RECESSION REMEDIES

Lessons Learned from Monetary and Fiscal Policy during COVID-19

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Monetary and Fiscal Policy

The pandemic posed a unique economic shock. The Federal Reserve moved quickly to support the economy. At the same time, the federal government borrowed more than $5 trillion—about 20% of one year's output—in 2020 and 2021 to protect households, businesses and state and local governments from the economic effects of the COVID-19 pandemic. Yet, through all that interest rates the Treasury paid to borrow remained relatively low.

This chapter examines the coordination between monetary and fiscal policy in responding to the economic effects of the pandemic. When the U.S. Treasury needed to issue that extraordinary amount of debt quickly, the Federal Reserve helped to facilitate that by keeping interest rates low - including the purchase of $3 trillion in Treasury debt, $1.45 trillion in seven weeks.

Evidence on Monetary and Fiscal Policy

Reprising recent history, this chapter highlights the types of investors that added to their holdings of U.S. Treasury debt during the first year of the pandemic:

- The Fed's holdings increased the most, by far, accounting for 56 percent of the Treasury issuance through the first quarter of 2021.
- Money market mutual funds that restrict their holdings to U.S. Treasury or agency (such as Fannie Mae and Freddie Mac) debt accounted for 27 percent.
- Domestic banks, for whom U.S. Treasury or agency debt fulfills regulatory requirements, accounted for 8 percent.
- Overseas investors increased their holdings but by much less than during the Global Financial Crisis of 2007–2009.

Private domestic investors who were free from regulatory requirements to buy Treasury debt reduced their direct holdings. That fact raises questions whether the federal government could have placed so much debt, so quickly, and on such favorable terms in the absence of the Federal Reserve's bond purchases.

Large federal budget deficits and rising debt probably put upward pressure on interest rates, the authors note, so other factors must have been holding them down. One such factor is the on-going decline in the neutral rate of interest—the one projected to prevail when the economy is at full employment and price stability; it has been falling for more than 20 years and global markets appear to expect it to remain low.

Nominal 10-Year Treasury Yield Decomposition, January 2018– July 2021
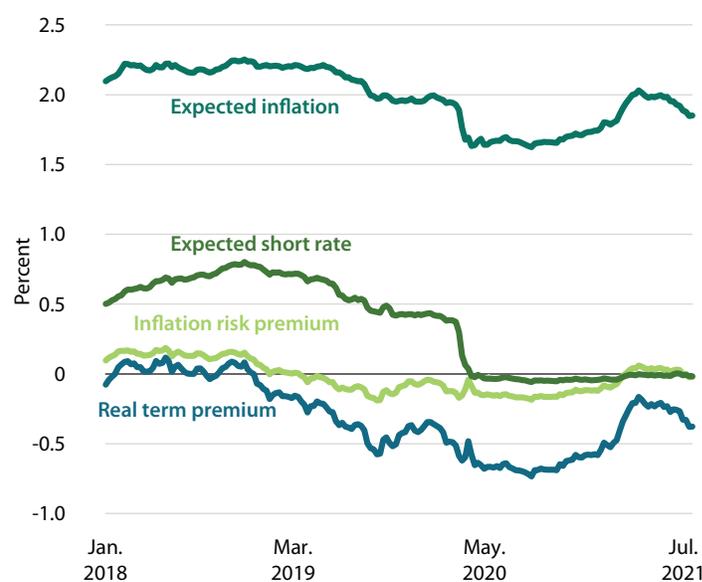
Source: D'Amico, Kim, and Wei 2018; Haver n.d.; authors' calculations.

Note: Decomposition produced with the D'Amico, Kim and Wei (DKW 2018) model.

Lessons Learned

Could the U.S. Treasury increase the federal debt so much, so quickly in a future crisis without driving up interest rates? The answer: Maybe, but don't count on it. A lot depends on maintaining the Fed's credibility as a politically independent central bank committed to delivering on its mandate of price stability as well as maximum employment.

Inflation is the crucial limiting factor: The Fed might not have bought so much Treasury debt if inflation had been more of a threat in the early months of the pandemic. In the absence of excessive inflation, substantial scope for future Fed responses remains, they say.

Still, many questions will need to be settled in coming years. While yields on Treasury debt as of early April 2022 are still low by historical standards, the end to the pandemic could send them higher. The dollar is strong on foreign exchange markets now, enticing foreign investors to buy U.S. Treasury debt, but that might not always be true. Most importantly, inflation remains elevated. It is, they conclude, too soon to say with confidence how many times the United States can afford to repeat this policy experiment. They urge caution in extrapolating recent successes far into the future.

Scan the QR code with your camera to access the full book, the Recession Remedies Podcast, and more.

Overview

The COVID-19 pandemic posed an extraordinary threat to lives and livelihoods, triggering a sharp economic downturn in the United States. Yet, the recovery was faster and stronger than nearly any forecaster anticipated due in part to the swift, aggressive, sustained, and creative response of U.S. fiscal and monetary policy.

Recession Remedies evaluates the breadth of the economic policy response. Chapters address Unemployment Insurance, Economic Impact Payments, loans and grants to businesses, help for renters and mortgage holders, aid to state and local governments, policies that targeted children, Federal Reserve policy, and the use of non-traditional data to monitor the economy and guide policy.

The Hamilton Project and the Hutchins Center on Fiscal & Monetary Policy at the Brookings Institution gathered scholars with deep expertise to describe specific economic policy responses to the pandemic, summarize the available evidence about the outcomes of those policies, and analyze the lessons learned for future recessions by separating policies that were pandemic-specific from those that were not. Because when the next recession arrives, it most likely won't be triggered by a pandemic. Overall, we learned that:

- A strong, broad, and inclusive social insurance system provides effective relief to households as well as macroeconomic stimulus.

- The sizable fiscal and monetary policy response helped stabilize the economy. However, its size, particularly in the spring of 2021, was a factor behind the unwelcome surge in inflation.

- Generous Unemployment Insurance may have smaller disincentive effects than previously thought.

- Support for the business sector should be more targeted.

- Support for households should better reflect the state of the economy and the needs of the households.

- Federal and state governments should improve their administrative capacity now so they can respond quickly to changing economic conditions.

- Policymakers need more reliable, representative, and timely data.

THE HAMILTON PROJECT

Hutchins Center on Fiscal & Monetary Policy at BROOKINGS