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United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
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February 6, 2020

Memorandum

To: Members, Committee on Financial Services

From: FSC Majority Staff

Subject: February 11, 2020, "Monetary Policy and the State of the Economy"

The Committee on Financial Services will hold a hearing at 10:00 a.m. on Tuesday, February 11, 2020, 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 and Background

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]

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 Federal Reserve Act to pursue "…the goals of maximum employment, stable prices, and moderate long-term interest rates."[3] Since moderate, long-term interest rates remain low only in a stable price environment, these goals are generally thought of as a *dual* monetary policy mandate of maximum employment and price stability. The Federal Open Market Committee (FOMC) currently defines the inflation target as 2.0 percent but has not set a numerical target for maximum employment.[4]

In order to provide the Federal Reserve with explicit policy instructions on how to achieve its dual mandate, Congress passed the Full Employment and Balanced Growth Act of 1978, referred to as the "Humphrey-Hawkins Act." The Act aimed 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 and increased congressional oversight through the monetary policy reporting system.[6]

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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] Federal Reserve Reform Act of 1977, Pub. L. No. 95-188, 91 Stat. 1387.
[4] See FOMC January 2020 policy meeting communications. Press Release. Jan. 29, 2020
[5] Full Employment and Balanced Growth Act of 1978, Pub. L. No 95-523, 92 Stat. 1887.
[6] For more information on the history of Humphrey-Hawkins see FSC Dems July 2019 hearing memo. Jul, 10, 2019.

The Federal Reserve system has several functions including conducting monetary policy, promoting financial stability, supervising and regulating certain financial institutions, and fostering payments and settlements.[7] Generally, the Board makes policy that the Reserve Banks implement and execute; however, monetary policy decisions are made by the FOMC.[8] 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 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. There are currently two vacancies on the Board.[9]

Federal Reserve Banks. All national banks are required to become members of a Reserve Bank in the region where the national bank is located. Commercial banks and state banks have the option of joining as 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.[10] 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 federal 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 four of the remaining Reserve Bank presidents. FOMC members decide whether to change the "fed funds rate," which is the benchmark interest rate and the primary tool of monetary policy. On July 31, for the first time in 11 years, the Federal Reserve cut interest rates by 0.25% citing uncertainty in the global economic outlook and muted inflation pressure.[11] Then, in September, the Fed cut interest rates by another 0.25%.[12] One month later, in October, the Fed cut interest rates by 0.25% for a third time bringing the federal funds target rate down to 1.5 to 1.75 percent.[13] The first FOMC policy meeting of this year occurred January 28-29. At this meeting, the FOMC decided to continue to maintain the federal funds rate while increasing both the interest on excess reserves (IOER) rate from 1.55% to 1.60% and the reverse repurchasing agreement rate from 1.45% to 1.50% with the goal of floating the fed funds rate in the middle.[14] The FOMC also decided to continue to build up reserve balances through the purchase of Treasuries through the second quarter of 2020 and conducting term and overnight repurchasing agreements (repos) through at least April 2020.[15]

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[7] See "About the Fed." Federal Reserve. Accessed on Jan. 28, 2020.
[8] See "What is the FOMC and when does it meet?" Federal Reserve. Accessed on Jan. 28, 2020.
[9] For more information on the composition of the Federal Reserve Board of Governors see FSC Dems July 2019 hearing memo. Jul, 10, 2019.
[10] For more information on Federal Reserve Banks see FSC Dems July 2019 hearing memo. Jul, 10, 2019.
[11] See FOMC July 2019 communications related to the July 2019 rate cut. Press release. Jul. 31, 2019.
[12] See FOMC September 2019 policy meeting communications. Press Release. Sept. 18, 2019.
[13] See FOMC October 2019 communications related to the October 2019 rate cut. Press Release. Oct. 31, 2019.
[14] See FOMC January 2020 policy statement. Press Release. Jan. 29, 2020.
[15] See FOMC January 2020 Implementation Note. Press Release. Jan. 29, 2020.

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 Treasury securities from primary dealers.[16] The discount rate is the rate that Reserve Banks charge member banks for short-term, collateralized loans. Reserve requirements are the shares of deposits that 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.[17] Generally, adjusting these short-term rates dictates the availability of funds to be lent or borrowed in the economy, with increases causing borrowing to become more expensive leading to "tighter" financial conditions and slower economic activity while decreases causing borrowing to become less expensive leading to "looser" financial conditions and accelerated economic activity. When these rates change, other interest rates in the economy tend to adjust accordingly.

