MEMORANDUM

To: Members of the Committee on Financial Services

From: FSC Majority Committee Staff

Date: July 12, 2013

Subject: Full Committee Hearing on "Monetary Policy and the State of the Economy"

The Committee on Financial Services will hold a hearing at 10 a.m. on Wednesday, July 17, 2013, in Room 2128 of the Rayburn House Office Building, to receive the testimony of the Chairman of the Board of Governors of the Federal Reserve System on the conduct of monetary policy and the state of the economy. Federal Reserve Chairman Ben S. Bernanke will be the only witness.

Background

The "Humphrey-Hawkins" Hearings

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 Chairman of the Federal Reserve articulates the strengths and weaknesses of the economy. Fed Chairman Ben Bernanke will testify before the House Financial Services Committee first during this cycle, and first again in mid-February of next year, a few weeks after the expiration of the current term of Fed Chairman Bernanke. The Chairman will testify to the Senate Banking Committee on July 18, and in July of 2014, the Senate will again receive the testimony first.

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. The Chairman of the Board of Governors serves a four-year term; Chairman Bernanke's second term expires at the end of January. Although his term as governor runs several more years, it would be highly unusual for him to remain on the board after his term expired unless he were to be re-nominated, which it is widely assumed he does not desire. Several names have been floated as possible successors, including Board Vice Chair Janet Yellen, former Treasury secretary Timothy Geithner, and former Treasury Secretary Larry Summers.

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

Despite sporadic improvements in some indicators -- notably housing-- the economy continues to struggle, having never really recovered after the 2008 economic crisis. The overall economic picture continues to be marked by stubbornly high unemployment, shaky consumer confidence, and erratic growth.

Perhaps most worrisome, steep and sudden slowdowns in the major developing countries (China, Russia, Brazil, India, South Africa) recently led the International Monetary Fund to predict slower world GDP growth than even that expected in the spring–about 3.1 percent for the year, the same as in 2012, a drop of two-tents of a percent form its April viewpoint. In the same World Economic Output (WEO), the IMF said it sees US economic growth for 2013 at a paltry 1.7 percent. That level is noticeably lower than predictions by the "Blue Chip" survey of top economists, who see a pickup in the second half of the year, predicting third quarter GDP growth of 2.3 percent and fourth quarter at 2.7 percent.

At that, though, GDP growth has been ragged. Initial figures for the fourth quarter of last year of a negative one-tenth of a percent were revised up to a positive four-tenths, and for the second quarter growth was 1.8 percent, giving a string of 15 quarters of at least some growth, but this is the first "recovery" since the second world war in which growth has not recovered to 3 percent or more. The economy remains wobbly enough that when Fed Chairman Bernanke intimated last month that the Fed could start "tapering" or slowing its $85 billion-a-month bond purchases – "quantitate easing"—the markets tanked temporarily.

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 also have 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 has staggered, 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 58.7%, up a paltry tenth of a percent in six months, 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. Meanwhile, although about 195,000 jobs were created last month, the unemployment rate crept up a tenth of a percent to 7.6 percent.

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. In the first quarter, house prices rose by 7.8% over last year, as measured by the FHFA. House sales in 2012 were the highest in five years—up 9.4 percent—and some predictions see sales up as much as 12 percent this year. Residential investment grew by 14 percentin the first quarter of this year.

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