



Special Series on Fiscal Policies to Respond to COVID-19

This is one of a series of notes produced by the Fiscal Affairs Department to help members address the COVID emergency. The views expressed in this paper are those of IMF staff and do not necessarily represent the views of the IMF, its Executive Board, or IMF management.

Managing Fiscal Risks Under Fiscal Stress¹

The rapidly evolving macroeconomic and financial conditions will adversely impact public finances globally. Many governments will see their revenues drop and expenditures rise. Also, more of governments' outstanding contingent liabilities will be realized. Finally, the various fiscal measures implemented by governments in response will create new fiscal risks. Governments should identify in a comprehensive way the various risks to their fiscal outlook, measure their fiscal impact, and manage them proactively. This note discusses strategies and steps governments can take to deal with fiscal risks.

I. MANAGING FISCAL RISKS—AN OVERVIEW

The COVID-19 pandemic is impacting the public finances of countries through increased spending and reduced revenue collection, and through contingent liabilities turning into actual liabilities. In addition, policy measures in response to the crisis will likely create new fiscal risks. When fiscal risks increase, governments first need to understand how baseline fiscal positions may be impacted. The lesson from past situations of major economic stress is that realizations from existing exposures can be large and are highly correlated with each other. In this context, governments need to assess a broad range of potential fiscal risks, including from:

- Sharply deteriorating macroeconomic conditions, sharp declines in commodity prices, large currency depreciations, and widening in sovereign spreads.
- Requirements to service existing explicit guarantees. These can take many different forms. For example, governments may be required to service existing loan guarantees for enterprises due to cash flow or liquidity problems. Reduced consumer demand (e.g., in the form of less traffic due to travel restrictions) could trigger government support payments to transport-sector Public Private Partnership (PPP) projects.
- Bailouts of troubled state-owned enterprises (SOEs), particularly in industries directly affected by COVID-19 (e.g., national airline companies), or to support subnational governments due to revenue shortfalls or difficulties servicing debt.

¹ Prepared by Emre Balibek, Amanda Sayegh, Sandeep Saxena, Michelle Stone, and Claude Wendling.

- A need to support liquidity in the financial sector.
- Top-ups for defined benefit pension funds affected by reductions in asset values and/or crystallization of pension guarantees.

During the global financial crisis, fiscal risks that materialized increased the public debt of the most heavily affected economies by an average of 26 percentage points of GDP, with a third of this coming from non-budget operations.²

Transparency in disclosing fiscal risks goes a long way in supporting the monitoring and mitigation of these risks. Governments should invest in understanding the impact various changes in macroeconomic and financial conditions can bring to their budget, and in identifying and quantifying major contingent liabilities and their potential to crystallize. The initial focus should be on large items with a high probability of crystallization; both explicit and implicit contingent liabilities should be considered.

II. POLICY MEASURES TO RESPOND TO THE COVID-19 OUTBREAK

Governments are using a range of support measures to address the macroeconomic and social challenges posed by the current COVID-19 pandemic (Annex 1). Support measures can take various forms, with different fiscal implications. Some will impact public finances directly in terms of higher fiscal deficits. Some will not impact fiscal deficits but may increase debt (off-budget/below the line operations), while others will expose them to medium- to long-term risks (contingent liabilities) that need to be identified and managed transparently.

- **Budgetary measures** include additional spending (e.g., health services and unemployment benefits); capital grants and targeted transfers (e.g., wage subsidies or direct transfers); or tax measures (cuts, relief, or deferrals), provided through standard budget channels. Their full cost will be reflected in the fiscal balance and government debt, unless these can be met by offsetting measures (e.g., expenditure reprioritization).
- **Off-budget or extrabudgetary measures** generally involve the creation of assets, such as loans or equity in firms; some measures can also be extrabudgetary due to lack of transparency. Off-budget measures are usually financed by debt, but only add to the recorded fiscal deficit if they are considered uneconomic, that is, the interventions will either result in an expected loss or have no reasonable likelihood of an economic rate of return. They often entail additional risks because they are not subject to the same scrutiny as traditional measures or defer costs to the future. These can include:
 - **Equity injections** to financial and non-financial public corporations to provide them with liquidity or longer-term support (e.g., Germany, South Korea, Chile).
 - **Loans** to firms or households to alleviate cash-flow and liquidity constraints (e.g., US, Norway, Thailand). These may have little or no upfront impact on the fiscal deficit but may increase debt. They entail risks to the government if loans are not repaid in the future.
 - **Asset purchases**, such as purchases of non-performing assets or low-grade corporate bonds to provide liquidity support to financial institutions (e.g., US Federal Reserve). Their net fiscal cost depends on expected and actual future asset recoveries.
 - **Assumptions of debt** by a government (particularly third-party debts and liabilities). Usually, these have no initial (upfront) fiscal cost but immediately increase public debt and may affect fiscal deficits down the road.

² IMF (2012) "Fiscal Transparency, Accountability, and Risk," Fiscal Affairs Department.

