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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

THURSDAY, JUNE 7, 2012

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, Bingaman, Klobuchar, Sanders, DeMint, Coats, Lee, and Toomey.

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

Staff present: Brenda Arredondo, Conor Carroll, Gail Cohen, Cary Elliott, Will Hansen, Colleen Healy, Madi Joyce, Jessica Knowles, David Michaelson, Patrick Miller, Matt Salomon, Annabelle Tamerjan, Justin Ungson, Jim Whitney, Andrew Wilson, Ted Boll, Al Felzenberg, Robert O'Quinn, Sean Ryan, Jeff Schlagenhauf, Michael Connolly, Christina Forsberg, 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. Thank you for being here, Chairman Bernanke. We are grateful for your presence here and your testimony.

After my opening statement, we will have Vice Chairman Brady go through his statement, and then we will get to the Chairman.

We all look forward today to Chairman Bernanke's report on the state of the economy and his perspective on additional actions that the Federal Reserve may take to strengthen the economic recovery.

With the May jobs report this past Friday, it is clear that Washington needs to continue our focus on creating jobs. Today's hearing is especially timely for that reason.

There are a number of bipartisan actions Congress can take right now to create jobs and strengthen the recovery. We know that the Surface Transportation bill now is one opportunity to create jobs. We have got to get that legislation out of conference and signed into law.

We know that infrastructure, transportation infrastructure, is central to our national competitiveness and the bipartisan bill that passed in the Senate with 70 votes—74 votes, I should say—would create almost 3 million jobs by accelerating those infrastructure projects.

Second, we should do more to support small businesses. By targeting tax incentives to firms that expand their payrolls, we can help to strengthen the recovery.

A bill that I have introduced would provide a tax credit of 10 percent for any increases to the payroll tax base—that could be hiring workers, increasing hours, or raising wages of existing employees.

Third, the Senate this week has taken up the Farm Bill, which is legislation which cuts the deficit by some $23 billion, and I think has tremendous bipartisan support. It helps farmers manage their risks relating to rapidly fluctuating prices for their crops, and it provides critical support to rural America—part of our country that was especially hard hit in the recession, and still has major challenges.

We have fiscal challenges to tackle in a bipartisan manner, as well. Without Congressional action, the automatic spending cuts contained in the Budget Control Act of 2011, along with the expiration of several tax cuts, will present a significant economic headwind in 2013.

The Congressional Budget Office recently estimated that real GDP growth will slow to just .5 percent in 2013 unless Washington in fact acts.

Chairman Bernanke has expressed concerns regarding the risk that a so-called "fiscal cliff" presents to the recovery. I share that concern, and I know a lot of others share that same concern.

But let us be clear: There are right ways and wrong ways to balance the budget. We have to be smart about the cuts we make so we can keep growing the economy and create jobs rather than make a bad situation even worse. That means we should not increase taxes on middle-income families.

We cannot put America on the road to full recovery unless we all agree on tackling the huge budget deficit and debt that America faces. We need to continue to cut spending. There is no doubt about that. And certainly you cannot reduce the deficit by spending tens of billions of dollars on tax cuts for the very wealthiest.

Additionally, just as when Chairman Bernanke was before this Committee when we spoke about this, I would like to address very briefly currency manipulation, especially on the part of China, because it has such a harmful impact on the American economy and American jobs.

We recently learned that China allowed its currency to weaken more in May than in any other month since 2005. Chairman Bernanke has testified previously that allowing the yuan to appreciate would be good for both the U.S. and China's economy as well.

The Chinese Government manipulates their currency so that their goods sell for less than they should. Some people may think it is some far off theoretical issue—it is not. When China cheats, we lose jobs.

So I urge my colleagues in the House to pass the currency exchange legislation that deals with this issue. It has passed in the Senate in a bipartisan way, and we want to get that out of the House.

So to sum up, our economy, while in much better shape than it was three years ago, is still recovering from the Great Recession. With unemployment above 8 percent, the labor market still needs

to heal. Europe continues to wrestle with debt issues, as well, and we know that, which will continue to impact U.S. financial markets and the global economy.

So against this backdrop, it is clear we need to stay focused on promoting a stronger economic recovery, and of course that means jobs.

Chairman Bernanke, thank you for your testimony and now we will turn to Vice Chairman Brady.

[The prepared statement of Chairman Casey appears in the Submissions for the Record on page 38.]

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

Vice Chairman Brady. Well, Chairman Casey, thanks for holding this hearing. And thank you, Chairman Bernanke, for appearing before the Joint Economic Committee at this critical juncture to discuss America's economic outlook.

While we are all anxious for signs of a strong, sustainable recovery, the recent jobs report for May was grim—with U.S. employers creating a mere 69,000 non-farm payroll jobs, the fewest in a year.

Job growth over the past two months has dropped by two-thirds over the first quarter of the year. Business and consumer confidence is down. First quarter GDP estimates were revised downward.

Four-and-a-half years after the recession began, Americans are enduring the 40th straight month of an official unemployment rate at or above 8 percent. This is a post-World War II record.

And much of the drop in the unemployment rate from its high of 10 percent in October of 2009 is attributable to Americans simply dropping out of the workforce. The labor force participation rate is scraping a 30-year low. Without this severe drop in the number of workers since the recession began, the unemployment rate would be nearly 11 percent.

Since the Recession ended, our economy has struggled to grow at an annualized average quarterly increase of 2.4 percent. And to place it in perspective, of the 10 economic recoveries since World War II lasting more than a year, this recovery ranks, regrettably, tenth. And dead last is unacceptable by any standard.

Today, because our economy is not flying strong and steady at 50,000 feet as it should be at this point, but rather flying low and slow, we are increasingly vulnerable to external shocks.

The economic crisis in Europe has intensified in recent weeks. A nascent bank run has begun in Greece. Greek banks are rapidly depleting their eligible collateral for lender-of-last-resort loans from the European Central Bank.

Not just Greece, but the European Union as a whole appears to be in recession. Questions of whether Greece or other member-states of the European Monetary Union will exit the euro and reissue national currencies are dominating the news.

Mr. Chairman, at this hearing I hope we will get your perspective on Europe, including the likelihood of a Greek exit from the Eurozone, the contagion risk for the exit of other EMU Member-States, and the consequences of these possible events for the European Union, the United States, and the rest of the world.

When you appeared before this Committee last October—in response to a question about the tools you are considering to mitigate and limit the adverse economic impact on the United States—you testified that you believe that the European Central Bank has enormous capacity to provide liquidity to European banks, that traditional currency swaps can provide dollar funding for global dollar money markets, and that the main line of defense is adequate supervision of well-capitalized American banks—with the Fed standing ready to provide as much liquidity against collateral as needed as lender-of-last-resort to the American banking system.

Is that still your assessment? And are you considering any tools beyond those?

In addition, American taxpayers and lawmakers—like their counterparts in Germany—are becoming increasingly concerned that they will be asked to bail out, however indirectly, struggling European governments and banks.

There is a growing concern that the U.S. Treasury will try to bail out the Eurozone either directly through the Exchange Stabilization Fund or indirectly through the International Monetary Fund. The Fed has a challenge as well, explaining to a skeptical Congress why traditional currency swap lines with the European Central Bank will not turn into an indirect bailout of Eurozone countries.

At the same time that European economies are weakening, growth is also slowing in both China and India. Given the prospects of a global slowdown, some economists are speculating that the Federal Reserve may initiate a third round of quantitative easing.

Mr. Chairman, during the questions I would like to discuss with you whether and under what conditions the Federal Reserve would consider launching a third round of quantitative easing.

It is my belief that the Fed has done all that it can do—and perhaps done too much. Further quantitative easing won't stimulate growth and create jobs. There exists a real risk that the massive amount of liquidity the Fed has already injected into the economy could trigger higher inflation before the Fed can execute its exit strategy.

I also believe another round of Fed intervention will increase uncertainty among job creators while ignoring the genuine reason for low business investment and job creation—which is sound, timely fiscal policy.

The businesses I look to along Main Street aren't holding back on hiring because they're waiting to learn what the government will do "for" them; they are holding back on hiring for fear of what the government will do "to" them.

The obsessive push for higher taxes on job creators, the unprecedented tax and fiscal cliff we face at the end of this year, the unsustainable structural federal debt and deficits, along with the flood of red tape and fear of the consequences of the President's new health care law, these are the true drags on the economy.

And no matter what actions the Fed takes, without strong leadership by the President today—and action by Congress now—on these fiscal issues, Americans will not see the jobs or the strong recovery we deserve.

And of course the combination of sluggish growth and the rapid accumulation of federal debt is a toxic brew that could eventually spark a debt-driven economic crisis here at home unless the United States soon reverses course.

Finally, Mr. Chairman, last January the Federal Open Market Committee adopted an explicit inflation target of two percent, measured by the price index for personal consumption expenditures. By doing so, the Fed has taken an important step toward establishing a rules-based monetary policy going forward that should help to achieve price stability and protect the purchasing power of the dollar over time.

Nevertheless, your adoption of the target raises as many questions as it answered. Is the two percent target a minimum, a midpoint, or a maximum? How wide is the range? How long will the Federal Reserve tolerate a deviance from the range before taking action?

I also appreciated that you distinguished between that which monetary policy can control—namely prices—and that which monetary policy cannot—namely employment.

By letter, I will request further clarification on this monetary policy statement in more depth.

With that, Chairman, I again thank you for appearing before the Committee and I look forward to your testimony.

[The prepared statement of Representative Brady appears in the Submissions for the Record on page 38.]

Chairman Casey. Thank you, Vice Chairman Brady.

Just two housekeeping matters before I introduce Chairman Bernanke. Number one is we will keep to our time limits more strictly than we sometimes do because of the number of members here. Number two, the Senate has a vote at 10:30—and I do not think that is going to change—so we will accommodate members for that reason.

But let me briefly introduce Chairman Bernanke. Dr. Bernanke began a second term as Chairman of the Board of Governors of the Federal Reserve System on February 1st of 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 1st, 2006 when he 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 of '05 to January of '06. Prior to beginning public service, Dr. Bernanke was a chaired professor at Princeton University. He has been a professor of economics and public affairs at Princeton since 1985.

Mr. Chairman, welcome.

STATEMENT OF HON. BEN BERNANKE, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WASHINGTON, DC

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 economic policy.

Economic growth has continued at a moderate rate so far this year. Real GDP rose at an annual rate of about 2 percent in the first quarter after increasing at a 3 percent pace in the fourth quarter of 2011. Growth last quarter was supported by further gains in private domestic demand, which more than offset a drag from a decline in government spending.

Labor market conditions improved in the latter part of 2011 and earlier this year. The unemployment rate has fallen about 1 percentage point since late August; and payroll employment increased 2,325,000 per month on average during the first 3 months of this year, up from about 150,000 jobs added per month in 2011.

In April and May, however, the reported pace of job gains slowed to an average of 75,000 per month, and the unemployment rate ticked up to 8.2 percent. This apparent slowing in the labor market may have been exaggerated by issues related to seasonable adjustment and the unusually warm weather this past winter.

But it may also be the case that the larger gains seen late last year and early this year were associated with some catch-up in hiring on the part of employers who had pared their workforces aggressively during and just after the Recession.

If so, the deceleration in employment in recent months may indicate that this catch-up has largely been completed and, consequently, that more rapid gains in economic activity will be required to achieve significant further improvement in labor market conditions.

Economic growth appears poised to continue at a moderate pace over coming quarters, supported in part by accommodative monetary policy. In particular, increases in household spending have been relatively well sustained.

Income growth has remained quite modest, but the recent declines in energy prices should provide some offsetting lift to real purchasing power.

While the most recent readings have been mixed, consumer sentiment is nonetheless up noticeably from its levels late last year. And despite economic difficulties in Europe, the demand for U.S. exports has held up as well. The U.S. business sector is profitable and has become more competitive in international markets.

However, some of the factors that have restrained the recovery persist. Notably, households and businesses still appear quite cautious about the economy. For example, according to surveys, households continue to rate their income prospects as relatively poor and do not expect economic conditions to improve significantly. Similarly, concerns about developments in Europe, U.S. fiscal policy, and the strength and sustainability of the recovery have left some firms hesitant to expand capacity.

The depressed housing market has also been an important drag on the recovery. Despite historically low mortgage rates and high levels of affordability, many prospective homebuyers cannot obtain mortgages as lending standards have tightened and the creditworthiness of many potential borrowers has been impaired.

At the same time, a large stock of vacant houses continues to limit incentives for the construction of new homes, and a substantial backlog of foreclosures will likely add further to the supply of vacant homes.

However, a few encouraging signs in housing have appeared recently, including some pickup in sales and construction, improvements in homebuilder sentiment, and the apparent stabilization of home prices in some areas.

Banking and financial conditions in the United States have improved significantly since the depths of the crisis. Notably, recent stress tests conducted by the Federal Reserve of the balance sheets of the 19 largest U.S. bank holding companies showed that those firms have added about $300 billion to their capital since 2009.

The tests also showed that, even in an extremely adverse hypothetical economic scenario, most of those firms would remain able to provide credit to U.S. households and businesses.

Lending terms and standards have generally become less restrictive in recent quarters, although some borrowers such as small businesses and, as already noted, potential homebuyers with less-than-perfect credit, are still reporting difficulties in obtaining loans.

Concerns about sovereign debt and the health of banks in a number of euro-area countries continues to create strains in global financial markets. The crisis in Europe has affected the U.S. economy by acting as a drag on our exports, weighing on business and consumer confidence, and pressuring U.S. financial markets and institutions.

European policymakers have taken a number of actions to address the crisis, but more will likely be needed to stabilize euro-area banks, calm market fears about sovereign finances, achieve a workable fiscal framework for the euro area, and lay the foundations for longer term economic growth.

U.S. banks have greatly improved their financial strength in recent years, as I noted earlier. Nevertheless, the situation in Europe poses significant risks to the U.S. financial system and economy and must be monitored closely. As always, the Federal Reserve remains prepared to take action as needed to protect the U.S. financial system and economy in the event that financial stresses escalate.

Another factor likely to weigh on the U.S. recovery is the drag being exerted by fiscal policy. Reflecting ongoing budgetary pressures, real spending by state and local governments has continued to decline. Real Federal Government spending has also declined, on net, since the third quarter of last year, and the future course of federal fiscal policies remains quite uncertain, as I will discuss shortly.

With regard to inflation, large increases in energy prices earlier this year caused the price index for personal consumption expenditures to rise at an annual rate of about 3 percent over the first three months of the year.

However, oil prices and retail gasoline prices have since retraced those earlier increases. In any case, increases in the prices of oil or other commodities are unlikely to result in persistent increases in overall inflation so long as household and business expectations of future price changes remain stable.

Longer term inflation expectations have indeed been quite well anchored according to surveys of households and economic forecasters and as derived from financial market information.

For example, the five-year-forward measure of inflation compensation derived from yields on nominal and inflation-protected Treasury securities suggests that inflation expectations among investors have changed little, on net, since last fall and are lower than a year ago.

Meanwhile, the substantial resource slack in U.S. labor and product markets should continue to restrain inflationary pressures. Given these conditions, inflation is expected to remain at or slightly below the 2 percent rate that the Federal Open Market Committee judges consistent with our statutory mandate to foster maximum employment and stable prices.

With unemployment still quite high and the outlook for inflation subdued, and in the presence of significant downside risks to the outlook posed by strains in global financial markets, the FOMC has continued to maintain a highly accommodative stance of monetary policy.

The target range for the federal funds rate remains at 0 to 1/4 percent and the Committee has indicated in its recent statements that it anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate at least through late 2014.

In addition, the Federal Reserve has been conducting a program, announced last September, to lengthen the average maturity of its securities holdings by purchasing $400 billion of longer term Treasury securities and selling an equal amount of shorter-term Treasury securities.

The Committee also continues to reinvest principal received from its holdings of agency debt and agency mortgage-backed securities in agency MBS and to roll over its maturing Treasury holdings at auction.

These policies have supported the economic recovery by putting downward pressure on longer-term interest rates, including mortgage rates and by making broader financial conditions more accommodative. The Committee reviews the size and composition of its securities holdings regularly and is prepared to adjust those holdings as appropriate to promote a stronger economic recovery in a context of price stability.

The economy's performance over the medium and longer term will also depend importantly on the course of fiscal policy. Fiscal policymakers confront daunting challenges. As they do so, they should keep three objectives in mind.

First, to promote economic growth and stability the federal budget must be put on a sustainable long-run path. The federal budget deficit, which averaged about 9 percent of GDP during the past three fiscal years, is likely to narrow in coming years as the economic recovery leads to higher tax revenues and lower income support payments.

Nevertheless, the CBO projects that if current policies continue the budget deficit would be close to 5 percent of GDP in 2017 when the economy is expected to be near full employment.

