financial markets operate smoothly and efficiently. In March 2020, the Covid-19 pandemic created liquidity strains and volatility in money and capital markets. The SARB implemented several measures to provide liquidity to stabilise markets and ensure orderly functioning. One measure was a programme of purchasing government bonds in the secondary market. Purchases were conducted across the yield curve and helped to reduce excessive volatility in the price of government bonds and supported price discovery, thus reducing dysfunctionality.

In addition to providing liquidity and promoting the smooth functioning of domestic financial markets, the bond purchase programme (BPP) allowed the SARB to enhance its monetary policy portfolio (MPP). The MPP is one of the instruments in the SARB's toolkit for managing money market liquidity and is used to inject or drain liquidity from the market.

The bond purchases were conducted in accordance with the SARB's responsibility to ensure that the local currency bond market was functioning in an orderly manner and was transmitting the price signals as closely as possible to the economic realities of the bond market at the time. Ensuring that the bond market functions in an orderly manner is important to the SARB, considering the role that this market plays in transmitting monetary policy stances to the broader economy.

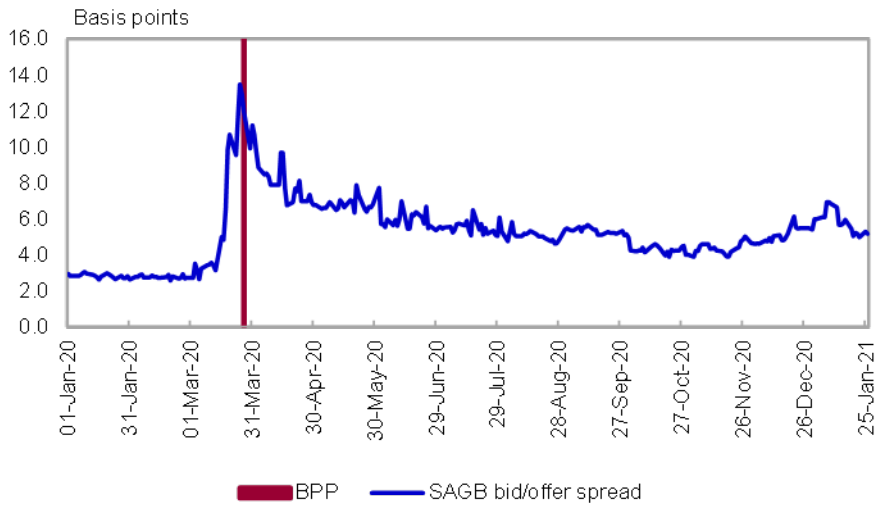
What have the effects been on financial conditions so far?

It is important to note that the SARB's BPP was not quantitative easing, nor was it a programme conducted for economic stimulus purposes. Rather, it was aimed at restoring orderly functioning to the bond market. Therefore, bond purchases were not executed with an expectation that they would eventually have an impact on macroeconomic variables, nor were attempts made to measure the potential impact.

The BPP has had both direct and indirect effects on financial conditions. The programme had a direct effect in smoothing market functioning within the domestic bond market. In the first two weeks of the programme, the SARB purchased ZAR 6.5 billion of government bonds. In the same period, yields across the South African government bond (SAGB) curve fell by an average of 60 basis points, while bid-offer spreads compressed by an average of 6 basis points after initially widening by close to 14 basis points (as shown in Graph 1 below). The SARB continued purchasing bonds, totalling ZAR 38.8 billion by the end of October 2020 (the last purchases conducted). In this period, bid-offer spreads continued to improve, with spreads currently trading around 2.5 basis points above their pre-Covid-19 levels.

SAGB bid-offer spread

Graph 1



BPP = bond purchase programme ; SAGB = South African government bond.

