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ECONOMIC REPORT

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FOMC CUTS FUNDS RATE TO ZERO; RELAUNCHES QE; STEPS IN TO SUPPORT FINANCIAL SYSTEM, CREDIT FLOWS

SUMMARY

- In an emergency meeting, the FOMC cut the fed funds rate a full percentage point, to a range of 0.00 to 0.25 percent.
- The FOMC also announced that it will be buying Treasuries across all maturities, as well as mortgage-backed securities, in an effort to support credit flows. This effectively relaunches quantitative easing.
- The FOMC took additional steps addressing domestic and global financial systems, to ensure the functioning of the Treasuries market and to support credit availability.
- These steps will support financial markets in the near term. Traditional monetary policy cannot prevent economic dislocation from the COVID-19 outbreak, but will be important for an economic recovery.
- The U.S. will experience a near-term economic contraction, with the probability of a full-fledged recession at greater than 50 percent.

In an emergency meeting held Sunday March 15, the Federal Open Market Committee cut the federal funds rate a full percentage point, to a range of 0.00 to 0.25 percent. This followed an emergency 0.50 percentage point cut in the funds rate on March 3. The funds rate, effectively at zero, is now back to where it was from November 2008 to December 2015, in the aftermath of the financial crisis and Great Recession (see Chart 1).

The FOMC took a number of additional steps to support the financial system and bank lending. The Federal Reserve will be purchasing at least $500 billion of U.S. Treasuries, across a range of maturities, and at least $200 billion of mortgage-backed securities “over coming months.” While the stated goal of these purchases is to “support the flow of credit to households and businesses,” they also function as an effective restart of quantitative easing, or QE. Under QE the Fed creates money electronically to place on its balance sheet, and then uses the funds to purchase long-term securities in an effort to push down long-term interest rates. The Fed used QE to support the economy during the recovery from the Great Recession, increasing its balance sheet from less than a trillion dollars in 2008 to $4.5 trillion by late 2014. The Fed began to gradually reduce the size of its balance sheet in late 2017, but reversed that process last year to head off dislocations in the financial system. The Fed’s balance sheet will move sharply higher in the near term following the March 15 announcement (see Chart 2).

The FOMC took additional steps to support the near-term availability of credit. The Fed encouraged banks to borrow from its discount window, a source of low-cost, short-term funding, and to use their capital and liquidity buffers to fund loans. The Fed also dropped reserve requirements, which required banks to keep a certain amount of cash on hand or on deposit at the central bank. Over the years the Fed has introduced other tools to ensure adequate bank capitalization, making reserves redundant; ending required reserves removes a possible obstacle to bank lending.

The Fed also, in cooperation with the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, and the Swiss National Bank, strengthened existing relationships that allow these foreign central banks to lend U.S. dollars to banks in their own economies, encouraging the continued flow of credit throughout the global economy.

These various efforts are designed primarily to ensure that credit in the U.S. continues to flow in the near term; reduced access to credit in the wake of the COVID-19 outbreak would exacerbate the damage to the U.S. economy and make any downturn much worse.

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The FOMC's emergency announcement was in lieu of the committee's scheduled meeting on March 17 and 18, which was cancelled. Therefore the FOMC will not release its scheduled Summary of Economic Projections, or "dot plot," which provides participants' expectations for the paths of the economy and the fed funds rate over the next few years. The next release of the SEP will come in June.

Only Cleveland Fed President Mester voted against the FOMC action. She supported the efforts "taken to promote the smooth functioning of markets and the flow of credit to households and businesses," but only wanted to reduce the fed funds rate to a range of 0.50 to 0.75 percent.

The FOMC's actions are welcome, and will help ensure that a financial market crisis does not exacerbate the current situation and that credit is available. However, rate cuts and QE are of limited use in preventing a near-term economic contraction; they cannot support household spending if consumers are unable to get to the store, they cannot support the labor market if workers are unable to get to their jobs, they cannot help small businesses whose customers disappear, and they cannot spur businesses to invest if the outlook is highly uncertain. However, they will support economic growth once the crisis is past and conditions start to return to normal.

The U.S. economy will contract for at least a few months due to supply chain disruptions, a big drop in consumer spending due to restrictions on movement, and a decline in business investment due to uncertainty. It is unclear whether this will meet either the lay definition of a recession (2-quarter contraction in real GDP) or the semi-official definition from the National Bureau of Economic Research, which requires contractions in a variety of economic measures "lasting more than a few months." There may be a small contraction in GDP in the first quarter; there will almost surely be a much sharper contraction in the second quarter.

