A tale of two responses

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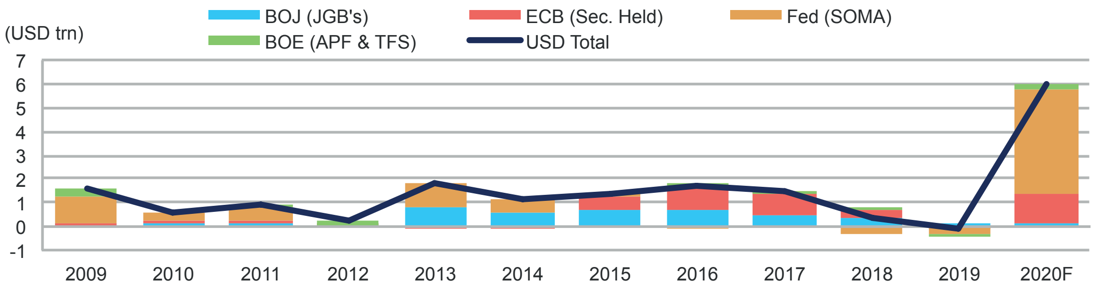
Global QE purchases in USD terms



Source: Fitch Ratings, Haver Analytics

The bond markets have evolved so much since the last crisis it is difficult to imagine how anyone could have written a more epic script, particularly when it comes to what constitutes the new "normal" level of yields and to the ever-expanding roles of central banks - the US Federal Reserve Bank (the Fed) and the European Central Bank (ECB) being at the forefront of this.

As the covid-19 shock waves reverberated, central banks were prompt to respond and the Fed and the ECB unarguably took over the reigns of economic policies. The magnitude of this pandemic has also highlighted the stark differences between the two approaches to preserving financial stability. Such differences really root from their policy objectives, which were set out decades ago.

Despite the pressure put on the Fed by US President Donald Trump, market participants have considered its response to be swifter and broader by going beyond the traditional monetary boundaries, and that is primarily due to the Fed's single mandate to ensure maximum employment, which the ECB just isn't designed to do. Jerome Powell and his committee have concentrated the Fed's response on preserving jobs in the US, notably by launching vast lending facilities to help small and medium-sized enterprises (SMEs) directly, and this includes its unprecedented pay check protection programme. The various funding measures are directed to companies with a maximum number of employees (15,000), so it is not as if the Fed is helping the local shoemaker or family-owned wine shop, but it is targeting companies directly, without going through the middle men – which are the banks – as the ECB has had to do.

Also, whilst the Fed has introduced an unprecedented municipal liquidity facility, it has not yet spent one dollar on purchasing corporate bonds, like the ECB has, and has only been buying municipals, US Treasuries and a relatively small number of exchange traded funds (ETFs).

The ECB, on the other hand, cannot follow the same fiscal route as the Fed because of the nature of its mandate within the European Union (EU) framework. Therefore, its response throughout the pandemic has been focused on ensuring maximum liquidity and channelling funds through the banking sector, and via its ever-growing emergency bond purchasing programme (PEPP). Currently, in Europe, 80% of companies' borrowing is channelled through banks as opposed to only 20% in the US.

The ECB hopes that by providing liquidity to banks and pouring money their way the banks will increase their lending to companies which need it. The problem with this approach is that there is a risk of such weapons becoming diluted if banks don't lend all this money that they are borrowing. Banks can easily do carry trades and profit from borrowing money at cheap levels, and there is a strong chance that they will also focus on preserving their capital ratios. At least, a lot of this happened during the bouts of quantitative easing that came after the global financial crisis. Although there are signs that banks in Europe have stepped up their lending in recent weeks, money delivered in this way is at risk of being dispersed in the wrong directions.

Undeniably, the ECB has done a great job at supporting the bond markets throughout this crisis, particularly with liquidity issues as the lockdowns hit hard in March. Neverthelss it has not been able to offer direct assistance to the real economy and businesses facing insolvency as the Fed has done.

The ECB is aware of its mandate limitations, and has intervened by buying increased amounts of corporate and government bonds to try and make sure that companies and countries can borrow at cheap levels during such trying times. The idea being that if governments have low funding costs, then they can press that fiscal button. Of course, banks and bond investors have benefited from this response, but European businesses and consumers are heavily dependent on fiscal stimulus packages put in place by their governments. Unlike in previous crises, the fiscal response from European leaders has been substantial, but this has come at a growing cost on public finances and this issue is not going to go away.

The ECB is certainly doing all that it can within its limits, and Christine Lagarde, the ECB's president, has continuously put pressure on European governments to create strategic rescue funds and the European Commission is getting more involved at the same time. However, as the recession lingers and lockdowns take longer than expected to lift, more will need to be done directly for those businesses at the heart of the economy that are currently battling to make ends meet. This is not only putting a bigger question mark over the future of the EU, but also brings to the surface a basic question for modern governments about what the roles of central banking should be today? Can effective monetary policy survive without fiscal union?

Even the Fed, despite its powerful and direct response, faces some questions. 40 million US workers lost their job in under three months, pushing the employment rate from 3.5% to 14.7% while the same measure only rose from 5.0% to 6.3% in Germany. Moreover, while the Fed addressed the insolvency problem in a more direct way, there is now a lot of talk about how its support for SMEs is going to end or enhance the "zombie" issue. Already we can see the breadth of businesses borrowing just to stay afloat, so jobs that should not exist are exhausting recovery funds and monopolising money that could be put in more sustainable places. These issues are more structural and lead to long-term effects, and this crisis has drawn attention to the Fed's independence. As it increasingly becomes best buddies with the US Treasury, there are reasons to wonder whether it is just another government department, or perhaps, another political tool.

Time will tell how these revelations pan out, but if there is one thing to emerge from this novel coronavirus crisis, it is that now could not be a better time to rethink the world's monetary constitution.