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Investigating the effect of COVID-19 pandemic on monetary policy responses of central banks in Italy and South Korea: a Comparative Review

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Abstract
COVID-19 and Climate Change alike have become humanity's biggest existential crises with both bringing forth trillions of dollars in losses for the global economy cumulatively; long term financial implications for Micro, Small, and Medium Enterprises; and a conundrum for central banks on the extent to which their support is justified. Considering the increasing frequency of climate change-induced disasters it is imperative that we evaluate the impact that COVID-19 has had on the monetary policies of central banks so as to be better prepared as both consumers and policymakers for the next big crisis. We have analysed the monetary policies of two nations Italy and South Korea for our evaluation considering their similarly sized populations for this analysis. Using secondary data we have compared their responses to the pandemic. Through this analysis and comparison, we have seen that COVID 19 has pushed the central banks to play a bigger role in supporting the economies of their respective nations. This could be seen in the way both these nations' central banks adopted policies that extended the envelope of their stimuli support in an unprecedented manner.
Key terms: *COVID-19, Monetary Policy, Central Bank, Inflation*

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I. Introduction

With the Covid-19 pandemic upending our conventional knowledge and understanding of economics, there is a pressing need to rethink and reassess our responses to crisis and non-crisis economic situations. Central Banks and governments across the world have had to grapple with an unprecedented liquidity crisis; volatile consumer demand; stagflationary fears; and rising poverty and inequality levels. No country has been able to save itself from this excess raft of socio-economic issues and it is important for us to assess the policies implemented during the pandemic to better understand the way policies during future crises will take shape. Climate Change is increasingly becoming a bigger cause of concern for all the stakeholders of our economies as it is single-handedly depleting our resources (the drought in Brazil), destroying our infrastructure(the Australian and American Bushfires have collectively cost more than $100 billion) and endangering human lives the COVID-19 pandemic is just the first of much bigger and worse crises to come our way.

With the risk from Climate Change becoming more relevant we analysed the monetary policies of Italy and South Korea, which were implemented during the pandemic. We chose the two countries due to their similar population size with South Korea having 51.7 million and Italy having 59.7 million people in 2019, which acts as an equalising factor for our analysis as the policies implemented in both the nations were targeted towards similar demography thus making this a relatively fair comparison. Furthermore, we chose the two nations due to the vast differences in their economies be it in terms of their GDP, Industry or their financial systems. These differences give us precedent and credence for our analysis since we gain disparate views on the same parameters, thereby helping us do an effective comparison. Lastly, by assessing and evaluating their responses to the COVID-19 pandemic we aim to understand how monetary policies were changed due to the pandemic.

Italy

Eurozone Structure

The Eurozone's financial structure has a monumental bearing on the economic working of the E19. Under this financial arrangement, the ECB decides on a common monetary policy for all its member states with common corridors for financial indicators like Inflation, Interest Rate and Deposit Rates. This system has had a direct impact on the Italian Economy over the years because of the lack of a domesticized approach to devising the monetary policy. This is because the monetary policy designed to resolve a collective set of problems faced by the economies of the 19 member states does not answer many of the localized problems of an individual nation which in Italy's case is its high public debt to GDP ratio or the stagflation its economy been experiencing. The National Central Banks (NCB) of the Eurozone have negligible room to devise their monetary policies that answer more directly to the present needs of their economies, and this makes the entire system vulnerable to the failures of anyone economy. This though can be offset by a fiscal policy response devised by the government, which the ECB is willing to provide support for, monetarily and otherwise. This is essentially what the Italian government has done too to spearhead a COVID-19 response package that answers to many of Italy's singular problems in a more pointed way.

