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Committee on Financial Services
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# Memorandum

**To:** Members, Committee on Financial Services

**From:** FSC Majority Staff

**Subject:** February 27, 2019, "Monetary Policy and the State of the Economy"

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The Committee on Financial Services will hold a hearing at 10:00 a.m. on Wednesday, February 27, 2019, in Room 2128, Rayburn House Office Building. Chairman of the Board of Governors of the Federal Reserve System, Jerome Powell, will testify on the conduct of monetary policy and the state of the economy. He will be the only witness.

**Purpose**

The Federal Reserve Act (FRA) directs the Chairman of the Board of Governors of the Federal Reserve System (Board) to testify before the House Committee on Financial Services and the Senate Committee on Banking twice a year, in February and July, on how the Board handles monetary policy and its observations on economic developments.[1] Each appearance requires the Board to supply the Committees with a written report known as the *Monetary Policy Report*.[2]

**"Humphrey-Hawkins Act"**

As a response to the Great Depression, the Employment Act of 1946 made maximum employment a formally recognized federal government policy "…under which there will be afforded useful employment for those able, willing, and seeking work, and to promote maximum employment, production, and purchasing power."[3]

In the 1970s, the United States experienced an unusual combination of high inflation and unemployment referred to as "stagflation." The Federal Reserve Reform Act of 1977 amended the FRA to among other things pursue "…the goals of maximum employment, stable prices, and moderate long-term interest rates."[4] Because moderate long-term interest rates remain low only in a stable price environment, the goals are generally thought of as a *dual* monetary policy mandate of maximum employment and price stability.

Because of the economic situation, former Sen. Hubert Humphrey (D-MN) and former Rep. Augustus Hawkins (D-CA) judged that the Federal Reserve needed explicit policy instructions. Following the 1977 amendments, Congress passed the Full Employment and Balanced Growth Act of 1978, eponymously referred to as the "Humphrey-Hawkins Act," amending the Employment Act

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[1] The Federal Reserve Act of 1913, Pub. L. No. 63-43, 38 Stat. 251.
[2] For the current Monetary Policy Report, see: https://www.federalreserve.gov/monetarypolicy/mpr_default.htm.
[3] Employment Act of 1946, Pub. L. No. 79-304, 60 Stat. 23.
[4] Federal Reserve Reform Act of 1977, Pub. L. No. 95-188, 91 Stat. 1387.

of 1946 to achieve balanced growth through: control of production, maximum employment, price stability, balanced budget and balanced trade.[5] It further stated explicit numeric unemployment and inflation goals. Additionally, to monitor economic development, the Act increased congressional oversight through the monetary policy reporting system.

**Federal Reserve**

The financial panic of 1907 was the impetus for the Federal Reserve Act of 1913, which created the Federal Reserve System—a central bank consisting of 12 regional Federal Reserve banks (Reserve Banks) headquartered in different U.S. geographic regions and the Board headquartered in Washington, D.C. The Federal Reserve system has several functions including conducting monetary policy, promoting financial stability, supervising and regulating financial institutions and fostering payments and settlements. Generally, the Board makes policy that the Reserve Banks implement and execute; however, monetary policy decisions are made by the Federal Open Market Committee (FOMC). The Federal Reserve is self-funded through income from the securities on its balance sheet and fees imposed on financial institutions. Excess income is remitted to the U.S. Treasury Department (Treasury) and is used to reduce the national debt.

*Board of Governors*

The Board consists of seven Governors of which there are a Chairman and two Vice Chairmen. The President nominates the Chairman, Vice Chairmen and Governors who are then confirmed by the Senate. The Chairman and Vice Chairmen serve four-year terms while Governors serve 14-year terms. Chairman Powell is the 16th Chairman of the Board and took office on February 5, 2018. Prior to becoming Chairman, he was nominated as a Governor in May 2012. Richard Clarida became Vice Chairman on September 17, 2018 and Randy Quarles became Vice Chairman of Supervision on October 13, 2017. Governor Lael Brainard was appointed on June 16, 2014 and Governor Michelle Bowman was appointed on November 26, 2018. There are currently two vacancies on the Board.

*Federal Reserve Banks*

Commercial banks that are a part of the Federal Reserve System are member banks of a Reserve Bank depending on what region the commercial bank is located. The member bank holds stock of its Reserve Bank, which pays a dividend, and along with this ownership it elects representation to its Reserve Bank's board of directors.

Each Reserve Bank is led by a president and board of directors. There are nine directors divided into Class A, Class B and Class C directors. Class A directors represent commercial banks elected by Federal Reserve member banks within the Reserve Bank's district. Class B directors represent the public but are elected by the member banks. Class C directors also represent the public but are selected by the Board. The Reserve Bank president is selected and appointed by the Class B and Class C directors and then approved by the Board. Reserve Banks are responsible for gathering economic, financial and business data within their regions to be used in the FOMC monetary policy deliberations.

