Studies in Applied Economics

POLICY RESPONSES TO THE COVID-19 PANDEMIC

Alexandria Edwards

Johns Hopkins Institute for Applied Economics, Global Health, and the Study of Business Enterprise
Policy Responses to the COVID-19 Pandemic
By Alexandria Edwards

About the Series
The Studies in Applied Economics series is under the general direction of Professor Steve H. Hanke, Founder and Co-Director of the Institute for Applied Economics, Global Health and the Study of Business Enterprise (hanke@jhu.edu).

About the Author
Alexandria Edwards (awedwards@jhu.edu) is a student in the Krieger School of Arts and Sciences at the Johns Hopkins University in Baltimore, pursuing a double major in Economics and International Studies and expecting to graduate in May 2022. She wrote this paper as an undergraduate researcher at the Institute for Applied Economics, Global Health, and the Study of Business Enterprise. On campus, Alexandria co-founded the Johns Hopkins chapter of Smart Woman Securities, the university’s only all-women’s investment team, and currently serves as the chapter’s Co-President.

Abstract
The COVID-19 pandemic has created severe economic disruptions, shutting down fundamental sectors of the United States economy and rocking financial markets. Unlike any prior financial crises, the current crisis is a necessary result of deliberate government actions implemented in order to prioritize public health and mitigate the spread of the virus. Consequently, both monetary and fiscal authorities have initiated major programs intended to inject liquidity into the financial system and provide support to businesses and individuals. This paper presents an outline and analysis of the recent actions taken by the Federal Reserve, as well as the Coronavirus Aid, Relief, and Economic Security (CARES) Act signed by the President on March 27th.

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I. Monetary Policy Response

Introduction

On March 9, 2020, Steve H. Hanke, Founder and Co-Director of the Institute for Applied Economics, Global Health, and the Study of Business Enterprise and Professor of Applied Economics at Johns Hopkins University, and John Greenwood, Chief Economist at Invesco in London and Fellow at the Johns Hopkins Institute for Applied Economics, Global Health, and the Study of Business Enterprise wrote an op-ed published in the Wall Street Journal, How the Federal Reserve Can Ease the Coronavirus Panic, in which they argued that, rather than rely solely on interest rates as the driver of monetary policy, the Federal Reserve should supply more liquidity to ease markets destabilized by the spread of the coronavirus.

Hanke and Greenwood argue that monetary policy should not be centered on interest rates, but rather the correct level of broad money in the economy. In the event of a panic such as the coronavirus crisis, the Fed should function as a lender of last resort and follow Walter Bagehot’s classic rule: supply ample funds at a penalty rate against decent collateral. To supply adequate liquidity to tumultuous markets, Hanke and Greenwood suggest measures such as quantitative easing purchases of long-term bonds, Treasury bill purchases, repos, and, most importantly, increasing the amounts of U.S. dollar swaps available to the central banks of Japan, China, South Korea, Taiwan and Hong Kong.1

In a subsequent letter, The Fed’s Liquidity Stimulus Must Be Enough to Succeed, 2 responding to the Wall Street Journal editorial, The Fed’s Market Emollients, 3 Hanke and Greenwood suggest that the magnitude of the necessary liquidity injection will likely be much higher than is widely believed, as regulations imposed by Dodd-Frank after the Global Financial Crisis and Basel III from 2015 effectively prevent banks from using their high levels of capital and liquidity to lend to customers. These regulations require banks to maintain Treasuries and agencies in times of stress under the liquidity coverage requirement (LCR).

The below chronology indicates that the Fed has precisely followed these recommendations. The central bank injected substantial funds into short term money markets, enacted an unlimited quantitative easing program of Treasury bond purchases, increased US dollar swap arrangements with foreign central banks, extending them to central banks not previously part of the program, and adopted numerous other measures in what is the biggest balance sheet expansion in the central bank’s history.

Timeline of Recent Actions

**March 3**

The Federal Open Market Committee (FOMC) lowered the federal funds rate target range by 50 basis points to 1.1.25%.

**March 12**

The Federal Reserve Bank of New York announced a $1.5 trillion repo offering through three separate repo auctions, promising to intervene substantially in short-term money markets.

On March 12, $500 billion in a three-month repo operation was offered, and an additional $500 billion in a three-month repo operation and $500 billion in a one-month repo operation were offered the next day. Three-month and one-month repo operations will also be offered on a weekly basis for remainder of monthly schedule. In addition, the Federal Reserve will continue offering at least $175 billion in daily overnight repo operations and at least $45 billion in two-week operations.

