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THE ECONOMIC OUTLOOK

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED TWELFTH CONGRESS

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THE ECONOMIC OUTLOOK

TUESDAY, OCTOBER 4, 2011

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to call, at 10:00 a.m. in Room G–50 of the Dirksen Senate Office Building, the Honorable Robert P. Casey, Jr., Chairman, presiding.

Senators present: Casey, Klobuchar, Sanders, DeMint, Coats, and Lee.

Representatives present: Brady, Burgess, Campbell, Duffy, Amash, Mulvaney, Hinchey, Maloney, and Cummings.

Staff present: Brenda Arredondo, Gail Cohen, Will Hansen, Colleen Healy, Jesse Hervitz, Madi Joyce, Matt Salomon, Ted Boll, Connie Foster, Robert O'Quinn, Sean Ryan, Jeff Schlagenhauf, Michael Connolly, and Rachel Greszler.

OPENING STATEMENT OF HON. ROBERT P. CASEY, JR., CHAIRMAN, A U.S. SENATOR FROM PENNSYLVANIA

Chairman Casey. The hearing will come to order.

I look forward to Chairman Bernanke's report on the state of the economy, his perspective on recent actions taken by the Federal Reserve, and his insights into the short- and long-term, long-run, I should say, challenges facing the United States economy.

My hope for today's hearing is to move beyond the partisan politics and finger pointing that sometimes colors discussions about the Federal Reserve and what it should or should not do. Instead, I think we should focus today on the economic challenges facing the country and the potential solutions to those problems.

All of us on this Committee share a belief that Congress needs to take action to bolster the economy and to help Americans get back to work. Similarly, monetary policy has an important role to play in strengthening our economy.

Millions of Americans are still struggling in the wake of the Great Recession. The economy is not growing fast enough or adding enough jobs to make significant progress in reducing unemployment.

Just by way of example:

Fourteen million Americans are unemployed and 6 million of the jobless—some 43 percent—have been out of work for 6 months or more.

Second, private-sector job creation which had been well above 200,000 a month in February, March, and April, fell to less than 20,000 in August.

State and local governments are reeling as they lay off workers to meet balanced budget requirements. In the past 12 months alone, state and local government payrolls have been slashed by 345,000.

In my home State of Pennsylvania, the unemployment rate—after declining to 7.4 percent in May—has climbed back to 8.2 percent in August, with more than a half a million people out of work.

Economic indicators also have been weakening abroad. With financial conditions in the Eurozone deteriorating, contagion spreading to other parts of the world is now a significant risk to the global economic outlook.

The Fed has already used a variety of approaches to ease monetary policy. In the current economic environment, we need to use all available tools to support our economy in the short run. We also need to take the actions that will get our fiscal house in order in the medium and long term. The two reinforce each other. Getting our economy growing at a healthy pace is critical to sustained deficit reduction.

As Chairman Bernanke observed in a September speech to the Economic Club of Minnesota—and I am quoting: "There is ample room for debate about the appropriate size and role for the government in the longer term, but—in the absence of adequate demand from the private sector—a substantial fiscal consolidation in the shorter term could add to the headwinds facing economic growth and hiring."

The Federal Reserve Act created the Federal Reserve System and established objectives for the Nation's monetary policy: maximum employment and stable growth—stable prices, I should say. This is what is commonly referred to as the Fed's dual mandate: maximum employment and stable prices.

The Federal Reserve's recent announcement that it will ease monetary policy further is consistent with that dual mandate. The Federal Open Market Committee said it will purchase $400 billion of long-term Treasury Securities and pay for those Securities by selling an equal amount of shorter-term government debt. In the so-called Operation Twist, the Fed is not expanding its portfolio but shifting its composition so that the average maturity of its holdings is longer.

The goal of the Fed's action is to bring down long-term interest rates further—reducing borrowing costs for businesses and consumers, sparking additional economic activity, and ultimately boosting employment. The Fed also affirmed that it will continue to pay close attention to inflation and inflation expectations.

Some in Washington have called on the Fed to, quote, "resist further extraordinary intervention in the U.S. economy", unquote, arguing that action by the Fed could further harm the U.S. economy.

I disagree. With so many Americans out of work, and with GDP growth having slowed to less than half of one percent annual rate in the first half of this year, additional actions are needed to strengthen the economy.

Let me say a word before I conclude about an issue that is in front of the Senate right now: currency as it relates to China.

This problem has had a substantial harmful impact on the U.S. economy and American jobs. A recent report by the Economic Pol-

icy Institute finds that the U.S. trade deficit with China—caused in large measure by China's undervaluation of the yuan—has cost our economy 2.8 million jobs over the past decade.

Chairman Bernanke, in testimony before this Committee in April of 2010, noted that, quote, "most economists agree that the Chinese currency is undervalued and has been used to promote a more export-oriented economy." Unquote. The Chairman also said at the time that it would be, quote, "good for the Chinese to allow more flexibility in their exchange rate," unquote, and that, quote, "we should continue to press for a more flexible exchange rate." Unquote.

I agree with those statements by the Chairman. This week the Senate has the opportunity to take action in response to China's unfair trade practices when we vote on bipartisan legislation to crack down, at long last, on China's currency manipulation. Last night the Senate passed the first procedural hurdle with a strong bipartisan vote to move forward with debate on the legislation.

So to sum up briefly, more than two years after the recovery officially began, our economy remains very vulnerable. Unemployment is stuck above 9 percent, and long-term unemployment remains at near record levels. We need to use every weapon in our arsenal to support a stronger economic recovery.

Chairman Bernanke, thank you for being here today. Thank you for your testimony that you are about to give in a few moments, and I look forward to working with you and others to make sure that we can focus on the economy, creating jobs, and putting America back to work.

[The prepared statement of Senator Casey appears in the Submissions for the Record on page 46.]

Vice Chairman Brady.

OPENING STATEMENT OF HON. KEVIN BRADY, VICE CHAIRMAN, A U.S. REPRESENTATIVE FROM TEXAS

Vice Chairman Brady. Chairman Casey, I join with you in welcoming Chairman Bernanke to today's hearing on the economic outlook.

Unfortunately, ominous clouds are gathering. Economic growth is nearly stagnant. We have 6.8 million fewer payroll jobs today than when the recession began in December 2007.

According to economists Carmen Reinhart and Kenneth Rogoff, recoveries from financial crises are weak and vulnerable to external shocks that may trigger double-dip recessions.

Republican Members of Congress recognize this. We are critical of the President's expensive economic policies because not only have they failed to spur job growth and restore business and consumer confidence, but also, as we feared, they have left America susceptible to a double-dip recession.

Today as we meet, America faces a growing risk from the European debt crisis. The United States and the European Union are major trading partners. I am very concerned about the effects of contagion from the euro crisis on American financial institutions and markets, as well as the broader economy. I am anxious, Mr. Chairman, to hear your assessment of the euro crisis and any steps that the Federal Reserve may take to quarantine any contagion.

In response to the financial panic, the Federal Reserve took extraordinary actions to stabilize U.S. financial institutions and markets during the fall of 2008. Many of these actions were both necessary and proper. Instead of rehashing the past, however, I would instead like to initiate a discussion on the framework for monetary policy in the future.

Nobel Laureate economist Robert Mundell said, "If you want a certain policy outcome, you have to use the right policy lever." Unfortunately, too many Washington policymakers are ignoring Mundell's wisdom.

Monetary policy affects prices. In contrast, budget, tax, and regulatory policies affect real output and jobs. While the Great Contraction from August 1929 to March of 1933 proved that bad monetary policy can shrink production and destroy jobs, good monetary policy cannot accelerate economic growth or foster job creation except in the very short term.

Washington—Congress—affects business investment, production, and job creation through its budget, tax, and regulatory policies. If the prospects for a swelling federal debt, higher taxes, and additional costs from the President's health care plan, as well as burdensome regulations, are deterring entrepreneurs from investing in new buildings, equipment, and software and therefore hiring more workers, there is little that the Federal Reserve can do to overcome this drag.

Until 1978, the Federal Reserve's mandate regarding monetary policy was merely to provide "an elastic currency." That year, the Full Employment and Balanced Growth Act, known informally as the Humphrey-Hawkins Act, was enacted. This Act imposed a dual mandate on the Federal Reserve that gives equal weight to achieving both price stability and full employment.

Since 1978, many countries have examined what a central bank should do and have opted for a single mandate for long-term price stability. By law, the 17 member states of the European Monetary Union and 13 other developed and major developing countries have enshrined mandates for price stability either as the sole goal or the primary goal with the subordination of other goals for their central banks. Moreover, Australia and Canada have adopted single mandates through published statements.

The time has come for Congress to reconsider the Federal Reserve's mandate. In my view, the dual mandate should be replaced with a single mandate for long-term price stability. I will introduce legislation to make this change in the near future.

While some may mistakenly claim that a single mandate means maximizing employment is unimportant, history proves the best way for the Federal Reserve to maximize employment is to focus on achieving long-term price stability.

Under a single mandate, the Federal Reserve would publicly announce an inflation target. The Federal Reserve would retain full operational independence from both Congress and the President to achieve that inflation target.

While I may criticize certain actions that the Federal Reserve has taken, I want to be absolutely clear. For our economy's sake, the Federal Reserve must remain independent and free from any undue political pressure in implementing monetary policy.

Congress should also reconsider the Federal Reserve's lender-of-last-resort policy. I remain deeply concerned about the precedents set in 2008 regarding clearly insolvent financial institutions—especially AIG, Bear Stearns, Fannie Mae, and Freddie Mac.

In 1913, Congress envisioned the Federal Reserve would act as lender-of-last-resort during financial crises. However, the Federal Reserve has never articulated a clear lender-of-last-resort policy.

As celebrated economist Allan Meltzer observed:

"The absence of a [lender-of-last-resort] policy has three unfortunate consequences. First, uncertainty increases. No one can know what will be done. Second, troubled firms have a stronger incentive to seek a political solution. They ask Congress or the administration for support or to pressure the Federal Reserve or other agencies to save them from failure. Third, repeated rescues encourage banks to take greater risk and increase leverage. This is the well-known moral hazard problem." End of quote.

If the Federal Reserve were to promulgate a clear statement about its lender-of-last-resort policy, it would go far to diminish uncertainty, reduce the likelihood of political interventions, and mitigate the moral hazard problem.

Finally, many years ago Congress gave the responsibility for exchange rate policy to the Secretary of the Treasury. This is a vestige of the long defunct Bretton Woods system of fixed exchange rates.

By controlling the money supply, the Federal Reserve directly affects the foreign exchange value of the U.S. dollar. Moreover, swings in exchange rates influence domestic prices. Thus, the responsibility for exchange rate policy should be moved from the Secretary of the Treasury to the Federal Reserve.

Chairman Bernanke, I look forward to your testimony and the questions that follow it.

I yield back.

[The prepared statement of Representative Brady appears in the Submissions for the Record on page 47.]

Chairman Casey. Thank you, Mr. Vice Chair.

Chairman Bernanke, I would like to provide a brief introduction. Dr. Ben Bernanke began a second term as Chairman of the Board of Governors of the Federal Reserve System on February the first, 2010. Dr. Bernanke also serves as Chairman of the Federal Open Market Committee, the System's principal monetary policymaking body. He originally took office as Chairman on February the first, 2006, when he also began a 14-year term as a member of the Board. Dr. Bernanke was Chairman of the President's Council of Economic Advisers from June 2005 to January 2006. Prior to beginning public service, Dr. Bernanke was a Chaired Professor at Princeton University, and he has been a Professor of Economics and Public Affairs at Princeton since 1985.

Dr. Bernanke, it is good to have you here.

STATEMENT OF HON. BEN S. BERNANKE, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Chairman Bernanke. Thank you.

Chairman Casey, Vice Chairman Brady, and other members of the Committee, I appreciate this opportunity to discuss the economic outlook and recent monetary policy actions.

It has been three years since the beginning of the most intense phase of the financial crisis in the late summer and fall of 2008, and more than two years since the economic recovery began in June 2009.

There have been some positive developments:

The functioning of financial markets and the banking system in the United States has improved significantly.

Manufacturing production in the U.S. has risen nearly 15 percent since its trough, driven substantially by growth in exports; indeed, the U.S. trade deficit has been notably lower recently than it was before the crisis, reflecting in part the improved competitiveness of U.S. goods and services.

Business investment in equipment and software has continued to expand, and productivity gains in some industries have been impressive.

Nevertheless, it is clear that overall the recovery from the crisis has been much less robust than we had hoped. Recent revisions of government economic data show that the recession was even deeper, and the recovery even weaker than previously estimated. Indeed, by the second quarter of this year—the latest quarter for which official estimates are available—aggregate output in the United States still had not returned to the level that it had attained before the crisis. Slow economic growth has in turn led to slow rates of increase in jobs and household incomes.

The pattern of sluggish growth was particularly evident in the first half of this year, with real GDP estimated to have increased at an average annual rate of less than one percent. Some of this weakness can be attributed to temporary factors.

Notably, earlier this year political unrest in the Middle East and North Africa, strong growth in emerging market economies, and other developments contributed to significant increases in the prices of oil and other commodities which damped consumer purchasing power and spending. And the disaster in Japan disrupted global supply chains and production, particularly in the automobile industry.

With commodity prices having come off their highs, and manufacturers' problems with supply chains well along toward resolution, growth in the second half of the year seems likely to be more rapid than in the first half.

However, the incoming data suggest that other, more persistent factors also continue to restrain the pace of recovery. Consequently, the Federal Open Market Committee, the FOMC, now expects a somewhat slower pace of economic growth over coming quarters than it did at the time of the June meeting when Committee participants most recently submitted their economic forecasts.

Consumer behavior has both reflected and contributed to the slow pace of recovery. Households have been very cautious in their spending decisions as declines in house prices and in the values of financial assets have reduced household wealth, and many families continue to struggle with high debt burdens or reduced access to credit.

Probably the most significant factor depressing consumer confidence, however, has been the poor performance of the job market. Over the summer, private payrolls rose by only about 100,000 jobs per month on average—half of the rate posted earlier this year.

Meanwhile, state and local governments have continued to shed jobs as they have been doing now for more than two years. With these weak gains in employment, the unemployment rate has held close to 9 percent since early this year. Moreover, recent indicators—including new claims for unemployment insurance and surveys of hiring plans—point to the likelihood of more sluggish job growth in the period ahead.

Other sectors of the economy are also contributing to the slower-than-expected rate of expansion. The housing sector has been a significant driver of recovery for most recessions in the United States since World War II. This time, however, a number of factors—including the overhang of distressed and foreclosed properties, tight credit conditions for builders and potential home buyers, and the large number of "underwater" mortgages—have left the new rate of home construction at only about one-third of its average level in recent decades.

In the financial sphere, as I noted, banking and financial conditions in the United States have improved significantly since the depths of the crisis. Nonetheless, financial stresses persist.

Credit remains tight for many households, small businesses, and residential and commercial builders, in part because weaker balance sheets and income prospects have increased the perceived credit risk of many potential borrowers.

We have also recently seen bouts of elevated volatility and risk aversion in financial markets, partly in reaction to fiscal concerns both here and abroad. Domestically, the controversy during the summer regarding the raising of the federal debt ceiling and the downgrade of the U.S. long-term credit rating by one of the major rating agencies contributed to the financial turbulence that occurred at about that time.

Outside the United States, concerns about sovereign debt in Greece and other euro-zone countries, as well as about the sovereign debt exposures of the European banking system, have been a significant source of stress in global financial markets.

European leaders are strongly committed to addressing these issues, but the need to obtain agreement among a large number of countries to put in place the necessary backstops and to address the sources of the fiscal problems has slowed the process of finding solutions.

It is difficult to judge how much these financial strains have affected U.S. economic activity thus far, but there seems little doubt that they have hurt household and business confidence, and that they pose ongoing risks to growth.

Another factor likely to weigh on the U.S. recovery is the increasing drag being exerted by the government sector. Notably, state and local governments continue to tighten their belts by cutting spending and employment in the face of ongoing budgetary pressures, while the future course of the federal fiscal policies remains quite uncertain.

To be sure, fiscal policymakers face a complex situation. I would submit that in setting tax and spending policies for now and the future, policymakers should consider at least four key objectives.

One crucial objective is to achieve long-run fiscal sustainability. The federal budget is clearly not on a sustainable path at present. The Joint Select Committee on Deficit reduction formed as part of the Budget Control Act is charged with achieving $1.5 trillion in additional deficit reduction over the next 10 years on top of the spending caps enacted this summer. Accomplishing that goal would be a substantial step. However, more will be needed to achieve fiscal sustainability.

A second important objective is to avoid fiscal actions that could impede the ongoing economic recovery. These first two objectives are certainly not incompatible, as putting in place a credible plan for reducing future deficits over the longer term does not preclude attending to the implications of fiscal choices for the recovery in the near term.

Third, fiscal policy should aim to promote long-term growth and economic opportunity. As a Nation, we need to think carefully about how federal spending priorities and the design of the tax code affect the productivity and vitality of our economy in the longer term.

Fourth, there is evident need to improve the process for making long-term budget decisions to create greater predictability and clarity while avoiding disruptions to the financial markets and the economy.

In sum, the Nation faces difficult and fundamental fiscal choices which cannot be safely or responsibly postponed.

Returning to the discussion of the economic outlook, let me turn now to the prospects for inflation. Prices of many commodities—notably oil—increased sharply earlier this year and, as I noted, led to higher retail gasoline and food prices.

In addition, producers of other goods and services were able to pass through some of these higher input costs to their customers. Separately, the global supply disruptions associated with the disaster in Japan put upward pressure on prices of motor vehicles.

As a result of these influences, inflation picked up during the first half of this year. Over that period, the price index for personal consumption expenditures rose at an annual rate of about 3–1/2 percent, compared with an average of less than 1–1/2 percent over the preceding two years.

As the FOMC anticipated, however, inflation has begun to moderate as these transitory influences wane. In particular, the prices of oil and many other commodities have either leveled off or have come down from their highs, and the step-up in automobile production has started to reduce the pressures on the prices of cars and light trucks.

Importantly, the higher rate of inflation experienced so far this year does not appear to have become ingrained in our economy. Longer-term inflation expectations have remained stable according to surveys of households and economic forecasters, and the five-year-forward measure of inflation compensation derived from yields on nominal and inflation-protected Treasury Securities suggests

that inflation expectations among investors may have moved lower recently.

In addition to the stability of longer term inflation expectations, the substantial amount of resource slack in U.S. labor and product markets should continue to restrain inflationary pressures.

In view of the deterioration in the economic outlook over the summer and the subdued inflation picture over the medium run, the FOMC has taken several steps recently to provide additional policy accommodation.

At the August meeting, the Committee provided greater clarity about its outlook for the level of short-term interest rates by noting that economic conditions were likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.

