The FX of Covid-19

With markets in turmoil due to the Covid-19 pandemic, some experts wonder how far its impact will reach. Sebastian Vismara, economist at BNY Mellon Investment Management, says the Federal Reserve may step in if signs of stress in US dollar funding worsen.

The Covid-19 shock and the associated uncertainty has done more than knock down stocks. Stress may also be building up in key funding markets. Risk aversion, also exacerbates a US dollar shortage, according to Sebastian Vismara, economist at BNY Mellon Investment Management. This is because risk-off environments usually result in greater demand for US dollars at a time when there is less willingness to lend in the currency.

In the run up to the Global Financial Crisis, lending in US dollars by global non-US banks, together with their reliance on short-term and volatile wholesale funding, became a crucial transmission mechanism for shocks that originated in the major funding markets for US dollars, according to Vismara. At the time, the Federal Reserve implemented a dollar liquidity program for some non-US central banks through central bank swap lines as part of a global policy response.

“Since then, vulnerabilities haven’t gone away.” says Vismara. “Over recent days there has been a tightening of US dollar funding amidst signs of stressed liquidity conditions. This has resulted in the US dollar cross currency basis\(^1\) moving significantly. The three-month OIS basis for EUR/US$ and US$/JPY declined by over 100bps compared to a few weeks ago. For borrowers of dollars, this has an impact equivalent to the Fed having significantly hiked interest rates. If things get worse, it will be mostly up to the Fed to provide US dollar liquidity to the market.”

Central banks around the world could potentially tap FX reserves\(^2\) to provide local banks with US dollar funding. However, those FX reserves would need to be monetized and these pressures might cause further stress in USD funding markets, according to Vismara. “It may very well fall on the Fed to provide the final backstop through US dollar swap lines eventually,” he says.

While currency swap lines\(^3\) already exists between the Fed and other central banks such as the European Central Bank (ECB), the Bank of England (BOE) and the Bank of Japan (BOJ), there is a risk that the Fed will be reticent in stepping-in to ease the US dollar shortage as it did in 2008 and 2015, according to Vismara. He believes it will – but notes the political situation is

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\(^1\) **The cross currency basis** indicates the amount by which the interest paid to borrow one currency by swapping it against another differs from the cost of directly borrowing this currency in the cash market. In general, the cross currency basis is a measure of dollar shortage in the market. The more negative the basis becomes, the more severe the shortage.

\(^2\) **Foreign Exchange Reserves** are assets held by a central bank, which are denominated in a foreign currency, usually for the purpose of backup funds in case the national currency rapidly devalues, or for trade purposes.

\(^3\) **A currency swap line** is an agreement between two central banks to exchange currencies.
markedly different than in 2008 and that the resulting uncertainty around the Fed’s likely response may explain some of the moves in FX basis swaps seen so far.

“If there is a US dollar funding squeeze, and if the Fed waits to ease pressures until it’s absolutely necessary, we may see further big moves in funding markets, cross-currency and Eurodollar, for example” he explains.

Return of the bear

While the effects of Covid-19 may have only begun to spill over into funding markets, the real elephant in the room is the return of the bear.

The 11-year-old US bull market came to an end on March 11, after the Dow Jones Industrial Average fell 20.3% from record highs reached in mid-February and the S&P 500 had a succession of 7% dips, which triggered a market-wide circuit breaker multiple times during the trading week ended on March 13.⁴

Shamik Dhar, chief economist at BNY Mellon Investment Management, notes that stocks have continued to sell off and, in many cases, are entering bear market territory. “Weakness is likely to continue until the rate of daily new infections starts to fall globally,” he says. “This could be some time away, especially if countries shift to ‘delay/mitigate’ from ‘contain’.”

While the Dow Jones Industrial Average slipped into bear market territory (which occurs whenever major stock indices fall more than 20%) the S&P 500 flirted with the threshold, sliding 19% from its recent peak. Looming uncertainty has caused the CBOE Volatility Index (VIX) to hit levels last seen during the Global Financial Crisis. The spike in volatility is related to significant tightening in overall financial conditions, as seen in the Goldman Sachs Financial Conditions Index.

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⁴ **Circuit breakers** halt trading when the S&P 500 falls past a certain threshold. It comes in three tiers. The first two activate at 7% and 13% drops from the prior day’s closing price, causing trading to halt for 15 minutes before resuming, and the final tier, which kicks in at a 20% decline, causing the markets to close for the remainder of the day.

While central banks have responded to market turmoil with measures ranging from emergency interest rate cuts (the Fed and BOE both cut 50bps, for instance) to emergency liquidity measures like the Fed’s increase in the size of its repo auctions, the market will be closely watching what they do next.

“There are pockets of concern in FX, ETFs, loans and high-yield markets, which are generally less liquid or have shown ‘flash crashes’ in the past. Should we start to see stress deepening, then everything depends on the central bank response,” Dhar concludes.
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