



Monetary Policy and the Federal Reserve: Current Policy and Conditions

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Summary

The Federal Reserve (the Fed) defines monetary policy as the actions it undertakes to influence the availability and cost of money and credit. Because the expectations of market participants play an important role in determining prices and growth, monetary policy can also be defined to include the directives, policies, statements, and actions of the Fed that influence how the future is perceived. In addition, the Fed acts as a “lender of last resort” to the nation’s financial system, meaning that it ensures continued smooth functioning of financial intermediation by providing financial markets with adequate liquidity.

Traditionally, the Fed has implemented monetary policy primarily through open market operations involving the purchase and sale of U.S. Treasury securities. The Fed traditionally conducts open market operations by setting an interest rate target that it believes will allow it to fulfill its statutory mandate of “maximum employment, stable prices, and moderate long-term interest rates.” The interest rate targeted is the federal funds rate, the price at which banks buy and sell reserves on an overnight basis. This rate is linked to other short-term rates and these, along with inflation expectations, influence longer-term interest rates. Interest rates affect interest-sensitive spending such as business capital spending on plant and equipment, household spending on consumer durables, and residential investment. Through this channel, monetary policy can be used to stimulate or slow aggregate spending in the short run. In the long run, monetary policy mainly affects inflation. A low and stable rate of inflation promotes price transparency and, thereby, sounder economic decisions by households and businesses.

Recently, in response to the financial crisis, direct lending became important once again and the Fed created a number of new ways for injecting reserves, credit, and liquidity into the banking system, as well as making loans to firms that are not banks. As financial conditions normalized, loans were repaid with interest and emergency lending programs have been wound down, with the exception of foreign central bank liquidity swaps.

Beginning in September 2007, in a series of 10 moves, the federal funds target was reduced from 5.25% to a range of 0% to 0.25% on December 16, 2008, where it now remains. In December 2012, the Fed pledged to maintain “exceptionally low rates” at least as long as unemployment is above 6.5% and inflation is low. With the federal funds target at the “zero lower bound,” the Fed has added additional monetary stimulus first through direct lending and, more recently, through purchases of Treasury and government-sponsored enterprise (GSE) securities. This practice is sometimes referred to as quantitative easing, which has tripled the size of the Fed’s balance sheet since the financial crisis began. On September 13, 2012, the Fed announced a new round of asset purchases, pledging to purchase \$40 billion GSE mortgage-backed securities per month until the labor market improves, as long as price stability is maintained. Coupled with \$45 billion in monthly purchases of Treasury securities, the Fed’s balance sheet is now increasing by about \$85 billion each month.

Congress has delegated responsibility for monetary policy to the Fed, but retains oversight responsibilities for ensuring that the Fed is adhering to its statutory mandate. H.R. 492 and S. 215 would switch to a single mandate of price stability. Congressional debate on Fed oversight has focused on audits by the Government Accountability Office (GAO). The Dodd-Frank Act enhanced the GAO’s ability to audit the Fed and required an audit of its emergency programs. H.R. 24, H.R. 33, and S. 209 would remove all remaining restrictions on GAO’s audit powers.

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Introduction

Congress has delegated responsibility for monetary policy to the Federal Reserve (the Fed), but retains oversight responsibilities to ensure that the Fed is adhering to its statutory mandate of “maximum employment, stable prices, and moderate long-term interest rates.”¹ The Fed’s responsibilities as the nation’s central bank fall into four main categories: monetary policy, ensuring financial stability through the lender of last resort function, supervision of bank holding companies, and providing payment system services to financial firms and the government. This report will discuss the first two areas of responsibility.²

The Fed’s monetary policy function is one of aggregate demand management. The Fed defines monetary policy as the actions it undertakes to influence the availability and cost of money and credit to promote the goals mandated by Congress, a stable price level and maximum sustainable employment. Because the expectations of households as consumers and businesses as purchasers of capital goods exert an important influence on the major portion of spending in the United States, and these expectations are influenced in important ways by the actions of the Fed, a broader definition of monetary policy would include the directives, policies, statements, forecasts of the economy, and other actions by the Fed, especially those made by or associated with the chairman of its Board of Governors, the nation’s central banker.

In addition, governments have traditionally assigned to a central bank the role of “lender of last resort” to the nation’s financial system. This role means that the Federal Reserve is responsible for ensuring the sustainability, solvency, and continued functioning of the nation’s financial system as a whole, although this does not necessarily extend to any individual financial institution. Thus, in times of financial stress or crisis, the Fed is responsible for ensuring that financial intermediation does not come to a halt. Historically, Federal Reserve intervention has been limited to the banking system. Indeed, the impetus for the founding of the Fed was an outgrowth of the financial panic of 1907. During its nearly 100-year history, the Federal Reserve has rarely been called upon to perform this role. It is now widely regarded as having failed to perform it during the collapse of the U.S. banking system in the contraction of 1929-1933. However, the financial crisis that began in the summer of 2007 with the bursting of the “housing

Recent Events of Note

- In the 112th Congress, H.R. 459, legislation removing statutory restrictions on GAO audits, passed in the House. GAO audits of the Fed required by the Dodd-Frank Act were released in July and October 2011 (see “Congressional Oversight and Disclosure” below).
- On September 13, 2012, Fed announced it would buy \$40 billion MBS per month, with no specified end date, popularly referred to as “QE3.” The Maturity Extension Program, popularly referred to as “Operation Twist,” ended at the end of 2012. In December 2012, the Fed announced that it would continue purchasing \$45 billion in long-term Treasury securities, but those purchases would no longer be offset by the sale of short-term Treasury securities (see “Unconventional Policy Measures at the Zero Bound”).
- The Fed renewed use of central bank liquidity swaps in response to the eurozone crisis (see “Central Bank Liquidity Swaps” below).
- In December 2012, the Fed announced that it expects to maintain “exceptionally low interest rates” until the unemployment rate reaches 6.5%, as long as inflation remains low (see “Congressional Oversight and Disclosure” below).

¹ Section 2A of the Federal Reserve Act, 12 USC 225a.

² For background on the makeup of the Federal Reserve, see CRS Report RS20826, *Structure and Functions of the Federal Reserve System*, by Marc Labonte.

price bubble” has placed this role front and center. The Fed has responded by making massive additions of reserves available to depository institutions (primarily commercial banks) through the purchase of U.S. Treasury and mortgage-related securities (popularly known as “quantitative easing”) and through lending facilities. In addition, it has created a number of additional ways to make credit available to a broader range of financial institutions as well as making loans directly to non-bank financial intermediaries. These innovations were unprecedented and several were authorized only in “unusual and exigent circumstances.”³

By 2011, these emergency activities had largely expired, with the exception of the central bank liquidity swaps. In September 2012, the Fed renewed its large-scale asset purchases (popularly referred to as “QE3”), pledging to purchase \$40 billion of GSE MBS per month.⁴ Unlike the previous two rounds of asset purchases, the Fed specified no planned end date to its purchases, instead pledging to continue purchases until labor markets improved, in a context of price stability. Coupled with \$45 billion in monthly purchases of Treasury securities, the Fed’s balance sheet is now increasing by about \$85 billion each month. In December 2012, the Fed pledged to maintain an “exceptionally low” federal funds target at least as long as unemployment is above 6.5% and inflation is low.