Moreover, under current policies and reasonable economic assumptions, the CBO projects that the structural budget gap and the ratio of federal debt to GDP will trend upward thereafter, in

large part reflecting rapidly escalating health expenditures and the aging of the population.

This dynamic is clearly unsustainable. At best, rapidly rising levels of debt will lead to reduced rates of capital formation, slower economic growth, and increasing foreign indebtedness.

At worst, they will provoke a fiscal crisis that could have severe consequences for the economy. To avoid such outcomes, fiscal policy must be placed on a sustainable path that eventually results in a stable or declining ratio of federal debt to GDP.

Even as fiscal policymakers address the urgent issue of fiscal sustainability, a second objective should be to avoid unnecessarily impeding the current economic recovery. Indeed, a severe tightening of fiscal policy at the beginning of next year that is built into current law—the so-called fiscal cliff—would, if allowed to occur, pose a significant threat to the recovery.

Moreover, uncertainty about the resolution of these fiscal issues could itself undermine business and household confidence. Fortunately, avoiding the fiscal cliff and achieving long-term fiscal sustainability are fully compatible and mutually reinforcing objectives.

Preventing a sudden and severe contraction in fiscal policy will support the transition back to full employment, which should aid long-term fiscal sustainability. At the same time, a credible fiscal plan to put the federal budget on a longer-run sustainable path could help keep longer-term interest rates low and improve household and business confidence, thereby supporting improved economic performance today.

A third objective for fiscal policy is to promote a stronger economy in the medium and long term through the careful design of tax policies and spending programs. To the fullest extent possible, federal tax and spending policies should increase incentives to work and save, encourage investments in workforce skills, stimulate private capital formation, promote research and development, and provide necessary public infrastructure.

Although we cannot expect our economy to grow its way out of federal budget imbalances without significant adjustment in fiscal policies, a more productive economy will ease the tradeoffs that are faced by fiscal policymakers.

Thank you, Mr. Chairman, I would be glad to take your questions.

[The prepared statement of Hon. Ben Bernanke appears in the Submissions for the Record on page 41.]

Chairman Casey. Thank you, Chairman Bernanke.

I will start with the first round of questions, and I will set forth a predicate for the question before I ask it, based upon three news items, I'll call them.

First of all, we know that China announced just today I guess that it has cut its benchmark lending rate for the first time in nearly four years in order to reverse an economic slowdown.

Secondly, the European Central Bank hinted at least that it would take no further action to aid the faltering European economy.

And then third, two Federal Reserve Board Governors, as well as Vice Chair Janet Yellen, have hinted at additional action by the Federal Reserve.

So based upon those three items, and based upon your testimony, the basic question I have for you is: Is the Federal Reserve planning to take any additional actions in the short term to spur economic growth and create jobs?

Chairman Bernanke. Well, Mr. Chairman, first I think China and Europe face rather different economic situations than we do. We obviously have to make our judgments based on what is happening here in the United States.

Looking forward to our meeting in about 10 or 11 days, I think the main question we have to address has to do with the likely strength of the economy going forward.

As I discussed in my testimony, the weakness in labor markets in the last couple of months may reflect the end of a catch-up period in which employers were offsetting the very sharp declines in employment that occurred during and after the Recession.

If that analysis is correct, then going forward in order to see continued improvement in employment and a lower unemployment rate, we will need to see growth at or above the trend rate of growth. And so that is the essential decision and the central question that we have to look at: Will there be enough growth going forward to make material progress on the unemployment rate?

So my colleagues and I are still working on our own assessments. Staff are working on their updated forecasts. We will have a new round of economic projections by all the participants in the FOMC between now and the meeting. And that is I think a key question.

If we decide that further action is required, then of course we also have to decide what action is appropriate, or what communication is appropriate. We have a range of options. Obviously the traditional reduction in the short-term interest rate is no longer feasible, but we do have options that we can consider.

In looking at those options, we are going to have to make some difficult assessments both about how effective they would be, and whether there are costs and risks associated with those steps that would outweigh the benefits that they might achieve.

Obviously I cannot directly answer your question; it is too soon for me to do that; and we have a committee meeting which will try to evaluate these questions. I think the key question we will be facing will be: Will economic growth be sufficient to achieve continued progress in the labor market?

And our mandate for maximum employment says that we should be looking to try to achieve continued improvement.

Chairman Casey. Well thank you. That helps to give us a sense of how you are approaching the question.

I want to ask you about the so-called, "fiscal cliff," which you have spoken to a number of times. A lot of Americans I think have a sense of it, but when you line up the matters that we have got to confront in literally just a number of months, the question of tax cuts, the automatic spending cuts that are put into place by last year's Budget Control Act, the payroll tax cut expiration, Federal Unemployment Insurance expires, and a whole host of other challenges.

Can you assess—and if you can assess it, we would want to hear your assessment—the impact on the economy just on one of those items? And specifically, if the tax cuts for middle-income folks were

to expire? Just that particular question, if you can make an assessment of that?

Chairman Bernanke. Well the potential expiration—I am not sure I can break it down to the different components—but the potential expiration of the so-called Bush tax cuts, the 2001–2003 tax cuts, is the single biggest item in the fiscal cliff and would have, I think if everything else held constant, would have an adverse effect on spending and growth in the economy that would be significant.

Now in saying that, I am again talking about the size, the fiscal impact of that. I am not necessarily saying that the right thing to do is to extend those cuts. It could be there are other steps you could take that would have a similar impact. But that is the single biggest component of the so-called "cliff."

Chairman Casey. And in keeping with my orders on time, I am going to turn to Vice Chairman Brady.

Chairman Bernanke. Thank you.

Vice Chairman Brady. Thank you, Chairman. You mentioned the options, a third round of quantitative easing. Would purchases in the third round be confined to Treasuries? Or would other debt securities be purchased?

Chairman Bernanke. We have, again, obviously made no decisions. The law permits us to purchase Treasuries and government agency securities, and those are the securities that we have purchased in the past and I wouldn't want to take anything off the table at this juncture.

But I want to emphasize, again, that there's really in some sense two steps here. The first is to determine whether we think that growth will be adequate to lead to further improvement in employment. And I think at the same time of course we will be assessing the price stability mandate and the outlook for inflation.

If we determine that further action is at least potentially warranted, then obviously we have a number of different options and we would have to consider each of them and the costs and benefits associated with them.

But at this point, I really can't say that anything is completely off the table.

Vice Chairman Brady. Well I guess my more direct question is: Long-term interest rates, other than in the financial crisis, we have not seen this level since the 1950s. Do you really think that is holding back our economy?

Chairman Bernanke. Well the question is, again: Could, again, if additional stimulus is needed, could the actions the Federal Reserve might take achieve additional financial accommodation?

Putting aside potential bad side effects, or costs that might be associated with that, I recognize that rates are quite low. So that clearly is a consideration. I do think that we do have methods—we do have tools that would allow us to get further accommodation in the economy and provide some support.

It is one thing—it is not quite the same thing to say that the problem of the U.S. economy is not lack of financial accommodation. It is a different thing to say that, and to say that, even if the main problems are coming from elsewhere, that the Federal Reserve might provide some support from using the tools that it has.

But I do want to say—and I have said this before—that monetary policy is not a panacea. It would be much better to have a broad-based policy effort addressing a whole variety of issues. I leave the details to Congress who has considered many of these issues.

So I would be much more comfortable if in fact Congress would take some of this burden from us and address those issues.

Vice Chairman Brady. Well I think that is the point I would like to make. You—my belief is, I wish you would take a third round of quantitative easing off the table. I wish you would look the market in the eye and say: The Fed has done all it can, perhaps too much. I wish you would look this President and Congress in the eye and say: It is time to do your job. Get your tax policy right. Get your financial house in order. Rebalance your regulation so that you are encouraging job creation. And mitigate the uncertainty and concern over the President's new health care law.

I am not asking you to say that today, but I wish you would. Because back home on Main Street I believe those are the elements that are holding this economy back. And until we get that right, no actions from the Fed will get this recovery moving in a way I think we would all be satisfied with.

May I ask, very quickly, on Europe. There are a lot of concerns about what will happen with Greece as far as exiting the euro. What type of contagion will occur in Europe. Earlier you said—or last October, you said the tools you believed important were providing liquidity through the currency swaps, ensuring American banks are in strong financial condition, and being there to provide liquidity to solvent banks.

Are there any other tools than that that you are considering, should that contagion reach us from Europe?

Chairman Bernanke. No. You have a pretty good list there. We did the swaps, as you know. They were very helpful in reducing stress in dollar funding markets. They have been coming down quite significantly from a peak of about $110 billion down to now about $20 billion. So their need seems to be declining.

I would like to emphasize that on the banking side we have worked really hard to try to make sure the banks and the financial system would be resilient to shocks coming across the Atlantic, including our stress tests which have shown very strong capital positions and liquidity positions. Our ongoing reviews of exposures of banks to Europe. So we are taking steps to try to make sure that we are as well prepared as possible in the financial system.

And then as I said in my remarks, the Federal Reserve retains broad-based authority to provide liquidity against collateral in the event of intense financial stress. That was retained in Dodd-Frank. And in its role as liquidity provider of last resort, the Federal Reserve stands ready to do whatever is necessary to protect our financial system.

Vice Chairman Brady. Thank you, Chairman.

Chairman Casey. Thank you, Vice Chairman Brady. Congresswoman Sanchez.

Representative Sanchez. Thank you, Mr. Chairman. And thank you, Mr. Chairman, for being before us today.

I want to go back to something you just said to my colleague from the Senate. You were talking about one of the biggest portions of that fiscal cliff would be the expiration of the Bush tax cuts. But, you said, I am not advocating that necessarily. There are other steps that Congress could do.

Could you, in your wisdom, tell us what those other steps might be? Just articulate them so I sort of have a to-do list, if that's the case. I think I know them, but——

Chairman Bernanke. I think I am wise enough not to tell you the answer to that question.

[Laughter.]

What I am saying is that the concern here in the short term is that all of these measures together, if they all occur, will amount to a withdrawal of spending and an increase in taxation, depending on how you count between 3 and 5 percent of GDP, which would have a very significant impact on the near-term recovery—whatever benefit you might see in those programs in the very long term.

And what I am saying is that in ways that are up to Congress, steps should be taken to mitigate that overall impact. And what combination of tax reductions and spending increases, that is really up to you, but if no action is taken—I mean, what is particularly striking here is that this is all preprogrammed.

Representative Sanchez. Right.

Chairman Bernanke. If you all go on vacation, it is still going to happen. So it is important to be thinking about that and working with your colleagues to see how you might address that concern at the appropriate time.

Representative Sanchez. That leads me into my second question. Because I hear this out a lot in—I hear it on television, I hear it among some of my colleagues even, I hear it from people back home—that we are all headed towards the Greece situation.

Now to some people, the Greece situation is: Hey, you spent too much, you didn't—you retired early, there are not enough workers, there's not enough economy going to sustain the people who are living on payments, if you will, mostly from the taxpayers.

Then there are other people who are saying, you know, the Greece situation is: You cut too much spending. And you're trying to collect taxes too fast. And the economy has contracted. And it's almost like a vicious cycle going on.

So my question to you is, for those people are saying we are headed toward the Greece situation, what do you think the Greece situation is? And is it really true that we are mirroring in any form that?

Because I see us in a totally different manner. Are we really subject to what's going on in Greece with the type of real economy that we have?

Chairman Bernanke. No. I think the United States and Greece are extremely different economies. Greece is a very small economy. The causes of the crisis vary quite a bit from country to country. Greece was in fact a country that overspent and overborrowed. And that is a major reason why it is currently in such trouble.

The United States is a large, diverse economy with deep financial markets, international reserve currency, independent monetary policy, great credibility after 200 years of paying our debts—which

by the way we should be, is a strength which we should not squander if at all possible.

That being said, I do not think we are in a Greek situation. And the evidence for that is that we are currently paying about 1.5 percent for 10-year money, where Greece cannot borrow at any price essentially.

That being said, I do not think we should be complacent. Obviously we have a situation which is not sustainable, and we do need to be thinking very seriously about how to put the fiscal budget on a path that will be sustainable in the longer term.

Representative Sanchez [presiding]. Thank you. And in the interests, because we have so many members, I will yield back my time.

And I will call on Mr. Campbell from California for his five minutes.

Representative Campbell. Thank you, Ms. Sanchez.

Chairman Bernanke, you have made it quite clear that so-called QE3 is the decision that has not been made and will not be made for at least 11 days.

What I would like to ask is, from my perspective a QE3 would affect interest rates potentially, and potentially liquidity, neither of which it seems to me are obstacles to growth at the moment, interest rates being historically low and there appears to be plenty of liquidity.

So my question is: Why, in considering a QE3, if the decision were made to do it—and I understand you have not made that—but in what ways do supporters of QE3 believe it would help the current economic situation?

Chairman Bernanke. So again, putting aside the question of whether we need further steps, putting aside the question of the adverse side effects that are risks and costs that might be associated with given policies, our analysis is that the quantitative easing programs we did in the past did ease financial conditions. They lowered interest rates. They lowered the spreads between private rates and government rates.

So in other words, even given a level of Treasury Security interest rates, it could lower the rate paid by corporations. We have lowered mortgage rates. It has raised stock prices and increased therefore wealth effects for consumers.

So in general we continue to believe that, while some may think that the effects are less powerful than they were for example in 2009, we continue to believe that potentially, that these sorts of measures could still add some additional accommodations, some additional support to the economy.

But then again, you know, as you point out, there may be some diminishing returns, and that would be a consideration we would have to look at as we try to analyze what our options are.

Representative Campbell. Okay. Let me move over to Europe, if I can. In your testimony you said that we should monitor the situation and that the Federal Reserve remains prepared to take action. And you outline what some of that action should be.

What should we as policymakers be monitoring?

And what action might we be prepared to consider or to take?

Obviously in Europe we cannot control their fiscal policy, their monetary policy, nor their political decisions. If there were to be a deterioration, a rapid deterioration of some situation in Europe, be it the currency or the banks or whatever, how can we put up a firewall? Or can we? Or what things might we be prepared to do?

You mentioned you are doing what you can to minimize the impact on the U.S. economy.

Chairman Bernanke. Well, the Congress and the Administration have not, you know, agreed to any kinds of direct support to Europe. The Administration has not, for example, asked for additional IMF funds.

So I think the main things that Congress could do would be to help strengthen our own economy. The more momentum, the stronger our economy, the better able we would be to withstand the financial spillover from problems in Europe. And so that goes back to my earlier points about getting our fiscal situation clarified, taking appropriate steps to help troubled parts of our economy from the employment market, to the housing market, to whatever else you would be looking at.

But again, I think my bottom line here is that there is not a whole lot that can be done that I can think of to attenuate the problems in Europe. We obviously have to monitor very carefully. I think the best thing we can do is try to make sure that we are strong and prepared here in the United States.

Representative Campbell. Are the risks to our economy and Europe, are they greater today than they were six months ago?

Chairman Bernanke. Well the risks have waxed and waned.

You know, this problem has been going on now for more than two years. This crisis has been going on for more than two years. And there have been periods of greater intensity and less intensity.

Earlier this year, particularly following the long-term refinancing operations conducted by the European Central Bank, as well as the debt restructuring of Greece, the situation calmed down fairly notably for awhile. But for a number of reasons, including the Greek election which raised questions about whether Greece would in fact meet the requirements of its program, and concerns about Spain and Italy, the Spanish banking system and so on, the stresses have risen pretty significantly in the recent month or two.

So I am not quite sure whether it is the highest point it has been, but it certainly is at a point where it is important for European leaders to take additional effective steps to contain the problem.

Representative Campbell. Thank you, Mr. Chairman.

Representative Sanchez. I will recognize Representative Cummings from Maryland now for five minutes.

Representative Cummings. Thank you very much.

Chairman Bernanke, it is good to see you again. When you appeared before this Committee last October, you testified that in most recessions the housing sector is usually, and I quote, "a big part of the recovery process," end quote.

You testified that many people are underwater, and that their loss of equity means that they are poorer, they are less willing to spend, and that addressing the housing situation is very, very important.

In January the Federal Reserve issued a report on current conditions in the United States housing market. The report says this, and I quote:

"Continued weakness in the housing market poses a significant barrier to more vigorous economic recovery."

Chairman Bernanke, I assume you still believe that addressing the housing crisis is critical to resolving our economic situation? Is that correct?

Chairman Bernanke. Yes.

Representative Cummings. And economists and experts across the political spectrum believe that one key tool to addressing the housing crisis is to target principal reductions for underwater mortgages because they help homeowners and save taxpayers money by avoiding default.

