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

BEN S. BERNANKE
CHAIRMAN

August 22, 2012

The Honorable Darrell E. Issa
Chairman
Committee on Oversight
and Government Reform
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for your letter of August 1, 2012, concerning monetary policy. Attached, please find responses to the questions posed in your letter. Please let me know if I can be of further assistance.

I hope this information is helpful to you.

Sincerely,

Enclosure

cc: The Honorable Elijah Cummings

Attachment

1. Given the extraordinarily low interest rates across the entire Treasury yield curve, can further easing cure "the country's sluggish growth and stubbornly high unemployment rate"?

There is scope for further action by the Federal Reserve to ease financial conditions and strengthen the recovery. However, because short-term interest rates are already at very low levels, additional monetary accommodation requires the use of nontraditional policy tools, such as balance sheet actions or communication about the likely future course of policy. The expected benefits of these tools need to be balanced against their potential costs and risks when the Federal Open Market Committee ("FOMC" or "Committee") decides whether additional action is appropriate. Moreover, as I have noted many times in congressional testimony and elsewhere, monetary policy is not a panacea, and policymakers in many different arenas should carefully examine the steps they could take to foster a more vigorous recovery. That said, as noted in the July FOMC statement, the Committee will closely monitor incoming information on economic and financial market developments and will provide additional accommodation as needed to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability.

2. Is the $1.5 trillion of cash in excess of the banks' reserve requirements "far more than enough to meet any unsatisfied demand" for prudent loans?

The volume of excess reserves currently on the balance sheet of banks is a consequence of the Federal Reserve's asset purchases. By putting downward pressure on longer-term interest rates and contributing to a broader easing in financial market conditions, these asset purchases have helped to promote a stronger recovery than otherwise would have occurred, and to forestall the possibility of a slide into deflation.

3. Does the $500 billion of reserves "that remain on bank balance sheets" substantially help the U.S. economy?

The monetary accommodation provided by the Federal Reserve has substantially helped the U.S. economy by easing financial conditions relative to the conditions that would have prevailed otherwise. The easing in financial conditions has promoted economic activity through a variety of channels, including reducing the cost of capital, boosting the aggregate wealth of U.S. households, and improving the competitiveness of U.S. businesses in the global marketplace. In addition, the easing has helped the economy by preventing a dangerous slide into deflation.

4. Does $100 billion or so held by foreign central banks significantly help the U.S. economy?

Consistent with statute, the Federal Reserve provides a range of basic banking services to foreign official institutions, including deposit accounts and overnight placements of deposit balances in reverse repurchase agreements. In the current environment, foreign official institutions have elected to maintain substantial balances with the Federal Reserve. Although these balances do

not directly affect the implementation of monetary policy, they are helpful in their role as a counterpart to a portion of the Federal Reserve's securities holdings. As noted in earlier answers, by putting downward pressure on longer-term interest rates and contributing to a broader easing in financial market conditions, the Federal Reserve's asset purchases have helped to promote a stronger recovery than otherwise would have occurred, and to forestall the possibility of a slide into deflation.

5. Given that monetary policy operates with long and variable lags, is the impact of Operation Twist complete at this time? If not, is it not premature to consider the next installation of quantitative easing?

The influence of the initial phase of the maturity extension program is still working its way through the economic system, and monetary policy changes typically take several quarters to achieve their full effect on economic activity. Of course, the extension of the maturity extension program--announced at the conclusion of the FOMC's June meeting--is still in the very early phases of having its effect on the economy. Because monetary policy actions operate with a lag, the stance of policy must necessarily be set in light of a forecast of the future performance of the economy. Policymakers aim to ensure that the stance of policy is appropriate, given the latest indicators regarding the state of the economy and the health of the financial system.

6. It appears that at the first sign of bad economic data, many market participants immediately begin calling for further easing. Does this reflect a learned behavior resulting from the Federal Reserve's prior apparent willingness to yield to market demands?

As noted in the preceding answer, monetary policy must necessarily be set in light of a forecast of the future performance of the economy. Market participants understand that basic fact; as a result, when new information becomes available regarding the future state of the economy, they draw their own inferences regarding the likely future course of policy. The Federal Reserve engages in its own independent analysis of incoming information and sets the stance of policy in a way that will best promote, in its judgment, the dual mandate given by the Congress--to promote price stability and maximum sustainable employment.