- **Government guarantees** that may be granted to banks, firms or households to address confidence concerns, to ease liquidity pressures or as part of sector-specific umbrella guarantee programs, for example to small businesses (e.g., UK, Germany, France, Australia). While these have no immediate upfront cost, they do create a contingent liability, with the government exposed to future calls on guarantees. Other contingent liabilities include letters of comfort and indemnities.
- **Extrabudgetary funds (EBFs)** that are created to provide/channel assistance in lieu of direct budget support. (e.g., the French Solidarity Fund). While this may be considered useful from an operational perspective, EBFs may easily undermine fiscal accountability and discipline. Creating new EBFs should be discouraged, particularly on an ongoing crisis. More importantly, EBFs should be part of the budget.
- **Quasi-fiscal operations** through the central bank and other state-owned financial or non-financial institutions aimed at liquidity support to the financial sector and individuals/businesses (e.g., Saudi Arabia), or price controls. International standards call for the subsidy component of QFAs to be recorded in the budget. However, like EBFs, if they are extrabudgetary, they will have no immediate or recorded fiscal impact but create potential risks and may undermine fiscal accountability and discipline.

The fiscal implications of all extrabudgetary and off-budget measures should be assessed, tracked, managed, and transparently reported. For EBFs and other off-budget fiscal operations there should be sunset clauses and/or a strategy to integrate such operations into the budget as the situation normalizes.

III. EVALUATING AND MANAGING RISKS ASSOCIATED WITH CRISIS RESPONSE POLICIES

While the impact of budgetary measures on fiscal deficits and debt is generally clear, off-budget measures create significant fiscal risks that may remain unknown and/or insufficiently understood. In deciding whether to use these measures governments should consider:

Rationale – is there a sound rationale for taking the measure? What policy objectives will be served? Are there more cost-efficient modes of public support to achieving these objectives?

- For example, governments may choose to bear risks in circumstances where there are market failures or incomplete markets—consequences of which can be exacerbated during periods of heightened uncertainty as in the current situation—or for macroeconomic stability considerations.
- Policy trade-offs need to be considered. For example, direct lending or budget support may be more cost effective than one-off guarantees to individual beneficiaries, since private borrowing carries a higher premium. They are also more transparent. While umbrella guarantees may be more cost effective where the benefits are extended across a large number of beneficiaries as they can have lower transaction cost.

Costs – what are the current and future fiscal costs of the support?

- Governments should assess the maximum exposure from contingent liabilities and other off-budget transactions and whether these can be accommodated in a worst-case situation. Assessing affordability ensures policymakers are aware of the fiscal impact of measures and can aid monitoring, accounting and management of these risks.
- Expected costs of guarantees and other contingent liabilities (e.g., those created through quasi-fiscal operations) should be estimated, including the likelihood that they materialize, and the possible magnitude of recovering these. In the current situation, however, with heightened uncertainty around the size and length of the economic impact of the COVID-19 outbreak, the probability that risks may materialize are almost impossible to estimate with accuracy.

- Appropriate provisions should be created in the government budget to meet the costs arising from default on guarantees and crystallization of other contingent liabilities.

Risk mitigation – what actions can be taken to mitigate risks or limit exposure?

- Limiting or capping the size of government risk exposure for certain interventions.
- Sunset clauses may be appropriate and exit strategies developed for when the economy recovers.
- For guarantees, partial guarantees could be provided, collateral secured, asset recovery provisions included, and/or risk-based fees can be charged.
- Global cooperation to respond to the current pandemic and economic fallout.
- Decisions on whether to limit or mitigate risks, or bear them outright, should be based on an assessment of the likely costs and benefits from a macroeconomic stability, fiscal sustainability and efficiency perspective.

Risk management – what mechanisms are in place to control and monitor risk exposure?

- Require a gatekeeper function/central approval – e.g., Minister of Finance or Cabinet (in some cases parliamentary approval may be required but could slow down support).
- Establish clear accountability for monitoring, managing and reporting contingent liabilities.
- Ensure a monitoring mechanism for regular review of: (i) the potential for risk realization as new information becomes available; (ii) whether existing policies remain appropriate; and (iii) whether existing mitigation measures are adequate.
- Establish intra-governmental coordination mechanisms to assess and monitor risks and policy responses, particularly between finance and economic ministries and central banks to monitor and manage financial sector exposures.
- Parliamentary involvement in monitoring the guarantees given and called as well as the impact on the economy and employment of support measures will help provide additional legitimacy.
- Ensure the full disclosure of all fiscal measures, be they direct or contingent, on-budget or off-budget.

IV. STRENGTHENING OVERALL PUBLIC FINANCIAL MANAGEMENT INSTITUTIONAL CAPACITIES

Strong public financial management (PFM) will guard against fiscal risks and enhance the government's capacity to respond to the crisis and manage fiscal risks. In a rapidly evolving crisis like the COVID-19 pandemic, it is useful to have a "whole-of-government" approach to managing public finances, e.g., by setting up an inter-ministerial PFM crisis management team, including to assess the potential fiscal/budgetary impact of new policies and policy proposals, and oversee the consistent application of PFM measures throughout the government. The following PFM measures are suggested:³

Maintain an up-to-date view of public finances

- Heightened (and more frequent) monitoring of revenue and expenditure, as well as off-budget operations will give an early indication of the impact on the overall fiscal position and on different sectors of the economy. This will require higher frequency updates from the tax agency, payment systems (IFMIS) and debt managers, as well as periodic monitoring of contingent liabilities and build-up of fiscal risks.

