EDITORIAL

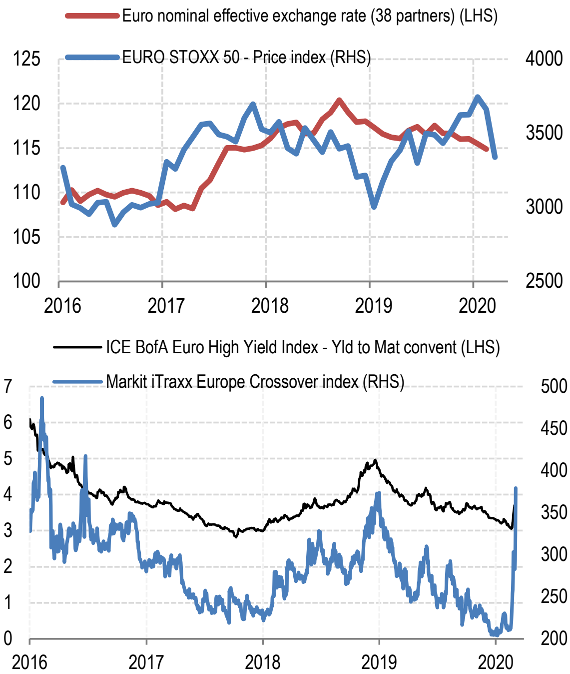
THE IMPORTANCE OF MONETARY POLICY IN ADDRESSING THE ECONOMIC CONSEQUENCES OF THE CORONAVIRUS

The Federal Reserve created a surprise this week by, quite unusually, going for an inter-meeting cut of the federal funds rate of 50 basis points. At first glance, the very nature of an epidemic makes monetary policy ill-equipped to address the consequences. The drop in demand and the disruption of supply are not related to the level of interest rates. Nevertheless, monetary policy has an important role to play in the current environment by seeking to avoid a deterioration of the financial and monetary conditions. This is a defensive move, the alternative being to run the risk that the tightening of these conditions acts as an additional brake on activity. It seems this has played a role in the decision of the FOMC and it now puts the onus on the ECB to act at its meeting next week.

This week has seen a large number of official statements expressing a readiness to act in order to address the economic consequences of the coronavirus epidemic. Bank of Japan Governor Kuroda declared that "*the BOJ will monitor developments carefully, and strive to stabilise markets and offer sufficient liquidity via market operations and asset purchases*" [1]. The ECB issued a statement by President Lagarde that, it "*[stands] ready to take appropriate and targeted measures, as necessary and commensurate with the underlying risks*." The conference call of G7 Finance Ministers and Central Bank Governors reaffirmed that all appropriate tools would be used to achieve strong, sustainable growth and to safeguard against downside risks. The Federal Reserve, confronted with accumulating anecdotal evidence on the impact of the epidemic on US companies decided to act and, quite unusually, went for an inter-meeting rate cut in the federal funds rate of 50 basis points.

At first glance, the very nature of an epidemic makes monetary policy ill-equipped to address the consequences. What difference will a rate cut make when households can't go to work or value chains of companies are disrupted? This was acknowledged by Jerome Powell in his press conference: "*We do recognize that a rate cut will not reduce the rate of infection, it won't fix a broken supply chain. We get that. We don't think we have all the answers. But we do believe that our action will provide a meaningful boost to the economy.*" [2] The skepticism about the effectiveness of monetary policy at the present juncture is also based on the observation that interest rates are already very low and that liquidity is abundant, as shown by the excess reserves of the banking system in many jurisdictions. In addition, the signaling channel –cutting rates today means they will stay lower for longer- is supposed to be rather weak. In the US, fixed income markets are pricing in several further rate cuts whereas in the eurozone, state-dependent forward guidance has locked in the very accommodative stance for years to come. This is not the time to worry about rate hikes.

FINANCIAL CONDITIONS IN THE EUROZONE



SOURCE: DATASTREAM, BLOOMBERG, BNP PARIBAS

1. Source: BOJ reassurance on coronavirus bolsters speculation of global policy action, Reuters, 2 March 2020
2.Source: Board of Governors of the Federal Reserve System, Transcript of Chair Powell's Press Conference, 3 March 2020

Monetary policy has an important role to play in the current environment by seeking to avoid a deterioration of financial conditions. Otherwise the tightening of these conditions would act as an additional brake on activity, on top of the direct effects of the epidemic. This has clearly played a role in the decision of the FOMC and it is to be expected that the ECB will think alike.

Nevertheless, monetary policy has an important role to play in the current environment by seeking to avoid a deterioration of the financial and monetary conditions. These relate to the level of policy rates but also to corporate bond spreads, the ease of access to financing, the level of exchange rate, etc. Typically, when financial markets are concerned about a significant worsening of the economic environment going forward, government bond yields decline and corporate bond spreads widen. Eventually, corporate bond yields will increase significantly. Access to bank financing may also become more difficult when the value of collateral declines[3] . Financial conditions tighten, even more so should the currency strengthen because other central banks are cutting rates. Trying to stabilize financial and monetary conditions is a defensive move, the alternative being to run the risk that the tightening of these conditions is an additional brake on activity, on top of the direct effects of the epidemic on demand, supply and confidence. It seems this has clearly played a role in the thinking of the FOMC. Quoting Jerome Powel from his press conference, "*More specifically, [the rate cut] will support accommodative financial conditions and avoid a tightening of financial conditions which can weigh on activity and will help boost household and business confidence. That is why you are seeing central banks around the world responding as they see appropriate in their particular institutional context*"

3. Recent research by the Bank of England emphasises the key role of real estate, which in the UK is very often used as collateral for company loans. This collateral also comprises residential property held by the company directors. Source: Bank of England, Bank Underground, How does monetary policy affect firms, 5 March 2020

These considerations are relevant in view of the ECB meeting of 12 March, although it should be emphasized that the recent appreciation of the euro versus the dollar comes on the back of a long depreciation and that the widening of corporate spreads, based on the CDS crossover index, has been rather limited in a historical perspective. Moreover liquidity remains abundant in the banking system, allowing for a smooth supply of credit. There is thus far not a significant tightening of financial and monetary conditions, which remain very accommodative, but a pre-emptive action looks like the preferred option compared to waiting to see how financing conditions evolve: the action of the Fed this week and the fact that the next Governing Council meeting is scheduled on 30 April, which in the current nervousness looks like ages away, imply that the question for next week's meeting is not whether something will be done but what.

Considering that this is not an issue of the level of the deposit rate or government bond yields and that bank liquidity is ample, a focus on influencing market-based financial conditions looks warranted. This would call for increasing the asset purchase program and in particular the corporate securities part, or, at a minimum, expressing the readiness to forcefully use this instrument should conditions require. As many larger companies will probably profit from such measure, targeted lending (TLRO) may probably also be considered as this would benefit SMEs.

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