And at our meeting in September, the Committee announced that it intends to increase the average maturity of the securities in the Federal Reserve's portfolio.

Specifically, it intends to purchase by the end of June 2012, $400 billion of Treasury Securities with remaining maturities of 6 years to 30 years, and to sell an equal amount of Treasury Securities with remaining maturities of 3 years or less, leaving the size of our balance sheet approximately unchanged.

This maturity extension program should put downward pressure on longer-term interest rates and help make broader financial conditions more supportive of economic growth than they would otherwise have been.

The Committee also announced in September that it will begin reinvesting principal payments on its holdings of agency debt and agency mortgage-backed securities—into agency mortgage-backed securities, rather than into long-term Treasury Securities.

By helping to support mortgage markets, this action too should contribute to a stronger economic recovery. The Committee will continue to closely monitor economic developments and is prepared to take further action as appropriate to promote a stronger economic recovery in a context of price stability.

Monetary policy can be a powerful tool, but it is not a panacea for the problems currently facing the U.S. economy. Fostering healthy job growth and job creation—economic growth and job creation is a shared responsibility of all economic policymakers in close cooperation with the private sector.

Fiscal policy is of critical importance, as I have noted today, but a wide range of other policies—pertaining to labor markets, housing, trade, taxation, and regulation, for example—also have important roles to play.

For our part, we at the Federal Reserve will continue to work to help create an environment that provides the greatest possible economic opportunity for all Americans.

Thank you. I would be happy to take your questions.

[The prepared statement of Hon. Ben S. Bernanke appears in the Submissions for the Record on page 48.]

Chairman Casey. Mr. Chairman, thank you very much.

I want to note for the record that members' statements will be made a part of the record. I would ask unanimous consent that they all be made part of the record.

[No objections.]

Without objection.

Mr. Chairman, I want to start close to where you left off with regard to the maturity extension program. I am looking at the top of page 6 of your testimony when you say, in pertinent part, quote, that the Fed "intends to purchase, by the end of June 2012, $400 billion of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less, leaving the size of our balance sheet approximately unchanged." Unquote.

That is described as the "maturity extension program." I have two questions on that:

Number one is, as a result of the implementation of that policy how much of a decline in long-term interest rates would you expect?

Chairman Bernanke. Well we would expect something on the order of 20 basis points, approximately. We see this as being roughly equal to something like a 50-basis-point cut in the federal funds rate. In that respect it is a significant step, but not a game changer in some respect.

Chairman Casey. And in terms of the intended or hoped-for economic boost from that, what is your sense of that? How can you assess that?

Chairman Bernanke. Well we think this is a meaningful but not an enormous support to the economy. I think it will provide some additional monetary policy accommodation. It should help somewhat on job creation and growth.

It is particularly important now that the recovery is close to faltering. We need to make sure that the recovery continues and does not drop back, and that the unemployment rate continues to fall downward.

So I do not have a precise number, but I would just put it as a moderate support; not something that is expected to radically change the picture, but should be helpful both in keeping prices near the price stability level, but also providing some support for growth.

Chairman Casey. I wanted to—I mean have some follow-ups with that, but I did want to move to the question of currency. It just happens to be a major issue and a front-burner issue for us this week.

I am going to read you a statement that you made, going back into 2006. This is a part of a speech you made at the Chinese Academy of Social Sciences in December of 2006, and I'm quoting:

"Greater scope for market forces to determine the value of the RMB would reduce an important distortion in the Chinese economy. Namely, the effective subsidy that an undervalued currency provides for Chinese firms that focus on exporting rather than producing for the domestic market.

A decrease in this effective subsidy would induce more firms to gear production toward the home market, benefitting domestic consumers and firms." Unquote.

I read that to you just by way of a reminder about things you have said about currency. When I talk to people in Pennsylvania, and beyond, but especially back home, there is a unanimity about this issue that is pretty rare, across regional, party lines, in terms

of the reality for people's lives—the adverse impact that China currency policies have had on our jobs in our communities.

I guess one question I wanted to ask you—and if you can answer the first one; the other two may be more difficult to answer—but has the Fed attempted to quantify the magnitude of the impact of this subsidy on the U.S. economy or U.S. jobs? Has there been a recent attempt to do that?

Chairman Bernanke. No, I don't think so. We have mostly followed work by the IMF and other international agencies, and also by think tanks, you know, like the Institute for International Economics, which have found that the Chinese currency is undervalued by a significant amount. The exact amount varies according to estimates.

Chairman Casey. And do you have any sense of the aggregate number of jobs lost that you could attribute to this policy?

Chairman Bernanke. I don't have a number. It's difficult to estimate because there are many direct as well as indirect effects. I mean, working through third-party, other trading nations, and so on.

I think right now a concern is that the Chinese currency policy is blocking what might be a more normal recovery process in the global economy. In particular, we have a two-speed recovery where advanced industrial countries like the United States and Europe are growing very, very slowly and where emerging market economies are growing quite quickly.

And a more normal recovery, a more balanced recovery, would have some more demand being shifted away from the emerging markets toward the industrial economies. The Chinese currency policy is blocking that process. And so it is to some extent hurting the recovery process.

So it is certainly a negative. I am sorry I do not have an exact number.

Chairman Casey. Thank you very much. Vice Chairman Brady.

Vice Chairman Brady. Thank you, Chairman. As often as not, a country that undergoes a severe financial crisis as America did falls into a double-dip recession within the first two or three years afterwards.

Given that America's economy is not flying strong and steady at 50,000 feet, but flying low and slow today, and given U.S. exposure in banks and money market accounts to Europe, do you have any concern that the turbulence from a financial crisis in Europe could trigger a double-dip recession here at home?

Chairman Bernanke. I do have concerns about the European situation. I should say first that we have looked very carefully at bank exposures, both to foreign sovereigns and to foreign banks; and in particular the exposures of U.S. banks to the most troubled sovereigns—Portugal, Ireland, and Greece—is quite minimal.

So the direct exposures there are not large. There are somewhat larger exposures in the money market mutual fund area, but there too they have moved mostly away from Portugal, Ireland, Greece, towards the other European countries like France and Germany.

So it is not so much the direct exposures that concern me. Rather, market uncertainty about the resolution of the Greek situation, about the broader resolution of both sovereign debt issues and Eu-

ropean banking issues has created an enormous amount of uncertainty and volatility in financial markets. And it is through that volatility and in direct effects I think that we are being affected now.

I believe that one of the reasons that our recovery has been slower this year than it was last year is that we have faced a lot of financial volatility, and some of that is coming from the European situation.

Vice Chairman Brady. If there is a liquidity run on European banks, if there is a financial crisis in Europe, what tools are you considering to mitigate and limit the adverse economic effects on the United States?

Chairman Bernanke. Well first, in Europe there are substantial facilities to provide liquidity to European banks. First, the European Central Bank has enormous capacity to provide liquidity to European banks.

And as you know, we have conducted a swap line with the European Central Bank whereby they give us euros, they give them dollars, and on their own responsibility and on their own credit risk they re-lend dollars as necessary to European banks that need dollars.

So we are doing what we can to cooperate with the European Central Banks and other central banks to provide dollar funding for global dollar money markets. That is the first thing.

Domestically, I think our main lines of defense would be to make sure that there is first adequate supervision of our banks, which we are very much engaged in, and I would have to say that the good news here is that U.S. banks have substantially increased their capital bases since the crisis three years ago.

But secondly, we would make sure that we would stand ready to provide as much liquidity against collateral as needed as lender-of-last-resort for our banking system.

Congressman, you mentioned earlier the lender-of-last-resort policy regarding AIG and other individual firms, and I basically agree with you. I would just note that Dodd-Frank has made that illegal. We could not do that again. We are not allowed to do any lending to individual firms, or to insolvent firms.

What we could do with the permission of the Secretary of the Treasury, is to provide a broad-based lending program to try to address a run on our financial system, which we do not anticipate, but we will certainly be prepared to respond if anything eventuates.

Vice Chairman Brady. I think the question is raised again because of Europe. In a financial crisis it is difficult to ascertain the difference between liquidity and insolvency. And without a clear lender-of-last-resort policy in advance, it lends itself to the uncertainty that we have seen obviously here in the United States and we are seeing I believe in Europe.

Can I ask you, are there any other tools you are considering other than the swap lines, creating liquidity with the European Central Bank? Any other tools you are looking at should that crisis occur?

Chairman Bernanke. Our basic tools are supervision and oversight and monitoring of our own financial system. And we are look-

ing broadly at the financial system, not just at banks, as part of our macro prudential responsibilities under the new legislation.

And secondly, standing ready, as central banks always have in financial crises, to provide backstop liquidity as necessary.

Vice Chairman Brady. Can you answer this? We have just a short time left, but you have been reading the papers, as I have. There is some concern that the swap lines with the European Central Bank create in effect a back door bailout to European banks and leave exposure for U.S. Taxpayers.

We have had swap lines in the past. My understanding is this lending is to the ECB, not to the banks themselves, but can you address the authority and the potential exposure that might occur?

Chairman Bernanke. You said it exactly right, Congressman. The authority is given to the Federal Open Market Committee by the Congress and has been used many times in the past. There is no question about the authority. But in terms of the exposure, as you say, our loan is really not a loan, it's a swap. Because what we are doing is we are swapping dollars for euros with the European Central Bank.

We have a contract with the European Central Bank that they will return to us the full amount of dollars, plus interest, that we give them. So we do not face any exchange rate risk, or any interest rate risk.

Moreover, they make the loans to their own banks about which they have appropriate information, supervisory information, and the like. And if there are any losses, they are responsible, not us.

So Taxpayers are under no risk whatsoever through these swap lines, which by the way proved very, very helpful during the 2008 crisis.

Vice Chairman Brady. Thank you, Mr. Chairman. Yield back.

Chairman Casey. Thank you, Vice Chair. Senator Sanders.

Senator Sanders. Thank you, Mr. Chairman, and thank you very much for being here, Mr. Bernanke.

Mr. Bernanke, let me start with a question coming from a slightly different direction. I think most Americans perceive today that the middle class is collapsing, poverty is increasing, real unemployment as you know is about 16 percent, 25 million people without jobs or underemployed, and yet at the same time we have growing inequality—income in wealth inequality in America.

The top 1 percent earn more income than the bottom 50 percent. The wealthiest 400 people own more wealth than the bottom 150 million Americans. That gap is the greatest of any major country on earth.

Do you believe that this economy will recover so long as we continue to have this growing gap between the very, very rich and everybody else where some people have so much, and so many people have so little? Are you concerned about that issue?

Chairman Bernanke. I am concerned, Senator. I have spoken on this issue. It is not a recent development. It has been happening since at least the late '70s that the inequality has been increasing, and at the top in particular there has been increased income.

There are a whole variety of reasons for it. I do not necessarily know that the short-term recovery of the economy is crucially tied to it, although it would help to have broader based purchasing

power throughout the economy. But I certainly agree that it is a real concern, and that it is something that we should try to address as a society.

Senator Sanders. In a similar vein, let me ask you this: Today we have on Wall Street the six largest financial institutions who have assets equal to more than 60 percent of the GDP.

Are you concerned that after we went through the disaster of too-big-to-fail a few years ago, that with that type of concentration of ownership where three out of the four largest financial institutions today are bigger than they were before we went through the bail-out, (a) are you concerned that we are going to be in a position again where Congress is going to have to bail out these financial institutions who have not changed their ways, who are still into highly speculative activities; and (b) are you concerned, when you have so much concentration of ownership in these top institutions that this does not create in any way, shape, or form a competitive dynamic economy?

Chairman Bernanke. Well, Senator, we very much supported the reforms in the Dodd-Frank Act which are intended to eliminate, or at least substantially reduce, the too-big-to-fail problem. And as I was saying to Congressman Brady, we no longer have the authority to bail out anybody. And, you know, it is our anticipation that Congress will never have to bail anybody out, because we have now put in resolution authority. We have put in extra supervision, more capital, and so on.

Senator Sanders. Be that as it may, I am not quite so confident that that reality may not come again, but here is my question. When you have six financial institutions with that much economic power, why shouldn't we break them up?

I mean, do you believe that if an institution is too big to fail it should be allowed to continue? Why don't we break them up? Provide more competitive aspects to the economy?

Chairman Bernanke. Well, the authority is there. If we determine that they present a grave threat to the economy——

Senator Sanders. Do you believe—if you were sitting where we were, would you be supportive of breaking up these large financial institutions?

Chairman Bernanke. I think I would look and see how the market works here. There are benefits to size. The 60 percent of GDP you mentioned is much smaller than many other countries that have banks that are bigger than their GDP.

I think the right response is to put extra cost, extra supervision on these firms that will give them an incentive to eliminate unnecessary size, to eliminate unnecessary activities, and to reduce their risk taking. And that is what Dodd-Frank attempts to do.

Senator Sanders. Let me, my last question is this: I secured a provision in Dodd-Frank, which you were not too enthusiastic about as I recall, which allowed for an audit of the Fed during the financial crisis. And what we learned is that the Fed provided, in a revolving way, some $16 trillion in low-interest loans to every financial institution in this country, many of the central banks throughout the world, many large corporations in America, many very wealthy individuals. My question is this: That at a time when large banks have parked over a trillion dollars at the Fed, why

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aren't we doing the same? Providing low-interest loans to small businesses so that they can create jobs?

In other words, if you during the financial crisis provided $16 trillion to banks all over this world, why are you not providing the kinds of money that small businesses now desperately need so they can expand and create jobs?

Chairman Bernanke. Well, Senator, as you pointed out, this is revolving. So many of these loans were overnight.

Senator Sanders. Yes, I understand that.

Chairman Bernanke. And over and over again. The Federal Reserve was created in 1913 to address financial panics. And like all central banks around the world for 300 years, the way we do that is provide backstop liquidity during a panic when financial institutions lose their funding.

And it is very much in the interests of the broader economy and to the average person that we prevent the collapse of the financial system. It is not our role, and we do not have the authority, to make general loans to the broader economy.

Senator Sanders. But you do have the authority. Some would disagree that—whether you should have that authority—to deal with unemployment. Unemployment is a crisis situation now. Why aren't you doing for small business what you did for the large financial institutions?

Chairman Bernanke. Well we are addressing unemployment. I just discussed in my testimony the aggressive steps we are taking to ease monetary policy, which is our main tool to address——

Senator Sanders. Are you prepared to provide low-interest loans to small businesses in the same way you provided it to large financial institutions around the world?

Chairman Bernanke. I don't think that's our role, and I am sure we don't have the authority to do that.

Senator Sanders. Thank you.

Chairman Casey. Thank you, Senator Sanders. Representative Campbell.

Representative Campbell. Thank you, Mr. Chairman, and Chairman Bernanke.

I would like to first follow up a little bit on what Vice Chairman Brady was talking about on the European situation. You know, with all the issues relative to our economy, we have some modicum of control—you and us up here, of monetary policy and fiscal policy. But I think one of the frustrations is that we do not have any control over Europe's decisions relative to their current problems and crises, but yet it can affect us here.

To what extent would a default in Greece, or in some of the other countries, where that sovereign debt has some—those holders of that sovereign debt have some laws, is our financial system sufficiently protected from that that kind—a default in Greece and perhaps another country over there would not impact our financial system, at least?

Chairman Bernanke. Well first it would depend on the conditions of the default. If it were done in a way where there were very substantial firewalls, backstop protections, done in a very orderly and controlled way, then that would be one thing.

If it was disorderly, unplanned, and disruptive, that would be a very different matter.

As I said to Congressman Brady, the direct exposures of our banks to Greece are minimal, but if there were a disorderly default which led to runs or defaults of other sovereigns, or stresses on European banks, it would create a huge amount of financial volatility globally that would have a very substantial impact not only on our financial system, but on our economy.

So it is a very, very serious risk if that were to happen. And that is why it is extremely important that the Europeans continue along the lines that they have been on, which is to try to address that situation.

Representative Campbell. I understand that, as you say, if it affects their economy and demand there is reduced, that obviously affects the global economy and there is not that much, I would perceive—and if you disagree, say so—that we can do about that.

But are there—you obviously are taking all the steps you believe you can, and that are prudent in order to create a firewall around our financial sector—is there anything we should be doing in that regard? Meaning Congress.

Chairman Bernanke. Unfortunately, as you pointed out at the beginning, we are kind of innocent bystanders here. The Federal Reserve, the Treasury, and others, have been consulting with and been kept informed by our European colleagues. I am persuaded that they are very much aware of the risks associated with the situation. They are very much committed to trying to address it.

The problems there are not really economic; they are essentially political because what they are trying to do is find solutions that will be acceptable to 17 different countries, which as you can imagine is very difficult.

So I do not have any good suggestions other than to support their efforts and to continue to push them to move aggressively to put this behind us. Because even the current situation of just ongoing uncertainty has been I think a negative for our economy.

Representative Campbell. Just switching gears for a moment, you mentioned housing, which I agree is one of the primary elements of the economy; that we cannot grow without housing, cannot grow robustly without housing being a part of that. And we never go into a recession without them contributing.

What can and/or should we be doing at this point in order to aid that sector of the economy specifically? Should we be looking at a new system of housing finance past Fannie and Freddie, to replace Fannie and Freddie as they currently exist? Should we be looking at the foreclosure situation? What are your thoughts on that?

Chairman Bernanke. This is a very important issue. I would just urge Congress to look carefully at what might be done. There are a lot of possibilities.

One issue is the treatment of real estate owned, REO. As you know, one of the problems is such a big overhang of foreclosed and distressed properties. Would there be programs that would allow REO to be converted to rental, or to rent-to-own? Some way to manage the REO overhang?

A second issue is refinancing. There are a lot of barriers to refinancing, including the fact that people who are underwater have

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a great deal of difficulty refinancing. Would it be possible to help that happen?

You mentioned Fannie and Freddie. I think for the near term it will be difficult to create a full-fledged alternative to Fannie and Freddie who are currently now the basic source of all securitization in the mortgage market. But to the extent that Congress is able to lay out a clear framework, or a clear path to a new housing finance system, I think that would create some certainty and maybe would allow some of the private sector securitization activities to resume.

So I think there are things that can be done, and I am sure there are many other things that could be done, and I would urge you to think about, you know, what Congress could do.

Representative Campbell. Thank you, Mr. Chairman.

Chairman Casey. Thanks, Representative Campbell. Senator Klobuchar.

Senator Klobuchar. Thank you very much, Chairman.

Chairman Bernanke, I know you were recently in my State and spoke there, and I think you saw the strong and vibrant business community in our State. It is a community that works together well. It is one of the reasons we have an unemployment rate that is 2 points better than the national average, and it is a State that tends to believe in making things, and inventing things, and exporting to the world.

