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Treasury-Fed Clash Exposes Broader Policy Stress.

Pressure is growing on the ability and willingness of officials to maintain the scale and scope of their initial responses to Covid-19.

Global markets woke up Friday morning to indications that exceptional and lasting policy support may be less certain than widely assumed. While short-term political considerations may well be playing a role — a view that most investors will be quick to grasp, dismissing the news as "noise" and reversible — a bigger phenomenon may well be in play: What was first designed as a huge "one-round" policy intervention has turned out to be much more than that, and the longer this "multiround" process persists, the greater the pressure on the ability and willingness of policy makers to deliver, especially in parts of the developing world.

Having eagerly supported the Federal Reserve's massive intervention in financial markets in March and April, outgoing Treasury Secretary Steven Mnuchin seems to have surprised even the central bank late Thursday by refusing to extend backing for some emergency lending programs into next year and asking for the return of money for them. This immediately triggered an unusually public response from the Fed lamenting the decision and stressing that the "full suite of emergency facilities" plays a key role as "a backstop for our still strained and vulnerable economy."

Some economists and market participants initially interpreted this as yet another indication of a problematic transition from the Trump administration to the incoming Biden team — one that is already complicating the country's response to the surge in Covid infections and hospitalizations and may well play out in foreign policy and military affairs. Having said that, the implications are overwhelmingly viewed as both temporary and reversible under the new administration that will take office on Jan. 20.

The Treasury's action came in the context of a general under-utilization of the Fed's programs. Some see this as a signal of low need, bolstered by Mnuchin's comment that "banks have the lending capacity to meet the borrowing needs of their corporate, municipal and nonprofit clients." Others feel that this under-utilization is due to the markets doing the work for the Fed, thereby increasing moral hazard and excessive risk-taking. Yet others are arguing the move is motivated by the desire to reallocate money to other programs such as the Paycheck Protection Program, effectively enhancing public sector support for the economy.

The U.S. is not alone in its policy support difficulties. In the U.K., the Treasury is facing a large increase in its fiscal imbalance, with the latest data from the Office for National Statistics showing that the deficit for the first six months of this fiscal year (April-October) amounted to a record 261 billion pounds. This is leading some to expect a public sector pay freeze to be announced as early as next week when the latest round of Covid-related lockdowns could well send Britain into a double-dip recession. Politics is also seen as playing a role as Prime Minister Boris Johnson is trying to gather Conservative Party support for his pivot toward greater military expenditure as part of the redefinition of the country's role on the world stage after Brexit.

Although short-term political considerations may well be playing a role, and these two countries can

reverse course should policy makers so desire, a greater phenomenon exists that could well become more important the longer it takes to develop and distribute vaccines to counter the threat of Covid-19.

The initial global reaction to the economic “sudden stop” caused by Covid-19 was highly influenced by what worked for the global financial crisis: that is, a large-scale multifaceted intervention underpinned by the three notions of “whatever it takes,” “all in” and “whole of government.” At its essence, this is what in game theory terms would be labeled a “one round” policy response. Yet Covid is requiring several rounds of responses as illustrated by the new infection wave in many countries and the realization that vaccines will not be widely available until sometime next year.

As time has passed, a small but growing number of countries are finding it hard to maintain the scale and scope of their initial policy interventions. Well before these latest twists, the U.S. faced political resistance to renew one element after another of its initial fiscal relief, and the U.K. reduced support for those facing job challenges before having to reverse course.

Markets will be quick to dismiss the latest developments, especially in the U.S., where a new administration is likely to restore funding and the Fed can in the interim augment the quantitative easing program already at its discretion. But they should not ignore the warning signs. Particularly in the developing world, policy makers’ willingness to continue to carry out a multiround policy response will increasingly face a harsh reality: that of declining ability.

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