COVID 19: Tools used by Central Banks as Monetary Response

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Preamble

Central banks were suddenly confronted with the challenge of responding to the Covid shock in early 2020, when many economies were still struggling to boost inflation a decade after the Global Financial Crisis (GFC). The hastiness and speed of the economic deterioration, the sharp increase in market volatility and the unprecedented uncertainty about the impact of the pandemic in an environment of already low inflation; motivated reaction from central bank that was unprecedented in terms of its speed, scope, and size. This was not a standard recession; triggered by overheating or financial excesses; it was akin to an induced economic deterioration. A different recession requiring a different response.

Short-term rates quickly fell to around zero in all advanced economies where they were already at low levels. Emerging markets also experienced sharp declines in short-term rates, approaching zero in several countries. Central banks were faced with the challenge of supporting real economies and stabilising financial markets through tools other than reductions in their main policy rates. Although there was widespread agreement that fiscal policy and policy on public health would play the lead role in fighting the pandemic and generating a recovery; monetary policy still had a critical role to play as markets froze. Capital flows to emerging markets collapsed, and economic activity came to a halt. Central banks quickly turned to the measures adopted during the Global Financial Crisis. They revived tools and facilities that had previously been developed, and then expanded on them and introduced an entirely new set of programmes to support additional segments of the economy.

Response from Central Banks

A global sudden stop of economic activity caused by a pandemic was the main problem presented by Covid shock that had never been faced before. It was an environment of unprecedented uncertainty that made forecasting growth and inflation extremely challenging. Indeed, a few central banks, such as the Federal Reserve (FED), the Bank of Canada (BoC) and the Bank of England (BoE), did not provide their usual forecasts in the initial phase of the pandemic because of this outsized uncertainty. In addition, financial markets reacted sharply and violently to the shock with a 'flight to cash' response that generated dislocations even in the most liquid US Treasury market. These market distortions raised concerns that the channels through which monetary policy usually worked might not turn out to be effective as expected.

The response of central banks in emerging market economies (EMEs) reflected several specific factors faced by those economies. An important aspect was that in early 2020, most EMEs were at a relatively low point of the business cycle, with aggregate demand generally below potential. Moreover, broad based and bold actions by central banks in AEs during spring curbed the appreciation of the US dollar and calmed the turmoil in global financial markets. The subsequent easing of financial conditions in EMEs helped their central banks orient monetary policy towards domestic objectives namely support of aggregate demand despite large capital outflows and sharp currency depreciations.

Tools deployed by Central Banks as a part of Monetary Response

In response, central banks acted quickly and aggressively, deploying a range of tools in a multidimensional strategy to address overlapping challenges. These tools can be roughly divided into four categories:

1. **Rate cuts and forward guidance** to ease stress in markets as well as support aggregate demand and help economies to rebound.
2. **Asset purchases** to address widespread dysfunction in key financial markets and, later, to provide additional support for aggregate demand.
3. **Liquidity provision and credit support** (lending to financial firms, purchases of corporate securities, direct lending to nonfinancial firms, and 'funding for lending' type programmes to support bank lending), often done in conjunction with governments, to support the provision of credit to businesses to ensure that viable firms could survive the crisis and be able to ramp up production and support employment once the crisis ebbed.
4. **Regulatory easing** such as reductions in the countercyclical capital buffer (CCyB) and other reductions in requirements for liquidity and capital buffers, to ensure banks would not amplify the contraction in credit and liquidity to meet regulatory standards.

Rate Cuts and Forward Guidance
Within few weeks, central banks with policy rates above the lower bound (FED, BoC, BoE) cut rates aggressively to their respective Effective Lower Bounds (ELB). Emerging markets were able to cut policy rates more aggressively, with some hitting their ELBs (such as Chile and Poland).

There was a sharp reduction in policy rates in countries that had space to lower rates; as against the lack of reduction in countries with rates already around zero. Many central banks augmented these reductions in policy rates with forward guidance, partly to compensate for the smaller amount of space available to reduce rates. Reflecting the unprecedented uncertainty of the situation, this forward guidance was initially open ended and not very precisely defined (linked to economic outcomes).