The Fed’s unprecedented response to the financial crisis has garnered renewed attention on the Fed from Congress. On the one hand, the Fed was given new regulatory responsibilities in The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) in an attempt to prevent future crises. On the other hand, the Dodd-Frank Act shifted its consumer protection responsibilities to the newly created Consumer Financial Protection Bureau, placed restrictions on the Fed’s emergency powers, and increased oversight of the Fed. Fed oversight and disclosure has been a focus of recent Congresses. In the 111th Congress, the Dodd-Frank Act allowed the Government Accountability Office (GAO) to audit the Fed’s monetary and lending activities and required the Fed to release detailed lending records for the first time. In the 112th Congress, H.R. 459, which the House passed as amended on July 25, 2012, would have removed remaining restrictions on GAO’s audit authority. Similar bills in the 113th Congress include H.R. 24, H.R. 33, and S. 209. H.R. 492 and S. 215 would switch to a single mandate of price stability.

This report provides an overview of monetary policy and issues for Congress. Legislative changes to the Fed’s duties and authority related to financial regulatory reform can be found in CRS Report R40877, *Financial Regulatory Reform: Systemic Risk and the Federal Reserve*, by Marc Labonte. Lending facilities created by the Federal Reserve and other government agencies during the financial crisis are discussed in CRS Report R41073, *Government Interventions in Response to Financial Turmoil*, by Baird Webel and Marc Labonte.

³ For a discussion of the 2007-2009 financial crisis, its origins, and the innovations by the Federal Reserve, see CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte. For historical perspective on Federal Reserve’s dealing in non-government debt, see Wheelock, David C. “Conducting Monetary Policy Without Government Debt: The Fed’s Early Years. *Review*, Federal Reserve Bank of St. Louis. May/June 2002, pp. 1-14.

⁴ Federal Reserve, press release, September 13, 2012, <http://www.federalreserve.gov/newsevents/press/monetary/20120913a.htm>.

How Does the Federal Reserve Execute Monetary Policy?

The Federal Reserve has traditionally relied on three instruments to conduct monetary policy. Each works by altering the reserves available to depository institutions. These institutions are required to maintain reserves against their deposit liabilities, primarily checking, saving, and time (CDs). These reserves can be held in the form of vault cash (currency) or as a deposit at the Fed. The size of these reserves places a ceiling on the amount of deposits that financial institutions can have outstanding, and deposit liabilities are related to the amount of assets these institutions can acquire. These assets are often called “credit” since they represent loans made to businesses and households, among others.

The Federal Reserve has three ways to expand or contract money and credit. The primary method is called open market operations and it involves the Fed buying existing U.S. Treasury securities (or those that have been already issued and sold to private investors). Should it buy securities, it does so with the equivalent of newly issued currency (Federal Reserve notes). This expands the reserve base and the ability of depository institutions to make loans and expand money and credit. The reverse is true if the Fed decides to sell securities from its portfolio.

The Fed can also change reserve requirements, controlling a portion of deposits that banks must hold as vault cash or on deposit at the Fed, which affects the available liquidity within the market. Currently, banks are required to hold 10% of their deposits above \$79.5 million in reserves. This tool is used rarely—the percentage was last changed in 1998.⁵ To increase control over reserve growth, the Federal Reserve began to pay interest on required and excess reserves in October 2008, reducing the opportunity cost of holding that money as opposed to lending it out.

Finally, the Fed permits certain depository institutions to borrow from it directly on a temporary basis. That is, these institutions can “discount” at the Fed some of their own assets to provide a temporary means for obtaining reserves. Discounts are usually on an overnight basis. For this privilege they are charged an interest rate called, appropriately, the discount rate. The discount rate is set by the Fed at a markup over the federal funds rate.⁶ Direct lending, from the discount window and other recently created lending facilities, is negligible under normal financial conditions, but was an important source of reserves during the financial crisis.

Because the Fed defines monetary policy as the actions it undertakes to influence the availability and cost of money and credit, this suggests two ways to measure the stance of monetary policy. One is to look at the cost of money and credit as measured by the rate of interest relative to inflation (or inflation projections), while the other is to look at the growth of money and credit

⁵ The deposit threshold is regularly adjusted for inflation. The Dodd-Frank Act encouraged regulators to implement heightened liquidity standards, particularly for Systemically Important Financial Institutions (SIFIs), that may affect reserve requirements once fully implemented. The status of SIFI regulation was discussed in a speech by Federal Reserve Governor Daniel Tarullo on June 3, 2011. The speech can be seen at <http://www.federalreserve.gov/newsevents/speech/tarullo20110603a.htm>.

⁶ Until 2003, the discount rate was set slightly below the federal funds target, and the Fed used moral suasion to discourage healthy banks from profiting from this low rate. To reduce the need for moral suasion, lending rules were altered in early 2003. Since that time, the discount rate has been set at a penalty rate above the federal funds rate target. However, during the financial crisis, the Fed encouraged banks to use the discount window.

itself. Thus, one can look at either interest rates or the growth in the supply of money and credit in coming to a conclusion about the current stance of monetary policy, that is, whether it is expansionary, contractionary, or neutral.

Since the great inflation of the 1970s, most central banks have preferred to formulate monetary policy more in terms of the cost of money and credit rather than on their supply. The Federal Reserve thus conducts monetary policy by focusing on the cost of money and credit as proxied by an interest rate. In particular, it targets a very short-term interest rate known as the federal funds rate. The FOMC meets every six weeks to choose a federal funds target and sometimes meets on an ad hoc basis if it wishes to change the target between regularly scheduled meetings. The FOMC is comprised of the 7 Fed governors, the President of the New York Fed, and 4 of the other 11 regional Fed bank presidents selected on a rotating basis.⁷

The federal funds rate is determined in the private market for overnight reserves of depository institutions. At the end of a given period, usually a day, depository institutions must calculate how many dollars of reserves they want to hold against their reservable liabilities (deposits).⁸ Some institutions may discover a reserve shortage (too few reservable assets relative to those it wants to hold) while others may have had reservable assets in excess of their wants. A market exists in which these reserves can be bought and sold on an overnight basis. The interest rate in this market is called the federal funds rate. It is this rate that the Fed uses as a target for conducting monetary policy. If it wishes to expand money and credit, it will lower the target which encourages more lending activity and, thus, demand in the economy. To support this lower target, the Fed must stand ready to buy more U.S. Treasury securities. Conversely, if it wishes to tighten money and credit, it will raise the target and remove as many reserves from depository institutions as are necessary to accomplish its ends. This will require the sale of treasuries from its portfolio of assets.⁹

The federal funds rate is linked to the interest rates that banks and other financial institutions charge for loans—or the provision of credit. Thus, while the Fed may directly influence only a very short-term interest rate, this rate influences other longer-term rates. However, this relationship is far from being on a one-to-one basis since the longer-term market rates are influenced not only by what the Fed is doing today, but what it is expected to do in the future and what inflation is expected to be in the future. This highlights the importance of expectations in explaining market interest rates. For that reason, there is a growing body of literature that urges the Federal Reserve to be very transparent in explaining what its policy is and will be and making a commitment to adhere to that policy.¹⁰ In fact, the Fed has responded to this literature and is increasingly transparent in explaining its policy measures and what these are expected to accomplish.

