Monetary and fiscal policy interactions in the wake of the pandemic

Bank of Thailand
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Abstract

Covid-19 poses enormous challenges to many countries around the world, including Thailand. Fiscal and monetary policy interactions were necessary to ensure swift economic recovery. Thailand was fortunate to possess strong initial conditions prior to the crisis with a low public debt level, strong financial institutions and robust external position. These factors allowed macroeconomic policies to mitigate large economic shocks. Coordination among public authorities became more prominent without compromising the Bank of Thailand's independence. Fiscal policy played an important role in supporting income recovery, while monetary and financial policies were essential in improving balance sheets of businesses and households. Despite increasing public debt in the short-term, to the extent that substantial fiscal stimulus accelerates economic recovery it would lower public debt-to-GDP in the medium-term. Nonetheless, fiscal reforms were necessary to ensure fiscal sustainability in the long-term which would provide a cushion against future crises. Given Thailand's financing structure and current challenges, measures such as large-scale asset purchases were deemed inappropriate at this juncture, whereas soft loans and credit guarantee schemes would directly address the liquidity distribution problem currently faced by small and medium-sized enterprises.

JEL classification: E52, E58, E61, E62.

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1. Interactions between monetary and fiscal policies

The Covid-19 pandemic induced unprecedented and severe effects on countries around the world. Large negative shocks disrupted economic activity in almost all sectors, while simultaneously increasing the stock of debt and reducing the flow of income. The Thai economy has also been hurt because of its reliance on tourism and exports, which exacerbated already elevated household debt. This poses enormous challenges to policymakers who must combat and mitigate the adverse impacts of these unprecedented shocks efficiently. Interactions and policy coordination between monetary and fiscal policies are necessary to ensure swift economic recovery and to promote economic resilience and sustainability.

Fortunately, Thailand entered this crisis with relatively strong initial conditions, which offered some degree of shock absorption and therefore some room for policy manoeuvres. First, given the low level of public debt prior to the pandemic, the government had sufficient fiscal space to promptly introduce relief measures and stimulus packages to support the economy in a countercyclical manner without a significant threat to sustainability (at least in the short run). Second, financial institutions were equipped with strong balance sheets, reflected by an average BIS ratio of 19.4% among commercial banks registered in Thailand at the end of 2019. This enabled banks to withstand the shocks and maintain their financial intermediary roles during the crisis. Third, solid external positions on the back of a strong current account continued to register surpluses, as well as ample international reserves relative to short-term debt – all of which helped to insulate Thailand against the risk of capital flight.

Various ratios indicate sound pre-Covid-19 conditions for Thailand — Table 1

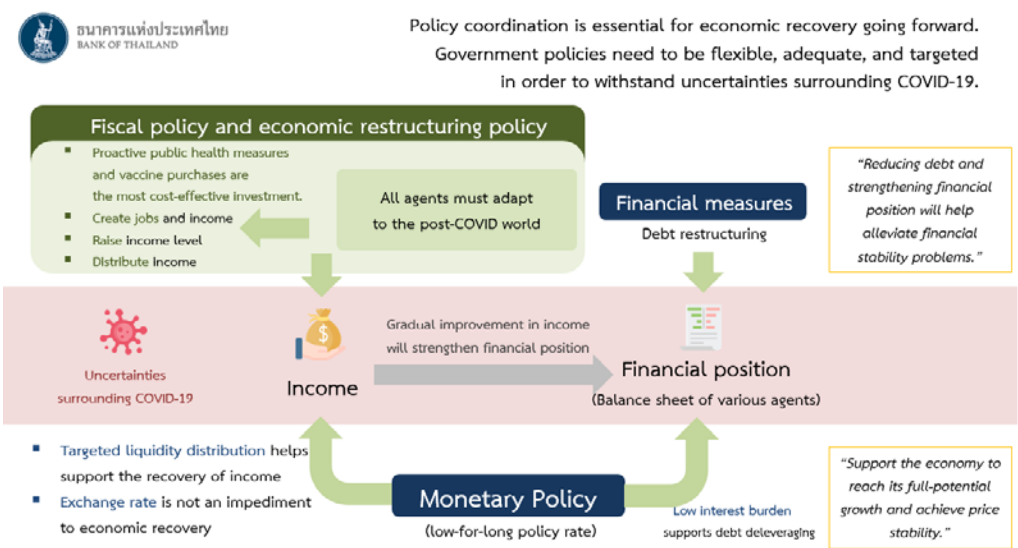
Key ratios		Pre-Covid-19 (end-2019)	Latest (Q3 2020)
Fiscal sustainability	Public debt to GDP ratio (%)	41.2	49.4
Financial institution stability	BIS ratio (%)	19.4	19.4
External stability	Foreign reserves (US$ billion)	259.0	275.2
	Foreign reserves to short-term external debt (times)	4.3	4.5

