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Abstract

Emerging economies are fighting COVID-19 and the economic sudden stop imposed by the containment and lockdown policies, in the same way as advanced economies. However, emerging markets also face large and rapid capital outflows as a result of the pandemic. This column argues that credible emerging market central banks could rely on purchases of local currency government bonds to support the needed health and welfare expenditures and fiscal stimulus. In countries with flexible exchange rate regimes and well-anchored inflation expectations, such quantitative easing would help ease financial conditions, while minimizing the risks of large depreciations and spiralling inflation.

Keywords: Coronavirus, COVID-19, Quantitative Easing, Emerging Markets, Fiscal Stimulus

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COVID-19 has now spread worldwide, and emerging economies have been fighting it with lockdowns and social distancing, in the same way as advanced economies. Brazil, India, and Russia have the highest numbers of confirmed cases after the US, according to the Johns Hopkins University Coronavirus Resource Center. COVID-19 is having even more profound disruptions in these countries due to both the tighter financial conditions and the lower tele-workability of jobs (Dingel and Neiman 2020).

Emerging economies have responded by allowing their currencies to depreciate and easing monetary policy, as they did during the global crisis. Several central banks have gone further and, for the first time, even before reaching the zero lower bound on policy rates, have started to engage in long-term government asset purchases, commonly referred to as quantitative easing (QE) – one of the 'unconventional' monetary policy tools employed by advanced economy central banks since the global crisis (Table 1).[1]

Quite surprisingly, given the conventional view on what emerging economies can and cannot do with their monetary policy, government bond markets and foreign investors have responded quite favourably to these announcements. In fact, long-term interest rates have fallen significantly in all but three cases (Table 1), and exchange rates either appreciated or slowed their depreciation (Table 1 and Arslan et al. 2020).

Table 1 Emerging market central bank announcements of government asset purchases in March and April 2020 and their impact

Country	Central Bank	Announcement Date	Simultaneous Interest Rate Cut? (Yes/No)	Monetary Policy Reference Rate %	3-Day Cumulative % Change In 10-Year Govt		3-Day Cumulative % Change In Exchange Rate	
Emerging Markets Average					-0.42	***	-0.09%	
Korea	Bank of Korea	3/25/20	No	0.75	-0.17	***	1.73%	**
Colombia	Banco de la República	3/24/20	No	4.25	-2.15	***	5.02%	***
South Africa	South Africa Reserve Bank	3/25/20	No	5.25	-0.73	***	-0.65%	
Poland	Narodowy Bank Polski	3/17/20	Yes	3.75	-0.08		-7.08%	***
Poland	Narodowy Bank Polski	4/8/20	Yes	2.75	-0.19	***	-0.12%	
Romania	Banca Națională a României	3/20/20	Yes	1.00	-1.80	***	3.29%	***
Hungary	Magyar Nemzeti Bank	3/24/20	No	0.90	-0.50	***	1.47%	
Hungary	Magyar Nemzeti Bank	4/28/20	No	0.90	-0.59	***	1.80%	**
Croatia	Hrvatska narodna banka	3/13/20	No	na	0.24	***	-1.38%	**
Phillipines	Bangko Sentral ng Pilipinas	3/24/20	No	3.25	-0.55	**	1.05%	***
Mexico	Banco de Mexico	4/21/20	Yes	6.00	-0.26	**	-3.08%	**
Turkey	Central Bank of the Republic of Turkey	3/31/20	No	9.75	0.75		-0.53%	
India	Reserve Bank of India	3/20/20	No	5.15	-0.11		-2.09%	***
Indonesia	Bank Indonesia	4/1/20	No	4.50	0.19		-0.70%	

Note: The table lists sovereign bond long-term asset purchase announcements during the COVID-19 pandemic. The table reports the amount announced, the three-day cumulative change in the country's ten-year government bond yield and the percent change in the bilateral

