FED following BOJ ? The FED cannot do it all !

Policymakers are facing a momentous challenge responding to the precarious economic fallout from the pandemic crisis with over 30 million new unemployed in the US alone and world output declining by the largest amount since the 1930s. But, **should governments spend whatever they can and central banks buy whatever they can?** Are there lessons that reveal one bridge too far into the abyss?

The previous article suggested that fiscal policy should not aggravate the next looming crisis but design a green recovery program as it is done in Europe and in parts of Asia. This article suggests that monetary policy should not fall into the trap of purchasing corporate debt or equities through the so-called credit facilities. The FED should not cross that bridge and should not follow the BOJ because it would lead into a political and irreversible Pandora's box of moral hazard for generations to come.

The FED and US politicians are already taking a victory loop since stockmarkets just had their best month since 1987. The S&P index rose 13% although horrendous health and economic carnage occurred during April. Corporate bonds of so-called "fallen angels" rose by 26%, including those from recently downgraded companies like Ford Motor Co, Delta Airlines, and Occidental Petroleum. Traders are calling it the "signaling effect" of the highly controversial "primary and secondary market corporate credit facilities" that were announced by the FED on March 23, 2020.

There are five important reasons that should caution the FED not to use those credit facilities: they are one-way streets, they failed in Japan, they created trouble for Chinese and European banks, they undermine principles of market economies, and they become ever-expanding political punching bags. Many economists and policy makers have already criticized such **uncontrolled use of monetary policy**, and it might be helpful to review the five main arguments:

First, balance sheets of the main central banks have expanded dramatically over the past decade: The FED just announced that its balance sheet expanded by 50% over the past five weeks to now \$6.7 trillion, about three times the size it was a decade ago. The FED is fully financing all the projected 2020 government deficits. The ECB has also doubled its balance sheet over the past five years with a massive program of quantitative easing (QE). And the BOJ has conducted huge quantitative and qualitative monetary easing (QQE) and also massive asset purchase programs, including buying corporate bonds, REITs, and equity ETFs. The BOJ balance sheet increased by 500% over the past decade to now \$6 trillion or 120% of GDP (chart 1).

The BOJ balance sheet has kept expanding every single quarter over the past decade and it has become a one-way street. The ECB increased its balance sheet in three out of four quarters over the past decade and also conducted asset purchase programs (APP) from March 2015 thru December 2018 and starting again from September 2019, with average monthly purchases of €60bn. Although the FED had tried to reduce its balance sheet over the past five years, it only managed a total 17% reduction through quantitative tightening before resuming the QE regime last fall. Mortgage-backed securities that the FED had started purchasing in 2010 more than doubled to a stock of \$1.8 trillion today, an obsession that has proven impossible to reverse, given some powerful corporate and political interests.

Second, BOJ's asset purchase programs have been addictive and ineffective since they were started in December 2010, initially with a ceiling of ¥450 bn for ETF purchases that was tripled to ¥1.4 trillion by 2012 and again raised to ¥6 trillion by mid-2016 while assets were expanded into mid and small-cap stocks. By the start of 2020, BOJ further expanded its ETF purchases to ¥12 trillion annually and also increased targets for corporate bond holdings to ¥4 trillion. Unrealized BOJ losses from ETF and REIT holdings have been estimated at ¥2 to ¥3 trillion although they have been politically welcome as a large number of companies saw their stock prices rise cumulatively by as much as 20% and the BOJ has become the largest shareholder in one quarter of Japanese companies, today holding over 5% of the total market size. Policy makers are unable to reverse this program despite widespread understanding that its impact on price discovery and corporate governance has been problematic.

The BOJ history illustrates how difficult it is to reverse unconventional tools of monetary policy. It also reveals the **declining effectiveness of these tools over time that necessitates rapid increases in size and duration**. The ETF purchases started small and expanded by a factor of 30 over a decade. The QQE program started small but grew to an equivalent of 15% of Japan's annual GDP since 2013 (chart 2) and it has persisted for many years. Similarly, the ECB had to scale up its QE program in 2016 to about 6% of its Eurozone GDP and extended it for two years. And the FED increased its volume through three rounds of QE from \$300 bn to \$600 bn to \$800 bn and now has spent \$2,500 bn just during the past two months with its estimated total size reaching 20% of US GDP during 2020. That astronomical size is getting close to an edge where confidence in the dollar as reserve currency could evaporate.

Third, unconventional monetary policy in Europe and China created lots of trouble for their banks. The ECB had introduced negative interest rates in mid-2014 in order to nudge banks to increase their lending but that policy structurally reduced the profitability of banks, which today cannot generate ROEs of 6%, which is half of what their US peers achieve. Returns of US banks outperformed those of European banks by 13% annually over five years. And Chinese state-owned banks performed even worse, as PBOC intervened in credit markets, distorted interest rates, and saddled them with huge non-performing loans. Controlled interest rates and artificial credit pricing created conditions for a financial repression, where many zombie firms have been subsidized by imposing taxes on savers, pensioners, and banks alike.