A few central banks went ahead giving the guidance with an implicit or explicit calendar guidance dimension (BoC, RBA) and adopting a yield curve control strategy to reinforce it. EM central banks were more cautious in the use of forward guidance in part because most were still above the ELB. Some of them, however, such as Brazil, used explicit forward guidance as an alternative to cutting rates lower.

Asset purchases
Asset purchases took a variety of forms, depending on the specific needs, history, and institutional framework of each country. Initially some central banks in advanced economies (Fed, BoC, BoE) focused on buying government securities with the main objective of alleviating dealers' balance sheet risk limits and easing market dislocations. The ECB launched the PEPP, which allowed for greater flexibility in the timing and distribution of purchases, with the purpose of ensuring that the effects of monetary policy were transmitted across all jurisdictions. The BoJ removed the upper limit on Japanese Government Bond (JGB) purchases and increased the size of its existing programmes of purchases of private assets, remaining the only central bank buying equities via exchange-traded funds. Number of central banks ventured into purchasing private assets or into subnational bonds (FED, BoC, RBI). Other central banks, like the RBA, adopted yield curve control, a strategy of committing to buying assets as needed to pin down a point in the yield curve, followed by a QE programme. India adopted its version of Operation Twist, which involved the simultaneous purchase of long-term government securities and selling corresponding short-term securities in a liquidity neutral fashion to compress the term premium and reduce the steepness of the yield curve along with open market purchases (GSAP -Government Security Acquisition Program)

Some of these asset purchase programmes became quite large and were carried out with unusual speed. For example, the holdings of government bonds of the Riksbank, BoC and BoE rose to over 40% of total government bonds outstanding, while Federal Reserve holdings of government and agency mortgage-backed securities rose by more than $2 trillion between mid-March and mid-June 2020.

A few countries acted not only the size of the programmes, but also the speed with which the bonds would be purchased. For example, the BoE bought government bonds at almost twice the pace as in the initial phase of QE during the GFC.

Among the emerging markets asset purchase strategies, there was substantial variation in which assets and even how they were purchased. For example, Chile purchased bank bonds, central bank notes, and term deposits (but not sovereign debt), while other EM central banks purchased sovereign debt in either the primary or secondary markets.

Liquidity Provision and Credit Support
Most central banks provided liquidity to banks and other financial institutions to help address emerging pressures in financial markets and mitigate any constraints on the availability of credit. These programmes commonly extended term credit under different configurations of cost and collateral requirements. In many cases, this involved an expansion in the types of entities eligible for support, including nonbank lenders and broker-dealers.

In addition, many central banks introduced programmes to support the availability of credit to a range of private sector companies, including nonfinancial companies. These programmes were intended to help ensure that viable companies could obtain the credit they needed to withstand the pandemic and restart growth once it ebbed. As noted earlier, in some cases central banks provided such credit through asset purchases, including purchases of commercial paper and corporate bonds (Fed, BoE, BoJ, BoC, and ECB). In addition, some central banks purchased shares of bank loans to businesses (the Fed's Main Street Lending Program) or extended loans in foreign currency (Riksbank, BoJ).

To achieve the same goal, many central banks also introduced programmes under which low-cost central bank funding was provided to lenders that increased their credit to the private sector or to specific sectors that have less access to corporate securities markets and are more reliant on banks (TLTRO by RBI etc.). In some cases, similar incentives were provided using targeted reductions in reserve requirements. In many countries, including in most of the EU, governments complemented these lending schemes with programmes of loan guarantees.

Some of these lending schemes amounted to quasi-fiscal operations or had goals outside traditional central bank mandates. For example, the ECB's pandemic emergency targeted longer-term refinancing operations (PETLTRO) programme which offered term loans to euro area banks at a rate below the ECB's deposit rate, offered an implicit subsidy of up to 50 basis points to banks. The PBOC provided a round of special central bank lending to facilitate issuing loans for 7,597 enterprises "which supported production and transportation of medical supplies and basic supplies". Similarly, the BoJ's decision to offer to pay a positive rate of 0.1% on the excess reserves of regional banks that reduce overhead costs or engage in mergers or business integration, while an incentive for the reform of Japan's regional banks, was an example of industrial policy carried out by the central bank. These quasi-fiscal operations may be justified as a second-best option; if the governments are not pursuing effective policies in a time of stress, the central bank can step in but raise questions about potential overreach of central banks beyond their mandates.

