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COVID-19: The Fed Goes to War

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Crisis Response

- Lender of last resort
- Market maker of last resort
- Monetary policy
- **State bank**

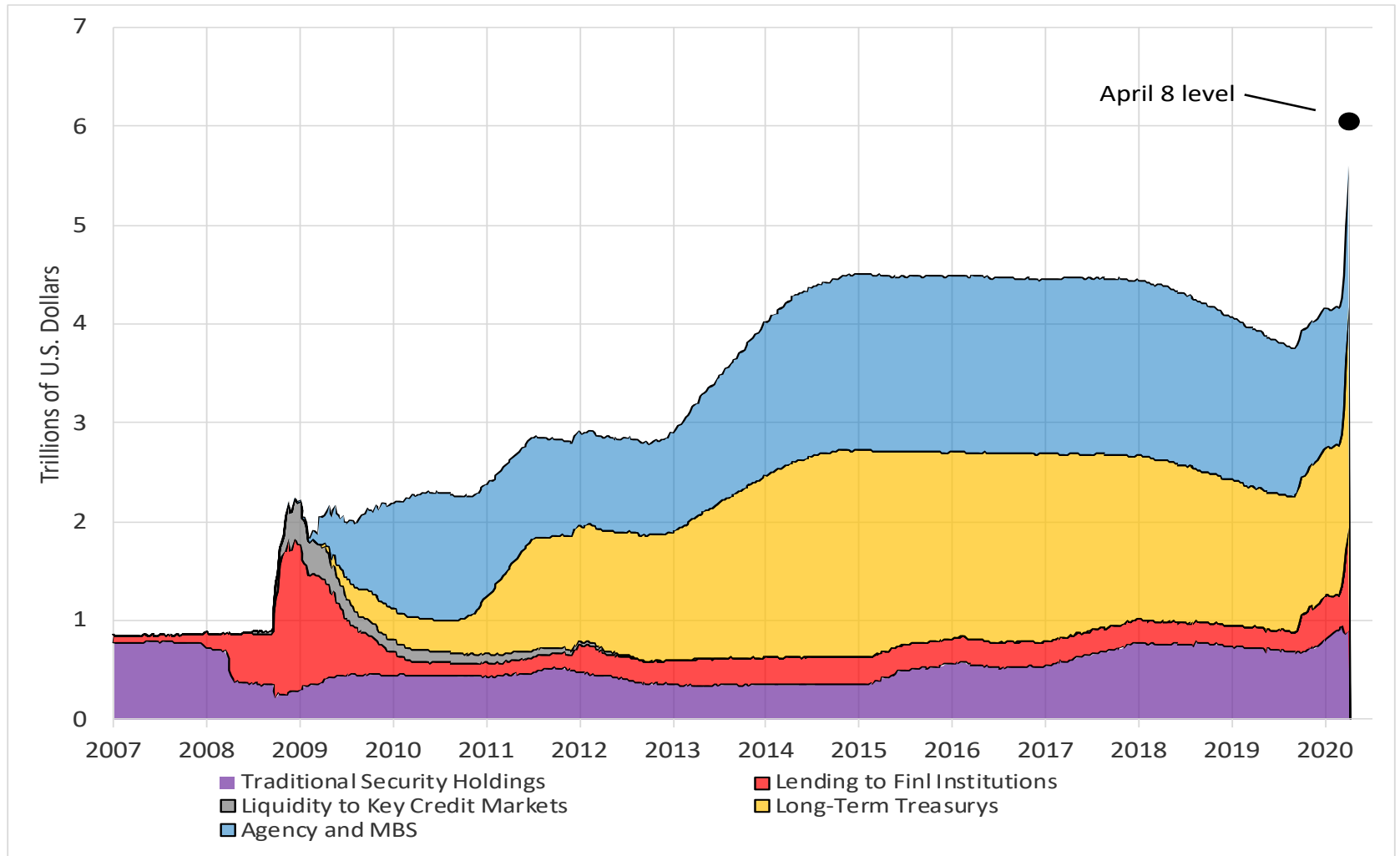
“Our emergency measures are reserved for truly rare circumstances, such as those we face today. When the economy is well on its way back to recovery, and private markets and institutions are once again able to perform their vital functions of channeling credit and supporting economic growth, we will put these emergency tools away.”

