# the Federal Reserve System

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**To:** Federal Open Market Committee

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**Subject:** Options for Further Monetary Policy Stimulus

If the Committee, like the staff, has read the incoming economic data over the past several months as suggesting a weaker outlook for economic growth and sees downside risks to that outlook, it may want to consider possible options for adding to the existing degree of monetary policy stimulus. The attached set of memos reviews three potential steps in that direction: lowering the interest rate paid on excess reserves (the IOER rate) along with the target range for the federal funds rate, changing the forward guidance in the statement to emphasize more clearly the Committee's intention to keep the federal funds rate near zero for a long period, and reinvesting the repayments of principal on the Federal Reserve's holdings of agency mortgage-backed securities (MBS) in new longer-term debt instruments.

Lowering the IOER rate and the federal funds target range represents policy easing by the traditional method of adjusting short-term interest rates. However, the scope for providing additional stimulus to the economy through this channel is likely fairly limited, as the decline in the IOER rate would most likely not be transmitted fully into other overnight interest rates due to their proximity to the zero lower bound. Moreover, while small reductions in the IOER rate could prove beneficial, more significant cuts could adversely affect the functioning of money markets. IOER rates below zero would also raise substantial legal and technical issues.

Making changes to strengthen the statement language is also related to the Federal Reserve's traditional policy instrument of short-term interest rates. However, while the FOMC has considerable experience with using its communications to influence expectations of federal funds rates over a short- or intermediate-term horizon, current circumstances present a more challenging situation. The market already appears to be pricing in considerable odds that the federal funds rate will remain within its current target range through 2011. Thus, to have a meaningful effect on financial conditions, the Committee might have to provide the market with a signal about its policy intentions very far into the future.

Reinvesting the repayments of principal on SOMA MBS holdings into Treasuries or MBS is an alternative way to achieve more accommodative financial conditions. Such a step would be aimed at keeping SOMA holdings of longer-term securities unchanged for a time, which would maintain the portfolio balance effects that were put in place through the Federal Reserve's large-scale asset purchases. Such an approach would avoid a passive tightening of the stance of monetary policy as repayments of principal reduce Federal Reserve holdings of MBS. We estimate that such repayments will total more than $300 billion between now and the end of 2011. While it is difficult to judge precisely, adoption of this policy option could reduce the ten-year Treasury yield by as much as 20 basis points.

A recent Blue Chip survey asked which of these three policy options would be the most effective at fostering economic growth. About half of the respondents (53 percent) indicated that reinvestments of maturing MBS proceeds or additional purchases of assets would be the most productive step, with the remainder of respondents about evenly split between stronger policy language (24 percent) and lowering the IOER rate (22 percent). In addition, the recent survey of primary dealers conducted by the Federal Reserve Bank of New York asked about the probabilities of each of these policy options being adopted by year-end. The median responses saw about a 35 percent chance of adopting a reinvestment strategy, a 35 percent chance of using stronger policy language, and only a 15 percent chance of lowering the IOER rate. However, those responses came in before some of the more extensive discussion of these options in the financial press in recent days.