And so you can imagine the frustration our business community has felt by some of the games that have been going on in Washington recently. I was thinking back to the last year that you testified, and you were talking about how, this was about a year ago, you indicated that the markets were signalling a lot of confidence in our political system to deliver a sustainable fiscal trajectory.

What effect do you think that the debate this summer over the Nation's debt limit, how that was handled, how this was simply handled even last week, I think it is something that the New York Times in an editorial last week called "governing by crisis." They talked about how each one of these confrontations have a high cost. They eat up valuable legislative bandwidth. They add uncertainty to the financial system. They contribute to a cynicism and lack of confidence in the political system that damages everyone.

And I would just like your opinion on how things have been handled in the last six months, and how they have—that has been inconsistent or consistent with the goals that you have laid out today?

Chairman Bernanke. Well, Senator, first let me just say that I strongly support efforts to put our fiscal policy back on a long-term sustainable path. I am in no way putting down that very important objective.

That being said, unfortunately the brinkmanship of the summer and at least the perception in the minds of some investors that the United States might actively consider defaulting on its debt, and more over the possibility that this might be recurring periodically, I think was a negative for the financial markets.

It was the reason that the downgrade occurred. The S&P cited the political process more than the amount of debt outstanding. And it is really no way to run a railroad, if I might say so. So I very much support continued strong bipartisan efforts to bring our

long-term fiscal situation under control, but I do sincerely submit to you—that doing it in a way that raises the risk of default on our debt is going to be counterproductive. Because eventually it is going to lead to higher interest rates, which will make deficits worse, which goes against exactly the purpose of the exercise.

Senator Klobuchar. Thank you. And I was actually one, I know also on this Committee, Senator Coats and Senator Warner, one of 37 Senators, a bipartisan group that said we need to reach that $4 trillion figure in debt reduction.

Now I believe we need to do that with a balanced approach; that we need to do it with a mix of the spending cuts, which are very important as you have pointed out; but also closing some of the loopholes which would enable us to bring down the corporate tax rate leading to one of your other goals of the sustainable growth, as well as looking at some of these fairness issues that Senator Sanders has addressed.

And do you see it as possible to moving forward with this $4 trillion debt reduction by doing it in a balanced way?

Chairman Bernanke. Well it is up to the Congress exactly how you would like to do it. I laid out some goals. One is to achieve the sustainability. That can be done with a larger sized government or a smaller government. It depends on what you want the government to do.

But I hope that as you think about—let me put it this way: As you think about reducing our deficits and putting us on a sustainable path, which is critically important, it is also important to think about how good is our tax system? How efficient and how effective is it? How equitable is it? How effective is our government spending? Is it producing the results we want? Is it supporting growth and recovery?

So we should continue to think about the components of the budget, as well as the overall need for sustainability.

Senator Klobuchar. Thank you. And one last thing that I have appreciated that you have talked about in some way, this need to focus on our country's competitiveness and innovation.

I saw a recent survey in my State that 46 percent of our businesses cannot find workers to serve in certain jobs. Our tech schools, some of them have 96 percent placement rates—and they are not your grandpa's tech schools anymore. They are training students to learn to run computer systems that are running the assembly lines that are running our Nation's papermills, or that are making our medical devices.

I just wondered if you could briefly talk about, as you mentioned, exports are so important, the need to retool our workforce and not just pretend this is something on the side, but should be a major piece of our competitive agenda.

Chairman Bernanke. This is where many of our exports are now, either in specialized high-tech capital goods, or professional services, for example. And so developing both the human capital, the expertise, the skills, and making sure that we retain our global leadership in research and development, I think these are incredibly important for productivity and living standards going forward.

Senator Klobuchar. Thank you, very much. I appreciate you being here.

Chairman Casey. Thank you, Senator Klobuchar. Representative Burgess.

Representative Burgess. Thank you, Mr. Chairman.

Just picking up on what Senator Klobuchar just said, a brief commercial: The Food and Drug Administration is undergoing a reauthorization process next year. It will be tough, because it is a political year as well, but it is absolutely critical to our ability for the approval of new medical devices and is something where we are severely insufficient in this country. We are driving that business overseas, and that investment overseas.

And at the same time, under the Affordable Care Act, we are going to be taxing that segment of our intellectual capital, and I just think it is unconscionable the way we have behaved.

We hear a lot of talk about the trillion dollars sitting on the sidelines that corporations have, a trillion dollars that they are just waiting to see what is going to happen. Is that accurate?

[The prepared statement of Representative Burgess appears in the Submissions for the Record on page 51.]

Chairman Bernanke. I think it is more than that. I think it is more like $2 trillion.

Representative Burgess. And what is it that they are waiting to see?

Chairman Bernanke. Well, partly it is a liquidity preference from the crisis where they want to make sure they have enough cash on hand in case there are more financial issues.

But more generally I think it is——

Representative Burgess. So are those capital requirements that you have imposed?

Chairman Bernanke. I am talking now about corporations, not about banks.

Representative Burgess. Okay.

Chairman Bernanke. Corporations remain very uncertain about the strength of the recovery. At this point they are able to meet demand with their existing capital stocks and workforces, and they are looking to see a stronger recovery and greater clarity before they deploy some of those funds.

Representative Burgess. And is that greater clarity from the Legislative Branch? Or from the Federal Reserve? Or from the Executive Branch? Where is that——

Chairman Bernanke. Well it comes from many areas. I think first and foremost will the recovery continue and be strong, or will it falter? And there is a lot of uncertainty about what the economy is going to do.

Certainly, policy uncertainty is an important issue. As far as the Federal Reserve is concerned, we in our regulatory efforts are doing our best to move as quickly as possible to provide clarity about the regulatory framework that we are responsible for.

Representative Burgess. Do you think tax policy influences it?

Chairman Bernanke. It's possible, yes. In general, the most clarity we can provide to firms and households, the more likely they are to make commitments of various sorts.

Representative Burgess. Let me ask you a question. I need to move on because time is limited.

Do you think that the actions that have been taken over the last three years have prevented a recurrence of the events that we saw in September of 2008? Have we prevented the next meltdown?

Chairman Bernanke. I think we made a substantial improvement in——

Representative Burgess. Wrong answer. Have we prevented—have we prevented? It is a 'yes' or 'no' question.

Chairman Bernanke. If we had not taken those actions, we wouldn't have had to prevent because we would have had a collapse.

Representative Burgess. Let me ask you this: A lot of people talk about the reinstitution of Glass-Steagall. You mentioned "moral hazard." Do we need to draw that bright line again?

Chairman Bernanke. I don't think Glass-Steagall per se would have avoided the crisis. Many investment banks or commercial banks that were not combined had significant problems.

We have made a lot of steps to try to address those issues. I know not everybody agrees on all of them, but I think we have made a lot of progress in getting our financial system back on a more stable footing.

Representative Burgess. Let me ask you this: In your testimony, the second-to-the-last paragraph, the closing sentence, you said:

"The Committee will continue to closely monitor economic developments and is prepared to take further action. . . ". Do you have further arrows in your quiver at this point? Have most of them already been used? Is the only arrow you have left the printing press?

Chairman Bernanke. Well the basic tool that the Federal Reserve has is operations in the open market that may or may not increase the money supply. But the attempts to reduce interest rates and to create more financial accommodation, we do have tools. But obviously we want to evaluate the costs and the benefits of any decisions we take, and we want to make sure that the economy is getting the appropriate amount of stimulus from us.

Representative Burgess. So the answer to that question is: The printing press may be the only arrow left in your quiver?

Chairman Bernanke. Well the printing press, I think that is a rather unfair characterization. The printing press literally is not actually involved.

I mean what we are doing right now is selling short-term securities and buying long-term securities. We are not changing the size of our balance sheet, and we are not changing the size of the money supply in any significant way.

Representative Burgess. As long as it works.

Let me just ask you something unrelated, because my time is running out. You see protests both on the right and the left. Right now the protesters that are getting the headlines are on the left in New York. What does that protest say to you? What are you hearing from that activity in New York right now?

Chairman Bernanke. Well I would say very generally, I think people are quite unhappy with the state of the economy and what is happening. They blame, with some justification, the problems in the financial sector for getting us into this mess. And they are dis-

satisfied with policy response here in Washington. And at some level I can't blame them. Certainly 9 percent unemployment and very slow growth is not a very good situation. That's what they are protesting.

Representative Burgess. And are you incorporating that into the remedies that you are proposing?

Chairman Bernanke. I am taking into account the growth rate in the unemployment rate, as well as the inflation rate. I am not taking the protests into account, specifically, but like everyone else, I am dissatisfied with what the economy is doing right now.

Representative Burgess. Thank you, Mr. Chairman.

Chairman Casey. Thanks, Representative Burgess. Representative Hinchey.

Representative Hinchey. Thank you very much, Mr. Chairman.

Chairman Bernanke, thank you very much. Thanks for being here, and thanks for all the responsibilities that you are engaged in.

I have a couple of simple questions to ask, one which expands upon what Mr. Sanders said just a few moments ago. We have a serious issue with distribution of wealth in this country, and that really needs to be addressed, and it needs to be straightened out.

The top 1 percent of Americans hold 33 percent of the total wealth in this country. The top 5 percent hold nearly 60 percent of the total wealth. The top 10 percent hold 72 percent of the total wealth. The bottom 50 percent of Americans holds only 3 percent of the total wealth.

All of that is a similarity and reminiscent to the deep Great Depression which our country suffered back in the 1930s. That needs to be overcome.

So can you tell me candidly what accounts for the significant concentration of wealth in this country? And in your opinion, what is the most effective initiative that Congress can do to increase household wealth among the working and middle class?

The working and middle class are the drivers of the economy of this country. When the working and middle class experience hardship, the entire economy declines. That is what we have got to concentrate on: working people, building them up, making them more successful.

Chairman Bernanke. Well in the shorter term, clearly it is people with the middle class, but also the working class, who take the brunt of high unemployment. The Federal Reserve is taking strong actions to try to restore economic growth and try and bring down the unemployment rate. I think that would be a very important step to take.

In the longer term, there are a number of reasons for this inequality which, as I pointed out to Senator Sanders, is not a new phenomenon. It has been growing for 30 or 40 years. A lot of it has to do with divergent educational and skill levels, and I think we have more diversity in terms of high quality and low quality educational systems in the U.S. than almost any industrial country, and we need to have stronger, more consistent training and education for everybody.

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We need to make sure people have technical skills, because technological change has been one place where a lot of people are getting left behind. We need to help people learn how to save and to budget. Financial literacy is an important issue.

People have talked about trade. Senator Casey mentioned the Chinese currency issue. I think we need to have open and fair trade. That would be helpful.

So there are a variety of things that can be done to try to do that. Many of them, unfortunately, don't happen overnight. But broadly speaking, I think we all agree that we want to create as much opportunity in this society as possible. And when there are people who do not have access to good education, they are kind of shut out from the beginning.

Representative Hinchey. Well I would suggest that some of the things you can do is to recommend to this Congress positive things we can do. And the concentration of wealth was affected in 1977–78, when Congress passed dramatic cuts In capital gains tax which primarily benefit wealthy people. That in and of itself has got to be dealt with, and dealt with effectively by this Congress to upgrade the quality of life for middle income people. That needs to be done.

Let me just ask a little bit about the Volcker Rule. Since the passage of Dodd-Frank, the Federal Reserve has been working on implementing the Volcker Rule. This important provision limits banks' ability to engage in proprietary trading. This Rule upholds the spirit of the important Glass-Steagall Act which separated commercial banking and investment banking until its unfortunate repeal back in 1999. That needs to be corrected.

Recently, news reports have indicated that a draft final rule will include a significant loophole allowing banks to continue to make risky bets with their own capital to hedge against portfolio risks. This new exception significantly diminishes the impact of the Volcker Rule.

How can we expect to see a change in bank behavior if we continue to allow proprietary trading through a watered down Volcker Rule?

Chairman Bernanke. Well first let me just say, we are about to put out a proposed rule. I would say within a couple of weeks we should have something out that the public can look at and give us comments on it.

It is a complicated rule, and we want to make sure it is workable. But at the same time, we certainly want to follow the spirit of the statute. There are in the statute provisions that allow banks to hedge their positions, which is something you want them to do because that reduces risk.

I'm not sure I know exactly what you are referring to, but I assure you that we will look very carefully and respond to any comments that you might have about the actual rule when it comes out.

Representative Hinchey. Well with regard to the Volcker Rule, it has been weakened. Now the question is, what are we going to do? Are we going to continue to allow it to be weakened? Or are we going to do something to correct that weakening and make it more effective, as it was intended?

Chairman Bernanke. I don't know what you mean by "run down." The rule is about to be put out. So when you see the rule, if you will tell us what your objections or concerns are, we will be happy to respond to them.

Representative Hinchey. Well you can see clearly what it means by weakened, I think.

Chairman Bernanke. If you're referring to current activities by the financial institutions, of course the Volcker Rule is not in effect yet and it will take some time before it is in effect. But it is our intention to follow the spirit of the rule. After all, Chairman Volcker was the Chairman of the Federal Reserve, and I look at his picture every day. So we will certainly try to make sure that the spirit of the rule is enforced.

Representative Hinchey. Thank you very much.

Chairman Casey. Thank you, Representative Hinchey.

Senator Coats.

Senator Coats. Thank you, Mr. Chairman.

Mr. Chairman, thank you for your service. Both sides of the financial houses here, the Congress and the Fed, face significant challenge. We are both sort of on the hot seat. I don't think it is appropriate for one to blame the other for the problem, and you have not done that.

It seems to me sometimes too much attention is focused on what the Fed should do when it is not within the Fed's purview of doing; it is in ours; and we are deflecting the blame over to you.

Nevertheless, you indicate in your opening statement here that—and I quote—"The future course of federal fiscal policies remains quite uncertain", and that uncertainty is something we all hear as we go back to our states and talk to businesses and others. It is pervasive throughout industry, throughout business, throughout households. And I guess the question is: How can we together work to eliminate some of that uncertainty and restore confidence not only in the investment market but in the consumer market?

Clearly that would have a positive impact in terms of our going forward. You outlined four key objectives in that regard in your statement, one of which is, as you describe, putting together a long-term fiscally sustainable credible plan.

You state that what is before the Congress in terms of what has been done in August, and what the goals are for the Super Committee that is going to report in November, are far short of what we need to do. That is reinforced by the rating agencies. It is reinforced by the President. It has been reinforced by various economists and analysts, saying generally anything short of $4 trillion in spending, viable spending cuts, over a 10-year period of time is going to be inadequate to regain that confidence and achieve the goal of a fiscally sustainable plan.

My question to you is, as others have suggested, you can't get there just—to get that kind of a plan—just through spending cuts. You need certain reforms in the system, one of which is entitlement reforms to mandatory spending, another of which is comprehensive tax reform.

My question is: How important is that to be part of a package that can be deemed what you would conclude to be long-term fiscally sustainable and credible?

Do you have some comments and thoughts on that?

Chairman Bernanke. Yes. So first it would be a major achievement to have a credible plan that delivered stability and sustainability over the next decade. As I was indicating to Senator Klobuchar, the quality of the product also matters. It is not just the bottom-line numbers. In terms both of economic efficiency and growth and in terms of certainty, reforming the tax code would be very useful and very valuable.

I think everybody agrees that it is a very complex and, in many ways, counterproductive system right now.

And likewise, evaluating the quality of our programs. Is it possible, for example, to deliver health care to senior citizens at the same level, or the same quality for less cost? Those are some of the issues that we need to address.

So I agree, the bottom-line number is critical, but so is whether or not we achieve some clarity and some improvement in both the tax and spending programs.

Senator Coats. Now some say this is not—putting that comprehensive package together by the end of this year, the Congress voting on that and pushing it forward, is not attainable particularly with regards to the complexity of the entitlement, the reform, and the tax reform.

Many suggest that, well, these are elements—these are initiatives that ought to be started up in 2013. Can we wait until then?

Chairman Bernanke. Well, Senator, you are a better judge than I am of how quickly this could be done in Congress, but clearly the sooner the better. 2013 is a ways away, and at least giving some indication of the directions that you are going and the broad ideas that you would be incorporating I think would be helpful.

Senator Coats. You state in your comments here that these difficult and fundamental fiscal choices cannot be safely or responsibly postponed. I assume you stand by that?

Chairman Bernanke. Yes, sir.

Senator Coats. And 2013, would that fall in that? Would you describe that as something that is safely and responsibly done?

Chairman Bernanke. I think we would all like to see as much progress as possible. And if that involves now laying out some plans and beginning the discussion, I think that would be very useful.

Senator Coats. My own belief is that at least some strong indication with some enforcement mechanism is necessary in that package now in order to assure the investment world and the consumer world that we are on the right path, and therefore have the psychological effect of improving confidence and helping move forward with some sustainable measures.

Thanks very much for your testimony.

Chairman Bernanke. Thank you.

Chairman Casey. Thank you, Senator Coats. Representative Mulvaney.

Representative Mulvaney. Thank you, Mr. Chairman.

Mr. Bernanke, as difficult as it is for two Southerners to talk about anything in five minutes, I will do my best to speak a little faster than I would if you and I met back home, and also be a little more blunt than if we had met back in South Carolina.

You came to our Committee on the Budget back in the springtime and gave much the same presentation, and encouraged us at that time to do everything that we could to get our fiscal house in order. We have talked about that several times here today.

In my opinion, we have woefully underperformed in that area and are continuing to make some of the mistakes that you brought to our attention last spring. We have not fixed the spending problem. We have not come up with a way to close the deficit.

I would suggest to you, sir, that the Fed is part of the difficulty with that. And I encourage you to consider the fact that with all of the steps that you take to keep interest rates low, in the long term, in the short term, to encourage lending, you are also encouraging borrowing.

You are encouraging the Federal Government to continue to do what we do. You have made our effective borrowing rate the lowest it has ever been in the history of the Nation, and therefore there are no consequences in the immediate term to our actions to continue borrowing money.

So I would suggest to you, sir, that you do consider that when you all go forward on the Open Market Committee, that one of the unintended consequences of doing what you are doing is making it easier for us to continue to do what we are doing—which is, to borrow money.

You make it more difficult for us to drive home to our colleagues the down side of incurring all of this significant debt.

With that, I will move on to my question, which deals with inflation. I think we have seen that inflation has either been flat or up in the last 13 months. It is up each month I think this year. Yet we are looking at an environment where industrial capacity is still low, unemployment is still high, wages are flat, factory orders I think it was announced they were down last month—they announced that this morning.

I recognize your comments about energy having some influence on inflation, recognizing that core inflation excludes raw energy costs; and also the Japanese auto market, the situation we had over there. But I think it is reasonable to suggest that monetary policy is having some inflationary pressures.

