SUMMARY

- After two emergency rate cuts in the first half of March and a restart of quantitative easing, the Federal Reserve has rapidly launched other emergency policies to limit the damage to the U.S. economy from the Viral Recession and support the eventual recovery.

- The Fed has revived and expanded the tools it used during Great Recession to contain financial turmoil, support a return to normal financial system functioning, and extend credit to nonfinancial businesses, households, and governments.

- PNC forecasts for the Fed to hold the federal funds rate near zero for the next few years.

- Since the Fed’s lending facilities are temporary tools, they are legally required to wind them down once the immediate crisis subsides. If the Fed continues to use unconventional monetary policy after that, they will first launch a more “standard” quantitative easing program that purchases only risk-free Treasury and agency securities.

- The Fed is unlikely to implement negative interest rates, which they consider inappropriate for the U.S. economy.

The Federal Reserve has gone all in to help the U.S. overcome the shutdown of large swathes of the economy and sudden plunges in household income and employment. In a series of emergency actions in March and April, the Fed cut the federal funds rate a cumulative 1.50 percentage points to near zero, restarted quantitative easing, and revived and greatly expanded upon the emergency lending programs it used to fight the 2008-09 financial crisis.

Many of the Fed’s actions aimed to calm March’s financial turmoil and “restore smooth market functioning so that credit can continue to flow,” as Chair Powell said on March 15. The Fed first announced a plan to buy $500 billion in Treasury securities and $200 billion in Fannie Mae and Freddie Mac mortgage-backed (agency) securities on March 15, then made the amounts open-ended (“the amounts needed”) to curtail the worst financial market stress since the ’07-’08 financial crisis. The Fed’s holdings of Treasury and agency bonds rose by over a trillion dollars in March, a monthly increase equal to 2013’s entire annual increase, which was during the Fed’s third round of quantitative easing (see Chart 1). The Fed also launched programs in March to ease a foreign dollar liquidity squeeze that was indirectly disrupting U.S. capital markets by forcing foreign central banks to sell their reserve assets, including U.S. securities, as capital flowed out of their countries. The Fed expanded currency swap facilities from the five foreign central banks already eligible for them to 14; in a currency swap, the Fed lends a foreign central bank dollars, secured by an equal value of foreign currency. The Fed also began lending to almost all other foreign central banks, secured by an equal value of foreign currency. The Fed also began lending to almost all other foreign central banks, secured by those banks’ holdings of Treasurys.

These measures complement other steps the Fed took to support the U.S. financial system, ensure an ample supply of credit to financial institutions, and ease constraints on commercial lending. The Fed restarted a “facility” (program) used in 2008 to make loans to primary dealers, the financial institutions that the New York Fed directly transacts with to implement monetary policy; the Fed also broadened the types of collateral that they accept for these loans to maximize credit to primary dealers. They lowered the cost of overnight credit offered to banks and other depository institutions through the Fed’s discount window; eliminated reserve requirements, a legacy regulatory tool made redundant by contemporary liquidity and capital rules; modified rules governing bank leverage to help banks absorb the trillions of dollars that the Fed is creating; and made several other changes to regulatory and accounting rules to facilitate lending and credit creation by banks and other financial institutions.
Finally, the Fed is supporting U.S. households, businesses, and governments through emergency lending facilities that channel credit to them, either directly through capital markets or indirectly through the banking system. The Fed used some of these facilities during the '08-'09 crisis, and have updated them for the current crisis. These include the Commercial Paper Funding Facility (CPFF), which lends directly to companies by buying the commercial paper (very short-maturity bonds) that they issue; the Money Market Mutual Fund Liquidity Facility (MMLF), which makes loans to financial institutions secured by assets held by the money market funds that those institutions sponsor, reducing concerns about increased redemptions from money market funds; and the Term Asset-Backed Securities Loan Facility (TALF), which makes loans to financial institutions to purchase asset-backed securities that finance auto loans, credit cards, business credit, and other types of household and small business credit.

