

ECONOMY FISCAL POLICY MEASURES IMPLEMENTED BY THE AUSTRALIAN GOVERNMENT TO RESCUE THE ECONOMY



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Executive Summary

Covid-19 has had an unprecedented impact in global economy. Due to the long-term lockdowns, unemployment skyrocketed, businesses started defaulting and collapsing. There were all the signs of a prolong recession in global economy. As the uncertainty rose in economy, simultaneously, volatility rose in financial markets. These stresses and intensified downside risk of the economy led to a demand for liquidity in the banking system. Even though the crisis due to covid-19 is a global phenomenon, this case study is mainly about the evolution of the Australian monetary system in response to the pandemic. The financial crisis caused by covid-19 has made the Reserve Bank of Australia to take unconventional measures and to modify some of their operational procedure. These changes have made the false assumptions and lack of realism of mainstream monetary theory even more visible.

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2.0 Discussion

2.1 Pre-Pandemic Monetary and Fiscal Policy Regime

Prior to the Pandemic in Australia, Reserve Bank of Australia (RBA) implemented a monetary policy by setting a target for the cash rate and managing the exchange settlement balances to achieve the target rate. Exchange settlement balances are the call deposits held at RBA by the banks which they use to make payments to other banks. If the supply of Exchange settlement (ES) balance exceeds the demand of the banking system, there will be a downward pressure on the cash rate. If the supply of the ES balances falls short of the demand of the banking system, there will be an upward pressure on the cash rate. Cash rate targeting is widely believed to be a recommended monetary policy to manage the macroeconomic stability by mainstream economists. By managing the cash rate target, RBA expects to sustain the annual rate of consumer price inflation between 2-3 per cent. Even though the Australian federal government had been running a budget deficit since the global financial crisis of 2008, they have always had an aspiration of running a balanced budget or a budget surplus. In fact, just before the pandemic started, the Australian government managed to bring the federal budget to balanced status. Almost all the policy makers believed that the Australian government debt must be paid back in order to run a deficit in the future, in case of an economic crisis. Politicians unanimously agree that Australian fiscal balance should be a surplus and managing the target cash rate by the RBA was paramount to managing the inflation. Hence, they rely on deregulation of labour and cheap imports to put downward pressure on the consumer price inflation.

2.2 Conventional Monetary Policy Implementation to Ease Liquidity Pressure in the Financial System.

The panic caused in financial markets resulted in volatility in financial asset prices, most notably in government bond markets. This is entirely due to the expected prolonged crisis in the real economy caused by covid-19. These stresses led to sharp demand for liquidity in the banking system. By the end of February 2020, there were no excess in exchange settlement reserves in the banking system. In March 2020, RBA Reserve Bank of Australia started injecting liquidity to the system through open market operations. Initially, RBA infused around \$45 Billion through repo operations. This was clear disintegration from pre-pandemic framework of tight liquidity management. RBA continued to offer one month and three months open market repos (OMO) repos daily and six months terms weekly. (Dowling, S., & Printant, S. (2021, June 17). These actions mitigated the funding pressure and also met the increased demand for the liquidity. After absorbing the initial shock, reverse repo lending fell far below pre-pandemic levels.

2.3 Government Net Spending Injects Liquidity and Creates Financial Wealth in the Private Sector.

Between March 2020 and September 2020, government bond issuances in primary markets reduced the liquidity by about \$90 billion in the ES balances held at RBA. This means, the Australian treasury account held at RBA will rise from \$90 billion. RBA simply deducts the value of the government securities issuance from the ES balance of the purchaser and add the same amount to the treasury account, which is the seller. This is a vital coordinated operation by the Australian Treasury and the RBA, enabling the Australian federal government to increase spending in the economy.

Unlike some other countries, the Australian government did not directly sell treasury securities to the RBA on the primary market, nor did it use the overdraft facility at the RBA. Government spending was offset by the issuances of treasury securities in the primary market most of the time. The purchase of these treasury securities in the primary market resulted in equal amount of reduction in ES balance held at the RBA. However, during the pandemic, as the government spending picks up the pace, issuance of government securities had slowed down, enabling net injection of around \$15 billion in liquidity in the system.

Net government spending creates net financial assets in the non-governmental sector (private sector). This is the reason some countries directly sell treasury securities to their respective central banks. Yet, the Australian government does not prefer that method. However, what matters at the end is the net government injection of liquidity (government net spending) that results in net financial assets in the private sector in order to boost the economy.

2.4 Policies to Support the Broader Economic and Financial Market Functioning

Reserve bank of Australia offered wide range of measures to support the economy and help the smooth functioning of financial markets arresting stress related to the pandemic. The policy actions of the RBA have included a reduction in the cash rate. In early march 2020, cash rate target was 0.75 per cent and it was reduced to 0.10 per cent by November 2020. RBA was committed not to increase the cash rate target until the economy reached full employment and managed inflation within 2-3 per cent of the target band. (Dowling & Printant, 2021).