Mr. Chairman, in 2008 you said this to the Independent Community Bankers of America, and I quote:

"In this environment, principal reductions that restore some equity for the homeowner may be a relatively more effective means of avoiding delinquency and foreclosure."

And a lot of people have characterized principal reductions as helping only homeowners, but can you please explain why in some cases they actually could help the taxpayers, too?

Chairman Bernanke. Well I think we have made some progress on this. First of all, the housing market looks to be stabilizing, which if true would be good news. And going forward, it would be helpful I think to the recovery.

There's been a lot of effort since I gave that speech to try to modify mortgages, to try to reduce foreclosures, and so on. And some of that has taken the form of principal reduction. Notably, the Fannie and Freddie have decided that some principal reduction, or at least they are looking at principal reduction as a tool for reducing foreclosures. And principal reduction is part of the settlement, you know, with the large servicers.

So we are going to get some more evidence on this I think very soon. The Board of Governors does not have an official position on principal reduction versus other means of modifying mortgages or otherwise avoiding foreclosure.

I think as a practical matter you would want—if there's a limited amount of resources available, you would want to consider whether, say for example reducing payments is more effective in some cases than reducing principal owed.

So I think there are some important questions there. But generally speaking, I think the point that I was trying to make a few years ago is that, while we all focus on the help that avoiding unnecessary foreclosures gives to the homeowner, if it is successfully done, it also reduces the losses to the lender. It supports the housing market. And that in turn helps the broader economy.

So to the extent that we can avoid unnecessary foreclosures and do so in a cost-efficient way, then there are benefits that are broader than just the help to the individual homeowner.

Representative Cummings. Now last November William Dudley, the president of the Federal Reserve Bank of New York, testified before the House Oversight Committee and he said this, and I quote:

"We think that you can devise a program for homebuyers that have mortgages that are underwater to incent them to continue to pay on those mortgages by giving them some program of principal reduction. Obviously the devil is in the detail, so you have to have good program design, but we are confident that one can design a program which would be beneficial net positive to the taxpayer."

Do you agree with Mr. Dudley, that a targeted principal reduction program could be designed in a way that would be net present value positive for taxpayers, investors, and homeowners?

Chairman Bernanke. Well first, president Dudley was speaking for himself, as I said before——

Representative Cummings. I understand that.

Chairman Bernanke [continuing]. The Board does not have an official position on that.

Where I do agree with him is to say that the devil is in the details. I mean, a lot would depend on what the criteria are for being eligible for principal reduction, and how it would be structured.

For example, a useful approach would be to give principal reduction but to have an equity-sharing arrangement whereby if there are future gains those would flow back to the lender.

So I think it depends very much on the way the principal reduction is structured. No doubt there are some situations where that would be the most effective method of averting unnecessary foreclosures, but I do think we should look not only at that, we should look at the whole range of tools for averting unnecessary foreclosures. And we should look at other issues like the conversion of foreclosed homes to rentals, steps to improve the access to credit of mortgage borrowers, and so on, to really address the whole range of issues in the housing market.

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

Chairman Casey [presiding]. Thank you very much. Representative Mulvaney.

Representative Mulvaney. Thank you.

Dr. Bernanke, I want to talk about a different topic here today, a somewhat esoteric topic that may not be of interest to a lot of folks but it is something that caught my attention.

I want to talk a little bit about the interest rate derivative market. And specifically the market for interest rate swaps. Apparently, if I have got my numbers correctly, the notional value of the size of this market has grown from $682 billion in 1987 to over $400 trillion today—roughly a sixth size of the world economy. And I recognize that is notional value. But it certainly implies a large underlying gross market value to this particular market.

And there was a Federal Reserve of New York report back in March called "An Analysis of OTC Interest Rate Derivative Transactions" that essentially said that this market was very difficult to measure, very difficult to see, very difficult to value. So that most of the transactions occurred over the counter and not in the broader exchanges, and they actually said that the lack of comprehensive transaction data has been a barrier to understanding how the OTC derivative markets operate.

And as I was reading this, it struck me that a lot of those words could be used to describe what happened with the mortgage-backed

securities and the collateralized debt obligations' issues that we had back in 2008.

So I guess my first question is: Should we be concerned about this market and its lack of transparency?

Chairman Bernanke. Well it is probably one of the most important derivatives markets, and we pay a lot of attention to it, as do the SEC and the CFTC, which has a lot of the jurisdiction over those swaps.

I think it is important to say, first, on the one hand that those numbers that you cite greatly overstate the actual exposures that the people involved in the swap are facing. Those are just notional values.

It is also true that interest rate swaps are typically among the most straightforward and simple to understand of derivatives. So that many of them are vanilla swaps that are pretty easy for regulators and for participants in the market to understand. So in some ways it does not pose the risks that the credit default swaps during the crisis posed, for example.

All that being said, you know, I agree with the general thrust, which is that we have seen that over-the-counter derivatives can be dangerous. And following the spirit of financial reform from this Congress, we and our fellow regulators are working to put as big a share as possible of swaps on centrally cleared, central counterparty type exchanges. And, to increase the transparency so that the regulators and the public will have more information.

So we are working in that direction. I agree with you, it is an important—important objective.

Representative Mulvaney. Does the size of this overall market somehow give a false impression of the true demand for debt, and thus a false impression of the true interest rates?

Chairman Bernanke. Well interest rate swaps are basically ways in which participants can convert, for example, a fixed interest payment into an interest payment which is floating and depends on some indicator.

So it is really a way of just customizing the flow of interest received, or interest paid. You can have enormous amounts of interest rate swaps based on a relatively modest amount of underlying debt.

So I don't think it overstates the amount of actual debt in the market. It is really a hedging tool for market participants who want to customize the flow of their payments and receipts and interest rates.

Representative Mulvaney. Does the size of the market, and the risks that some of the larger financial institutions—because I think that mostly just large financial institutions play in this market—and given the losses that they could incur, given rapid swings in interest rates, does that somehow impair your ability to perform your job?

Does it impair your ability to exercise independence in monetary policy?

Chairman Bernanke. No, I don't think it does because the underlying instruments, credit instruments, are still the same, which is just a way of sharing the risk, or the pattern of interest receipts and payments.

I should have said that to the extent that interest rate swaps are not traded on central counterparties, we are also working when, if they're traded over the counter, the regulators are also working to make sure that (a) there is sufficient margin posted on both sides of the swap so that if there are rapid changes in the value of the swaps that both parties will be protected; and also, in fact this afternoon we are going to have a meeting at the—open meeting at the Federal Reserve to discuss Basel III, and our discussion will include capital requirements for the market book, including derivatives.

So in other words, even over-the-counter financial institutions are going to be protected both by the capital that they hold and by the margin that they place when they transact with counterparties.

So it is important for us to take steps to make sure that individual banks are not exposed unduly to large swings in interest rates, for example.

The counter example is AIG, which was basically taking a huge one-way bet. And when it lost the bet, it lost enormous amounts of money which nearly brought down the company.

So we want to avoid a situation like that. And that means as much central counterparty trading as possible, and adequate capital and margin for over-the-counter transactions.

Representative Mulvaney. Thank you, Mr. Chairman.

Chairman Casey. Thank you very much. Senator Klobuchar.

Senator Klobuchar. Thank you, very much.

Thank you, Mr. Chairman, for being here. I continue to work with a bipartisan group of Senators—there's something like 45 of us, Democrats, Republicans—trying to come up with a comprehensive solution for the debt. We have made some headway, and it would be a mix of spending cuts and revenue to get us to that $4 trillion figure in 10 years in debt reduction.

You made it clear that you believe we need to do something significant to address these fiscal challenges. Do think a balanced approach would be about the best way to do it with a mix of the spending cuts and the revenue?

Chairman Bernanke. Well first of all, I congratulate you on these efforts. I am glad to see people are working hard on this.

It is really not my place to advise Congress on the particular mix of spending and tax changes, so I hope you will understand that. But I am glad to see that there is a bipartisan effort involved in trying to address this important problem.

Senator Klobuchar. But I remember the last time we talked, you did talk—at the hearing, you talked about how if we failed to act again and went to the brink, as happened last summer with the debt ceiling, that that clearly created some problems with our economy and the fiscal situation in this country.

Chairman Bernanke. The debt ceiling is a somewhat separate issue. It is a strange thing that Congress can approve say to spend $5 and to tax $3, and not approve the $2 issuance of debt, which is implied by those two previous decisions. No other country that I know of has anything like the debt limit rule that we have.

And the brinkmanship last summer over the debt limit had very significant adverse effects for financial markets and for our econ-

omy. For example, it really knocked down consumer confidence quite noticeably.

So that is a somewhat separate issue. But I urge Congress to come to agreement on that well in advance so as not to push us to the 12th hour.

But again, I think that trying to put our fiscal situation on a sustainable basis is perhaps one of the most important things that Congress can be working on.

Senator Klobuchar. You know, when you look at the Fed's last action since late 2008, short-term interest rates have been held at zero. The Fed has pushed over $2 trillion in the U.S. Treasury, and mortgage securities, in an effort to support our economy.

Do the past actions inform you as you go forward in the current economic situation as you make your decisions?

Chairman Bernanke. Yes. Obviously when we began these nonstandard actions, we did not have the benefit of very much experience except looking say at Japan. But we now have more actual data, more experience. We've been able to observe the effects of these actions on financial market prices.

We have some model-based analysis of the effects on the broader economy. So there's still a lot of uncertainty about the effectiveness of these tools, and the channels through which they work. And it is probably also the case that monetary policy is less effective than it would normally be because of various constraints on lending and so on.

But all that said, having had that experience has certainly made us better informed and better prepared to use these tools if necessary.

Senator Klobuchar. Okay. My State is doing better than a lot of the states. Our unemployment rate is at 5.6 percent, but there are still people hurting. And one of the things that I have noticed when you look at the numbers in past recoveries, we have seen a more direct correlation nationally between economic growth and hiring.

We do not seem to have that correlation today. What has changed? And do you think we could be doing more to address that issue?

Chairman Bernanke. Well I talked about this a bit in my testimony. In fact, the pace of improvement in the labor market from last summer through say March, was actually surprisingly strong, given the relatively tepid rate of growth in overall economic activity. And it was a puzzle that we were trying to understand.

I gave a speech about this in March. And one hypothesis is that there was a burst of extra hiring that reflected the reversal of what might have been excessive layoffs during the recession period, where firms felt they had actually laid off too many workers——

Senator Klobuchar. This is the catch-up you were referring to?

Chairman Bernanke. The catching up to that. If that is true, which we do not know for sure because there are a lot of other things going on, but if that is true then the implication is that if growth stays near the potential rate of growth, say 2 to 2½ percent, that the improvement in the unemployment rate going forward might be quite limited.

And so that is, again, as I said, a question that we really have to think about.

Senator Klobuchar. Thank you.

Chairman Casey. Senator DeMint.

Senator DeMint. Thank you.

Thank you, Mr. Chairman, for being here. My experience in business and politics tells me that most of the time when we're trying to solve problems we are actually treating symptoms. And I am worried about that with our political policy, as well as monetary policy.

It is pretty clear our current tax rates did not cause the deep recession. As you know, they were implemented during a downturn in the early 1990s. We had six years of growth.

The problem clearly came from loose credit policies that resulted in subprime mortgages and toxic securities. And we have not really addressed that, except it appears that we overaddressed it from talking to a lot of businesses, home builders, realtors; that we have constricted credit to such a degree that local banks do not have the flexibility to deal with their local economies because the Federal Government and various agencies are telling them what has to be in their portfolio.

So I feel like maybe the solution is much simpler. Maybe not simple, but in effect we are not addressing that problem that would allow the flexibility. You know we cannot deal with the overbuilding of houses. It is going to take years to do that.

But I don't think we have addressed the true cause, or at least a big part of the cause. Instead, we have tried unprecedented bank bailouts, unprecedented government spending, unprecedented federal monetary activism, and it is not working.

And so I am concerned about that. And the thing I am really concerned about now is, since 2008 the national debt has increased about 50 percent, but the interest paid on that debt has increased about 2 percent. And I think some of the things you are doing in the Federal Reserve is giving us a false sense of security.

Last year I think you bought over 75 percent of the debt that we created, which masks the real problem and I think probably give us a debt interest rate that is much lower than it would be.

And part of my concern now is, as my colleague just said, that on one side you appear by these huge derivative markets and other things that are going on to have to keep our interest rates low, and on the other side if you don't keep Treasury yields low banks are going to park the free money we're giving them in Treasuries.

It seems you are caught in a Catch 22 now where you have to work both sides of this to keep interest rates abnormally low and you have to continue to buy Treasuries, or we will be paying so much on our national debt that the fiscal problems we are looking at will complicate overnight.

So we are on one side doing things that don't appear to address the true root causes of our problem. We seem to now be in a quagmire that we can't get out of.

Now I am sure you have a totally different take on that, but I think you would have to agree that the activism has been unprecedented and reason to at least cause some concern?

Chairman Bernanke. Well of course there's been a whole range of approaches and responses to this crisis, which of course was a terrible crisis and required a strong response.

I guess I would comment on your point about interest rates and the federal debt. The reason we keep interest rates low is not to accommodate Congressional fiscal policy. The reason we keep interest rates low is because we think it is going to help the economy recover just a bit faster and keep inflation near our 2 percent target. Those are our objectives for low interest rates.

But I would question whether or not low interest rates are in some way enabling fiscal deficits. The deficit over the last three years has been over a trillion dollars a year, as you know, about 9 percent of GDP.

If we were to raise interest rates by a full percentage point, and ignoring the fact that most debt is of longer duration and would not reprice—that would still only raise the annual deficit by something a little over a hundred billion dollars.

Senator DeMint. Which is a trillion dollars over ten years. I mean, that is real money.

Chairman Bernanke. No. A trillion dollars a year is what I am saying is what the current deficit is.

Senator DeMint. Right. But is the interest cost on that, if it would be $100 billion a year, we're talking $1 trillion over 10 years, we are talking real money.

Chairman Bernanke. A trillion there, a trillion here.

[Laughter.]

Yes, sir. No, I agree with that. But what I am saying is that the situation is—the deficits are so large, particularly going out over the next few years, irrespective of the level of interest rates, that I would think that Congress would have plenty of motivation to try to address that; and that, whether or not the interest rates are currently 1½ percent for 10 years, or 2½ percent, just does not make that much difference.

Senator DeMint. I want to respect the Chairman's time, but just one other point. My concern now is we are equating pro-growth economic policies with more government spending. And our President is talking about that to the Europeans. Austerity is bad? And on the one hand you are telling us this debt is creating a potential huge crisis, yet you're telling us we need to keep spending with more debt.

What is the real signal here?

Chairman Bernanke. Well first of all, it is not necessarily more spending. Appropriate tax relief would also help in the same way. But I have always said, and I said in my remarks, and I have said this a number of times, that you do not want to just do short-run stuff and ignore the long-run. You don't want to just do long-run stuff and ignore the short-run. You need a balanced program, I would say a "do no harm" policy is what I am looking for here that at least avoids derailing the recovery in the short term, but combines that with a strong and credible plan for reducing the deficit over the medium term.

I think that is the best policy. It may be very difficult to achieve, but that—in principle, that would be the best way to go.

Senator DeMint. Thank you, Mr. Chairman.

Chairman Casey. So far we have got a bipartisan commitment to keeping time. Senator Sanders.

Senator Sanders. Thanks very much, Mr. Chairman.

And, Mr. Bernanke, thank you very much for being with us. I am going to try to be as brief as I can. I think I have three questions which I would appreciate your answering.

Number one, the first one deals with conflicts of interest at the Fed. As you know, Jamie Diamon is the CEO and Chairman of J.P. Morgan Chase, which is the largest financial institution in this country.

During the Fed bailout, if you like, when $16 trillion in low interest loans over a period of time were given out to every financial institution in this country, J.P. Morgan Chase received over $300 billion of those loans.

The American people, I believe, perceive a conflict of interest when you have, among others, the head of the largest financial institution in America sitting on the New York Fed, which is presumably supposed to be regulating the Fed—regulating these financial institutions.

I think many people, including myself, see this as a situation where the fox is guarding the henhouse, and that we need real reform in the Fed to make sure that it is representing the middle class and small businesses of this country, rather than just Wall Street and the big-money interests.

Would you be supportive of legislation that I have introduced which says that representatives of financial institutions—not just Mr. Diamon but others—get off of the Fed and they be replaced by folks from the general public?

Chairman Bernanke. Well you raised—Senator, you raised an important point, which is that this is not something the Federal Reserve created.

Senator Sanders. Right.

Chairman Bernanke. This is in the statute.

Senator Sanders. Yes.

Chairman Bernanke. Congress, in the Federal Reserve Act, said this is the governance of the Federal Reserve. And more specifically, that bankers would be on the board and——

Senator Sanders. Six out of nine.

