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Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff
Subject: February 24, 2021, Full Committee Hearing entitled, "Monetary Policy and the State of the Economy"

The Committee on Financial Services will hold a virtual hearing entitled, "Monetary Policy and the State of the Economy," on Wednesday, February 24, 2021, at 10:00 am, on the virtual meeting platform Cisco Webex. The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System, will be the sole witness.

Purpose and Background

The Federal Reserve Act directs the Chairman of the Board of Governors (Board) of the Federal Reserve System (Federal Reserve or Fed) to testify before the House Committee on Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs twice a year 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]

The Federal Reserve consists of a 7-member Board of Governors, as well as 12 Reserve Banks located in various regions around the country. The Fed's functions include conducting monetary policy, promoting financial stability, supervising and regulating certain financial institutions, and fostering payments and settlements.[3] The Board has seven Governors, including a Chair, a Vice Chair, and a Vice Chair for Supervision. The President nominates the Chair, Vice Chairs, and Governors, who are confirmed by the Senate. Governors serve 14-year terms, while the Chair and Vice Chairs serve four-year terms, and must be designated for their roles separately from their appointment as Governors. Chair Powell is serving a term as Chair that began in February 2018 and will expire in February 2022. Following the Senate's confirmation of Christopher Waller as Governor in December 2020, there is currently one vacancy remaining on the Board.[4]

Generally, the Board makes policy that the Reserve Banks implement and execute. However, monetary policy decisions are made by the Federal Open Market Committee (FOMC), which is comprised of the Board, the president of the Federal Reserve Bank of New York, and an annual rotation of four of the remaining Reserve Bank presidents. For more background on the Federal Reserve System's structure and its conduct of monetary policy, see the Financial Services Committee memo prepared for the "Monetary Policy and the State of the Economy" hearing from February 2020.[5]

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[1] The Federal Reserve Act of 1913, Pub. L. No. 63-43, 38 Stat. 251.
[2] *Id.*
[3] *See* Federal Reserve, *About the Fed* (accessed Feb. 12, 2021).
[4] Washington Post, *Senate confirms Christopher Waller to the Fed board as Judy Shelton's path narrows* (Dec. 3, 2020).
[5] House Committee on Financial Services, *Monetary Policy and the State of the Economy* (Feb. 11, 2020).

The Fed's response to the COVID-19 pandemic

In February 2020, the severity of the COVID-19 outbreak began to disrupt supply chains for many U.S. businesses and caused financial market turmoil, prompting the FOMC to make an emergency announcement on March 3, 2020 that it would reduce the federal funds rate by fifty basis points.[6] After the World Health Organization declared a global pandemic on March 11, 2020, it became clear that the pandemic would cause a drain on consumer demand and have significant economic ramifications. The FOMC announced on March 15, 2020 that it would cut the overnight interest rate 1 percent, to a range between 0 and 0.25 percent (also called the "zero lower bound").[7] At the same time, the FOMC announced that it would make large scale asset purchases (LSAPs) of $500 billion in Treasury securities and of at least $200 billion in agency mortgage-backed securities issued by Fannie Mae, Freddie Mac, and Ginnie Mae over the next few months.[8] In the months since, the FOMC has continued making LSAPs, which are often referred to as "quantitative easing."

On March 17, 2020, the Fed began utilizing its Section 13(3) lending powers to set up a wide range of facilities aimed at addressing severe liquidity constraints in financial markets, and on March 23, the Fed established the Primary Market Corporate Credit Facility and Secondary Market Corporate Credit Facility (SMCCF).[9,10,11] Through Title IV of the CARES Act, $454 billion was appropriated to the Treasury to support the establishment of additional emergency lending facilities at the Federal Reserve, and the Fed was directed to establish facilities to support small businesses (which became the Main Street Lending Program, or MSLP), as well as state, local, and territorial governments (which became the Municipal Liquidity Facility, or MLF).

