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United States House of Representatives
Committee on Financial Services
Washington, D.C. 20515

MAXINE WATERS, CA, RANKING MEMBER

M E M O R A N D U M

To: Members of the Committee on Financial Services

From: FSC Majority Committee Staff

Date: February 28, 2013

Subject: March 5, 2013, Monetary Policy Subcommittee hearing entitled "Near-Zero Rate, Near-Zero Effect? Is 'Unconventional' Monetary Policy Really Working?"

The Subcommittee on Monetary Policy and Trade will hold a hearing at 10 a.m. on Tuesday, March 5, 2013, in Room 2128 of the Rayburn House Office Building, entitled "Near-Zero Rate, Near-Zero Effect? Is 'Unconventional' Monetary Policy Really Working?" to discuss issues related to the Federal Reserve's conduct of monetary policy before, during and since the financial crisis. This will be a one-panel hearing with the following invited witnesses:

- Mr. David Malpass, President, Encima Global L.L.C.
- Dr. Allan H. Meltzer, Carnegie Mellon University
- Dr. John B. Taylor, Stanford University
- Dr. Joseph E. Gagnon, Senior Fellow, The Peterson Institute

The Federal Reserve and Monetary Policy

The Federal Reserve consists of a Board of Governors and twelve regional Federal Reserve Banks. The Board of Governors consists of seven members who are appointed by the President and confirmed by the Senate and who serve staggered 14-year terms. Each Reserve Bank is responsible for a particular geographic area of the United States and has its own board of nine directors. The Reserve Banks are responsible for a variety of functions, including operating a nationwide payments system and distributing the nation's currency and coins. Collectively, the Board of Governors and the Reserve Banks are responsible for supervising and regulating bank holding companies and for providing banking services to depository institutions and the federal government.

Depository institutions maintain accounts at Reserve Banks and use the funds held in these accounts to meet end-of-day reserve and other balance requirements. If a depository institution anticipates that it will have a surplus federal funds balance, it can lend these surplus funds to other institutions, usually through overnight, unsecured loans. The federal funds rate—the interest rate charged for these transactions—is an important benchmark in financial transactions. The Federal Open Market Committee (FOMC)—whose members are the seven Federal Reserve Board Governors, the president of the Federal Reserve Bank of New York, and four presidents selected from the other Reserve Banks—sets a "target" federal funds rate at a level it believes will foster financial and monetary conditions consistent with achieving its monetary policy objectives of stable prices and maximum employment, and it adjusts that target in response to economic developments.

To meet its target rate, the FOMC conducts open market operations (the buying and selling of securities, usually U.S. Treasuries), imposes reserve requirements on depository institutions, permits depository institutions to hold contractual clearing balances, and extends secured credit through its discount window facility. Adjusting the federal funds rate or changes in expectations about future federal funds rates in turn can affect other short-term interest rates, longer-term interest rates, the foreign exchange value of the dollar, and stock prices.

If the economy slows and employment softens, the Federal Reserve will be inclined to ease monetary policy to stimulate aggregate demand. When growth in aggregate demand grows to a level commensurate with the economy's ability to produce goods and services, slack in the economy will be absorbed and employment will return to a more sustainable path. By contrast, if the economy shows signs of overheating and inflation pressures are building, the Federal Reserve will be inclined to counter these pressures by tightening monetary policy, reducing the growth in aggregate demand below the economy's potential to produce goods and services in order to defuse inflationary pressures and put the economy on a path to sustainable expansion. As William McChesney Martin, a former Chairman of the Federal Reserve, famously put it, the job of the Federal Reserve is "to take away the punch bowl just as the party gets going"—that is, to raise interest rates when economy reaches peak activity after a recession.

There are limits, however, to the effectiveness of monetary policy. First, monetary policy is not the only force acting on output, employment, and prices. Many other factors affect aggregate demand and aggregate supply and, consequently, the economic position of households and businesses. Some of these factors (such as changes in consumer confidence, natural disasters, or supply disruptions) cannot be anticipated. Second, given that it takes time to compile key information on the economy, the Federal Reserve runs the risk of setting policy based on stale information. Because economic data describe the past state of the economy rather than the current one, the FOMC is, as one economist has described it, in the position of a driver navigating the highway by looking in his rearview mirror. This problem is compounded by the lag time between policy action and its effects on aggregate demand. Third, it is impossible for the Federal Reserve—or anyone else—to know exactly how a given adjustment in the federal funds rate will affect growth in aggregate demand. The Federal Reserve relies on economic models to provide rules of thumb for how the economy will respond, but these models are subject to error, particularly when changes to fiscal and regulatory policies alter the assumptions upon which the models are based.