Chairman Bernanke. Sorry?

Senator Sanders. Six out of nine in the regional banks are from the banking industry.

Chairman Bernanke. That's correct. And that is in the law.

Senator Sanders. Right.

Chairman Bernanke. And what we have done is try to make something useful out of that. What we have done is, first of all, we have taken a lot of actions to negate conflict of interest. And under Dodd-Frank, the GAO did a comprehensive study, as you know, of our governance and did point out some appearances of conflict——

Senator Sanders. I know. I wrote that provision. I am familiar with it.

Chairman Bernanke. Yes. And I congratulate you.

But it also found that there were not "actual" conflicts of interest.

Senator Sanders. Right.

Chairman Bernanke. Because there is a firewall so that the bankers do not have any information, or ability to influence supervisory decisions.

I will answer your question, though. The answer to your question is that Congress set this up. We have tried—I think we have made it into something useful and valuable. We do get information from it. But if Congress wants to change it, you know, of course we will work with you to find alternatives.

Senator Sanders. Okay. Thank you. And I think that is something—you are quite right. This is something the Congress established a long time ago. I think it is time to change it.

My second question is: In America today we have the most unequal distribution of wealth and income of any major country on earth, worse than at any time in our country since before the Great Depression.

You've got 400 individuals owning more wealth than the bottom 150 million Americans. You've got the top 1 percent owning 40 percent of the wealth of America. While, incredibly enough, the bottom 60 percent own only 2 percent of the wealth in America.

The last report that I have seen in terms of income, not wealth, suggests that in 2010 93 percent of all new income from the previous year went to the top 1 percent.

Now my question is, we can talk about economic growth all you want, but to the average person it doesn't mean a damn thing if all of that new income is going to the top 1 percent.

Do you believe that we can see an expanding middle class if we continue to have that kind of grossly inequitable distribution of wealth and income?

Chairman Bernanke. Well I think it is not so much a question of bringing down the top 1 percent as it is bringing up the lower 99 percent. The question is: How can you strengthen the middle class? How can you make middle class incomes higher and more secure?

This has been, as you know, a trend that has been going on for 35 years and it is related to a lot of factors, including globalization, the technical change which has made a high school education simply less valuable.

I would be very much in favor of measures to strengthen the middle class and to help the average American do better, focusing on approaches like education and so on would be very constructive.

Senator Sanders. Last question.

Chairman Bernanke. Yes.

Senator Sanders. You have six of the largest financial institutions in this country, the large Wall Street banks, that have together assets equivalent to two-thirds of the GDP of the United States of America, over $9 trillion.

You have some folks on the Regional Feds, and I, and some others, beginning to talk about the need to break up these huge financial institutions which have so much economic and political power. The top six banks write two-thirds of the credit cards in this country, and half of the mortgages.

My suspicion is, if Teddy Roosevelt were here, a good Republican, he would be talking about breaking up these financial institutions.

How do you feel about the need to finally break up these large financial institutions that have so much economic and political power?

Chairman Bernanke. Well I first commented, a lot of these people saying they want to break up the banks are not very specific. Does that mean making them a little smaller? Does it mean making everything community banks?

I really would like to see a plan that clarifies what is really meant by that. The Dodd-Frank Act put forward a strategy for ending too-big-to-fail. I think it is incredibly important to end too-big-to-fail.

That strategy involves taking away the advantages of size. It means that banks will be allowed to fail, but through a safe method that will avoid the effects on the broader financial markets through the orderly liquidation authority that Dodd-Frank created for the FDIC.

It means that large banks will pay—will have higher capital requirements, tougher supervision, will be subject to a whole set of rules that smaller banks will not face. I will guess that if the size of banks is basically motivated by a too-big-to-fail motivation, as we take that away the market forces themselves will make it attractive for banks to downsize, rationalize, and so on.

I would add an additional tool that we have from the Dodd-Frank is the so-called "living wills" which require banks to give us information about their very complex structures.

One approach would be to ask banks, for the purposes of being able to be brought into receivership if necessary, is to simplify their structures to avoid these very complex interconnected types of situations that I think are as much a problem as sheer size.

Senator Sanders. Okay. Thank you very much.

Chairman Casey. Senator Coats.

Senator Coats. Thank you, Mr. Chairman.

And thank you, Mr. Chairman. On page 4 of your statement you talk about inflation. You say with regard to inflation: "Longer-term inflation expectations have, indeed, been quite well anchored", "expectations among investors have changed little, on net, since last fall and are lower than a year ago." " . . . substantial resource slack in U.S. labor and product markets should continue to restrain inflationary pressures."

That is good news. That is good news for all of us. Let me ask you a question about the reverse of that, and that is: deflation.

We have gotten some bad employment numbers not only for May but the revision for April. We have bad news out of Asia. It appears that the Australian manufacturing is in recession. India has posted its slowest growth in nine years. China, many say, is on the verge of a manufacturing downturn.

A lot of people are saying that we are at stall-speed here in the United States. The question is: What is the risk of spending too much time worrying about inflation and ending up in a potentially deflationary new recession, perhaps prompted by a shock from Europe if they can't pull it together?

What are your concerns about that? What is the Fed thinking about that? Is that something we should worry about? Is that

something you are worrying about? What kind of guidance can you give us on that?

Chairman Bernanke. Well when we set our definition of price stability as 2 percent inflation, we meant that to operate in both directions. We do not want inflation above that, but we also do not want inflation well below that. We obviously want to avoid deflation.

And it is one of the principal motivations for the so-called QE2 we did in November of 2010 to avoid deflationary pressures. And we were in fact successful and brought inflation back to—back to target.

Now part of your question was about general slow-down in the global economy. And there are some signs certainly in Europe. China cut interest rates today. Some of the emerging markets have seen some slowdown. So there's certainly some signs of global slowdown and we are trying to assess how important those are, and what implications they have for the United States.

I would say, though, at this juncture that with respect to deflation specifically that we think deflation is at this point probably a pretty low probability risk. And at the moment, inflation seems to be pretty stable, close to 2 percent. We haven't seen much indication of declining inflation, particularly when you look at the—either the noncommodity prices, or look at expectations.

So that particular concern right now is not I think very much in our forefront of our concerns.

Senator Coats. What would a shock to the system, a war in the Middle East, euro coming apart, what would that do to that analysis of what you just gave?

Chairman Bernanke. I think it depends on what the shock is and how it ramifies. A shock in the Middle East presumably would cause oil prices to go up a lot. That would tend to be inflationary. But it would also probably slow the economy further because it would be like a tax increase on consumers who would have to pay more for gas and therefore less for other things.

The euro situation depends a lot on the situation, which we hope will not occur, in which there is a big escalation of financial stress. It would depend a lot on exactly how that happened. If Greece for example were to leave the Eurozone but the stresses were contained there, then the effects would likely be fairly moderate.

If the financial distresses were to spread more broadly, then that would create a lot of volatility in our own financial markets and would put stress on our financial institutions, would probably reduce lending, and would at a minimum tend to slow the economy.

But again, I don't think deflation is the main concern here. I think the main concern is promoting adequate growth to continue to bring down unemployment over time.

Senator Coats. Given the kind of fragile economic state that we are in and the situation unfolding in Europe, do you sleep well at night?

Chairman Bernanke. Do I?

Senator Coats. Do you sleep well at night?

Chairman Bernanke. I generally sleep pretty well, yes. But I have a lot to do during the day and I need to be well rested.

[Laughter.]

Senator Coats. Thank you, Mr. Chairman.

Thank you.

Chairman Casey. Thank you. Representative Maloney.

Representative Maloney. Thank you, Mr. Chairman.

And welcome, Mr. Bernanke. I would like to respectfully speak in opposition to the point of view that has been put forward by my colleagues on the other side of the aisle in strong opposition to any QE3.

I believe that the Fed should use any tool in your arsenal, whatever it is, to provide support to our fragile economy. And we need to ensure against any downward turns that would hurt housing, employment, and all the other areas in our economy.

I think it is particularly important, coming up on your June 19th meeting, that you act forcefully to help our economy, given the fact that China has cut its benchmark lending rate. And already, in response to that, the price of gold has gone up; the dollar fallen.

I would like to hear your comments on China. Will China be buying our Treasury Notes now with this economic downturn in what appears to be in their economy, and combined with the news from the past month that the Eurozone debt and banking crisis seems to have deteriorated further in Europe? So could you comment further? You have, in many ways, but even further on China specifically and the impact China will have in the overall, really, our economy? They have been a partner in our financial recovery, and your comments on China?

Chairman Bernanke. Well, China has slowed somewhat. So far the slowdown is pretty moderate. They still have rates of growth that we would love to have here.

Part of the slowdown is policy-induced, intentional. In particular, China took a number of actions to try to avoid what looked to be a building bubble in real estate prices. So they took a number of actions to mitigate that. That tended to slow activity.

And they have in general tried to slow growth both to achieve a more sustainable pace of growth, and also as a part of their process for trying to switch from an export-led economy to one that has a greater emphasis on domestic demand.

So there has been some slowing there. We watch that very carefully. But so far I don't think the change in Chinese prospects on net are enough to be concerning for the United States, particularly since there are some offsetting factors—notably, when China slows, that tends to bring down oil prices, and that is actually a positive for the U.S. economy.

I think the greater concerns for us right now are still coming from Europe. Even as the situation is still being managed, we are seeing of course, as you can see every day, the volatility in large movements in stock prices and other asset prices, and the uncertainty that that generates.

So that is a concern.

Representative Maloney. I would also like to ask you a question about the so-called "fiscal cliff" that we confront next year if current laws governing taxes and spending are maintained and the Bush tax cuts expire. Also, the payroll tax cut expires. The Federal Unemployment Insurance expires. And the automatic spending cuts mandated by the Budget Control Act would take effect.

CBO tells us that this will cause the economy to fall into a recession. It also tells us that if we continue all current policies, we can avoid a recession but that our long-term budget situation will continue to deteriorate. Certainly neither of these outcomes are satisfactory.

My question is: What would happen if we failed to achieve a budget agreement in the lame duck session and all the fiscal cliff priorities kicked in?

Chairman Bernanke. Well I agree very much with the CBO's general analysis there. If no action were taken and the fiscal cliff were to kick in in its full size, I think it would be very likely that the economy would begin to contract, or possibly go even into a recession, and that unemployment would begin to rise.

So that is obviously something we want to avoid if at all possible. At the same time, I am not advocating undoing all of these measures and simply ignoring the distant future. I mean, I think as I have said before, what we need is a combination of sensible policies that allow the recovery to continue over the next year or two, with a long-term credible plan for putting our budget on a sustainable path.

Representative Maloney. Thank you. My time has expired.

Chairman Casey. Thank you. Representative Burgess.

Dr. Burgess. Thank you, Mr. Chairman.

Dr. Bernanke, welcome to our Committee again. I just want to pick up, Senator DeMint used the word "quagmire," Senator Coats used the term "stall-speed." And I've got to admit, I am concerned about some of these same things.

The Vice Chair of the Fed yesterday at the Boston Economic Club described adverse shocks that could push the economy into territory where a self-reinforcing downward spiral of economic weakness would be difficult to arrest.

I am not an economist, but that sounds bad. Is that right?

Chairman Bernanke. The concern she is expressing is that if growth is not sufficiently strong, that it would not take too much to put us back into a——

Dr. Burgess. That's correct.

Chairman Bernanke [continuing]. Into either a recession or at least a significant slowdown.

Dr. Burgess. So I won't admit to having trouble sleeping every night, but what does bother me at night is Lehman Brothers. And that is, when I wake up at three o'clock in the morning, that is what I am worried about.

Now I do not know what the next Lehman Brothers will look like. I do not even know whether it would be in this country, or perhaps be in Europe, but I think she summed it up pretty well. And this was reported on the CNBC Squawkbox this morning. And I must admit, when they played that clip it really got my attention because this was one of the things that has bothered me since September of 2008.

I see a lot of parallels as we cruise into this summer season with the summer of 2008. Gas prices have moderated, so perhaps you can move that off the table a little bit, but similar situations. Presidential election year coming up, and the economy still in tough shape and has not recovered.

And we see all this stuff happening in Europe. So you said on page 3 of your testimony down right at the bottom of the page, you said you're "prepared to take action as needed". Can you outline for us very briefly maybe what the top three steps are of that "action as needed" item that you have there?

Chairman Bernanke. Sure. First of all, we are already taking some actions, important actions. Notably, that we are working to ensure that banks have adequate capital and liquidity. And as I noted, banks are now much better capitalized than they were prior to Lehman, which is helpful.

Dr. Burgess. Can I ask you a question about that?

Chairman Bernanke. Certainly.

Dr. Burgess. You talk about "our banks"——

Chairman Bernanke. Our banks.

Dr. Burgess. Our domestic banks.

Chairman Bernanke. Yes.

Dr. Burgess. You really cannot control what is happening in banks in Europe. Is that correct?

Chairman Bernanke. I cannot, no.

Dr. Burgess. And we cannot do a stress test. Timothy Geithner can't run over there and do a stress test.

But if we are asked to help with the situation in Europe, what assurance do you have, or can you give us, or can you tell us that we can give the American people, that we are doing that due diligence? Or is that help just not available? Is that one of the things that's just not on your—within your realm of being able to help?

Chairman Bernanke. Well I think the U.S. Government's position has been, reasonably, that Europe is a rich region, and that they have the resources necessary to achieve stability.

I think the main problems over there are political, rather than economic. There's a lot of different—17 countries are involved, and a lot of different interests. So, you know, I'm not sure that there's much that the United States can do other than be supportive and try to provide whatever advice and, you know, verbal help that we can do, but——

Dr. Burgess. We can send them a get-well card.

Chairman Bernanke. Send them a get-well card. What the Federal Reserve can do is try to protect our own country, and we are doing that by strengthening our financial system by making sure—or at least by monitoring on a regular basis the exposures that our financial institutions have to Europe, both direct and indirect, and how they are hedged.

We have done the swaps, which was I think a useful thing that we did to help stabilize the money markets, the bank funding markets over there.

I think the main thing that we have not done yet, but could do if financial conditions got sufficiently severe, would be to use our authority through the discount window, or through our 13.3 authority, to lend to financial institutions against collateral to make sure that lack of liquidity was not a reason that they would collapse or at least stop lending.

So I think that's the main tool that we obviously have in reserves that we could use, and we will use if financial conditions call for it.

Dr. Burgess. Let me ask you this. Are there any U.S. banks whose capital could be seriously jeopardized by what's happening in Europe that then could push a Lehman-type scenario to the forefront?

Chairman Bernanke. Well as I said, we've been monitoring the direct exposures. And for the most part, our banks are far less exposed to European sovereign debt and the European financial institution debt than are the European banks. Which is why there's such a difficult interaction between the sovereign debt problems and the banking problems in Europe.

That being said, if there's widespread contagion, hard to predict, operating through financial markets, operating through the potential problems of a large European institution, whatever that might be, then we can't really foresee or guarantee that there might not be serious stresses on some U.S. financial institutions. In which case, the Federal Reserve with the experience that we had in 2008, is certainly going to do what's necessary to try to mitigate that problem.

But I don't mean to be represented as saying that there is no problem. There is a risk. And all we can do is prepare for it as best we can.

Dr. Burgess. Thank you, Mr. Chairman. I will yield back.

Chairman Casey. Representative Hinchey.

Representative Hinchey. Well thank you very much, Mr. Chairman.

Dr. Bernanke, thank you very much for everything that you have done, and for all the things that you are engaged in, and for also being with us here today to talk about these issues.

I think that we have come a long way, considering the financial meltdown that occurred back in 2007, but we have still got a long way to go.

I think there are still some things that Congress must do to ensure we do not go down the same paths of our European counterparts. And I think that that is an interesting set of circumstances there.

Since the end of the Recession, our economy has steadily improved. We are still working hard on that. We have created 4 million private-sector jobs, and unemployment has steadily decreased to 8.2 percent now.

President Obama I think deserves enormous credit for turning the economy around. If it had not been for his action and those of the Democratic majority, I have no doubt our country would have fallen into a deeper economic depression.

So we obviously have a long way to go, but the President is on the right path. The Fed's aggressive action and monetary policies that have stimulated the economy have also been instrumental to getting our economy back on track.

Europe, on the other hand, has been a total disaster. Europe has clearly proven that austerity was the wrong policy to pursue during a recession. If you look at the situation that they're dealing with there, Greece and Spain, 20 and 24 percent respectively unemployment in those two countries. Britain has shown zero economic growth over the course of the past year.

So naturally I am surprised that with such strikingly different recoveries occurring between the United States and Europe, that so many United States lawmakers will continue to support the same types of policies that are utilized by Europe.

