# EDITORIAL



## MONETARY POLICY: TODAY'S RELIEF, TOMORROW'S HEADACHE?

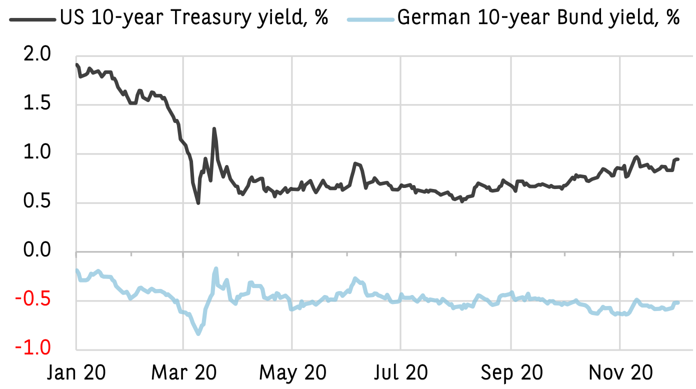
**The Federal Reserve and the ECB have been highly successful in influencing asset prices as part of their effort to cushion the shock to the economy from the Covid-19 pandemic. However, one might wonder whether today's relief could cause an investor's headache tomorrow. The difficulty of an exit strategy does not imply that certain monetary tools should not be used in the first place. After all, they do have positive effects. However, the likelihood of a bumpy normalisation process of monetary policy calls for careful preparation by central banks as well as investors. These considerations could become particularly relevant should the recovery in 2021 end up surprising to the upside.**

The Federal Reserve and the ECB have been highly successful in influencing asset prices as part of their effort to cushion the shock to the economy from the Covid-19 pandemic. Despite huge increases in public sector borrowing requirements and hence the ensuing supply of paper, bond yields have been remarkably stable in the US and Germany (chart 1). In the US, it is only recently that yields have risen somewhat. Another striking observation is the breakdown in the correlation between Wall Street and the treasury market. In recent years, share prices and bond yields were often moving in tandem, both going up or down. Since the equity rally that started in the spring of this year, this is hardly the case (chart 2). In reaction to the pandemic, the Federal Reserve has also extended its remit by announcing it would buy newly issued bonds of corporations rated investment grade before the pandemic. This happened with the backing of the Treasury, which would cover any losses on these purchases due to defaults. As a consequence, the spread widening versus treasuries was far more limited than in 2008 despite a rise in the unemployment rate that was considerably larger than during the Great Recession of 2008 (chart 3). In the euro area, the ECB's Pandemic Emergency Purchase Programme – through its flexibility in terms of pace and geographical allocation – has been instrumental in stabilising Bund yields and in narrowing sovereign spreads (chart 4).

Via a variety of transmission channels, these policies have influenced activity and demand in the economy. However, one might wonder whether today's relief could cause a headache tomorrow. Recent financial history reminds us that this is a genuine risk. In 2013, Fed Chair Ben Bernanke triggered the 'taper tantrum' by suggesting that the Federal Reserve might reduce the pace of its asset purchases[1]. It remains to be seen how markets will react when the ECB will announce, one day, that it is contemplating to scale back or even stop its net purchases under the Pandemic Emergency Purchase Programme. Granted, it can be argued that this will be conditioned by the eurozone having sufficiently recovered from the pandemic, which implies that investors should not be concerned about a near-term increase in sovereign risk. On the other hand, the asset allocation of

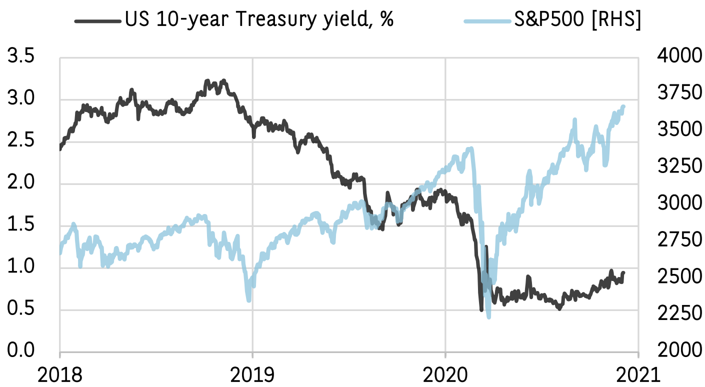
1. Bernanke said *"If we see continued improvement [in the economy] and we have confidence that that is going to be sustained then we could, in the next few meetings, take a step down in our pace of [asset] purchases"*. Source: "The history and future of QE", Speech given by Ben Broadbent, Deputy Governor Monetary Policy Society of Professional Economists, London, 23 July 2018).