FRB [Chair Jay Powell](#), April 9, 2020.

COVID-19 Response: Whatever it takes

- Bigger, faster and more aggressive
- Two weeks to cut policy rates
- “QE Infinity” \Rightarrow reserves surge
- Alphabet soup: “expired” and new tools
 - Central bank dollar liquidity swaps
 - CPFF, PDCF, MMLF, TALF
- State Bank (PPPLF, PMCCF, SMCCF, Main Street Lending Program, Municipal Liquidity Facility)

Fed Assets



The Fed: Pre-pandemic

- Fed previously aspired to be “*asset neutral*”
- Fed not authorized to lend directly to nonfinancials
- Fed can take nonfinancial liabilities as collateral
- Crisis of 2007-09: baby steps as a state bank
 - 2008-09: CPFF credit to nonfins through SPVs
 - 2009-12: TALF loans against ABS collateral

The Fed as a State Bank: COVID-19

- Gov't uses the Fed's balance sheet to allocate credit
- Fed credit to nonfinancials through
 - Commercial Paper Funding Facility (CPFF)
 - Primary Market Corporate Credit Facility (PMCCF)
 - Secondary Market Corporate Credit Facility (SMCCF)
 - Payment Protection Program Lending Facility (PPPLF)
 - Main Street Lending Program (MSNLF & MSELF)
 - Municipal Liquidity Facility (MLF)
- Massive taxpayer backstop
 - \$215b so far out of \$454b in CARES Act;
allows massive leverage through Fed

Wartime Fed

- During and after World War II, the Fed:
 - Capped long-term Treasury at 2%
 - Residual supplier of war finance
 - Sacrificed monetary control: fiscal dominance
 - Treasury Accord (1951): gained control & independence
- World War V (2020-202x?)
 - Fed deeply engaged in credit allocation
 - Future of Fed's monetary policy independence at risk

Will the Fed's policies work?

- Still headed for deepest postwar downturn...
- ... and record unemployment rate
- Financial system stronger than in 2007, but...
- ... tidal wave of bankruptcies could swamp the system

Appendix

- Reserves at the Fed
- Great Financial Crisis 2007-09
- Can the Fed still be independent?
- The Warning from SRISK
- Impact of Fed USD liquidity swaps
- Fed liabilities

Reserves at the Fed

FRED 

— Liabilities and Capital: Other Factors Draining Reserve Balances: Reserve Balances With Federal Reserve Banks: Wednesday Level



Source: Board of Governors of the Federal Reserve System (US)