⁷ H.R. 1512 would remove the regional Fed bank presidents from the Federal Open Market Committee.

⁸ Depository institutions are obligated by law to hold some fraction of their deposit liabilities as reserves. In addition, they are also likely to hold additional or excess reserves based on certain risk assessments they make about their portfolios and liabilities. Until very recently these reserves were non-income earning assets. The Fed now pays interest on both types of reserves. It is too early to assess how this shift in policy will affect bank reserve holdings.

⁹ For a technical discussion of how this is actually done, see Edwards, Cheryl L., “Open Market Operations in the 1990s,” *Federal Reserve Bulletin*, November 1997, pp. 859-872.

¹⁰ See, for example, Santomero, Anthony M. “Great Expectations: The Role of Beliefs in Economics and Monetary Policy.” *Business Review*, Federal Reserve Bank of Philadelphia. Second Quarter 2004, pp. 1-6, and Sellon, Gordon H., Jr., “Expectations and the Monetary Policy Transmission Mechanism,” *Economic Review*, Federal Reserve Bank of Kansas City, Fourth Quarter 2004, pp. 4-42.

Using market interest rates as an indicator of monetary policy is fraught with danger, however. The interest rate that is essential to decisions made by households and businesses to buy capital goods is what economists call the “real” interest rate. It is often proxied by subtracting from the market interest rate the actual or expected rate of inflation. The real rate is largely independent of the amount of money and credit since over the longer run, it is determined by the interaction of saving and investment (or the demand for capital goods). The internationalization of capital markets means that for most developed countries the relevant saving and investment that determines the real interest rate is on a global basis. Thus, real rates in the United States depend not only on our national saving and investment, but on the saving and investment of other countries as well. For that reason national interest rates are influenced by international credit conditions and business cycles.

The recent financial crisis underlines that open market operations alone can be insufficient at times for meeting the Fed’s statutory mandate. Since the crisis, many economists and central bankers have argued that a macroprudential approach to supervision and regulation is needed, and this may affect conduct of monetary policy to maintain maximum employment and price stability.¹¹ Whereas traditional open market operations managed to contain systemic risk following the bursting of the “dot-com” bubble in 2000, direct lending by the Fed on a large scale was unable to contain systemic risk in 2008. In a recent speech, Fed Chairman Bernanke said he is committed to serving on and working closely with the Financial Stability Oversight Committee, created by the Dodd-Frank Act, to safeguard against systemic risk.¹² He also described how the Fed has recently restructured its internal operations to facilitate a macroprudential approach to supervision and regulation.¹³

Economic Effects of Monetary Policy in the Short Run and Long Run

How do changes in short-term interest rates affect the overall economy? In the short run, an expansionary monetary policy that reduces interest rates increases interest-sensitive spending, all else equal. Interest-sensitive spending includes physical investment (i.e., plant and equipment) by firms, residential investment (housing construction), and consumer-durable spending (e.g., automobiles and appliances) by households. As discussed in the next section, it also encourages exchange rate depreciation that causes exports to rise and imports to fall, all else equal. To reduce spending in the economy, the Fed raises interest rates, and the process works in reverse. An examination of U.S. economic history will show that money- and credit-induced demand expansions can have a positive effect on U.S. GDP growth and total employment. The extent to which greater interest-sensitive spending results in an increase in overall spending in the economy in the short run will depend in part on how close the economy is to full employment. When the economy is near full employment, the increase in spending is likely to be dissipated through higher inflation more quickly. When the economy is far below full employment,

¹¹ Bank for International Settlements, “Monetary Policy in a World with Macro Prudential Policy,” speech by Jaime Caruana on June 11, 2011, <http://www.bis.org/speeches/sp110610.htm>.

¹² For more information, see CRS Report R41384, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Systemic Risk and the Federal Reserve*, by Marc Labonte.

¹³ Chairman Ben Bernanke, “Implementing a Macroprudential Approach to Supervision and Regulation,” speech at the 47th Annual Conference on Bank Structure and Competition, Chicago, Illinois, Federal Reserve, May 5, 2011, <http://www.federalreserve.gov/newsevents/speech/bernanke20110505a.htm>.

inflationary pressures are more likely to be muted. This same history, however, also suggests that over the longer run, a more rapid rate of growth of money and credit is largely dissipated in a more rapid rate of inflation with little, if any, lasting effect on real GDP and employment. (Since the crisis, the historical relationship between money growth and inflation has not held so far, as will be discussed below.)

Economists have two explanations for this paradoxical behavior. First, they note that, in the short run, many economies have an elaborate system of contracts (both implicit and explicit) that makes it difficult in a short period for significant adjustments to take place in wages and prices in response to a more rapid growth of money and credit. Second, they note that expectations for one reason or another are slow to adjust to the longer run consequences of major changes in monetary policy. This slow adjustment also adds rigidities to wages and prices. Because of these rigidities, changes in the growth of money and credit that change aggregate demand can have a large initial effect on output and employment albeit with a policy lag of six to eight quarters before the broader economy fully responds to monetary policy measures. Over the longer run, as contracts are renegotiated and expectations adjust, wages and prices rise in response to the change in demand and much of the change in output and employment is undone. Thus, monetary policy can matter in the short run but be fairly neutral for GDP growth and employment in the longer run.¹⁴

It is noteworthy that in societies where high rates of inflation are endemic, price adjustments are very rapid. During the final stages of very rapid inflations, called hyperinflation, the ability of more rapid rates of growth of money and credit to alter GDP growth and employment is virtually nonexistent, if not negative.

Monetary vs. Fiscal Policy

Either fiscal policy (defined here as changes in the structural budget deficit) or monetary policy can be used to alter overall spending in the economy. However, there are several important differences to consider between the two.

First, economic conditions change rapidly, and in practice monetary policy can be much more nimble than fiscal policy. The Fed meets every six weeks to consider changes in interest rates, and can call an unscheduled meeting any time in between. Large changes to fiscal policy typically occur once a year at most. For example, there were three large tax cuts from the 2001 recession through 2006,¹⁵ in the same period, interest rates were changed 29 times. Once a decision to alter fiscal policy has been made, the proposal must travel through a long and arduous legislative process that can last months before it can become law, while monetary policy changes are made instantly.¹⁶

¹⁴ Two interesting papers bearing on what monetary policy can accomplish by two former officials of the Federal Reserve are Santomero, Anthony M. "What Monetary Policy Can and Cannot Do," *Business Review*, Federal Reserve Bank of Philadelphia, First Quarter 2002, pp. 1-4, and Mishkin, Frederic S. "What Should Central Banks Do?," *Review*, Federal Reserve Bank of St. Louis, November/December 2000, pp. 1-14.

¹⁵ The tax cuts are the Economic Growth and Tax Relief Reconciliation Act (P.L. 107-16), the Job Creation and Worker Assistance Act (P.L. 107-147), and the Jobs and Growth Tax Relief Reconciliation Act (P.L. 108-27).