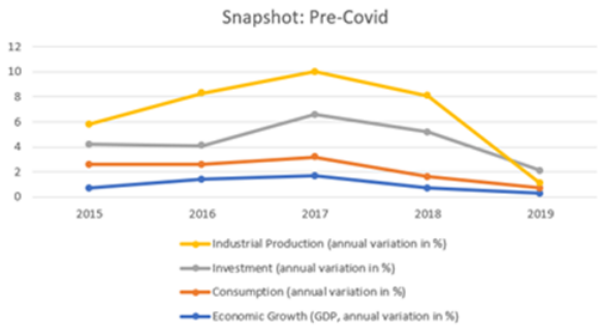
The Italian Economy Pre-COVID

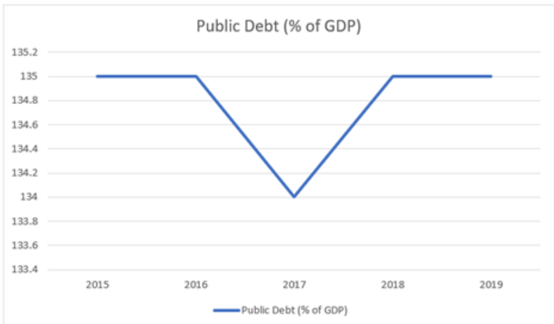
The Italian Economy had been ailing under a weak financial sector and a high public debt load even before the pandemic struck. All these systematic failures had been plaguing the economy since 2016 when it had identified the need to spend $45 billion to shore up banks saddled with bad debts. The country like many Western nations had also been weighed down by crippling stagflation that was further exasperating the crisis at hand. The country had also been pushed into a recession during the 2018 fiscal year when a series of economic and political missteps resulted in a severe economic downturn. The country was further one of the slowest growing nations in the Euro Bloc with a growth rate of about 7.9% between 1999 and 2019 in comparison to Germany's 30.2% and Spain's 43.6% during the same period. This had further exacerbated its debt-to-GDP ratio as the size of the economy has not been able to keep pace with the debt accruals. Even before the pandemic, the ratio had stood at a mighty 135% and the pandemic is projected to have pushed it higher to 157%.

The Impact of the Pandemic

The impact of the pandemic on the Italian economy was particularly severe with the GDP falling 8.9 per cent in 2020. The contraction was the result of a vertical fall in domestic demand, and, in particular, in private consumption, which fell by 10.7 per cent in volume. The nation's traditional dependence on automobiles, 11% of manufacturing turnover and 6.2% of Italian GDP, textiles, 1.3% of the Italian GDP, and tourism, 7.6% of the Italian GDP, was one of the strongest factors contributing to the economic downturn. The three sectors cumulatively account for almost 15% of the GDP and with the pandemic's effects being largely concentrated towards these sectors it was no surprise that the Italian economy suffered far worse than many compatible economies.

In 2020, prices were also squeezed by the collapse in commodity demand and prices, with inflation averaging almost zero throughout the year. The steep nosedive of inflation and the GDP growth rate together meant that the stagflation in the economy had further exasperated. The crisis forced the state to suspend the Stability and Growth Pact, which led to a staggering 9.5% deficit in the budget. While it is important to take into account the extraordinary circumstances the risks that this deficit poses cannot be ignored. This coupled with the nations historically weak financial sector could have catastrophic consequences in the future, but the positives to be taken note of are the substantial management and reduction in the nation's non-performing loans (NPLs), which reduced from 16.5% to about 8.1% per cent at end-June 2019.





Policies Implemented

Being a member of the ECB, Italy had a two-pronged response to the economic downturn. The monetary policy was devised by the ECB, taking into account the health of E19, while the government prepared a more pointed and localized response through their fiscal policy.

Under the ECB's monetary policy deposit facility rates had been reduced to as low as -0.5% to incentivize greater lending by financial institutions in order to ease the liquidation pressures in the E19 economies. Furthering this liquidation push through the financial institutions of the Eurozone was the 0% Main Refinancing Operation (MRO) rates, which ensured that banks could expand their lending facilities by leveraging their balance sheet at no additional costs. Additionally, the expansive Asset Purchase Program adopted by the ECB has been one of the most ambitious and monumental policies of their response to the dramatic short-term impacts of the pandemic. They created a temporary Pandemic Emergency Purchase Program (PEPP) with a culminating envelope of €1.85 trillion, as of December 2020, while also having simultaneously expanded their traditional Asset Purchase Program (APP) by €120 billion during the pandemic. The comprehensive APP helped prevent a rout in Italian bond markets by orchestrating a sizable, the exact numbers have not been disclosed, buying of the Italian bond for as long as required.