The New York Fed also announced that it would adjust its monthly $60 billion “reserve management” purchases to bring the maturity of the Fed’s holdings in line with their existing portfolio by spreading its purchases across nominal coupons, Treasury bills, and Treasury Inflation Protected Securities (TIPS), among other securities. It is important to note that that these purchases are distinct from quantitative easing. In October 2019, the Fed had announced it would begin monthly purchases of approximately $60 billion in Treasury bills to help counteract the spike in repo rates in September 2019, which was triggered by the Fed’s $600 billion reduction of its balance sheet during the period 2017-2019. These purchases were intended to keep market rates aligned with the federal funds target range, rather than materially alter its monetary policy stance.

**March 15**

On March 15, the Fed announced a large-scale emergency program in response to economic disruptions caused by the COVID-19 outbreak. The FOMC lowered the federal funds rate target range to 0-0.5%, the “zero lower bound,” and announced a new round of quantitative easing. The Fed announced it would purchase at least $700 billion in assets over the coming 4-6 months.

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6 Ibid.
months, including at least $500 billion in Treasury securities and $200 billion in agency mortgage backed securities.

The Fed took measures to encourage banks to actively use discount window lowering primary credit rate by 150 basis points to 0.25% and permitting depository institutions to borrow from the discount window for as long as 90 days. In addition, the Fed relaxed bank capital requirements by eliminating reserve requirements and encouraging banks to use capital and liquidity buffers to lend to households and businesses.

The Fed also announced a coordinated international central bank effort with the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, and the Swiss National Bank, to lower pricing on U.S. dollar liquidity swap arrangements by 25 basis points and expand offerings. These actions are intended to enhance liquidity in the US dollar markets outside the US.

**March 17**

The Fed announced the introduction of two new facilities.

The **Commercial Paper Funding Facility (CPFF)** is authorized to buy corporate paper at the three-month overnight index swap (OIS) rate plus 200 basis points, and will be structured as a credit facility to a special purpose vehicle (SPV) that will purchase unsecured and asset-backed commercial paper. The Treasury will provide $10 billion of credit protection from the Exchange Stabilization Fund (ESF).

The Fed also announced the revival of the **Primary Dealer Credit Facility (PDCF)**, first set up in 2008. This facility will provide overnight and term funding with maturities up to 90 days, beginning March 20, allowing primary dealers to support smooth market functioning and credit availability to businesses and households. Credit extended may be collateralized by a broad range of investment grade debt and equity securities, and the interest rate charged will be the primary credit rate.

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10 Ibid.


March 18

The Fed announced the creation of an additional facility, the **Money Market Mutual Fund Liquidity Facility (MMLF)**\(^{14}\) Loans are available to eligible financial institutions, secured by high-quality assets purchased from money market mutual funds, and the Treasury will provide $10 billion of credit protection from the ESF. The structure of the MMLF is similar to that of the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) that operated from late 2008-2010.

March 19

The Fed announced a further expansion of US dollar liquidity swap lines. Temporary US dollar liquidity swap lines were extended to additional central banks. Up to $60 billion each was extended to the central banks of Australia, Brazil, Mexico, Singapore, South Korea, and Switzerland, and up to $30 billion each was extended to those of Denmark, Norway, and New Zealand.\(^{15}\) These U.S. dollar liquidity arrangements will remain in place for at least six months.

March 20

The frequency of US dollar liquidity swap operations was updated from weekly to daily in a coordinated effort with Bank of Canada, Bank of England, Bank of Japan, the European Central Bank, and the Swiss National Bank. Daily operations will begin March 23 and continue at least through the end of April.

Additionally, the MMLF expanded acceptable collateral to include high-quality municipal debt.\(^{16}\)

March 23

On March 23, the Fed took major actions to provide substantial liquidity to the economy through what is in effect an unlimited quantitative easing purchase program, exercised through the introduction of additional lending facilities.\(^{17}\)

In an expansion of the asset purchase program announced on March 15, the Fed announced purchases of $375 billion in Treasury securities and $250 billion in mortgage securities that

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\(^{16}\) Federal Reserve Board of Governors. (2020, March 20). Federal Reserve Board expands its program of support for flow of credit to the economy by taking steps to enhance liquidity and functioning of crucial state and municipal money markets. [Press Release] [https://www.federalreserve.gov/newsevents/pressreleases/monetary20200320b.htm](https://www.federalreserve.gov/newsevents/pressreleases/monetary20200320b.htm)

week, with **no limit on future purchases**. The Fed will also begin to purchase agency commercial mortgage backed securities (CMBS).