myf.red/g/qGiU

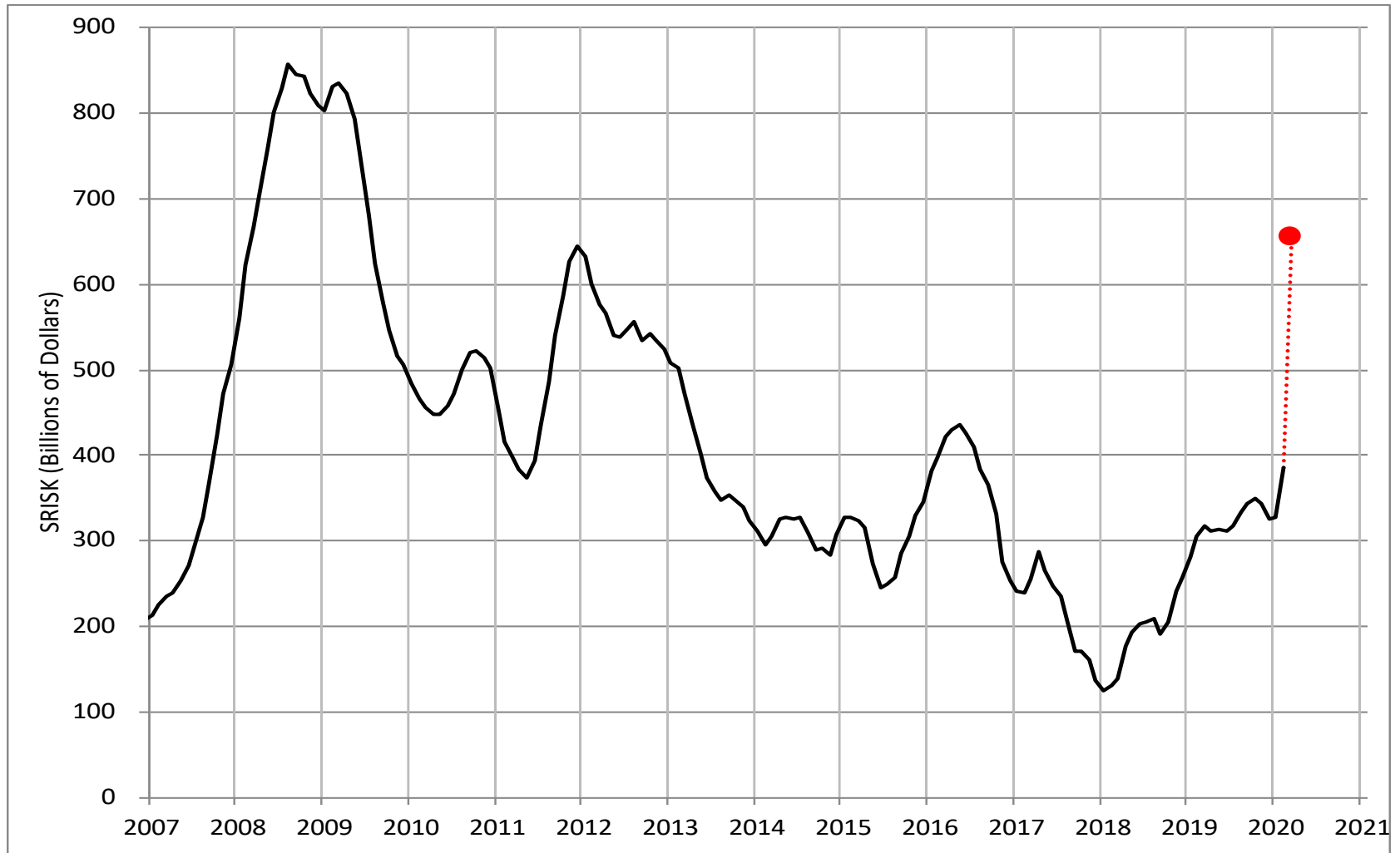
Great Financial Crisis 2007-09

- Lender of last resort
 - Aug 2007 to Mar 2008:
trial & error, delivering liquidity where needed
 - Sept 2008: lending balloons to banks & nonbanks
- Market maker of last resort
 - Substitutes for private intermediation after Lehman:
(MBS purchases; MMMF, CPFF, TALF)
- Monetary policy
 - 16 months to lower policy rate near zero
 - Mar 2008 (Bear): shift toward riskier assets & credit to nonbanks
 - Dec 2008: forward guidance (“for some time”)
 - Sept 2008: QE expands balance sheet