Now, when you were before the Budget Committee last spring, I asked you if you were comfortable with your ability to turn off the flow, turn off the flow of money which you referred to as the flow into the punch bowl. Now, since then you have announced two fairly significant new plans—the program to reinvest in mortgage-backed securities instead of allowing the balance sheet to shrink, and also the Operation Twist of extending the maturities structure on the debt.

I ask you, sir, if you believe that those two policies have in any way impaired your ability to deal with inflation should the need arise?

Chairman Bernanke. Congressman, I need to respond to that first point. I don't think that is a valid point. We keep interest rates down somewhat. I don't think that eliminates the responsibility of Congress to take its own action.

But putting that aside, looking at Europe we see the European Central Bank buying the debt of Greece, and the interest rate in

Greece is, whatever it is, 40 percent. If investors lose confidence in the U.S. fiscal situation, the Fed's actions are not going to have any effect on that.

Representative Mulvaney. And I would not suggest you are the only thing depressing our interest rates. Certainly the flight to quality out of Europe is depressing our borrowing costs, but I think you all represented 40 or 45 percent of our borrowings every month during QE–1 and QE–2. You all are a big part of where we go to get the money.

And until you all start saying no, you can't borrow any more, we are going to continue to do what we have done for the last 30 years.

Chairman Bernanke. Well, we need to keep interest rates low to provide support for the economy, which needs the support. On the inflation situation, the impact of energy and food prices, which arose from a large number of reasons early in the year, is now receding and inflation expectations in the financial markets from forecasters, from the public, are quite low and quite stable.

I don't expect inflation to be a problem going forward. As far as exiting our policies we laid out in June a exit strategy that was in our minutes and was widely discussed, and we have all the tools we need to reverse our policies at any time. And I really am quite confident about that.

And when the times comes, we will certainly do what is necessary to maintain price stability. And right now, we are much further away from full employment than we are from price stability.

Representative Mulvaney. My last question is this: We are operating now in an environment where inflation is above your target rate. Unemployment is above everybody's target rate. Dealing with those two situations would, some would say, require two different things. It would take one thing to solve employment and that would actually make inflation worse, or you can help solve inflation and make employment worse.

My question to you is this. Now, you talked a lot today about clarity, and I agree, and stability in the markets is what the Fed is supposed to provide. Would you be better positioned to provide clarity and stability if we were to remove one of your two mandates?

Chairman Bernanke. Well, Congressman, it is a complicated question. I can't answer it real quickly. I would say that we do have some ability to improve the employment situation, and I think the dual mandate has worked pretty well on average over time.

I would also point out that central banks that have inflation as their primary, or technically only mandate, do pay attention to economic conditions if for no other reasons than that affects inflation expectations.

So, I think our dual mandate is workable. Although, I agree that in the long run the only thing the Fed can control is inflation. In the long run, low inflation is the best thing we can do for growth. I agree with all that.

So my bottom line is, I think we can make the dual mandate work. I think it has worked pretty well. But of course it is up to Congress. If you want us to change to a single mandate, we will do whatever you assign us to do.

Representative Mulvaney. Thank you, sir.

Chairman Casey. Thank you, Representative Mulvaney. Representative Duffy.

Representative Duffy. Thank you.

And thank you for coming in, Mr. Chairman—over here on this side, now. I appreciate your testimony.

Quickly, as I talk to a lot of folks who are studying what is happening in Greece, many of them will say it is kind of a foregone conclusion that Greece is going to default. I know you are not going to say that.

But as we look here, I think your testimony today is basically saying we don't have primary exposure to Greece or Italy, but we do have secondary exposure through the banking system.

How great is that exposure?

Chairman Bernanke. Well again, our banks have de minimis exposure to the sovereign debt of Portugal, Ireland, and Greece. They have quite modest exposure to the sovereign debt of Italy and Spain. They have much more substantial exposure to the banking systems of Italy, Spain, France. And of course, very substantial exposure to the economies, more broadly speaking.

So the direct exposures to say Greece are quite small, but indirectly to the Continent and more generally through the stability of the financial markets overall, of course we have significant exposure.

Representative Duffy. And we see that, I think you've indicated, it's pretty clear that what the Europeans have to do to stave off this crisis, it is not an issue of do they know what to do, it is do they have the political will to actually step forward and do what is necessary.

Do you think they are doing enough? Do you think they have the political will to get the job done?

Chairman Bernanke. I think they appreciate how much is at stake. I mean, it is not just short-term stability; it is the continuation of their common European project. It is the continuation of their common currency. So I think there is a very strong desire and will to achieve success here.

But again, the process has been slowed by the political complexities.

Representative Duffy. And I think it is analogous to what we see here. I mean, we have a situation in this country where we look out into the future and you go: Listen, we are going to down the road have some serious issues with our debt. And we will all sit around these tables, and we have bipartisan discussions, but there is not a political will to get it done.

And when we have our own conversations today about our debt, where it's set at $14.5 trillion, and it's pretty tough to get a political consensus to deal with it, do you think it gets more politically easier to deal with the debt when it is 10 years down the road, and $25 trillion?

I mean, the more debt we rack up, the more politically difficult it gets, doesn't it?

Chairman Bernanke. I have great sympathy for you. These are very, very difficult problems. They involve very fundamental questions of what the government should do and how big it should be.

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And I understand that there is an enormous amount of disagreement, and I hope that we will be able to find a common ground.

Representative Duffy. But looking at what we see in Greece, I mean would you say it is fair that the alarm bells are going off with regard to American debt?

Chairman Bernanke. Well there are two sides to that. On the one side, clearly as Mr. Mulvaney pointed out we have got flight to quality coming into U.S. debt. If people are seeing all kinds of problems in the global financial system, they are buying U.S. debt and driving yields of the U.S. debt down to very low levels.

That being said, I think everybody appreciates now that you can't run large deficits forever. We are seeing that in other countries. And in fact, S&P downgraded the U.S. Treasuries. So clearly this is an issue that we have to address, and it is not something that can wait 10 years.

Representative Duffy. Okay, and I just want to quickly pivot to Operation Twist. You are in the process of selling short-term Treasuries, $400 billion, and are going to purchase long-term Treasuries.

Are you doing a market-value to market-value? Or are you going market-value to par-value?

Chairman Bernanke. It is going to be par to par, which means the market values are not going to exactly match.

Representative Duffy. So is this going to be a minor QE–3 that's going to happen through these purchases?

Chairman Bernanke. It is possible that the value of the securities holdings may change, but it would be very small and not significant in terms of stimulative effect.

Representative Duffy. The last time we chatted in a hearing over the summer you indicated you were considering QE–3. Is that still on the table as one of your tools that you may use?

Chairman Bernanke. We never take anything off the table because we don't know where the economy is going to go. We can't forecast what might happen in the future. But we have no immediate plans to do anything like that.

Representative Duffy. I would yield back.

Chairman Casey. Thank you, Representative Duffy. Senator Lee.

Senator Lee. Thank you. Thank you, Chairman Casey, and Vice Chairman Brady.

I don't want to make a lengthy statement. I am far more interested in your testimony. But I do want to share just a couple of my own thoughts about the current state of our economy, and share some of my concerns about the Federal Reserve System.

In 1977, Congress gave the Federal Reserve the dual mandate that Representative Mulvaney referred to, to promote both maximum employment and simultaneously promote stable prices.

Unfortunately, since that time—and more recently, just in the last few years—we have had anything but maximum employment and stable prices. Most Americans believe, correctly I think, that prices of products and services they buy on a daily basis, things like gasoline, electricity, heating oil, health care services, have increased significantly in recent years and have grown more volatile. And at the same time, we have unemployment in excess of 9 per-

cent. And a lot of Americans, as a result of those factors, are struggling in this difficult economy.

So the result of that, in my view, is the Federal Reserve may well be said to be failing in its Congressional Mandate, two-fold mandate, that we have just described. And I wonder whether some action ought to be taken to remedy that, or at least to bring the mandate more into line with reality.

I would add that I am troubled by the Federal Reserve's role in shoring up failing banks—some would say "bailing out," others would say "shoring up" or engaging in some form of swaps. But regardless of what they are doing, they are arguably creating asset bubbles through policies that lead to artificially low interest rates and the general veil of secrecy under which the Federal Reserve typically operates is also of concern to me.

So with some of those concerns in mind, I want to ask you a couple of questions. Given that many Americans are retirees, including the Baby Boom Generation getting ready to retire, those saving for retirement often invest in fixed-income products, including a lot of Treasury Securities.

Are you concerned about the implications of these historically low interest rates on retirees and those saving for retirement?

Chairman Bernanke. Congressman, could I please reply quickly to your earlier——

Senator Lee. Please feel free.

Chairman Bernanke [continuing]. Statement on inflation.

Inflation has come down over the last 30 years, and during my tenure it has been about 2 percent, which is essentially price stability. So I think the record on price stability has been very, very good according to BLS statistics.

On unemployment, I would blame the current crisis mostly on the financial crisis. Obviously the Fed had some responsibility there but it was not, in my opinion, coming from the dual mandate; it came from financial oversight issues.

We are not bailing anybody out. All central banks have a responsibility to provide backstop liquidity to solvent institutions only, fully collateralized. We do not lose any money. We do not take any risk. This is what central banks do to try to reduce financial stress and to help the economy.

As far as Fed audits, we are very thoroughly audited at this point. I would refer everyone to our website which has an FAQ "Is the Fed audited?" We are audited by the GAO, by the Inspector General, by outside private accountants. We produce regular financial statements. All of our emergency lending facilities have been thoroughly audited and nobody has found any impropriety whatsoever.

So that is really just an urban legend.

Thanks for letting me respond to that.

On the saving issue, it is a very difficult question. I guess one consolation for Treasury holders is they have had a lot of capital gains as interest rates have gone down. But more seriously than that, I understand that fixed income savers do often suffer from low interest rates. It is a consideration. It is something we think about.

But clearly if you are going to be investing in the U.S. economy you need a strong economy. And it is our view that the low interest rates over a period of time, not permanently, help have a stronger economy going forward, and that gives better opportunities for investment for all savers.

And so ultimately, I think the short-term low rates are necessary to give the kind of economy we need that people can get ultimately high returns in.

Senator Lee. What do you expect interest rates to do over the next few years? Or maybe I should direct it more specifically toward Treasury Yield Rates. Where do you expect those to go in the next five or six years?

Chairman Bernanke. Well it depends very much on how the economy evolves. If the economy recovers gradually, as we currently anticipate, then over time Treasury Rates will go up.

Senator Lee. I see my time has expired. Thank you, Chairman.

Chairman Casey. Thank you, Senator Lee. Senator DeMint.

Senator DeMint. Thank you, Senator Casey.

And thank you, Mr. Chairman, thank you for your service to our country. It is a very difficult time, and I appreciate your calmness through the storm here.

Over the past three years, the Federal Reserve has engaged in what seems to me like unprecedented action. Originally these actions were aimed at managing a financial crisis as a lender-of-last-resort. And we clearly were in crisis.

But the Fed has continued to expand its balance sheet with multiple rounds of quantitative easing, Operation Twist, an exponential increase in monetary supply relative to the growth of the economy. And you've in effect become a major player in the private sector economy, much beyond banking, but a major economic player.

My question is: If you had a single mandate of just protecting the value of the dollar itself, how much of the actions that you have taken in the last three years would change if you did not have the mandate of protecting employment?

Because this may be the way we want it to be, but it does seem, when you combine Congressional and Executive policies with what the Fed has done in the markets, that it is getting to where the private sector players do not know what to expect from government.

How much of that would change if you did not have a mandate to increase employment?

Chairman Bernanke. Well at certain times there would be a difference in policy, certainly. But in this case, as I have mentioned, our forecast for inflation is that it will be somewhere around 2 percent next year, which is pretty close to what most central banks around the world, even those that have only a single mandate, define as price stability.

Our second round of quantitative easing last August in 2010 was in response to an inflation rate that was below 1 percent and falling, and we were concerned about the risk of deflation. So the efforts just to keep inflation close to sort of the 2 percent target, the fact that it is close to 2 percent now, suggests we would have had

to do most of what we have already done just to keep inflation there.

So the evidence is that all the things we have done have not driven inflation above the price stability level.

Senator DeMint. Are we concerned that we are setting the stage for that to happen, though, in effect? It does seem that the dollar is okay for now because the euro is in such bad shape. And as you have said before in testimony, you understand as the economy grows you are going to have to withdraw the stimulus effect of monetary supply.

Is this something we can really control at this point? As I think the monetary supply continues to increase dramatically, the Federal Reserve has bought through intermediaries a significant amount of our debt, as you have expanded your balance sheet.

Is this something we can come back and control? And is that much control a good thing?

Chairman Bernanke. Well, Senator, first the monetary base, which is the reserves the banks hold with the Fed, has grown tremendously, reflecting the size of our balance sheet. But the money supply that most Americans think about, currency in circulation, checking accounts, those things, has not grown unusually, first.

But secondly, as we have discussed on a number of occasions, I have given several speeches and we have provided this exit strategy in the June minutes, we have a number of tools for exiting. We are very confident that on a technical level we can do so, and we will be paying very careful attention to inflation as we make that determination.

So I assure you that we are quite confident that we can reverse our policies when necessary.

Senator DeMint. Thank you, Mr. Chairman. Thank you, Senator Casey.

Chairman Casey. Thank you, Senator DeMint.

We will move to a second round of questioning now. They will be something approaching a lightning round, three minutes, so that everyone knows that.

I will start, and then I will turn to our Vice Chair. I did not want to let too much time go by without re-emphasizing some of the good news in the early part of your testimony. We do not have enough. I t is good to have a list of good news items.

I was just looking at page one. By my count there are at least four, maybe five, depending on how you break them up, but the functioning of financial markets and the banking system improved significantly. That is one you mentioned.

Manufacturing production has risen 15 percent.

The trade deficit is noticeably lower—notably lower, I should say, in your testimony.

Business investment in equipment and software has continued to expand.

And productivity gains in some industries have been impressive.

So that is good news. But when you get to the point in your testimony where you have the four objectives, which again I think are helpful for us:

Number one, long-term fiscal sustainability;

Number two, avoiding actions that could impede a recovery;

Third, the fiscal policy aim should be on long-term growth; and then

Four, improving the process of how we do things around here.

I wanted to focus on kind of the first two or three, the focus on the long-term fiscal sustainability, which has been your focus, appropriately so. And you also say that we need short-term strategies as well.

One of the strategies put in place back in December of 2010 was the payroll tax cut for the employee. And now there is a debate about the next step to take, whether we extend that or whether there is a cut put in place for the employer.

I guess, other than a strategy like that, or maybe even extending unemployment insurance benefits—that is one that is on the table as well—not that you want to have a recitation of a long menu, but any other short-term strategies that you think would be helpful?

Chairman Bernanke. I made reference to housing as an area where there might be various steps that could be taken to make the market work better.

In terms of growth, considering investments in capital, whether it's public capital, or supporting private capital formation, or human capital formation is one possibility.

The unemployed obviously is a major area of concern. Perhaps assistance could be provided there. But on the tax side, a couple of people have mentioned tax reform, and that is something to look at that could provide more certainty and a more effective and efficient tax system going forward.

Those are some ideas. Obviously, I am not endorsing specific policies, and I have no concerns about the creativity of your colleagues in finding strategies to work on.

Chairman Casey. Thank you. Vice Chairman Brady.

Vice Chairman Brady. Thank you. I am pleasantly pleased to get a second round, so we will do a lightning round with you, Chairman, if that is okay.

Transparency is a major issue with the Fed, and we hear critics today. I've experienced you to be honest. You've been an advocate for transparency through the financial crisis, both in meetings here and in our meetings face to face as well.

To that end, is there any logistical reason why the lag time between Open Market Committee meetings and the release of the transcripts shouldn't be reduced from five to two years or less? Is there any reason we can't see that sooner?

Chairman Bernanke. There is no logistical reason. My concern is that two years is within a tightening or easing cycle. What we noticed when the transcripts were released with a five-year lag was that the meetings became much more constrained. People started reading their statements. There was just much less give and take.

I think with that short a lag, I think you are actually going to inhibit discussion and you may have adverse impacts on markets. We provide a great deal of information in our minutes, in our testimonies, and speeches, and the like. And I am happy to meet with you and discuss issues that you might have.

I think no other central bank in the world provides the transcripts with any lag, as far as I know. So this is actually quite a

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transparent policy that we have. And I do think it would create some problems to shorten that considerably.

Vice Chairman Brady. With China there is a focus on currency. But noting that the U.S. devalued its currency by a peak of about 15 percent over two years, it's now closer to 12 percent today, and since the driver behind the currency legislation seems to be our trade deficit, what I hear from our businesses is that, while currency certainly is an issue especially for select industries, there are a number of trade barriers we face in China from theft of intellectual property rights, directed subsidies, closed capital account, restrictions on raw and rare export materials, on and on, choosing of national champions, on and on.

If Congress is to tackle our trade deficit with China, isn't it more important that we look at the whole range of trade barriers that restrict our sales into that growing market?

Chairman Bernanke. On our currency, Congressman, the dollar is about the same place it was in the summer of 2008. It has gone up and down with flows of flights to safety, but it hasn't been really on a trend.

On your question, absolutely. I have been involved in the strategic and economic dialogue since its inception, and we talk every time with the Chinese about all these issues, and I think continue to press your discussion with them about these trade barriers and these related issues. I think it is very important and very constructive.

Vice Chairman Brady. Thank you, Mr. Chairman.

Chairman Casey. Thank you, Vice Chairman Brady. Senator Sanders.

Senator Sanders. Thank you, Mr. Chairman.

Mr. Chairman, as you know, there are people demonstrating against Wall Street in New York City and other cities around the country. And I think the perception on the part of these demonstrators, and millions of other Americans, is that as a result of the greed, the recklessness and the illegal behavior on Wall Street we were plunged into this horrendous recession we are currently in.

Do you agree with that assessment? Did Wall Street's greed and recklessness cause this recession that led to so many people losing their jobs?

Chairman Bernanke. Excessive risk taking on Wall Street had a lot to do with it, and so did some failures on the part of regulators.

Senator Sanders. Do you believe that we have made any significant progress since the collapse of Wall Street to suggest that we will not, either in the short term or the longer term, once again see a collapse on Wall Street and the necessity of a bailout?

Chairman Bernanke. Senator, yes, we are making substantial progress, although I would point out that many of the rules implementing Dodd-Frank are not yet in force or fully implemented. But I believe as this process goes forward that we will have made a very substantial improvement, yes.

Senator Sanders. Well I would respectfully disagree, but let me ask you this on another subject.

I get calls in my Vermont office every week from people who are paying 25 or 30 percent interest rates on their credit cards. Some

would argue that that is usury, and yet that is the policy of the largest financial institutions in this country.