What do you think are the key lessons that we should learn from Europe's failed monetary policies, particularly austerity? What do you think the United States is most at risk, in the context of that situation, of repeating?

Chairman Bernanke. Well I think in fairness you have to agree that there are structural differences. You have 17 different countries on a single monetary policy, essentially a fixed exchange rate.

There are in fact some very serious fiscal situations. Greece for example probably has no alternative but to try to cut its deficits. So there are some important differences.

I think, though, that the main message I would take is the one I have been trying to sell here for the last couple of hours, which is that a sensible fiscal policy is one that takes into account both the short-run needs of the economy, not to lose fiscal support sharply and rapidly during a period of fragile recovery; while at the same time combining that with a medium-term plan, we do have to address these fiscal sustainability issues.

So I don't think it is inconsistent to do both of those things. And that is where I would differ with at least a few of the countries in Europe. But again, the situation is much more complicated. The countries that have capacity to expand their budgets, for example, like Germany, have much less need than the countries like Greece which have very little capacity to spend more or borrow more.

Representative Hinchey. Well Germany is another example. But the other things are negative examples that we have to deal with, and we have to be acting I think in a very positive way.

Also, after Congress and President Obama acted in 2009 and 2010 to turn around our economy, since then the House has basically done nothing significant to revive our economy. As a result, the Fed has really led the efforts to help get our economy back on track.

However, we have nearly exhausted all the Fed's tools to nurture our economy back to health. Congress needs to step up to the plate. Clearly our actions back in 2009 and 2010 turned things around. But more needs to be done.

We cannot allow the European austerity model and allow growth to just continue to fail, and have it fail on us. The American Jobs Act is a prime example, unfortunately, of stalled legislation in the House that would inject nearly $450 billion worth of tax cuts, jobs, business opportunities, all of those things, into our economy.

I think it has been a major mistake to sit on this legislation when it could be helping so many people. So do you think Congress has carried its fair share of the burden with regards to stimulating economic activity? And do you think legislation such as the American Jobs Act is important to help the Fed stimulate job growth and economic activity?

Chairman Bernanke. Well I certainly agree, as I have said before, that monetary policy cannot carry this burden by itself. We need good policies over a range of areas from Congress.

Now you know I am not going to endorse a specific program. But I hope that Congress can work together to address their problems across the economy in a number of different sectors, and I hope that, you know, Congress will work collaboratively to try to address some of those problems.

Representative Hinchey. Thank you.

Chairman Casey. Representative Duffy.

Representative Duffy. Thank you, Mr. Chairman.

And good morning, Mr. Chairman. I want to talk to you about too-big-to-fail. We had all heard two years ago when Dodd-Frank passed that this was going to be our silver bullet to address this issue of too-big-to-fail, and to make sure that the taxpayers wouldn't hold the bag should one of these large institutions fail, to make sure that it doesn't roil our whole economy.

And I guess I would argue that Dodd-Frank has not fully and completely addressed the issue of too-big-to-fail. And it still exists. I think it has come up more recently as we look at what is happening in Europe. But here at home it has come up with regard to J.P. Morgan, and they experienced a $2 billion loss that might go up to $4 or $5 billion.

And some have argued that the Volcker Rule would have addressed—had it been implemented, and it is going to come shortly—had it been implemented, it would have addressed this massive loss from J.P. Morgan.

One of my concerns, though, is as you look at the Volcker Rule and you look at these trades, it becomes very difficult to determine what is prop trading and what is macro hedging.

So as you sit in a classroom, it might be easy to work through the Volcker Rule, but in practice isn't it very difficult to use the Volcker Rule to stop the issue of J.P. Morgan?

Chairman Bernanke. Well let me just say, in the specific case we are still investigating it, and I don't want to talk very much about the specific case. But in general, yes, differentiating proprietary trading from legitimate hedging activities and marketmaking activities is inherently very difficult, and regulators are looking at 19,000 comment letters and trying to figure out how to do that as best as possible.

The one comment I would make, which my colleague, Governor Tarullo, made yesterday is the one requirement of the Volcker Rule is that there be very extensive documentation and explanation to the supervisors in advance for complex hedges, as well as auditing and appropriate incentives for the executives involved in the activities of the traders.

So at a minimum, if the Volcker Rule had been in place we would have known a lot more about this whole situation. And that might have been helpful.

Representative Duffy. And the classroom theory, I agree with. I am not opposed to it. I am concerned about the implementation. But isn't really the silver lining here that there was no taxpayer loss here? J.P. Morgan had the appropriate capital requirements to cover the loss, which is what you guys are talking about later on today when you're going to talk about Basel III. Isn't the real issue here is not thousands of new rules and a 2000-page bill, but really increasing the capital requirements of our American banks? Mak-

ing sure that they have more skin in the game, and that the taxpayer is not going to bear that loss, the investors in those banks are going to be responsible for the losses of bad trades?

Chairman Bernanke. I agree with you entirely. The reason for high capital requirements—and we are looking to greatly increase capital requirements—is because we are not going to be able to anticipate everything that could happen. And the good news here is that J.P. Morgan's losses are a very small fraction of their very substantial capital base.

There have been losses to the shareholders, as you say, but there is not any risk that the firm will fail or that taxpayers will be in danger in any way.

So, yes, capital is extremely important and I agree with you a hundred percent on that.

Representative Duffy. And so in essence we increase those ratios. And I imagine you would—and I do not have much time—but you would agree with the SIFI surcharge, making sure that our larger banks are required to hold more capital? Yes?

Chairman Bernanke. Yes.

Representative Duffy. Okay. Just quickly, sometimes—and I know you have to do this—but when you talk to us, what you say can be open to interpretation. You do a very nice job of that. But as you're talking about the cliff, as we are talking about taxes specifically, are you telling us if we allow nothing to happen and we see all of these taxes increase—the Bush tax cuts, the Obama tax cuts go away—there is going to be a direct impact on economic growth and job creation?

Chairman Bernanke. I am looking not just to the taxes, but also the sequester and the end of the payroll tax, and everything else. Yes, I think that it—I mean, of course economic forecasting is an imperfect science, but everything we understand about fiscal policy suggests it would be a significant short-term effect. Yes.

Representative Duffy. Okay. So in essence our—you are not here to advise us, but if you were you are telling us to extend them?

Chairman Bernanke. I would tell you to try to avoid a situation in which you have a massive cut in spending and increase in taxes all hitting at one moment, as opposed to trying to spread them out over time in some way that will create less short-term drag on the U.S. economy.

Representative Duffy. I appreciate your testimony. I yield back.

Chairman Casey. Thank you.

Senator Lee.

Senator Lee. Thank you very much, Mr. Chairman.

And thank you for joining us today, Chairman Bernanke.

What are some of the risks that accompany quantitative easing? Could you walk us through those and help us understand the risk factors you consider as you approach a decision like that one?

Chairman Bernanke. Well I think a preliminary thing to say is that, since we have less experience with quantitative easing our estimates and our understanding of its efficacy and exactly how much is needed and so on are less than the traditional monetary policy.

But in terms of potential side effects, a number have been identified. But I think the two that we would pay most attention to:

First, there are some who believe that greatly expanding our balance sheet would make the exit strategy more difficult, and that therefore inflation is more likely. And then that might lead inflation expectations to go up, which could be a problem.

Now I want to be very clear that we are very confident that we can exit in a timely way from our balance sheet strategy, and that there is in fact no justification for such a concern. But nevertheless, some people might have that concern. So that is one issue.

The second issue——

Senator Lee. No justification for which concern?

Chairman Bernanke. The concern that inflation will rise excessively because we can't get out of our balance sheet position.

Senator Lee. Okay. Okay. So go ahead to your second point.

Chairman Bernanke. The second one has to do with financial stability. The question is does the prospect of very low interest rates for a long time, does it create problems for certain types of firms like life insurance companies or pension funds? Does it induce excessive risk taking? Does it lead to effects that could be counter productive in the longer term?

There, we do extensive monitoring, extensive analysis to try to identify any such problems. But it is always possible that we might miss something.

Senator Lee. Okay. And it sounds like you are not discounting—you are not refuting the possibility that it can have inflation effects, you are just saying that you think you can time it in such a way that it is less likely to?

Chairman Bernanke. There are two separate issues. One is our timing of when we take monetary policy back to a more normal stance.

In any monetary policy easing episode, there is always the question of whether the Fed gets it exactly right—too soon? Too late?

And it is always the case that if the Fed waits too long to remove monetary accommodation, you could get some inflation effect.

What I am talking about here is the question of whether it is technically possible to undo the balance sheet expansion in a timely way. We are very confident that we have the technical tools to bring the balance sheet down to a more normal level, to bring the amount of reserves in the banking system down to a more normal level, at the appropriate—you know, when we decide it is time to tighten monetary policy.

So the technical side, we think we are quite comfortable with.

It is always the case, no matter, under the most normal traditional monetary policy that the timing of withdrawal of stimulation is difficult. And it is always possible that you could either undershoot or over-shoot, and that is unavoidable.

Senator Lee. With Treasury yield rates being at all-time historic lows, I think it becomes difficult to dispute that at some point in the next few years we will start to see a normalization and we will start to see yield rates return to their historic averages, perhaps above.

Do you have any sense, and can you offer us any insight into when we might expect to see that happen?

Chairman Bernanke. Well, we have indicated that we expect to keep short-term rates low until late 2014, at least. But even then, longer term rates might be rising. If in fact we are removing short-term rate reductions at that point, since long rates include expectations of short rates even beyond that window, you could be seeing some movement by then.

We do expect of course rates to normalize over time, but the exact timing is very difficult to judge because it depends very much on the recovery of the economy. And while we see the economy moving in a moderate pace in the right direction, the point at which we are comfortable that it is time to withdraw monetary stimulus is obviously quite uncertain.

Senator Lee. Is there a risk of a sharper rebound the longer you keep the rates low?

Chairman Bernanke. Um, I don't think so. It is true that, that the quantitative easing measures have pushed down the so-called term premia on longer term rates, and if those were to normalize quickly that would make the increase in rates a little faster than might otherwise be the case.

But we have stress-tested both our economic models and our financial portfolio—I mean the financial portfolios of financial institutions, and we don't see at this point any serious risk either to economic recovery or to the financial stability of that return of interest rates to more normal levels.

But it's obviously, again, something we need to pay close attention to.

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

Chairman Casey. Thank you very much.

Chairman Bernanke, thank you for your testimony.

For the Members, the record will remain open for five business days to submit either additional questions or of course a statement.

And we are adjourned.

[Whereupon, at 11:50 a.m., Thursday, June 7, 2012, the hearing of the Joint Economic Committee was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF SENATOR BOB CASEY, CHAIRMAN,
JOINT ECONOMIC COMMITTEE

I look forward to Chairman Bernanke's report on the state of the economy and his perspective on additional actions that the Federal Reserve may take to strengthen the economic recovery.

With the May jobs report released on Friday—it is clear that Washington needs to continue our focus on creating jobs. Today's hearing is especially timely.

There are a number of bipartisan actions Congress can take right now to create jobs and strengthen the recovery.

First, we need to get the Surface Transportation Reauthorization out of conference and signed into law.

Our transportation infrastructure is central to national competitiveness and the bipartisan bill that passed the Senate, with 74 votes, would create almost three million new jobs by accelerating infrastructure projects.

Second, we should do more to support small businesses. By targeting tax incentives to those firms that expand their payrolls, we can help to strengthen the recovery.

The Small Business Jobs and Tax Relief Act would provide a tax credit of 10 percent for any increases to the payroll tax base—hiring new workers, increasing hours, or raising wages of existing employees up to the $110,100 cap for the payroll tax. The proposed credit is capped at $500,000 per firm in order to target the tax credit to small businesses.

Third, the Senate this week has taken up the Farm Bill, responsible legislation that cuts the deficit by $23 billion, helps farmers to manage risks relating to rapidly fluctuating prices for their crops, and provides critical support to rural America.

We have fiscal challenges to tackle in a bipartisan manner. Without congressional action, the automatic spending cuts contained in the Budget Control Act of 2011 along with the expiration of several tax cuts will present a significant economic headwind in 2013.

The non-partisan Congressional Budget Office recently estimated that real GDP growth will slow to 0.5 percent in 2013 unless Washington acts.

Chairman Bernanke has expressed concerns regarding the risk the fiscal cliff presents to the recovery. I share that concern. But let's be clear there are right ways and wrong ways to balance the budget. We have to be smart about the cuts we make so we can keep growing the economy and create jobs rather than make a bad situation even worse.

We can't put America on the road to full recovery unless we all agree on tackling the huge budget deficit and debt America faces. We need to continue to cut spending. And certainly, you cannot reduce the deficit by spending tens of billions on tax cuts for the very wealthiest.

Additionally, just as when Chairman Bernanke was before this Committee in October, 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.

We recently learned that China allowed its currency to weaken more in May than in any other month since 2005.

Chairman Bernanke has testified previously that allowing the yuan to appreciate would be good for both the U.S. and Chinese economies. The Chinese Government manipulates their currency so that their goods sell for less than they should. Some people may think it's some far off theoretical issue but when China cheats, Pennsylvania and the rest of the country loses lots of jobs.

I urge my colleagues in the House to pass legislation, such as the Currency Exchange Rate Oversight Reform Act already passed by the Senate, to crack down on countries that manipulate their currencies to promote their own exports.

To sum up briefly: our economy, while in much better shape than it was three years ago, is still recovering from the Great Recession. With unemployment above 8 percent, the labor market still needs to heal. Europe continues to wrestle with debt issues, which impact U.S. financial markets and the global economy.

Against this backdrop, it is clear that we need to stay focused on promoting a stronger economic recovery.Chairman Bernanke, thank you for your testimony.

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

Thank you, Chairman Bernanke, for appearing before the Joint Economic Committee at this critical juncture to discuss America's economic outlook.

While we're all anxious for signs of a strong, sustainable recovery, the recent jobs report for May was grim—with U.S. employers creating a mere 69,000 non-farm payroll jobs, the fewest in a year. Job growth over the past two months has dropped by two-thirds over the first quarter of the year. Business and consumer confidence is down. First quarter GDP estimates were revised downward.

Four and a half years after the recession began Americans are enduring the 40th straight month of an official unemployment rate at or above 8%—a post-World War II record. And much of the drop in the unemployment rate from its high of 10% in October of 2009 is attributable to Americans simply dropping out of the workforce—the labor force participation rate is scraping a 30-year low. Without this severe drop in the number of workers since the recession began, the unemployment rate would be nearly 11%.

Since the recession ended, our economy has struggled to grow at an annualized average quarterly increase of 2.4%. To place it in perspective, of the 10 economic recoveries since World War II lasting more than a year, this recovery ranks, regrettably, tenth. And dead last is unacceptable by any standard.

Today, because our economy isn't flying strong and steady at 50,000 feet as it should be at this point, but rather flying low and slow, we are increasingly vulnerable to external shocks.

The economic crisis in Europe has intensified in recent weeks. A nascent bank run has begun in Greece. Greek banks are rapidly depleting their eligible collateral for lender-of-last-resort loans from the European Central Bank. Not just Greece, but the European Union as a whole appears to be in recession. Questions of whether Greece or other member-states of the European Monetary Union (EMU) will exit the euro and reissue national currencies are dominating the news.

Mr. Chairman, at this hearing I hope we'll get your perspective on Europe, including the likelihood of a Greek exit from the Eurozone, the contagion risk for the exit of other EMU Member-States, and the consequences of these possible events for the European Union, the United States, and the rest of the world.

When you appeared before this Committee last October—in response to a question about the tools you are considering to mitigate and limit the adverse economic impact on the United States—you testified you believe that the European Central Bank has enormous capacity to provide liquidity to European banks, that traditional currency swaps can provide dollar funding for global dollar money markets, and that the main line of defense is adequate supervision of well-capitalized American banks—with the Fed standing ready to provide as much liquidity against collateral as needed as lender-of-last-resort to the American banking system.

Is that still your assessment? Are you considering any tools beyond those?

In addition, American taxpayers and lawmakers—like their counterparts in Germany—are becoming increasingly concerned that they will be asked to bailout, however indirectly, struggling European governments and banks.

There is a growing concern that the U.S. Treasury will try to bail out the Eurozone either directly through the Exchange Stabilization Fund or indirectly through the International Monetary Fund. The Fed has a challenge as well, explaining to a skeptical Congress why traditional currency swap lines with the European Central Bank will not turn into an indirect bailout of Eurozone countries.

At the same time that European economies are weakening, growth is also slowing in both China and India. Given the prospects of a global slowdown, some economists are speculating that the Federal Reserve may initiate a third round of quantitative easing.

