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The Federal Reserve’s Response to COVID-19: Policy Issues

SUMMARY

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The Coronavirus Disease 2019 (COVID-19) pandemic has caused widespread disruptions to the economy. The Federal Reserve (Fed) took multiple policy actions in response to the crisis, and Congress took the unprecedented step of providing up to $500 billion to the Treasury to support Fed programs through the Coronavirus Aid, Relief, and Economic Security Act (CARES Act; P.L. 116-136).

The Fed acted to promote economic and financial stability in both its monetary policy and its *lender of last resort* roles. Some of these actions were intended to stimulate economic activity by reducing interest rates, and others were intended to provide liquidity so firms have access to needed funding. The Fed acted as a lender of last resort for banks by making short-term loans through the discount window, which it encouraged banks to access and made the borrowing terms more attractive when the pandemic began. Because foreign banks are reliant on U.S. dollar funding but cannot borrow from the discount window, the Fed has also allowed foreign central banks to swap their currencies for U.S. dollars so that the central banks can lend those dollars to banks in their jurisdictions. Swaps outstanding peaked at nearly $450 billion in May 2020 but have been below $100 billion since August 2020.

The Fed set up a series of emergency facilities in response to COVID-19 to expand its lender of last resort role to other sectors of the economy. The Fed created facilities to assist commercial paper markets, corporate bond markets, money market mutual funds, primary dealers, asset-backed securities, states and municipalities, and a Main Street Lending Program for mid-size businesses and nonprofits. It also created a facility to make funds available for lenders to make loans to small businesses through the Paycheck Protection Program (another CARES Act program). The Fed charged interest and fees to use these facilities that may increase its net income, but the facilities expose taxpayers to the risk of losses if borrowers default or securities fall in value. Assistance outstanding under these facilities peaked at nearly $200 billion in April 2020 but hovered around $100 billion for the rest of the year. Treasury pledged $215 billion to backstop potential losses on these facilities.

The Fed can ease overall liquidity conditions by entering into repurchase agreements (repos), which are economically equivalent to short-term collateralized loans. In response to the crisis, the Fed has made $1 trillion in overnight repos available at auction every day and has made an additional $500 billion in longer-term repos available at least once a week. Actual take-up rates, however, were much lower and have been zero since June 2020.

The Fed lowered interest rates to stimulate interest-sensitive spending. In March 2020, it reduced short-term interest rates to a range of 0% to 0.25%. Because rates were already comparatively low before March, reducing rates provided relatively limited additional monetary stimulus. To provide more stimulus, the Fed also made large-scale purchases of Treasury securities and mortgage-backed securities in an effort to reduce interest rates generally. Those purchases also added more liquidity to the financial system. The Fed used this tool—popularly referred to as “quantitative easing” (QE)—in the 2007-2009 financial crisis. Its 2020 purchases were larger. In April alone, the Fed’s securities holdings increased by about $1.2 trillion. The Fed has financed all of these activities by expanding its balance sheet, which surpassed its previous all-time high ($4.5 trillion) by March 2020 and exceeded $7 trillion by May 2020. The Fed has pledged that it will not raise interest rates until the economy has reached full employment and consistently maintained 2% inflation and that it will continue large-scale asset purchases until “substantial further progress” has been made toward those goals.

Fed Chair Jerome Powell said in May 2020, “the Fed has lending powers, not spending powers.” Traditionally, financial assistance that goes beyond short-term liquidity to solvent financial firms has been the purview of the Administration and Congress, not the Fed. Congress decided in the CARES Act to provide most of the $500 billion for economic stabilization to support Fed—instead of Treasury—programs, however. In principle, the Fed’s lender of last resort powers are intended to address illiquidity, not insolvency (i.e., when a business is no longer viable). As the pandemic persists, losses threaten to shift liquidity problems to solvency problems, arguably blurring the line between lending and spending. The more the Fed’s COVID-19 response comes to resemble spending, the greater the implications may be for the Fed’s political independence.

The emergency programs backed by the CARES Act expired at the end of 2020, while most other emergency programs were extended until March 2021. With the pandemic worsening in the winter of 2020, Congress debated whether the CARES Act programs should be extended. P.L. 116-260 prohibited the Fed from reopening CARES Act programs for corporate bonds, municipal debt, and the Main Street Lending Program.