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Why the Federal Reserve deserves credit for its actions during COVID-19

By Mark Zandi
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We should be proud of the heroes that have stood up in our ongoing war against COVID-19. Most obvious are the essential workers who continue to provide the critical services we rely on. There are the doctors and nurses caring for those stricken by the virus, the teachers instructing our children under trying conditions, and the grocery store workers ensuring we put meals on the table, to name a few.

A largely unsung hero that deserves a loud call out is the Federal Reserve Board. No one deserves more credit for keeping the economy together during the pandemic. You may recall that the chairman of the Fed, Jay Powell, was a consistent pre-pandemic target for President Trump's criticism. Needless to say, the President's tweets lambasting Powell couldn't have been more badly misplaced.

The Fed was the first to act when it became clear we weren't prepared and wouldn't be able to dodge the virus: it slashed interest rates to effectively zero. If you've wondered why the stock market has rallied to new record highs despite corporate profits being crushed, it is the zero rates. Stock investors know the Fed has their back, and while stock prices are unlikely to continue straight up, if it looks as if they are headed down in a significant way, the Fed will step in to ensure they don't.

Housing has also quickly revived in significant part due to the Fed's success in bringing down mortgage rates. If the pandemic isn't a threat to your job and you've even casually thought about becoming a homeowner or trading up to a bigger home, then this is the time to do it. Hard to imagine there will be other opportunities to get a 30-year fixed-rate mortgage with a rate below 3%.

The Fed gets kudos for erecting a firewall between the mounting economic chaos and the financial system. The firewall is built of a plethora of credit facilities that support different parts of the system to allow households and businesses to continue getting the credit they need to buy homes and cars and operate their firms.
A good example is a facility that allows larger businesses to issue commercial paper, which are IOUs from these businesses to investors in exchange for cash. That's cash to pay workers, vendors and other bills. Early during the financial crisis over a decade ago I received a harried call from the CEO of a major retailer asking what could be done to restart the commercial paper market. No banks were lending, and if he couldn't issue these IOUs, he wouldn't be able to pay his workers at the end of the week. Fortunately, the Fed came through in the nick of time, the market reopened, and he made payroll.

Based on the lessons learned during the dark days of the financial crisis, the Fed wasted no time when the pandemic struck. Not only did it backstopped the commercial paper market, but it moved quickly to help the municipal bond market, where state and local governments raise fund; the corporate bond market, where businesses borrow for big investments; the asset backed securities market that funds credit card and auto loans; and the money market mutual funds, where many of us park our savings.

The Fed also made a big change this past week to the way its sets interest rates, the upshot of which is that rates are unlikely to rise next year or even the year after.

The Fed sets interest rates in order to achieve the dual goal of full employment and stable and low inflation. Before this week's change, this meant a low unemployment rate and a 2% inflation rate. If unemployment got too low and inflation rose above their 2% target, the Fed would promptly raise interest rates.

Not anymore. The Fed announced that it will no longer treat 2 percent inflation as an effective ceiling, but will aim to set rates so that inflation averages 2 percent over the business cycle. This means that if inflation falls below 2 percent for any length of time, the Fed will use its rate-setting power to nudge inflation above 2 percent for as long as needed to maintain the average. With inflation more-or-less running below 2 percent since the financial crisis, this suggests the Fed will allow for lower interest rates for longer.

The Fed also made clear that it believes that the job market can remain tighter for longer before engendering significant inflationary pressures. This was a lesson learned in the last expansion when unemployment fell to a 60-year low of 3.5 percent, yet inflation remained below the Fed's target. With indications that it will take years to significantly reduce the currently high joblessness, this also suggests that the Fed will keep rates low for a long time.

While the Trump administration and Congress dither over another fiscal rescue package, the Fed continues to act. It understands that with the pandemic still raging and American's financial lives being torn apart by double-digit unemployment and millions of layoffs each week, they can't stand to the side.

Sounds like a hero to me.

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