Throughout the COVID-19 crisis, Chair Powell has stressed that economic recovery depends on the path of the virus, as well as significant fiscal support from Congress. During his post-FOMC press conference on January 27, 2021, Powell cited stimulus payments and expanded unemployment benefits as two factors that contributed to economic recovery since last spring, but cautioned that economic activity slowed after the course of the virus worsened throughout the winter.[12] Highlighting signs of economic weakness in a February 10, 2021 speech, Powell said that "the pandemic has led to the largest 12-month decline in labor force participation since at least 1948."[13] Powell also noted that "Employment in January of this year was nearly 10 million below its February 2020 level, a greater shortfall than the worst of the Great Recession's aftermath," and that "Correcting [worker misclassification] and counting those who have left the labor force since last February as unemployed would boost the unemployment rate to close to 10 percent in January."[14] Echoing several of Powell's points about continued economic distress, over 120 economists signed an open letter in January 2021 calling the COVID-19 pandemic the "greatest economic disaster since the Great Depression," and urging Congress to enact a sweeping stimulus package

[6] Washington Post, *Fed makes largest emergency cut to interest rates since the financial crisis,* (March 3, 2020).
[7] Federal Open Market Committee, *Federal Reserve Issues FOMC Statement,* (March 15, 2020).
[8] Id.
[9] Congressional Research Service, *Treasury and Federal Reserve Financial Assistance in Title IV of the CARES Act,* (Jan. 6, 2021). (See for a full description of these emergency lending facilities and their various purposes).
[10] *See* Congressional Research Service, *The Federal Reserve's Response to COVID-19: Policy Issues* (Feb. 8, 2021). (Contains a full description of these emergency lending facilities and their various purposes).
[11] *See* Congressional Research Service, *Federal Reserve: Emergency Lending,* (Mar. 27, 2020). (CRS-R44185). (Contains detailed description of the Federal Reserve's emergency lending powers).
[12] Federal Reserve Board of Governors, *Transcript of Chair Powell's Press Conference* (Jan. 27, 2021).
[13] Chair Jerome H. Powell, *Getting Back to a Strong Labor Market*, Board of Governors of the Federal Reserve System (Feb. 10, 2021).
[14] *Id.*

including "substantial unemployment benefits and stimulus checks, help for struggling renters and homeowners, and significant state and local aid that will pay for essential workers."[15]

CARES Act Emergency Lending Facilities

On November 19, 2020, former Treasury Secretary Steven Mnuchin wrote to the Fed requesting the return of any unused portion of funds committed to the Fed's emergency lending facilities at the end of 2020.[16] Although the Fed stated that it "would prefer that the full suite of emergency facilities established during the coronavirus pandemic continue to serve their important role as a backstop for our still-strained and vulnerable economy,"[17] Chair Powell agreed to Mnuchin's request.[18] The Fed had made over $40 billion in purchases through the MLF, MSLP, SMCCF, and other CARES Act facilities, and will hold those assets to maturity. Data from the Special Inspector General for Pandemic Response (SIGPR) indicates that roughly $102 billion in unused emergency lending facility funds were returned from the Fed to Treasury at the end of December 2020.[19] The SIGPR has opened an inquiry into the legal rationale Secretary Mnuchin used to shut down the facilities, and is also examining whether political interference played a role in certain oil and gas firms receiving MSLP loans.[20] On December 27, 2020, the Consolidated Appropriations Act of 2021 was signed into law, eliminating the CARES Act facilities and what remained of the $454 billion CARES Act appropriation, although the Fed and Treasury retain the authority to set up emergency lending facilities, so long as they are not identical to those created following the CARES Act.[21]

Economic recovery and the Fed's new monetary policy framework

Because of the severity of the recession, the FOMC's most recent summary of economic projections show that 16 of 17 FOMC participants expected interest rates to remain at zero through 2023.[22] Minutes from the FOMC's December meeting indicate that market participants expect the federal funds rate to remain at zero through 2024, and also show that FOMC participants agree that LSAPs will be necessary for some time, although there appears to be internal debate over how soon the FOMC should consider adjusting or reducing LSAPs.[23] At its January 2021 meeting, the FOMC adopted its Statement on Longer-Run Goals and Strategy, affirming the new monetary policy framework announced by the Fed last August. In remarks explaining the Fed's new monetary policy framework, Chair Powell has emphasized the benefits of a tight labor market, and stated that "going forward, employment can run at or above real-time estimates of its maximum level without causing concern, unless accompanied by signs of unwanted increases in inflation or the emergence of other risks that could impede the attainment of our goals."[24] The Fed also expressed its intention to rely less heavily on the Non-Accelerating Inflation Rate of Unemployment, which was historically used as the Fed's benchmark for the maximum level of employment, but is considered to be a highly uncertain estimate.[25] Finally, the new framework clarifies that the Fed's inflation target of two percent will not be treated as a ceiling, and that "following periods

