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Economics Group

Special Commentary

The Fed Announces a Barrage of Policy Changes

The Federal Reserve surprised many market participants on Sunday evening, March 15, when it announced a barrage of policy changes, which we will address in more detail subsequently. But to summarize, the FOMC cut the target range for the fed funds rate 100 bps, returning it to 0.00% to 0.25%, where it was maintained from December 2008 to December 2015. The FOMC re-instated its quantitative easing (QE) program via renewed purchases of Treasury and mortgage-backed securities. It slashed its discount rate to only 0.25%, an all-time low, and it encouraged banks to draw on Fed facilities and to use their capital and liquidity buffers to lend to households and businesses. Finally, the Federal Reserve, in concert with other major central banks, cut the interest rate that it charges on its swap lines, which foreign central banks use to borrow dollars from the Fed. All of these steps are an effort by the Fed to ease strains in financial markets and cushion the U.S. economy, as much as possible, from the growth-halting effects of the COVID-19 pandemic. In our view, the FOMC stands ready to do even more, within its legal authority, to support financial and credit markets.

Let’s start with the cut in the target range for the fed funds rate. As we wrote in a report last week, we were anticipating that the FOMC would cut 100 bps at its scheduled meeting on March 18, “if not sooner,” so the timing of yesterday’s rate cut was not totally unexpected. We wrote in another report last month that lower rates will offer some support to businesses and household via lower interest payments on floating-rate debt obligations.

The FOMC also authorized the trading desk at the Federal Reserve Bank of New York to purchase $500 billion worth of Treasury securities and $200 billion worth of mortgage-backed securities (MBS) “in coming months.” The Fed hopes that these renewed QE purchases of securities will help reduce tensions in other financial markets via an eventual narrowing of credit spreads (over U.S. Treasury securities). In that regard, MBS spreads have widened significantly in recent weeks. Renewed QE purchases of MBS by the Fed should eventually bring those spreads down, which then should help to bring mortgage rates for new purchases and refinancing lower as well.

The committee also took a number of steps to shore up lending activity at the nation’s banks. First, it slashed its discount rate 150 bps to an all-time low of only 0.25%. The discount window has historically been used by banks that have difficulty borrowing from other financial institutions. Consequently, there is often a stigma attached to banks that borrow at the discount window. By taking the rate on discount window borrowing all the way down to the top of the new range for the fed funds rate, the FOMC is trying to encourage banks to use this facility and remove any stigma that may be attached to its use. The committee wants banks to use the discount window, if needed, so that they can continue to lend to households and businesses, which may need credit support in coming weeks and months if the economy grinds to a virtual halt.

The committee also noted that Federal Reserve District Banks have intraday credit facilities available to support the “smooth functioning of payment systems and the settlement and clearing of transactions across a range of credit markets,” and it encouraged banks to use these facilities. In our view, this reference is meant to re-assure market participants that the Fed stands ready to ensure that credit markets remain functioning in coming weeks and months. During the darkest
days of the financial crisis, the Fed invented a number of programs that provided direct liquidity support to various sectors in the credit markets. If necessary, the Fed will re-instate these programs, or variants thereof, in order to keep credit markets functioning, in our view.

The FOMC also encouraged banks “to use their capital and liquidity buffers as they lend to households and businesses who are affected by the coronavirus.” The committee is essentially signaling to banks that they will not draw the ire of regulators if they use the capital and liquidity they have built up over the past number of years to support lending to households and businesses during this time of need. Again, the Fed is attempting to provide as much credit support to the economy as possible as it heads into a downturn.

Finally, the FOMC announced some changes to the swap lines that it has in place with other major central banks. Because the U.S. dollar is the world’s principal reserve currency, many commercial banks in foreign economies often lend in dollars. Foreign central banks can provide these commercial banks with liquidity support in their own currencies, but these central banks have limited resources to provide dollar liquidity. Therefore, in times of financial stress, foreign central banks borrow dollars from the Fed via the swap lines and then lend those dollars to the commercial banks that they supervise. (The Fed generally does not have counterparty relationships with these banks that would allow the Fed to lend directly to them.)

Specifically, the Fed reduced its swap line borrowing rate 25 bps. The rate now stands at the U.S. dollar overnight index swap (OIS) rate plus 25 bps. In addition, the FOMC announced that foreign central banks could borrow for 84 days, which will supplement the one-week operations that are currently in place. These moves are intended to ease strains in dollar funding markets that can cause spikes in dollar interest rates, not only for foreign borrowers but for domestic borrowers as well.

In sum, all of the moves that the FOMC announced on March 15 are intended to ease strains in financial markets and to support the credit-creation process in the economy as much as possible. In our view, the FOMC stands ready to do even more, within its legal authority, to support financial and credit markets. In that regard, the committee could re-instate some of the programs, or variants thereof, which it created during the financial crisis to keep credit markets functioning. But many of the steps that the Fed is undertaking will offer only limited support to economic activity directly. The federal government has announced some fiscal measures already. In our view, it will need to do more to support the economy in coming months.