¹⁶ To some extent, fiscal policy automatically mitigates changes in the business cycle without any policy changes because tax revenue falls relative to GDP and certain mandatory spending (such as unemployment insurance) rises when economic growth slows, and vice versa.

In addition to differences in implementation lags, both monetary and fiscal policy face lags due to “pipeline effects.” In the case of monetary policy, interest rates throughout the economy may change rapidly, but it takes longer for economic actors to change their spending patterns in response. For example, in response to a lower interest rate, a business must put together a loan proposal, apply for a loan, receive approval for the loan, and then put the funds to use. In the case of fiscal policy, once legislation has been enacted, it may take some time for authorized spending to be outlaid. An agency must approve projects and select and negotiate with contractors before funds can be released. In the case of transfers or tax cuts, recipients must receive the funds and then alter their private spending patterns before the economy-wide effects are felt. For both monetary and fiscal policy, further rounds of private and public decision-making must occur before “multiplier” or “ripple” effects are fully felt.

Second, political constraints have led to fiscal policy being employed mostly in only one direction. Over the course of the business cycle, aggregate spending in the economy can be expected to be too high as often as it is too low. This means that stabilization policy should be tightened as often as it is loosened, yet increasing the budget deficit has proven to be much more popular than implementing the spending cuts or tax increases necessary to reduce it. As a result, the budget has been in deficit in all but five years since 1961. This has led to an accumulation of federal debt that gives policymakers less leeway to potentially undertake a robust expansionary fiscal policy, if needed, in the future. By contrast, the Fed is more insulated from political pressures,¹⁷ and experience shows that it is as willing to raise interest rates as it is to lower them.

Third, the long run consequences of fiscal and monetary policy differ. Expansionary fiscal policy creates federal debt that must be serviced by future generations. Some of this debt will be “owed to ourselves,” but some (presently, about half) will be owed to foreigners. To the extent that expansionary fiscal policy “crowds out” private investment, it leaves future national income lower than it otherwise would have been.¹⁸ Monetary policy does not have this effect on generational equity though different levels of interest rates will affect borrowers and lenders differently. Furthermore, the government faces a budget constraint that limits the scope of expansionary fiscal policy—it can only issue debt as long as investors believe that the debt will be honored—even if economic conditions require larger deficits to restore equilibrium.¹⁹

Fourth, openness of an economy to highly mobile capital flows changes the relative effectiveness of fiscal and monetary policy. Expansionary fiscal policy would be expected to lead to higher interest rates, all else equal, which would attract foreign capital looking for a higher rate of return.²⁰ Foreign capital can only enter the United States on net through a trade deficit. Thus, higher foreign capital inflows lead to higher imports, which reduces spending on domestically produced substitutes, and lower spending on exports. The increase in the trade deficit would cancel out the expansionary effects of the increase in the budget deficit to some extent (in theory, entirely). This theory is supported by experience—as the budget deficit increased, so did the trade

¹⁷ For more information, see CRS Report RL31056, *Economics of Federal Reserve Independence*, by Marc Labonte.

¹⁸ An exception to the rule would be a situation where the economy is far enough below full employment that virtually no crowding out takes place because the stimulus to spending generates enough resources to finance new capital spending.

¹⁹ The analogous constraint on monetary policy is that after a certain limit, expansionary monetary policy would become highly inflationary. But from the current starting point of price stability, problems with inflation would presumably only occur after a point where the economy had returned to full employment.

²⁰ For more information, see CRS Report RL31235, *The Economics of the Federal Budget Deficit*, by Brian W. Cashell.

deficit.²¹ Expansionary monetary policy would have the opposite effect—lower interest rates would cause capital to flow abroad in search of higher rates of return elsewhere. Foreign capital outflows would reduce the trade deficit through an increase in spending on exports and domestically produced import substitutes. Thus, foreign capital flows would (tend to) magnify the expansionary effects of monetary policy.

Fifth, fiscal policy can be targeted to specific recipients. In the case of normal open market operations, monetary policy cannot. This difference could be considered an advantage or disadvantage. On the one hand, policymakers could target stimulus to aid the sectors of the economy most in need, or most likely to respond positively to stimulus. On the other hand, stimulus could turn out to be allocated on the basis of political or non-economic factors that reduce the macroeconomic effectiveness of the stimulus. As a result, both fiscal and monetary policy have distributional implications, but the latter's are largely incidental, whereas the former's can be explicitly chosen.

In cases where economic activity is extremely depressed, monetary policy may lose some of its effectiveness. When interest rates become extremely low, interest-sensitive spending may no longer be very responsive to further rate cuts. Furthermore, interest rates cannot be lowered below zero. In this scenario, fiscal policy may be more effective. As is discussed in the next section, some would argue that the U.S. economy experienced this scenario following the recent financial crisis.

Of course, using monetary and fiscal policy to stabilize the economy are not mutually exclusive policy options. But because of the Fed's independence from Congress and the Administration, the two policy options are not always coordinated. If compatible fiscal and monetary policies are chosen by Congress and the Fed, respectively, then the economic effects would be more powerful than if either policy were implemented in isolation. For example, if stimulative monetary and fiscal policies were implemented, the resulting economic stimulus would be larger than if one policy were stimulative and the other were neutral. But if incompatible policies are selected, they could partially negate each other. For example, a stimulative fiscal policy and contractionary monetary policy may end up having little net effect on aggregate demand (though there may be considerable distributional effects). Thus, when fiscal and monetary policymakers disagree in the current system, they can potentially choose policies with the intent of offsetting each others' actions.²² Whether this arrangement is better or worse for the economy depends on what policies are chosen. If one actor chooses inappropriate policies, then the lack of coordination usefully allows the other actor to try to negate its effects.

The Recent and Current Stance of Monetary Policy

Until financial turmoil emerged in 2007, a consensus had emerged among economists that a relatively stable business cycle could be maintained through prudent and nimble changes to

²¹ See CRS Report RS21409, *The Budget Deficit and the Trade Deficit: What Is Their Relationship?*, by Marc Labonte and Gail E. Makinen.

²² It is important to take this possibility into consideration when evaluating the potential effects of fiscal policy on the business cycle. Because the Fed presumably chooses (and continually updates) a monetary policy that aims to keep the economy at full employment, the Fed would need to alter its policy to offset the effects of any stimulative fiscal policy changes that moved the economy above full employment. Thus, the actual net stimulative effect of a fiscal policy change (after taking into account monetary policy adjustments) could be less than the effects in isolation.

interest rates via transparently communicated and signaled open market operations. That consensus would break down as the financial crisis worsened, and the Fed took increasingly unconventional and unprecedented steps to restore financial stability.

Before the Financial Crisis

As the U.S. economy was coming out of the short and shallow 2001 recession, unemployment continued rising until mid-2003. Fearful that the economy would slip back into recession, the Fed kept the federal funds rate extremely low.²³ The federal funds target reached a low of 1% by mid-2003. As the expansion gathered momentum and prices began to rise, the federal funds target was slowly increased in a series of moves to 5¼% in mid-2006.