US & GERMAN BOND YIELDS




SOURCE: REFINITIV, BNP PARIBAS

S&P500 AND US 10-YEAR TREASURY YIELD




SOURCE: REFINITIV, BNP PARIBAS

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investors would need to change to make up for the void left by the ECB, which would no longer be buying government bonds or at least not as much as before. Such an allocation change could require an increase in sovereign spreads.

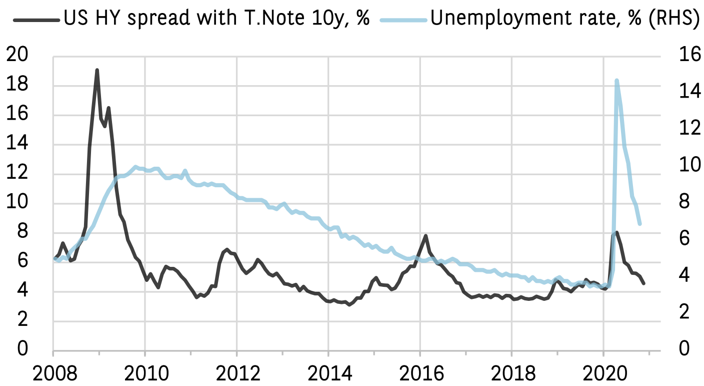
Another question concerns the new inflation targeting strategy of the Federal Reserve, introduced at the end of the summer. Committing to accept a moderate overshooting of the inflation target during a certain time represents an invitation for investors to take more risk. After all, the much-dreaded monetary tightening has now become a more distant prospect. This begs the question how these investors will react when inflation has reached 2%. Their reaction will not only be strongly influenced by the perceived reaction function of the Federal Reserve but also by the vagueness of the latter's new strategy. What is a moderate overshoot? How long will it be accepted? It runs the risk of generating abrupt 'taper tantrum'-like reactions. The ensuing rise in treasury yields would affect not only other asset classes, both in the US and abroad, but could also have consequences for the real economy, via an increase in mortgage rates and wealth effects.

Finally, the corporate bond programme of the Federal Reserve also gives rise to mixed reviews. On the one hand, it is credited with avoiding that many more corporations would default, thereby softening the shock of the pandemic to the economy[2]. On the other hand, bond investors could consider it as a put option extended by the central bank and expect that such an operation could be repeated in the future. This would lead to a structurally lower reward per unit of credit risk. For the borrower, it could create an incentive for gearing up the balance sheet[3].

The difficulty of an exit strategy does not imply that certain monetary tools should not be used in the first place. After all, they do have positive effects, in terms of stabilizing investor expectations and, indirectly, influencing the real economy. However, the likelihood of a bumpy normalisation process of monetary policy calls for careful preparation by central banks as well as an acute awareness on the side of investors. For the former this concerns in particular the communication strategy whereas for the latter, the level of risk-taking is of key importance. These considerations could become particularly relevant should the recovery in 2021 end up surprising to the upside.

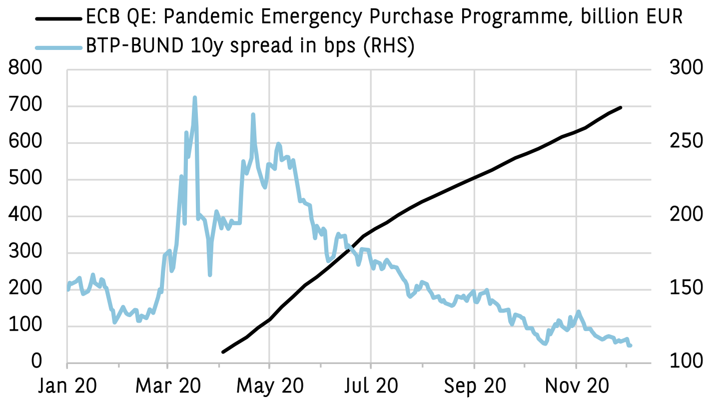
**William De Vijlder**

**US: UNEMPLOYMENT RATE AND CORPORATE BOND SPREAD**




SOURCE: FEDERAL RESERVE, BLS, REFINITIV, BNP PARIBAS

**PEPP OF THE ECB**




SOURCE: ECB, REFINITIV, BNP PARIBAS

2. According to recent research, *"the Fed's corporate debt intervention prevented an even larger decline in real GDP, ranging from 0.6 to 2-¼ percent four quarters later."* Source: *How New Fed Corporate Bond Programs Dampened the Financial Accelerator in the COVID-19 Recession*, Michael D. Bordo and John V. Duca, Federal Reserve Bank of Dallas Working Paper 2029, November 2, 2020, https://doi.org/10.24149/wp2029.
3. Quoting Bordo and Duca (2020), *"the new corporate facilities are not exactly a free lunch and their true costs and hence net benefit will depend on how they are eventually unwound and the extent of the moral hazard effects they induce."*