Do you believe that if the Bank of America and Citigroup is charging somebody 30 percent interest rates that that constitutes usury and should be prohibited?

Chairman Bernanke. I would have to know more information, Senator. The Congress just passed a whole set of rules requiring banks to be much clearer about the information they disclose on credit cards——

Senator Sanders. Disclosure, that's correct.

Chairman Bernanke. And on practices as well in terms of——

Senator Sanders. But the bottom line is, today there are people in America—and I think you won't deny this—who are being charged 25 or 30 percent interest rates. Now Congress has passed legislation which has been in effect for many, many years limiting the interest rates that credit unions can charge to 15 percent. Credit unions are doing just fine.

Can you give us any reason why Congress should not do the same for the large financial institutions?

Chairman Bernanke. I think as long as there is complete clarity about the conditions of the card, and people understand what the provisions are, I am not quite sure what the basis would be.

Senator Sanders. What the basis would be is that when people are in bad economic shape, they do not have a whole lot of money. They have to borrow. They have no alternative. And right now, the Bank of America and Citigroup are charging them 30 percent. That seems to me to be outrageous. It seems to me to be usurious. And it seems to me to be wrong. And I would urge your support to do what you can to make sure that those outrageous interest rates are done away with.

The last point is, picking up on a point that I made earlier, I disagree with some of my colleagues here who think that the Fed should not continue to focus on unemployment. As I understand it, Section 13.3 of the Fed Reserve Act does allow you to provide emergency loans to any individual, partnership, or corporation under unusual and exigent circumstances.

I would argue that when real unemployment today is 16 percent, those are unusual circumstances. I believe you do have the emergency authority to provide emergency loans to small businesses so that we can create millions of jobs. Would you give some consideration to doing that?

Chairman Bernanke. Well again I think there are several other provisions besides unusual and exigent. They include, among other things, that the loans be fully secured. I mean you couldn't just give a loan——

Senator Sanders. Right.

Chairman Bernanke [continuing]. Without collateral, for example.

Senator Sanders. Right.

Chairman Bernanke. Of course with banks and financial institutions we supervise them, and we know what their financial condition is, and we know that they are solvent when we make them a short-term loan.

But we are not banks. We do not have any capacity to evaluate a small business. If you think that the banking system is not working, why wouldn't Congress consider its own provision?

Senator Sanders. Congress might, but I would just simply suggest that during the financial crisis you acted very, very boldly—$16 trillion in revolving loans.

I would urge you to try to do the same, give the same line of thought, to the unemployment crisis right now.

Thank you, Mr. Chairman.

Chairman Casey. Thanks, Senator Sanders. Representative Campbell.

Representative Campbell. Thanks, Mr. Chairman. I will stay on the same two topics I was on before.

During 2008, we talked about too-big-to-fail, but also too-interconnected-to-fail. Dodd-Frank and some of us have other ideas to try to deal with that.

Getting back to the European contagion, the risk to us is due to interconnectivity. I presume if they had a disorderly, I believe as you described it, default of Greece or some other thing there, is it international financial interconnectivity that puts us at risk? And if so, is there anything, obviously not in the short term, but that we ought to be thinking about that in the future?

Because obviously it is frustrating you and frustrating up here as well that here is thing going on over which we have no control, but which could have a major impact on us.

Chairman Bernanke. Well that is part of the issue. And there are provisions in the financial reform that penalize interconnectivity in various ways, and try to force more transparency about counterparties and those sorts of thing. But I think beyond that as we are seeing in the markets recently, just general pulling back, general risk aversion.

In 2008, we saw an enormous impact on emerging market economies that had very little direct connection to what was happening in the U.S. in the financial markets.

So just the general fear, and the general risk aversion would also be a very big effect. Even between institutions that were not interconnected in that sense that you are talking about.

Representative Campbell. So the concern actually is almost more psychological, or as much psychological as it is purely economic?

Chairman Bernanke. It is psychological, but also in the sense that when there are losses occurring, in a panic people will not know what is safe and what is not safe, and their general reaction is to just pull back from everything.

Representative Campbell. Yes. Okay. Switching back to housing again, you mentioned about people being able to finance, or refinance who are currently underwater in their houses.

One of the issues with that of course is the regulatory system that financial institutions have to deal with, Basel II and so forth. Do you have any thoughts or suggestions along that line of how you could do that and still maintain compliance with the international regulatory systems and so forth?

Chairman Bernanke. Yes, I think that could be done. If I am mistaken I would be happy to look at it. The key here is if you are

refinancing your own loan, one that you made, then you don't have to in some sense underwrite it from scratch. The credit risk is already yours.

So the fact that it is an underwater loan, the refinance might actually make it more likely to pay off because the payments would be reduced, and maybe it could be combined with some kind of principal forgiveness that could be worked off as well.

There are various ways to structure that. So I am not aware of any fundamental reason why a bank could not do that on its own loan.

Representative Campbell. Thank you.

Chairman Casey. Thank you, Representative Campbell. We are joined by Representative Cummings, and, Representative, we are down to the three-minute drill here but we are willing to extend yours another two minutes.

Representative Cummings. Thank you very much, Mr. Chairman. I am sorry I couldn't be here. I was ranking member at my main committee.

Chairman Bernanke, I want to thank you for appearing before the Committee today, and I thank you for your service. And I really mean that. Whether the members of this Committee agree or disagree with the policies of the Federal Reserve Board, I think we all can agree that you have been tireless and steadfast in your efforts to use the Fed's tools to address the extraordinary economic circumstances that continue to confront our Nation. And I thank you.

Mr. Chairman, according to economist Mark Zandi, housing is ground zero for the economy's problems, high unemployment, and lost jobs. A recent Wall Street Journal editorial declared that housing is to the United States what Greece is to the eurozone. Because just as the eurozone won't prosper until Greece gets its act together, the United States recovery won't gain traction until the housing sector deals with the excesses of the past.

From the Federal Reserve's standpoint, you have lowered interest rates first to unlock the credit markets, and currently to spur borrowing and spending. But as one observer recently stated regarding your most recent round of bond buying, and I quote: "The Fed is trying to pump air into a balloon that has a big hole in it, and that balloon is called housing." End of quote.

Mr. Chairman, how critical is the stabilization of the housing market to our economic recovery? And do you believe, Mr. Chairman, that we are doing enough to stabilize the housing market and end this foreclosure crisis that we are going through?

Chairman Bernanke. You make a very good point. As I discussed in my testimony, housing is very central to the situation we have now. Housing is usually a big part of the recovery process, and here it is not doing anything.

Moreover, many people are underwater. That is affecting them financially. Their loss of equity means that they are poorer. They are less willing to spend. So addressing the housing situation is very, very important.

And indeed, as you point out, the Fed has done a lot to bring mortgage rates down, but it is not very effective if people cannot

get a mortgage loan. So I think a lot could be done to address the mortgage and housing situation.

I mentioned a few things to Mr. Campbell earlier. Just to reiterate quickly, looking at the management of real estate owned by banks or by the GSEs to make sure that they are maintained, converted to rentals as appropriate, converted to rent-to-own, avoiding destabilization of neighborhoods from foreclosed houses, helping people who are underwater to refinance, removing unnecessary barriers to mortgage access.

There are a whole range of things. Getting Fannie's and Freddie's future clarified so that people can plan and so that maybe the private sector will come back in and provide some more mortgage credit. I think there are a whole range of things, and I am sure that you and your colleagues have other ideas. And I do think that, relatively speaking, that what would seem like small measures could actually have a very positive effect in housing, and for the whole economy.

Representative Cummings. Would you agree that it is going to be almost impossible to resolve our economic situation when you have people losing their houses at the rate they are losing them? Would you agree with that?

Chairman Bernanke. I would agree with that, yes.

Representative Cummings. Let me just ask you one other question.

Mr. Chairman, do you agree with Director Elmendorf that there is no inherent contradiction between implementing policies that would boost economic growth in the short term and implementing policies that would impose fiscal restraint several years from now?

Chairman Bernanke. I do agree with that. And I mentioned that also in my testimony, that we should be looking simultaneously at long-term consolidation, long-term fiscal stabilization; at the same time, trying to think about what actions we should take now to make sure the recovery continues.

Representative Cummings. And finally, Mr. Chairman, do you believe that, given the fragile state of the United States economy, the most prudent course is to implement policies now that spur economic growth, and implement fiscal consolidation once the economy has recovered?

Chairman Bernanke. Well I think you can do them simultaneously if you have a strong, credible plan for consolidating the fiscal situation over the next few years. But also, to take what actions are necessary—and I am not endorsing any specific one—but taking whatever actions are necessary to help the recovery in the near term.

Representative Cummings. Thank you, Mr. Chairman.

Chairman Casey. Thank you, Representative Cummings. Representative Burgess.

Representative Burgess. Thank you, Mr. Chairman.

Thank you, Chairman Bernanke, for staying with us for a second round. Let me just ask a follow-up to something that was asked a moment ago I think by Senator Sanders. It certainly comes up in every town hall that I do back home.

You talked about a failure of the financial system, and a failure of the regulatory system. In your opinion, why wasn't there a more

aggressive effort to find out what went wrong and who was responsible? Perhaps even prosecute someone for those failings?

Chairman Bernanke. Well the Congress set up a Financial Crisis Inquiry Commission, and it provided a report. And, you know, that was your——

Representative Burgess. It was pretty ineffective, wasn't it? And we certainly had nothing to compare with the Pecora Commission of the 1930s that arguably a lot of people wanted to see. Water under the bridge, and I acknowledge that.

Let me ask you this. When we came up on that August 2nd deadline this summer and there was some concern as to whether or not the debt limit would be extended, what was keeping you awake at night then? And did you have any contingency plans that you were putting in place at the Fed to deal with the fact that Congress might not extend the debt limit?

Chairman Bernanke. We certainly did have contingency plans. First of all, the Fed is the fiscal agent of the Treasury. We are technically responsible for getting the payments done. So we were working on plans on how we would address the situation if the government had to cut back on what it was paying.

So we were dealing with that set of issues. And we were also looking at what we might be able to do to try to reduce the impact on financial markets and on the banking system. But we were quite concerned that the failure of the Congress to pass the debt limit in a timely way would create a crisis of confidence in the financial system, and we were not quite sure that we really had the tools to address that.

Representative Burgess. I don't mean to interrupt, but my time is short. Would that crisis of confidence in any way have mirrored or matched the crisis in confidence that occurred after the failure of Lehman Brothers?

Chairman Bernanke. If there had been a default on U.S. debt, it is possible that you would have had something in the same order of magnitude, yes.

Representative Burgess. And did you have tools to deal with that?

Chairman Bernanke. We would have had some palliative tools, but we could not have prevented a very serious crisis, no.

Representative Burgess. Well let me just ask you another question because we are all now focusing on the Debt Commission. Your predecessor, in talking to a group of us right before he left, a question came up about Medicare and long-term financial sustainability of Medicare. The Chairman thought for a moment and he said: I believe when the time comes Congress will make the necessary adjustments, and the sustainability of the Medicare Program will continue.

He stopped for a minute, and then he said: What concerns me more is will there be anyone there to deliver the services that you require in that program.

And that was a pretty powerful statement for him to make, and one that has concerned me in the now five or six years since. One of the things we are looking at in the Deficit Commission, if the targets are not met, one of the rescissions is going to be in the Medicare system, not to affect beneficiaries but likely be on pro-

viders, which I would argue will ultimately affect beneficiaries. Do you have any thoughts or any concerns about that?

Chairman Bernanke. Well there is a constraint, which is that physicians and hospitals do not have to take Medicare patients. And so you have to pay enough to induce them to do so. Which makes me think that the fundamental issue is getting health care costs down and making our health care sector more productive—not just in terms of Medicare, but in terms of our entire economy.

Representative Burgess. And in your opinion is centralized command and control of the health care system the way to do that?

Chairman Bernanke. There are lots of different ways to address health care, and lots of different models around the world.

Representative Burgess. Maybe we can visit about that more later.

Chairman Bernanke. We can speak about that later.

Representative Burgess. Thank you, Mr. Chairman.

Chairman Casey. Thanks, Representative Burgess. Representative Hinchey.

Representative Hinchey. Thank you, Mr. Chairman.

Chairman Bernanke, thank you very much for everything you are doing here. It is very interesting. I wanted to mention about unemployment and trade deficit.

The U.S. economy has not been able to regain its footing since the near Wall Street collapse which came about in 2008. GPD is low. Unemployment remains stubbornly high. And we are still facing a significant foreclosure crisis across the country.

Can you respond to how much of a current economic situation is due to a large trade imbalance this country has with China and other countries? And also, what effect does the trade deficits have on manufacturing jobs that are being outsourced into other countries, particularly to China?

And also, how do you anticipate the current eurozone crisis will affect our already struggling economy?

Chairman Bernanke. Well as I indicated in an earlier question, I do not have a number in terms of jobs, but I do think that the Chinese currency policy, besides creating problems for them—in particular, they have dealt with some inflation lately, which is a result to a large extent of their currency policy—has been to some extent preventing global adjustment.

That is, we have a two-speed recovery where emerging market economies have been growing very quickly; advanced industrial economies have been growing very slowly. And some of the more balanced growth paths could be achieved if there was greater flexibility in currencies.

China's currency policy not only affects obviously U.S.-China relations, but it also affects third-party currency policies as well.

You asked me about Europe. We have discussed Europe quite a bit. I would press my European colleagues to take strong actions to try to address that problem. I know that they are very concerned about it, and they are working hard to try to address it.

Currently even now we are seeing a lot of volatility in the financial markets, which is no doubt a negative influence on the U.S. recovery, and unless the European situation is brought under control—which I anticipate it will be, but requires still considerable

more effort on the part of the Europeans—it could be a much more serious situation for the U.S. economy.

Representative Hinchey. Well the fact that US multinational corporations can shield profits abroad encourages outsourcing of manufacturing outside of this country. This also had a negative effect. Are you interested in trying to get this changed? A lot of us here in Congress oppose it, but nevertheless it remains in effect.

And that has a significant impact on more jobs leaving this country and going to other places.

Chairman Bernanke. I'm not quite sure which specific issue you're referring to.

Representative Hinchey. I am referring to the fact that corporations can shield profits overseas avoiding US taxation. Are you interested in maintaining the jobs here in this country rather than exporting them outside of this country? And by doing so, by changing that tax shield, that encourages the exportation of jobs outside of this country?

Chairman Bernanke. Well I certainly can agree that we want to encourage policies that maintain good jobs in the United States; absolutely.

Representative Hinchey. Thank you very much.

Chairman Casey. Thanks, Representative Hinchey. Representative Mulvaney.

Representative Mulvaney. Dr. Bernanke, earlier today you said that the Committee will continue to closely monitor economic developments and is prepared to take further action as appropriate to promote a stronger economic recovery, in the context, obviously, of price stability.

Given that we are already at the zero amount on federal funds rates, you have already announced the decision to reinvest the mortgage-backed security position instead of unwinding that, and you have announced Operation Twist earlier this month, or late last month, depending on what month today is—what's left? When you talk about further additional activity, what other tools are you contemplating?

Chairman Bernanke. Well, I talked about some of them in the Humphrey-Hawkins testimony. Generally speaking, there's a variety of things under the heading of communication, giving information to the public about how long and under what conditions we would hold interest rates low. That is one way of providing more stimulus.

Continuing to buy securities in the Open Market, would be a second way.

A third relatively small step would be to reduce the interest that we pay on the reserves that banks hold with the Federal Reserve.

Those are the main directions that I could cite.

Representative Mulvaney. Gotcha. And in the little time I have left, I want to make clear from my earlier comments that I am not blaming the Fed for our inability in Congress to work out our fiscal situation. What I am saying is:

As dysfunctional as this body is—and it is, there is no question—the laws of economics still apply to us. And if you participate in a process that allows us to borrow money at less than 2 percent, which is what our effective rate was last year, I can assure you

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that we will do it. I have heard those discussions within my own party, within the Congress as a whole: Why not borrow money now? It's so cheap, you would be stupid not to.

I will assure you that there are other moral hazards out there other than just, for example, the banking community. There is a moral hazard as it applies to this institution as well.

In layman's terms, what effectively the government is facing right now is a teaser rate. We are able to borrow so much money right now at a reduced rate, there is a very strong impetus here to simply put off the tough decisions for another day. If the interest rates today were at the historical average and the government was paying 5 or 6 percent on its money, I can assure you we would be having a lot longer, more serious conversations about what to do about this debt than we are having today.

But I in no way meant to imply that the Fed was responsible for our shortcomings.

And with that, I yield back my time.

Chairman Casey. Thank you, Representative. Senator Lee.

Senator Lee. Thank you. Mr. Bernanke, I want to refer back to something that I understood you to have said earlier, which is roughly to the effect that Congress not engage in any deep spending cutting activities until such time as the economy recovers. If I understood you correctly, I think you were saying that if we engaged in too much deep cutting in the near term future that might thwart any recovery.

First of all, did I understand you correctly in saying that? Was that——

Chairman Bernanke. I didn't say that precisely. What I said was that you can do both. You can take policy actions which are supportive of recovery, and that would involve perhaps not doing sharp near-term cuts that might involve other things, other things that might be helpful like in the housing market. At the same time that you provide clarity and a strong and credible plan for achieving fiscal stability. Those two things are not incompatible.

Senator Lee. Okay. So a strong and credible plan. Does that imply both spending cuts and tax reform?

Chairman Bernanke. Well that is up to Congress. As I have said often before, I am in favor of the law of arithmetic. Spending cuts, tax increases, as long as it adds up and as long as the policies themselves make sense, I think that is what counts.

Senator Lee. But do you have an opinion as to the rate at which that cutting might occur? I mean, are you suggesting not to cut more than a trillion dollars over the first three years?

Chairman Bernanke. No, I don't have specific numbers, except to say that I think as you look at the amount of cuts, and I think maybe Senator Casey mentioned $4 trillion over the next decade or so to get stability in the debt-to-GDP ratio, clearly that is something that can be done with an increasing effect over the decade.

Senator Lee. Now there is a fair amount of empirical support for the notion that if you are wanting to help an economy recover, but you are also trying to balance the federal budget, that there are a couple of ways of going about it.

One way is to increase taxes. The other way is to cut federal spending, or perhaps a combination of the two. But the empirical

evidence tends to support the notion that you will help the economy recover faster if you focus primarily on cutting expenses rather than on increasing taxes. Do you agree with that viewpoint?

Chairman Bernanke. The empirical evidence is very complex. There is some literature which suggests that sharp budget cuts can lead to recovery. But that is only in limited circumstances. I do not think that is a general proposition.

I think generally you ought to look at your tax and spending policies and ask are these policies doing what we want them to do for our economy? And are the tradeoffs that they engender good tradeoffs for us?

