Box B

The Policy Response of Central Banks in Emerging Market Economies to COVID-19

Global financial conditions tightened noticeably at the onset of the COVID-19 crisis, placing significant strain on emerging market economies (EMEs). Government and corporate bond yields rose sharply, and exchange rates depreciated alongside substantial portfolio outflows. In response, and in contrast to some previous crisis periods, central banks in these economies implemented a broad range of easing measures. Together with the fiscal response of EME governments and the actions of governments and central banks globally, these measures contributed to the stabilisation of many, though not all, emerging financial markets and improved economic conditions more broadly.[1] This box outlines the key features of the monetary policy response of EMEs outside China to the COVID-19 crisis, acknowledging that there has been a diversity of experience and in many countries long-term challenges related to health outcomes, economic growth and financial stability remain.

Reducing policy rates

Central banks in EMEs lowered their policy rates substantially between March and July this year to ease financial conditions and support economic growth. As a result of the reductions in policy rates, as well as expectations that rates will remain low for some time, local currency government bond yields have declined to historic lows in many EMEs, thereby reducing borrowing costs more broadly. In contrast, a few EMEs such as South Africa and Turkey continue to face borrowing costs that are substantially higher than at the start of the year, reflecting elevated concerns about their economic outlooks and the capacity of policy makers in those economies to respond to any further significant shocks.

Historically, many EME central banks have not lowered their interest rates by as much as current economic conditions by themselves would warrant because of the potential for a large exchange rate depreciation and adverse consequences that could follow from that. While a depreciation typically supports the economy through net exports it can also lead to large and persistent increases in inflation when inflation is not well-anchored. Higher inflation can reverse some or all of the benefits of a nominal depreciation for the price competitiveness of an EME's domestically produced goods. Moreover, for economies with substantial foreign currency borrowing, a depreciation in the exchange rate can increase the cost of servicing and repaying debt that is unhedged. Similarly, a decline in interest rates and depreciation of the exchange rate can encourage large-scale portfolio outflows, making it difficult to roll over external funding.

Over recent decades in many EMEs central bank independence has increased and central banks have improved their policy frameworks, which has in turn helped to contain inflation and anchor inflation expectations. Local currency financial markets have also developed in many EMEs and central banks have accumulated substantial foreign exchange reserves. These developments have reduced the difficult trade-offs that many EME central banks have faced in the past and increased their scope to ease monetary policy this year. Indeed, the scale of the declines in EME policy rates this year is in sharp contrast to the Asian Financial Crisis and some more recent periods when EME policy rates were generally *increased* at times of tightening financial conditions for emerging markets (Graph B.1 and Graph B.2).

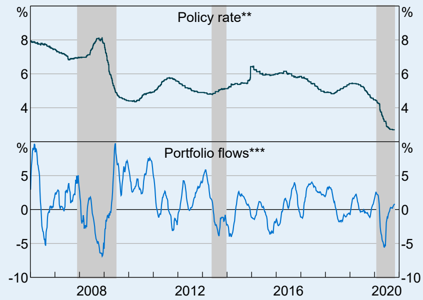
Large declines in inflation this year for many EMEs have also reduced the trade-offs EME central banks have faced, as has the large easing of monetary policy in advanced economies, which reduced currency depreciation and capital outflow pressures on EMEs. However, a few EMEs have not had benign inflation outcomes this year, and this has posed challenges for monetary policy. Turkey has experienced a large depreciation of the exchange rate and high inflation, and the central bank has responded recently by increasing policy interest rates. Argentina has also experienced continued high inflation and exchange rate depreciation. In India, recent high inflation is expected to be temporary, but the central bank has indicated it is an obstacle to the provision of further monetary stimulus.

Foreign exchange market intervention

EME central banks intervened extensively in the foreign exchange market during the most acute phase of the COVID-19 crisis to support their currencies. These interventions dampened financial stability risks that can arise from sudden increases in the value of foreign currency obligations. Estimates from the International Monetary Fund (IMF) suggest that while the scale of intervention in March was the largest in US dollar terms since the global financial crisis, the accumulation of reserves over the past decade meant that it was a less significant event when measured relative to the total stock of available reserves.[2] As conditions in emerging markets have stabilised of late, intervention to support currencies has been

Graph B.1

Emerging Market Policy Rates and Portfolio Flows*



* Shaded areas show approximate periods of the Global Financial Crisis, Taper Tantrum, COVID-19

** Average of India, Indonesia, Malaysia, Philippines, Thailand, Brazil, Chile, Mexico, Russia, South Africa

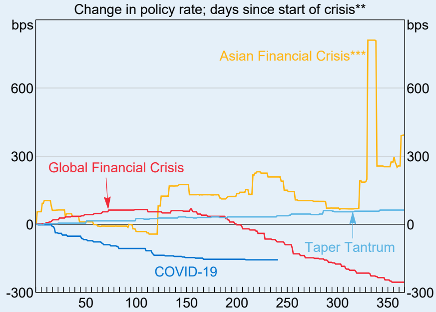
*** One-quarter rolling sum of net inflows to emerging market investment funds; per cent of assets under management