Financial Crisis. The 2008 financial crisis led the Federal Reserve to take a novel approach to monetary policy. To improve the overall financial conditions, the Federal Reserve reduced the fed funds rate to nearly zero and provided additional forward guidance to the markets that the Federal Reserve intended to keep interest-rates at this level for an extended period. However, this strategy proved insufficient as economic conditions worsened. As a result, the Federal Reserve engaged in large-scale asset purchases of Treasuries and agency mortgage-backed securities (MBS), referred to as quantitative easing (QE).[18] The QE program,[19] which lasted from November 2008 to October 2014, significantly increased the size of the Federal Reserve's balance sheet from $870 billion in August 2007 to $4.5 trillion in early 2015.[20] The large balance sheet has resulted in the Federal Reserve remitting significantly more in net income to the Treasury.[21]

Policy Normalization. To reduce its balance sheet, the Federal Reserve announced 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 continuing to adjust monetary policy by targeting the fed funds rate.[22] 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 had to use 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.

In March 2019, the Federal Reserve decided to reverse course on shrinking its balance sheet and returned to maintaining a large amount of excess reserves in the banking system.[23] In the aftermath of the September 2019 repo market disruption, the Federal Reserve announced in their October 2019 FOMC meeting a new round of balance sheet expansion with monthly purchases of $60 billion in Treasury bills through at least the second quarter of 2020.[24] The January 2019 FOMC meeting affirmed that Treasury

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[16] Primary dealers are counterparties that buy U.S. Government securities from the FRBNY and resell them to the public.
[17] Financial Services Regulatory Relief Act of 2006, Pub. L. No. 109-351, 120 Stat. 1966.
[18] 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.
[19] 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.
[20] For recent balance sheet trends see: https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm
[21] For this year's remittances, see: https://www.federalreserve.gov/newsevents/pressreleases/other20200110a.htm
[22] See FOMC January 2020 policy meeting communications. Press Release. Jan. 29, 2020.
[23] See FOMC March 2019 policy meeting communications. Press Release. Mar. 20, 2019.
[24] See FOMC October 2019 policy meeting communications. Press Release. Oct. 11, 2019.

bill monthly purchases would continue at the rate of $60 billion through the second quarter of 2020 to maintain at a minimum the level of reserves that prevailed in early September 2019.[25]

Repo Market Interventions. Repurchase agreements or "repos" are transactions that amount to collateralized short-term loans, often made overnight. Repo deals enable big investors and others with excess cash—such as mutual funds—to earn a return by briefly lending cash that might otherwise sit idle, and enable banks and broker-dealers that need short-term funding to get needed financing by loaning out securities they hold in return. Prior to September 16, 2019 the FOMC announced[26] that it would shrink its balance sheet and reserves to a level many in the industry thought would be insufficient to meet the demand for cash in the markets.[27] Then, on September 16, 2019, the repo market experienced unanticipated volatility due to a lack of cash in the market.[28] The federal funds rate, which was supposed to be floating at the target rate of 2 percent, shot up to 10 percent. The Federal Reserve responded by injecting $75 billion in cash into the banking sector which pushed the rate back down to 2 percent by September 19. [29]

The Federal Reserve has sought to address this liquidity crunch at the heart of the September repo market disruption from two directions: 1) expanding its balance sheet to hold more excess reserves, thus reducing the need rely on repos to reach the federal funds rate target, and 2) continuing to operate a short-term facility for repos, allowing the Federal Reserve to ramp up production to provide additional reserves as needed to smooth market volatility from, for example, investors selling assets and corporations paying taxes.[30] At the January 2019 FOMC meeting, the Committee resolved to continue the balance sheet expansion started in October 2019 by purchasing an additional $60 billion per month of Treasury bills through at least the second quarter of 2020. The Committee also indicated that it would continue to conduct term and overnight repos at current levels through April 2020 in anticipation of tax season and subsequent reductions in reserve levels.[31]

Climate Change. The Federal Reserve Bank of San Francisco issued a March 2019 report which found climate change increases the risk to financial institutions by increasing the potential for loan losses and bankruptcies caused by extreme weather events. These climate-related financial risks could also affect the broader economy through elevated credit spreads, greater precautionary saving, and, in the extreme, a financial crisis.[32] Last month, Chair Powell indicated that while climate change is an "important issue" that poses systemwide financial stability risks "over the longer term" the overall response to climate change needs to be decided "by elected officials and not the Fed."[33]

Recent Supervisory and Regulatory Developments

The Federal Reserve takes a macroprudential approach to regulating and supervising a broad range of financial institutions for safety and soundness.[34] 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.[35] Below are some supervisory and regulatory developments since Chair Powell last testified before the Committee in July 2019:

[25] For FOMC communications related to the January policy meeting, see: https://www.federalreserve.gov/newsevents/pressreleases/monetary20200129a.htm
[26] See FOMC March 2019 policy meeting communications. Press Release. Mar. 20, 2019..
[27] Liz Capo McCormick and Alexandra Harris. "The Repo Market's a Mess. (What's the Repo Market?)" Washington Post. Sept. 29, 2019.
[28] *Ibid.*
[29] *Ibid.*
[30] See Minutes of the Federal Open Market Committee, December 10-11, 2019 pp. 5-8. FOMC. December 2019.
[31] See FOMC January 2020 Implementation Note. Presse Release. Jan. 29, 2020.
[32] Glenn D. Rudebusch "Climate Change and the Federal Reserve." Federal Reserve Bank of San Francisco. Mar. 25, 2019.
[33] See Chair Powell's remarks "Transcript of Chair Powell's Press Conference: January 29, 2020". Preliminary Transcript. Jan. 29. 2020.
[34] 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.
[35] *See* "Supervision and Regulation Report," Federal Reserve Board of Governors, May 10, 2019.