Mr. Chairman, during the questions, I would like to discuss with you whether and under what conditions the Federal Reserve would consider launching a third round of quantitative easing.

It's my belief that the Fed has done all that it can do—and perhaps done too much. Further quantitative easing won't stimulate growth and create jobs. There exists a real risk that the massive amount of liquidity the Fed has already injected into the economy could trigger higher inflation before the Fed can execute its exit strategy.

I also believe another round of Fed intervention will increase uncertainty among job creators while, ignoring the genuine reason for low business investment and job creation: sound, timely fiscal policy.

The businesses I look to along Main Street aren't holding back on hiring because they're waiting to learn what the government will do for them—they're holding back on hiring for fear of what the government will do to them.

The obsessive push for higher taxes on job creators, the unprecedented tax and fiscal cliff we face at the end of this year, the unsustainable structural federal debt and deficits, along with a flood of red-tape, and fear of the consequences of the President's new health care law—these are the true drags on the economy.

No matter what actions the Fed takes, without strong leadership by the President today—and action by Congress now—on these fiscal issues, Americans will not see the jobs or the strong recovery we deserve.

And, of course, the combination of sluggish growth and the rapid accumulation of federal debt is a toxic brew that could eventually spark a debt-driven economic crisis here at home unless the United States soon reverses course.

Finally, Mr. Chairman, last January the Federal Open Market Committee adopted an explicit inflation target of 2%, measured by the price index for personal consumption expenditures.

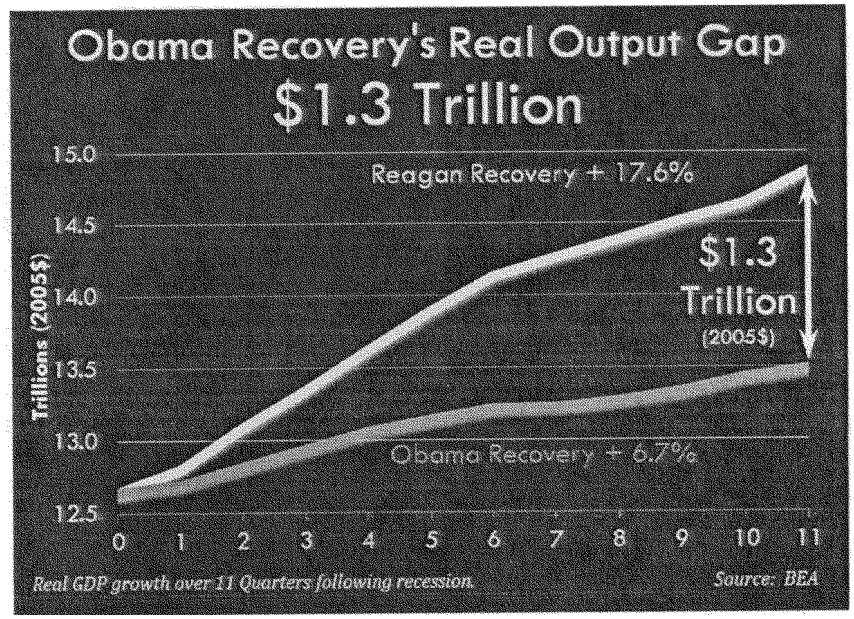
By doing so the Federal Reserve has taken an important step toward establishing a rules-based monetary policy going forward that should help to achieve price stability and protect the purchasing power of the dollar over time.

Nevertheless, your adoption of an explicit target raised as many questions as it answered. Is the 2% target a minimum, mid-point, or a maximum? How wide is the range? How long will the Federal Reserve tolerate a deviance from the range before taking action?

I also appreciated that you distinguished between that which monetary policy can control—namely prices—and that which monetary policy cannot control—namely employment.

By letter, I will request further clarification on this monetary policy statement in more depth.

With that, I again thank you for appearing before the Committee, and I look forward to your testimony.



For release on delivery
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June 7, 2012

Statement by

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

U.S. Congress

June 7, 2012

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

Economic growth has continued at a moderate rate so far this year. Real gross domestic product (GDP) rose at an annual rate of about 2 percent in the first quarter after increasing at a 3 percent pace in the fourth quarter of 2011. Growth last quarter was supported by further gains in private domestic demand, which more than offset a drag from a decline in government spending.

Labor market conditions improved in the latter part of 2011 and earlier this year. The unemployment rate has fallen about 1 percentage point since last August; and payroll employment increased 225,000 per month, on average, during the first three months of this year, up from about 150,000 jobs added per month in 2011. In April and May, however, the reported pace of job gains slowed to an average of 75,000 per month, and the unemployment rate ticked up to 8.2 percent. This apparent slowing in the labor market may have been exaggerated by issues related to seasonal adjustment and the unusually warm weather this past winter.[1] But it may also be the case that the larger gains seen late last year and early this year were associated with some catch-up in hiring on the part of employers who had pared their workforces aggressively during and just after the recession.[2] If so, the deceleration in employment in recent months may indicate that this catch-up has largely been completed, and, consequently, that more-

[1] In particular, the unusually warm weather this past winter may have brought forward some hiring in sectors such as construction where activity normally is subdued during the coldest months; thus, some of the slower pace of job gains this spring may have represented a payback for that earlier hiring. In addition, the estimated seasonal factors for some economic indicators may have been influenced by the timing of the steepest part of the decline in activity during the 2008-09 winter months; if so, the seasonal adjustment process may have resulted in an overstatement of economic activity this past winter and the understatement of activity in other months.

[2] For further discussion, see Ben S. Bernanke (2012), "Recent Developments in the Labor Market," speech delivered at the National Association for Business Economics Annual Conference, Washington, March 26, www.federalreserve.gov/newsevents/speech/bernanke20120326a.htm.

rapid gains in economic activity will be required to achieve significant further improvement in labor market conditions.

Economic growth appears poised to continue at a moderate pace over coming quarters, supported in part by accommodative monetary policy. In particular, increases in household spending have been relatively well sustained. Income growth has remained quite modest, but the recent declines in energy prices should provide some offsetting lift to real purchasing power. While the most recent readings have been mixed, consumer sentiment is nonetheless up noticeably from its levels late last year. And, despite economic difficulties in Europe, the demand for U.S. exports has held up well. The U.S. business sector is profitable and has become more competitive in international markets.

However, some of the factors that have restrained the recovery persist. Notably, households and businesses still appear quite cautious about the economy. For example, according to surveys, households continue to rate their income prospects as relatively poor and do not expect economic conditions to improve significantly. Similarly, concerns about developments in Europe, U.S. fiscal policy, and the strength and sustainability of the recovery have left some firms hesitant to expand capacity.

The depressed housing market has also been an important drag on the recovery. Despite historically low mortgage rates and high levels of affordability, many prospective homebuyers cannot obtain mortgages, as lending standards have tightened and the creditworthiness of many potential borrowers has been impaired. At the same time, a large stock of vacant houses continues to limit incentives for the construction of new homes, and a substantial backlog of foreclosures will likely add further to the supply of vacant homes. However, a few encouraging signs in housing have appeared recently, including some pickup in sales and construction,

improvements in homebuilder sentiment, and the apparent stabilization of home prices in some areas.

Banking and financial conditions in the United States have improved significantly since the depths of the crisis. Notably, recent stress tests conducted by the Federal Reserve of the balance sheets of the 19 largest U.S. bank holding companies showed that those firms have added about $300 billion to their capital since 2009; the tests also showed that, even in an extremely adverse hypothetical economic scenario, most of those firms would remain able to provide credit to U.S. households and businesses. Lending terms and standards have generally become less restrictive in recent quarters, although some borrowers, such as small businesses and (as already noted) potential homebuyers with less-than-perfect credit, still report difficulties in obtaining loans.

Concerns about sovereign debt and the health of banks in a number of euro-area countries continue to create strains in global financial markets. The crisis in Europe has affected the U.S. economy by acting as a drag on our exports, weighing on business and consumer confidence, and pressuring U.S. financial markets and institutions. European policymakers have taken a number of actions to address the crisis, but more will likely be needed to stabilize euro-area banks, calm market fears about sovereign finances, achieve a workable fiscal framework for the euro area, and lay the foundations for long-term economic growth. U.S. banks have greatly improved their financial strength in recent years, as I noted earlier. Nevertheless, the situation in Europe poses significant risks to the U.S. financial system and economy and must be monitored closely. As always, the Federal Reserve remains prepared to take action as needed to protect the U.S. financial system and economy in the event that financial stresses escalate.

Another factor likely to weigh on the U.S. recovery is the drag being exerted by fiscal policy. Reflecting ongoing budgetary pressures, real spending by state and local governments has continued to decline. Real federal government spending has also declined, on net, since the third quarter of last year, and the future course of federal fiscal policies remains quite uncertain, as I will discuss shortly.

With regard to inflation, large increases in energy prices earlier this year caused the price index for personal consumption expenditures to rise at an annual rate of about 3 percent over the first three months of this year. However, oil prices and retail gasoline prices have since retraced those earlier increases. In any case, increases in the prices of oil or other commodities are unlikely to result in persistent increases in overall inflation so long as household and business expectations of future price changes remain stable. Longer-term inflation expectations have, indeed, been quite well anchored, according to surveys of households and economic forecasters and as derived from financial market information. For example, the five-year-forward measure of inflation compensation derived from yields on nominal and inflation-protected Treasury securities suggests that inflation expectations among investors have changed little, on net, since last fall and are lower than a year ago. Meanwhile, the substantial resource slack in U.S. labor and product markets should continue to restrain inflationary pressures. Given these conditions, inflation is expected to remain at or slightly below the 2 percent rate that the Federal Open Market Committee (FOMC) judges consistent with our statutory mandate to foster maximum employment and stable prices.

With unemployment still quite high and the outlook for inflation subdued, and in the presence of significant downside risks to the outlook posed by strains in global financial markets, the FOMC has continued to maintain a highly accommodative stance of monetary policy. The

target range for the federal funds rate remains at 0 to 1/4 percent, and the Committee has indicated in its recent statements that it anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate at least through late 2014. In addition, the Federal Reserve has been conducting a program, announced last September, to lengthen the average maturity of its securities holdings by purchasing $400 billion of longer-term Treasury securities and selling an equal amount of shorter-term Treasury securities. The Committee also continues to reinvest principal received from its holdings of agency debt and agency mortgage-backed securities (MBS) in agency MBS and to roll over its maturing Treasury holdings at auction. These policies have supported the economic recovery by putting downward pressure on longer-term interest rates, including mortgage rates, and by making broader financial conditions more accommodative. The Committee reviews the size and composition of its securities holdings regularly and is prepared to adjust those holdings as appropriate to promote a stronger economic recovery in a context of price stability.

The economy's performance over the medium and longer term also will depend importantly on the course of fiscal policy. Fiscal policymakers confront daunting challenges. As they do so, they should keep three objectives in mind. First, to promote economic growth and stability, the federal budget must be put on a sustainable long-run path. The federal budget deficit, which averaged about 9 percent of GDP during the past three fiscal years, is likely to narrow in coming years as the economic recovery leads to higher tax revenues and lower income support payments. Nevertheless, the Congressional Budget Office (CBO) projects that, if current policies continue, the budget deficit would be close to 5 percent of GDP in 2017 when the economy is expected to be near full employment.[3] Moreover, under current policies and

[3] This projection is the alternative fiscal scenario in the Congressional Budget Office (2012), *Updated Budget Projections: Fiscal Years 2012 to 2022* (Washington: CBO, March), available at www.cbo.gov/publication/43119.

reasonable economic assumptions, the CBO projects that the structural budget gap and the ratio of federal debt to GDP will trend upward thereafter, in large part reflecting rapidly escalating health expenditures and the aging of the population. This dynamic is clearly unsustainable. At best, rapidly rising levels of debt will lead to reduced rates of capital formation, slower economic growth, and increased foreign indebtedness. At worst, they will provoke a fiscal crisis that could have severe consequences for the economy. To avoid such outcomes, fiscal policy must be placed on a sustainable path that eventually results in a stable or declining ratio of federal debt to GDP.

Even as fiscal policymakers address the urgent issue of fiscal sustainability, a second objective should be to avoid unnecessarily impeding the current economic recovery. Indeed, a severe tightening of fiscal policy at the beginning of next year that is built into current law--the so-called fiscal cliff--would, if allowed to occur, pose a significant threat to the recovery. Moreover, uncertainty about the resolution of these fiscal issues could itself undermine business and household confidence. Fortunately, avoiding the fiscal cliff and achieving long-term fiscal sustainability are fully compatible and mutually reinforcing objectives. Preventing a sudden and severe contraction in fiscal policy will support the transition back to full employment, which should aid long-term fiscal sustainability. At the same time, a credible fiscal plan to put the federal budget on a longer-run sustainable path could help keep longer-term interest rates low and improve household and business confidence, thereby supporting improved economic performance today.

A third objective for fiscal policy is to promote a stronger economy in the medium and long term through the careful design of tax policies and spending programs. To the fullest extent possible, federal tax and spending policies should increase incentives to work and save,

encourage investments in workforce skills, stimulate private capital formation, promote research and development, and provide necessary public infrastructure. Although we cannot expect our economy to grow its way out of federal budget imbalances without significant adjustment in fiscal policies, a more productive economy will ease the tradeoffs faced by fiscal policymakers.

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

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

June 8, 2012

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

Dear Mr. Chairman:

Thank you for testifying before the Joint Economic Committee on June 7, 2012 to discuss the economic situation. In accordance with Chairman Casey's decision to keep the record open for written questions, I would like to ask you the following series of questions:

- On January 25, 2012, the Federal Open Market Committee, which controls our nation's monetary policy, released a statement describing its longer-run goals and policy strategy. In that policy statement, the FOMC judged that "inflation at the rate of 2%, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate."
  - How did you choose a 2 percent inflation target? Why was it not 1 percent or zero percent?
  - Is the 2 percent inflation target a floor or a ceiling? Or, is the 2 percent inflation target an average over a specific period of time?
  - How would you articulate the FOMC's tolerance for short-term, medium-term, and long-term deviations from its 2 percent inflation target?
  - Would you be willing to deviate from the 2 percent target to goose employment in the short term?

- Can you please describe the benefits provided by an explicit inflation target?
- Can you describe why you chose to use the price index for personal consumption expenditures as the basis for your inflation target?
  - What the measurement biases (either upward or downward) are associated with the PCE?
  - Are there times when the inflationary pressure from an overly accommodative monetary policy does not flow evenly down the goods and services channel, which is measured by the PCE price index, and the asset channel? Under such circumstances, would the PCE price index fail to reflect all of the price inflation that is occurring in the economy?
  - What supplemental measures of price inflation will the Federal Reserve use to make sure some price inflation is not escaping the PCE price index's net?
- In your testimony, you said:

> *To the fullest extent possible, federal tax and spending policy should increase incentives to work and save, encourage investment in workforce skills, stimulate private capital formation, promote research and development, and provide necessary public infrastructure.*

Economists widely acknowledge that the current federal income tax system is biased against saving and investment through the system's multiple layers of taxation of the same stream of income and the system's requirement that most business investments must be depreciated over time instead of expensed. The current system of worldwide taxation with foreign tax credits penalties U.S. multinational firms that are successfully selling American goods and services overseas.

- Given these antigrowth biases of the present federal income tax system, if Congress were to replace the present individual and corporate income tax system with either (1) a Hall-Rabushka flat tax, or (2) a broad-based, single-rate consumption tax (such as the FAIR tax) with the initial rate set on a revenue-neutral basis, would such a fundamental tax reform achieve that objectives that you set in your testimony to increase the long-term growth potential of the U.S. economy by increasing incentives to work and save, stimulating private capital formation, and promoting research and development?

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

July 2, 2012

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

Dear Mr. Vice Chairman:

Enclosed are my responses to the written questions you submitted following the June 7, 2012, 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 Chair Brady:

1. On January 25, 2012 the Federal Open Market Committee, which controls our nation's monetary policy, released a statement describing its longer-run goals and policy strategy. In that policy statement, the FOMC judged that "inflation at the rate of 2%, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer-run with the Federal Reserve's statutory mandate."

- **How did you choose a 2 percent inflation target? Why was it not 1 percent or zero percent?**

As noted in the Committee's statement of its *Longer-Run Goals and Policy Strategy,* the Committee is firmly committed to fulfilling its statutory mandate from the Congress of promoting both maximum employment and price stability. The Committee judges that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with our statutory mandate. Over time, a higher inflation rate would reduce the public's ability to make accurate longer-term economic and financial decisions, leading to costly misallocations and inefficiency.