RBA was committed to purchase Australian federal and state government debt on the secondary market to achieve the yield to maturity on three-year government bonds to the cash rate target (0.10 per cent) and to achieve broader reduction in yields on long-term government and semi - government securities. Under the long-term bond purchase program, the RBA initially announced a \$100 billion package to be commenced in November 2020 and subsequently a second \$100 billion package was announced in February 2021. (Dowling, S., & Printant, S. (2021, June 17). At the end, the RBA has purchased \$240 billion worth of government securities expressed in market value terms. Government bond holdings in the RBA have risen from around 5-10 per cent of total assets held at RBA to 50 per cent of total assets. The decision to purchase government bonds with long-term maturity has resulted in the increase in average maturity term from approximately 15 months to 5 and half years.

The RBA offered a three-year term funding facility (TFF) in March 2020 for the banking system (3-year repo funding) to support the extending credit facilities to the small and medium sized businesses. Eligible quota was 3 per cent of the total outstanding credit of the institution and to be drawn down by the end of September 2020. If the institutions increase their lending efforts to the small and medium sized businesses, they are eligible for an additional quota of 2 per cent of the total outstanding credit of the institution.

The balance sheet of the RBA has nearly tripled in size from around \$170 billion to surpass \$460 billion. The size increment is equivalent to 15 per cent of the GDP. During the pre-pandemic period, the size of the RBA balance sheet is rather independent of the public policy stance. However, during the pandemic, the RBA policy measures have directly influenced the size of its balance sheet.

All these coordinated monetary policy measures by the RBA have significantly increased the liquidity in the banking system. Instead of offsetting market operations to remove the additional liquidity, the RBA decided to leave them in the system in order to provide additional monetary stimulus. As a result, supply of surplus exchange settlement balances has shot up to \$250 billion, in contrast to the pre-pandemic average of \$2-3 billion. (Dowling, S., & Printant, S. (2021, June 17). The excess liquidity and the lack of demand for the reserves in the banking system caused the cash rate to fall below the official target rate of the RBA, heading towards the rate paid by the RBA on exchange settlement balances.

2.5 Unconventional Fiscal Policy Measures to Rescue the Economy.

By March 2020, covid-19 pandemic was seen as a national emergency. Australia was going through a series of lockdowns and various restrictions on travel, such as within the state, across Australian states and with the rest of the world. A severe crisis was looming in the real economy due to the closure of businesses, loss of income, rising unemployment and subsequent threat of cooperate failures and defaults and collapse in financial markets. The government immediately announced it was prepared to engage in deficit spending in order to prevent the economy entering into a prolong recession. Initial package was around \$200 billion worth of fiscal support for the economy. But eventually the government had engaged in over \$343 billion in deficit spending.

National lockdown in the economy started a free fall of the GDP as the spending in the economy dropped drastically. However, the government public policy support programs such as income support scheme and Job retention scheme have immediately supported the income and employment. Even though the income level was restored, part of the spending was reduced due to covid-19 related restrictions. This has resulted in significant rise in house hold saving levels and subsequent reduction in house hold debt level as well.

Flow of funds data reveals a significant increase in the Australian household sector surplus between 2020 and 2022. This can be attributed to government implemented economic measures such as income support programs, tax cuts, moratoriums for the loans, subsidies and government grants during the covid-19 pandemic to maintain the income levels of the households. On the other hand, government-imposed travel restrictions and lockdowns have resulted in drastic decline in economic activities causing decrease in household expenditure. According to basic accounting principles the spending of one person becomes the income of another. When we apply this theory to the Austrian economy, spending by the state sector becomes an income for the private sector. If the private sector has a surplus, at least one other sector must be in deficit. In this case, the Australian government has accumulated a deficit and the private sector has a surplus. Similarly, if one country has a current account surplus, then at least one other country must have a current account deficit.

2.6 Not All Countries Have the Same Degree of Monetary Sovereignty.

Not all countries have the same level of monetary sovereignty. For example, United States of America has far greater degree of monetary sovereignty since USD is the global currency. There is a massive demand from the rest of the world for the USD, especially from the developing countries. USA has twin deficits, both budget deficit and trade deficit, which explains the demand for USD both domestically and internationally.

Even Australia enjoys a considerable level of monetary sovereignty, rest of the world is willing to send its supplies to Australia in return of receiving payments from AUD. Australia does not carry a foreign debt burden. Countries which have greater monetary sovereignty such as Australia has demonstrated the power of a sovereign currency during a crisis by rescuing the economy through deficit spending to an extent where household savings have doubled after the crisis.

Countries which carry a massive foreign debt burden such as Sri Lanka, Argentina, Pakistan (most of the developing countries) have a limited degree of monetary sovereignty. Unfortunately, same cannot be said to the developing countries which have compromised their monetary sovereignty by having large amounts of foreign debt. As a result of this, in some developing countries, economic crisis and social unrest continue up to date.

Countries such as Greece and Italy (eurozone countries) have given up their monetary sovereignty and adopted Euro as their currency. These countries do not have their own respective central banks. Therefore, they need to increase the borrowing during a crisis. During the global financial crisis, eurozone countries were subjected to strict fiscal reforms in order to make them eligible for lending programs conducted by the ECB. That created social unrest and sharp decline in economies for the countries which have high debt to GDP levels.