Sources: Bank of Thailand and Public Debt Management Office

Policy coordination between fiscal authorities, public agencies and the central bank during this crisis was enhanced without compromising central bank independence. In normal times, the Bank of Thailand (BOT) coordinates with the Thai government and other regulatory agencies to support economic growth and promote stability. For example, the price stability objective is agreed upon in the form of a memorandum of understanding (MOU) regarding the annual and the medium-term inflation target between the Monetary Policy Committee (MPC) and the Ministry of Finance every year. During this crisis, the coordination became more prominent in several ways.

Fiscal policy, monetary policy and financial measures synchronised and complemented each other (Graph 1). These measures supported flows of income and repair of private sector and household balance sheets, which in turn helped to mitigate economic scars and maintain economic resilience. Fiscal policy played a major role in supporting flows of income. During the pandemic targeted income transfers and various incentive measures helped sustain employment. In the aftermath of the pandemic, government facilitated economic restructuring should provide an uplift the country's productivity in response to the changing environment.

Policy coordination between fiscal and monetary policies | Graph 1



Sources: Bank of Thailand and Public Debt Management Office

Meanwhile, monetary policy provided immediate support to private sector balance sheets via lower interest burdens. Thailand was among the first central banks to lower the policy rate in response to the pandemic. Also, debt restructuring and debt holidays were crucial in repairing balance sheets and facilitating deleveraging. These policies were designed to secure output, price and financial stability objectives. At the same time, to ensure adequate liquidity distribution to firms and households in need, the BOT closely coordinated with government agencies to ensure the credit channel was functioning well. A policy mix of the BOT's soft loan programme in conjunction with the government's credit guarantee scheme helped to ensure that ample liquidity in the financial system could be distributed to those in need, especially to SMEs which tend to face higher credit risks than large corporates. Overall, these policies were holistically designed to secure output, price and financial stability objectives.

2. Fiscal deficits, public debt and fiscal sustainability

As fiscal policy plays a crucial role in supporting the flows of income in the economy, the Thai government launched a series of stimulus packages worth approximately THB 2.6 trillion[1] or 15% of GDP. One of these packages was a THB 1 trillion baht Emergency Decree Loan for a public health plan, a financial relief plan and an

[1] This included three phases of stimulus packages approved by the Thai cabinet between March and April 2020 and additional measures launched in the period January–February 2021.

economic restructuring plan which would be expedited as necessary over the period 2020–2021. Another included financial relief measures of approximately THB 400 billion through tax reliefs, financial assistance from the social security fund via direct transfers and a reduction in the required contribution, together with financial support from public utility companies including a reduction of utility bills and refunding meter deposits. The third was a provision of liquidity support totalling THB 1.2 trillion, including a collaboration between the Ministry of Finance, the BOT's THB 500 billion soft loan programme, the setup of the THB 400 billion corporate bond stabilisation fund (BSF) and the specialised financial institutions' soft loans and credit guarantee schemes.

The sizable fiscal response was possible because of the strong fiscal position Thailand was in prior to the pandemic. Notably, the fiscal deficit had been lower than 4% of GDP over the past 10 years. The public debt[2] remained well below 60% of GDP over the past decade. As of December 2019, public debt stood at 41.2% of GDP. Thailand's public debt is subject to minimal risks given: (1) the average remaining time to maturity is approximately 10 years; (2) most public debt is subject to fixed interest rates; and (3) almost all of the public debt is denominated in Thai baht. Almost all foreign currency debt was hedged against foreign exchange risks. Moreover, the management of fiscal policy and positions was further enhanced by the enactment of the Fiscal Responsibility Act, B.E. 2561 (2018), which set up fiscal rules and guidelines to ensure fiscal discipline including more transparent public spending practices and better governance for overall fiscal management.

An example of fiscal rules under the Fiscal Responsibility Act, B.E. 2561 (2018) Table 2

Fiscal rule		**Recent threshold**
Public debt	Public debt outstanding*	< 60% of GDP
	Foreign currency debt*	<10% of public debt
	Foreign currency debt service*	<5% of exports of goods and services
	Government debt service*	<35% of government annual revenue
Government expenditure	Principal repayment*	2.5-4.0% of total annual budget
	Capital expenditure	>20% of annual budget and not less than the budget deficit
Quasi-fiscal measures	Outstanding of compensation for expenses/revenue loss*	≤30% of total annual budget

* These ratios are set by the Fiscal Policy Committee.