However, the Committee judged that a significantly lower inflation goal, such as 1 or 0 percent, would be associated with more adverse outcomes for employment and growth. Nominal interest rates, which are ultimately tied to the level of inflation, cannot fall below zero, and so a lower inflation goal could limit the Federal Reserve's ability to provide monetary stimulus in periods of economic weakness. The result would be an elevated probability of falling into deflation, which can have severely negative consequences for economic growth that are difficult to reverse. Reflecting these concerns, central banks across the globe typically target levels of inflation that are above minimum levels in order to provide themselves adequate margin against the risk of deflation.

- **Is the 2 percent inflation target a floor or a ceiling? Or, is the 2 percent inflation target an average over a specific period of time?**

The FOMC's 2 percent long-term goal for inflation is a symmetric target, not a ceiling. Because the FOMC does not have perfect control of the economy, inflation can be either below or above the Committee's goal. The FOMC's objective in these cases is to bring inflation back to 2 percent over time.

- **How would you articulate the FOMC's tolerance for short-term, medium-term, and long-term deviations from its 2 percent inflation target?**

In setting monetary policy, the Committee seeks to mitigate deviations of inflation from its longer-run goal and deviations of employment from the Committee's assessment of its maximum level. Because the FOMC does not have perfect control of inflation, there will naturally be circumstances in which inflation deviates from its 2 percent target for a time, and in such

circumstances the FOMC's objective would be to bring inflation back to 2 percent. In doing so, it will follow a balanced approach in promoting its dual objectives.

- **Would you be willing to deviate from the 2 percent target to goose employment in the short term?**

As noted above, in setting monetary policy, the Committee seeks to mitigate deviations of inflation from its longer-run goal and deviations of employment from the Committee's assessment of its maximum level. These objectives are generally complementary. However, under circumstances in which the Committee judges that the objectives are not complementary, it would follow a balanced approach in promoting these two objectives, taking into account the magnitude of the deviations and potentially different time horizons over which inflation and employment are projected to return to levels the FOMC judges to be consistent with its objectives.

2. Can you please describe the benefits provided by an explicit inflation target?

Announcing an explicit longer-term goal for inflation to the public, as the Federal Open Market Committee (FOMC) did in its January 25, 2012 statement, has important benefits. As the Committee noted in its statement, "the Committee seeks to explain its monetary policy decisions to the public as clearly as possible. Such clarity facilitates well-informed decision-making by households and businesses, reduces economic and financial uncertainty, increases the effectiveness of monetary policy, and enhances transparency and accountability, which are essential in a democratic society."

3. Can you describe why you chose to use the price index for personal consumption expenditures as the basis for your inflation target?

The PCE price index covers a wide range of household spending, and therefore serves as a reasonable measure of the cost of living faced by households over time. While the same is also true of the Consumer Price Index (CPI), which is an alternative measure of consumer prices, the PCE price index has some advantages, including the fact that the PCE measure employs a formula for aggregating prices that better accounts for the changes in consumers' purchasing patterns that occur when relative prices change.

- **What measurement biases (either upward or downward) are associated with the PCE?**

Any price statistic (or economic statistic more generally) will suffer from some amount of measurement error, and there are probably several sources of measurement error in the PCE price index that keep it from being a perfect measure of the cost of living. These sources of measurement error are mostly inherited from the disaggregated CPIs and Producer Price Indexes (PPIs) that the Bureau of Economic Analysis uses to construct the PCE price index, and include the treatment of changes in the quality of goods; the introduction of new goods; changes in the mix of retail outlets; and changes in buying patterns in response to changes in relative prices.

The Committee chose the PCE price index because it deals with these challenging measurement issues better than other available estimates of the cost of living. Price measurement remains an active area of academic research.

- **Are there times when the inflationary pressure from an overly accommodative monetary policy does not flow evenly down the goods and services channel, which is measured by the PCE price index, and the asset channel? Under such circumstances, would the PCE price index fail to reflect all of the price inflation that is occurring in the economy?**

It will generally be the case that monetary policy actions will have different effects on the prices of goods and services and on asset prices. (Indeed, policy actions can even have different effects across different goods and services, where this difference depends on things like the demand or cost structure of the industry producing the good or service.) In particular, prices for goods and services are *current* prices--that is, prices currently charged by producers for their output. Asset prices, by contrast, often incorporate expectations about *future* price movements--for example, the holder of a long-term bond will care about future inflation rates, while the price of a share of a company's stock will depend on the company's earnings prospects, which in turn depend on the prices that the company will have to pay for its inputs and the prices it will receive for its output in the future. The PCE price index attempts to measure current prices for a wide range of goods and services purchased by households, and does not seek to capture changes in asset prices. In formulating the stance of monetary policy, we pay close attention to a wide range of asset prices. We do this in order to ascertain the state of credit and financial markets as well as to understand and predict the evolution of the economy.

- **What supplemental measures of price inflation will the Federal Reserve use to make sure some price inflation is not escaping the PCE price index's net?**

In addition to the PCE price index, the Federal Reserve monitors (and will continue to monitor) a host of other price measures, including--but not limited to--the following.

- The consumer price index (CPI), which provides an alternative gauge of consumer price inflation.

- The producer price index (PPI), which reports wholesale prices for finished consumer and capital goods and which also reports separate price indexes for raw materials, semi-finished goods, and services.

- The price deflator for the Gross Domestic Product, which measures prices for domestically produced output (and which therefore includes prices for capital goods, government purchases, and exports in addition to consumption prices).

In addition, the Federal Reserve monitors a number of measures of labor costs, along with "core" inflation measures that exclude volatile prices such as those for food and energy (and which can therefore provide a better read of underlying inflation trends in real time). Finally, the Federal Reserve keeps track of various commodity price measures (such as oil, crop, and industrial materials prices).

The reason for monitoring so many price measures is that alternative measures include different types of goods and services; moreover, even price measures with roughly similar scopes can be calculated in different ways. We believe that considering many different price measures imparts a degree of robustness to our analysis that would be absent if we focused on just one index.

4. In your testimony, you said:

> ***To the fullest extent possible, federal tax and spending policy should increase incentives to work and save, encourage investment in workforce skills, stimulate private capital formation: promote research and development, and provide necessary public infrastructure.***

Economists widely acknowledge that the current federal income tax system is biased against saving and investment through the system's multiple layers of taxation of the same stream of income and the system's requirement that most business investments must be depreciated over time instead of expensed. The current system of worldwide taxation with foreign tax credits penalties U.S. multinational firms that are successfully selling American goods and services overseas.

- **Given these antigrowth biases of the present federal income tax system, if Congress were to replace the present individual and corporate income tax system with either (1) a Hall-Rabushka flat tax, or (2) a broad-based, single-rate consumption tax (such as the FAIR tax) with the initial rate set on a revenue-neutral basis, would such a fundamental tax reform achieve that objectives that you set in your testimony to increase the long:-term growth potential of the U.S. economy by increasing incentives to work and save, stimulating private capital formation, and promoting research and development?**

The decisions about the size and structure of our tax system have important consequences on economic efficiency, fairness, and the size of government. These decisions entail balancing many factors to implement policies that reflect our values and priorities as a nation. There is widespread agreement that our tax code is overly complicated and inefficient. A basic principle of public finance is that the economic efficiency of a tax system can usually be enhanced if tax rates can be lowered while at the same time the tax base is broadened in order to raise the same amount of revenue. Reforms that simplify the tax system and consequently lower effective tax rates could provide tangible economic benefits by reducing the resources necessary for households and businesses to comply with the tax code and by improving incentives to work and save.

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Congress of the United States
House of Representatives

COMMITTEE ON BUDGET

JOINT ECONOMIC COMMITTEE

COMMITTEE ON SMALL BUSINESS
CHAIRMAN OF
SUBCOMMITTEE ON
CONTRACTING AND WORKFORCE

June 14, 2012

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

Dear Dr. Bernanke:

Thank you for your testimony on the Economic Outlook to the Joint Economic Committee on Thursday, June 7. The insight you provide is widely considered to be among the highest caliber, and I enjoy having the opportunity to work together to confront the economic challenges facing our nation.

As you know, time constraints often leave many questions unasked. I appreciate your willingness to work with the Committee to allow these questions to be presented within a reasonable timeframe after the hearing. Enclosed are additional questions I have regarding the topic we discussed. Your thoughtful comments on these can help inform the public debate surrounding our financial system.

Thank you in advance for your consideration, and I look forward to working together in the days ahead.

Best regards,

Mick Mulvaney
Member of Congress

Questions for the Record
Joint Economic Committee
Hearing on the Economic Outlook
U.S. Representative Mick Mulvaney (SC-05)
June 7, 2012

In response to Rep. Mulvaney's questions, Chairman Bernanke noted interest-rate swaps are less risky than pre-crisis Collateralized Debt Obligations and Credit Default Swaps because they are fairly straightforward and are largely used for hedging purposes. However, he added that "over-the-counter derivatives can be dangerous."

Q1: Based on the Chairman's statement that interest-rate swaps are largely used to hedge, what data does the Federal Reserve use to distinguish how much trading activity in the interest-rate swaps market is related to hedging risk versus taking speculative positions?

Q2: If interest rate swaps are largely used for hedging, what is the source of the possible danger that the Chairman believes that over-the-counter derivatives present?

Some market experts have stated the interest-rate swaps market can impact the yield curve on U.S. Treasuries.

Q3: Can the interest-rate swaps market impact the yield curve on U.S. Treasuries? If so, how can it affect the U.S. Treasuries market?

According to the Office of the Comptroller of the Currency's Fourth Quarter 2011 Derivatives Trading Activity Report, the total credit exposure to risk-based capital ratio imposed by derivatives traded for the top five banks is 316%. Chairman Bernanke noted the importance of having as much interest rate swap activity trade through a central counterparty as possible (which the Federal Reserve is currently working to promote), adopting higher capital standards for banks (in the form of Basel III), and imposing adequate margin requirements for OTC transactions. Currently, Basel II puts a 0% standard risk weight on financial institutions' holdings of debt issued by domestic and foreign sovereigns with credit ratings of AA- or higher. This incentivizes financial institutions to hold sovereign debt rated AA- or higher on their balance sheets.

Q4: Does the risk weight methodology on sovereign debt rated AA- or higher indirectly affect trading activity in the OTC derivatives market? If so, then how does it impact a financial institution's total credit exposure to risk-based capital ratio, especially as it relates to the institution's ability to meet its OTC derivatives obligations when responding to market shocks (e.g. abrupt rise in interest rates)?

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

BEN S. BERNANKE
CHAIRMAN

July 16, 2012

The Honorable Mick Mulvaney
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the June 7, 2012, 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 Representative Mulvaney:

In response to Rep. Mulvaney's questions, Chairman Bernanke noted interest-rate swaps are less risky than pre-crisis Collateralized Debt Obligations and Credit Default Swaps because they are fairly straightforward and are largely used for hedging purposes. However, he added that "over-the-counter derivatives can be dangerous."

1. Based on the Chairman's statement that interest rate swaps are largely used to hedge, what data does the Federal Reserve use to distinguish how much trading activity in the interest rate swaps market is related to hedging risk versus taking speculative positions?

Data from the Bank for International Settlements (BIS) as of December 2011 indicate that the global gross notional amount of interest rate swaps outstanding stood at roughly $402 trillion. Regulatory reporting data for the same period indicate that the gross notional outstanding amount of interest rate swaps of U.S. insured commercial banks stood at roughly $136 trillion. Of these swaps, roughly $87 trillion are short term, i.e., a maturity of less than one year. Interest rate swaps are commonly used by banks and other financial and non-financial entities to hedge risks arising from fixed and variable interest payments.

2. If interest rate swaps are largely used for hedging, what is the source of the possible danger that the Chairman believes over-the-counter derivatives present?

Aside from interest rate risk, swaps are subject to counterparty risk. Specifically, swaps are subject to the risk that the counterparty that has promised to make a number of contractual payments may default on that obligation. Moreover, the default event may occur at a time when the required payment is significant, thus resulting in a substantial loss. Over-the-counter derivatives must be subject to rigorous and continuous risk management to guard against counterparty as well as market risks that are inherent in such contracts.

3. Some market experts have stated the interest-rate swaps market can impact the yield curve on U.S. Treasuries.

Can the interest rate swaps market impact the yield on U.S. Treasuries? If so, how can it affect the U.S. Treasuries market?

The interest rate swaps market is very active, and arbitrage across fixed income markets generally implies that swap rates and rates on fixed-income instruments, including Treasuries, tend to move together. These co-movements reflect common economic factors--such as expectations and uncertainties about future economic and financial conditions--and common technical factors--such as mortgage-duration-related hedging activities.

In some cases, however, idiosyncratic supply and demand factors specific to the swaps market may not pass through significantly to Treasury yields. For example, in the period between mid-September and mid-November 2008, the 30-year swap rate declined more than 45 basis points while the 30-year Treasury yield edged up a few basis points, leaving the 30-year swap spread

sharply narrower. Market participants reportedly attributed this development to increased needs by pension funds and insurance companies to receive fixed rates in the interest rate swaps market in order to extend the durations of their asset portfolios following significant equity market losses that caused the duration of their asset holdings to shorten.

That said, a significant disruption in the interest rate swaps market could have significant repercussions for the Treasury market and other fixed income markets. For example, a disruption in the swaps market could impair the ability of many investors to properly manage interest rate risk. In that event, investors might tend to pull back from risk taking, which could put upward pressure on the yields on many fixed-income instruments, including longer-term Treasury securities. On the other hand, any upward pressure on Treasury yields in this scenario might be damped if investors who previously relied on the swaps market for interest rate risks management began to rely more heavily on Treasury markets for this purpose.

U.S. interest rate swaps are derivative assets whose payments depend upon fluctuations in the U.S. Treasury yield curve. Typically, the value of derivatives are considered to depend on the underlying value of the reference asset, e.g., the U.S. yield curve, but not vice versa. This "frictionless" view of market dynamics, however, is likely an oversimplification in reality. Demand for and the supply of U.S. Treasury securities that are required to settle certain interest rate derivatives may have an effect on U.S. Treasury prices and yields at different points in time. These effects, though they may be significant at times, are not thought to have a persistent effect on the value of U.S. Treasury securities.

4. According to the Office of the Comptroller of the Currency's Fourth Quarter 2011 Derivatives Trading Activity Report, the total credit exposure to risk-based capital ratio imposed by derivatives traded for the top five banks is 316%. Chairman Bernanke noted the importance of having as much interest rate swap activity trade through a central counterparty as possible (which the Federal Reserve is currently working to promote), adopting higher capital standards for banks (in the form of Basel III), and imposing adequate margin requirements for OTC transactions. Currently, Basel II puts a 0% standard risk weight on financial institutions' holdings of debt issues by domestic and foreign sovereigns with credit ratings of AA- or higher. This incentivizes financial institutions to hold sovereign debt rated AA- or higher on their balance sheets.

Does the risk weight methodology on sovereign debt rated AA- or higher indirectly affect trading activity on the OTC derivatives market? If so, then how does it impact a financial institution's total credit exposure to risk based capital ratio, especially as it relates to the institution's ability to meet its OTC derivatives obligations when responding to market shocks (e.g. an abrupt rise in interest rates)?

OTC derivative obligations are typically settled in cash. According to the 2012 ISDA Margin Survey, between 80 and 85 percent of all collateral received and posted on OTC derivative

transactions is in the form of cash and U.S. Treasury securities.[1] Between five and fifteen percent of all collateral received and posted, however, is in the form of non-U.S government securities. When these securities are accepted, they are typically subject to a haircut that reduces the recognized value of the collateral relative to the face value of the security. The haircut applied on such securities that are accepted for discount window loans ranges between five and fifteen percent, which is broadly suggestive of haircuts that would be applied by private market participants.[2] Accordingly, non-U.S. government securities may be used at a modest discount to satisfy OTC derivative obligations.

[1] The 2012 ISDA Margin survey can be found at: http://www2.isda.org/functional-areas/research/surveys/margin-surveys/

[2] Collateral haircuts that are applied to discount window loans can be found at: http://www.frbdiscountwindow.org/discountmargins.cfm?hdrID=21?genid=22&desc=Collateral%20Margins%20Table&url=discountmargins.cfm?hdrID=21

Joint Economic Committee
Republicans

Representative Kevin Brady *Vice Chairman*
Senator Jim DeMint *Senior Republican Senator*

June 12, 2012

Chairman Bernanke:

I would like to thank you for your recent testimony before the Joint Economic Committee on June 7th, 2012. As a follow up to your testimony, I would like to submit the following questions for the record. I look forward to your response to what I consider important questions about the state of our economy.