It is now argued by some economists that the financial crisis was, at least in part, due to Federal Reserve policy to ensure that the then-ongoing expansion continued.²⁴ In particular, critics now claim that the low short-term rates were kept too low for too long after the 2001 recession had ended, and this caused an increased demand for housing that resulted in a “price bubble.” The shift in financing housing from fixed to variable rate mortgages made this sector of the economy increasingly vulnerable to movements in short-term interest rates. An alternative perspective, championed by Chairman Bernanke and others, was that the low mortgage rates that helped fuel the housing bubble were mainly caused by a “global savings glut” over which the Fed had little control.²⁵ One consequence of the tightening of monetary policy later in the decade, critics now claim, was to burst this “price bubble” (a bubble that was also due, in part, to lax lending standards that were subject to regulation by the Fed and others).

Direct Assistance During and After the Financial Crisis

The bursting of the housing bubble led to the onset of a financial crisis that affected both depository institutions and other segments of the financial sector involved with housing finance. As the delinquency rates on home mortgages rose to record numbers, financial firms exposed to the mortgage market suffered capital losses and lost access to liquidity. The contagious nature of this development was soon obvious as other types of loans and credit became adversely affected. This, in turn, spilled over into the broader economy, as the lack of credit soon had a negative effect on both production and aggregate demand. In December 2007, the economy entered a recession.

As the spillover effects from the housing slump to the financial system, as well as its international scope, became apparent, the Fed responded by reducing the federal funds target and the discount rate.²⁶ Beginning on September 18, 2007, and ending on December 16, 2008, the target was reduced from 5¼% to a range between 0% and ¼%, where it currently remains.

²³ Historical and current targets for the federal funds rate can be found at <http://www.federalreserve.gov/fomc/fundsrate.htm>.

²⁴ In a WSJ opinion article, six economists are polled regarding if the Fed was to blame for creating the housing bubble that in part led to the recent financial crisis, and five of six responded that the Fed in some degree was to blame. See David Henderson, “Did the Fed Cause the Housing Bubble?,” *Wall Street Journal*, March 27, 2009.

²⁵ See Ben Bernanke, “The Global Saving Glut and the U.S. Current Account Deficit,” speech at the Virginia Association of Economists, March 10, 2005.

²⁶ For a detailed account of the Fed’s role in the financial crisis, see CRS Report RL34427, *Financial Turmoil: Federal* (continued...)

With liquidity problems persisting as the federal funds rate was reduced, it appeared that the traditional transmission mechanism linking monetary policy to activity in the broader economy was not working. It also began to concern the monetary authorities that the liquidity provided to the banking system was not reaching other parts of the financial system. Using only traditional monetary policy tools, additional monetary stimulus cannot be provided once the federal funds rate has reached its zero bound. To circumvent this problem, the Fed decided to use non-traditional methods to provide additional monetary policy stimulus.

First, the Federal Reserve introduced a number of emergency credit facilities to provide increased liquidity directly to financial firms and markets. The first facility was introduced in December 2007, and several were added after the worsening of the crisis in September 2008. These facilities were designed to fill perceived gaps between open market operations and the discount window. The loans primarily provided by these facilities were designed to provide short-term loans backed by collateral that exceeds the value of the loan.²⁷ A number of the recipients were non-banks that are outside the regulatory umbrella of the Federal Reserve; this marked the first time that the Fed lent to non-banks since the Great Depression. The Fed began to employ a seldom used emergency provision, Section 13(3) of the Federal Reserve Act,²⁸ that allows it to make loans to other financial institutions and to non-financial firms as well. The Fed justified their pursuit of this policy on the grounds that it falls under its mandate to “promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.”²⁹

The Fed provided assistance through liquidity facilities, which included both the traditional discount window and the newly created emergency facilities previously mentioned, and through direct support to two specific institutions, AIG and Bear Stearns. The magnitude of this assistance has been large. Total assistance from the Federal Reserve at the beginning of August 2007 was approximately \$234 million provided through liquidity facilities, with no direct support given. In mid-December 2008, it reached a high of \$1.6 trillion, with a near high of \$108 billion given in direct support. From that point on, it fell steadily. Assistance provided through liquidity facilities fell below \$100 billion in February 2010, and support to specific institutions fell below \$100 billion in January 2011.³⁰ By 2012, central bank liquidity swaps, discussed below, was the only facility created during the crisis that was still active, although some expired facilities still held legacy assets. With one exception, all assistance through expired facilities has been fully repaid with interest, and eventual repayment in that case is expected.³¹

(...continued)

Reserve Policy Responses, by Marc Labonte.

²⁷ See CRS Report R41073, *Government Interventions in Response to Financial Turmoil*, by Baird Webel and Marc Labonte.

²⁸ 12 U.S.C. 343.

²⁹ Federal Reserve Act, Section 2A, 12 USC 225a.

³⁰ Data from “Recent Balance Sheet Trends,” *Credit and Liquidity Programs and the Balance Sheet*, http://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm. Values include totals from credit extended through Federal Reserve liquidity facilities and support for specific institutions.

³¹ One facility, the Term Securities Lending Facility, still had long-term loans outstanding. The Fed expects that all assistance through this facility will be repaid with interest once the loans mature. For more information, see <http://www.federalreserve.gov/monetarypolicy/talf.htm>.

Central Bank Liquidity Swaps

The Fed's central bank liquidity swap lines, or temporary reciprocal currency agreements, are the only lending facility introduced during the recent financial crisis that is still active. The first swap lines were created in December 2007. Overall, ten central banks have drawn on the swap lines at some point, and four more were eligible to—but did not—use the swap lines.³² In October 2008, the Fed made the swap lines with certain countries unlimited in size. The swap lines expired in February 2010, but were subsequently reopened in May 2010 with the Bank of Canada, the Bank of England, the European Central Bank (ECB), the Bank of Japan, and the Swiss National Bank in response to the eurozone crisis. The Fed has extended the expiration date of the swap lines several times, most recently to February 1, 2014.

Under a swap with, say, the ECB, the ECB temporarily receives U.S. dollars and the Fed temporarily receives euros. After a fixed period of time (up to three months), the transaction is reversed. Interest on swaps is paid to the Fed at 0.5 percentage points above the U.S. dollar overnight index swap rate (OIS), a private borrowing rate. The temporary swaps are repaid at the exchange rate prevailing at the time of the original swap, meaning that there is no downside risk for the Fed if the dollar appreciates in the meantime (although the Fed also does not enjoy upside gain if the dollar depreciates). Except in the unlikely event that the borrowing country's currency becomes unconvertible in foreign exchange markets, there is no credit risk involved because the swap is with other central banks (the foreign central bank bears losses if the private bank it lends the dollars to defaults). The Fed has reported no losses under the program. The swaps were created under the section of the Federal Reserve Act providing authority for open market operations (Section 14); they did not require the emergency authority found in Section 13(3) of the Federal Reserve Act.³³

Swaps outstanding peaked at \$583 billion in December 2008 and fell to zero by March 2010. After reestablishment in May 2010, small amounts were drawn from May 2010 to March 2011. They were then unused between March and August 2011. Swaps outstanding increased suddenly in December 2011, averaging more than \$100 billion from late December to February 2012. Their use has since declined, and less than \$10 billion was outstanding by the end of 2012. To date, most of the swaps have been with the European Central Bank; the Bank of Japan has been the second largest counterparty.