$300 billion in new financing to employers and businesses will be provided through three lending facilities:

1. **The Primary Market Corporate Credit Facility (PMCCF)**, which is open to investment grade companies and provides bridge financing of four years. Companies can issue bonds and sell them directly to the Fed.
2. **The Secondary Market Corporate Credit Facility (SMCCF)**, which will purchase investment grade corporate bonds in the secondary market and US-listed exchange traded funds with broad exposure to the corporate bond market. The goal of this program is to increase liquidity in the secondary corporate bond market.
3. **The Term Asset-Backed Securities Lending Facility (TALF)**, which enable issuance of asset-backed securities backed by student loans, auto loans, credit card loans, SBA loans, and other certain assets by lending to holders of these securities.

The Treasury will provide $30 billion in equity to cover losses using the Exchange Stabilization Fund.

The Fed also announced a further expansion of the MMLF to include a wider range of securities, including municipal variable rate demand notes (VRDNs) and bank certificates of deposit, as well as an expansion of CPFF and reduction in pricing. The CPFF will now include high quality, tax-exempt commercial paper as eligible securities.

**March 24**

The Fed announced that it would scale back its non-critical regulatory oversight of financial institutions, with the biggest reductions targeted to smaller firms. However, large banks are still required to submit their capital adequacy plans by April 6.18

**March 26**

The New York Fed announced it **would immediately begin purchases of agency CMBS**, with a $1 billion purchase of fixed rate Fannie Mae Delegated Underwriting and Servicing (FNMA DUS) pools, with a 10 year loan term, a yield maintenance protection term of 9.5 years (FNMA DUS 10/9.5), and a weighted average life greater than or equal to 7 years. The New York Fed also anticipates three additional operations next week, totaling approximately $3 billion. Purchases

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18 Federal Reserve Board of Governors. (2020, March 24). *Federal Reserve provides additional information to financial institutions on how its supervisory approach is adjusting in light of the coronavirus.* [Press Release]

https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200324a.htm
will be made across fixed-rate FNMA DUS pools, fixed-rate Freddie Mac K-series Deals, and Ginnie Mae Project Loan pools, and details of each operation will be released one day prior.\textsuperscript{19}

The Fed also announced that it would provide regulatory reporting relief to small financial institutions. Recognizing the disruptions felt especially by smaller firms, the Fed will not take action against any financial institution with less than $5 billion in total assets that submits financial statements after filing deadlines, as long as required reports are submitted within 30 days of the initial deadline.\textsuperscript{20}

\section*{II. Fiscal Policy Response}

\textbf{Introduction}

On the fiscal policy front, Professor Hanke and several former White House colleagues, including Ambassador C. Boyden Gray, who has previously served as White House Counsel, Ambassador to the European Union, United States Special Envoy for European Affairs, and United States Special Envoy for Eurasian Energy, have advocated for a program that provides direct cash payments to Americans and businesses. With mandatory shutdowns of major parts of the economy, the federal government has effectively made it illegal for most of the population to work. Thus, the government must compensate Americans for this loss of freedom to work, which is tantamount to an infringement of property rights. The federal government must also replace lost cash flows of businesses resulting from these mandated shutdowns.

The roughly $2.2 trillion relief package signed by the President on March 27 includes these fundamental recommendations. The Coronavirus Aid, Relief, and Economic Security (CARES) Act includes $301 billion in direct payments to individuals, as well as provisions for upwards of $500 billion in grants, loans, and other aid to both small and large businesses.

While the legislation rightly allocated substantial amounts of direct aid to households and businesses, many of the additional provisions fall outside the bounds of this mandate, creating a massive expansion of government that will likely have lasting long-term effects. Beyond the targeted relief programs and extension of unemployment insurance, the bill expands virtually every component of the social safety net, signifying a substantial growth of the welfare state with no clear distinction between immediate needs and permanent government expansion.