Source: Fiscal Responsibility Act, B.E. 2561 (2018) and related notifications issued by the Fiscal Policy Committee

Nevertheless, public debt increased significantly during the Covid-19 crisis. Thailand's public debt-to-GDP ratio increased from 41.2% in December 2019 to 51.8% in December 2020 and was projected to reach 57.6% by 2022, due to the fiscal stimulus packages and lower government revenue collections.[3]

2 According to the Public Debt Management Act, B.E. 2548 (2005), public debt means a debt incurred by the Ministry of Finance, a state agency or a state enterprise through the raising of loans or a debt guaranteed by the Ministry of Finance but does not include debts of state enterprises which conduct money lending business, asset management business or credit insurance business where such debt is not guaranteed by the Ministry of Finance, as well as debt incurred by the Bank of Thailand.

3 According to the medium-term fiscal framework for the fiscal year 2022–2025.

Rising public debt in the short term would not pose a threat to fiscal sustainability in the medium term given a rebound in economic activities after the pandemic ends. The public debt-to-GDP ratio could be stabilised if the economy expands at a faster pace than public debt after the pandemic abates. After the 1997 Asian Financial Crisis, Thailand's public debt-to-GDP ratio declined to 47.5% within three years, down from the peak of 57.8% in fiscal year 2000.[4] This was mainly attributed to a strong rebound in economic activities after the crisis, although the government continued to run budget deficits every year afterward, except for the fiscal years 2005 and 2006 when balanced budgets were introduced.

Going forward, an earlier than warranted fiscal cutback could entail a greater risk of derailing the much needed economic recovery and would be likely to incur larger fiscal costs in the future. This is because other economic engines are not expected to recover rapidly while the economic outlook remains highly uncertain, with a considerable number of downside risks. As such, it is crucial that flexible fiscal policy is continuously put in place and borrowings are effectively spent to alleviate the adverse impacts and prevent economic scars which would potentially put the economy into a prolonged sluggish recovery. If this happens, more stimulus would be needed from the fiscal authorities, which could be far more costly.

Fiscal reforms are indispensable to ensure fiscal sustainability in the long term**.** Once the outbreak subsides, fiscal policy should have a greater emphasis on economic restructuring, such as upskilling and reskilling of existing labour, and accelerating infrastructure investment. These policies are key to maintaining the productive capacity of the Thai economy. Moreover, the Covid-19 crisis highlighted the importance of having sufficient fiscal space to cushion unprecedented shocks. Once the economy returns to normal, the government should expedite fiscal reforms ensuring that sufficient fiscal space is available by improving the imbalance between government revenue and expenditure. This imbalance between revenue and expenditure would be likely to deteriorate sooner than expected due to the impaired balance sheet of the private sector and rapid transition to an aging society. These developments further require the government to play an important role in improving income distribution and strengthening the social protection system. Fiscal reforms are crucial to ensure fiscal sustainability and provide the government with resources to fulfil its objectives for years to come.

3. The need for large-scale asset purchases (LSAPs) in the case of Thailand

In the previous financial crisis, many central banks adopted unconventional monetary policies, including large-scale asset purchases (LSAPs) and yield curve control. In general, such unconventional monetary policies are implemented mainly to provide further accommodation when conventional tools face constraints (eg when the effective lower bound is reached) and to address financial market dysfunction.

Given weaker economic conditions and lower fiscal and monetary policy spaces following the Covid-19 pandemic, some central banks have started to employ LSAPs

4 World Economic Outlook Database, IMF.

more aggressively and, specifically, adopt direct monetary financing to fund fiscal deficits.

Bond purchases by the BOT are warranted if they are in accordance with fulfilling the price, output and financial stability mandate. Bond buying with the intention of monetary financing is prohibited by law. Since 1999, the BOT has regularly participated in government bond purchases as part of its open market operations to ensure that money market interest rates move consistently with the announced policy rate.

In March 2020, the BOT engaged in government bond purchases to enhance liquidity in the financial markets in response to excessive yield volatility and runs on money market funds. In addition, the BOT established the Mutual Fund Liquidity Facility (MFLF) and the BSF as temporary facilities to provide liquidity for mutual funds through commercial banks and to provide bridge financing to high-quality firms with bonds maturing during 2020–2021 at the higher-than-market rate.

These measures were designed to stabilise the volatile bond market and not to provide further stimulus by lowering long-term yields. Consequently, the outstanding transactions of the MFLF has been zero since the end of November 2020 while the BSF has never been drawn. This indicates that the facilities served their purposes in rebuilding confidence and reducing panic in the financial markets.