Senator Lee. Okay. Thank you.

Chairman Casey. Thanks, Senator Lee. Representative Cummings.

Representative Cummings. Chairman Bernanke, on April 13th, 2011, the Federal Reserve Board, along with the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and to a limited extent the Federal Deposit Insurance Corporation, issued a joint report summarizing the results of a horizontal review of the foreclosure practices of the Nation's 14 largest mortgage servicers.

Specifically, you found, and I quote, "critical weaknesses in servicers," end of quote. "Foreclosure practices, foreclosure document preparation processes, and oversight and monitoring of third-party vendors, including foreclosure attorneys, which individually or collectively resulted in unsafe and unsound practices in violations of applicable federal and state law and requirements." End of quote.

Simultaneously, you entered into consent orders with these servicers and third-party service providers which required servicers and providers to take steps to correct the problems identified in the review. Specifically, the banks were required to retain independent firms to conduct a thorough review of foreclosure actions that were pending any time from January 1, 2009, through December 31st, 2010, to identify borrowers that have been financially harmed by deficient practices.

I understand that the retention of these firms and the process by which these reviews are to be conducted was required to be spelled out in engagement letters that the regulators have to approve.

This is my question: Mr. Chairman, what is the status of these engagement letters?

Have all of the banks retained their independent firms and spelled out the manner in which they are going to identify borrowers who have been harmed by their improper and, in many instances, illegal practices?

And, Mr. Chairman, how do you respond to the criticism that when the consent orders were released,the primary criticism was that they were overly vague and allowed the servicers to develop their own plans for identifying harmed borrowers and correcting deficiencies going forward.

How do you respond to that criticism? What is the methodology that each servicer will use to ensure that looking back every single harmed borrower in our districts is identified and remediated? And

going forward, that this kind of industry-wide breakdown never occurs again?

I know that is a lot, but you get the drift.

Chairman Bernanke. Well the engagement letters with the consulting firms and the remediation plans are being developed and they will be carefully reviewed and approved by the supervisor——

Representative Cummings. Do we have a timetable on that? A timeline on when we expect that to happen? Because people are losing their homes, as you well know.

Chairman Bernanke. Well the letters are being reviewed, and they will be, I think—I can assure you it will be very soon, but the point is that the process is already underway.

Representative Cummings. Okay.

Chairman Bernanke. The servicers are already reaching out to find people who had problems. In fact, there was something in the paper this morning about that. And they have already made progress in improving their operations and addressing some of the worst abuses. But we will continue to monitor them very carefully. So it is a process that has already begun, and we are well advanced in getting the formal agreements completed and reviewed.

Representative Cummings. Thank you, Mr. Chairman.

Chairman Casey. Representative Cummings, thank you.

Mr. Chairman, thank you for your testimony. I just want to note for the record that for Members the record will be open for five business days to submit statements or additional questions in writing. And we are adjourned.

[Whereupon, at 12:09 p.m., Tuesday, October 4, 2011, the hearing was adjourned.]

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SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF ROBERT P. CASEY, JR., CHAIRMAN, JOINT ECONOMIC COMMITTEE

I look forward to Chairman's Bernanke's report on the state of the economy, his perspective on recent actions taken by the Federal Reserve, and his insights into the short- and long-run challenges facing the U.S. economy.

My hope for today's hearing is to move beyond the partisan politics and finger pointing that sometimes colors discussions about what the Federal Reserve should or shouldn't do. Instead, we should focus on the economic challenges facing the country and the potential solutions.

All of us on this Committee share a belief that Congress needs to take action to bolster the economy and help Americans get back to work. Similarly, monetary policy has an important role to play in strengthening our economy.

Millions of Americans are still struggling in the wake of the Great Recession. The economy is not growing fast enough or adding enough jobs to make significant progress reducing unemployment.

- 14 million Americans are unemployed and six million of the jobless (43 percent) have been out of work for six months or more.
- Private-sector job creation, which had been well above 200,000 a month in February, March and April, fell to less than 20,000 in August.
- State and local governments are reeling, as they lay off workers to meet balanced budget requirements. In the past 12 months alone, state and local government payrolls have been slashed by 345,000.
- In Pennsylvania, the unemployment rate, after declining to 7.4 percent in May, has climbed back up to 8.2 percent in August (with more than 516,000 workers unemployed).

Economic indicators have also been weakening abroad. With financial conditions in the Eurozone deteriorating, contagion spreading to other parts of the world is now a significant risk to the global economic outlook.

The Fed has already used a variety of approaches to ease monetary policy. In the current economic environment, we need to use all available tools to support our economy in the short-term. We also need to take the actions that will get our fiscal house in order in the medium and long-term. The two reinforce each other. Getting our economy growing at a healthy pace is critical to sustained deficit reduction.

As Chairman Bernanke observed in a September speech to the Economic Club of Minnesota:

> "There is ample room for debate about the appropriate size and role for the government in the longer term, but—in the absence of adequate demand from the private sector—a substantial fiscal consolidation in the shorter term could add to the headwinds facing economic growth and hiring."

The Federal Reserve Act created the Federal Reserve System and established two objectives for the nation's monetary policy—maximum employment and stable prices. This is what is commonly referred to as the Fed's dual mandate.

The Federal Reserve's recent announcement that it will ease monetary policy further is consistent with that dual mandate. The Federal Open Market Committee said it will purchase $400 billion of long-term Treasury securities and pay for those securities by selling an equal amount of shorter-term government debt. In the so-called Operation Twist, the Fed is not expanding its portfolio, but shifting its composition so that the average maturity of its holdings is longer.

The goal of the Federal Reserve's action is to bring down long-term interest rates further—reducing borrowing costs for businesses and consumers, sparking additional economic activity and ultimately boosting employment. The Fed also affirmed that it will continue to pay close attention to inflation and inflation expectations.

Some in Washington have called on the Fed to "resist further extraordinary intervention in the U.S. economy," arguing that action by the Fed could further harm the U.S. economy. I disagree. With so many Americans out of work and GDP growth having slowed to a less than 1 percent annual rate in the first half of this year, additional actions are needed to strengthen the economy.

Finally, I would like to address currency manipulation, especially on the part of China, because it has such a harmful impact on the U.S. economy and American jobs. A recent report by the Economic Policy Institute finds that the U.S. trade deficit with China—caused in large measure by China's undervaluation of the yuan—has cost our country 2.8 million jobs over the past decade.

Chairman Bernanke, in testimony before this Committee in April 2010, you noted that "most economists agree the Chinese currency is undervalued and has been used to promote a more export-oriented economy." You also said that it "would be good

for the Chinese to allow more flexibility in their exchange rate" and that "we should continue to press for a more flexible exchange rate."

I agree. This week, the Senate has the opportunity to take action in response to China's unfair trade practices when we vote on bipartisan legislation to crack down on China's currency manipulation. Last night the Senate passed the first procedural hurdle, with a strong bipartisan vote to move forward with debate on the legislation.

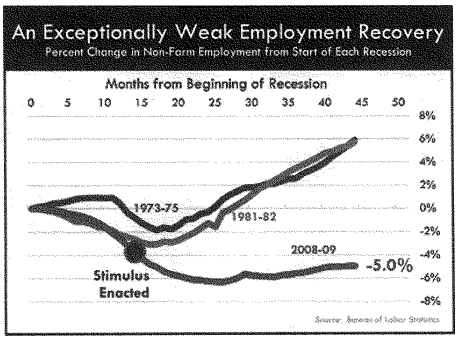
To sum up briefly: more than two years after the recovery officially began, our economy remains vulnerable. Unemployment is stuck above 9 percent and long-term unemployment remains at near-record levels. We need to use every weapon in our arsenal to support a stronger economic recovery.

Chairman Bernanke, thank you for your testimony. I look forward to working with you as the committee continues to focus on strengthening the economy, creating jobs, and putting Americans back to work.

PREPARED STATEMENT OF KEVIN BRADY, VICE CHAIRMAN, JOINT ECONOMIC COMMITTEE

Chairman Casey, I join with you in welcoming Chairman Bernanke to today's hearing on the economic outlook.

Ominous clouds are gathering. Economic growth is nearly stagnant. We have 6.8 million fewer payroll jobs today than when the recession began in December 2007, according to the Bureau of Labor Statistics. At the comparable point during the Reagan recovery, there were 5.4 million more payroll jobs.



According to economists Carmen Reinhart and Kenneth Rogoff, recoveries from financial crises are weak and vulnerable to external shocks that may trigger double-dip recessions. Republican members of Congress recognize this. We are critical of the President's expensive economic policies because not only they have failed to spur job growth and business confidence, but also, as we feared, they have left America susceptible to a double-dip recession.

Today as we meet, America faces a growing risk from the European debt crisis. The United States and the European Union are major trading partners. I am very concerned about the effects of contagion from the euro crisis on American financial institutions and markets, as well as the broader economy. I am anxious to hear your assessment of the euro crisis and any steps that the Federal Reserve may take to quarantine any contagion.

In response to the financial panic, the Federal Reserve took extraordinary actions to stabilize U.S. financial institutions and markets during the fall of 2008. Many of these actions were both necessary and proper, while some of them I question. Instead of rehashing the past, however, I would instead like to initiate a discussion with you on the framework for monetary policy in the future.

Nobel laureate economist Robert Mundell said, "If you want a certain policy outcome, you have to use the right policy lever." Unfortunately, too many Washington policymakers are ignoring Mundell's wisdom.

Monetary policy affects prices. In contrast, budget, tax, and regulatory policies affect real output and employment. While the Great Contraction from August 1929 to March 1933 proved that bad monetary policy can shrink production and destroy jobs, good monetary policy cannot accelerate economic growth or foster job creation, except in the very short term.

Washington affects business investment, production, and job creation through its budget, tax, and regulatory policies. If the prospects for a swelling federal debt,

higher taxes, and additional costs from Obama-care and burdensome regulations are deterring entrepreneurs from investing in new buildings, equipment, and software and therefore hiring more workers, there is little that the Federal Reserve can do to overcome this drag.

Until 1978, the Federal Reserve's mandate regarding monetary policy was merely to provide "an elastic currency." That year, the Full Employment and Balanced Growth Act, known informally as the Humphrey-Hawkins Act, was enacted. This act imposed a dual mandate on the Federal Reserve that gives equal weight to achieving both price stability and full employment.

Since 1978, many countries have examined what a central bank should do and have opted for a single mandate for long-term price stability. By law, the 17 member-states of the European Monetary Union and 13 other developed and major developing countries have enshrined mandates for price stability either as the sole goal or the primary goal with the subordination of other goals for their central banks. Moreover, Australia and Canada have adopted single mandates through published statements.

The time has come for Congress to reconsider the Federal Reserve's mandate. In my view, the dual mandate should be replaced with a single mandate for long-term price stability. I will introduce legislation to make this change in the near future.

While some may mistakenly claim that a single mandate means maximizing employment is unimportant, history proves that the best way for the Federal Reserve to maximize employment is to focus on achieving long-term price stability.

Under a single mandate, the Federal Reserve would publicly announce an inflation target. The Federal Reserve would retain full operational independence from both Congress and the President to achieve the inflation target.

While I may criticize certain actions that the Federal Reserve has taken, I want to be absolutely clear. For our economy's sake, the Federal Reserve must remain independent and free from any undue political pressure in implementing monetary policy.

Congress should also reconsider the Federal Reserve's lender-of-last-resort policy. I remain deeply concerned about the precedents set in 2008 regarding clearly insolvent financial institutions, especially AIG, Bear Stearns, Fannie Mae, and Freddie Mac.

In 1913, Congress envisioned that the Federal Reserve would act as lender of last resort during financial crises. However, the Federal Reserve has never articulated a clear lender-of-last-resort policy.

As celebrated economist Allan Meltzer observed:

> The absence of a [lender-of-last-resort] policy has three unfortunate consequences. First, uncertainty increases. No one can know what will be done. Second, troubled firms have a stronger incentive to seek a political solution. They ask Congress or the administration for support or to pressure the Federal Reserve or other agencies to save them from failure. Third, repeated rescues encourage banks to take greater risk and increase leverage. This is the well-known moral hazard problem.

President Dwight Eisenhower said, "In preparing for battle I have always found that plans are useless, but planning is indispensable." Similarly, if the Federal Reserve were to promulgate a clear statement about its lender-of-last-resort policy, it would go far to diminish uncertainty, reduce the likelihood of political interventions, and mitigate the moral hazard problem.

Finally, many years ago, Congress gave the responsibility for exchange rate policy to the Secretary of theTreasury. This is a vestige of the long defunct Bretton Woods system of fixed exchange rates.

By controlling the money supply, the Federal Reserve directly affects the foreign exchange value of the U.S. dollar. Moreover, swings in exchange rates influence domestic prices. Thus, the responsibility for exchange rate policy should be moved from the Secretary of the Treasury to the Federal Reserve.

Chairman Bernanke, I look forward to your testimony.

PREPARED STATEMENT OF BEN S. BENANKE, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Chairman Casey, Vice Chairman Brady, and other members of the Committee, I appreciate this opportunity to discuss the economic outlook and recent monetary policy actions.

It has been three years since the beginning of the most intense phase of the financial crisis in the late summer and fall of 2008, and more than two years since the

economic recovery began in June 2009. There have been some positive developments: The functioning of financial markets and the banking system in the United States has improved significantly. Manufacturing production in the United States has risen nearly 15 percent since its trough, driven substantially by growth in exports; indeed, the U.S. trade deficit has been notably lower recently than it was before the crisis, reflecting in part the improved competitiveness of U.S. goods and services. Business investment in equipment and software has continued to expand, and productivity gains in some industries have been impressive. Nevertheless, it is clear that, overall, the recovery from the crisis has been much less robust than we had hoped. Recent revisions of government economic data show the recession as having been even deeper, and the recovery weaker, than previously estimated; indeed, by the second quarter of this year—the latest quarter for which official estimates are available—aggregate output in the United States still had not returned to the level that it had attained before the crisis. Slow economic growth has in turn led to slow rates of increase in jobs and household incomes.

The pattern of sluggish growth was particularly evident in the first half of this year, with real gross domestic product (GDP) estimated to have increased at an average annual rate of less than 1 percent. Some of this weakness can be attributed to temporary factors. Notably, earlier this year, political unrest in the Middle East and North Africa, strong growth in emerging market economies, and other developments contributed to significant increases in the prices of oil and other commodities, which damped consumer purchasing power and spending; and the disaster in Japan disrupted global supply chains and production, particularly in the automobile industry. With commodity prices having come off their highs and manufacturers' problems with supply chains well along toward resolution, growth in the second half of the year seems likely to be more rapid than in the first half.

However, the incoming data suggest that other, more persistent factors also continue to restrain the pace of recovery. Consequently, the Federal Open Market Committee (FOMC) now expects a somewhat slower pace of economic growth over coming quarters than it did at the time of the June meeting, when Committee participants most recently submitted economic forecasts.

Consumer behavior has both reflected and contributed to the slow pace of recovery. Households have been very cautious in their spending decisions, as declines in house prices and in the values of financial assets have reduced household wealth, and many families continue to struggle with high debt burdens or reduced access to credit. Probably the most significant factor depressing consumer confidence, however, has been the poor performance of the job market. Over the summer, private payrolls rose by only about 100,000 jobs per month on average—half of the rate posted earlier in the year.[1] Meanwhile, state and local govenunents have continued to shed jobs, as they have been doing for more than two years. With these weak gains in employment, the unemployment rate has held close to 9 percent since early this year. Moreover, recent indicators, including new claims for unemployment insurance and surveys of hiring plans, point to the likelihood of more sluggish job growth in the period ahead.

Other sectors of the economy are also contributing to the slower-than-expected rate of expansion. The housing sector has been a significant driver of recovery from most recessions in the United States since World War II. This time, however, a number of factors—including the overhang of distressed and foreclosed properties, tight credit conditions for builders and potential homebuyers, and the large number of "underwater" mortgages (on which homeowners owe more than their homes are worth)—have left the rate of new home construction at only about one-third of its average level in recent decades.

In the financial sphere, as I noted, banking and financial conditions in the United States have improved significantly since the depths of the crisis. Nonetheless, financial stresses persist. Credit remains tight for many households, small businesses, and residential and commercial builders, in part because weaker balance sheets and income prospects have increased the perceived credit risk of many potential borrowers. We have also recently seen bouts of elevated volatility and risk aversion in financial markets, partly in reaction to fiscal concerns both here and abroad. Domestically, the controversy during the summer regarding the raising of the federal debt ceiling and the downgrade of the U.S. long-term credit rating by one of the major rating agencies contributed to the financial turbulence that occurred around that time. Outside the United States, concerns about sovereign debt in Greece and other euro-zone countries, as well as about the sovereign debt exposures of the European banking system, have been a significant source of stress in global financial markets.

[1] The figure of 100,000 private jobs per month adjusts for the effects of the two-week strike by communications workers at Verizon, which held down measured payrolls in August.

European leaders are strongly committed to addressing these issues, but the need to obtain agreement among a large number of countries to put in place necessary backstops and to address the sources of the fiscal problems has slowed the process of finding solutions. It is difficult to judge how much these financial strains have affected U.S. economic activity thus far, but there seems little doubt that they have hurt household and business confidence, and that they pose ongoing risks to growth.

Another factor likely to weigh on the U.S. recovery is the increasing drag being exerted by the government sector. Notably, state and local governments continue to tighten their belts by cutting spending and employment in the face of ongoing budgetary pressures, while the future course of federal fiscal policies remains quite uncertain.

To be sure, fiscal policymakers face a complex situation. I would submit that, in setting tax and spending policies for now and the future, policymakers should consider at least four key objectives. One crucial objective is to achieve long-run fiscal sustainability. The federal budget is clearly not on a sustainable path at present. The Joint Select Committee on Deficit Reduction, formed as part of the Budget Control Act, is charged with achieving $1.5 trillion in additional deficit reduction over the next 10 years on top of the spending caps enacted this summer. Accomplishing that goal would be a substantial step; however, more will be needed to achieve fiscal sustainability.

A second important objective is to avoid fiscal actions that could impede the ongoing economic recovery. These first two objectives are certainly not incompatible, as putting in place a credible plan for reducing future deficits over the longer term does not preclude attending to the implications of fiscal choices for the recovery in the near term. Third, fiscal policy should aim to promote long-term growth and economic opportunity. As a nation, we need to think carefully about how federal spending priorities and the design of the tax code affect the productivity and vitality of our economy in the longer term. Fourth, there is evident need to improve the process for making long-term budget decisions, to create greater predictability and clarity, while avoiding disruptions to the financial markets and the economy. In sum, the nation faces difficult and fundamental fiscal choices, which cannot be safely or responsibly postponed.

