Reflections

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Should central banks buy stocks?

Almost everywhere in the world, there is feverish activity today to find ways to soften the negative economic consequences resulting from all the restrictions imposed because of the COVID-19 pandemic. All stimulus measures have in common the goal of making it easier for the economy to survive until activity can return to normal. One hot topic is whether central banks can take the step from buying bonds to buying equities in order to support companies that need capital to survive. A few central banks have already gone down that route and stock purchases actually have some advantages over bond purchases.

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Most countries have now begun to lift their coronavirus-related restrictions, but there is still great uncertainty about how long it will take to reopen and, above all, how quickly demand will return. After all, just because car dealers or restaurants are allowed to open does not necessarily mean customers will be queuing to visit them. As a result, almost everyone believes that businesses will need continued support for several months after restrictions are lifted. For some sectors, it may take even longer.

Loans or grants?
The list of official support measures for businesses has grown longer and longer. Today it includes everything from loans to pure grants. But these support mechanisms have also started to be challenged. A discussion has begun on what is effective and what is reasonable from the standpoint of fairness. The effectiveness of loans is being questioned, since many businesses do not want to incur more debt in uncertain times. In terms of fairness, however, loans are uncontroversial since they will be repaid once the business has recovered. The opposite is true of grants. Giving money directly to companies is effective, since it entails no increased risk to the owners, but from the standpoint of fairness it is doubtful that taxpayers should be giving away money to individual businesses. The crux is that while business people prefer to receive grants, taxpayers prefer to offer loans.

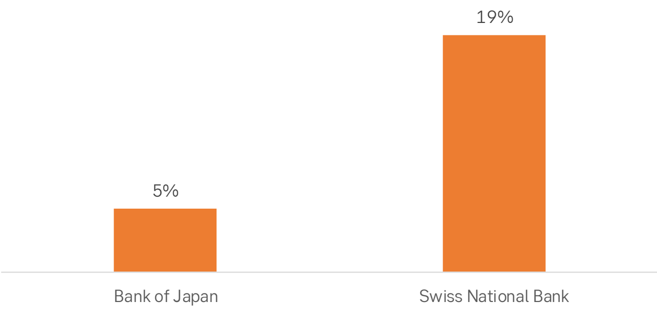
The third way
However, there is a third way, where instead of loans or grants, taxpayers provide businesses with equity capital: money in exchange for shares. It is just as effective as a grant because the business owners do not have to increase their risks, and taxpayers have a potential upside in the form of future returns on invested capital, provided that the business survives. The problem with this solution is instead political. Whereas some leftist politicians will cheer the idea that the central government will become a major shareholder in the business community, the same idea is upsetting to non-socialist politicians, and well as the business community itself, which is worried about creeping nationalisation. Various alternatives have been proposed – such as letting the government buy special non-voting preference shares – but there is lingering scepticism about the concept of allowing the government to become a major shareholder in private companies. There is another solution, however: the government stays out of the way and instead hands over the task of providing businesses with equity capital to the central bank. Most central banks are able to purchase all types of financial assets as part of their monetary policy mandate, paying for them with "newly printed" money. Today the US Fed cannot buy shares directly and carry them in its own balance sheet. That would require a change in the law. However, the Fed could make such purchases indirectly, via a “special purpose vehicle” (SPV).

Since the central banks in most countries also enjoy constitutionally protected independence from political influence, there is little risk that the central bank's shareholding would become a way for the government to control companies. For example, a company in need of capital could carry out a new share issue that the central bank participates in, buying shares on the stock exchange at market price. This would supply the company with the capital it needs for survival. Meanwhile through their central bank, taxpayers would receive shares that pay returns in the future. Even if the central bank does not participate directly in individual new share issues, the mere knowledge that the bank is present as a major buyer in the stock market would help increase risk appetite among other investors and persuade them to help supply fresh capital.

Letting central banks own equities is nothing new
Switzerland and Japan are two examples of countries whose central banks today have large equity portfolios. At the end of the first quarter of 2020, the Swiss National Bank (SNB) had more than USD 130 billion of its foreign exchange reserves in shares and the bank has direct ownership in nearly 7,000 companies scattered all over the world. Switzerland’s motive for buying shares is to prevent its own currency from appreciating too much. This is why the SNB buys only foreign shares (paying for them with "newly printed" Swiss francs). Bank of Japan equity

purchases are more directly aimed at boosting economic activity and investor confidence in order to push Japanese inflation higher. The BOJ has been buying Japanese company shares via the exchange traded funds (ETF) market for nearly a decade. Today the central bank is among the ten largest shareholders in nearly half of Japan's listed companies. As a direct effect of the coronavirus crisis, in March the BOJ also doubled its annual target for stock purchases to the equivalent of USD 120 billion. By the end of 2020, BOJ is thus likely to be the country's largest single owner of company shares, with an equity portfolio worth over USD 370 billion.

Central banks equity holdings
(% of GDP)



If Sweden's Riksbank or the ECB were to start buying company shares, just as in Japan their motive would be to ensure fulfilment of their inflation target. Such share purchases will prevent a lot of companies from going bankrupt and thus avoid a deep, lengthy recession (or even depression) that would definitely not be compatible with long-term stable inflation of 2 per cent.

Bond purchases no longer as effective

Central banks could also argue with some credibility that with interest rates as depressed as they are today, it is no longer effective from a stimulus standpoint to continue expanding their bond purchases in an attempt to push down interest rates and bond yields even further. Buying corporate bonds is one alternative that is currently being tried out, but the central banks are missing many companies that are too small to have bond programmes. Besides, like other loans this is not risk capital in the same way as equities. If central banks want to boost confidence in the economy and in the stock market, direct company share purchases are also far more impactful than trying indirectly – via bond purchases – to push down rates and yields so that equity investments will appear relatively more attractive.

Never say never when it comes to central banks

Although equity purchases in general appear to be a fairly potent alternative to today's bond purchases, it is of course highly uncertain whether major central banks such as the Fed or ECB or smaller players such as the Riksbank will actually start buying stocks, even on a small scale. One obvious objection is that shares are a riskier investment than bonds, and central banks have a preference for safe security holdings. The decision obviously depends primarily on how the coronavirus crisis unfolds. But it is worth noting that the past decade has been filled with surprising and highly controversial decisions by central banks. Viewed in retrospect, equity purchases would probably be viewed as a less extreme measure than the introduction of negative key interest rates some years ago.