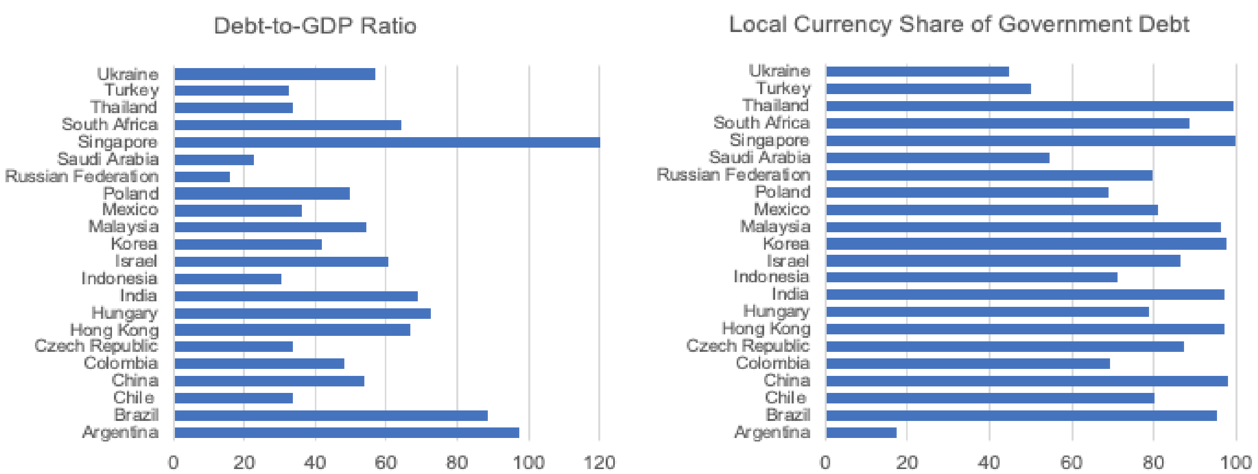
exchange rate versus the US dollar (+ is appreciation) following the announcement, as well the average value across all announcements. * indicates statistical significance at the 10% level, ** indicates statistical significance at the 5% level and *** indicates statistical significance at the 1% level. The table also reports the level of the policy rate on the day before the QE announcement and whether a rate cut was simultaneously enacted.
Source: Hartley and Rebucci (2020), and authors calculations.

While it is too early to say how the pandemic will ultimately affect emerging economies, it is reasonable to expect the same wave of corporate bankruptcies and surging unemployment that currently afflicts advanced economies to different degrees. Furthermore, a subset of commodity-producing emerging economies have seen sharp declines in their export prices (Hevia and Neumeyer 2020). Others have been hit by the collapse of remittances and tourism. Thus, deflation and stagnation risks (Benigno and Fornaro 2018, Blanchard 2020) are bigger than inflation risk in both sets of countries. But emerging economies face unprecedented challenges stemming not only from the pandemic-induced economic sudden stop but also from the traditional sudden stop in capital flows and terms of trade shocks and their more limited ability to borrow.

To complicate matters, IMF resources might not be sufficient as several economies could face simultaneously sizeable financial needs (García-Herrero and Ribakova 2020). International cooperation and coordination aimed at boosting IMF resources or supporting the debt rescheduling or restructuring proposed by Bolton et al. (2020) might come too late.

In this context, how can emerging economies respond to the combination of financial and economic stress induced by the pandemic shock?

Figure 1 Government debt-to-GDP and local currency shares (%)



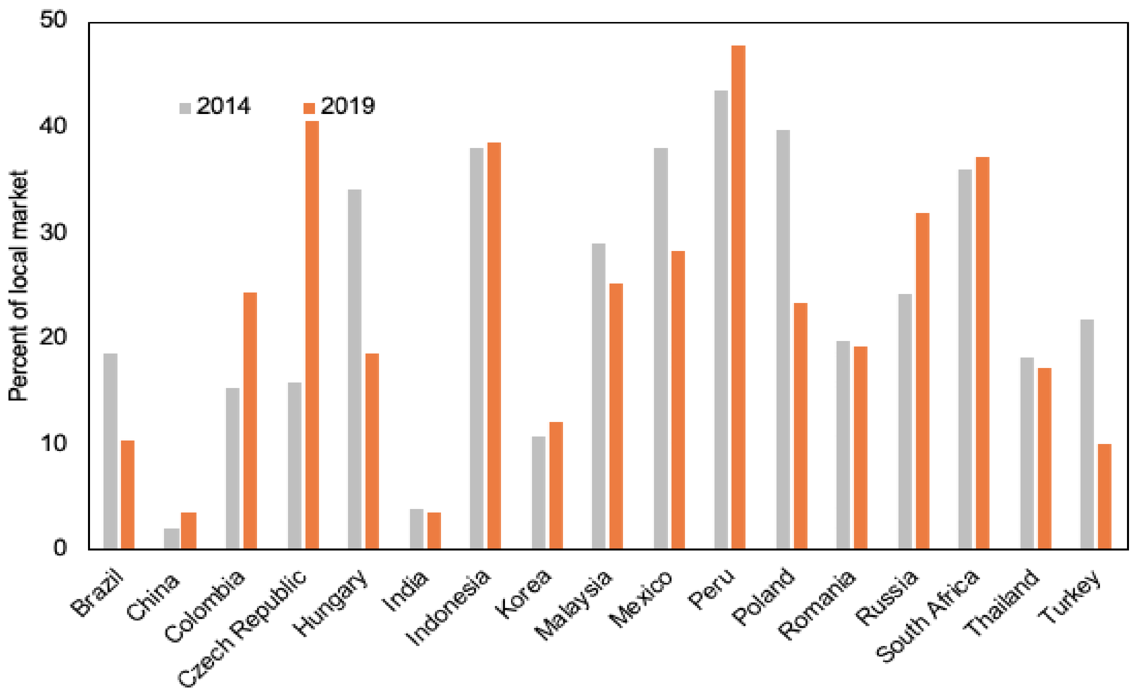
Source: IIF.