All banks have reserve accounts, which are deposit accounts, at the Reserve Banks. They maintain balances in those accounts to make or receive payments and meet daily reserve balance

[5] Full Employment and Balanced Growth Act of 1978, Pub. L. No 95-523, 92 Stat. 1887.

requirements. Depending upon need, banks can lend or borrow funds, typically uncollateralized overnight loans, from one another in a bank funding market such as the federal funds market. The Federal Reserve can change the overall amount of funds available to lend or borrow by changing the interest rate on these funds known as the federal funds rate (fed funds rate). The FOMC sets a target fed funds rate consistent with its dual mandate.

*Federal Open Market Committee*

The FOMC is the 12-member monetary policymaking group that meets about eight times a year to review the economic and financial conditions that dictate what stance to take with monetary policy. It consists of the Board, the president of New York Federal Reserve Bank (FRBNY) and a rotation of the four remaining Reserve Bank presidents. Non-voting Reserve Bank presidents attend the policy meeting and participate in the monetary policy discussion. FOMC members decide whether to change the fed funds rate, which is the benchmark interest rate and the primary tool of monetary policy. The FRBNY Open Market Desk executes monetary policy by trading U.S. government securities. The first FOMC policy meeting of this year occurred January 29-30. The FOMC decided[6] to not increase the interest rate due to the uncertain economic outlook and clarified the path forward on its balance sheet normalization.

**Monetary Policy**

The Federal Reserve manages monetary policy through: open market operations (OMO), the primary credit rate often referred to as the "discount rate" and reserve requirements. The FOMC decides OMO while the Board decides the discount rate and reserve requirements. OMO is how the Federal Reserve targets the fed funds rate through the buying and selling of U.S. Treasury securities from primary dealers.[7] The discount rate is the rate Reserve Banks charge member banks for short-term, collateralized loans. Reserve requirements are the shares of deposits a member bank must maintain in cash against its liabilities. Reserve Banks offer interest on required and excess reserves. Recently, interest on reserves (IOR) has become a primary monetary policy tool. The Financial Services Regulatory Relief Act of 2006 allowed Reserve Banks to pay IOR.[8] Generally, adjusting these short-term rates dictates the availability of funds to be lent or borrowed in the economy. When these rates change, other interest rates in the economy tend to adjust accordingly. Increasing these short-term rates can slow economic activity as borrowing becomes more expensive thus resulting in "tighter" financial conditions. Decreasing these short-term rates can accelerate economic activity as borrowing becomes less expensive thus resulting in "looser" financial conditions.

*Financial Crisis*

The 2008 financial crisis required the Federal Reserve take a novel approach to monetary policy. To improve the overall financial conditions, the Federal Reserve resorted to reducing the fed funds rate to nearly zero, known as the zero-lower bound and providing additional forward guidance to the markets that the Federal Reserve intended to keep interest-rates at this level for an extended period. However, keeping short-term rates at the zero-lower bound proved insufficient as economic conditions worsened. The Federal Reserve then began engaging in large-scale asset purchases of

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[6] For the current FOMC policy statement, see: https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm.
[7] Primary dealers are counterparties that buy U.S. government securities from the FRBNY and resell them to the public.
[8] Financial Services Regulatory Relief Act of 2006, Pub. L. No. 109-351, 120 Stat. 1966.

Treasuries and agency mortgage-backed securities (MBS), often referred to as quantitative easing (QE).[9]

Because of the QE program,[10] which lasted for six years between November 2008 and October 2014, the Federal Reserve significantly increased the size of its balance sheet. After ending new purchases in October 2014, the Federal Reserve continues to maintain the balance sheet at approximately $4.0 trillion. The large balance sheet has resulted in the Federal Reserve remitting significantly more in net income to the Treasury to pay down the national debt.[11]

*Policy Normalization*

To normalize its balance sheet, the Federal Reserve announced[12] in September 2014 that it would allow the balance sheet to "run-off" or slowly decline by not reinvesting in Treasuries or MBS when they mature and continue to adjust monetary policy by targeting the fed funds rate. The Federal Reserve announced that it would run-off securities until it holds "no more securities than necessary to implement monetary policy efficiently and effectively." Because of the large amount of excess reserves, the Federal Reserve cannot adjust the fed funds rate through manipulating reserve balance levels as it did before the crisis. It has resorted to using two other market interest rates—the interest rates on reserves and large-scale reverse repurchase agreement rates, or repos—to guide the fed funds rate towards its desired target.

**Regulation and Supervision**

The Federal Reserve takes a macroprudential approach to regulating and supervising a broad range of financial institutions[13] for safety and soundness. The agency also supervises for compliance with consumer protection laws and regulations, and it implements community reinvestment requirements to promote a fair financial services marketplace.[14]

Following the 2008 financial crisis, the Federal Reserve initially required that banking organizations increase their capital levels and strengthen their liquidity positions based on improvements made to the Basel Committee on Banking Supervision's (Basel) framework.[15] Section 165 of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) also required the Federal Reserve to apply enhanced prudential standards (EPS) to BHCs with more than $50 billion in consolidated assets.[16] EPS requires heightened regulatory policies for riskier, more complex banking organizations (e.g. stronger capital, liquidity, leverage, stress testing, and living wills requirements). In May 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) raised the threshold to $250 billion. The Federal Reserve has the

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[9] These unconventional measures were first outlined in 2004 by then-Governor Bernanke, along with economists Vincent Reinhart and Brian Sack, see: https://www.federalreserve.gov/pubs/feds/2004/200448/200448pap.pdf.