Returning to the discussion of the economic outlook, let me turn now to the prospects for inflation. Prices of many commodities, notably oil, increased sharply earlier this year, as I noted, leading to higher retail gasoline and food prices. In addition, producers of other goods and services were able to pass through some of their higher input costs to their customers. Separately, the global supply disruptions associated with the disaster in Japan put upward pressure on prices of motor vehicles. As a result of these influences, inflation picked up during the first half of this year; over that period, the price index for personal consumption expendituresrose at an annual rate of about 3½ percent, compared with an average of less than 1½ percent over the preceding two years.

As the FOMC anticipated, however, inflation has begun to moderate as these transitory influences wane. In particular, the prices of oil and many other commodities have either leveled off or have come down from their highs, and the step-up in automobile production has started to reduce pressures on the prices of cars and light trucks. Importantly, the higher rate of inflation experienced so far this year does not appear to have become ingrained in the economy. Longer-term inflation expectations have remained stable according to surveys of households and economic forecasters, and the five-year-forward measure of inflation compensation derived from yields on nominal and inflation-protected Treasury securities suggests that inflation expectations among investors may have moved lower recently. In addition to the stability of longer-term inflation expectations, the substantial amount of resource slack in U.S. labor and product markets should continue to restrain inflationary pressures.

In view of the deterioration in the economic outlook over the summer and the subdued inflation picture over the medium run, the FOMC has taken several steps recently to provide additional policy accommodation. At the August meeting, the Committee provided greater clarity about its outlook for the level of short-term interest rates by noting that economic conditions were likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013. And at our meeting in September, the Committee announced that it intends to increase the average maturity of the securities in the Federal Reserve's portfolio. Specifically, it intends to purchase, by the end of June 2012, $400 billion of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less, leaving the size of our balance sheet approximately unchanged. This maturity extension program should put down-

ward pressure on longer-term interest rates and help make broader financial conditions more supportive of economic growth than they would otherwise have been.

The Committee also announced in September that it will begin reinvesting principal payments on its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities rather than in longer-term Treasury securities. By helping to support mortgage markets, this action too should contribute to a stronger economic recovery. The Committee will continue to closely monitor economic developments and is prepared to take further action as appropriate to promote a stronger economic recovery in a context of price stability.

Monetary policy can be a powerful tool, but it is not a panacea for the problems currently faced by the U.S. economy. Fostering healthy growth and job creation is a shared responsibility of all economic policymakers, in close cooperation with the private sector. Fiscal policy is of critical importance, as I have noted today, but a wide range of other policies—pertaining to labor markets, housing, trade, taxation, and regulation, for example—also have important roles to play. For our part, we at the Federal Reserve will continue to work to help create an environment that provides the greatest possible economic opportunity for all Americans.

PREPARED STATEMENT OF REPRESENTATIVE MICHAEL C. BURGESS, M.D.

Thank you Mr. Chairman for the recognition. I'm glad to be here today to discuss this important subject.

Our economy is stuck in a rut, a major rut. Chairman Bernanke, the last time you appeared before our committee in April 2010 some of my Democratic friends were proclaiming that the economy was on a path to economic recovery, due in part to the Fed. Indeed you Chairman Bernanke stated an economic recovery had begun. Well unfortunately that's not true anymore.

We're not moving forward or backward. The Federal Reserve has done a great deal in the last three years to fix this problem, whether it be lowering interest rates to historically low levels, buying treasury bonds and other securities to lower rates further, or the latest steps by the Fed.

Unfortunately our economy is still not where we want it to be. Where the economy would be without the aforementioned steps, no one can be sure. However, what we do know is we need to move forward.

I believe the best thing the federal government can do is get out of the way of businesses and let them create jobs. Republicans here in Washington have said a great deal recently about relieving the regulatory burden and with that I totally agree. But we also need to do more. We need to reform and simplify the tax code. We need to cut the debt. We need to increase domestic energy production of all types. We need to get corporate America to invest some of its $1 trillion in cash reserves into the economy. Finally, we need to repeal the health care law that will cost the federal government trillions of dollars.

I am eager to hear from Chairman Bernanke today to hear what Congress can do to help, and also to hear his words to the American people about what they can be doing. Thank you Mr. Chairman and I yield back.

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Congress of the United States
JOINT ECONOMIC COMMITTEE
(CREATED PURSUANT TO SEC. 5(A) OF PUBLIC LAW 304, 79TH CONGRESS)
Washington, DC 20510–6602

October 18, 2011

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Dear Mr. Chairman:

Thank you for testifying before the Joint Economic Committee. Would you please answer the following questions for the hearing record?

- From 1981 to 2003, the Federal Reserve phased-out federal agency debt and mortgage-backed securities from the System Open Market Account to separate monetary policy from credit allocation by conducting open market operations entirely through Treasuries. During the first round of quantitative easing in 2009, the Federal Reserve bought $169 billion of federal agency debt securities and $1.1 trillion of federal agency mortgage-backed securities. At the time, the Federal Reserve said that it would allow these securities to run off as principal was repaid. On Wednesday, September 21, 2011, the Federal Reserve reversed course, stating that it will now reinvest any repaid principal into new federal agency mortgage-backed securities.
  - Does this policy change mean that the Federal Reserve is allocating credit to the housing sector?
  - Does the Federal Reserve intend to make federal agency mortgage-backed securities a permanent feature of the System Open Market Account going forward?
  - Does allocating credit to the housing sector compromise the independence of the Federal Reserve to conduct monetary policy consistent with long-term price stability?

- The following questions relate to the foreign exchange value of the U.S. dollar:
  - Does the Federal Reserve's monetary policy affect the foreign exchange value of the U.S. dollar?

- Is it fair to say that while a depreciating U.S. dollar may help exports, it also results in higher U.S. dollar prices for internationally traded commodities like oil? And does this put upward pressure on prices for consumer goods like gasoline?

- Which is better for the U.S. economy over the long term: (1) a weaker dollar, (2) a stronger dollar, or (3) a dollar with stable purchasing power?

❖ As dollars are being created and sent throughout the world, the search for a place to deploy them is affecting other countries, such as Brazil and Switzerland, in significant ways. For example, Switzerland is being forced to print more of its currency to offset its rising value against the U.S. dollar. This practice will eventually affect the United States as dollars recycle back into our economy.

- Are you considering how this phenomenon might play out?

- If so, how do you see things evolving?

❖ The Federal Reserve performs an essential function for financial stability by serving as lender-of-last-resort to (1) prevent the unnecessary failures of otherwise solvent U.S. banks and other financial institutions; (2) reduce the likelihood of financial contagion and disruptions in U.S. financial markets; and minimize any adverse effects on real output and employment in the U.S. economy.

- Is there any affirmative reason why the Federal Reserve—in its 98-year history—has never clearly articulated its lender-of-last-resort policy?

- Is Allan Meltzer correct when he states that the absence of an official lender-of-last-resort policy has led to (1) Increased economic uncertainty because no one knows with certainty how the Federal Reserve may act; (2) financially distressed firms seeking political solutions in the form pressure from Congress or the Administration being placed on the Federal Reserve to act to save them; and (3) a moral hazard problem from financial institutions taking greater risks based upon assumptions of how the Federal Reserve will act, though there is no guarantee of Federal Reserve action?

- Is mitigating the risks of moral hazards a positive in terms of economic stability?

- After fulfilling its lender-of-last-resort role, should the Federal Reserve, in an orderly way, sell any acquired debt securities not normally held in its System Open Market Account?

- As you know, there is some debate in Congress over whether the inflation measure used to price index federal programs and the tax code should be changed to another measure such as Chained CPI.
  - Which of the following indices do you believe is the best measure of overall consumer price inflation in the economy:
    - CPI-U,
    - Chained CPI-U,
    - Personal Consumption Expenditures (PCE) Price Index,
    - The market based version of the PCE Price Index,
    - Or some measure?

- President George W. Bush and your predecessor Alan Greenspan repeatedly warned Congress about the systemic dangers that Fannie Mae and Freddie Mac posed to the global financial system. These warnings went unheeded. On September 6, 2008, Fannie Mae and Freddie Mac were found insolvent and placed into receiverships. So far, U.S. taxpayers have pumped $104 billion into Fannie Mae and $65 billion into Freddie Mac just to keep these GSEs alive. Standard & Poor's estimated that another $405 billion will be needed to capitalize new entities to replace Fannie Mae and Freddie Mac.
  - Has the failure to resolve Fannie Mae and Freddie Mac once and for all increased the total cost of resolution that taxpayers will eventually bear?
  - Has this failure deterred private financial services firms from investing in housing finance and offering financially sound mortgage loan products?
  - Has this failure delayed the bottoming of the housing market and any recovery in housing prices?

- The Basel Committee on Banking Regulation promulgated capital standards for banks in 1988, 2004, and 2010, giving risk weights to various assets and off-balance-sheet items.
  - Did the low risk-weight given to residential mortgages and residential mortgage-backed securities have the unintended consequence of encouraging U.S. banks to have excessive exposure to housing loans and housing-related securities prior to 2008?
  - Did the extremely low risk-weight given to bills, notes, and bonds of developed country governments have the unintended consequence of encouraging European banks to have excessive exposures to Greek, Irish, Italian, Portuguese, and Spanish government debt, which are now threatening the financial stability of the euro-zone?

- Should capital standards be more neutral toward the credit allocation decisions that banks make?

❖ Earlier this year, I introduced legislation that would reduce non-interest spending over the next decade relative to the size of the economy to 16.5% of potential GDP, slightly below the average of the Clinton Administration's 16.7%. In addition, the legislation provided a number of other tools to enforce fiscal discipline.

- Without asking you to endorse any specific provisions of the legislation, I would like your views on the various approaches the legislation takes from an economic perspective.

❖ As I mentioned, the legislation utilizes potential GDP as estimated by the Congressional Budget Office as the denominator in calculating a cap on federal spending. Using potential GDP is intended to focus policy decisions on non-cyclical, structural issues. Therefore, this metric would eliminate the need to implement significant spending reductions in an economic downturn, but would also act as a restraint on spending in periods of economic expansion.

- If Congress chose to enact spending limitations based on the size of the economy, what do you see as the policy advantages and disadvantages of using potential GDP as the metric instead of nominal GDP?

❖ The legislation also utilizes non-interest spending as the numerator in calculating the cap. The policy reason for utilizing non-interest spending was based on three principles: (1) Congress cannot directly control interest rates and should focus on what it can control; (2) excluding interest payments eliminates the effect of interest rate volatility over both the long term and short term on the cap; and (3) excluding interest payments insulates the Federal Reserve from undue pressure to keep interest rates artificially low to help implement fiscal policy.

- Do you agree that this approach would create a more stable environment for policymakers?

- Do you believe insulating the Federal Reserve from pressure to keep interest rates artificially low is appropriate?

❖ The legislation also contains a sequestration metric that would reduce all discretionary spending by a maximum of 10% in any year and limit mandatory spending reductions to the elimination of cost-of-living escalators. I recognize that this approach would in some years not reduce spending sufficiently to reach the spending cap.

- Is it more important that a spending control mechanism achieve a particular cap in a specific year or that it keeps you on a path toward the stated objective even if it were to take a few more years to reach the stated cap?

- Would removing uncertainty regarding government shutdowns through some type of permanent continuing resolution law be viewed as a positive or a negative by financial markets?

❖ The legislation that I introduced also contains a couple of budget process reforms designed to force prioritization of spending. It would require the President's budget submission not only to meet caps required by law, but also to prioritize all non-interest federal spending into five categories with at least 12% in each category.

- Without asking you to comment on the choice of five categories with a minimum of 12% in each category, do you believe that requiring some prioritization of spending in the budget process would be a positive development in the eyes of financial markets?

I look forward to reading your response to these questions.

Thank you.

Sincerely,

Representative Kevin Brady
Vice Chairman
Joint Economic Committee

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

January 25, 2012

The Honorable Kevin Brady
Vice Chairman
Joint Economic Committee
United States Senate
Washington, D.C. 20510

Dear Mr. Vice Chair:

Enclosed are my responses to the written questions you submitted following the October 4, 2011, hearing before the Joint Economic Committee. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Questions for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Vice Chairman Brady:

1. From 1981 to 2003, the Federal Reserve phased-out federal agency debt and mortgage-backed securities from the System Open Market Account to separate monetary policy from credit allocation by conducting open market operations entirely through Treasuries. During the first round of quantitative easing in 2009, the Federal Reserve bought $169 billion of federal agency debt securities and $1.1 trillion of federal agency mortgage-backed securities. At the time, the Federal Reserve said that it would allow these securities to run off as principal was repaid. On Wednesday, September 21, 2011, the Federal Reserve reversed course, stating that it will now reinvest any repaid principal into new federal agency mortgage-backed securities.

- **Does this policy change mean that the Federal Reserve is allocating credit to the housing sector?**

In August 2010, the Federal Open Market Committee (FOMC) began reinvesting principal received from agency debt and agency mortgage-backed securities in longer-term Treasury securities in order to support economic recovery in the context of price stability. At the time, the Committee sought to avoid the upward pressure on longer-term interest rates that might result if the maturing agency holdings were permitted to reduce the size of the System Open Market Account (SOMA) portfolio. (For more details, see the minutes of the August 2010 meeting, p. 8: http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20100810.pdf.)

At its meeting on September 20-21, 2011, the FOMC decided to change its reinvestment policy with respect to agency debt and agency mortgage-backed securities, directing reinvestment to agency mortgage-backed securities rather than longer-term Treasury securities. This change in reinvestment policy was expected to help reduce the spread between yields on mortgage-backed securities and those on comparable-maturity Treasury securities and so contribute to lower mortgage rates. In addition, the change in reinvestment policy could help prevent the shares of outstanding longer-term Treasury securities held by the Federal Reserve from reaching levels high enough to result in a deterioration in Treasury market functioning. The FOMC believed that this action would help to support conditions in mortgage markets and thereby contribute to a stronger economic recovery.

- **Does the Federal Reserve intend to make federal agency mortgage-backed securities a permanent feature of the System Open Market Account going forward?**

As noted in the minutes of the June 2011 FOMC meeting (http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20110622.pdf), as the economy recovers, the Federal Reserve will need to reduce the current substantial degree of monetary accommodation in order to avoid an undesirable increase in inflation. As it does so, the Committee intends to normalize the size and composition of the System Open Market Account (SOMA) portfolio, including by selling of our holdings of agency securities. Such sales will likely commence sometime after the first increase in the target for the federal funds rate. The timing and pace of sales will be communicated to the public in advance; that pace is

anticipated to be relatively gradual and steady, but it could be adjusted up or down in response to material changes in the economic outlook or financial conditions. Once sales begin, the pace of sales is expected to be aimed at eliminating Federal Reserve holdings of agency securities over a period of three to five years, thereby minimizing the extent to which our holdings might affect the allocation of credit across sectors of the economy.

➢ **Does allocating credit to the housing sector compromise the independence of the Federal Reserve to conduct monetary policy consistent with long-term price stability?**

The continuing difficulties in the housing market have broad implications for the U.S. economy and financial system. To address these issues, the FOMC has taken actions to support conditions in mortgage markets in order to better foster its dual mandate from the Congress of maximum employment and price stability. The Federal Reserve's actions have involved the purchase of agency-guaranteed mortgage-backed securities through a competitive process. While the guarantee provided for these mortgage-backed securities by the housing-related government-sponsored agencies has encouraged the flow of credit to the housing sector over many decades, the Federal Reserve's recent purchases of such securities have been aimed at reducing mortgage rates and other long-term interest rates relative to what they would otherwise be in order to foster a stronger economic recovery in the context of price stability.

2. The following questions relate to the foreign exchange value of the U.S. dollar:

➢ **Does the Federal Reserve's monetary policy affect the foreign exchange value of the U.S. dollar?**

All else equal, changes in the stance of U.S. monetary policy would normally be expected to lead to some change in the foreign exchange value of the dollar, and a tightening of policy would lead to some appreciation. However, the Federal Reserve's policies are only one of many macroeconomic and financial factors that influence the foreign exchange value of the dollar. Other factors include U.S. fiscal policy, foreign monetary and fiscal policies, risk sentiment, and market expectations for relative growth outlooks and relative inflation rates. Because monetary policy actions can also influence some of these other factors, such as risk sentiment or expectations for growth, the overall effect of Federal Reserve policy on the value of the dollar can be complex.

➢ **Is it fair to say that while a depreciating U.S. dollar may help exports, it also results in higher U.S. dollar prices for internationally traded commodities like oil? And does this put upward pressure on prices for consumer goods like gasoline?**

The economic effects of exchange rate movements will depend in part on the factors behind them. For example, if dollar depreciation were caused by a weaker outlook for U.S. growth, then one might expect to see commodity prices fall, whereas if dollar depreciation were caused by a diminished perception of risk in financial markets, then commodity prices might be expected to rise. Nonetheless, holding these other factors constant, a depreciation of the dollar should make

U.S. goods cheaper abroad and foreign goods more expensive in the United States. Over time this should have several effects. First, it should increase the exports of the United States and reduce imports, increasing U.S. aggregate demand and economic activity. Second, it should put some upward pressure on import prices, including the prices of imported commodities, and eventually may put some upward pressure on prices of some consumer goods. In practice, many of these effects are smaller for the United States than for other economies, because the United States is relatively large and international trade comprises a small share of U.S. GDP.

- **Which is better for the U.S. economy over the long term: (1) a weaker dollar, (2) a stronger dollar, or (3) a dollar with stable purchasing power?**

The Treasury Department has the lead role in U.S. exchange rate policy and has for some time emphasized that a strong dollar is in the interest of the United States, as well as of the global economy. This position is not meant to suggest that any particular level of the dollar is desired or targeted, and U.S. policy seeks to foster global conditions that allow currencies be traded in free and competitive markets.

In the long run, allowing exchange rates to be freely determined by market forces permits them to respond to changing economic conditions and to act as a stabilizing force in the economy. Ultimately, the real exchange value of the dollar will depend upon the fundamental strength of the U.S. economy and confidence in its markets. Economic policies that promote price stability, sustainable economic growth, and financial stability will support both the fundamental vitality of our economy and a strong dollar.

3. As dollars are being created and sent throughout the world, the search for a place to deploy them is affecting other countries, such as Brazil and Switzerland, in significant ways. For example, Switzerland is being forced to print more of its currency to offset its rising value against the U.S. dollar. This practice will eventually affect the United States as dollars recycle back into our economy.

- **Are you considering how this phenomenon might play out?**

- **If so, how do you see things evolving?**

First, I should begin by noting that the Swiss National Bank has set a ceiling on the exchange value of the Swiss franc against the euro, not the U.S. dollar, in order to combat the sharp rise in the value of the franc against the euro that had occurred over the first half of this year. The appreciation of the Swiss franc against the euro largely reflected investor concerns about continuing fiscal and financial pressures in the euro area, leading them to seek Swiss financial assets as a safe haven, and these factors have little to do with the Federal Reserve's policies.

