Fed injects a big dose, but it's got the wrong medicine for the coronavirus pandemic

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Twelve days that shook the world and drove the Federal Reserve to decisive action. Alas, traditional monetary-policy medicine may not be up to the task of addressing a pandemic that has disrupted financial markets and shut down large swaths of the economy.

After an emergency 50-basis-point rate cut on March 3, the Federal Reserve doubled down Sunday evening, lowering its benchmark rate by an additional 100 basis points to a range of 0%-0.25% following another emergency meeting.

After ramping up its $60 billion of monthly Treasury bill purchases to include Treasuries of all maturities and offering $1.5 trillion of liquidity to the market via repurchase agreements on March 3, the Fed doubled down Sunday evening with announced purchases of at least $500 billion of Treasuries and at least $200 billion of agency mortgage-backed securities.

In addition, the Fed reduced reserve requirements to zero, encouraged banks to borrow from its discount window at a rate of 0.25%, and, in coordination with five other central banks, lowered the price of U.S. dollar swap arrangements to facilitate dollar liquidity abroad.

The one thing the Fed could have done but didn't do was cease paying banks interest on excess reserves. (It lowered the rate on IOER from 1.1% to 0.1%.) Paying banks not to lend never made sense during the financial crisis, and it doesn't make sense now, especially since the Fed's other actions are dedicated to making credit more readily available.

"If you want the banking system to be liquid, don't encourage banks to hold more reserves than necessary by making it more attractive to hold them," said George Selgin, director of the Cato Institute's Center for Monetary and Fiscal Alternatives.

Will these monetary measures help? The additional purchases and liquidity injections should help to "support the smooth functioning of markets," as the Fed said in a statement released Sunday. But as economic stimulus, the actions fall short.

And it's not because the Fed is holding back. The Fed's actions should attenuate some of the recent illiquidity in the market for U.S. Treasury securities, which manifested itself last week as Treasuries fell even as stocks were getting pummeled.

It's merely a question of the suitability of monetary policy to address the damage caused by the coronavirus.

It's been well documented that monetary policy is not suited to address supply shocks. When the coronavirus first disrupted manufacturing production and supply chains in China, there was nothing the Fed could do to provide necessary parts to auto manufacturers across the globe.

It is becoming increasingly apparent that lower interest rates aren't an appropriate weapon to address the kind of demand shock resulting from the coronavirus either. If consumers are hunkered down at home, lower mortgage rates aren't going to stimulate home purchases.

Yes, supermarkets are jammed because fearful consumers are stocking up on food and household supplies. But consumers aren't spending on travel, sporting events, Broadway shows, restaurant meals, or trips to the mall, even if those venues remain open.

The stay-at-home mentality enveloping the U.S. and much of the developed world just isn't responsive to lower interest rates.

Similarly, traditional fiscal policy — tax cuts and government spending —won't do much to stimulate demand in a locked-down type of environment. Neither a payroll tax cut nor an extension of the tax filing date will encourage new spending under the circumstances.

The best stimulus, in fact, may be "coronavirus testing kits," according to a March 10 Wall Street Journal op-ed by economist Alan Blinder.

"If most Americans who wanted a test could get one, and if people who tested positive stayed home and sought medical attention, fear of going out wouldn't disappear, but it would dissipate," Blinder wrote. "Think of it as a super-effective form of fiscal stimulus. Test kits are ridiculously cheap compared with the GDP and job losses they might forestall."

It wasn't too many weeks ago that Fed officials were comfortable that monetary policy and the economy were "in a good place." No longer. And the Fed and federal government are lacking the tools to put it there.

On the fiscal front, in addition to an $8.3 billion emergency aid package signed by President Donald Trump last week, the House of Representatives passed an emergency relief package on Saturday to address the effects of the coronavirus. House Speaker Nancy Pelosi negotiated the deal with Treasury Secretary Steve Mnuchin, which has the president's support and is likely to be passed by the Senate this week.

Among the provisions included in the package are paid sick leave, free coronavirus testing, extended unemployment benefits, additional funding for state Medicaid programs, and money for food assistance for those who rely on food stamps or receive free school lunches.

In addition, Trump announced a $50 billion aid package to help small business survive the crisis.

In the same way as the Fed can provide succor to the financial system, these fiscal measures will help low-income families and small firms to manage during the crisis. It will keep them whole, so to speak. They are unlikely to produce a Keynesian-type spending multiplier effect, however.

Fiscal and monetary policy are really limited in what they can do to stimulate the economy in the face of a pandemic.

Policies to address the health crisis, social distancing to reduce the spread of the virus, medical innovations that will, likely after the crisis has past, yield an effective vaccine, and the passage of time are the appropriate antidotes.

Addressing the national and global public health emergency may, in the long run, be a better stimulus than any targeted short-term relief measures from the Fed and federal government.