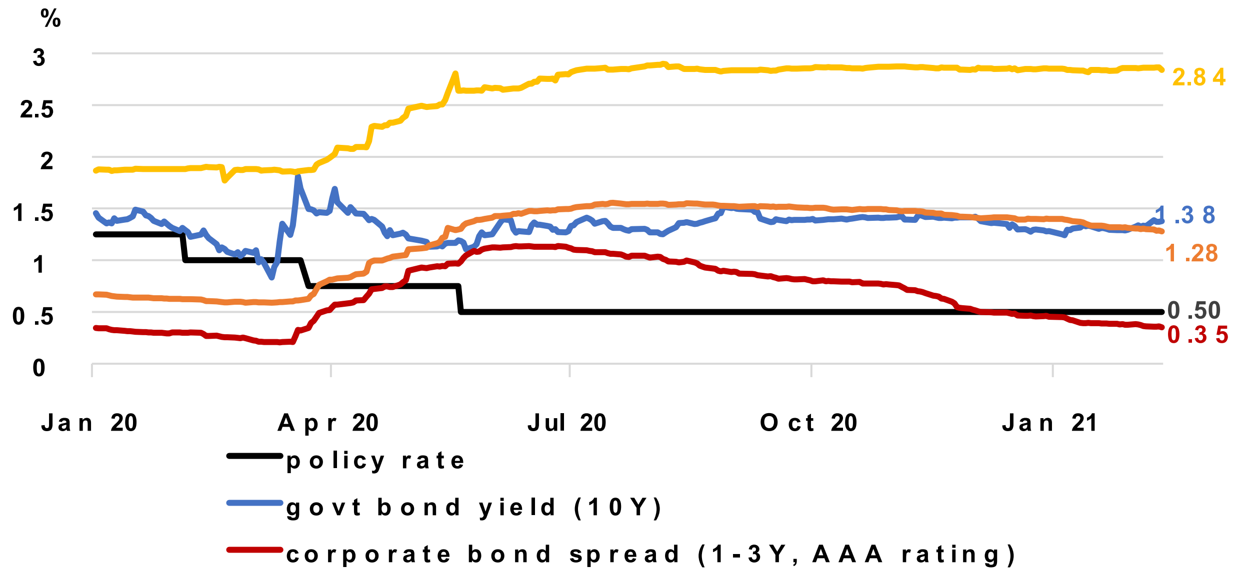
For Thailand at this juncture, employing LSAPs to provide further accommodation would not address the uneven liquidity distribution problem and would only provide limited benefits compared with measures that work through the banking system channel. Overall liquidity in the financial system remains ample but the challenge is to channel the liquidity to those who need it most. More than 70% of non-financial corporate debt has been financed through bank credit, while only large corporates have access to the bond market. Thus, LSAPs – which help to lower funding costs by lowering bond yields and inject liquidity into the private sector – would only benefit large corporates who do not have liquidity shortages and could worsen inequality problems. The bond market continues to function well. Bond yields are already low, in line with the low level of the policy rate and the easing global financial conditions. Liquidity distribution is a key challenge for Thailand and measures that reduce credit risks are desirable. A combination of soft loans and credit-guarantee schemes are more relevant in boosting the effectiveness of policy transmission through the credit channel. Furthermore, benefits of an LSAP to emerging market economies may not be as large as in advanced economies; whereas the costs, especially to financial stability in the longer run, may pose larger concerns to policymakers.

Finally, the rising fiscal burden would not constrain monetary policy or affect the BOT's monetary policy operations. The central bank and the fiscal authorities understand the importance of the common goal-integrated mandate to achieve macroeconomic stability. During the Covid-19 crisis, the BOT and the Public Debt Management Office have been collaborating on public sector bond issuance. In particular, the BOT suspended several central bank bond tenors to accommodate government bond issuances, taking into account the government's rising financing needs during the pandemic. This ensures suitable bond supply and minimal effect on market yields.

Strong macroeconomic stability prior to the Covid-19 crisis and sound policy coordination between monetary, fiscal and public health authorities enabled Thailand to issue timely policy packages in response to the crisis. This policy coordination has become more prominent and complementary. Legal provisions and sound macroeconomic performance allowed the BOT to maintain independence.

Amid high uncertainty surrounding the crisis, policymakers saw the importance of scenario planning and policy coordination, where policies need to be flexible to withstand such uncertainties.[5] The monetary and fiscal authorities will continue to work closely to ensure smooth monetary policy normalisation and fiscal consolidation to achieve sustainable growth and restore policy space for any future need.

Bond yields remained low in line with the policy rate — Graph 2



Source: Bank of Thailand, the Thai Bond Market Association (ThaiBMA)

[5] For example, the THB 1 trillion loan decree allows for the reallocation of the budget to cater to different objectives.