Most central banks also communicated explicit support for expansionary fiscal policy to support their economies. While this was easier to justify due to the nature of the shock and the very low level of interest rates, it represented a break from the past behaviour of many central banks, which generally either did not talk about fiscal policy or recommended fiscal consolidation. Instead, central banks actively supported their governments' large fiscal packages, and at times appeared to be explicitly coordinating monetary and fiscal policy. This blurring of the line between monetary and fiscal policy was not limited to advanced economies – the government and the central bank in Indonesia issued joint decrees to coordinate the financing of the Covid-related deficit.

Regulatory Easing

Supervisors in many countries, which in many cases included the central bank, eased regulatory and macroprudential standards to support the provision of credit. This easing mostly came in reaction to the initial market turmoil in March 2020, but also to avoid adverse effects of other policy actions on the flow of credit to households and businesses. This regulatory easing operated in two main areas. The first focus was to soften regulatory capital and liquidity requirements, such as reducing countercyclical or systemic risk capital buffers to allow banks to temporarily operate below required capital and liquidity levels and suspending some constraints on leverage. These were sometimes combined with restrictions on dividend distributions. One prominent example of this easing was the countercyclical capital buffer (CCyB). Out of sixteen countries that had previously set a CCyB above zero, fifteen quickly lowered it in many cases to zero. The second focus was allowing regulatory forbearance on assets and loan valuations, including easing collateral eligibility rules and allowing banks to apply more favourable valuation of assets and lower risk weights for certain loans, as well as providing more flexibility in the treatment of non-performing loans. Prudential supervisors in many countries also encouraged banks to help borrowers affected by the pandemic to restructure loans and grant moratoria on loan repayments to small businesses and individuals.

Summary (Tabular Comparison)

Central bank measures by category																						
		Advanced Economies #											Emerging Asia *									
Tool Type	Measure	US	EA	JP	GB	CA	AU	CH	DK	NO	NZ	SE	CN	HK	ID	IN	KR	MY	PH	SG	TH	VN
Interest	Policy Rate Cut	✓			✓	✓	✓			✓	✓	✓	✓	✓	✓	✓	✓	✓	✓		✓	✓
Lending Operations	Liquidity Provision	✓	✓	✓	✓	✓	✓		✓	✓	✓	✓	✓	✓	✓	✓	✓		✓		✓	
	Targeted Lending	✓	✓	✓	✓		✓	✓			✓	✓	✓			✓	✓	✓	✓	✓	✓	✓
Asset Purchases	Government Bonds	✓	✓	✓	✓	✓	✓				✓	✓			✓	✓	✓		✓		✓	
	Commercial Papers	✓	✓	✓	✓	✓						✓					✓					
	Corporate Bonds	✓	✓	✓	✓	✓						✓					✓				✓	
	Other Private		✓	✓		✓						✓										
Foreign Exchange	USD Swap Line	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓					✓			✓		
	Swaps														✓	✓				✓		
	Spot Intervention							✓						✓	✓							
Reserve Policy	Remuneration						✓	✓			✓		✓		✓							
	Requirement Ratio	✓											✓	✓	✓	✓		✓	✓			
	Compliance																	✓	✓			

US: USA, EA: Euro Area, JP: Japan, GB: Great Britain, CA: Canada, AU: Australia, CH: Switzerland, DK: Denmark, NO: Norway, NZ: New Zealand, Se: Sweden

* CN: China, HK: Hong Kong, ID: Indonesia, IN: India, KR: South Korea, MY: Malaysia, PH:Phillipins, SG: Singapore, TH: Thailand, VN: Vietnam

Source: BIS Working paper

Conclusion

While the pandemic continues, a preliminary assessment suggests that central banks have responded effectively to the initial phases of the Covid shock through a combination of forceful monetary policy that built on the programs first tried in response to the Global Financial Crisis. Further combined with an entirely new set of initiatives to directly support financial markets and provide credit to the economy. This response has entailed an unparalleled expansion of reach well beyond the narrow inflation-targeting focus of most central banks. These programmes were crucial to stabilise economies and financial markets when countries were locked down and while vaccines were developed and rolled out. But this expansion of reach and responsibilities also raises numerous questions about monetary policy and the role of central banks in the future.

Citation

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