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INSIGHT

Federal Reserve: Recent Actions in Response to COVID-19

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Coronavirus (COVID-19) has created significant economic disruption. In response, the Federal Reserve (Fed) has taken a number of steps to promote economic and financial stability involving the Fed's monetary policy and "lender of last resort" roles. Some of these actions are intended to stimulate economic activity by reducing interest rates and others are intended to provide liquidity to financial markets so that firms have access to needed funding.

Actions to Lower Interest Rates

Federal Funds Rate

Traditionally, the Fed conducts monetary policy by changing the federal funds rate, the overnight interbank lending rate. In response to COVID-19, on March 3, the Fed reduced the federal funds rate from a range of 1.5%-1.75% to a range of 1%-1.25% to stimulate economic activity. On March 15, it reduced the range to 0%-0.25%. Economists refer to this as the "zero lower bound" to signify that the Fed's traditional monetary policy tool has been exhausted at this point, and cannot be used to provide additional stimulus. This is the second time this interest rate has ever hit the zero lower bound—the first time was in 2008, during the financial crisis.

At that time, the Fed developed two other tools to provide stimulus at the zero lower bound—forward guidance and quantitative easing. Both aim to reduce long-term interest rates which, unlike short-term rates, are not directly determined by the Fed, but are important for stimulating economic activity. These tools are being revived in response to COVID-19.

Forward Guidance

Forward guidance refers to Fed public communications on its future plans for short-term interest rates, and it took many forms following the 2008 financial crisis. As monetary policy returned to normal in recent years, forward guidance was phased out. It is being used again today. For example, when the Fed reduced short-term rates to zero on March 15, it announced that it "expects to maintain this target range

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until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals."

Quantitative Easing

Large-scale asset purchases, popularly referred to as *quantitative easing* or *QE*, were also used during the financial crisis. Under QE, the Fed expanded its balance sheet by purchasing securities. Three rounds of QE from 2009 to 2014 increased the Fed's securities holdings by $3.7 trillion.

On March 23, the Fed announced that it would increase its purchases of Treasury securities and mortgage-backed securities (MBS)—including commercial MBS—issued by government agencies or government-sponsored enterprises to "the amounts needed to support smooth market functioning and effective transmission of monetary policy.... " These would be undertaken at the unprecedented rate of up to $125 billion daily during the week of March 23. As a result, the value of the Fed's balance sheet is projected to exceed its post-financial crisis peak of $4.5 trillion. One notable difference from previous rounds of QE is that the Fed is purchasing securities of different maturities, so the effect likely will not be concentrated on long-term rates.

Actions to Provide Liquidity

Reserve Requirements

On March 15, the Fed announced that it was reducing reserve requirements—the amount of vault cash or deposits at the Fed that banks must hold against deposits—to zero for the first time ever. As the Fed noted in its announcement, because bank reserves are currently so abundant, reserve requirements "do not play a significant role" in monetary policy.

Term Repos

The Fed can temporarily provide liquidity to financial markets by lending cash through repurchase agreements (repos) with primary dealers (i.e., large government securities dealers who are market makers). Before the financial crisis, this was the Fed's routine method for targeting the federal funds rate. Following the financial crisis, the Fed's large balance sheet meant that repos were no longer needed, until they were revived in September 2019. On March 12, the Fed announced it would offer a three-month repo of $500 billion and a one-month repo of $500 billion on a weekly basis through the end of the month in addition to the shorter-term repos it had already been offering. These repos would be larger and longer than those offered since September.

Discount Window

In its March 15 announcement, the Fed encouraged banks (insured depository institutions) to borrow from the Fed's discount window to meet their liquidity needs. This is the Fed's traditional tool in its "lender of last resort" function. The Fed also encouraged banks to use intraday credit available through the Fed's payment systems as a source of liquidity.

Foreign Central Bank Swap Lines

Both domestic and foreign commercial banks rely on short-term borrowing markets to access U.S. dollars needed to fund their operations and meet their cash flow needs. But in an environment of strained liquidity, only banks operating in the United States can access the discount window. Therefore, the Fed has standing “swap lines” with major foreign central banks to provide central banks with U.S. dollar funding that they can in turn lend to private banks in their jurisdictions. On March 15, the Fed reduced the cost of using those swap lines and on March 19 it extended swap lines to nine more central banks.

Emergency Credit Facilities for the Nonbank Financial System

In 2008, the Fed created a series of emergency credit facilities to support liquidity in the nonbank financial system. This extended the Fed’s traditional role as lender of last resort from the banking system to the overall financial system for the first time since the Great Depression. To create these facilities, the Fed relied on its emergency lending authority (Section 13(3) of the Federal Reserve Act). To date, the Fed has created six facilities—some new, and some reviving 2008 facilities—in response to COVID-19.

- On March 17, the Fed revived the commercial paper funding facility to purchase commercial paper, which is an important source of short-term funding for financial firms, nonfinancial firms, and asset-backed securities (ABS).
- Like banks, primary dealers are heavily reliant on short-term lending markets in their role as securities market makers. Unlike banks, they cannot access the discount window. On March 17, the Fed revived the primary dealer credit facility, which is akin to a discount window for primary dealers. Like the discount window, it provides short-term, fully collateralized loans to primary dealers.
- On March 19, the Fed created the Money Market Mutual Fund Liquidity Facility (MMLF), similar to a facility created during the 2008 financial crisis. The MMLF makes loans to financial institutions to purchase assets that money market funds are selling to meet redemptions.
- On March 23, the Fed created two facilities to support corporate bond markets—the Primary Market Corporate Credit Facility to purchase newly issued corporate debt and the Secondary Market Corporate Credit Facility to purchase existing corporate debt on secondary markets.
- On March 23, the Fed revived the Term Asset-Backed Securities Loan Facility to make nonrecourse loans to private investors to purchase ABS backed by various nonmortgage consumer loans.

Many of these facilities are structured as special purpose vehicles controlled by the Fed because of restrictions on the types of securities that the Fed can purchase. Although there were no losses from these facilities during the financial crisis, assets of the Treasury’s Exchange Stabilization Fund have been pledged to backstop any losses on several of the facilities today.

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