

MEMORANDUM

To: Members of the Committee on Financial Services

From: FSC Majority Staff

Date: September 6, 2013

Subject: September 11, 2013, Monetary Policy and Trade Subcommittee Hearing on “The Fed Turns 100: Lessons Learned over a Century of Central Banking”

The Subcommittee on Monetary Policy and Trade will hold a hearing on “The Fed Turns 100: Lessons Learned over a Century of Central Banking” at 2 p.m. on Wednesday, September 11, 2013, in Room 2128 of the Rayburn House Office Building. This hearing will examine the Federal Reserve’s one-hundred year history to determine what has worked in monetary policy and what has not, and also consider how well the Federal Reserve has managed its lender of last resort function. This will be a one-panel hearing with the following witnesses:

- Professor Alan H. Meltzer, Carnegie Mellon University
- Professor Marvin Goodfriend, Carnegie Mellon University
- Mr. Alex J. Pollock, American Enterprise Institute
- Professor Larry White, George Mason University
- Dr. Joseph E. Gagnon, Peterson Institute for International Economics

Background

During the nineteenth and early twentieth centuries, financial panics led to chronic bank failures and business bankruptcies that severely disrupted the economy. In 1907, Congress established the National Monetary Commission, which proposed the creation of a central bank that would help prevent and contain further financial disruptions. After extensive debate, Congress enacted the Federal Reserve Act in 1913 “to provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the

United States, and for other purposes.”¹ The Federal Reserve Act sets forth a “dual mandate” for monetary policy: maximum employment and stable prices.²

The Federal Reserve is an independent central bank. Its decisions about monetary policy do not have to be ratified by the President or his administration, and it does not rely on Congressional appropriations for its funding. The Federal Reserve is subject to limited Congressional oversight in the form of semi-annual reporting and testimony at hearings before the House Financial Services Committee and the Senate Banking Committee, popularly known as the “Humphrey-Hawkins” hearings. The Federal Reserve is also subject to non-policy-related audits undertaken by the U.S. Government Accountability Office (GAO).

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.

Domestic Monetary Policy and the Economy

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 its surplus to another institution in need of a larger balance, 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 on a rotating basis—sets a “target” federal funds

¹ Further legislation has since clarified and supplemented the purposes of the Federal Reserve System. Key laws affecting the Federal Reserve include: the Banking Act of 1935; the Employment Act of 1946; the Bank Holding Company Act of 1956 and the amendments of 1970; the Federal Reserve Reform Act of 1977; the International Banking Act of 1978; the Full Employment and Balanced Growth Act of 1978 (also called the Humphrey-Hawkins Act after its original sponsors); the Depository Institutions Deregulation and Monetary Control Act of 1980; the Financial Institutions Reform, Recovery, and Enforcement Act of 1989; the Federal Deposit Insurance Corporation Improvement Act of 1991; the Gramm-Leach-Bliley Act of 1999; and the Dodd-Frank Act of 2010.

² Although it commonly is referred to as a “dual mandate,” the Act’s mandate actually is triple: “to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.”

rate at a level it believes will foster financial and monetary conditions consistent with achieving its monetary policy objectives, and it adjusts that target in line with evolving economic conditions.

A change in the federal funds rate, or even a change in expectations about the future level of the federal funds rate, can set off a chain of events that will affect other short-term interest rates, longer-term interest rates, the foreign exchange value of the dollar, and asset prices. In order to bring the actual federal funds rate in line with its target rate, the FOMC conducts activities intended to influence the supply and demand for federal funds by depository institutions. These activities include open market operations (the buying and selling of securities, usually U.S. Treasuries), imposing reserve requirements, permitting depository institutions to hold contractual clearing balances, and extending secured credit through its discount window facility.

Through its control of the federal funds rate, the Federal Reserve is able to foster financial and monetary conditions consistent with its monetary policy objectives. If the economy slows and employment softens, for instance, 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. In contrast, if the economy is showing 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, and some of these factors (such as changes in consumer confidence, natural disasters, or supply disruptions) cannot always be anticipated. Second, key information on the economy becomes available after the fact, so the Federal Reserve runs the risk of setting policy on the basis of stale information, and there will be some time before economic shocks are recognized and countered, given the lag between a policy action and the effect of the action 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

At the height of the financial crisis and in its aftermath, 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 percent to between 0 and .25 percent. Using Section 13(3) of the Federal Reserve Act and other authorities, the Federal Reserve created several credit facilities to lend to various entities and even other central banks.

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. In particular, the unemployment rate climbed from 8.6% in March 2009 to 9.6% in October 2010. 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.” Under the program, the Federal Reserve buys longer-term Treasury securities and sells off an equal amount of shorter-term securities in an effort to further reduce longer-term interest rates (thus “twisting” the yield curve) without expanding the overall size of the Federal Reserve’s balance sheet. To date, the Federal Reserve has bought and sold approximately \$667 billion (roughly \$45 billion per month) in securities.

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. Federal Reserve officials had mixed views about the third round of quantitative easing. Some supported ending the policies when the unemployment rate fell to a particular level, and others opposed any target dates or performance-based thresholds.

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. Perhaps more important—and unexpectedly—the Federal Reserve set a target unemployment rate of 6.5 percent and announced that it wanted to keep the inflation rate no higher than 2.5 percent over a one to two-year horizon. This indicates that the Fed does not expect to shift from its low-interest rate stance until those targets are met.