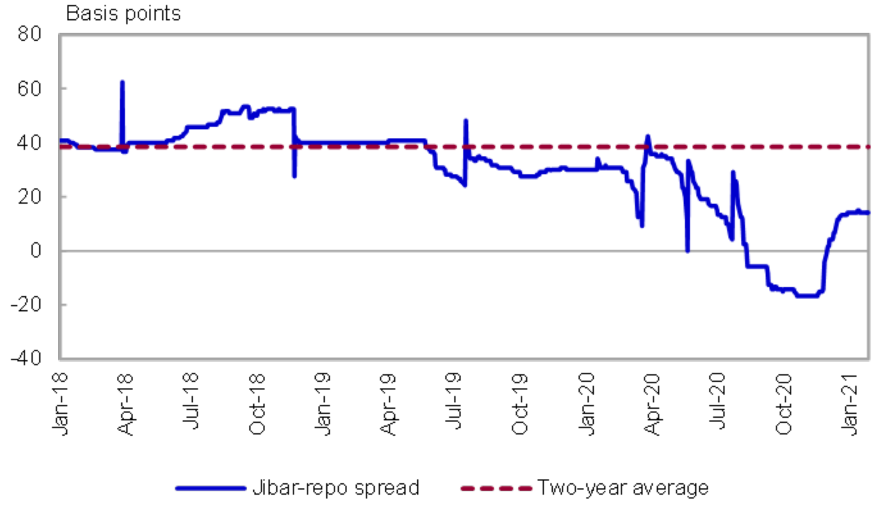
Source: South African Reserve Bank

Beyond a direct impact on the bond market, it is difficult to dissect spillover effects of the BPP to the broader financial conditions in isolation from the series of liquidity provision measures implemented by the SARB.

The unprecedented amount of unsterilised liquidity (through the BPP, among other things) is believed to have contributed to a widespread decline in cash market rates. For example, the most widely referenced three-month Johannesburg Interbank Average Rate (Jibar) declined sharply to trade at a negative spread to the policy rate. The Jibar-repurchase rate (repo) spread was significantly below its two-year average. While money market rates will inevitably decline in line with the reduction in the policy rate, Graph 2 shows that the spread of the three-month Jibar over the policy rate declined into negative territory, well below its two-year average of around 40 basis points. Note that the SARB also launched other partially sterilised liquidity facilities, which are believed to have had a much larger impact on cash market rates.

Jibar-repo spread differential

Graph 2



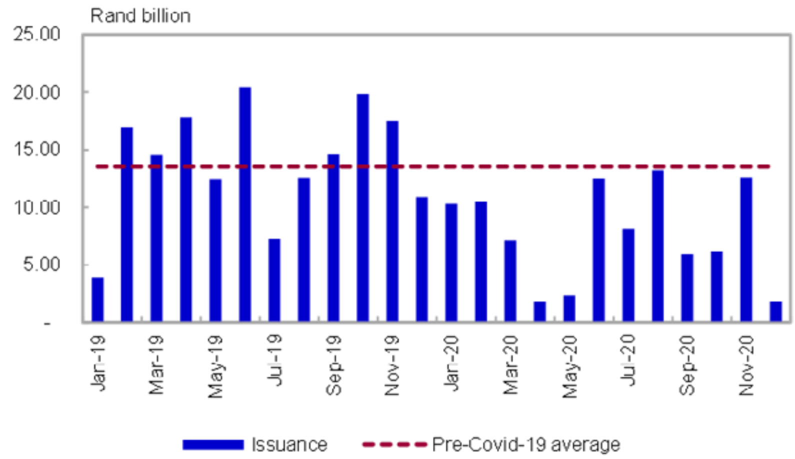
Jibar = Johannesburg Interbank Average Rate.

Source: South African Reserve Bank

The corporate bond market came to a near complete halt during the onset of the Covid-19 crisis. As shown in Graph 3, corporate bond issuance declined to a low of ZAR 1.75 billion in April 2020 compared to an average of ZAR 9.3 billion in the preceding three months and ZAR 17.8 billion in April 2019. As market functioning began to improve following the implementation of liquidity measures, confidence within the corporate bond market returned, with issuance rising to as much as ZAR 12.46 billion in June 2020. More recently, corporate bond issuance fell to ZAR 1.82 billion in December 2020; however, this is mostly a function of seasonal dynamics, where issuance generally tapers during this time of the year.

