

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: July 18, 2018
To: Federal Open Market Committee
From: Thomas Laubach and David Wilcox
Subject: Monetary Policy Options at the Effective Lower Bound: Assessing the Current Policy Toolkit

In recent years, central banks have been confronted with the possibility that policy rates will be constrained by the effective lower bound (ELB) far more frequently than previously expected, owing to the apparent structural decline in equilibrium real interest rates. In this environment, a key question is the extent to which the FOMC's current monetary policy strategy and toolkit can provide adequate policy accommodation in future economic downturns. The upcoming FOMC meeting will offer participants an opportunity to discuss this topic.

As background for that discussion, the attached memo, prepared by Hess Chung, Taisuke Nakata, Matthias Paustian and Diego Vilán (Division of Research and Statistics), and Etienne Gagnon, Bernd Schlusche, James Trevino, and Wei Zheng (Division of Monetary Affairs), assesses the adequacy of the FOMC's current policy strategy and the toolkit used during the post-crisis period to address an economic downturn in a low interest rate environment. The first part of the memo presents different estimates of the probability of events in which the policy rate is constrained by the (ELB) and of the associated macroeconomic outcomes, assuming that the federal funds rate is set by a policy rule and policymakers do not use additional forward guidance or balance sheet policies to add accommodation. The second part of the memo explores the extent to which departures from the baseline policy rule in the form of threshold-based forward guidance for the federal funds rate, in conjunction with balance sheet policies of the type and scale previously deployed by the Committee, can mitigate the effects of significant recessionary shocks that leave the federal funds rate constrained by the ELB.

This memo is intended as part of prudent planning: Understanding what the current toolkit can do when the ELB events occur is necessary background for informed consideration of whether alternative policy tools and strategies should be developed. A discussion of alternative policy strategies is tentatively scheduled to occur at an FOMC meeting early next year.

At the upcoming FOMC meeting, following brief staff presentations and Q&A, there will be an opportunity for participants to comment on these topics (not a full go-round). If you would like to comment, it would be helpful if you could address the questions on the following page.

**Discussion Questions for the July/August FOMC Meeting:
Monetary Policy Options at the Effective Lower Bound:
Assessing the Current Toolkit**

1. How concerned are you that the effective lower bound (ELB) could limit attainment of the Committee's maximum employment and price stability objectives in future economic downturns?
2. In your view, how effective would forward guidance – explicit communication about the future path of the policy rate – and balance sheet policies of the type previously used by the Committee be in providing additional policy accommodation at the ELB? Are there other existing policy tools to be considered as options for dealing with the ELB? Should the Committee communicate in advance how it would intend to use its policy toolkit when and if the ELB constrains policy?
3. Should the Committee evaluate alternative monetary policy strategies, i.e., strategies that would require changing the Committee's Statement on Longer-Run Goals and Monetary Policy Strategy, in order to address the risk that the ELB may prevent the attainment of its maximum employment and price stability objectives?