Guiding Principles

on Central Banks' Strategies to support economic recovery post COVID 19 pandemic

The Arab Monetary Fund

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Background

Economies and financial markets around the world have been and are still affected by the emerging coronavirus pandemic, which has posed unprecedented challenges on policymakers to advance economic development. Economies have been hit with exorbitant costs driven by the immense pressure on health systems, translated by government subsidy programs that aim at addressing the decline in cash flows for both companies and individuals, as well as relief plans to address rising unemployment rates and bankruptcy filings, all to maintain economic and social stability.

The pandemic has also posed additional challenges and risks on financial stability, ultimately pressuring central banks to act towards achieving certain optimal balancing model, as part of their efforts to maintain financial stability. Central banks are seeking to take the necessary measures to protect the financial sector, while they are equally concerned to protect individuals and enterprises, especially the micro, small and medium-sized ones.

Many central banks have launched stimulus, precautionary and preventive measures utilizing monetary policy instruments to inject liquidity into the banking sector, through raises mechanisms including the levels of interest rates and the required reserve ratio. They have also facilitated credit/loan guarantee schemes in support of productive sectors, which enabled the banking sector to reschedule loans for individuals and enterprise alike. In addition, central banks have launched various support programs focusing on the sustainability of productive sectors.

Further, several central banks have decided to take swift macroprudential measures to offset the painful economic and financial effects of COVID-19, including the reduction or even the withdrawal of certain requirements. From a capital instruments perspective, both the countercyclical capital buffer (CCyB) and the capital conservation buffer (CCoB) have been either reduced or revoked, in addition to easing the risk weights within the capital adequacy ratio of certain sectors. This was accompanied by further restrictions on the distribution of dividends and bonuses in the banking sector. As for the liquidity tools, a number of central banks have eased the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) from the initial prescribed ratio of 100%, while other central banks have also set limits on the Debt to Income ratio (DTI) and/or the Loan to Value ratio (LTV). Governments around the world have also taken multiple measures regarding their fiscal policies estimated at $ 11 trillion in support of the real economy (Global Financial Stability Report, June 2020).

Medical research laboratories across the globe continue to accelerate the development of a safe and effective vaccine for the COVID-19. According to the World Health Organization's (WHO), the coronavirus vaccine should be ready before the end of this year, while widespread vaccinations are not expected until mid-2021. Such forecast comes along the reopening of economies and the easing of general lockdown restrictions associated with the COVID-19 crisis where economies at the country level are gradually recovering.

In the same context, the Bank for International Settlements (BIS) emphasized the importance of implementing exceptional measures to stimulate economic activities at least during the crisis, that could be preferably extended for the post-crisis period accompanying the economic recovery. Similarly, the International Monetary Fund (IMF) have stressed on the importance of continuing to adopt accommodative monetary policies during periods of recovery. From its end, the Arab Monetary Fund (AMF) is stressing on the need to prepare for the post-crisis era by carefully timing and phasing the reversal of crisis-specific exceptional measures and monetary instruments in order to minimize the associated impact while ensuring a speedy and maximized economic recovery. The AMF's statement comes in accordance with its 2020-2025 strategy and the proactive approach it has adopted to respond to the emergency needs of the Arab countries, through the general guidelines it has published on May 2020 titled "General Guidelines for Central Banks to Deal with COVID-19 Implications on Financial Stability"

In view of the above, and in accordance with the Arab Monetary Fund's commitment to provide support to its member countries on economic, financial and monetary reforms aiming at enhancing financial stability in the Arab region and preparing for the recovery phase, the AMF has issued a set of guiding principles, listed below, on the central banks' strategies to supporting economic recovery post the COVID 19 pandemic. These principles culminate the outcome of several rounds of discussions and consultative meetings organized by the AMF at the level of the Central bank governors, deputy governors, members of the Arab Committee on Banking Supervision, the Financial Stability Task Force, the Financial Inclusion Task Force and the Regional Fintech Working Group in the Arab Countries. It must be recognized that the implementation of such Guiding Principles is subject to the specificities of each central bank, its objectives in accordance with its statute, and its national economic context.

Guiding Principles

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Principle (1)

The Crisis Management Committee or the Financial Stability Committee within the Central Bank would ensure early preparation and readiness for the post-crisis phase, by adopting a post-crisis strategy.

Principle (2)

To ensure sufficient liquidity flow into the economy, the central bank would maintain the exceptional economic support measures during the recovery phase for a sufficient period of time, to be estimated by the said committee, referred to in Principle (1).

Principle (3)

In case the committee aforementioned in Principle (1) does not include representatives from the Ministry of Finance and the Securities Commission, it is advisable to establish appropriate coordination between all official stakeholders across the different measures to be taken during the economic recovery phase.

Principle (4)

The coordination between the economic and macro-prudential policies, in addition to the balanced timing and phasing of the reversal of support measures, is a key success factor for the adopted measures towards promoting economic growth. While the early withdrawal of support packages may lead to a decrease in credit volumes required to support the corporate and household sectors, the delay in such a reversal may in turn increase the systemic risks in the financial sector.