Corporate bond issuance

Graph 3

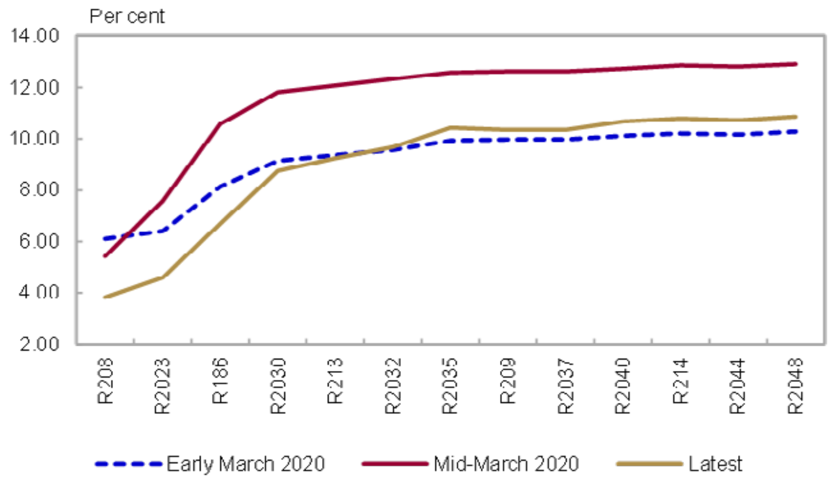


Source: South African Reserve Bank

Have asset purchases affected the fiscal policy room for manoeuvre?

While the premise of the BPP was to smooth market functioning within the domestic bond market, it inadvertently presented the fiscal authorities with several benefits. The SARB's bond purchases were not limited to a specific point on the curve and were undertaken across the spectrum of the SAGB curve. This approach resulted in falling yields across the curve, as reflected in Graph 4. Lower yields essentially eased the government's cost of funding despite a deterioration in the country's fiscal backdrop. Moreover, declining yields increased participation in non-competitive auctions, thus leading to higher-than-expected proceeds. This created opportunities for the government to reconsider its funding strategy, as there were now opportunities to reduce the size of government bond auctions.

SAGB yield curve — Graph 4



Source: South African Reserve Bank

Session II

Does the increase in fiscal deficits and public debt raise macroeconomic and financial stability risks? Is monetary policy likely to be constrained by fiscal policy going forward? Through what channels? How large is the threat of fiscal dominance, including because of greater political pressures?

South Africa's fiscal deficit reached double digits in the 2020 financial year owing to Covid-19 relief spending, reduced revenue and a diminished gross domestic product (GDP). Many projections see debt breaching 100% of GDP within five years.[2] During the 2010s, South African government debt grew rapidly – by 31 December 2020, total gross loan debt as a percentage of GDP was 77.1%. It is estimated to be 87.3% in 2023–24. The SARB expects GDP to recover to 2019 levels in 2023. The risk

[2] National Treasury sees debt peaking at around 95% of GDP.

premium has been elevated as a result. These developments have raised concerns around macroeconomic and financial stability risks.

Talking points included consequences for credit ratings and the impact on lending rates throughout the economy and the extent to which government borrowing could crowd out the private sector. There is also concern about increasing reliance on foreign investment and the risks of capital flight and sudden stops. Other concerns include the growing interest bill, which has reached 4.6% of GDP, and the increasing exposure of the banking sector to sovereign debt through HQLAs. Further fiscal deterioration could erode the value of HQLAs (mostly government bonds), negatively impacting bank balance sheets.

To the extent that increased government borrowing and a higher term premium may influence lending rates, rising debt issuance could reduce the expansionary effects of the SARB's recent series of rate cuts (which totalled 300 basis points in 2020). This, in addition to the sovereign debt-related risks listed above, maintains the position of fiscal policy as a relevant concern for the SARB.

While public political pressure tends to rise during economic crises, the SARB does not perceive the challenges to its independence to be an imminent threat. Its mandate is protected by the South African Constitution. The SARB is also not prepared to engage in quantitative easing at this time, as its governor has frequently stated. The SARB continues to focus on its constitutional mandate to pursue price stability in the interest of balanced and sustainable economic growth.

Additional stimulus, undertaken independently

NT provided various other relief measures, including budgetary support to strengthen the health sector, labour and firms, as shown in Table 1. The SARB provided unprecedented rate relief, cutting the repo rate by 300 basis points in 2020 to cushion consumers and businesses. The SARB also instituted capital relief measures which made about ZAR 250 billion available to meet the commercial banks' liquidity demands and to support continued credit extension.[3]

[3] The SARB's Prudential Authority reduced the LCR from 100% to 80%, lowered Pillar 2A capital requirements from 1% to 0% and provided capital relief on loan restructures.