Domestic Monetary Policy During and After the Financial Crisis

During the height of the financial crisis, the Federal Reserve took extraordinary measures to inject liquidity into the financial system. Beginning in September 2007, the FOMC lowered the target federal funds rate from 5.25% to between 0 and .25%. Though the Federal Reserve pushed the federal funds rate to zero, economic growth remained sluggish, even after the acute phase of the crisis ended. Because conventional monetary stimulus was no longer available to the Federal Reserve because the

funds rate could not go below zero, the Federal Reserve turned to "quantitative easing"—a policy in which the Federal Reserve purchased long-dated government securities—as a stimulative monetary policy. By purchasing government securities with long maturities, the Federal Reserve hoped to stimulate the economy by injecting more money into the financial system and driving down long-term interest rates, including rates on mortgages and business loans. In March 2009, the Federal Reserve started its first round of quantitative easing, which consisted of purchasing approximately $1.2 trillion in Treasury and agency-backed securities and debt. Economic conditions did not improve. On November 3, 2010, the Federal Reserve announced its plan to purchase an additional $600 billion in longer-term Treasuries, a move popularly known as "QE2" because it was the second effort at quantitative easing since the onset of the financial crisis. As a result of QE2, which concluded in the summer of 2011, the Federal Reserve's balance sheet grew to over $2.5 trillion.

Despite the criticism of its unconventional monetary policy, the Federal Reserve implemented another program in September 2011, known as its Maturity Extension Program or "Operation Twist." In September 2012, the Federal Reserve announced that it would further "increase policy accommodation by purchasing additional agency mortgage-backed securities at a pace of $40 billion per month." Known as "QE3" or "QE infinity," this new policy was open-ended, lacking either a target date or a specific unemployment rate threshold that would trigger its end.

On December 12, 2012, the Federal Reserve announced that it would keep buying $40 billion in mortgage-backed securities per month and that it would begin buying $45 billion in long-term Treasury securities per month. The FOMC, which had committed to holding target rates at essentially zero "at least until the mid-pint of 2015," set a target unemployment rate of 6.5% and announced that it wanted to keep the inflation rate no higher than 2.5% over a one to two-year horizon.

The State of the Economy

As Federal Reserve Chairman Ben S. Bernanke reported to the committee February 27, 2013, in his semi-annual report to Congress, the economy continues to struggle after the 2008 economic crisis. While individual sectors or indicators have shown sporadic improvement, the overall economic picture is marked by stubbornly high unemployment, shaky consumer confidence, and erratic growth.

Most recently, observers were shaken by the gross domestic product figures for the fourth quarter of 2012, which shrank for the first time since the recession's end in mid-2009. The fourth-quarter GDP growth rate was a negative .1%, the lowest since the first quarter of 2011 growth rate of .1% and a surprise following the third quarter of 2012's growth rate of 3.1%. Part of the pullback was attributed to a falloff in defense spending, but inventories—which had built up somewhat during the third quarter—were drawn down in the fourth. The U.S. was not alone in having a tough fourth quarter: all of Europe's major economies, buffeted by the euro zone crisis, shrank in the fourth quarter, and most showed negative growth for the whole year.

As evidence of the difficulty that businesses have in planning long-term investments, neither the GDP growth rate nor unemployment were near the levels predicted four years ago. The Administration's 2009 growth estimate for 2013 was 4.1% and its estimated unemployment rate was 5.6%. The Congressional Budget Office and the "Blue Chip" survey of leading economists were not quite that optimistic, but had generally similar views. The Federal Reserve's economic projections have also been overly optimistic. In 2010, the Fed projected 2012 GDP growth between 3.5 and 4.5%, far higher than the 2.2% that materialized. Now, most economists see torpid growth for at least another 18 months.

As economic growth slowed in the fourth quarter of 2012, unemployment rose by 1%, to 7.9%. Unemployment has been above 7% since December 2008, and peaked at 10% in October 2009. The percentage of the population at work is low—it is now at 58.6% according to the Bureau of Labor Statistics, close to where it was when unemployment peaked and about 4% lower than the historical average—at a time the work-eligible population is estimated to be growing at more than 100,000 per month.

Led by fourth-quarter drops in energy prices, headline inflation was zero in January, and core inflation was up 0.3%. Nonetheless, the Federal Reserve's accommodative monetary policy has pushed the dollar's value down against a broad basket of currencies. While the dollar's value is somewhat higher than its historic low in July 2011, the weak dollar has pushed up exports and pulled down imports, so January's trade deficit of $38.5 billion was the lowest in three years.

One bright spot in the economy has been signs of recovery in the housing market, although it is difficult to calculate how much of that improvement is attributable to federal subsidies in the form of the Federal Reserve's low interest rates and the federal government's support of the housing market by means of its continued lifeline to Fannie Mae and Freddie Mac. House prices rose by 5.5% last year, as measured by the Case-Schiller index. House sales in 2012 were the highest in five years. Residential investment grew by 10% or more in four of the last five quarters.

Most economists predict that U.S. economic growth will remain sluggish, at least throughout this year. The Blue Chip economists predict that GDP growth will be slightly less than 2%, and even the most optimistic FOMC forecast for the year does not see a 3% growth rate. Neither the Blue Chip nor the Fed economists predict that inflation will rise above the Fed's comfort level of about 2%. Unfortunately, the Blue Chip and Fed economists predict that unemployment will remain above 7% this year.

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