³ See Companion Note "Preparing Public Financial Management Systems to Meet Covid-19 Challenges" for a more elaborate discussion.

- Institute a weekly fiscal developments note, showing i) the variation of revenue and spending from normal, ii) the impact of policy announcements (both new and change in cost of previous announcements), including off-budget; iii) realizations of contingent liabilities; and iv) the debt and liquidity position of government.

Maintain costings of emergency response options and actions

- All government decisions and announcements need to be costed, recorded, and monitored.
- Initial costings should involve both the Ministry of Finance and line ministries that execute priority spending such as the Health Ministry; these may be rough, but costings should be updated as events unfold, and more information becomes available.
- Clear communication of fiscal policy responses helps maximize business and consumer confidence.

Remove barriers to necessary emergency spending

- Put in place legislative approvals for new spending, and more flexible use of existing spending authorities. For example, the recent supplementary budget in France was prepared and adopted within a week.
- Seek external support from international financial institutions including capacity development, where needed.
- Identify low priority and lagging spending to create room for new emergency spending measures.

Ensure cash gets where it is needed most

- Ensure the timely flow of information between government units on cash flow needs.
- Closely monitor cash balances, through daily information sharing with banking providers.
- Focus cash releases on high priority spending items.
- Explore opportunities for tapping any significant pool of government cash outside of the treasury single account system and bringing it under treasury's control.

Manage debt positions, market access and overall risk⁴

- Ensure continuity of funding and adopt a flexible approach; if risk perception in the market is high, approaches could be needed to mitigate refinancing risk. If market access is lost, it is hard to regain.
- Debt managers should closely monitor market developments. Issuance techniques and pricing systems may need to be adapted to accommodate the market participants needs' (e.g., auctions announced with a shorter lag, uniform price auctions, syndications, or offering shorter-term instruments).
- Liability management exercises may be needed to manage refunding risks.
- Public entities (including financial institutions and SOEs) should coordinate rather than compete for funds in the market.
- Increase flexibility via cash buffers, credit lines, and other alternative sources of financing, including multilateral lending facilities and grants available particularly for developing countries.
- Track risks from forex and short-term debt and contingent liabilities, considering long-term impacts on fiscal space and debt sustainability.

Keep PFM functions operational

- It is important to ensure that core PFM systems (particularly payments and approvals) continue to function and business continuity plans are activated so that essential services can be provided. This may be

⁴ A forthcoming note (Debt Management Responses to the COVID-19 Pandemic) discusses the role and responses of debt managers in more detail.

challenging because of staff absences, not only because of illness but also because of physical impediments (e.g., government restrictions on movement). The latter may require remote/online tools to be in place for staff who are able to work but cannot come to work and should ensure that potential cyber security risks are managed.

- Controls may need to be temporarily relaxed to facilitate faster payments e.g. delegating authority for reallocation of funds and payment approvals or reducing pre-audit controls on high-priority and low risk payments.
- Ensure close coordination with subnational governments, and with other governments where relevant, including through more frequent coordination meetings.

ANNEX 1: EXAMPLES OF POLICY MEASURES TO RESPOND TO THE COVID-19 OUTBREAK

Category	Policy Measures	Fiscal and Risk Management
Budget measures (fiscal costs reflected in deficit and balance sheet)	<ul style="list-style-type: none"> • Spending (e.g., health services and unemployment benefits); • Capital grants and targeted transfers (e.g., wage subsidies or direct transfers); or • Tax measures (cuts, relief or deferrals). 	<ul style="list-style-type: none"> • Approve and execute measures through usual budget and PFM mechanisms • Reflect full costs up-front in fiscal deficit, debt and financing
Below-the-line or 'off-budget' measures (fiscal costs reflected in increased debt and financing)	<ul style="list-style-type: none"> • Equity injections to SOEs • Loans to firms or households • Asset purchases (non-performing) • Debt assumption • Off-budget operations 	<ul style="list-style-type: none"> • Ensure clear rationale for intervention • Assess fiscal costs • Ensure mechanisms for central approval • Disclose all measures
Government guarantees (no up-front cash flows but exposure to risks and potential future costs)	<ul style="list-style-type: none"> • Umbrella guarantees to financial sector and other sectors • One-off guarantees to specific institutions/entities 	In addition to above: <ul style="list-style-type: none"> • Quantify the size of risk • Consider partial guarantees and risk-based guarantee charges • Retain ability to recover assets • Make provision for expected costs in budget
Other contingent liabilities	<ul style="list-style-type: none"> • Quasi-fiscal operations 	<ul style="list-style-type: none"> • Quantify the size of risk • Disclose all contingent liabilities