The likelihood of a full-blown recession, as opposed to a temporary contraction, is at least 50 percent right now. It depends on a number of factors, many of them non-economic: how long the current crisis lasts, how effective the government response is, and whether the healthcare system effectively deals with the COVID-19 outbreak.

The longer the immediate crisis lasts, the greater the potential for a full-fledged US recession. As more people lose their jobs, the more income will be lost, increasing the potential for consumer spending to fall even after the worst of the outbreak has passed. In addition, the loss of so much stock market wealth could be a drag on consumer spending once the immediate crisis is over. There is also the potential for significant damage to the global economy as COVID-19 makes its way around the world.

Chart 1: Fed Funds Rate Headed Back to Zero

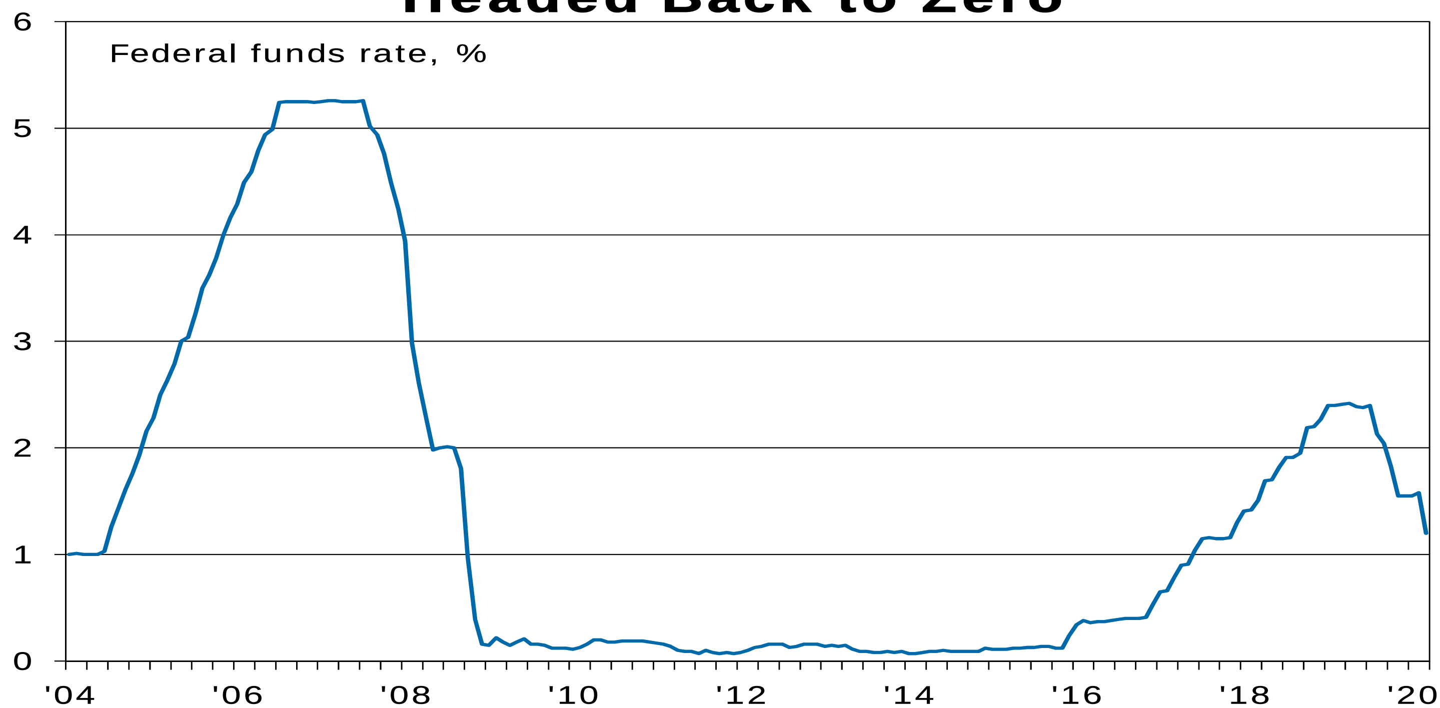

Chart source: Federal Reserve Board

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One major positive is that the fundamentals of the U.S. economy were good heading into this crisis, which means the economy should bounce back quickly if the outbreak is short-lived. The labor market was excellent, the personal saving rate was high, consumer balance sheets were in great shape, and the housing market was well-balanced (with the exception of a few markets that were overpriced). The financial system is well-capitalized, thanks to reforms put in place after the financial crisis. The one major concern ahead of COVID-19 was high corporate debt levels, although interest burdens are low given low interest rates.