[10] There were three rounds—QE1, QE2 and QE3. Between QE2 and QE3 was the Maturity Extension Program often referred to as *Operation Twist* where the Federal Reserve swapped short-term Treasuries for long-term Treasuries.

[11] For this year's remittances, see: https://www.federalreserve.gov/newsevents/pressreleases/other20190110a.htm.

[12] For FOMC communications related to Policy Normalization, see: https://www.federalreserve.gov/newsevents/pressreleases/other20190110a.htm.

[13] State-chartered banks that are members banks, bank holding companies, thrift holding companies, U.S. branches of foreign bank organizations and systemically important non-bank financial institutions.

[14] *See* "Supervision and Regulation Report," Federal Reserve Board of Governors, November 9, 2018, https://www.federalreserve.gov/publications/supervision-and-regulation-report.htm.

[15] The United States participates in Basel, a global policymaking group that formulates an international regulatory framework of prudential standards.

[16] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376-2223.

discretion to apply EPS to a firm between $100 billion and $250 billion, though EGRRCPA contains other provisions that relaxes certain EPS for all large banks.[17]

Over the last two years, Treasury has issued a series of reports with recommendations to make changes to the post-crisis regulatory framework,[18] some of which the Federal Reserve is implementing. For example, the Federal Reserve and other regulators[19] followed-up in June 2018 with proposed[20] changes to the *Volcker Rule*, which was originally designed to prevent financial institutions from making proprietary trades, a trade that is solely for the benefit of the bank, using taxpayer-backed deposits. On April 11, 2018, the Federal Reserve and Office of the Comptroller of the Currency (OCC) proposed a rule[21] to change the enhanced supplemental leverage ratio (eSLR) for global systemically important banks (G-SIB), and effectively lower bank-level capital. On October 31, 2018, the Federal Reserve issued a proposal[22] in accordance with EGRRCPA that would categorize banks with more than $100 billion in consolidated assets into four categories and relax liquidity requirements for banks with up to $700 billion in assets. The Federal Reserve has modified its supervisory approach to large bank supervision, and is altering its stress testing regime.

**Payments System**

The Federal Reserve also manages the national payments system.It clears checks, ensures there is enough currency in circulation, processes electronic payments through the Automated Clearinghouse (ACH) and for larger financial transactions through Fedwire, and acts as the fiscal agent for the U.S. government. The Treasury maintains an account at the FRBNY where it processes Social Security and payroll checks as well as issues, transfers and redeems U.S. Treasury securities. In October 2018, the Federal Reserve proposed updating its interbank payments system to turn it into a real-time payments system.[23]

To further ensure the stability of the payments system, the Dodd-Frank Act also extended the Board's supervisory and regulatory authority to systemically important financial market utilities—entities that clear and settle transactions between financial institutions.

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[17] *See* "Economic Growth, Regulatory Relief, and Consumer Protection Act (P.L. 115-174) and Selected Policy Issues," Marc Labonte and David W. Perkins, June 6, 2018, http://www.crs.gov/Reports/R45073.

[18] For Treasury's recommendations to change the post-crisis regulatory framework, see: https://home.treasury.gov/policy-issues/top-priorities/regulatory-reform.

[19] Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Securities and Exchange Commission and Commodity Futures Trading Commission.

[20] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 FR 33432 (proposed July 17, 2018), https://www.federalregister.gov/documents/2018/07/17/2018-13502/proposed-revisions-to-prohibitions-and-restrictions-on-proprietary-trading-and-certain-interests-in.

[21] Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Bank Holding Companies and Certain of Their Subsidiary Insured Depository Institutions; Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies, 83 FR 17317 (proposed April 11,2018), https://www.federalregister.gov/documents/2018/04/19/2018-08066/regulatory-capital-rules-regulatory-capital-enhanced-supplementary-leverage-ratio-standards-for-us.

[22] Applicability Thresholds for Regulatory Capital and Liquidity Requirements, 83 FR 66024 (proposed October 31, 2018), https://www.federalregister.gov/documents/2018/12/21/2018-27177/proposed-changes-to-applicability-thresholds-for-regulatory-capital-and-liquidity-requirements.

[23] Potential Federal Reserve Actions To Support Interbank Settlement of Faster Payments, 83 FR 57351 (proposed October 3, 2018), https://www.federalregister.gov/documents/2018/11/15/2018-24667/potential-federal-reserve-actions-to-support-interbank-settlement-of-faster-payments-request-for.