Sources: BIS; EPFR Global; RBA

Graph B.2

Emerging Market Policy Rate Responses to Crises*

Change in policy rate; days since start of crisis**



* Average of India, Indonesia, Malaysia, Philippines, Thailand, Brazil, Chile, Mexico, Russia, South Africa

** Approximate start dates of Asian Financial Crisis 2 July 1997; Global Financial Crisis 1 July 2008; Taper Tantrum 22 May 2013; COVID-19 1 March 2020

*** Average of India, Malaysia and Philippines only

Sources: BIS; RBA

scaled back and some countries, particularly in the Asian region, have been accumulating foreign exchange reserves.

EME governments did not rely heavily on measures to restrict capital flows during the COVID-19 crisis. In the past, some EMEs have placed restrictions on capital outflows to reduce currency depreciation pressures but these measures can also reduce the availability of external financing over the longer term.

Supporting government bond market functioning

Most EME central banks have purchased local currency government bonds this year to address disruptions to market functioning; many purchased government bonds in secondary markets for the first time. Central bank purchases have contributed to a normalisation of conditions, helping to offset the sudden and large retreat of foreign investors from EME local currency government bonds, which had contributed to declines in liquidity and sharp increases in yields.[3]

In most cases, bond purchases by EME central banks have been equivalent to 0.5–1.5 per cent of GDP, which is much less than the case of central banks in advanced economies. The EME purchases have been focused on addressing market dysfunction, whereas asset purchases in advanced economies have also sought to provide a broader easing of financial conditions by lowering longer-term risk-free interest rates. Government bond markets are also generally smaller as a share of GDP in emerging economies than in advanced economies. Notably, government bond purchases by EME central banks have been generally modest even though fiscal deficits in EMEs have increased substantially and government bond issuance has increased accordingly.

Many EMEs with US dollar obligations were also exposed to the dysfunction in US dollar markets in the early period of the crisis. The US Federal Reserve established temporary US dollar liquidity arrangements with a group of central banks including Brazil, Mexico and South Korea, allowing them to provide US dollar funding to their local markets. Other EMEs also benefited because the swap lines reduced some of the excess demand for US dollars. The broader monetary policy easing in advanced economies also reduced US dollar funding pressures for all EMEs.

Purchases of government debt at issuance

A couple of emerging market central banks have purchased government bonds directly from the government fiscal authority. In contrast to other purchases by central banks, these direct purchases have been made in the primary market: at the fiscal authority's auctions or by direct non-competitive transactions between the fiscal authority and the central bank.

In addition to its existing bond buying program, Bank Indonesia announced a deficit burden-sharing arrangement with the Indonesian Ministry of Finance in July under which Bank Indonesia will purchase government bonds in the primary market. The value of bonds purchased will be between 2½ and 6 per cent of GDP depending on the final implementation of the program and demand for the bonds from investors. The central bank's purchases have been split into three parts and directly linked to components of the government's fiscal response to the COVID-19 crisis including health and social security spending, and support for businesses. The government and central bank have indicated that two of the three parts of the central bank's purchases are limited to purchases in the current fiscal year.

In the Philippines, the central bank has purchased government bonds equivalent to 3 per cent of GDP directly from the Philippines Treasury through a provisional advance facility. The limit on the size of this facility was increased this year to 30 per cent of average government revenues over the previous three years (from 20 per cent), and will remain at the higher level for two years.

While the direct purchases of government bonds by Indonesia and the Philippines have raised some concerns about central bank independence, the response in financial markets has been muted thus far. To the extent that these programs are temporary measures, this should reduce concerns regarding central bank independence.

Supporting the flow of funding to businesses

EME central banks have generally focused their monetary policy operations on lowering funding rates for governments and financial institutions. In some emerging markets, central banks have also offered term funding facilities, refinancing programs or loan guarantee schemes, often targeted towards small and medium enterprises. However, these programs have generally been modest. Corporate asset purchase programs have been established by a limited number of EMEs. ✈

Endnotes

[1] An alternative discussion of EME's policy response including comparisons to the advanced economy response is available in Bank for International Settlements (2020), 'Annual Economic Report 2020'. Available at <bis.org/publ/arpdf/ar2020e.htm>.

[2] For more information on foreign exchange reserve operations by EMEs, see IMF (2020), 'GMM Box: Update on EM Reserve Operations', *Global Markets Monitor*, 9 July. Available at <https://www.imfconnect.org/content/dam/imf/News%20and%20Generic%20Content/GMM/archive/GMM%20July%209,%202020.pdf>.

[3] For a discussion of the nature and impacts of EME central bank purchases of government bonds, see IMF (2020), 'Global Financial Stability Report', October, Chapter 2. Available at <imf.org/en/Publications/GFSR/Issues/2020/10/13/global-financial-stability-report-october-2020#Chapter2>.