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[15] Invest in America, *120+ economists call on Congress to Pass Sweeping Additional COVID relief package* (Jan. 28, 2021).
[16] U.S. Department of the Treasury, *Letter from Secretary Steven T. Mnuchin on the Status of Facilities Authorized Under Section 13(3) of the Federal Reserve Act* (Nov. 19, 2020).
[17] Politico, *Trump team to yank emergency economic support, triggering public Fed dissent* (Nov. 19, 2020).
[18] Federal Reserve Chair Powell letter to Treasury Secretary Mnuchin (Nov. 20, 2020)
[19] Quarterly Report to the United States Congress, *Office of the Special Inspector General for Pandemic Recovery*, (Dec. 31, 2020).
[20] *Id.*
[21] House Financial Services Committee, *Waters Releases Extended Statement for the Record on the Consolidated Appropriations Act* (Dec. 22, 2020).
[22] Federal Open Market Committee, *Summary of Economic Projections* (Dec. 16, 2020).
[23] Board of Governors of the Federal Reserve System, *Minutes of the Federal Open Market Committee* (Dec. 15-16, 2020).
[24] Chair Jerome H. Powell, *New Economic Challenges and the Fed's Monetary Policy Review*, Board of Governors of the Federal Reserve System (Aug. 27, 2020).
[25] Fed, *What is the lowest level of unemployment that the U.S. economy can sustain?* (Sep. 16, 2020).

when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time."[26]

The Role of the Fed and Monetary Policy in Racial Wealth Gaps and Inequality

Presenting the semi-annual monetary policy report to Congress in June 2020, Chair Powell spoke about the uneven effects of the economic fallout from COVID-19, describing how "low-income households have experienced by far the sharpest drop in employment, while job losses of African Americans, Hispanics, and women have been greater than those of other groups."[27] Powell continued, "If not contained and reversed, the downturn could further widen gaps in economic well-being that the long expansion had made some progress in closing."[28] Following nationwide protests of racial injustice over the summer of 2020, Atlanta Fed President Raphael Bostic published an essay titled "A Moral and Economic Imperative to End Racism." Bostic described the Fed's role "in helping to reduce racial inequities and bring about a more inclusive economy" through its monetary policy, regulatory decisions, oversight of the payments system, and community and economic development functions.[29] All 12 Federal Reserve Banks have since announced a series of virtual events focused on structural racism.[30] Economists at the Federal Reserve Bank of New York cited Bostic's essay in a paper studying the effects of accommodative monetary policy on the racial gaps in income and wealth, which "remain enormous."[31] The researchers found that "Over a five-year horizon, accommodative monetary policy leads to larger employment gains for black households, but also to larger wealth gains for white households."[32]

Its recent attention to racial inequities notwithstanding, the Federal Reserve System has not historically been a publicly representative institution. In February 2021, an analysis by the *New York Times* found that, despite efforts by Congress to enhance diversity among the Fed's leadership and staff spanning several decades, "Across the board and the Fed system's 12 regional banks, 1.3 percent of economists identified as Black alone. That aggregate figure masks wide variation. Five of the banks lacked a single economist who identified as only Black. People who identified as "two or more races" — of whom there were six in the Fed's whole system — were not included in the count since their racial identity was not specified."[33]

Regulatory developments

COVID-19 Response. As the economic downturn from the COVID-19 pandemic continued in June 2020, the Fed imposed restrictions on dividend payments and stock repurchases by the largest banks. Also in response to the COVID-19 crisis, the Fed supplemented its annual stress tests on large banks with tests of banks' responses to a sharp recession with a swift recovery, as well as a longer lasting recession. Based on banks' performance on those stress tests, the Fed announced in December that it was lifting some of its restrictions on dividends and stock repurchases, although Governor Lael Brainard dissented from that decision, noting that some banks reached their regulatory minimums for capital under certain stress test scenarios.[34] Chair Powell said on January 27th that the Fed would continue evaluating restrictions on dividends and buybacks going forward.[35]

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[26] Fed, *Statement on Longer-Run Goals and Monetary Policy Strategy* (Aug. 27, 2020).
[27] House Financial Services Committee, *Monetary Policy and the State of the Economy* (Jun. 12, 2020).
[28] *Id.*
[29] Federal Reserve Bank of Atlanta, *A Moral and Economic Imperative to End Racism* (Jun. 2020).
[30] Federal Reserve Bank of Minneapolis, *Race and the Economy* (Oct. 2020).
[31] Federal Reserve Bank of New York, *Monetary Policy and Racial Inequality* (Jan. 2021).
[32] *Id.*
[33] New York Times, *Why are there so few Black Economists at the Fed?* (Feb. 2, 2021).
[34] New York Times, *Banks Can Resume Buybacks and Pay Dividends If They're Profitable* (Dec.18, 2020).
[35] Board of Governors of the Federal Reserve System, *Transcript of Chair Powell's Press Conference*, (Jan. 27, 2021).