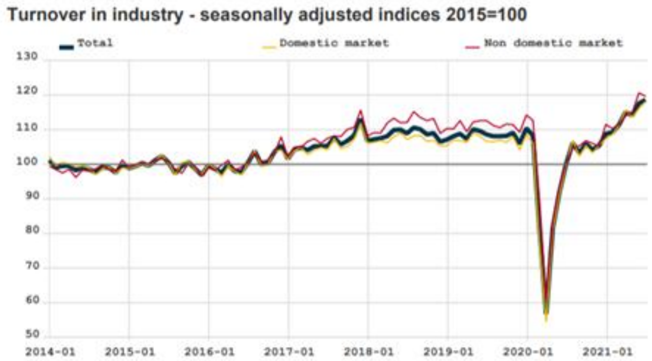
The ECB's policy extended to providing euro liquidity to other central banks using two primary lines arrangement: repo and swap. Through the swap line arrangements, the ECB had created a reciprocal credit line with a network of central banks including but not limited to the Bank of England and Federal Reserve. This arrangement ensured that the central banks maintained a stable and liquid currency market. The repo line arrangement helped safeguard the smooth transmission of the monetary policy in the euro area. Providing short-term liquidity support helps reduce risks related to a sell-off of euro-denominated assets and spillovers of market dysfunctions from other economies to the euro area.

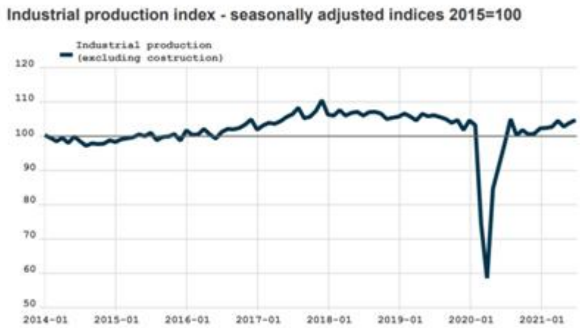
Lastly, the Italian government's fiscal policy introduced measures amounting to over 108 billion in terms of net debt to provide far-reaching support to SMEs, households and, even, the many Italian regions in 2020. The government's policies were part of a four-part package called "Decreto Rilancio" primary of the Liquidity, Relaunch and August decrees. Much like other economies of the world, Italy too had implemented a moratorium on loan repayments, government-guaranteed credit lines to SMEs and income to those families in dire need of state support. The government had further made changes in the laws governing business and investor activity of the southern nation to make it easier for businesses to borrow, conduct business activities and tougher to file insolvency. The Liquidity Decree was monumental as it pushed the envelope by guaranteeing credit of up to 400 billion taking the total mobilized credit to a staggering 750 billion. The Relaunch Decree further expanded this liquidity push by increasing the mandate of the SACE guarantees by 34 billion that further eased the liquidity pressures in the economy. Another monumental policy change was allowing Italian businesses to be exempted from the IRAP (a regional tax on productive activity) which allowed businesses to mobilise a greater part of their turnover to business activities instead of tax operations thus paving way for a broader push to restart and simultaneously increase the industrial operations.

Italian Economy Post-Covid-19

Presently, the Italian Economy is surging due to the sharp rebound in demand seen post-Covid in many of the worldly economies. While beneficial over the short term, the longevity of this trend is a big question mark that would be tough to resolve considering the fluidic and dynamic nature of the COVID-19 pandemic, which could alter the economics of the nation in a flash of a second. The demand has been favourable in spearheading a recovery in the broader economy as can be seen in the graphs below.

Moving forward, Italy has received the greatest share of the ECB's Next Generation EU with 191.5 billion being greenlighted for their Italian Recovery Plan to help ensure that the pandemic-stricken economy not only recovers but also stays on a path of sustained growth. The Italian government has created a National Recovery & Resilience Plan using this and additional capital allocations to spearhead an economic recovery plan built around three strategic axes shared at a European level: digitization and innovation, ecological transition, and social inclusion. This plan coupled with the rest of the E19s support-based stimulus could potentially help maintain the growth seen post-Covid-19 in western economies which have traditionally been stagnant in the past. Since these economies are partners in trade and financial arrangement they are exposed to each other's growth and contractions. Thus, a favourable growth rate in the larger E19 could also influence a sustained and long-term Italian recovery.