Principle (5)

There is a need for an incremental and gradual reintroduction of the capital and the liquidity margins that were eased during the Coronavirus crisis period, as well as for an assessment to evaluate the need for the maintaining current restrictions on the distribution of dividends and bonuses in the banking sector.

Principle (6)

A continuous adoption of a accommodative monetary policy to consolidate economic recovery with no increase in the interest rates withing the monetary policy tools for a suitable period of time, while considering its increase in a gradual basis, that accommodates the changes in the fiscal policies and macroprudential policy tools.

Principle (7)

In case of an orientation towards a decrease of the required reserve ratio, commercial banks may be allowed to achieve a lower percentage than the required minimum within an acceptable margin set by the Central Bank, and accordingly this margin can be allocated to specific areas such as granting credit to micro, small and medium companies.

Principle (8)

Appropriateness of continuing to adopt government financing programs led by the Central Bank to support productive economic activities with appropriate interest rates and terms, in a manner that balances the intended stimulus with the cost to the treasury.

Principle (9)

Establishing appropriate frameworks that enables banks to deal with customers whose cash flows have been affected by the Corona pandemic, while also studying solutions related to mitigating the negative impact on their creditworthiness, provided that it is taken into account in their credit reports.

Principle (10)

In case the interest rates on banking products are not linked directly to the interest rates of the monetary policy tools, it is advisable that the Central Bank pushes commercial banks to not raising the interest rates on credit in the recovery phase, but to wait for the appropriate period that suits the changes related to the interest rates on monetary policy.

Principle (11)

Holding continuous consultative meetings between the Central Bank and the commercial banks, to discuss the possibility and the adequacy of continuing to suspend or to reschedule private sector loans to some customers, in a way to limit the insolvency cases of viable companies.

Principle (12)

Conducting an assessment study of the financial sector pre and post the coronavirus crisis to determine the magnitude of its impact especially in terms of Financial Soundness Indicators. While not to rely only on the achieved indicators, but also to build forecast for such indicators based on scientific methodologies and econometrics models to eventually put in place appropriate plans, solutions and recommendations to address deficiencies or weaknesses if any.

Principle (13)

The Central Bank to request from the commercial banks to prepare and provide him with a report approved by their Board of Directors that assesses the extent to which they are and have been affected by the Corona pandemic. The report would also cover the expected impact on their Financial Strength Indicators, especially the ratio of non-performing loans, capital adequacy ratio, profitability and liquidity, provided that the report would also include an assessment of credit, market and operational risks, and a time plan that addresses any weaknesses or deficiencies therein.

Principle (14)

The Central Bank to constantly assesses the systemic risks in the financial and non-financial sectors and to eventually make use of appropriate tools to mitigate them, if any.

Principle (15)

The Central Bank to compile the lessons learned from the Coronavirus crisis as well as the future implications across key aspects including: Financial stability, banking supervision, monetary and prudential policies, development of early warning systems, crisis management, recovery plans, and macro and micro stress tests.

Principle (16)

Developing and expanding the usage of stress tests and increasing the intensity of such tests to assess the ability of both the banking and the financial sector to withstand the repercussions of the current crisis.

Principle (17)

The Banking Supervision Department to evaluate any fundamental weaknesses that have appeared across the different commercial banks (Especially the Domestic Systemically Important Banks D-SIBs) as a result of the pandemic and to subsequently submit a report to the Crisis Management Committee or the Financial Stability Committee, including any appropriate recommendations.

Principle (18)

Strengthening the digital infrastructure of the financial sector, encouraging digital transformation, and creating development and investment opportunities in the fields of financial technologies, to potentially enhance the competitiveness of the local private sector.

Principle (19)

Considering the possibility of the Central Bank to coordinate with the official authorities to develop a mechanism that supports the asset markets (stocks and real estate) affected by the Coronavirus crisis to eventually take appropriate measurements that would enable its recovery.

Principle (20)

Supporting the non-banking financial sector and strengthening its regulatory framework while also enabling coordination between the Central Bank and other supervisory authorities to develop mechanisms that limit the impact of the Corona pandemic on the sector.

Principle (21)

Central Banks are advised to take appropriate measures to minimize crowding out effects on liquidity between the public and private sectors and maintain a healthy balance of investment spending.

Principle (22)

Central Banks may enhance the role of loan guarantee institutions in supporting micro, small and medium enterprises, thus ultimately providing the necessary guarantees for better opportunities to access credit.

Principle (23)

Central Banks are encouraged to consider putting in place appropriate procedures to ensure effective communication between financial and non-financial institutions, for the purpose of maximizing confidence towards speedy economic recovery.

Principle (24)

Central banks are advised to continuously evaluate the impact of tools and procedures that have been adopted in terms of their effectiveness and long term impact rather than their immediate results; this also applies to central banks' consideration of undesirable outcomes arising as well as the approach to mitigating them.