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The Fed’s monetary war

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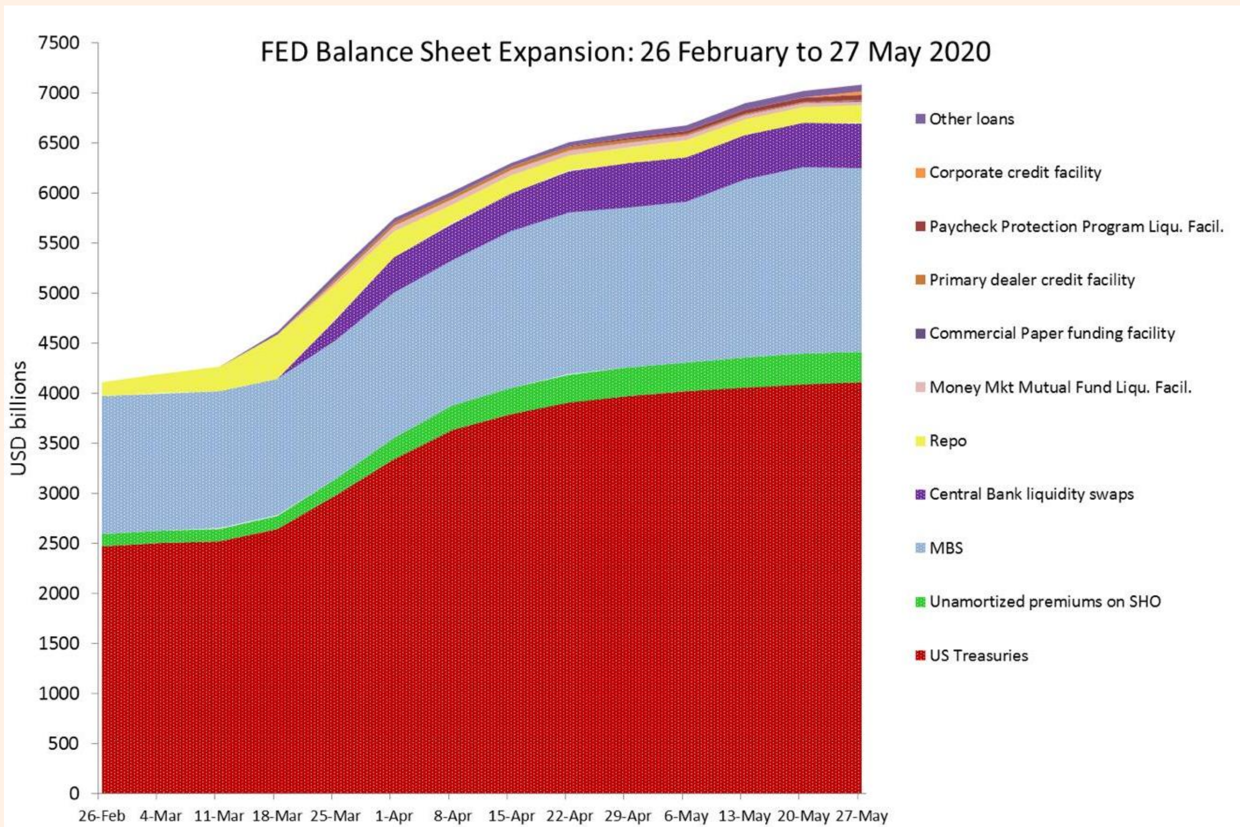
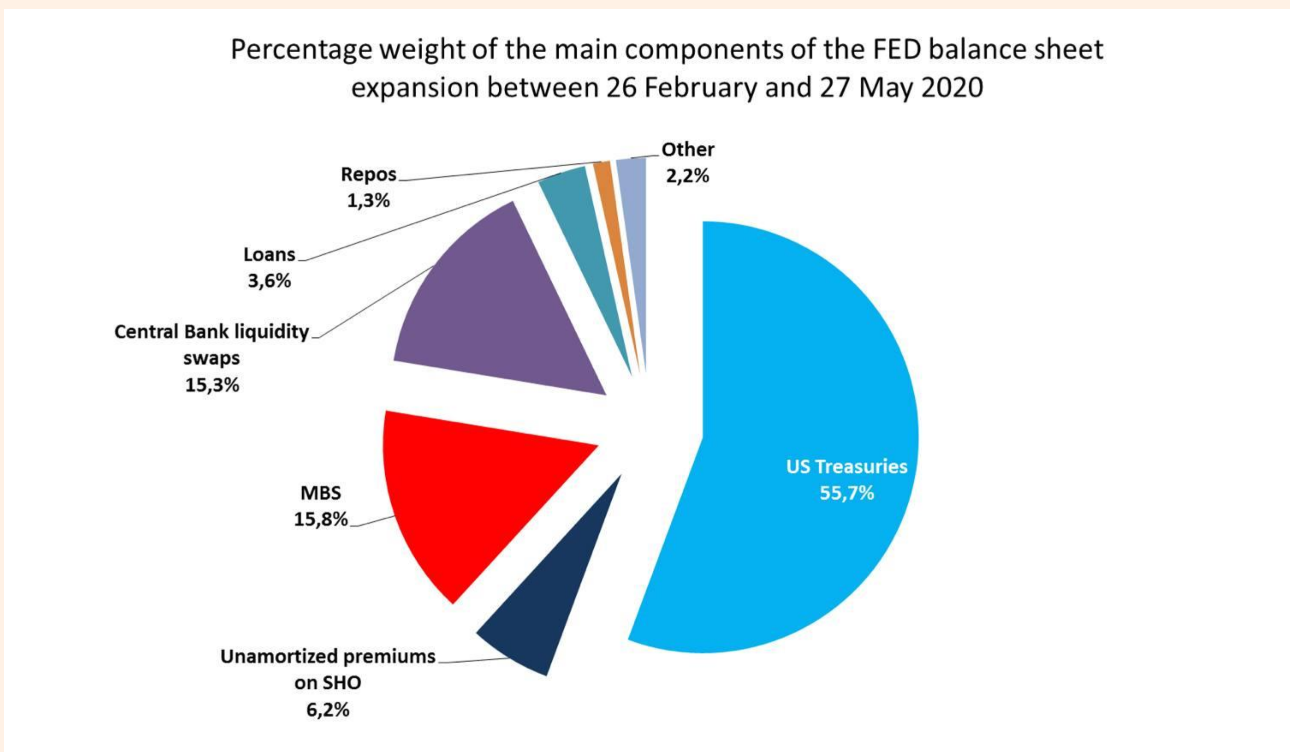
This is a guest post Marcello Minenna, general director of the Italian Customs and Monopolies Agency, in which he argues that the recent balance sheet expansion of the Federal Reserve is akin to a type of temporary nationalisation of the economy. He also argues that dollar swap line operations which favour the Cbank-6 suite will eventually tempt others without access, such as the People’s Bank of China, to consider liquidating their US Treasury holdings. The views expressed are strictly personal.

