

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

July 5, 2019

Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff
Subject: July 10, 2019, “Monetary Policy and the State of the Economy”

The Committee on Financial Services will hold a hearing at 10:00 a.m. on Wednesday, July 10, 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. The FOMC* has defined the inflation target as 2.0 percent but has not set a numerical target for maximum employment.

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 of 1946 to achieve balanced growth through: control of production, maximum employment, price stability, balanced

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.

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 Federal Reserve system has several functions including conducting monetary policy, promoting financial stability, supervising and regulating financial institutions and fostering payments and settlements.⁶ 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 can become a member bank of a Reserve Bank in the region the commercial bank is located. All national banks must be member banks while state banks have the option of being a member bank. 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 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 FOMC sets a target fed funds rate in this market 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

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

⁶ See: <https://www.federalreserve.gov/aboutthefed/pf.htm>.

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 fourth FOMC policy meeting of this year occurred June 18-19. At the June meeting, the FOMC decided⁷ to not increase the interest rate due to the uncertain economic outlook, namely volatile trade talks.

Monetary Policy

The Federal Reserve traditionally managed 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.⁸ 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.⁹ 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 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, this proved insufficient as economic conditions worsened. The Federal Reserve then began engaging in large-scale asset purchases of Treasuries and agency mortgage-backed securities (MBS), referred to as quantitative easing (QE).¹⁰

Because of the QE program,¹¹ 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 currently maintains a balance sheet of approximately \$4.0 trillion. The large balance sheet has resulted in the Federal Reserve remitting significantly more in net income to the Treasury.¹²

Policy Normalization

To reduce its balance sheet its balance sheet, the Federal Reserve announced¹³ 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

⁷ For the current FOMC policy statement, see: <https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>.

⁸ Primary dealers are counterparties that buy U.S. Government securities from the FRBNY and resell them to the public.

⁹ Financial Services Regulatory Relief Act of 2006, Pub. L. No. 109-351, 120 Stat. 1966.

¹⁰ 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>.

¹¹ 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.

¹² For this year’s remittances, see: <https://www.federalreserve.gov/newsevents/pressreleases/other20190110a.htm>.

¹³ For FOMC communications related to Policy Normalization, see:

<https://www.federalreserve.gov/newsevents/pressreleases/other20190110a.htm>.

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. As of the March FOMC policy meeting, the FOMC has decided to stop shrinking the balance sheet in September and maintain a large amount of excess of reserves in the banking system.¹⁴

Regulation and Supervision

The Federal Reserve takes a macroprudential approach to regulating and supervising a broad range of financial institutions¹⁵ for safety and soundness. The agency also supervises for compliance with consumer protection laws for banks with less than \$10 billion in assets, and it implements community reinvestment requirements for depository institutions it oversees.¹⁶

Following the 2008 financial crisis, the Federal Reserve initially required that banking organizations, especially the largest banks, increase their capital levels and strengthen their liquidity positions based on requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) and improvements made to the Basel Committee on Banking Supervision’s framework. However, over the last several years, the U.S. Department of the Treasury has issued a series of reports with recommendations to make changes to the post-crisis regulatory framework,¹⁷ some of which the Federal Reserve is implementing. For example, the Federal Reserve and other regulators are considering rolling back the Volcker Rule,¹⁸ which is a Dodd-Frank provision that prohibits banks from engaging in proprietary trading. On April 11, 2018, the Federal Reserve and Office of the Comptroller of the Currency (OCC) proposed a rule¹⁹ 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 proposal²⁰ in accordance with the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)²¹ 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 is also in the process of modifying its supervisory approach to living wills and stress testing.²² These proposals have generated strong concerns from a range of experts, including former Fed Governor Dan Tarullo.²³

¹⁴ For FOMC communications related to the March policy meeting, see:

<https://www.federalreserve.gov/newsevents/pressreleases/monetary20190320c.htm>.

¹⁵ 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.

¹⁶ See “Supervision and Regulation Report,” Federal Reserve Board of Governors, May 10, 2019,

<https://www.federalreserve.gov/publications/supervision-and-regulation-report.htm>.

¹⁷ For Treasury’s recommendations to change the post-crisis regulatory framework, see: <https://home.treasury.gov/policy-issues/top-priorities/regulatory-reform>.

¹⁸ See Bloomberg, “Wall Street Nears a Big Win in the Latest Revamp of Volcker Rule,” Apr. 25, 2019,

<https://www.bloomberg.com/news/articles/2019-04-25/wall-street-nears-a-big-win-in-the-latest-revamp-of-volcker-rule>.

¹⁹ 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>.

²⁰ 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>.

²¹ 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>.

²² See Remarks by Vice Chairman for Supervision Randal K. Quarles, “A New Chapter in Stress Testing,” Nov. 9, 2018,

<https://www.federalreserve.gov/newsevents/speech/quarles20181109a.htm>.

²³ See Remarks by Dan Tarullo, “Taking the Stress Out of Stress Testing,” May 21, 2019, <https://ourfinancialsecurity.org/wp-content/uploads/2019/05/Tarullo-AFR-Talk.pdf>.

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 modernizing its interbank payments system to achieve a real-time payments system.²⁴ 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.

Facebook, Libra and Calibra

On June 18, 2019, Facebook announced its plans to develop a new cryptocurrency, called Libra, and a digital wallet to store this cryptocurrency, called Calibra. According to a white paper released by Facebook, Libra will be built on blockchain, backed by a reserve of assets, and governed by the Libra Association.²⁵ The Libra Association is an independent, not-for-profit organization headquartered in Geneva, Switzerland. Aside from Facebook, the Libra Association (“Association”) is currently comprised of 27 other companies and organizations. By the target launch date of early 2020, Facebook hopes to have recruited over 100 firms into the Libra Association.

According to Facebook, Libra will be “fully backed” by a basket of bank deposits and short-term government securities that will be held in the Libra Reserve. New Libra will only be minted when certain authorized resellers purchase them from the Association with assets that comprise the basket. Libra can only be burned or destroyed when authorized sellers sell Libra to the Association in exchange for the underlying assets that comprise the basket. Calibra is a Facebook subsidiary, which will operate as a digital wallet for Libra and is expected to be available in 2020 through Facebook Messenger, Whatsapp, and as a standalone internet application.²⁶ According to Facebook, Calibra will allow users to send other users Libra using smartphones. Facebook hopes to expand the use of Calibra to other services like bill pay.

Cryptocurrencies such as Libra pose special challenges to the Fed. To fulfill its dual mandate of low inflation and maximum employment, the Fed manipulates the money supply by putting cash into the system when it buys securities or taking cash out of the system when it sells securities. The level of money in the economy dictates the short-term benchmark interest rate, the price paid by banks to borrow money in the bank lending market, which determines all other lending rates. The Fed can effectively transmit monetary policy in this manner because it has a monopoly on the money supply, which consists of U.S. currency or cash, and checking and savings account balances. Because the Fed can control the money supply and demand, it can appropriately respond to major economic disturbances. In the event that another currency not under government control such as cryptocurrency becomes widely used and viable, this could adversely affect the conduct of monetary policy because as another form of currency is used widely for payments, the Fed would lose its monopoly on controlling inflation and inflation targeting through manipulating cash in the system.

²⁴ 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>.

²⁵ <https://libra.org/en-US/white-paper/#introducing-libra>.

²⁶ <https://newsroom.fb.com/news/2019/06/coming-in-2020-calibra/>.