Community Reinvestment Act. On May 20, 2020, the Office of the Comptroller of the Currency (OCC) finalized a rule substantially revising the Community Reinvestment Act (CRA), and altering how OCC-regulated banks would be assessed for compliance with the law.[36] The Fed and FDIC did not sign on to the OCC's final rule, which was criticized by a wide range of stakeholders.[37] In September 2020, the Fed advanced its own notice of proposed rulemaking on modifications to the CRA utilizing a different approach,[38] which has generated some initial positive feedback from community and civil rights groups, as well as banking trades.[39,40]

Nonbank Regulation. Responding to a question about heightened financial market volatility in January 2021, Chair Powell was careful to point out that nonbank supervision is a responsibility that falls mostly to the Financial Stability Oversight Council, on which he serves as one of ten voting members.[41] Powell also noted that "outsized economic and financial shock of the pandemic really appeared in the nonbank sector."[42] Powell's comment was further substantiated by the Fed's November 2020 financial stability report, which found that "measures of leverage at life insurance companies are at post-2008 highs and remain elevated at hedge funds relative to the past five years. Some nonbank financial institutions felt significant strains amid the acute period of extreme market volatility, declining asset prices, and worsening market liquidity earlier this year."[43]

Climate change as a financial stability risk

In its November 2020 financial stability report, the Fed characterized climate change as a financial stability risk for the first time, describing how "repricing events and direct losses associated with climate hazards can result in an increased frequency and severity of financial shocks."[44] Governor Brainard has also highlighted how policymakers are focused on "so-called transition risks: the risks associated with the transition to a policy framework that curtails emissions."[45] In late January 2021, S&P announced that it was considering credit downgrades for 13 major oil companies, citing "growing risk to their businesses from the energy transition, price volatility, and future profitability."[46] On December 15, 2020, the Fed announced that it had joined the Network for Greening the Financial System, an international consortium of central banks dedicated to climate risk management.[47] On January 25, 2021, the Fed announced the formation of the Supervision Climate Committee, a new team within the Fed's Supervision and Regulation Department that will consider the ramifications of climate change for the financial institutions that the Fed regulates.[48]

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[36] OCC, *OCC Finalizes Rule to Strengthen and Modernize Community Reinvestment Act Regulations* (May 20, 2020).
[37] *See* National Community Reinvestment Coalition (NCRC), *Analysis Of The OCC's Final CRA Rule* (Jun. 15, 2020).
[38] Fed, *Federal Reserve Board issues Advance Notice of Proposed Rulemaking on an approach to modernize regulations that implement the Community Reinvestment Act* (Sep. 21, 2020).
[39] *See* NCRC, *NCRC Initial Analysis of Federal Reserve's ANPR on the Community Reinvestment Act: A Step Forward But Needs to be More Rigorous* (Oct. 16, 2020).
[40] *See* ICBA, *Statement on Fed CRA Notice* (Sep. 21, 2020).
[41] Board of Governors of the Federal Reserve System, *Transcript of Chair Powell's Press Conference* (Jan. 27, 2021).
[42] *Id.*
[43] Board of Governors of the Federal Reserve System, *Financial Stability Report* (Nov. 2020).
[44] *Id.*
[45] Fed Governor Lael Brainard, *Why Climate Change Matters for Monetary Policy and Financial Stability* (Nov. 8, 2019).
[46] S&P Global, *Oil majors' credit rating under threat from growing climate risks* (Jan. 26, 2021).
[47] Board of Governors of the Federal Reserve System, *Federal Reserve Board announces it has formally joined the Network of Central Banks and Supervisors for Greening the Financial System, or NGFS, as a member* (Dec. 15, 2020).
[48] Federal Reserve Bank of New York, *Kevin Stiroh to Step Down as Head of New York Fed Supervision to Assume New System Leadership Role at Board of Governors on Climate* (Jan. 25, 2021).