The 2020 versions of these facilities have considerably more firepower than the '08-'09 versions, fueled by capital allocated by the Treasury Department to the Fed to secure the facilities’ lending. The CPFF, MMLF, and TALF are each backed by $10 billion of capital injected by Treasury; in their '08-'09 incarnations, their lending was secured by de facto haircuts or fees paid by the institutions they lent to. In addition, the 2020 CPFF can directly buy commercial paper from issuers; its '08-'09 counterpart could only buy commercial paper indirectly from money market funds.

Other facilities launched in March and April are new, and have far more lending capacity than the programs previously mentioned since they are backed by $195 billion of the $454 billion in capital provided by the CARES Act. The Fed is leveraging that $195 billion up almost 12 times, to fund up to $2.6 trillion in lending. All together, the Fed’s lending facilities can provide up to $2.8 trillion in funding, backed by $215 billion in Treasury capital.

The Fed will fund up to 100 percent of the loans made through the $660 billion Paycheck Protection Program; channel an additional $600 billion in credit to mid-sized business through the Main Street Lending Facility, which will use $75 billion in Treasury capital; buy up to $750 billion in corporate bonds through the Primary and Secondary Market Corporate Credit Facilities, using $75 billion in Treasury capital; and provide $500 billion in loans to state and local governments through a Municipal Liquidity Facility, using $35 billion in Treasury capital. The Main Street Lending Program (MSLP) will make 4-year loans to small and mid-size companies that employ up to 15,000 workers or have revenues of less than $5 billion. MSLP loans will defer principal and interest payments for one year. Banks originating these loans can sell up to 85 to 95 percent of them to the MSLP, and must retain the rest on their books.

These programs not only increase the amount of credit the Fed provides, they also broaden the ways the Fed can provide it well beyond what the central bank did during the '08-'09 crisis. The Primary and Secondary Corporate Credit Facilities can buy corporate bonds from companies that were rated at least BBB- on March 22, even if they were subsequently downgraded as the economy deteriorated; in
addition to buying bonds, the secondary bond-buying facility can buy exchange-traded bond funds, with “the preponderance” of purchases directed to investment-grade bond ETFs and “the remainder” to high-yield (junk) bond ETFs. The Main Street Lending Facility and Paycheck Protection Program Lending Facility are also new programs. And the Fed can expand these programs if needed, since they have so far used only half the capital provided by CARES.

The Fed’s lending facilities are temporary responses to specific dislocations in capital markets and the financial system. In fact, the Federal Reserve Act’s section authorizing these programs, 13(3), requires the Fed to terminate these emergency lending programs “in a timely and orderly fashion.” Chair Powell indicated at his March 15 press conference that the Fed’s leadership is not seeking permission to keep using these facilities after the financial system returns to normal functioning.

PNC forecasts for the Fed to hold the federal funds rate in its current 0.00 to 0.25 percent range near zero for the next few years (see Chart 2). If the recovery from the Viral Recession is disappointingly weak and inflation trends below the Fed’s 2 percent objective, the Fed might ask Congress to authorize permanent lending facilities like those currently in use to broaden its monetary policy toolkit. If so, the Fed would want tools that lower borrowing costs for broad segments of the economy and encourage overall economic activity, and not focus on narrow segments of the financial system. Foreign central banks already use such tools: The Bank of Japan and European Central Bank regularly buy state and local government bonds, corporate bonds, equity exchange-traded funds, and real estate investment trusts.

But the Fed is more likely to first target risk-free Treasury and agency securities like they did in 2011 ("QE2") and 2013-14 ("QE3") if they extend their current quantitative easing program past when the immediate financial turmoil subsides. In QE, the Fed puts money on its balance sheet electronically and uses the funds to purchase long-term securities in an effort to reduce long-term borrowing costs.

The Fed could make the goals of its QE more explicit by setting targets for long-term interest rates, an approach known as “yield curve control.” The BoJ has been using yield curve control since 2016. One step that the BoJ and ECB have taken that is unlikely in the U.S. is a negative short-term policy rate; Chair Powell continues to say that the Fed does “not see negative policy rates as likely to be an appropriate policy response here in the United States.”

Chart 2: Fed Funds Rate to Stay Near Zero For Years

Federal funds rate, %, dotted line is PNC’s forecast

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