South Korea

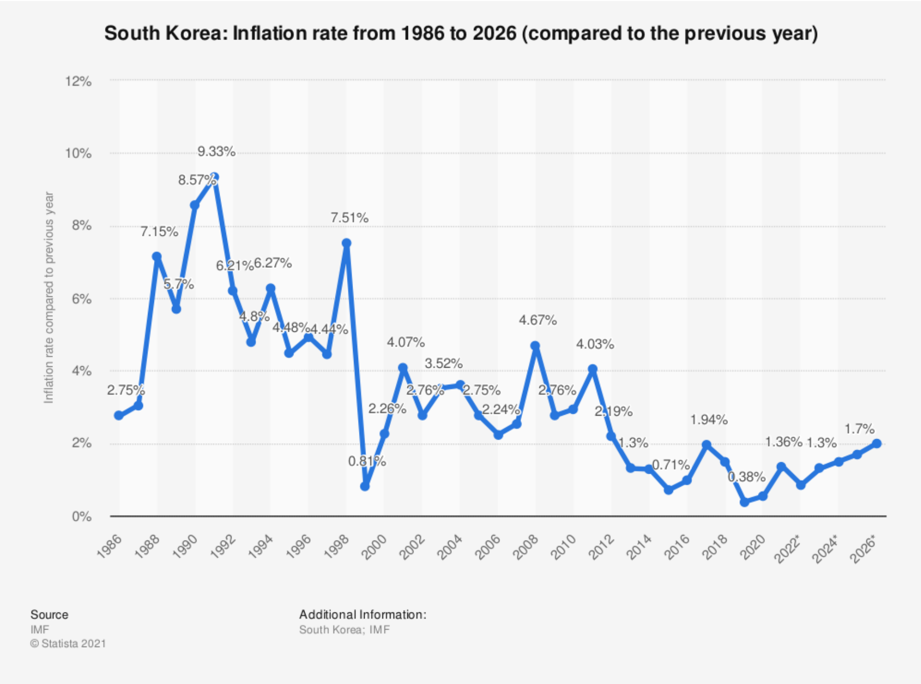
South Korean Economy Pre-COVID 19

Over time, Korea has transitioned quite swiftly from a low-income to a high-income economy. Beginning withinside the early 1960s, the Korean economic system grew very swiftly, by pushing through more and more aggressive export-orientated manufacturing, underpinning their growth on excessive foreign funding, growing academic attainment, and developing a working-age population, thus effectively shifting the production possibility frontier outwards. Structural changes including stronger regulations in regions before the boom takeoff, sound macroeconomic regulations, upgrades in institutions, and an orientation closer to industrialization through export competitiveness, kicked off a cycle of improved inputs thus resulting in an output boom, hence transferring Korea to an excessive funding equilibrium. However, the country now faces a unique set of demanding situations than those it efficaciously faced in the past. More recently, demographics—which formerly have been favourable to boom—are posing a major challenge as the population ages. Meanwhile, demand for shifts in policies is exposing structural weaknesses that have been much less obvious during stages of the boom but are causing major hindrances now. This issue has been exacerbated by South Korea's reliance on the Chaebol system and the private multinationals that form a key component of the economy, and thus their slumps in growth are reflected directly by the country's economy. Amidst this deflation, the growth rate of the GDP fell alarmingly from 3.2% in 2017 to 2% in 2019, however, a relatively average debt to GDP ratio of 42.25% in 2019 is a positive indicator that may allow South Korea's economy to bounce back.

Impact of the Pandemic

With a 3% fall in GDP growth rate and an already shrinking GDP, the South Korean economy was definitely hit by the pandemic and its effects. A distinctive feature of the COVID-19 shock was that it resulted in major reallocation in the service industry, rather than the manufacturing industry which in previous financial crises had been more susceptible to such alterations. Furthermore, the resounding effects on economic activity were observed to be highest in low-wage industries, wherein adaptability to swift structural transformation is tougher to achieve. Nevertheless, it is important to note that, unlike numerous other countries, the size of the recession sparked by the pandemic was lower in South Korea compared to previous recessions faced by the economy.

The volatile inflation rates of South Korea, on the other hand, saw an increase as it moved from a mere 0.38% in 2019 to 1.36% in 2021. This increase may have been a result of the expansionary policies implemented by the South Korean government which had its impact. Regardless, the economy was unable to meet its targeted inflation rate of 2% and a trend of deflation is clearly visible over time, which is a worrying concern for the ageing population of South Korea.