Supervision Proposal. In January, Vice Chair of Supervision Quarles delivered remarks previewing the Federal Reserve's plans to issue new supervisory proposals related to the oversight of large banks along with changes to the overall supervisory process.[36] The proposals are aimed at improving transparency but have raised concerns that the changes would undermine the Federal Reserve's role in supervising financial institutions.

Enhanced Prudential Standards. In October 2019, the Federal Reserve finalized a rule to create a tiered and tailored enhanced prudential standards (EPS) framework for banks of various sizes, including foreign banking organizations. In November, the Federal Reserve issued, along with the OCC and FDIC, a final rule to revise capital and liquidity requirements for banks with $100 billion or more in total assets.[37] The rule separates certain banking organizations into four categories based on factors including asset size, cross-jurisdictional activity, reliance on short-term wholesale funding, nonbank assets, and off-balance sheet exposure.

Volcker Rule. In October 2019, federal regulators, including the Federal Reserve, finalized significant revisions to the Volcker Rule.[38] Critics have characterized that rule as effectively undoing the Volcker Rule's prohibition on speculative proprietary trading with federally insured deposits.[39] In January, federal banking agencies proposed revisions to the Volcker Rule's restrictions of banks investing in or sponsoring hedge funds or private equity funds.[40] The January proposal has also faced strong criticism.[41]

Community Reinvestment Act (CRA). While the OCC and FDIC has issued a Notice of Proposed Rulemaking (NPRM) to overhaul CRA with a public comment period of 60 days, the Federal Reserve declined to sign on to the NPRM and instead has publicly shared their data and analysis in examining potential reforms.[42]

Facebook, Libra, and Calibra

In June 2019, Facebook announced its plans to develop a new cryptocurrency, called Libra, and a digital wallet to store this cryptocurrency, called Calibra.[43] 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.[44] Libra has been met with opposition by regulators and politicians in the United States and abroad due to concerns over privacy, lack of oversight, and threats to countries' national security and monetary sovereignty.[45] Eight of the twenty-eight founding members of the Libra Association have exited the Libra Association following pushback from regulators.[46] In late December 2019, Switzerland's finance minister and out-going President, Ueli Maurer, declared Libra a 'failure' in its current form, stating central banks would "not accept the basket of currencies underpinning it" and that it would need to be redesigned in order to appease Swiss financial regulators.[47]

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[36] *See* Vice-Chair Quarles remarks "Spontaneity and Order: Transparency, Accountability, and Fairness in Bank Supervision" (Jan. 17, 2020)
[37] *See* "OCC Issues Final Rule to Change Applicability Thresholds for Regulatory Capital and Liquidity Requirements." Nov. 1, 2019
[38] Federal Reserve, OCC, FDIC, SEC, and CFTC, joint statement, "Agencies Finalize Changes to Simplify Volcker Rule," press release, Oct. 8, 2019.
[39] See Pete Schroeder, "U.S. regulators hand Wall Street a major win with stripped-down 'Volcker Rule'," Reuters, Aug. 20, 2019. Also see Statement by FDIC Board Member Martin Gruenberg, Aug. 20, 2019
[40] For more information on proposed changes to Volcker Rule see: https://www.fdic.gov/news/board/2020/2020-01-30-notice-dis-a-fr.pdf?source=govdelivery&utm_medium=email&utm_source=govdelivery[41] For example, see Martin Gruenberg's remarks, Jan. 30, 2020, https://www.fdic.gov/news/news/speeches/spjan3020b.pdf.
[41] For example, see Martin Gruenberg's remarks, Jan. 30, 2020, https://www.fdic.gov/news/news/speeches/spjan3020b.pdf.
[42] See Governor Lael Brainard's remarks, "Strengthening the Community Reinvestment Act by Staying True to Its Core Purpose," Jan. 8, 2020.
[43] See "An Introduction to Libra". Libra Association. Accessed on Jan. 27, 2020.
[44] *Ibid.*
[45] Facebook's 'failed' Libra cryptocurrency is no closer to release". Bloomberg. Jan.20, 2020. https://www.bloomberg.com/news/articles/2020-01-20/facebook-s-failed-libra-starts-2020-facing-fresh-swiss-hurdles
[46] *Ibid.*
[47] *Ibid.*