Total Covid-19 package

Table 1

ZAR millions	2020/21
Budgetary support (spending)	130 000
Credit Guarantee Scheme	200 000[4]
Measures for income support (including further tax deferrals, Skills Development Levy holiday and Employment Tax Incentive extension)	70 000
Drawdown on government balance sheet for wage protection (eg UIF, Compensation Fund)	40 000
Contingent amount for additional employment and wage support	60 000
Repo rate reduction estimate	80 750
Regulatory relief measures	250 000
Total Covid-19 package	830 750
Percentage of GDP	16.78%

Note: The Pillar 2A relief amounts to a further ZAR 31.2 billion and if we assume that the average minimum capital adequacy ratio of all banks amounts to 12.48% and the average risk weighting of exposures to bank clients is 100%, an additional amount of ZAR 250 billion could be supplied to the South African economy.

Source: National Treasury and SARB

Do large-scale domestic asset purchases make the exchange rate more vulnerable to confidence crises? Could they increase the risk of higher inflation? Under what conditions?

Large-scale asset purchases have become a relatively common tool for central banks, which means they are less likely to provoke adverse reactions in foreign exchange markets. Nonetheless, they could have negative effects where they are not proportional to central bank mandates (price stability and financial stability). For instance, South Africa's 2020 asset purchases, at about 0.6% of GDP, have been fairly modest. Their scale has been consistent with restoring financial stability goals (market functioning has normalised without additional assistance) and maintaining price stability (the policy rate remains well above the zero lower bound and inflation is expected to stay within the target range for the foreseeable future). By contrast, larger purchases could have raised difficult credibility questions.

In an extreme scenario, large-scale asset purchases might have been perceived as signaling the onset of fiscal dominance, and potentially a breakdown of central bank independence, indicating much higher inflation in future. South Africa's strained fiscal position, and its decade-long failure to achieve debt-stabilisation commitments, would have made this outcome more plausible. In a less extreme scenario, markets could also have come to fear a SARB bias towards low rates, both to reduce government borrowing costs and to protect the central bank's own balance sheet, which would be exposed to interest rate risk on asset holdings as well as ongoing sterilisation costs for the liabilities created to purchase the assets. Unlike conventional short-rate operations, asset purchases expose central banks to risks and costs, which may distort policymakers' incentives. In turn, market perceptions of weakened monetary policy credibility would weaken exchange rates.

[4] An amount of R100 billion was immediately availed, with the option to avail another R100 billion.

Some observers tend to draw a close connection between money creation to finance asset purchases and inflation. Expert analysis, however, has largely moved on from this diagnosis, recognising that asset purchase policies after the 2009 global financial crisis did not lead to inflationary upsurges. It has become clearer that central bank money is not lent on through a fixed money multiplier (as textbooks may suggest). In situations where central banks are constrained by the zero lower bound or where money creation is sterilised, asset purchases are unlikely to lower interest rates materially and drive up inflation.

There are nonetheless inflationary risks in several scenarios. As discussed, asset purchases create risks for central banks, which could dilute their commitment to price stability. If the solvency of central banks is undermined by losses on asset holdings or by sterilisation costs, then it might be necessary to request recapitalisation by the government, potentially compromising central bank independence. A central bank's reputation could also suffer in the public eye if it were accused of losing money or being bankrupt. Finally, it is possible that government could become dependent on central bank financing and might be able to co-opt monetary policy to this end, creating a situation of fiscal dominance. There are many historical examples of states which dealt with fiscal unsustainability by giving up price stability.

It is also possible that asset purchases could drive up inflation for more technical reasons. While it is possible to sterilise bank reserves in abundant quantities, as the Board of Governors of the Federal Reserve System has demonstrated with its policy of paying interest on excess reserves, not all central banks have developed the tools to sterilise large-scale money creation and thereby retain control of policy rates (assuming they are set above zero). In South Africa, for instance, reverse repos and SARB debentures have not always attracted adequate uptake, weakening the SARB's ability to sterilise even moderate amounts of liquidity. Inadequately sterilised liquidity interventions could impair monetary policy transmission and drive up inflation.