"\textit{Emergencies' have always been the pretext on which the safeguards of individual liberty have been eroded.}" – Friedrich A. Hayek\textsuperscript{21}


In the context of the current crisis, Friedrich Hayek’s words are especially pertinent. Once liberties are effectively suspended in a true emergency, Hayek further notes that “it is not difficult for anyone who has assumed such emergency powers to see to it that the emergency will persist.” It falls on the American voting public to remain on guard once this crisis subsides to ensure the system returns to some semblance of normalcy, rather than allowing the current moment to function as a pretense for a permanent expansion of government power.

In a 2001 article published in the Financial Times, Prof. Hanke and economist Robert Higgs applied Hayek’s theory to historical examples and reached the same conclusion. In what they describe as the “the Law of the Ratchet,” national crises result in enlarged budgets and new laws and government agencies, acting as a ratchet that “shifts the trend line of government’s size and scope up to a higher level.” While increased spending may be necessary during crises, opportunists in government often perceive that these national emergencies can function as a pretext to advance their objectives.

This ratchet effect is evident in numerous historical cases. During the Great Depression, organized farm lobbies succeeded in securing the passage of the Agricultural Adjustment Act, an ostensibly temporary emergency relief measure, and the agricultural sector has continued to receive massive government subsidies. During World War II, virtually every interest group tried to benefit from the newly enlarged government budget, and even those remote from the war effort claimed to be performing “essential war work.”

These are just a few historical examples of the validity of Hayek’s warning, which will become increasingly relevant in the current crisis.

**Key provisions**

The main provisions of the $2 trillion CARES bill can be broken down into five key categories:

1. **Direct payments to households**

   The bill allocates around $301 billion, 1.4% of GDP to provide direct cash payments to Americans from the US Treasury. Under this program, adults are eligible for up to $1,200 and $2,400 per couple, with additional payments of $500 per child. These payments phase out for individuals earning over $75,000 per year, or $150,000 per couple. Individuals earning $99,000 and married couples earning $198,000 are ineligible.

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22 Ibid.
24 Ibid.
26 Q4 2019 GDP was $21.73 trillion. Source: U.S. Bureau of Economic Analysis, Gross Domestic Product [GDP], retrieved from FRED, Federal Reserve Bank of St. Louis; [https://fred.stlouisfed.org/series/GDP](https://fred.stlouisfed.org/series/GDP)
2. Support for businesses through grants and loans

$500 billion (2.3% of GDP) has been allocated for loans and other direct aid to businesses impacted by COVID-19, authorizing the federal government to take direct equity stakes in distressed companies. Of this, $25 billion is earmarked for passenger airlines, $4 billion for cargo airlines, and $17 billion to companies deemed “critical to national security,” such as Boeing. In exchange for the grants, air carriers must agree not to furlough, lay off, or cut pay for employees until September 30. Assistance is also dependent on companies agreeing not to buy back shares or issue dividends, as well as limits on executive compensation.

The remaining $454 billion (2.1% of GDP) is allocated to the Treasury’s ESF to backstop losses of the lending facilities introduced by the Federal Reserve.

3. Expansion of unemployment insurance

$250 billion (1.2% of GDP) has been allocated to expand unemployment insurance payments. The bill includes a $600 per week increase for the first four months and allowing each state to contribute to additional benefits. Additionally, availability is extended to contract workers, freelancers, and other nontraditional workers, and the duration of jobless benefits was extended to 39 weeks from the 26 previously available in most states.

4. Increased funding for healthcare

$150 billion (0.7% of GDP) has been earmarked for direct aid to state and local governments in order to provide funds for hospitals, equipment, testing supplies, and hiring of medical professionals. An additional $117 billion (0.5% of GDP) has also been directly allocated for hospitals and veterans’ care, and $27 billion will be added to emergency fund that would boost dozens of projects developing drugs and vaccines against coronavirus.

5. Aid to small businesses

$367 billion (1.7% of GDP) will be available to provide loans and grants to businesses with fewer than 500 employees.

Tax and personal finance provisions

Taxes

$221 billion (1.04% of GDP) will be provided in numerous tax benefits for businesses, including deferrals and extended deadlines. Employers will be able to defer 2020 payroll taxes, paying half in 2021 and half in 2022. A tax credit will be provided for retaining employees equal to 50% of payroll, which is limited to $10,000 per employee per quarter and for employers with 100+ employees. Businesses may also claim deductions by applying today’s losses against past profits to claim cash refunds. Restaurants and retailers would also benefit from the fixing of a 2017 tax

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law mistake that limited depreciation deductions. In addition, individuals who do not itemize deductions may claim up to $300 for charitable contributions.

