 SDN/2022/003

IMF Staff Discussion Notes
Fiscal Affairs Department

The State as Financier of Last Resort

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Authorized for distribution by Vitor Gaspar
October 2022

ABSTRACT: During the COVID-19 pandemic and global financial crisis, governments swiftly served as financiers of last resort through large financial support measures (FSMs) such as loan and guarantee programs and equity injections in firms. This Staff Discussion Note argues that such FSMs prevented bankruptcies and attenuated the recession by increasing firms' liquidity, reducing risk premiums, and boosting confidence. But FSMs also carry large and long-lasting fiscal costs and risks. The note presents recommendations for managing the legacies of the COVID-19 programs and preparing for future crises. Ideally, FSMs should be assessed and included in budget plans, though a balance needs to be struck between speed and scrutiny.

ISBN: 979-8-40022-069-2

RECOMMENDED CITATION: Battersby, Bryn, Espinoza, Raphael, and others. 2022. *The State as Financier of Last Resort*. Staff Discussion Note SDN2022/003. International Monetary Fund, Washington, DC.

JEL Classification Numbers:	H12; H32; H81; E62
Keywords:	Fiscal policy; Below the line; Equity injections; Government guarantees; Government loans; Bailout; Fiscal risks; Public sector balance sheet
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* This note was prepared under the general guidance of Paolo Mauro and was led by Raphael Espinoza and Jason Harris. The note benefitted from helpful comments from IMF departments, Vitor Gaspar, Paolo Medas and Carolina Renteria.

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Executive Summary

During the COVID-19 crisis and the global financial crisis (GFC), governments expanded their roles, serving as financiers of last resort. A prominent avenue, primarily aimed at firms, was large-scale use of financial support measures (FSMs) such as credit guarantees, loan programs, and equity injections. This Staff Discussion Note analyzes the macroeconomic benefits and fiscal costs of such measures; it also sketches a framework for managing their legacy and improving their design in preparation for future crises.

Financial support measures can be a large, rapid, and effective part of a policy response to extreme crises but bring elevated fiscal risks with long running implications for public finances. During the GFC, public sector interventions in the financial sector summed to trillions of US dollars and a decade later, governments' balance sheets remained exposed to a few of these programs (Igan and others 2019). Many of the lessons drawn from the GFC were applied during the COVID-19 pandemic, relating to the importance of rapid deployment of fiscal measures in the face of a deep slump, particularly where monetary policy is constrained, as well as the increased need for transparency and understanding of risks (IMF 2012, 2013). Announced FSMs reached nearly $6 trillion globally, with the largest measures being guarantee programs in advanced economies and were also used in some emerging market economies. FSMs can be swiftly deployed, with various instruments suited to different circumstances (Table 1) and are complementary to budget measures that can take more time. FSMs are most effective where governments have the fiscal space or credibility to back them up and a pre-existing FSM frameworks that allow rapid scaling up. Because they can require complex institutional arrangements, often arranged to fit existing circumstances (for example, involving development or central banks), their deployment increases the importance of transparently reporting them.

FSM's macroeconomic benefits come from preventing bankruptcies by increasing firms' liquidity, reducing risk premiums and boosting confidence, but they are less effective during normal recessions. Using firm-level microsimulations, this note finds that FSMs can reduce bankruptcies significantly. However, these programs also increase corporate debt, and many firms permanently affected by the crisis are still likely to go bankrupt. Using FSMs in crises that are expected to be temporary and targeting the measures to firms that are likely to remain solvent helps ensure resources are used efficiently. Using a general equilibrium model, we show how FSMs reduce the risk of a vicious cycle between bankruptcies, high risk premium, households' and firms' pessimism, and contraction of activity. However, during normal recessions, when bankruptcies do not rise significantly, FSMs are less effective, and standard fiscal and monetary policies should be relied on. An empirical analysis of the announcement effect of the FSMs undertaken during the pandemic shows that these measures can lead to larger improvements in contemporaneous and forward-looking economic indicators than traditional budget measures, if governments have fiscal space. These benefits come at the cost of increased fiscal risks, as the public balance sheets' exposure to losses on FSM-related assets expands.

However, FSMs require strong institutional frameworks to be delivered effectively, and their otherwise opaque nature calls for enhanced transparency, monitoring, and ongoing management. Many FSMs are undertaken outside traditional budget and fiscal reporting, reducing transparency and raising governance issues. Thus, the bar for intervention should be set high, and the fiscal costs and fiscal risks that FSMs entail should be quantified and reported for as long as they remain in place. Developing policy frameworks now will mean FSMs are ready to be rolled out quickly in the future; will help governments determine which measures to use in different circumstances; and will assist in setting risk mitigation measures at the design stage, when the government's ability to control fiscal risks is greatest.