Swap lines are intended to provide liquidity to private banks in non-domestic denominations. Because banks lend long-term and borrow short-term, a solvent bank can become illiquid, meaning it cannot borrow in private markets to meet short-term cash flow needs. For example, many European banks have borrowed in dollars to finance dollar-denominated transactions. Normally, foreign banks could finance their dollar-denominated borrowing through the private inter-bank lending market. As some banks have become reluctant to lend to each other through this market, central banks at home and abroad have taken a much larger role in providing banks with liquidity directly. Normally banks can only borrow from their home central bank, and central banks can only provide liquidity in their own currency. The Fed's swap lines allow foreign central banks to provide needed liquidity to their country's banks in dollars. News articles indicate that

³² U.S. Government Accountability Office, *Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance*, GAO-11-696, July 21, 2011, Appendix IX, <http://www.gao.gov/new.items/d11696.pdf>.

³³ Prior to the crisis, swaps had been used sporadically dating back to 1962, according to William Dudley, Testimony Before the Committee on Oversight and Government Reform, U.S. House of Representatives, December 16, 2011.

access to dollar liquidity deteriorated for European banks when the eurozone crisis has worsened.³⁴ Initially, the swap lines were designed to provide foreign central banks with access to U.S. dollars. In April 2009, the swap lines were modified so that the Fed could access foreign currency to provide to its banks as well; to date, the Fed has not done so.

Unconventional Policy Measures at the Zero Bound After the Crisis

Quantitative Easing and the Growth in the Balance Sheet and Bank Reserves

With direct lending falling as financial conditions began to normalize in 2009 and the federal funds rate at its zero bound, the Fed was faced with the decision of whether to try to provide additional monetary stimulus through unconventional measures. Its first decision was whether to maintain the elevated level of liquidity in the financial system now that assistance through its liquidity facilities was declining, in order to prevent a removal of monetary stimulus while the economy was still fragile. It decided to keep the liquidity in place, and in March 2009, the Fed announced plans to purchase \$300 billion of Treasury securities, \$200 billion of Agency debt (later revised to \$175 billion), and \$1.25 trillion of Agency mortgage-backed securities. These purchases were completed by the end of March 2010.³⁵ This was clearly not a “business as usual” monetary policy, but something quite extraordinary, sometimes referred to as “quantitative easing.” While there may not be a universally accepted definition of quantitative easing, this report defines it as actions to further stimulate the economy through growth in the Fed’s balance sheet once the federal funds rate has reached the “zero bound.”

Beginning in November of 2010, the Federal Reserve, dissatisfied with the high level of unemployment, took steps to encourage economic growth by purchasing an additional \$600 billion of Treasury securities and continuing the practice of replacing maturing securities. The purchases were made at a pace of \$75 billion a month and were completed in about eight months. The Fed has focused on purchasing securities with maturities between 2½ and 10 years in length.³⁶ This policy became popularly known as “QE2.” According to the Fed, these actions were taken to promote a stronger pace of economic recovery because progress to date toward the Fed’s policy objectives had been “disappointingly slow.”³⁷

After the completion of QE2, the Fed took no further monetary policy actions for about six months. On September 21, 2011, the Fed announced the Maturity Extension Program, which has been popularly coined “Operation Twist” after a similar 1961 program.³⁸ Under this program, the Fed purchased \$667 billion in long-term Treasury securities and sold an equivalent amount of

³⁴ See, for example, “The Dash for Cash,” *The Economist*, December 3, 2011, p. 85.

³⁵ In this context, Agency securities and MBS are primarily issued by Fannie Mae and Freddie Mac, with some securities issued by the Federal Home Loan Banks and Ginnie Mae. The Fed began purchasing Agency securities and MBS in smaller quantities in late 2008.

³⁶ CRS Report R41540, *Quantitative Easing and the Growth in the Federal Reserve’s Balance Sheet*, by Marc Labonte.

³⁷ Federal Reserve, “Federal Open Market Committee,” press release, November 3, 2010, <http://www.federalreserve.gov/newsevents/press/monetary/20101103a.htm>.

³⁸ The original Operation Twist was devised as a way to stimulate the economy given that monetary policy was constrained by the need to maintain the gold standard. Since such a constraint does not exist today under the current market-determined exchange rate, the Fed could have stimulated the economy through expansionary monetary policy instead, although at the zero bound, this would have been limited to unconventional forms of stimulus, such as quantitative easing.

short-term Treasury securities from its portfolio. The program expired at the end of 2012. The Fed has argued that the Maturity Extension Program will stimulate the economy by reducing long-term borrowing rates throughout the economy.³⁹ Unlike “quantitative easing,” the Maturity Extension Program has no effect on the size of the Fed’s balance sheet, bank reserves, or the monetary base. For this reason, the Maturity Extension Program would be expected to have a smaller effect on economic growth, interest rates, and inflation than if an equivalent amount of Treasury securities were bought through quantitative easing (i.e., if the purchase of long-term Treasury securities were not “sterilized” by the sale of short-term securities). The Maturity Extension Program ended at the end of 2012. The Fed announced that it would continue to purchase \$45 billion in long-term Treasury securities each month, but would no longer offset those purchases through the sale of short-term Treasury securities.

On September 13, 2012, in light of continuing high unemployment and inflation slightly below its long-term target, the Fed announced it would restart large-scale asset purchases (popularly referred to as “QE3”), pledging to purchase \$40 billion of government-sponsored enterprise (GSE) mortgage-backed securities (MBS) per month. Coupled with its monthly purchases of Treasury securities, QE3 is a modestly higher monthly purchase rate than QE2. Unlike the previous two rounds of asset purchases, the Fed specified no planned end date to its purchases, instead pledging to continue purchases until labor markets improved, in a context of price stability.⁴⁰ Some economists have argued that pledging to pursue a policy for “as long as it takes” is more effective than announcing a limited and predetermined duration.⁴¹

To understand the effect of quantitative easing on the economy, it is first necessary to describe its effect on the Fed’s balance sheet. The assistance provided by the Federal Reserve to banks and non-bank institutions is considered an asset on the Fed’s balance sheet because it represents money owed to or assets owned by the Fed. This assistance and its holdings of Treasury securities, MBS, and GSE debt comprise most of the assets on the Fed’s balance sheet.

From the time its first emergency lending facility was introduced in December 2007 until the crisis worsened in September 2008, the Fed “sterilized” the effects of lending on its balance sheet by selling Treasury securities. After September 2008, the Fed allowed its balance sheet to grow, and between September and November 2008, it more than doubled in size, increasing from under \$1 trillion to over \$2 trillion. The increase in assets during this time took the form of direct assistance to the financial sector through emergency liquidity facilities.

From November 2008 to November 2010, the overall size of the Fed’s balance sheet did not vary much; however, its composition changed. As of December 2010, loans made up \$46 billion of the \$2,427 billion of the Fed’s balance sheet and securities made up \$2,225 billion. The purchases of \$600 billion in Treasury securities increased the balance sheet from \$2.3 trillion in November 2010 to \$2.9 trillion. It remained around that level until September 2012, when it began rising at roughly the same monthly rate as asset purchases (\$85 billion since December 2012) for the duration of QE3. It was about \$3 trillion at the end of 2012.