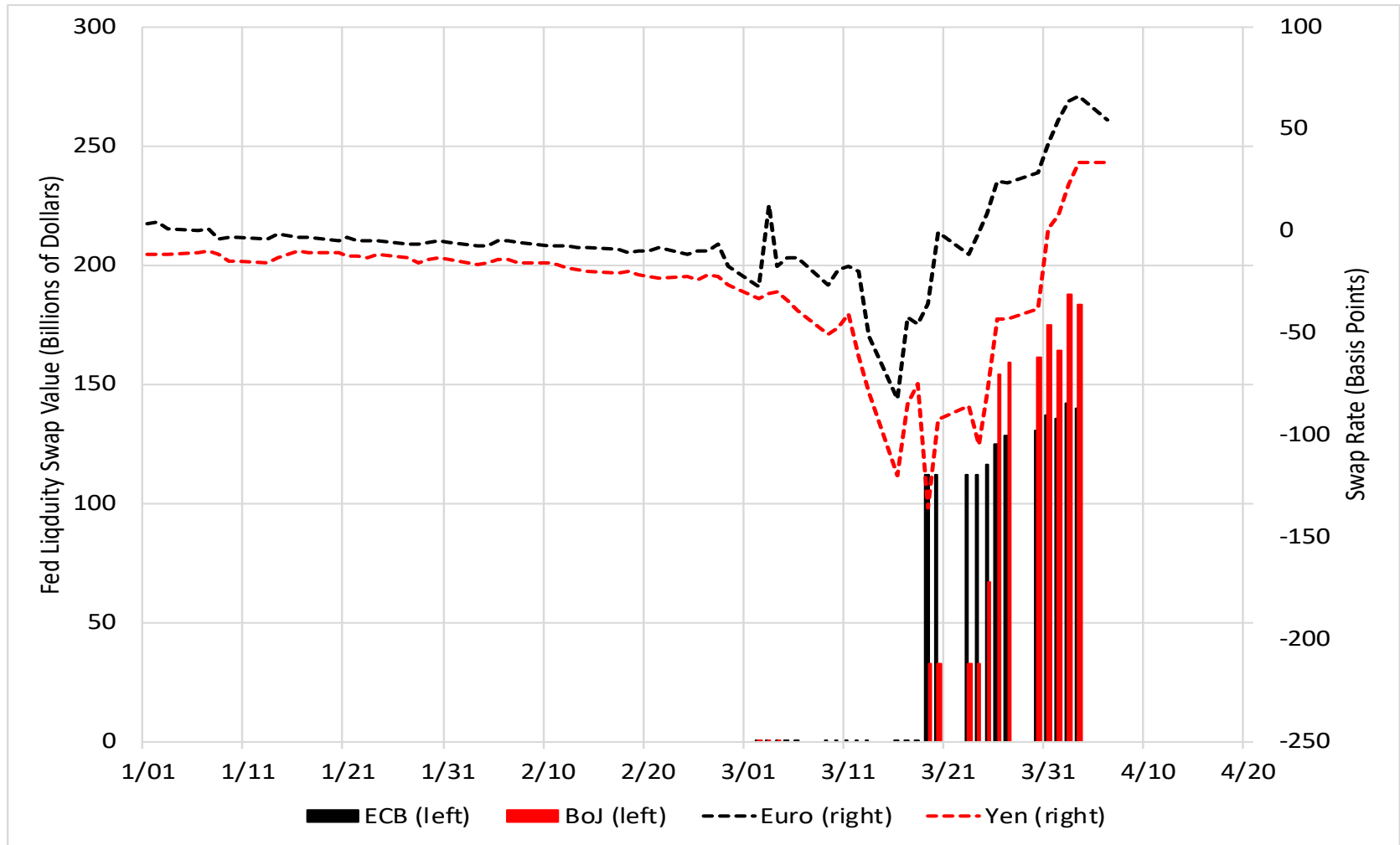
Can the Fed still be independent?

- Since mid-1980s:
 - Fed set monetary policy independently as a de facto inflation-targeting central bank
 - Mandate price stability & maximum sustainable employment
 - Congressionally authorized tools
- *Operational independence:*
 - Credibility to keep inflation low and stable for decades.
- Can a Fed engaging in credit allocation remain independent?
(CARES Act endorsement necessary, but not sufficient)

The Warning from SRISK



Impact of Fed USD Liquidity Swaps



Notes: The bars (left axis) show the value of Fed liquidity swaps with the ECB (black) and the BoJ (red). The dotted lines show the three-month cross-currency basis swap rates for the euro (black) and yen (red).

Fed Liabilities

