Federal Reserve Actions: Their Impact and the Crisis

By Mo Saleh, CFC Vice President of Financial Risk Management

As news reports cover the extraordinary economic disruptions facing our country and the world, I've answered a few questions to help members better understand the rapidly changing financial markets and Federal Reserve actions—and their impact on CFC. All referenced macro-financial data are sourced from Bloomberg LP and bank industry analysts. For further questions, please reach out to your RVP.

What is the federal funds rate?

The target federal funds rate is the interest rate regulated banks charge each other to lend Federal Reserve funds overnight. It is also a benchmark for the general direction of interest rates on credit cards, mortgages and bank loans, as well as the main tool of the nation's central bank—the U.S. Federal Reserve (the "Fed")—to influence the U.S. economy. Arguably, that makes it the most important interest rate in the world.

There is also a ripple effect from the fed funds rate to the short-term London Interbank Offered Rate. LIBOR, as it's commonly called, is the rate banks charge each other for one-month, three-month, six-month and one-year loans. The fed funds rate also indirectly influences longer-term interest rates because investors expect a higher or lower rate for a longer-term Treasury note depending on whether the Federal Open Market Committee (FOMC) is raising or lowering the federal funds rate. The yields on Treasury notes typically drive long-term mortgages and long-term corporate loan rates.

What is the Fed's zero-bound policy rate action and supplementary market interventions?

In an emergency response to the global outbreak of the novel coronavirus, COVID-19, the FOMC lowered the target for the fed funds rate twice in March 2020, dropping it by a total of 150 basis points to virtually zero. The last and only other time the Fed was that aggressive was in December 2008. In a massive effort to stem the global financial crisis of 2007–2008, the FOMC lowered the fed funds rate 10 times to reach a near zero policy rate in a 15-month period[1].

Following the FOMC's latest move, multiple other Fed-induced market interventions have been either announced (e.g., Commercial Paper Funding Facility was announced on March 18 though not expected to launch until mid-April) or launched (e.g., the Fed's purchase of hundreds of billions of dollars in U.S. Treasurys and corporate debt in the secondary market) to combat the financial market complications created by the COVID-19 pandemic.

The Fed typically lowers the target rate to maintain or revive economic growth and raises it to fight inflation above 2 percent. When the Fed lowers the rate, it's called expansionary monetary policy.

When interest rates are low and the financial market environment is not as unpredictable, banks are often likely to borrow from each other to meet their reserve requirements[2]. Lower rates also

[1] In 2008, the FOMC began setting the target policy rate as a range, rather than a single rate.

[2] The Federal Reserve requires that banks keep a certain amount on hand each night. This reserve requirement prevents banks from lending out every single dollar they have on deposit. It makes sure they have enough cash on hand to start each business day. Reserve requirements are

typically mean credit card rates decline and consumers tend to shop more, which facilitates economic growth. With cheaper bank lending rates, businesses also expand[3]. It can, however, take 12 to 18 months for a change in the policy rate to affect the entire economy.

What is the impact of a zero-bound policy rate during a financial market crisis?

None of the typical business norms apply when a crisis unfolds, as it did in 2008 and again now as a result of the global pandemic. The Dow Jones Industrial Average fell almost 13 percent—the biggest one-day drop in history—after the FOMC cut rates in mid-March. Rather than calm financial markets, the Fed's rate cut unintentionally signaled that fears about an economic collapse were broadly justified. The severity of the virus outbreak and its impact on domestic and global economic growth have become even more evident since then. Economists' expectations for significant negative economic growth in the first half of this year are likely unprecedented in terms of downward speed and magnitude.

The health crisis has also resurfaced some of issues of the 2008 liquidity crisis in the money markets, although in a much more compressed timeframe of less than 30 days. The money market is an important component of the economy as it provides short-term funds to corporations and financial institutions and, ultimately, the American consumer. The money market deals in short-term borrowings of less than or equal to 365 days and primarily impacts the cost of variable-rate loans.

A key source of funding for the money market is the >$1 trillion Commercial Paper ("CP") market, which has experienced a significant drop in liquidity, particularly in March. While most top-tier CP issuers rated A1/P1 (e.g., CFC) continue to have access to funding on a daily basis, tight liquidity conditions have caused the cost of borrowing in the CP market to rise by as much as 50 to 350 basis points.

In other extreme circumstances, the CP market has been either closed or limited to overnight issuance, which has exacerbated rollover risk for issuers in the market. This has been especially true for second-tier and third-tier corporate issuers. These issuers have not been able to access the CP market economically or efficiently, resulting in massive drawdowns of bank revolving credit facilities—totaling approximately $150 billion nationwide.

Forecasters expect money market rates to decline once all of the Fed's monetary policies are officially launched and the financial markets and the broader economy show signs of stabilizing.

---

met by banks borrowing from each other based on the cost of money as set by the FOMC through lowering or raising the underlying interbank rate.

[3] When the Fed raises rates, it's called contractionary monetary policy. A higher fed funds rate means banks are less likely to borrow money to keep their reserves at the mandated level. As a result, they lend less money out. The money they do lend will be at a higher rate because they are borrowing money at a higher rate.