³⁹ Federal Reserve, *Press Release*, September 21, 2011, <http://www.federalreserve.gov/newsevents/press/monetary/20110921a.htm>.

⁴⁰ Federal Reserve, *Press Release*, September 13, 2012, <http://www.federalreserve.gov/newsevents/press/monetary/20120913a.htm>.

⁴¹ Michael Woodford, “Methods of Policy Accommodation at the Interest-Rate Lower Bound,” working paper, August 2012, available at <http://www.kansascityfed.org/publicat/sympos/2012/mw.pdf?sm=jh083112-4>.

This increase in the Fed's assets must be matched by a corresponding increase in its liabilities on its balance sheet, mostly in the form of currency, bank reserves, and cash deposited by the U.S. Treasury at the Fed. Bank reserves increased from about \$46 billion in August 2008 to \$820 billion at the end of 2008. Since October 2009, bank reserves held at the Fed have been between \$1 trillion and \$1.7 trillion.⁴² The increase in bank reserves can be seen as the inevitable outcome of the increase in assets held by the Fed because they, in effect, financed the Fed's asset purchases and loan programs. Reserves increase because the loans or proceeds from asset purchases are credited to the recipients' reserve accounts at the Fed.

Whether the additional reserves will be lent out by banks, resulting in lower market interest rates and an expansion of new spending, as posited in the textbook explanation of how monetary policy works, is another story. Recent experience is not reassuring, as the large volume of reserves added to the banking system by the Fed have remained as excess bank reserves, without commensurate increases in lending or other activities by banks. Some economists fear that the response of banks to additional reserves is a sign that the economy has entered a "liquidity trap," where total spending in the economy (aggregate demand) is unresponsive to additional monetary stimulus. This phenomenon could help explain why the unprecedented growth in the monetary base (the portion of the money supply controlled by the Fed) has not translated into higher inflation to date. Critics fear that it is simply a matter of time before quantitative easing leads to high inflation, and argue that these long-term risks outweigh any modest short-term benefits.⁴³

By contrast, the Fed has argued that quantitative easing has successfully stimulated the economy, mainly through lower long-term interest rates.⁴⁴ Janet Yellen, vice chair of the Board of Governors of the Federal Reserve System, defended these policies in a recent speech. She argues that the evidence has shown that the financial securities purchases by the Federal Reserve have proven effective in easing financial conditions. With unemployment remaining high and expectations that inflation will be low over the medium run, she argues that the accommodative stance of the Fed regarding their monetary policy is appropriate.⁴⁵ Some critics have questioned whether quantitative easing has been effective, given economic growth remains sluggish.

Another concern is that by purchasing MBS, the Fed is allocating credit to the housing sector, putting the rest of the economy at a disadvantage compared with that sector. Arguments in favor of MBS purchases are that housing is the sector of the economy most in need of stabilization, given the nature of the crisis; MBS markets are more liquid than most alternatives, limiting the potential for the Fed's purchases to be disruptive; and that there are few other assets that the Fed is legally permitted to purchase, besides Treasury securities.

⁴² See H.3. Federal Reserve Statistical Releases, Aggregate Reserves of Depository Institutions and the Monetary Base at <http://www.federalreserve.gov/releases/h3/Current>.

⁴³ See, for example, "An Open Letter to Chairman Bernanke," November 15, 2010, <http://economics21.org/commentary/e21s-open-letter-ben-bernanke>.

⁴⁴ For a thorough discussion and defense of the Fed's recent actions, see Chairman Ben Bernanke, "Monetary Policy Since the Onset of the Crisis," speech at the Federal Reserve Bank of Kansas City Economic Symposium, August 31, 2012, available at <http://www.federalreserve.gov/newsevents/speech/bernanke20120831a.htm>. See also Thomas Bullard, *Effective Monetary Policy in a Low Interest Rate Environment*, The Henry Thornton Lecture, Cass Business School, London, March 24, 2009.

⁴⁵ Board of Governors of the Federal Reserve System, "2011 International Conference," speech by Janet L. Yellen on June 1, 2011, <http://www.federalreserve.gov/newsevents/speech/yellen20110601a.htm>.

The Fed's securities holdings earn interest that the Fed uses to fund its operations. (The Fed receives no appropriations from Congress.) The Fed's income exceeds its expenses, and it remits most of its net income to the Treasury, which uses it to reduce the budget deficit. While the increase in first lending and then mortgage-related securities increased the potential riskiness of the Fed's balance sheet, its ex-post effect was to more than double the Fed's net income and remittances to Treasury. Remittances to Treasury rose from \$35 billion in 2007 to \$79 billion in 2010, and were \$89 billion in 2012.

Forward Commitment

Another tool that the Fed has used recently in an attempt to achieve additional monetary stimulus at the zero bound is to announce that the Fed plans to keep the federal funds rate low for an extended period of time, which has been called "forward guidance" or "forward commitment." Over time, this forward guidance has become more detailed and explicit. In September 2012, the Fed extended its expected time frame for "exceptionally low levels for the federal funds rate" from late 2014 to mid-2015. In December 2012, the Fed replaced the date threshold with an economic threshold: it pledged to maintain an "exceptionally low" federal funds target at least as long as unemployment is above 6.5% and inflation is low.

It is difficult to pinpoint how effective the forward guidance tool has been, in part because it depends on how credible the market finds the commitment. A problem with this approach is that economic conditions may unexpectedly change (e.g., inflation is higher than expected), so this commitment is likely only a contingent one.

Congressional Oversight and Disclosure

Critics of the Federal Reserve have long argued for more oversight, transparency, and disclosure.⁴⁶ Criticism intensified following the extensive assistance provided by the Fed during the financial crisis. More specifically, critics have focused on the Government Accountability Office (GAO) audits of the Fed and the disclosure of details on the identities of borrowers and the terms of those loans.

Some critics have downplayed the degree of Fed oversight and disclosure that already takes place. For oversight, the Fed has been required by statute to report to and testify before the House and Senate committees of jurisdiction semi-annually since 1978. At these hearings, which take place in February and July, the Fed Chairman presents the Fed's *Monetary Policy Report to the Congress*, testifies, and responds to questions from committee members.⁴⁷ In addition, these committees periodically hold more focused hearings on Fed topics. On January 25, 2012, the Fed began publishing its forecasts for its federal funds rate target, and announced a longer-run goal of 2% for inflation. The Fed hopes that greater transparency about its intentions will strengthen understanding of its actions by financial market participants, thereby making its actions more effective.

⁴⁶ For more information, see CRS Report R42079, *Federal Reserve: Oversight and Disclosure Issues*, by Marc Labonte.

⁴⁷ These hearings and reporting requirements were established by the Full Employment Act of 1978 (P.L. 95-523, 92 Stat 1897), also known as the Humphrey-Hawkins Act, and renewed in the American Homeownership and Economic Opportunity Act of 2000 (P.L. 106-569).