7. Does the Federal Reserve continue to maintain that it can raise interest rates sufficient to stop any inflation? Does political pressure limit the Federal Reserve's ability to sufficiently increase interest rates?

The Federal Reserve will be steadfast in its adherence to the task of promoting the dual mandate given by the Congress--to promote price stability and maximum sustainable employment. We are confident that we have the tools to normalize the stance of policy at the appropriate time as the strength of the recovery improves. The Federal Reserve's independence gives it the latitude which is crucially important to pursue its statutory mandate without consideration of political factors.

8. Will the Federal Reserve consider re-adopting the Taylor Rule approach to normalize monetary policy and prevent furthering risks to our economic stability in the long run?

The Federal Reserve will use the entire repertoire of analytical tools currently exercised by central banks around the world in pursuit of its dual mandate. As part of the policy-setting process, the Federal Reserve consults a range of statistical and econometric tools that have been useful over the years for assessing the appropriate stance of policy. One set of tools consists of rules in the form of the ones commonly called "Taylor Rules." It is worth noting that some variants of these simple rules suggest that the Federal Reserve should maintain a highly accommodative stance of policy for some time. The Federal Reserve also consults other simple rules and other empirical frameworks in order to enhance the robustness of its policy-setting process.

9. These statements are highly critical of recent Federal Reserve policies and constitute serious allegations. Does twisting the yield curve to push down long term interest rates obscure signals for potential economic growth, hide risks of inflation and alter returns on investment across the entire economy?

The FOMC sets the stance of policy with a firm eye on the dual mandate given by the Congress--namely, to promote price stability and maximum sustainable employment. In setting the stance of policy, the Committee is keenly attuned to the risks of inflation and other factors that could affect the future performance of the economy. The FOMC noted in its recent statement that it anticipates that inflation over the medium term will run at or below the rate that it judges most consistent with its dual mandate.

10. Does reduced interest income to savers resulting from quantitative easing act as a tax on savers? Is it a transfer payment to debtors, including the U.S. government? Please note that in your response to Question No. 14 of my letter last year, you responded that the Federal Reserve's actions are intended to benefit everyone.

It is in everyone's interest--savers and borrowers alike--to have an economy that is performing at the highest level of its capacity. The returns to long-term investment depend critically on the vitality of economic activity, the pace of inflation, and the stability of the financial system. The Federal Reserve is striving to promote these factors that bear so critically on economic well-being.

11. If the answer to Question No. 10 is that you believe that reduced interest income does act as a tax then will the Federal Reserve calculate the extent of such a tax so that the current Administration can accurately evaluate the revenue associated with this tax when considering further tax policy recommendations?

Please see my response for question 10.

12. Do you expect that if the financial institutions lose confidence in the Federal Reserve's ability or willingness to continue to manipulate long term interest rates downward, then long-term interest rates would rise quickly and substantially?

Maintaining credibility and confidence is critically important to the maintenance of the Federal Reserve's effectiveness. To that end, the Federal Reserve acts in ways that are transparent, predictable, and readily understandable in light of the dual mandate given by the Congress--to promote price stability and maximum sustainable employment.

13. Do you expect that lenders would tend to defer providing long term loans until after the market corrects, particularly if the loan under consideration would be considered relatively less liquid?

Lenders will determine the profitability of extending long-term loans based on a complex set of considerations, including not only the rate on the loan but also the cost of funds to the lender and the creditworthiness of the borrower. To the extent that lenders anticipate that the Federal Reserve will take the steps necessary to foster its dual mandate of maximum employment and stable prices, they will be more willing to provide credit to would-be borrowers.

14. Given the changes to the derivatives markets stemming from the Dodd-Frank Act and CFTC and SEC regulation, have the regulatory compliance costs associated with hedging transactions increased dramatically?

Most compliance costs associated with CFTC and SEC regulations relate to the business conduct and risk management standards of the dealer offering swap contracts to its clients rather than to the clients themselves. The agencies issuing these regulations would be in a better position to assess any compliance costs.

15. To the extent that Dodd-Frank requires trading on clearing exchanges or posting margin, does this create substantial cash flow challenges that may act as an additional barrier to hedging transactions?