The government response will be crucial. The more effective the federal response to COVID-19, the shorter the contraction and the less long-term damage the economy will suffer. The longer the crisis drags on, the greater the likelihood of a full-fledged recession and the more severe it will be.

There is also a need for a federal government fiscal policy response to support aggregate demand. This will be less important in the short run, when restrictions on movement weigh on economic activity, but more important over the medium run to support a stronger recovery. Concerns about the budget deficit should not interfere with the need for fiscal stimulus; that is a problem for later. Fiscal stimulus should focus on getting money out into the economy quickly; this is not a time for subtlety or pet projects. Aid should be focused on the most vulnerable, especially workers who lose their jobs and are ineligible for unemployment insurance, and small businesses that have fewer resources to fall back on during a crisis.

Layoffs are already underway. Most vulnerable are those in consumer-facing industries, such as leisure/hospitality services, retail trade, and travel. Initial claims for unemployment insurance will be important in gauging the labor market. Those are released at 8:30 every Thursday morning for the previous week.

All regional U.S. economies will contract, but some will contract more than others. The largest contractions will be areas with a lot of high-tech manufacturing, which is experiencing supply-chain disruptions, and those that are major tourist areas.

Chart 1: Fed’s Balance Sheet Will Add at Least $700 Billion “Over Coming Months”

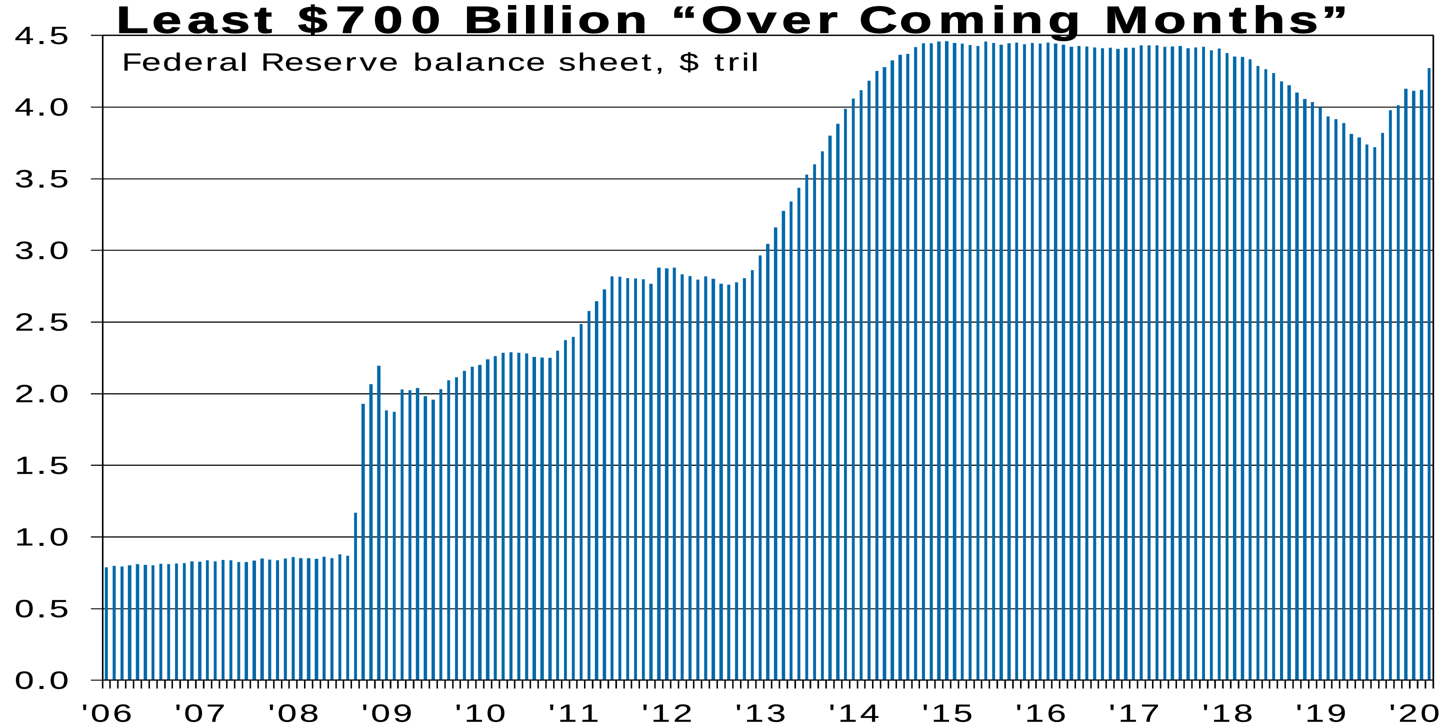

Chart source: Federal Reserve Board

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