Contrary to popular belief, GAO has conducted frequent audits of the Fed since 1978, subject to statutory restrictions. In addition, the Fed's financial statements are audited by private-sector auditors. The Dodd-Frank Act (P.L. 111-203) resulted in an audit of the Fed's emergency activities during the financial crisis, released in July 2011, and an audit of Fed governance, released in October 2011. The effective result of the audit restrictions remaining in law is that GAO cannot evaluate the economic merits of Fed policy decisions. In the 112th Congress, the House passed H.R. 459 on July 25, 2012, which would remove all statutory restrictions on GAO audits.

For disclosure, the Fed has publicly released extensive information on its operations, mostly on a voluntary basis. For example, it has long released a weekly summary of its balance sheet. The expanded scope of its lending activities during the financial crisis eventually led it to release a monthly report that offered more detailed information. Historically, the Fed had never released information on individual loans, such as the names of borrowers or amounts borrowed, however. In December 2010, as a result of the Dodd-Frank Act, the Fed released individual lending records for emergency facilities, revealing borrowers' identities. Going forward, individual records for discount window and open market operation transactions will be released with a two-year lag. In addition, Freedom of Information Act lawsuits filed by Bloomberg and Fox News Network resulted in the release of individual lending records for the discount window (the Fed's traditional lending facility for banks).

Although oversight and disclosure are often lumped together, they are separate issues and need not go together. Oversight relies on independent evaluation of the Fed; disclosure is an issue of what internal information the Fed releases to the public. Contrary to a common misperception, a GAO audit would not, under current law, result in the release of any confidential information identifying institutions that have borrowed from the Fed or the details of other transactions.

A potential consequence of greater oversight is that it could undermine the Fed's political independence, which is discussed in the next section. The challenge for Congress is to strike the right balance between a desire for the Fed to be responsive to Congress and for the Fed's decisions to be somewhat immune from political calculations. A potential drawback to greater disclosure is that publicizing the names of borrowers could potentially stigmatize them in a way that causes runs on those borrowers or causes them to shun access to needed liquidity. Either outcome could result in a less stable financial system. A potential benefit of publicizing borrowers is to safeguard against favoritism or other conflicts of interest.

The Federal Reserve's Mandate and Its Independence

The Constitution grants Congress the power to "coin money, and regulate the value thereof..." However, operational responsibility for making U.S. monetary policy has been delegated by Congress to the Fed. Congress is still responsible for oversight, setting the Fed's mandate, and approving the President's nominations for the Fed's Board of Governors, but several institutional features grant the Fed significant "independence" from the political process.⁴⁸ The Federal Reserve system is quasi-public in structure: its regional banks are owned by its member banks.

⁴⁸ For more information, see CRS Report RL31056, *Economics of Federal Reserve Independence*, by Marc Labonte.

The governors are appointed to staggered 14-year terms, and can only be removed by Congress for cause. It is self-funded and its budget is not subject to the congressional appropriations process. It has been granted broad *discretion* to interpret and carry out its congressional mandate as it sees fit on a day-to-day basis.

Although the Fed's statutory mandate might be expected to be a significant curb on its independence, The Federal Reserve Act of 1977 (P.L. 95-188, 91 Stat. 1387) charged the Fed with "the goals of maximum employment, stable prices, and moderate long-term interest rates." Note that the Fed controls none of these three indicators directly; it controls only overnight interest rates through the use of open market operations, the discount window, and reserve requirements. There will be times when the goals will be at odds with each other, and the Fed will have to choose to pursue one at the expense of the other two. For example, an energy price shock would be expected to raise prices and reduce employment. In this case, the current mandate could be used to justify expansionary monetary policy in response to lower employment or contractionary monetary policy in response to higher prices. Critics have argued that the ambiguity inherent in the current mandate makes for less than optimal transparency and accountability. It may also strengthen political independence if it allows the Fed to deflect congressional criticism by pointing, at any given time, to whatever goal justifies its current policy stance.

The most popular alternative to the current mandate is to replace it with a single mandate of price stability.⁴⁹ This proposal is often coupled with a proposal for the Fed to be given a numerical inflation target, and the Fed would then be required to set monetary policy with the goal of meeting the target on an ongoing basis. Proponents of inflation targeting say that maximum employment and moderate interest rates are not meaningful policy goals because monetary policy has no long-term influence over either one. They argue a mandate that is focused on keeping inflation low would deliver better economic results and improve transparency and oversight. Opponents, including former Fed chairman Greenspan, say that the flexibility inherent in the current system has served the United States well in the past 25 years, delivering both low inflation and economic stability, and there is little reason to fix a system that is not broken. They argue that some focus on employment is appropriate given that monetary policy has powerful short-term effects on it, and that too great a focus on inflation could lead to an overly volatile business cycle. Various forms of inflation targeting have been adopted abroad.⁵⁰ Other economists argue that a single mandate would do little to curb the Fed's independence, and would therefore have little practical effect on its decision making.

Without any statutory changes, the Fed has taken steps similar to some of the features of an inflation targeting regime by publishing its longer-run goal for inflation (which it set at a 2% increase in the personal consumption expenditures price index) and releasing its projections of inflation and the federal funds rate target beginning in January 2012. Whether this amounts to *de facto* inflation targeting will depend on how monetary policy will react to future deviations from this longer-run goal.

Most economists argue that central bank independence leads to good monetary policy because it reduces the temptation to raise inflation in the long run in order to lower unemployment in the short run. Researchers have made cross-country comparisons to try to make the case that

⁴⁹ See CRS Report R41656, *Changing the Federal Reserve's Mandate: An Economic Analysis*, by Marc Labonte.

⁵⁰ See CRS Report RL31702, *Price Stability (Inflation Targeting) as the Sole Goal of Monetary Policy: The International Experience*, by Marc Labonte and Gail E. Makinen.

countries with independent central banks are more likely to have low inflation rates and better economic performance.⁵¹ As noted in the previous section, independence from Congress may make oversight less effective, however.

Other policymakers express concern about the Fed's independence from the private banks that are members of the Federal Reserve System. National banks are required to, and state banks can choose to, pay into the capital stock of the Fed to become members. The Fed regulates its member banks for safety and soundness, and lends to them through the discount window. Currently, six of the nine directors of the 12 Federal Reserve regional banks are chosen by the member banks, and three of those six directors are from the banking industry. The regional bank directors primarily play an advisory role, although the six directors that are not from the banking industry choose the Fed's regional bank presidents.⁵² Further, policy is set by the Board, not the regional banks, with the exception of monetary policy, which is set by the Federal Open Market Committee, composed of the seven governors, the President of the New York Fed, and four other regional bank presidents on a rotating basis. Past proposals have sought to strengthen the powers of the regional bank presidents at the expense of the Board of Governors, and vice versa. Other proposals have sought to remove the member banks' representatives from the boards of the Federal Reserve regional banks.

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⁵¹ For a review of the research and criticisms, see CRS Report RL31955, *Central Bank Independence and Economic Performance: What Does the Evidence Show?*, by Marc Labonte and Gail E. Makinen.

⁵² The selection of regional bank presidents was altered by the Dodd-Frank Act (P.L. 111-203). Previously, all nine directors of the regional banks selected the regional bank presidents.