Since late February, the Federal Reserve has intervened in an imposing way to stem the devastating economic repercussions of the pandemic. After two consecutive cuts in the policy rates for a total of 150 basis points (the target for the upper limit on the Federal Funds Rate has gone from 1.75 per cent to 0.25 per cent), in just three months, its balance sheet assets jumped from $4.16tn to $7tn (more than 70 per cent).

Already at the time of the global financial crisis, the Fed had shown its willingness to resort to a large arsenal of measures to support the economy and financial system: in the aftermath of the Lehman bankruptcy (September 15, 2008), it took just two months to increase the assets in its portfolio by 140 per cent. However, in absolute terms, the interventions of the last few months are unprecedented, also taking into account that this time it started from an already fairly high level of assets (over $4tn compared to $926bn at the beginning of September 2008) and, nevertheless, in a very short space of time, proceeded to inject into the system almost $3tn.



The key drivers of this powerful increase are quantitative easing (QE), notably via the purchase programme of government bonds and mortgage-backed securities (MBS), and the use of dollar liquidity lines by foreign central banks (central bank liquidity swaps).

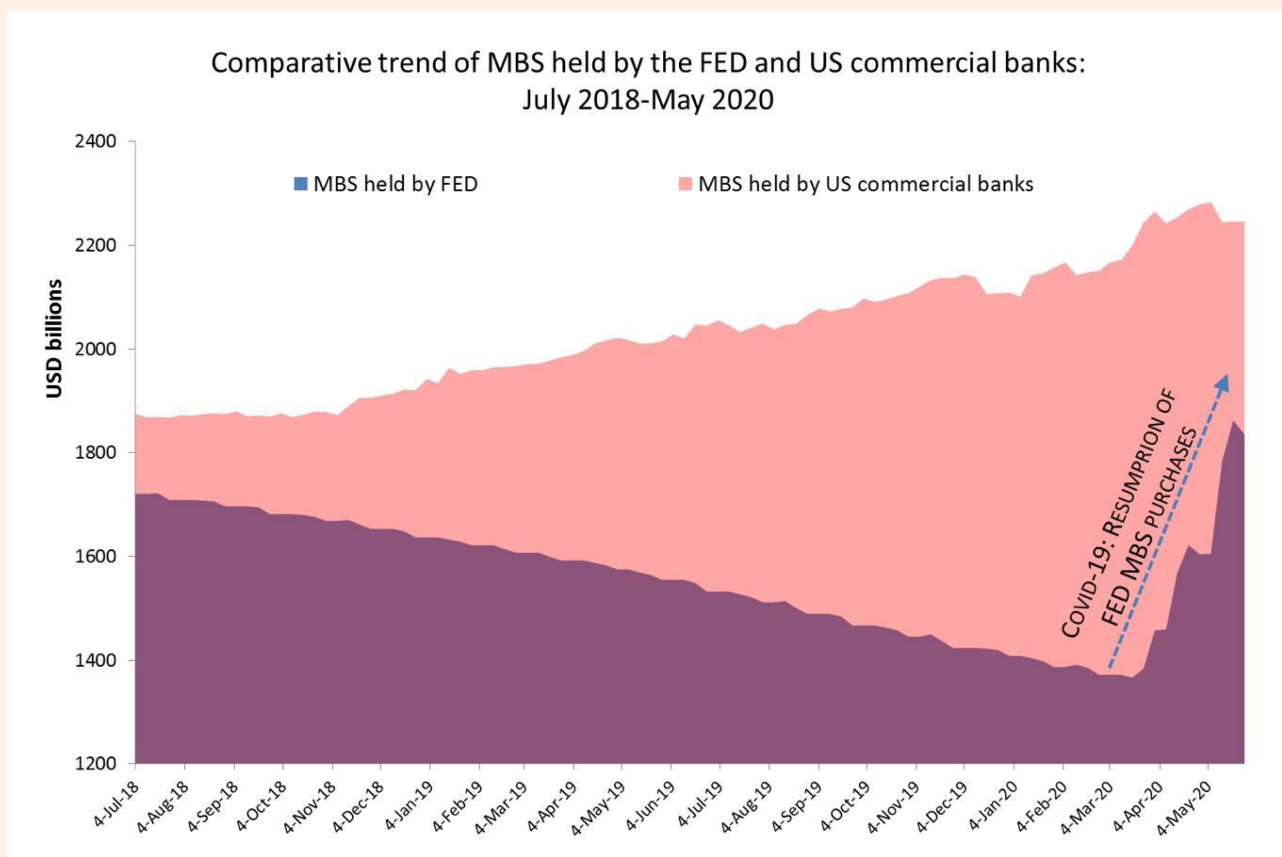


A bond-buying spree

Between Treasuries and MBS, the classic QE component amounts to $2.1tn, equal to 71.5 per cent of the entire balance sheet increase made in response to the pandemic.

The massive securities purchase inflated the assets held by the Fed also through the boom in unamortised premiums on securities held outright: an increase of over $180bn in three months, equal to 6.2 per cent of the entire balance sheet expansion. As mentioned above, Fed securities purchases take place on the secondary market: when the market price it pays is above the face value, the difference represents a premium which is intended to be amortised in annual instalments.

The unamortised part – evidently greater for recently purchased securities – is recognised as an asset item. Between the end of February and the end of May, this item underwent a record increase of 147 per cent, a sign that the Fed on average paid a particularly high premium on the securities purchased in recent months. This evidence is to be reconnected to the drop in government yields and to the consequent Treasuries' appreciation.



A discriminatory network

The other major component of the Fed assets' expansion are the dollar swap lines with central banks from other currency areas. Faced with the huge dollar liquidity needs generated globally by the Covid-19 crisis, the Fed has strengthened the permanent swap line with the other central banks of the C6-network (Bank of Canada, ECB, Bank of Japan, Swiss National Bank and Bank of England) and has opened temporary dollar swap lines with the monetary authorities of several other countries. At the end of May, the overall use of these liquidity lines amounted to $448bn, equal to 15.3 per cent of the entire change in Fed assets recorded in the last quarter.

