



Federal Reserve: Monetary Policy Actions in Response to COVID-19

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The **Federal Reserve** (Fed) has taken a number of steps to promote economic and financial stability in response to the coronavirus pandemic (COVID-19). This Insight covers actions related to **monetary policy**—actions intended to lower interest rates or increase overall liquidity. Due to the severity of economic disruption, actions that increase overall liquidity have not been sufficient to maintain financial stability, and the Fed has also directly lent to firms and purchased private securities. Direct Fed lending and other financial assistance in response to COVID-19 is covered in CRS Insight IN11327, *Federal Reserve: Emergency Lending in Response to COVID-19*, by Marc Labonte.

Actions to Lower Interest Rates

Federal Funds Rate

Traditionally, the Fed conducts monetary policy by changing the federal funds rate, the overnight interbank lending rate. In response to COVID-19, on March 3, the Fed **reduced** the federal funds rate from a range of 1.5%-1.75% to a range of 1%-1.25% to stimulate economic activity. On March 15, it **reduced** the range to 0%-0.25%. Economists refer to this as the “zero lower bound” to signify that the Fed’s traditional monetary policy tool has been exhausted at this point, and cannot be used to provide additional stimulus. This is the second time this interest rate has ever hit the zero lower bound—the first time was during the 2008 financial crisis.

Lower interest rates stimulate interest-sensitive spending, such as business capital spending on plant and equipment, household spending on consumer durables, and residential investment. In addition, when interest rates diverge between countries, lower rates cause capital outflows that put downward pressure on the dollar exchange rate, which in turn stimulates spending on exports and imports. Through these channels, monetary policy can be used to stimulate overall spending in the short run.

During the 2008 financial crisis, the Fed developed two other tools to provide stimulus at the zero lower bound—forward guidance and quantitative easing. Both aim to reduce long-term interest rates, which—unlike short-term rates—are not directly determined by the Fed, but are important for stimulating economic activity. These tools are being revived in response to COVID-19.

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Forward Guidance

Forward guidance refers to Fed public communications on its future plans for short-term interest rates, and it took many forms following the 2008 financial crisis. As monetary policy returned to normal in recent years, forward guidance was phased out. It is being used again during COVID-19. For example, when the Fed reduced short-term rates to zero on March 15, it announced that it “expects to maintain this target range until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals.”

Quantitative Easing

Large-scale asset purchases, popularly referred to as **quantitative easing** or *QE*, were also used during the financial crisis. Under QE, the Fed expanded its balance sheet by purchasing securities. Three rounds of QE from 2009 to 2014 increased the Fed’s securities holdings by **\$3.7 trillion**.

On March 23, the Fed **announced** that it would increase its purchases of Treasury securities and mortgage-backed securities (MBS)—including commercial MBS—issued by government agencies or government-sponsored enterprises to “the amounts needed to support smooth market functioning and effective transmission of monetary policy.” These would be undertaken at the unprecedented rate of up to **\$125 billion daily** starting on March 23. As a result, the Fed’s balance sheet is now larger than its post-2008 financial crisis peak of \$4.5 trillion. One notable difference from previous rounds of QE is that the Fed is purchasing securities of different maturities, so the effect likely will not be concentrated on long-term rates.

Actions to Provide Liquidity

In normal conditions, liquidity is plentiful, meaning financial firms can easily borrow at reasonable interest rates. Financial uncertainty, such as that caused by COVID-19, can cause liquidity to dry up. At any given interest rate, the Fed has tools to increase or decrease the overall availability of liquidity in financial markets.

Reserve Requirements

On March 15, the Fed announced that it was reducing **reserve requirements**—the amount of vault cash or deposits at the Fed that banks must hold against deposits—to zero for the first time **ever**. As the Fed noted in its announcement, because bank reserves are currently so abundant, reserve requirements “do not play a significant role” in monetary policy.

Repo Operations

The Fed can temporarily provide liquidity to financial markets by lending cash through repurchase agreements (**repos**) with primary dealers (i.e., large government securities dealers who are market makers). Before the 2008 financial crisis, this was the Fed’s routine method for targeting the federal funds rate. Following this, the Fed’s large balance sheet meant that repos were no longer needed, until they were revived in September 2019 in **response to a spike in repo rates**.

On March 15, the Fed **announced** it would regularly offer overnight and longer-terms repos of \$500 billion, which have been continued to date since March 12. These repos are larger and longer-lasting than those offered since September 2019.

Foreign Central Bank Swap Lines

Both domestic and foreign commercial banks rely on short-term borrowing markets to access U.S. dollars needed to fund their operations and meet their cash flow needs. But in an environment of strained liquidity, only banks operating in the United States can access the discount window. Therefore, the Fed has standing “[swap lines](#)” with major foreign central banks to provide central banks with U.S. dollar funding that they can in turn lend to private banks in their jurisdictions. On March 15, the Fed [reduced](#) the cost of using those swap lines, and on March 19 it [extended](#) swap lines to nine more central banks. Use of the swap lines quickly exceeded their use during the euro crisis. On March 31, the Fed created the [Foreign and International Monetary Authorities Repo Facility](#) to allow foreign central banks to temporarily swap Treasury Securities for U.S. dollars.

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