The Fed Must Go Much Further

- **The Fed wears the global burden of rising to the occasion…**
- **…partly because others have failed**
- **Cutting to the ELB won't suffice…**
- **...nor will flooding repo markets that markets just rejected**
- **The Fed needs to buy credit through MBS…**
- **...and implement a fuller suite of measures**
- **Price discovery will continue as market dysfunction is contained**

The Federal Reserve often wears a disproportionate burden in times of crisis management, but this is especially true today. Limited policy options at other major central banks are combining with inadequately prepared health sectors and global political dysfunction, including the incompetent leadership provided by the US administration. As a consequence, the heavies burden of calming markets lands at the doorstep of the Eccles building in Washington.

WHAT'S DONE IS NOT ENOUGH

The Federal Reserve must not disappoint yet the measures that have been introduced and/or that are expected to date would do just that. Simply cutting the policy rate by 50bps thus far and then another 75bps or even 100bps next week would disappoint markets that are already largely priced for such a move and yet continue to take dollops of risk off the table.

Further, while today's broadened Fed purchases to include coupon bearing Treasuries and the NY Fed's dramatic US$1.5 trillion escalation of the size and scope of its temporary repo operations (here) are welcome steps, such policy stances on their own risk magnifying problems in credit markets that have already seen significant spread widening (charts 1–3, for examples). This could be one reason why stock markets were left unimpressed by today's NY Fed actions.

Surely the Fed must have learned this lesson in the roll-out of QE1 when it bought MBS first in November 2008 only to add Treasuries in March 2009 in a reversal of today's order of operations. Distorting the relative price signals in markets runs the risk over time of encouraging asset allocation shifts away from what is not being targeted. This is one reason why the Fed's subsequent LSAP programs (summarized here) tended to buy both Treasuries and credit on top of the fact that it limited the Fed's dominance over buying just one class of instruments and courting dysfunction by crowding out other participants. There is a limit to a central bank's share of an instrument class without courting market dysfunction.

TIME TO GO ALL-IN

The Fed must go all-in with its crisis fighting tools at its upcoming meeting on March 17th–18th. Still, an equally heavy burden rests upon health policy planners,

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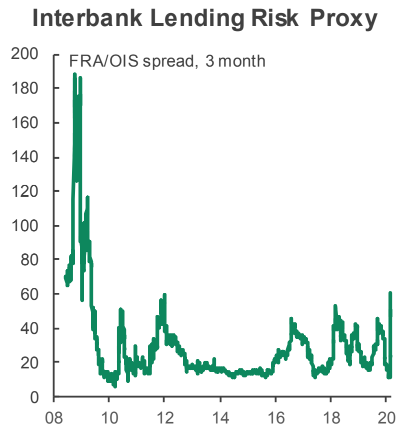
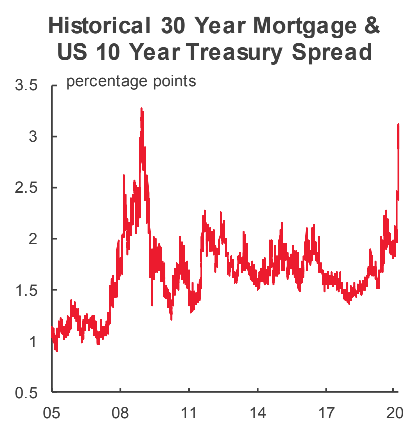
Chart 1



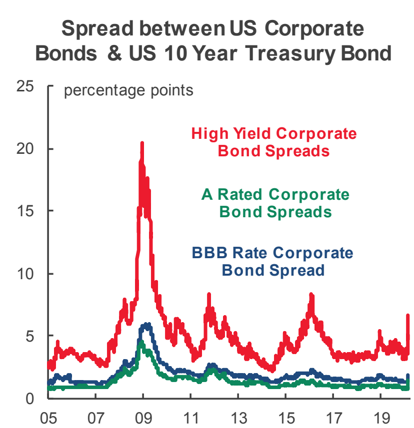
Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Chart 3



Sources: Scotiabank Economics, Bloomberg.

companies and individuals to maximize social distancing practices in order to contain the spread of the virus. There remains a disturbingly high tendency to dismiss the risks posed by COVID-19 even as deniers have watched markets crumble and the health impact of the virus escalate.

Because no one knows the duration or depth of the COVID-19 and OPEC+ shocks to the world economy and its financial system, a risk management approach to monetary policy counsels over-commitment. Recession risk has risen sharply and the Fed's strategic review of its past policy stances appears to have convinced them—rightly—that dithering has magnified problems in the past as opposed to getting more aggressively ahead of the curve.

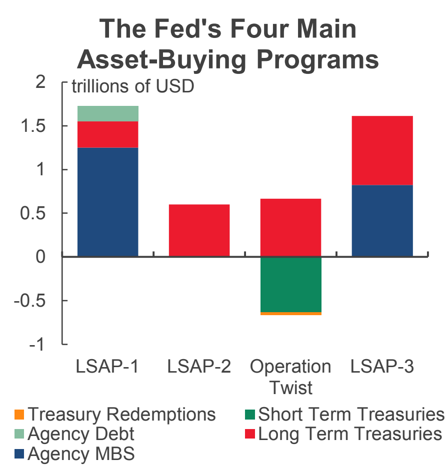
POLICY OPTIONS

For the FOMC, this likely means a multi-pronged approach including the following steps.

1. We expect the Federal Reserve to slash its policy fed funds target range by a minimum 75pbs and more appropriately 100bps to 0–0.25%.