Unlike during the global financial crisis in 2008, during the covid-19 pandemic era, the European Commission provided the general escape clause to the EU fiscal guideline rules. This meant the eurozone countries were allowed to have a flexible fiscal policy as per the preference of their respective governments. Total of € 750 billion) package of funding support was announced to the eurozone. Out of which, (€ 390 billion) was grants and the balance was loans, which was channeled through a special recovery and resilience facility (RRF). (IMF,2020). High-debt countries hit hard by the pandemic were the biggest beneficiaries of the RRF. Further, special job protection programs were conducted and expansion of collateral eligibility measures and collateral haircuts were implemented by the ECB. This coordinated effort by European Commission and the ECB during the pandemic has provided much needed fiscal support to the eurozone helping them to avoid a prolonged crisis in both financial and economic fronts.

2.7 Raising Inflation in the Post-Pandemic Era

Government implemented policies during the pandemic have infused liquidity to the economy and the abundance of funding was readily available in banking systems and financial markets. Interest rates declined significantly, making it cheaper to borrow to secure short-term funding. However, by 2022, inflation was continuously rising mainly due to the bottlenecks in the supply side caused by the pandemic. There were significant delays in transportation across the globe and even within countries, creating a short supply in essential products. In Australia, target cash rate was increased to 0.35 per cent by May 2022.

Major central banks around the world were also raising the interest rate around the same time. Specially, the interest rate increments by the Federal R-reserve have had a devastating impact in developing countries. Heavy USD outflow from the developing economies have resulted in a free fall of their exchange rates. Aftermath of the pandemic has caused most developing countries to go through a prolonged economic crisis due to USD shortages, causing short supply of essential products and rising cost of living. Most of the developing countries have increased the interest rates to double digits to tame the persistent inflation making the situation worse.

3.0 Conclusion

Countries around the world have implemented both conventional and unconventional monetary policy measures during the pandemic to rescue their respective economies from a prolonged recession.

Australian government also took a similar approach. Initially, the RBA implemented a conventional approach through open market operations (repo) and injected liquidity to the banking system. The decision of the government to reduce the target cash rate and not to offset the excess liquidity in the system in order to maintain the stable supply of ES balances reduced the short-term interest, making the cost of borrowing cheaper. But as the situation got worse, government net spending exceeded their own security issuances, creating a surplus in the private sector. Unorthodox policies such as deficit spending have resulted in increased net saving in the private sector and it certainly avoided a deepening of the economic crisis. Further, it demonstrates the fiscal space available for a sovereign country which has a sovereign currency since that country has no financial constraints. However, these countries were facing real resource constraints (short supply in essential items) due to the covid-19 government-imposed lockdowns around the world and within the countries. These supply shortages eventually caused persistent inflationary situations in these countries such as Australia. Not all the countries have the same degree of monetary sovereignty, especially developing countries indebted in USD. As the central banks around the world raised the interest rates to manage the inflationary pressure as a conventional monetary policy tool, these developing countries are paying the price for their external debt due to depreciation of currencies, rising cost of living and deepening of the economic crisis.

4.0 Recommendation

4.1 For Developing Countries (Lower Level of Monetary Sovereignty)

Reducing the target cash rate and injecting liquidity through repo operations in order to reduce the short-term interest rate, and enforcing the reduction of variable interest rates in loans, since most private sector loans are based on variable interest in developing countries. However, this must be coupled with strict capital and trade controls to preserve the foreign reserves.

Monthly income support programs to support targeting low-income earners enabling them to purchase essentials and pay their rents without increasing their indebtedness.

Interest and/or debt forgiveness program for small to medium size local producers to cover at least two years of the impact caused by the pandemic.

Medium to long term low interest funding facility for the banking system to encourage them to extend credit to small and medium size businesses at low interest and fixed rates.

A job guarantee program by the state to provide jobs for those who have lost their jobs during the pandemic and for those who are struggling to find work.

Interest and/or foreign debt forgiveness program for developing countries by the institutional investors such as the IMF, World Bank and ADB, making it easier for those countries to restructure the foreign debt on better terms with rest of the investors.

Medium to long term low interest foreign currency loans for developing countries by the institutional investors such as the IMF, World Bank and ADB to avoid a prolonged financial and economic crisis.

Suggesting a new trading block and a new currency for international trade with countries that have similar interest to bypass the USD as the reserve currency in order for these countries to avoid supply side bottlenecks and to fend off IMF austerity measures.

4.2 For Developed Countries (Higher Level of Monetary Sovereignty)

Targeted monthly income support programs to sufficiently cover low-income earners enabling them to purchase essentials and pay their rents in full without increasing their indebtedness.

Interest and/or debt forgiveness program for low-income earners who lives on rental properties allowing them to restart their lives without the debt overhang.

A job guarantee program by the state to provide jobs for those who have lost their jobs during the pandemic and for those who are struggling to find work.

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