Second, while the Federal Reserve's monetary policies can influence capital flows by affecting domestic rates of return, other factors are also important. For example, the strong rates of growth in many emerging market economies over the last decade have provided a natural

incentive to investors to seek investment opportunities in those countries. In addition, when countries fix or manage their exchange rates, this can affect their current account balance and their pattern of capital flows; this has been the key factor behind the large amounts of reserve accumulation by certain emerging market countries in recent years.

Over the longer term, the G-20 countries have pledged to take actions that should promote a more balanced international system, with countries with large current account surpluses implementing policies to shift to growth based more on domestic demand and allow greater exchange rate flexibility and those with large current account deficits implementing policies to increase national savings. Such steps should materially lessen the net flow of capital from many emerging market economies to the United States and other advanced economies.

4. The Federal Reserve performs an essential function for financial stability by serving as lender-of-last-resort to (1) prevent the unnecessary failures of otherwise solvent U.S. banks and other financial institutions; (2) reduce the likelihood of financial contagion and disruptions in U.S. financial markets; and minimize any adverse effects on real output and employment in the U.S. economy.

➢ **Is there any affirmative reason why the Federal Reserve--in its 98-year history--has never clearly articulated its lender-of-last-resort policy?**

Because the appropriate policy actions tend to be very specific to the situation at hand, policymakers rarely provide detailed statements indicating exactly how they will utilize their policy tools to address crisis situations. National governments, for example, do not provide ex-ante policy statements about their potential use of tax and expenditure policies to address financial crises. Similarly, central banks do not generally commit to a particular course of action in advance of a crisis. Instead, many central banks have adopted broad principles that will guide their actions in a crisis. In the case of the Federal Reserve, Congress has already provided many of the broad principles underlying the Federal Reserve's long-standing approach to its lender-of-last-resort responsibility in Title XI of the Dodd-Frank Wall Street Reform Act. The Dodd-Frank Act provides that emergency lending should be for the purpose of providing liquidity to the financial system, and not to aid a failing financial institution. The Federal Reserve may only provide emergency credit as part of a broad-based lending program. Emergency credit may not be extended to insolvent firms. The security for emergency loans must be sufficient to protect taxpayers from losses; in particular, the Federal Reserve must follow sound risk management practices in valuing and margining collateral so that taxpayers are protected and the Federal Reserve is adequately secured. Any emergency lending program must be terminated in a timely and orderly fashion.

➢ **Is Allan Meltzer correct when he states that the absence of an official lender-of-last-resort policy has led to (1) increased economic uncertainty because no one knows with certainty how the Federal Reserve may act; (2) financially distressed firms seeking political solutions in the form pressure from Congress or the Administration being placed on the Federal Reserve to act to save them; and (3) a moral hazard problem from financial**

institutions taking greater risks based upon assumptions of how the Federal Reserve will act, though there is no guarantee of Federal Reserve action?

It is difficult to directly verify these assertions, but it seems very unlikely that the Federal Reserve's lender-of-last-resort policy is a significant factor in the three areas noted. On the first point, many would argue that economic uncertainty is unusually elevated at present. Among the major sources of economic uncertainty, most point to the continuing weakness in the housing market, the sluggish recovery in the labor market, the highly unsettled situation in Europe, and the potential for repercussions in the financial sector. On the second point, as discussed in the answer above, the Federal Reserve can only provide emergency credit as part of a broad-based lending program to support the financial system and cannot provide emergency credit to insolvent firms. On the third point, the Federal Reserve has utilized its emergency lending authorities in two periods: the Great Depression and the financial crisis of 2007-2009. Based on this history, it seems very unlikely that firms would actively take on greater risks now given the very small likelihood that the Federal Reserve would utilize its emergency lending authorities to provide liquidity assistance. Moreover, with the passage of the Dodd-Frank Act, the Federal Reserve is more constrained in its ability to provide emergency credit than it was in 2008. In addition, the Dodd-Frank Act put in place new tools that the government can use to resolve failing systemically important institutions in an orderly manner. Finally, regulators are more attuned than ever to potential liquidity risks and are actively taking steps to ensure that financial institutions maintain adequate liquidity buffers. All of these factors suggest that moral hazard associated with the Federal Reserve's lender-of-last-resort power is likely to be minimal.

- **Is mitigating the risks of moral hazards a positive in terms of economic stability?**

Economic stability is promoted through sound monetary and fiscal policies, and a well-regulated financial system. Taken together, these policies increase efficiency, reduce incentives for excessive risk-taking, and mitigate moral hazard. However, there could be exceptional circumstances--such as those that existed in 2008--when the federal government would be justified in pursuing extraordinary actions. In these unusual situations, the Federal Reserve's lender-of-last-resort policies may be necessary to restore economic stability.

The Dodd-Frank Wall Street Reform and Consumer Protection Act strengthened financial regulation and oversight, and created the Financial Stability Oversight Council to monitor developments in the financial system, identify emerging risks, and take action as appropriate to address such risks. These reforms have strengthened the financial system and reduced both the probability and severity of future crises.

- **After fulfilling its lender-of-last-resort role, should the Federal Reserve, in an orderly way, sell any acquired debt securities not normally held in its System Open Market Account?**

In fulfilling its responsibilities as lender-of-last-resort, the Federal Reserve provided a substantial volume of loans through a number of emergency lending programs. Almost all of this

emergency credit has already been repaid with interest. We have suffered no losses on the loans we provided during the crisis, and we do not anticipate any losses on the loans that are still outstanding.

In addition to providing liquidity, the Federal Reserve used its monetary policy tools to support the economy during and after the crisis. Our monetary policy actions included reducing the federal funds rate, our usual policy interest rate, to very low levels by the end of 2008. Since that time, we have provided additional monetary policy accommodation through the purchase of longer-term securities, including Treasury securities and agency debt and mortgage-backed securities. These purchases have put downward pressure on longer-term interest rates and supported functioning in the mortgage and other private credit markets, thereby helping to foster the Federal Reserve's dual mandate from the Congress of maximum employment and price stability.

As the economy recovers, the Federal Reserve will need to remove this policy accommodation at an appropriate time in order to avoid an undesirable increase in inflation. As noted in the minutes of the June 2011 FOMC meeting (http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20110622.pdf), the move to less accommodative monetary policy will include the normalization of the size and composition of the Federal Reserve's balance sheet, including sales of our holdings of agency securities. Such sales will likely commence sometime after the first increase in the target for the federal funds rate. The timing and pace of sales will be communicated to the public in advance; that pace is anticipated to be relatively gradual and steady, but it could be adjusted up or down in response to material changes in the economic outlook or financial conditions. Once sales begin, the pace of sales is expected to be aimed at eliminating Federal Reserve holdings of agency securities over a period of three to five years, thereby minimizing the extent to which our holdings might affect the allocation of credit across sectors of the economy.

5. As you know, there is some debate in Congress over whether the inflation measure used to price index federal programs and the tax code should be changed to another measure such as Chained CPI.

- **Which of the following indices do you believe is the best measure of overall consumer price inflation in the economy:**
- **CPI-U,**
- **Chained CPI-U,**
- **Personal Consumption Expenditures (PCE) Price Index,**
- **The market based version of the PCE Price Index,**
- **Or some measure?**

The choice of price measure for indexation purposes depends on what the Congress hopes to achieve, and there is no unambiguously best choice. That said, considering consumer price measures for the nation as a whole, economists generally believe that the CPI-U tends to overstate changes in the cost of living, in part because it does not fully account for consumers'

substitution in response to changes in relative prices. The C-CPI-U (or chained CPI) uses a formula that does account for such substitution and so probably comes closer to measuring changes in the cost of living than the CPI-U does.

Like the chained CPI, the PCE price index also uses a formula that accounts for consumer substitution across in response to relative price changes. The PCE price index differs from the CPIs in a variety of ways, importantly including the fact that it is somewhat broader in scope than either CPI measure: The CPIs are limited to expenditures made by individuals out of pocket, whereas the PCE index also includes (a) the full weight of medical expenditures in the economy, whether paid by individuals, their employers, or governments, (b) expenditures by nonprofit institutions, and (c) a variety of items for which market-based prices are not available (such as the provision of ATM use and other banking services provided without explicit charge). Often, the CPI's out-of-pocket scope is viewed as most appropriate for indexation of programs affecting households, but there is no unambiguous answer to that question and it is a decision that the Congress will need to make.

I should note that all of the measures on your list other than the CPI-U, including the chained CPI, are revised over time. Such revisions complicate the use of these measures for indexation purposes (though by no means are those complications insurmountable), and Congress may wish to take those complications into account in making its decisions.

6. President George W. Bush and your predecessor Alan Greenspan repeatedly warned Congress about the systemic dangers that Fannie Mae and Freddie Mac posed to the global financial system. These warnings went unheeded. On September 6, 2008, Fannie Mae and Freddie Mac were found insolvent and placed into receiverships. So far, U.S. taxpayers have pumped $104 billion into Fannie Mae and $65 billion into Freddie Mac just to keep these GSEs alive. Standard & Poor's estimated that another $405 billion will be needed to capitalize new entities to replace Fannie Mae and Freddie Mac.

- **Has the failure to resolve Fannie Mae and Freddie Mac once and for all increased the total cost of resolution that taxpayers will eventually bear?**

The conservatorships for Fannie Mae and Freddie Mac facilitated the provision of mortgage credit during a very severe U.S. housing downturn, the worst housing downturn since the Great Depression. The continued flow of mortgage credit, even under stressed financial conditions, has likely been a force for stability in U.S. housing markets. In turn, housing market stabilization has likely not only reduced the total cost of resolution that taxpayers will eventually bear for these organizations, but also reduced the costs associated with resolving other financial institutions that have failed because of mortgage defaults, thereby helping to protect the deposit insurance fund. That said, it is difficult to estimate on net cost, the influence of the decision not to resolve Fannie Mae and Freddie Mac since these entities can influence virtually all aspects of mortgage finance, including underwriting standards, servicing costs and revenues, real estate prices through their dispositions of foreclosed properties, secondary prices for mortgage-backed securities, and hedging costs.

- **Has this failure deterred private financial services firms from investing in housing finance and offering financially sound mortgage loan products?**

Steep declines in house prices, relatively high unemployment rates, and a lack of certainty with respect to government's future involvement in mortgage finance have heightened risks and uncertainties associated with investing in housing finance. Investors have been extremely cautious about investing in private-label mortgage loan products, even including securities that are backed by loans that have been underwritten to high standards. Furthermore, investors are hesitant to act until the ongoing uncertainty about the future of Fannie Mae and Freddie Mac is resolved. The Administration's white paper on the future of mortgage finance laid out three possibilities for the future of Fannie Mae and Freddie Mac, and I hope that these possibilities will focus the discussion on how best to go forward.

- **Has this failure delayed the bottoming of the housing market and any recovery in housing prices?**

House prices have recovered in some locations, but not in others. Home prices depend on both demand and supply, and housing demand is only partly driven by the availability and terms of mortgage credit. Potential homeowners also factor in rental costs, local housing market liquidity and the potential for house price appreciation in the future, as well as their current debt and their income prospects. Housing supply is also only partly driven by the actions of government-sponsored enterprises. Recently, however, Fannie Mae and Freddie Mac have become significant sellers of real estate in some locations because of mortgage defaults and foreclosures. These entities have an obligation to conserve their assets on behalf of the taxpayers and the Congress may want to consider whether this is the best method of handling these properties. Regardless, it is unlikely that the conservatorships of Fannie Mae and Freddie Mac have significantly delayed the bottoming of housing markets. In some locations, there simply remains too much housing stock for current housing demand.

7. The Basel Committee on Banking Regulation promulgated capital standards for banks in 1988, 2004, and 2010, giving risk weights to various assets and off-balance-sheet items.

- **Did the low risk-weight given to residential mortgages and residential securities have the unintended consequence of encouraging U.S. banks to have excessive exposures to housing loans and housing-related securities prior to 2008?**

Under the general risk-based capital rules, first lien residential mortgages that meet certain criteria, such as being prudently underwritten, performing in accordance with their original terms, and not being 90 days or more past due, are assigned to the 50 percent risk weight category. Prudent underwriting standards include a conservative ratio of the loan balance to the value of the property. Residential mortgages that do not meet these criteria or that are made for the purpose of speculative property development are assigned to the 100 percent risk weight category, together with most wholesale and retail credits. With respect to residential mortgage-

backed securities (RMBS) that are externally rated, those of relatively high credit quality, as evidenced by a triple-A rating, are assigned to the 20 percent risk weight category, while lower quality RMBS (e.g., rated BB) are assigned to the 200 percent risk weight category. Thus, the risk weights are designed to reflect the relative risks of the exposures.

Many factors influence banks' portfolio allocation decisions. While regulatory capital requirements may have some influence, more predominant factors include investment yield, perceived risk and return tradeoffs, liquidity, and fees and profits associated with lending volume.

- **Did the extremely low risk-weight given to bills, notes, and bonds of developed country governments have the unintended consequence of encouraging European banks to have excessive exposures to Greek, Irish, Italian, Portuguese, and Spanish government debt, which are now threatening the financial stability of the euro-zone?**

It is difficult to generalize about the impact of Basel Accord risk weights because of differences in details of implementation across nations and because of the changes that have occurred over time. It is roughly correct that, under both Basel I and Basel 2, European Union banks could use a zero risk-weight on the debt of any European Union government. However, a zero risk weight does not encourage holding concentrated exposures to any particular sovereign. And national banking systems usually have substantial exposures to the debt of their own sovereign for various practical reasons, including to serve as collateral at the central bank and because such debt is usually liquid within the nation.

- **Should capital standards be more neutral toward the credit allocation decisions that banks make?**

It is important that regulatory capital requirements ensure that banks hold capital commensurate with the risk of their exposures, including off-balance sheet items. Prior to 1989, regulatory capital requirements were credit neutral and every asset had the same capital requirement regardless of its risk. Banks thus had an incentive to hold higher risk assets, which generated more yield per unit of required regulatory capital. In response, U.S. and international bank regulators developed risk-sensitive risk-based capital ratios so as not to disincentivize banks from holding more liquid, lower risk assets. The banking agencies' use of both leverage and risk-based regulatory capital ratios help to limit gaming opportunities associated with each type of ratio.

8. Earlier this year, I introduced legislation that would reduce non-interest spending over the next decade relative to the size of the economy to 16.5% of potential GDP, slightly below the average of the Clinton Administration's 16.7%. In addition, the legislation provided a number of other tools to enforce fiscal discipline. Without asking you to endorse any specific provisions of the legislation, I would like your views on the various approaches the legislation takes from an economic perspective.

As I mentioned, the legislation utilizes potential GDP as estimated by the Congressional Budget Office as the denominator in calculating a cap on federal spending. Using potential GDP is intended to focus policy decisions on non-cyclical, structural issues. Therefore, this metric would eliminate the need to implement significant spending reductions in an economic downturn, but would also act as a restraint on spending in periods of economic expansion.

- **If Congress chose to enact spending limitations based on the size of the economy, what do you see as the policy advantages and disadvantages of using potential GDP as the metric instead of nominal GDP?**

Formal fiscal rules do not replace the need for policymakers to make the difficult choices necessary to put the federal budget on a sustainable path, but they can help the process by setting clear and transparent goals that may establish the credibility of changes in policy and reduce uncertainty. Although fiscal rules have not always proven successful, a number of countries seem to have found budget rules – sometimes, but not always, including a spending limit – helpful in achieving greater budget discipline. In practice, spending limits often have been based on cyclically-adjusted measures of spending or spending relative to potential GDP. As a result, spending decisions are based on factors that can be more directly controlled by policymakers rather than the near-term performance of the economy. This strategy does present some challenges since potential GDP is not measured directly and estimates of it are subject to revision.

9. The legislation also utilizes non-interest spending as the numerator in calculating the cap. The policy reason for utilizing non-interest spending was based on three principles: (1) Congress cannot directly control interest rates and should focus on what it can control; (2) excluding interest payments eliminates the effect of interest rate volatility over both the long term and short term on the cap; and (3) excluding interest payments insulates the Federal Reserve from undue pressure to keep interest rates artificially low to help implement fiscal policy.

- **Do you agree that this approach would create a more stable environment for policymakers?**

The experience in the United States and other countries suggests that fiscal rules focusing on budget measures that policymakers can control more directly tend to work better than budget measures that are affected significantly by the near-term performance of the economy and other factors outside of fiscal policymakers' direct control. That experience suggests that spending targets that exclude interest payments on the public debt would be more likely to work in practice than spending targets that include interest payments.

- **Do you believe insulating the Federal Reserve from pressure to keep interest rates artificially low is appropriate?**

There is substantial evidence from many different countries that the independence of decision-making by the central bank from short-term political considerations is important for achieving good economic performance. The Federal Reserve will continue to make monetary policy decisions in order to best meet our legislatively-determined dual mandate of promoting maximum employment and price stability.

10. The legislation also contains a sequestration metric that would reduce all discretionary spending by a maximum of 10% in any year and limit mandatory spending reductions to the elimination of cost-of-living escalators. I recognize that this approach would in some years not reduce spending sufficiently to reach the spending cap.

- **Is it more important that a spending control mechanism achieve a particular cap in a specific year or that it keeps you on a path toward the stated objective even if it were to take a few more years to reach the stated cap?**

Putting the federal budget on a sustainable path is a long-run problem, and it will require many years of difficult choices. Accordingly, it is probably more important for fiscal policy to achieve sustainable long-term goals than to necessarily meet particular annual targets.

- **Would removing uncertainty regarding government shutdowns through some type of permanent continuing resolution law be viewed as a positive or a negative by financial markets?**

Uncertainty about the budget process and government operations has almost certainly contributed to financial market volatility at various times. Taking steps to eliminate both actual and potential disruptions in government operations should help reduce the uncertainty of financial market participants about budget policies.

11. The legislation that I introduced also contains a couple of budget process reforms designed to force prioritization of spending. It would require the President's budget submission not only to meet caps required by law, but also to prioritize all non-interest federal spending into five categories with at least 12% in each category.

- **Without asking you to comment on the choice of five categories with a minimum of 12% in each category, do you believe that requiring some prioritization of spending in the budget process would be a positive development in the eyes of financial markets?**

Putting the federal budget on a sustainable path will require that the Congress, the Administration, and the American people make difficult policy choices that ultimately lead to the prioritization of some policies over others. That prioritization process could probably be achieved in a number of different ways. Nevertheless, the choices that are made with regard to federal spending and tax policy will affect a wide range of economic incentives that will be part of determining the future economic performance of our nation.

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