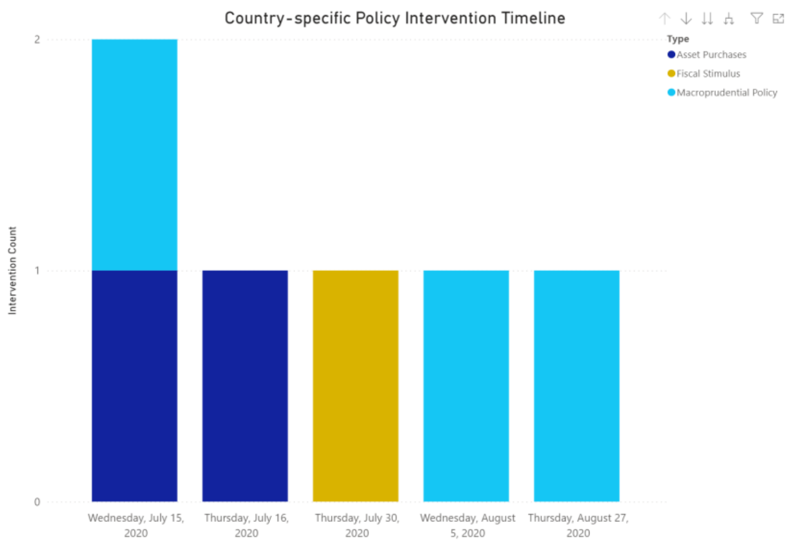
Policies Implemented

● Open Market Operation: The Bank of Korea began purchasing a significant amount of local bonds to aid in the prevention of the possibility of a liquidity crunch. The move expanded Korea's purchase program to become more inclusive and include bonds issued by public enterprises.

● Interest Rate: The Bank of Korea cut its repo rates from 1.25% to an all-time low of 0.50%. The interest rate was then increased to 0.75% in August 2021.

● CBBLF: the Bank of Korea initiated the Corporate Bond-Backed Lending Facility (CBBLF), a novel scheme, to counter the deterioration in credit flow by providing a safety net to all institutions.

● Floor Ceiling: The Bank of Korea raised the ceiling of the Bank Intermediated Lending Support Facility from 25 trillion won to 35 trillion Won.



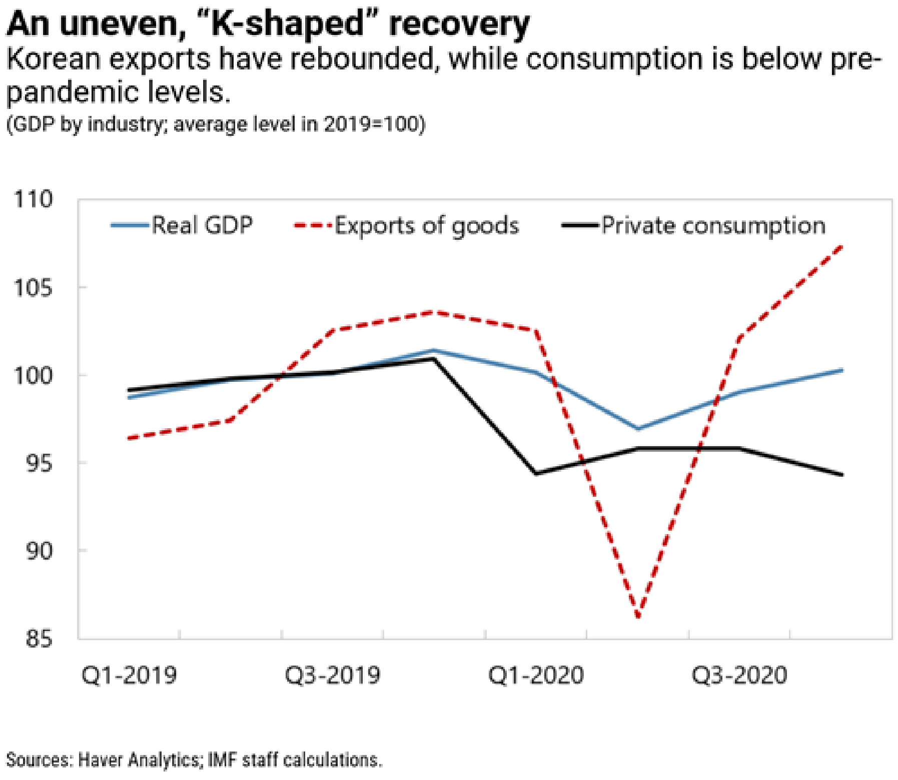
Apart from the intervention of the central bank, South Korea's traditional reliance on its Chaebol system as well as its financial sector for support was once again witnessed as the financial sector provided around 2.1 Billion euros worth of financial support directed at small and medium enterprises. A major portion of the financial stimulus was funded through the extremely high inheritance tax that South Korea levies on chaebols such as Samsung. The following conditions were enacted by the government:

- An Emergency Fund, providing direct financial support to SMEs and self-employed, aimed at encouraging these firms to keep their employees
- Insurance on loans and government guarantees.
- Support for the safe and sanitary reopening of small and medium enterprises
- Transition of brick-and-mortar shops to online business encouraged.
- Limitation of on-site inspections to simplify processes and reduce costs.

Therefore, the Korean government used minimal policies reliant on asset purchases and macroprudential moves to fuel an expansionary policy powered by the monetary system implemented by the Bank of Korea.

South Korean Post-COVID-19

Korea's financial system has combated the economic effects of the pandemic relatively well due to sound macro-financial policy management which has experienced worse situations such as in the Asian Financial Crisis. However, the economic challenges posed by the pandemic have been unique and thus have caused negative ripple effects in the economy.



While the economy and its export seem to be revising, the fall in private consumption is a major concern. Although the nation's debt is manageable, low-interest rates have resulted in the Korean household debt being one of the highest in the OECD at over 190 per cent of disposable income. In addition, South Korea's blind and extensive support for SMEs has caused around half of the total stock of SME bank credit (around 22 per cent of GDP) comprising firms with earnings that are insufficient to cover their interest payments. In light of this, an increase in interest rates, as seen in August, will cause heightened concerns for the economy, and might further cause deflation and a negative growth rate. Hence, while the pandemic's effects may have been countered by swift, effective policies, a few major concerns of debt, low-interest rates, and volatile inflation still impede the South Korean economy, thus making it not one of the most effective long-term solutions implemented by a country to counter COVID 19.

Evaluation

● Both the nations had an extensive asset purchase program in place even before the pandemic, and they both extended the envelope of these programs by a considerable amount during the pandemic to ease liquidity pressures in the markets. The moves in both nations helped prop up the weak markets as the government buying effectively policed a sharp sell-off across asset markets like the stock and bond markets, which helped prevent an even more severe crisis.

● Repo rates in Italy, known as the Main Refinancing Operations, were lower than that of South Korea. Italy's MROs, as set by the ECB, were 0% in comparison to South Korea's 0.5%. Italian banks, thus, could borrow at no additional interest from the central banks as compared to South Korea's 0.5% rate. Italy's rates had been the same for the past few years considering the stagflationary pressures in the economy pre-covid, and the advent of the pandemic further justified the rate. South Korea had been a growing economy before COVID-19, which justifies the fact that their repo rates were 0.5% considering the previous economic conditions and repo rates.

● Debt served as a key factor in the decision making processes of both countries. Italy was already sunken deep in public debt before the pandemic began, however, South Korea was in a much more comfortable position. Regardless, both countries provided insurance against loans and guarantees as well. This was a much-appreciated move in Italy, however, in South Korea, it just led to the increase of the already high levels of household debt. It could be argued that South Korea could have taken advantage of its position and released a larger stimulus package and that Italy's membership in the European Union was crucial in the release of apt aid and relief in such times to the Italian economy.

● Small and medium enterprises were some of the most supported sectors in the entire economy due to their limited financial and business outlay, which made them particularly vulnerable to the short-term, as well as the long term, effects of the pandemic. The Italian and South Korean governments alike had an extended loan moratorium, collateral-free loans, some of which were even secured by the government, and tax relaxations to offset the financial drag caused by the pandemic.

II. Conclusion

Therefore, the study indicated that while South Korea was viewed positively due to their restriction of the COVID-19 outbreak and Italy was reprimanded for the same, Italy in fact implemented numerous measures and policies which had a long term constructive effect in bringing the country out of stagflation. On the other hand, South Korea initiated lesser measures and stimuli in order to combat COVID-19, thus being unable to effectively negate the deflation taking place in the economy. While most policies implemented by both countries were similar, it was found that Italy's management of debt, huge fiscal deficit, and European Union's backing was integral in its economy's revival. By studying such policies, this exploration has successfully assessed the policies implemented by South Korea and Italy, compared and contrasted their effects, and evaluated their effectiveness.

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