Thanks to these interventions, compared to March – when the excess demand for dollars on the international markets had created pressures on several currencies resulting in a widening of the cross currency basis (i.e. the premium paid on the markets to borrow dollars with respect to their implied cost according to the covered interest parity) – the situation now appears to be normalising.

Dollar swap-line discrimination

However, some stress remains, especially with regard to central banks that have not been given the opportunity to access dollar swap lines, such as those of China, India, Russia, Turkey and Saudi Arabia. This discriminatory strategy is not without risks even for the US since to obtain dollars some large foreign investors – notably China – could be tempted to liquidate their large holding of US Treasuries.

To contain this threat, on March 31 the Fed set up a temporary dollar lending line (FIMA repo facility) for foreign monetary authorities with accounts at the Federal Reserve Bank of New York, allowing them to borrow dollars at 25 bps over the IOER rate – that is, the rate paid on reserves in excess of regulatory requirements – by posting their holdings of US Treasuries as collateral. However, so far the resort to this facility has been rather modest as it is excessively expensive compared to alternative dollar funding strategies.

At present some of the countries that continue to experience dollar funding strains are drawing on their stock of foreign exchange reserves (such as Saudi Arabia) while others are allowing a weakening of their currency against the dollar, as in the case of the China.

Repos and liquidity

Altogether QE purchases and central banks liquidity swaps represent 93 per cent of the entire Fed monetary bazooka. The remaining 7 per cent includes repos to

support liquidity on the domestic interbank market (in continuity with the response to the sudden freezing of this market which occurred last September) and various liquidity facilities.

These include a commercial paper funding facility, a paycheck protection liquidity instrument and a corporate credit facility. The latter also provides for the purchase of US-listed ETFs that have a broad exposure to the US corporate bond market (including fallen angels – where credit ratings have recently been downgraded from investment grade to junk) and with a preference for the energy sector in order to support the shale industry. Although the volumes are contained for now, the provision of such a facility is particularly meaningful as it hints at the Fed's potential capacity to 'nationalise' a part of the real economy (the only other central bank that has gone further so far is the Japanese one with the direct purchase of corporate shares).

Further targeted credit lines have been set up for money market mutual funds and for primary dealers with an evident role alongside the QE to support Treasury prices. A targeted lending program for small and medium-sized businesses (Main Street Lending Program) that were financially sound before the start of the pandemic, should also start soon.

Don't fight the Fed?

In short, this is a tremendous effort to support an economy struggling with the worst crisis since 1929. And although recently the pace of growth of the Fed's balance sheet has slowed compared to the peaks seen in late March and early April, the worst doesn't seem to be over.

The federal government is significantly increasing the public debt to tackle the crisis: from February to April 2020 net issuance exceeded $1.8tn (over 1.7 times the net issuance of the entirety of 2019), and, of course, the debt is set to rise in the coming months.

For now, the dollar is holding up well, thanks to the exorbitant privilege of being the only true global reserve currency, but some are beginning to wonder how long it can last.

The dramatic deterioration in the growth perspectives is compounded by impending deflation and widespread social unease that has been raging in protracted anti-racist protests in recent weeks. Moreover, the effectiveness of the enormous Fed balance sheet expansion is to some extent invalidated by the further slowdown in money velocity: the prolonged lockdown and the spike in bank deposits indicate that the number of transactions carried out with a unit of currency over a given time period is sharply decreasing.

In the coming months, the Fed could continue with the toolkit used so far (by the end of the year its total assets could reach $10-12tn), or opt for alternative measures. One possibility would be another cut in the policy rates which, however, are already at an all-time low: cutting again would mean moving to a negative interest rate policy such as that in force for some time in other currency areas including the euro area. So far, however, several leading figures of the Fed have shown little inclination for this move.

Rather, it seems likely that the Fed will soon move to directly target the yield curve (so-called yield-curve control), as the Bank of Japan has been doing since 2016 (and what the Fed did during the Second World War). To definitively convince the markets that rates will not go up for a long time yet, the Fed could therefore undertake to cap government yields below preset thresholds at certain maturities, probably between two and five years. Operationally this would entail (potentially unlimited) Treasury purchases on these maturities in order to discourage ex ante any adverse trade by market operators.

In the last Federal Open Market Committee policy meeting no clues emerged in this regard: the Fed has pledged to continue QE and to keep short-term rates near zero at least until 2022. Yet, many market players believe that the shift to a yield curve control framework could materialise this year. It remains to be seen whether even such a move would be enough to reboot the economy. For sure the Fed has already entered times of monetary war.