Sincerely,

Senator Jim DeMint

1. Is the U.S. at greater risk now of a recession than at any other time over the past three years?

2. In the spirit of transparency, I would like to ask you about the Federal Reserve's current disaster preparedness if interest rates on U.S. debt spike quickly as they have in many European nations.
   a. Is the Federal Reserve prepared for a spike in U.S. borrowing costs?
   b. What actions might the Federal Reserve take if interest rates on U.S. debt spike?
   c. If the U.S. were suddenly to face 10-year borrowing rates of 5%, 8%, or 10%, do you think the U.S could sustain its debt path? What is the breaking point between sustainability and unsustainability?
   d. Has the Federal Reserve considered the benefits and consequences of the U.S. printing its way out of debt if interest rates rise to extreme levels?

3. What would be the impact on banks engaged in interest rate swaps if rates were to rise to 8%? Are the large banks adequately capitalized to handle such a change?

4. Whereas fiscal stimulus has a measurable cost, people seem to view monetary stimulus as a free lunch. Is monetary stimulus free, and if not, what are its costs and who will bear them?

5. In an effort to promote maximum employment do you think that the Federal Reserve's policies have compromised stable prices?

6. What changes will you have to see in the economy to allow interest rates to rise?

7. FOMC participants have cited numerous times the downside economic risks associated with uncertainty over U.S. fiscal policy and uncertainty regarding regulatory policies. Do you believe that fiscal policy uncertainty is materially affecting business and household behavior and that fiscal policy uncertainty is a risk to economic growth, as FOMC meeting participants repeatedly identify?

8. Dr. Lawrence Summers, former economic advisor to President Obama, recently argued in a Washington Post article that the government should increase its debt – especially long-term debt – in order to lock in low rates and that the Fed should refrain from quantitative easing and operation twist type policies. Do you agree with this argument?

9. An economist at the Center on Budget and Policy Priorities recently argued that the economy could handle the pain if Congress delays fiscal decisions until the beginning of next year. Would you consider a deferral of impending fiscal decisions into next year to be a low-risk strategy, or would this be a gamble that financial markets, businesses, and households can weather mounting fiscal uncertainty without significant economic consequence?

10. The IMF has said that, in order for SDRs to play a more meaningful role as a reserve asset to reduce global imbalances, the volume of SDRs would have to be expanded. Currently, SDRs

account for a little less than 4% of global reserves. The IMF has suggested increasing annual allocations of SDRs to 13% of global reserves by the 2020s.

a. What do you think the IMF's motive is in increasing SDRs reserves?
b. Do you see a problem with allowing countries to have greater access to credit reserves by the increase of SDRs?

11. A Citigroup analysis recently said that US and European regulators are essentially forcing banks to buy government debt and allowing them not to count government bond holdings against their capital reserve requirements in order to create a steady market for government bonds and to keep the yields low. Do you think that this could make the debt crisis worse by obscuring the real cost of borrowing?

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

1. Is the U.S. at greater risk now of a recession than at any other time over the past three years?

On June 20th, Federal Open Market Committee (FOMC or Committee) participants released an updated set of economic projections. While committee participants generally marked down their projections for economic growth, most still see the economy as expanding at a moderate pace over coming quarters before then picking up gradually (the most pessimistic projections for real GDP growth were 1.6 percent in 2012 and 2.2 percent in 2013). That said, most participants see the balance of risks as weighted mainly toward slower growth and higher unemployment; in particular, strains in global financial markets continue to pose significant downside risks to the recovery and to further improvement in labor market conditions.

2. In the spirit of transparency, I would like to ask you about the Federal Reserve's disaster preparedness if interest rates on U.S. debt spike quickly as they have in many European nations.

a. Is the Federal Reserve prepared for a spike in U.S. borrowing costs?
b. What actions might the Federal Reserve take if interest rates on debt spike?

It is important to initially establish the underlying explanation for a higher-than-anticipated level of Treasury yields. If the spike in yields is a result of unexpectedly strong growth in economic activity, this would be a welcome development and the Federal Reserve would act appropriately to ensure that its mandate of maximum employment in a context of stable prices was met. Moreover, in this case, the negative effects of higher interest costs on the federal budget would be substantially more than offset by the effects of increased tax revenues and reduced spending for income-support programs.

In contrast, if the spike in interest rates were the result of a loss of confidence on the part of financial market participants in the ability of the government to manage its fiscal policy--as we have seen in a number of countries recently--there is little that the Federal Reserve could do to counteract rising interest rates. This potentially severe adverse development is why, in my testimony and on many other occasions, I have urged fiscal policymakers to put in place as soon as possible a credible long-term budget plan that would both put fiscal policy on a sustainable trajectory and avoid undue risk in the near term to the pace of the recovery. Such a plan would help keep long-term interest rates low and improve household and business confidence, thereby providing support to the near-term recovery.

c. If the U.S. were suddenly to face 10-year borrowing rates of 5 percent, 8 percent, or 10 percent, do you think the U.S. could sustain its debt path? What is the breaking point between sustainability and unsustainability?

As the Congressional Budget Office (CBO) recently reported, the federal budget already is on an unsustainable path if recent fiscal policies are continued. (This is the extended alternative fiscal

scenario presented in the CBO's The 2012 Long-Term Budget Outlook, June 2012.) The CBO's projection assumed that nominal 10-year Treasury rates would rise to about 5 percent in the longer run, close to their historical average over the past four decades. If interest rates rose quickly and sharply to higher levels because of concerns about the ability of fiscal policymakers to control the federal budget then federal government debt would rise even faster than the unsustainable increases estimated in the CBO's long-term projection.

d. Has the Federal Reserve considered the benefits and consequences of the U.S. printing its way out of debt if interest rates rise to extreme levels?

The Federal Reserve is strongly committed to its dual mandate of maximum employment and price stability. Any action to boost inflation in response to elevated levels of federal debt would only lead to further increases in interest rates and add to the nation's problems.

3. What would be the impact on banks engaged in interest rate swaps if rates were to rise to 8%? Are the large banks adequately capitalized to handle such a change?

Regulatory guidance (SR 96-13, SR 10-1, and SR12-2) emphasizes the importance of effective corporate governance, policies and procedures, risk measuring and monitoring systems, stress testing, and internal controls related to the interest rate risk ("IRR") exposures of institutions. The regulators expect all institutions to manage their IRR exposures using processes and systems commensurate with their earnings and capital levels, complexity, business model, risk profiled, and scope of operations. Specifically, regulators expect institutions to:

- Regularly assess a range of alternative future interest rate scenarios, including meaningful interest rate shocks, to identify the inherent risk. Scenarios should be severe but plausible, in light of the existing level of rates and interest rate cycle.

- Communicate IRR tolerances so that the board of directors and senior management clearly understand the institution's risk tolerance limits and approach to managing the impact of IRR on earnings and capital adequacy. The tolerances should be explicit, and address the potential impact of changing interest rates on earnings and capital from a short-term and long-term perspective.

- The Federal Reserve recently completed our second annual Comprehensive Capital Analysis and Review (CCAR). In the CCAR, the Federal Reserve assessed the internal capital planning processes of the 19 largest bank holding companies and evaluated their capital adequacy under a very severe hypothetical stress scenario that included a peak unemployment rate of 13 percent, a 50 percent drop in equity prices, and a further 21 percent decline in housing prices.

- Interest rate shocks were included in this assessment, but not to the degree of a 400 percent increase in rates to 8 percent.

- That stated, for the largest bank holding companies (BHCs), which engage in dealer activities and make markets trading interest rate derivatives, their interest rate risk profiles are generally not as directionally sensitive as regional and community banks. In other words, certain changes in the *shape* of the yield curve, not just the absolute level, are more likely to result in outsized losses at the largest BHCs than parallel shifts of the curve up or down. Such changes associated with macroeconomic stress were used in the CCAR hypothetical stress scenario.

- Note, trading activity in interest rate OTC derivatives does generate counterparty credit risk. In scenarios where there are extreme moves in underlying risk factors--such as rates moving to 8 percent--counterparty credit risk exposures could increase significantly. In CCAR, such exposures were stressed in the hypothetical scenario. In addition, counterparty credit risk exposures are regularly assessed and monitored in the supervisory process for the largest BHCs.

4. Whereas fiscal stimulus has a measurable cost, people seem to view monetary stimulus as a free lunch. Is monetary stimulus free, and if not, what are its costs and who will bear them?

While monetary policy does not have direct costs for U.S. taxpayers analogous to those associated with fiscal policy, there certainly are important costs and risks in conducting monetary policy that the FOMC considers in its deliberations. The Federal Reserve conducts monetary policy to foster its statutory mandate to promote maximum employment and stable prices. In reaching its decisions, the Committee carefully reviews the outlook for economic growth and inflation, and it adjusts the stance of policy as appropriate to foster its statutory goals of maximum employment and stable prices. However, the economic outlook is always uncertain and there are many potential costs and risks in conducting policy. For example, the FOMC could maintain a stance of policy that turns out to have been too tight. In this case, output could fall below potential, unemployment could rise, and inflation could fall persistently below levels that the Committee judges to be consistent with price stability. Alternatively, the FOMC could also maintain a stance of policy that provides too much accommodation for too long. In that scenario, output could move above potential and inflation could move persistently above mandate-consistent levels. The costs associated with either of these scenarios would be greatly compounded if households and businesses came to question the Federal Reserve's willingness and ability to achieve price stability in the long-run. In that case, long-term inflation expectations could become unanchored and the Federal Reserve could find it very difficult to achieve its statutory mandate.

As the Committee noted in its recent statement, economic growth is expected to remain moderate over coming quarters and then to pick up very gradually. Consequently, the Committee anticipates that the unemployment rate will decline only slowly toward levels that it judges to be consistent with its dual mandate. Furthermore, strains in global financial markets continue to pose significant downside risks to the economic outlook. The Committee anticipates that inflation over the medium term will run at or below the rate that it judges most consistent with its

dual mandate. Moreover, long-term inflation expectations have remained stable. Against this backdrop, the Committee has judged that it is appropriate to maintain a highly accommodative stance of monetary policy.

5. In an effort to promote maximum employment do you think that the Federal Reserve's policies have compromised stable prices?

The Federal Reserve's accommodative policy actions have not compromised price stability. Since the onset of the recession, consumer prices--as measured by the price index for personal consumption expenditures--have risen at an average annual rate of 1 3/4 percent--a bit below the 2 percent rate of inflation that the Committee has indicated that it judges most consistent with its statutory mandate. After increasing earlier this year as crude oil and gasoline prices rose, inflation has declined more recently as those prices have fallen back. Meanwhile, longer-term inflation expectations have remained stable. Over the medium term, as reflected in the Committee's Summary of Economic Projections, the Committee anticipates that inflation will run at or below the rate that it judges most consistent with its dual mandate.[1] Private-sector forecasts of inflation over the medium term are broadly consistent with those of the Committee participants.

6. What changes will you have to see in the economy to allow interest rates to rise?

The Federal Open Market Committee has indicated in its recent statements that it currently anticipates that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--are likely to warrant exceptionally low levels of the federal funds rate at least through late 2014. As the economic recovery continues, the Committee eventually will need to make monetary policy less accommodative in order to ensure that the economy expands at a sustainable pace and to prevent inflation from persistently exceeding its longer-run objective. In determining the appropriate time to increase its target for the federal funds rate, the Committee will consider a range of factors, including actual and projected rates of resource utilization, the medium-term outlook for inflation, and the risks to the achievement of the Committee's objectives.

7. FOMC participants have cited numerous times the downside economic risks associated with uncertainty over U.S. fiscal policy and uncertainty regarding regulatory policies. Do you believe that fiscal policy uncertainty is materially affecting business and household behavior and that fiscal policy uncertainty is a risk to economic growth, as FOMC meeting participants repeatedly identify?

Heightened uncertainty both about the economic outlook and about fiscal policy may be leading firms to be more reluctant to hire and invest along with making households less willing to buy big ticket items. Improved economic conditions should help reduce this uncertainty, but policymakers should also seek to reduce the uncertainty about fiscal policy. As I have stated on

[1] The Committee's most recent projections collected at the time of its June meeting can be found at http://www.federalreserve.gov/monetarypolicy/fomcprojtabl20120620.htm

many occasions, a key task for fiscal policymakers should be to put in place a credible long-term budget plan that would both put fiscal policy on a sustainable trajectory and avoid undue risk in the near term to the pace of the recovery. Doing so earlier rather than later would not only reduce uncertainty, hold down interest rates, and help maintain the U.S. government's credibility in financial markets, but it would also ultimately be less disruptive by avoiding abrupt shifts in policy and by giving those affected by budget changes more time to adapt.

8. Dr. Lawrence Summers, former economic advisor to President Obama, recently argued in a Washington Post article that the government should increase its debt – especially long-term debt – in order to lock in low rates and that the Fed should refrain from quantitative easing and operation twist type policies. Do you agree with this argument?

The Federal Open Market Committee's large scale asset purchases and maturity extension program have been designed to stimulate the economy by putting downward pressure on longer-term interest rates, thereby making financial conditions more accommodative. Dr. Summers notes that large scale asset purchases may be appropriate, but that there may be limits on the extent to which lower long-term rates can induce more private spending. He also raises the concern that very low rates could encourage speculative activity. As noted in the minutes of the FOMC meetings, these issues have been discussed by the FOMC. On balance, the Committee has judged that the effects of asset purchases in putting downward pressure on long-term interest rates and in easing financial conditions more broadly has been helpful in supporting the economic recovery and fostering the FOMC's statutory mandate of maximum employment and stable prices. Of course, monetary policy is not a panacea for all of the nation's economic difficulties. Indeed, Dr. Summers also argued that increased government spending financed by low-cost long-term debt could be helpful in boosting the economy. Of course, appropriate policies for spending and government borrowing are complicated and are the responsibility of Congress and the administration. In my view, to best support the economy, fiscal policy needs to be set on a sustainable path over the medium term by putting in place a credible longer-run budget plan, while avoiding near-term fiscal risks to the recovery.

9. An economist at the Center on Budget and Policy Priorities recently argued that the economy could handle the pain if Congress delays fiscal decisions until the beginning of next year. Would you consider a deferral of impending fiscal decisions into next year to be a low-risk strategy, or would this be a gamble that financial markets, businesses, and households can weather mounting fiscal uncertainty without significant economic consequence?

A key goal for fiscal policymakers should be to put in place a credible longer-term plan for placing the federal budget on a sustainable trajectory while avoiding undue risk in the near-term to the pace of the recovery. The policies now written into law that create the so-called fiscal cliff do not meet both of these objectives because they would put the still-fragile recovery at risk. The economic consequences of failing to avert the full implications of the fiscal cliff are highly uncertain, but it is clear that those consequences would be unwelcome. Fiscal policymakers should work on a credible plan that would support the performance of the economy in both the

near term and the long term by setting the federal budget on a sustainable path while giving attention to the growth-related implications of the spending and tax choices that they make.

10. The IMF has said that, in order for SDRs to play a more meaningful role as a reserve asset to reduce global imbalances, the volume of SDRs would have to be expanded. Currently, SDRs account for a little less than 4% of global reserves. The IMF has suggested increasing annual allocations of SDRs to 13% of global reserves by the 2020s.

a. What do you think the IMF's motive is in increasing SDRs reserves?

The IMF does not make annual allocations of SDRs. SDR allocations have occurred three times: in the early 1970s, in the late 1970s, and in 2009.

Under the IMF Articles of Agreement, the IMF membership can decide to make a general allocation of SDRs with an 85 percent majority vote if the Board of Governors finds that the conditions set forth in the Articles regarding a long term global need to supplement existing reserve assets have been met:

> ...the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world.

The IMF reviews the need for an SDR allocation every five years, prior to the beginning of a so-called "basic period." At the time of the last review in mid-2011, there was no consensus among the IMF membership on the need for an allocation of SDRs during the 10th basic period, which commenced on January 1, 2012.

b. Do you see a problem with allowing countries to have greater access to credit reserves by the increase of SDRs?

The Secretary of the Treasury has primary responsibility for international economic policy, including policies regarding the IMF. SDR allocations raise a range of issues relating to the functioning of the international monetary system. A potential problem that has been discussed is whether an increase in SDRs could be inflationary. However, that does not appear to be a serious risk, especially in regard to the U.S. economy, especially as any new SDR allocation would likely be a very small fraction of the global money supply.

11. A Citigroup analysis recently said that U.S. and European regulators are essentially forcing banks to buy government debt and allowing them not to count government bond holdings against their capital reserve requirements in order to create a steady market for government bonds and to keep the yields low. Do you think that this could make the debt crisis worse by obscuring the real cost of borrowing?

Financial institutions need liquidity to manage their daily operations and to withstand periods of acute funding stress without reliance on central bank liquidity support. Robust liquidity risk management and liquidity buffers are especially important because a liquidity shortfall at a single institution can have system-wide repercussions. Amongst non-cash assets, debt issued by highly-rated governments in developed economies is viewed as the most monetizeable in adverse states of the world.

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