Fourth, **moral hazard has encouraged excessive risk taking by investors into increasingly leveraged structures**. The largest US corporate bond funds generated 2019 returns of 14% (high-yield HYG) and 17% (inv-grade LQD) reflecting the reduced credit spreads and confidence in potential assistance from the Federal Reserve. By March 20, 2020, these funds had lost their 2019 returns in two weeks, as credit default spreads widened to about half of the 2009 levels on Friday. By Monday, the FED had stepped in at the urging of Blackrock (the manager of these bond funds) and provided another "FED put" to purchase corporate credit ETFs through its new facility which immediately reversed losses of these funds. Moreover, the FED allowed even "fallen angels" (non-investment grade) corporate debt to be included in its purchases. The FED not only condoned moral hazard but "altered investor incentives for years to come", according to Paul Tucker, the former Deputy Governor at the Bank of England.

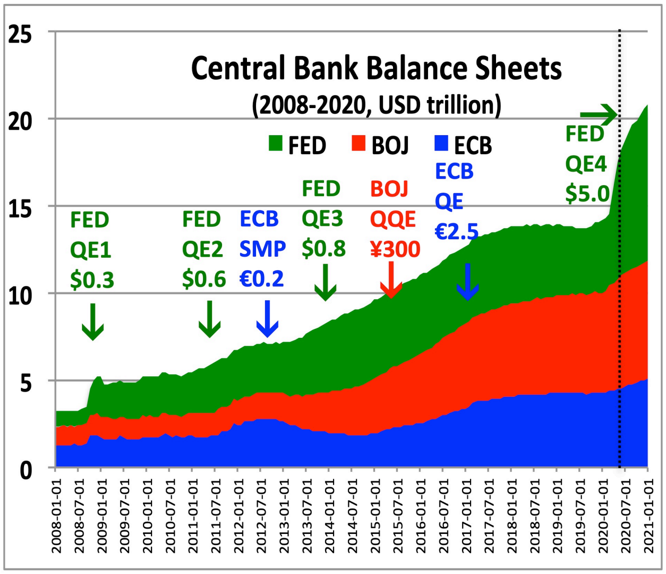
The **US Treasury does have all the necessary tools to manage this crisis**, just as it has managed previous crises. Ford Motor borrowed $6 bn from the US Treasury in 2009, although such a bailout was politically controversial. Ford Motor still is the worst managed carmaker in Detroit with the highest leverage and the lowest quality. It just suspended its electric vehicle development while the US administration has rolled back the emission standards. Its credit ratings have been downgraded in March but it is now eligible for FED purchases under its new credit facility. Boeing and Delta Airlines are two other examples where the US Treasury could intervene with bailouts in the interest of national security. Boeing indeed asked for a $60 bn bailout but then was put under the FED umbrella that then helped Boeing raise initially $25 bn in capital markets. Occidental Petroleum lobbied for government help as it lost its investment grade credit due to its high leverage but recent reports from Politico indicate that the FED now "is seeking to prop up struggling energy companies through its expansion of an emergency lending program aimed at mid-size businesses".

Finally, such politicized FED support for US corporations undermines the reputation and independence of the FED and will prove impossible to reverse. The Federal Reserve Act of 1913 established autonomy of the FED and the 1935 Banking Act enhanced the FED independence by removing the Secretary of the Treasury from its Board. It is unlawful for the President to threaten to fire the FED chairman and to demand interest rate cuts and expansion of QE policies. It is equally unlawful for the Secretary of the Treasury to demand for the FED to make corporate bond purchases based on 10% credit guarantees issued by the Treasury. However, it is politically expedient to generate maximum support from the FED to support equity markets and corporate bond markets with a view towards upcoming elections. If the FED is politically obedient to the current administration, the temptation will only further increase for the next administration to exploit the FED for political favors.

[“The FED can’t do it all”](), that’s what Alan Blinder says in the WSJ. The FED should “buy what it can”, but in good conscience, so that it can still serve the next generation and preserve the unique status of the dollar as reserve currency without becoming a political punching bag. The US Treasury should “spend what it can”, but in good conscience, so that it does not trigger the next national security crisis having undermined a [green recovery]() that is being pursued by cities across the globe. A crisis does reveal character, and policy makers now need to step up to show real character.

http://emleaders.com/pdf/eml-fed_2020.pdf

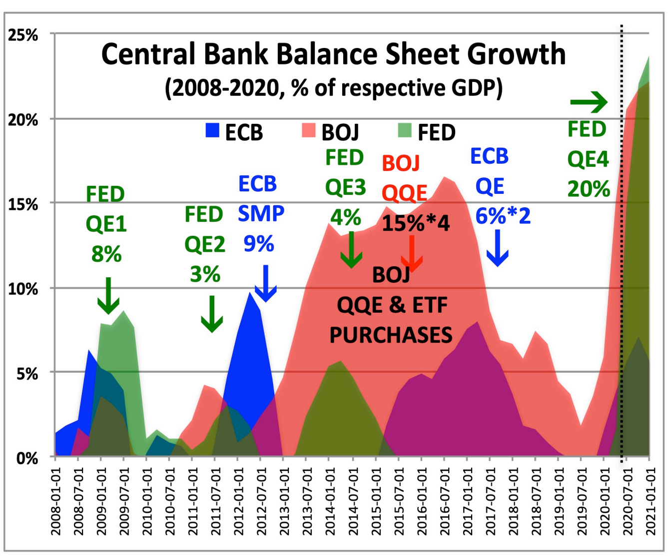
Central Banks Stocks **Chart 1**



Sources: IMF, ECB, BOJ, Federal Reserve & FRED St. Louis (April 2020)

FED $7trn=35%GDP ECB $5trn=40%GDP BOJ $6trn=120%GDP

Central Banks Flows **Chart 2**



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