2. We also think the Fed should lower the primary discount rate (charged to banks) to 0.5% and thus reduce the spread over the upper limit of the fed funds target range by 25bps. Strong guidance that banks are encouraged to use it while being immune from negative signaling effects must accompany the move. This would introduce the backstop option of cheap funding similar to the move in December 2008. There may be a stigma attached to borrowing at the window, but that doesn't mean it wouldn't be utilized effectively as we learned back then. Other options like the 2007 Term Auction Facility that released funds with a lag—itself can be confidence building in terms of the firm's viability. The movement of risk-seeking behavior toward non-banks that have risen in importance may nevertheless limit the effectiveness of this option.

Chart 4



Sources: Scotiabank Economics, Federal Reserve of New York.

3. A more neutral approach to buying market instruments more aggressively rather than targeting institutions may therefore be more appropriate. The announcement of an open-ended Large Scale Asset Purchase Program (LSAP) focused upon buying both mortgage backed securities and Treasuries is feasible and in our view an appropriate extension of past rounds (chart 4). The program should be implemented shortly thereafter and perhaps target an initial flow amount of at least US$30B/mth or more. This amount would be over the current policy of reinvesting mortgage payments into Treasuries up to US$20B/mth with monthly flows over this amount being recycled into MBS. Some American variant of 'whatever it takes' would be appropriate guidance to the flexibility to adjust the scale and timing of the program as needed. Supporting points follow.

- The open ended nature of such a program would be similar to QE3 but dissimilar to the finite program sizes of QE1 and QE2. Such a move would appropriately recognize that we don't know the parameters of the shocks we are experiencing and thus cannot attach a finite timeline to providing appropriate stimulus. The Fed has experience in managing tapered purchases that will be needed at some future indeterminate point.

- Treasuries and MBS are the only asset purchase tools that the Fed can effectively utilize in large enough amounts to calm markets. The Federal Reserve Act limits the assets the Fed can purchase to "any obligation which is a direct obligation of, or fully guaranteed as to principal and interest, by any agency of the United States." Put another more blunt way, the Fed cannot buy private sector assets without Congress changing the Federal Reserve Act which is likely just shy of impossible at least in any timely manner.

- It is also not needed. Buying MBS focuses purchases upon a large, deep market and serves as a proxy for indirectly injecting liquidity into other related markets. Since the 30 year fixed mortgage rate is priced off 10s and swapped out, buying mortgages can address rising swap spreads through arbitrage. Buying MBS can also mitigate the risk that credit PMs engage in forced selling of other credit instruments—like corporate bonds—in order to safeguard fund liquidity. Thus, buying MBS can indirectly benefit the corporate bond market.

- The Fed must also continue buying Treasuries alongside an MBS purchase program. Buying MBS in isolation of controlling base yields through Treasury buying risks pushing and pulling on all-in credit yields. A broad approach that utilizes the Fed's full range of approved instruments within the confines of the Act would neutralize distortions as much as possible.

4. At a minimum, the Fed should probably shelve talk of introducing a so-called stress capital buffer with the June 30th release of stress test results pending. Lowering required capital buffers may also be a powerful policy option.

5. Trigger swap lines and do so across more central banks than existing standing facilities in order to provide unlimited US dollar funding to them and hence to borrowers in their respective regions. This would be a large liquidity infusion across mature and less developed markets.

6. Strong forward guidance that the policy rate will be unchanged throughout at least the 2020–21 horizon. Markets need to hear a commitment to sustained easing.

7. Forecast guidance should aggressively mark down expected growth this year and showcase a rebound in 2021 that policy makers are prepared to look through as they maintain extraordinary easing. The effects would reasonably incorporate hope that a rebound will occur and thus inject confidence in that regard, but also indicate that the Treasury curve should not begin thinking about taking back cuts. The bond market and its thousands of agents that clear information constantly is telling policy makers something here. Years of undershooting the inflation target can be used as justification in favour of allowing a run-hotter period of inflation overshooting.

8. The Fed should expedite roll-out of the critical elements of its strategic review of the policy framework. They've been at it for years, revealing aspects of preferences in dribs and drabs since last Summer and markets cannot wait for the Fed to reveal what it might do in the next crisis when it is now upon us. Announcing the full embrace of average inflation targeting in a policy band could be quite effective.

9. The Fed should be thinking ahead to potential subsequent steps it may consider and could be prepared to discuss these in Chair Powell's press conference. One idea is to contemplate a funding for lending scheme like the Bank of England's program. This is very unlikely to be implemented quite as soon as the upcoming meeting but it merits further study and investigation of how to effectively implement such a program. The purpose would be to provide targeted cheap financing to lenders if they then lend the proceeds to businesses.

NEGATIVE RATES AND OTHER MAKEUP STRATEGIES HAVE LITTLE SUPPORT

Overall, this blend of tools may well be just what it takes to lend enough market confidence to avoid a worsening of severe dislocation effects. Guidance that the Fed's staff members have been instructed to report back to the FOMC with a range of other feasible options may also be helpful in keeping the creative window open. Funding and broader market pressures are abundant, but not yet close to GFC levels. A narrow window of opportunity exists to inject such confidence. The tools depicted above are tried and tested and in conformance with our reading of various communications the Fed has offered throughout its strategic review as it has laid out policy options for countering future—and perhaps now present—recession risk. By our reading of the communications including successive rounds of meeting minutes, what are not on that list in the minds of the majority of FOMC participants are other options like negative policy rates and more explicit inflation makeup strategies such as price-level targeting or nominal GDP level targeting. The absence of negative rates as a policy option may be something that Fed Chair Powell could emphasize to limit concerns across financials after the problems that have plagued banks in negative rate jurisdictions like Europe and Japan to very limited benefit especially given the sharply different nature of the US financial system.