FISCAL AFFAIRS

Special Series on Fiscal Policies to Respond to COVID-19

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Fiscal Policy Responses to the Sharp Decline in Oil Prices

I. BACKGROUND

Oil prices have declined sharply as a result of both global demand contraction and supply increase.

- Since early 2020, demand for oil has plummeted as the Covid-19 pandemic threatens to bring the global economy to a standstill.
- The slump in demand is coinciding with a rise in supply as major oil producers announced an expansion in production. As a result, international crude oil price benchmarks fell from about US$50 a barrel on March 6 to US$20-35 since mid-March.
- The prospects for recovery in oil prices are highly uncertain. Oil futures predict a slow and partial recovery, with only a modest pick-up by end-2020 and leaving end-2024 levels still below those at end-2019.

II. EXPECTED MACROECONOMIC EFFECTS

Oil exporters are facing a triple macro-fiscal shock: a sharp revenue loss from the collapse in global oil prices, negative economic impact on domestic non-oil activity, and increased spending pressures arising from the policy response to the effects of Covid-19. In many oil-exporting countries, a large share of government revenue is provided by the resource sector. Experience during previous oil price drop episodes has demonstrated that policy responses are often procyclical by necessity, with cuts to public expenditure that can hamper long-term growth (IMF, 2015). Many oil exporters currently have limited fiscal space, making maintaining—let alone increasing—spending extremely challenging as oil revenues drop.

Rising fiscal pressures are likely to result in higher public debt, gross or net, as even countries with public financial assets will need to dig deep in them. The weakening fiscal position and growth slowdown could affect investor confidence and increase the cost of borrowing due to higher risk premia, further limiting the fiscal space and potentially prompting concerns over debt sustainability for countries with already high debt.

External and financial balance sheet pressures could also emerge. The current account balances of oil exporters are likely to deteriorate, and a coinciding pullout of foreign investors and tighter global financing

conditions would pressure FX reserves and/or the exchange rate. Deteriorating exposures to oil-related sectors could undermine bank balance sheets, raise liquidity and credit risks, and lead to tighter domestic financing conditions that would further pressure the economy. The deterioration of balance sheets of the government, household, and nonfinancial corporate sectors could also lead to mutually reinforcing adverse feedback loops.

The effect on oil importers could be less benign than usually thought. Importers would benefit from real income gains and falling production costs as oil prices decline. These effects could provide some welcome relief, especially in countries with high informality where the coverage of tax and benefit systems is limited. However, weak global demand, the supply restrictions caused by social distancing, and limited scope for monetary policy easing in many countries would reduce these positive effects. [1] Countries relying on remittances from oil exporters would also be negatively affected by diminished remittance inflows.

III. POLICY RESPONSES IN THE SHORT AND MEDIUM TERM

Short Term

The immediate and urgent priority for oil exporters is to mobilize the necessary resources to mitigate the direct health, social, and economic effects of the Covid-19-related shock. Several oil-exporters have already announced fiscal packages to this effect (mainly focused on increases in healthcare spending and various forms of income support and tax relief). [2] The active fiscal response may need to be relatively large, particularly where automatic stabilizers (e.g., unemployment insurance and developed social assistance schemes) are underdeveloped. Fiscal policies should also be coordinated with monetary, exchange rate, and financial policies. In-depth guidance on appropriate immediate fiscal policy measures can be found here.

To the extent possible, oil exporters should accommodate temporary increases in spending through use of buffers (drawing on existing liquid assets, new borrowing, or grants). Should mobilizing additional financing prove infeasible, expenditure rebalancing could provide some relief, focused on reductions to non-essential current spending where fiscal multipliers are relatively low, although some scaling down of public investment may be unavoidable as well for countries with limited fiscal buffers. [3] Additional resources could also be generated by the removal of energy subsidies that would no longer be needed to maintain stable retail energy prices (see Box). To ensure the credibility and transparency of the adopted measures, expenditure rebalancing should generally be done through supplementary budgets.

The size and nature of the policy response should be tailored to individual country circumstances. Oil exporters are a diverse group, including both high- and low-income economies and a variety of fiscal positions. The size of the fiscal response will hence depend on country-specific factors, including health care needs, the magnitude of the oil revenue loss, the extent of buffers and available fiscal space consistent with debt sustainability, and the room for response of other macroeconomic policies (in particular monetary policy, which may be constrained by the (in)flexibility of the exchange rate).

1 Similar factors also subdued the positive effect for importers from the 2014-15 oil price drop.

2 For specific country responses, see https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19.

3 Where possible, priority capital spending should be postponed rather than cancelled, while investment related to the crisis response (for example, health infrastructure) should be protected.