The conventional view is that all economies should enact fiscal stimulus to the extent to which they have space to do so, meaning small budget deficits and low levels of government debt to GDP. By this yardstick, fiscal space in emerging markets is limited, with an average share of government debt to GDP of more than 50% at the end of 2019 (Figure 1, left panel) and hence close to historically *intolerable* levels for emerging economies.

Here we argue that emerging economies with a *flexible exchange rate* regime, well anchored inflation expectations, and issuing *local currency* sovereign debt should embrace QE more aggressively with the aim of easing financial conditions and providing monetary financing of the budget deficit.

As noted by Arslan et al. (2020), government bond purchase programmes of the type announced can restore liquidity in the local bond market, thereby lowering the cost of borrowing for the rest of the economy. This is particularly relevant for economies in which foreign investors hold a significant share of the local currency sovereign debt outstanding (Figure 2). In fact, these investors' liabilities are in US dollar giving rise to currency mismatches in their balance sheet (the 'original sin redux'). As a consequence, risk-off episodes can trigger fire sales of local bonds that put pressure on emerging market government bond yields and exchange rates (Carstens and Shin 2019). Emerging market central banks can be purchasers of last resort and preserve liquidity and stability in the local government bond market.

Figure 2 Share of foreign ownership of local government bonds



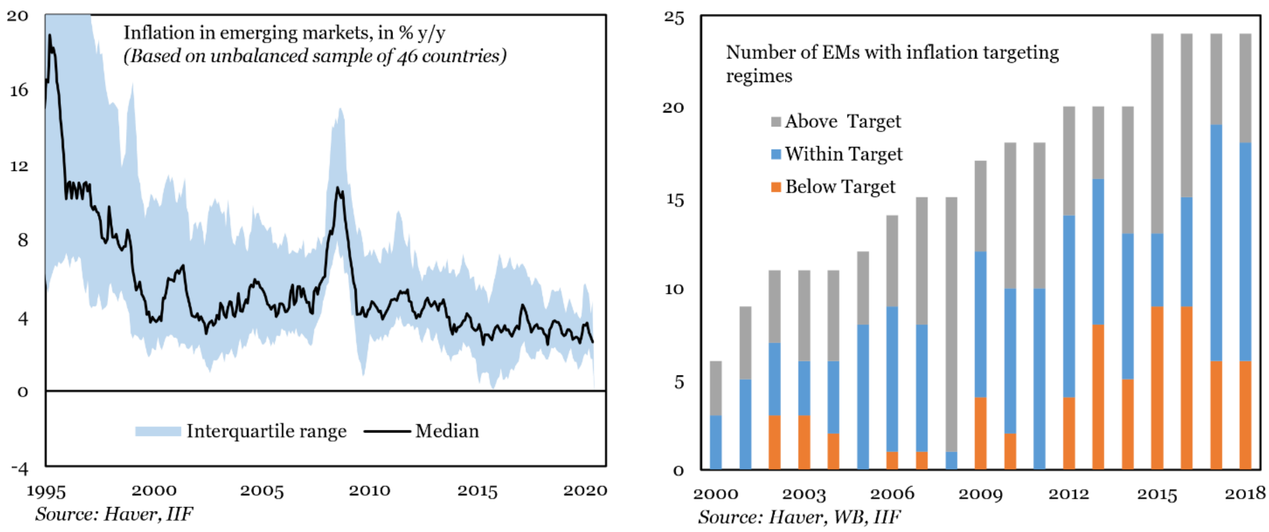
Source: IIF

In addition, QE programmes could effectively provide monetary financing of the budget deficit and therefore can support the provision of the health and welfare services necessary to mitigate the COVID-19 crisis, thereby protecting against deflation and stagnation risks.[2] As long as there is abundant slack in the economy, monetary financed fiscal expansions will not be inflationary. Loosening the domestic monetary policy stance in sync with advanced economies can also help to prevent carry trades and other speculative inflows of short-term capital from destabilising the recovery, once the recession is eventually over.

Many emerging economies operate under a flexible inflation targeting regime, letting their exchange rate float to different degrees, and have long been able to issue sovereign debt in their local currency. This latter critical strength was acquired over the past several years in an attempt to eliminate foreign exchange risk in the government balance sheet and was facilitated by the abundant global liquidity conditions created by the advanced economies' adoption of QE after the global crisis. Indeed, local currency bonds now represent the lion's share of the stock of government debt in these countries, with an average share of local currency debt in total government debt of 79% at the as of end 2019 (Figure 1, right panel).