Non-financial entities that use swaps for hedging business risks are exempt from clearing requirements that would require the posting of margin. Financial entities will be required to post initial and variation margin in their swap activities. Variation margin requirements that crystallize both gains and losses that have already occurred do not represent a drain on overall cash flow. Initial margin requirements which result in liquid resources being tied up for the duration of a swap contract may represent a cash flow challenge to some hedging transactions. At the same time, however, the provision of initial margin effectively secures the transaction in a way that may result in more favorable pricing terms that will at least in part offset the cash flow burden, making the net effect unclear.

16. Does the increased interest rate and credit risk that would result from an anticipated bond market correction, or, alternatively, the use of more expensive hedges to mitigate that risk, impose a substantial barrier to new loan issuance today?

Long-term interest rates embed expectations about the future course of short-term interest rates. To the extent that short-term rates are expected *today* to rise *in the future*, those expectations will be reflected in the rates offered on longer-term loans. Survey evidence indicates that one important impediment to increased lending today is lack of demand for new loans by qualified borrowers. By supporting the economic recovery, the Federal Reserve's asset purchases should help to ease loan supply and strengthen loan demand and so boost overall bank lending. While the strains in the housing market continue to hamper the growth of mortgage credit, bank loans to businesses have been expanding at a solid pace for several quarters.

17. As a result of the scenarios described in Question Nos. 13 through 16 above, do Federal Reserve policies create incentives to invest in Treasury bonds and avoid issuing riskier and less-liquid loans to businesses?

Federal Reserve policies currently in place have the effect of driving *down* prospective yields on very safe assets such as Treasury securities. If the yields and prices on alternative assets (aside from Treasuries) did not adjust, then those alternative assets would suddenly have become a relatively better deal in the financial marketplace. Accordingly, an important collateral effect of Federal Reserve policies is to encourage investors to shift out of Treasuries and into other asset classes. Through this process, the initial impulse of the Federal Reserve's move to increase its holdings of Treasury securities is transmitted into other assets.

18. Are financial institutions executing carry trades on U.S. Treasuries, wherein these institutions rely on short term repo transactions to fund investments in longer-dated Treasury notes and bonds?

A significant volume of Treasury securities are financed in repo markets. However, the bulk of this activity does not reflect investors engaged in traditional carry trades, which exploit differences between shorter-term and longer-term interest rates, but rather the funding of inventories by securities dealers as part of their normal market-making activities. Nonetheless, as evidenced during the crisis, maturity mismatches stemming from the repo financing of Treasuries can expose securities firms and other financial institutions to significant liquidity and funding risks. However, the volume of Treasuries financed in the repo market has declined since the crisis, and financial institutions have strengthened their capital and liquidity positions and so are better able to manage such risks.

The Federal Reserve and other federal regulators are actively working to further strengthen the risk management at financial firms through enhanced supervision and structural reforms.

19. Will the central banks be able to [buy on an emergency basis], given that they have already expanded their balance sheets?

Such situations are quite unlikely. That said, the Federal Reserve continues to have the necessary tools to deal with any foreseeable emergency situation.

20. Is a bond market correction likely to occur when the Federal Reserve reduces the size of its portfolio?

The Committee has indicated that it will normalize the size of its balance sheet through gradual pre-announced sales in order to ensure that markets have an appropriate amount of time to make adjustments. Nonetheless, yields on longer-term assets are lower now than they will be once the economy has returned to a cyclically more-normal position. The Federal Reserve will calibrate the stance of its policy, including the level of the federal funds rate and the size of its securities holdings, to the state of the economy, aiming always to promote the mandate given by the Congress--namely, to promote price stability and maximum sustainable employment.

21. Is Mr. Kessler's view on the impact of Staples and Google on our economy accurate?

The continual regeneration of the structure of the economy and the composition of business activity is a critical part of a capitalist economy. Without that regeneration, the productivity of the economy and the efficiency of capital allocation would be severely damaged.

22. Is productivity enhanced through creative destruction?

Productivity is enhanced by maintaining a flexible and dynamic economy that allows for the continual reallocation of capital toward its most efficient uses. Productivity is also affected by a range of government actions, including the characteristics of the tax code and the quality of education that society provides, to name just two.