Bankruptcy

The bill would ensure that people who file for bankruptcy do not have to use stimulus checks to pay past debt and extends repayment time frame from 5 to 7 years.

Credit reporting

Lenders that allow struggling consumers to defer or skip loan payments will be required to report the borrowers as current on their payments, even if they are not.

Mortgages

Companies that service federally backed mortgages will be required to grant forbearance of up to 360 days to borrowers harmed by the outbreak. Servicers are also prohibited from initiating foreclosure and processing foreclosure-related evictions for 60 days, beginning March 18. Owners of multifamily properties can request forbearance up to 90 days, during which tenants cannot be evicted for nonpayment.

Retirement

The law temporarily loosens rules on hardship distributions from retirement accounts, giving affected individuals access to up to $100,000 without the 10% penalty, doubles the amount 401(k) participants can take in loans from an account for the next 6 months to the lower of $100,000 or 100% of the account balance, and suspends mandatory distributions government requires most to take from tax-deferred accounts for 2020.

Student loans

The Act permits suspension of federal student loan payments through September 30, without any interest accruing.

Additional industry-specific provisions

Banking

The Act delays the implementation of new accounting rule that would have required banks to immediately use reserves for estimated loan losses all at once, rather than spreading out over life of the loan. Additionally, the Office of the Comptroller of the Currency is authorized to allow banks to lend above typical size restrictions. More lending flexibility is also allowed to smaller community banks with less than $10 billion in assets via a higher leverage ratio.

Farming

Over $48 billion has been allocated to agriculture and nutrition programs, including $14 billion to replenish the Commodity Credit Corp., a Depression-era program to stabilize farm incomes,
and $9.5 billion to support producers of specialty crops, livestock, and dairy, as well as those who supply farmer’s markets, restaurants, and schools.

Hotels and restaurants

The hotel and restaurant sectors benefit from a patchwork of loans, grants, and tax relief, primarily from the $350 billion for small businesses. The Act also defines each individual hotel as its own business, allowing hotel owners with several properties to qualify for aid packages.

Public transportation

$25 billion in supplemental spending was allocated for public transit. National passenger railroad Amtrak secured about $1 billion to cover COVID-19 related revenue losses, as well as enhanced unemployment benefits.

The “Pork”

While massive amounts were allocated to important purposes, considerable funds have been directed to agencies with questionable relevance to the COVID-19 pandemic. For example, NASA will receive $60 million, the National Archives will receive $8 million, and the Energy Department will receive an additional $99 million.28

The bill goes even further: The Forest Service will receive $27 million for “capital improvement and maintenance,” $3 million for “forest and rangeland research,” and $7 million for wildfire management. The National Foundation on the Arts and the Humanities gets $75 million, the Kennedy Center gets $25 million, the Institute of American Indian and Alaska Native Culture and Arts Development receives a $78,000 “payment,” and a water project in central Utah gets $500,000, to name a few examples of special interest provisions.29 Clearly, a great deal can be obscured in 880 pages of legislation.

Conclusion

The Fed has rolled out an unprecedented balance sheet expansion in response to the economic downturn, reviving many of its 2008 crisis-era programs and introducing new initiatives. The announcement of an unlimited quantitative easing program reflects the recognition that the scale of the necessary liquidity injections will likely be unprecedented as well, as Hanke and Greenwood suggested.

The current program also repudiates the commonly held notion that the Fed has essentially run out of ammunition in the low interest rate environment of the last decade. Rather than suppressing interest rates, the primary function of the Fed’s balance sheet expansion is to

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29 Ibid.
supply a sufficient quantity of broad money to the economy to enhance liquidity and allow the flow of credit.

On the fiscal side, the federal government took swift action to implement a substantial program to mitigate the economic disruptions caused by the pandemic. Providing direct cash payments to Americans and businesses functions as temporary compensation for restricting the right to work, and loan programs will further support industries deeply affected by the outbreak and mandatory shutdowns.

However, the legislation could signify a long-term expansion of government if these large-scale programs become permanently institutionalized. Many programs enacted during the Great Depression are still around today and have become core fibers of the modern social safety net. The $2.2 trillion CARES act is more than twice the size of the New Deal and the largest aid package in history. While the government must provide relief to Americans and businesses and support the economy during its compulsory shutdown, and has rightly done so, there must also be a balance to prevent the exploitation of a crisis to permanently enlarge the federal government.
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