While QE could help prevent the economy from spiralling into deflation and stagnation, like any aggressive monetary expansion, it can pose risks stemming from the possibility that the exchange rate depreciates excessively and inflation expectations de-anchor. However, inflation is low and stable in emerging markets (Figure 3, left panel). In addition, expectations are well anchored, with many more countries with inflation rates within or below rather than above target (Figure 3, right panel). Moreover, large depreciations led only to moderate and temporary bursts of inflation during the global crisis, as the exchange rate passthrough had already fallen to levels close to those in advanced economies as documented for instance by Jašová et al. (2016). Yet, economies with a poorly diversified production base and heavily dependent on imports for consumption or production purposes may face stronger price pressures. So, not all countries will be in a position to expand their playbook along the QE dimension to provide quasi-fiscal stimulus.

Figure 3 Emerging market inflation and inflation targets



Source: Ribakova et al. (2019).

Finally, another risk associated with more decisive adoption of QE in emerging markets is related to the extent to which the private sector rather than the government is exposed to foreign exchange risk (e.g. Avdjiev et al. 2020). In this case, a sharp depreciation would put pressure on the private sector balance sheets. Yet, under COVID-19, the biggest threat to corporate liquidity and solvency is the shutdowns' impact on cash flows rather than the balance sheet hit stemming from the large depreciations of the past few months. Indeed, this is one way, albeit not the only one, to interpret the exchange rate impacts of the QE announcements already implemented reported in Table 1. Central banks can also accompany QE with liquidity provision in foreign currency to the corporate sector drawing down on their reserves war chests.

In sum, while it is important to avoid easy generalisation to the universe of emerging economies as a whole, QE appears to be a viable macroeconomic policy response to COVID-19 for countries with a credible institutional framework in which the central bank operates a floating exchange rate regime and the sovereign issues debt in its own local currency. QE can preserve stability in the local capital markets and can finance needed health and welfare expenditures and fiscal stimulus. QE can also buy time, while international cooperation and coordination coalesce, and the resources needed to provide adequate international aid packages are assembled.

Emerging economies have been left to fend for themselves as capital flew out of their markets, and the pandemic infected their economies. The COVID-19 pandemic is different from previous sudden stop episodes, posing formidable challenges to the best-prepared economies and policymakers, with its singular mix of negative effects on aggregate supply and demand, and global nature. Emerging economies should expand their policy toolkit and should not attempt to fight this new crisis only with old tools – if anything because the tried recipe of fiscal austerity and exchange rate depreciation is not suitable to respond to the current economic challenges.

Authors' note: The views expressed and the assumptions made are solely those of the authors and do not reflect those of the institutions with which they are affiliated, including Bruegel, the Federal Reserve Banks of New York, the Federal Reserve System, and the Institute of International Finance.

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Endnotes

1 Other central banks not listed in Table 1 are legally restricted or prohibited to conduct such operations. Some of these have recently obtained or may be seeking legislative changes relaxing such restrictions, including for instance Brazil, Chile, Czech Republic and Costa Rica.

2 For a similar recommendation for the euro area and the EBC, see De Grauwe and Diessner (2020).