Suspending fiscal rules temporarily may be necessary to ensure an effective response to the unprecedented crisis. Oil exporters' ability to muster a fiscal response to the crisis should not be constrained by excessively rigid fiscal and operational rules—for example, restrictions on withdrawing resources from oil funds or on increasing spending (or debt) to deal with the pandemic. Where these rules restrict the authorities' ability to direct resources to critical needs, countries should use the escape clauses embedded in the rules, and—if these clauses are not flexible enough—consider suspending the rules temporarily. To maintain the credibility of the rule-based framework during its suspension, the government should signal its commitment to fiscal sustainability by:

- Clearly communicating the reasons for the activation of the escape clauses or the suspension of the rule. This could involve external verification by a fiscal council.
- Establish (ex-ante) a limit to the period of suspension of the rule and outline in a budget document (e.g., the supplementary budget that suspends the rule) how the government envisages returning to the fiscal rule's targets subsequently. This outline could explicitly discuss the uncertainty around the scenarios and possibility of revisions if the shock proves to be longer or the economic impact larger than expected.
- Regularly report on progress and explain any necessary deviations. This will allow parliament, fiscal council (where it exists), and the public in general to be informed and verify compliance with the convergence plan.

The success of the short-term policy response would be enhanced if it is accompanied by a commitment to preserve fiscal sustainability in the medium term. While it is too early for specific plans, a commitment to future fiscal consolidation—when the recovery gets going strongly—will allay concerns about the impact of the deployed measures on fiscal sustainability. This in turn may expand the resource envelope available for the current emergency fiscal response, e.g., by preserving access to new borrowing and/or reducing the country risk premium.

Medium term

Once the pandemic has subsided, oil exporters would need to prepare for a prolonged period of low oil prices. Provided that part of the oil price shock is persistent, a medium-term fiscal adjustment is likely to be needed. [4] The size of the adjustment should be guided by long-term objectives for fiscal sustainability and stabilization and its pace determined by the availability of financial buffers or access to capital markets. Fiscal consolidation should rely on measures that minimize the effects on growth and focus on efficiency gains in current spending.[5] Over the longer run, a strengthening of automatic stabilizers by expanding safety nets can help to quickly direct resources where they are most needed in future shocks. And in the event that the shock to oil prices turns out to be fully transitory, such a gradual growth-friendly fiscal adjustment would help to rebuild buffers to respond to future shocks.

A credible fiscal framework is essential to support a strategy of easing policy over the short run and a gradual consolidation over the medium term, particularly for exporters with limited fiscal space. A long-term fiscal anchor, linked to the sustainability objective, should guide the setting of medium and short-term fiscal targets, while the fiscal path should also ensure accumulation of adequate stabilization savings to mitigate the impact of

4 While there is considerable uncertainty, it is helpful to think of the current oil price shock as combining a persistent and a transitory element. The persistent element is related to the persistency in the slowdown in global activity and efforts to reduce the use of oil.

5 Danforth et al (2016), provides practical guidance on growth-friendly fiscal consolidations for oil exporters.

future shocks. [6] Sound fiscal rules and broader institutional frameworks can support these goals. Given the size of the shock, fiscal frameworks in many oil exporting countries should be revised, updating long-term anchors and medium-term targets. If suspended during the crisis, fiscal rules should also be revised to reflect the updated framework before being re-introduced.

Box: How to Use the Windfall Savings from Lower Oil Prices

Reduce retail prices or reduce budget subsidies? In countries providing substantial energy subsidies, policymakers face a choice between passing, fully or partially, the fall in international oil prices to consumers or keeping retail prices unchanged and reducing subsidies. Considerations influencing this choice include:

- the prioritization of fiscal needs—reducing subsidies will free up resources for other purposes;
- the need for a fiscal stimulus vs. measures supporting the most affected sectors – cutting retail prices would amount to a general stimulus, which may or may not be helpful in a lockdown;
- the expected persistence of the low oil price period—the shorter and more uncertain the duration, the less justified the cut in prices;
- the country's policy objectives to reduce emissions in the fight against climate change;
- the strength of the regulatory framework—automatic formula-based adjustments give more confidence that prices will follow costs both up and down as needed.

Lower oil prices bring a chance to reduce energy subsidies (without raising retail prices) and free up scarce resources to address the COVID-19 pandemic. Lower international oil prices reduce the differential between the existing domestic pre-tax prices and the actual cost of energy (import costs plus transportation and distribution margins) or its opportunity costs (the revenue foregone by not selling the product at the prevailing international price). This offers an opportunity to reduce subsidies and redirect the released resources to the fight against the pandemic. Successful reforms in this sensitive area would entail (i) a proactive communication strategy to shape the national debate in a way conducive to winning the public support for such a shift; (ii) engagement with civil society and other stakeholders/influencers to explain the benefit of reforms (greater fiscal space for emergency spending now, increased pro-growth and social spending later), and (iii) replacing a regressive form of redistribution with inequality-reducing enhancements of social safety nets.[1]

After the pandemic has subsided, policy responses could focus on phasing out the remaining subsidies and redirecting these resources to support the economic recovery. Countries that still maintain subsidies could advance towards formula-based price adjustment with the objective of fully liberalizing prices over time. Further, countries could increase taxation on fuel products to address their environmental impact and generate much-needed resources for proactive measures to aid the recovery (e.g., high-priority public investments that were postponed during the crisis).

1 For a detailed discussion, see Parry et al. (2014) and IMF (2019).

6 IMF (2012) provides an in-depth analysis of fiscal frameworks for resource-rich countries.

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