JEB HENSARLING, TX , CHAIRMAN

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

MAXINE WATERS, CA, RANKING MEMBER

MEMORANDUM

To: Members of the Committee on Financial Services

From: FSC Majority Staff

Date: February 5, 2016

Subject: February 10, 2016, Full Committee Hearing Entitled "Monetary Policy and the State of the Economy"

The Committee on Financial Services will hold a hearing at 10 a.m. on Wednesday, February 10, 2016, in Room 2128, Rayburn House Office Building, to receive the testimony of the Chair of the Board of Governors of the Federal Reserve System, Janet Yellen, on the conduct of monetary policy and the state of the economy. Chair Yellen will be the only witness.

The Full Employment and Balanced Growth Act of 1978 — commonly referred to as the Humphrey-Hawkins Act — sets four benchmarks for the economy: full employment, growth in production, price stability, and balance of trade and budget. To monitor progress towards these goals, the Act mandates that the Board of Governors of the Federal Reserve present semi-annual reports to Congress on the state of the U.S. economy and the nation's financial welfare. At these hearings before the Senate Banking Committee and the House Committee on Financial Services, the Chair of the Federal Reserve articulates the strengths and weaknesses of the economy.

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. The Chair of the Board of Governors serves a four-year term.

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) 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 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 inflationary 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. 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 at times when the economy is experiencing solid growth but before inflationary excesses manifest themselves.

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.