



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

BEN S. BERNANKE
CHAIRMAN

May 28, 2010

The Honorable Alan Grayson
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Enclosed are my responses to the written questions you submitted following the February 24, 2010, hearing before the Committee on Financial Services. 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,

A handwritten signature in black ink, appearing to be "B. Bernanke", written in a cursive style.

Enclosure

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Congressman Grayson:

1. The Federal Reserve has taken extraordinary measures to prevent losses by large financial institutions. This has led to widespread speculation that such measures might include intervention in the stock market. Has the Federal Reserve--alone or in concert with the Treasury Department or any part of the government--ever taken any action with the purpose or effect of supporting the stock market or an individual stock? The means to do so included in this inquiry include, but are not limited to, the futures market, the Exchange Stabilization Fund, foreign custody accounts, the System Open Market Account, and any other account, mechanism or financial instrument. Has the Federal Reserve, Treasury, or any part of the government ever directed, acted in conjunction with or otherwise engaged a proxy or intermediary--including but not limited to a private sector entity or foreign central bank--with such a purpose or effect? Please respond to both parts of this question. Please note that we are asking you to enumerate each such action, with a description on each occasion of who, what, when, where and why.

The Federal Reserve has not intervened to support the stock market or an individual stock.

2. How do you plan on dealing with all of the mortgage-backed securities on the Fed's balance sheet? A central bank normally holds sovereign debt, so as to avoid counterparty risk; does the Federal Reserve regard mortgage-backed securities as sovereign debt? Please identify the current market value of the mortgage-backed securities held by the Federal Reserve, and the market value at the time of the Federal Reserve's last published balance sheet.

The Federal Reserve's holdings of mortgage-backed securities (MBS) are not equivalent to sovereign debt, but they are fully guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae and thus pose essentially no credit risk to the Federal Reserve. To help reduce the size of its balance sheet and the quantity of reserves in the banking system, the Federal Reserve is allowing agency debt and MBS to run off as they mature or are prepaid. In the long run, the Federal Reserve anticipates that its balance sheet will shrink toward more historically normal levels and that most or all of its security holdings will be Treasury securities. The Federal Reserve may also choose to sell securities in the future when the economic recovery is sufficiently advanced and the FOMC has determined that the associated financial tightening is warranted. Any such sales would be at a gradual pace, would be clearly communicated to market participants, and would entail appropriate consideration of economic conditions.

The Federal Reserve publishes information its balance sheet on a weekly basis in the Board's H.4.1 statistical release. In addition, the Federal Reserve provides a great deal of information regarding its credit and liquidity programs and the balance sheet in a monthly report to Congress. The fair value of the Federal Reserve's securities holdings is reported on a quarterly basis along with detailed quarterly information on the Federal Reserve's balance sheet and income statement. The fair value of the Federal Reserve's holdings of Treasury and agency securities, excluding interest, as of September 30, 2009, was \$980 billion. The fair value of the

Federal Reserve's holdings of agency-guaranteed MBS, as of September 30, 2009, was \$703 billion, respectively.

3. William White, chief economist of the BIS, warned the Federal Reserve in 2003 publicly of the clear and present danger of asset bubbles such as those in the housing market and stock market, yet he was ignored. You, a monetary economist and an expert on the Great Depression, provided Alan Greenspan with the rationale for loose monetary policies at that time, and later. The record shows that White was right, and you and Greenspan were wrong. What measures had the Fed taken to make sure it does not repeat this error? How have you changed the models you use to judge the presence of asset bubbles? What do you propose to do in the case of another housing bubble, or stock market bubble?

I don't believe that monetary policy during the early and mid-2000s was responsible for the boom and subsequent bust in the U.S. housing market. Monetary policy over this period was aimed at fostering the dual objectives of maximum employment and stable prices established by the Congress. The target federal funds rate was cut from 6-1/2 percent to just one percent between 2000 and 2003, reflecting the steady increase in the unemployment rate through the first part of the decade as well as a decline in the rate of inflation to levels that raised policymaker concerns that the United States could enter deflation, with policy constrained by the zero bound on nominal interest rates. As the unemployment rate subsequently fell back, the Federal Reserve raised interest rates to more normal levels, but, given the modest pace of the recovery and still-low inflation, policy was tightened fairly gradually.

Statistical and economic models suggest that following a somewhat higher path for the federal funds rate through this period would not have had a substantial effect on housing demand or home prices. Instead, the very rapid run-up in house prices between the late 1990s and 2006 appears to have been primarily the result of two factors. First, high levels of global saving put significant downward pressure on longer-term interest rates, including mortgage rates, thereby increasing the affordability of houses. Second, increasingly weak mortgage underwriting standards, particularly for subprime variable rate mortgages (many of which were originated outside the regulated banking sector), greatly increased the demand for homes by households that might not have been able to purchase a home--or at least as large a home--had mortgages been underwritten more appropriately.¹

Since poor underwriting practices played a significant role in the development of the recent crisis, regulatory and supervisory policies, rather than monetary policy, are likely to be more effective in avoiding similar crises in the future. At the Federal Reserve, we have taken several steps to strengthen the supervision and regulation of the financial institutions we supervise, as well as to incorporate a more macroprudential approach into our supervisory regime. A macroprudential approach considers the potential impact of a practice or condition not only on the safety and soundness of individual institutions, but also on the stability of the financial system as a whole. For example, we have played a key role in international efforts to ensure that systemically critical financial institutions hold more and higher-quality capital, have enough liquidity to survive highly stressed conditions, and meet demanding standards for company-wide

¹ See Bernanke, Ben S., "Monetary Policy and the Housing Bubble," speech presented at the American Economic Association Annual Meeting, Atlanta, Georgia, January 3, 2010.

risk management. In addition, we have begun to put in place a quantitative surveillance mechanism that will bring together the Federal Reserve's experts in banking, markets, and economics to analyze the emerging risks to individual financial institutions as well as to assess potential risks to the financial system as a whole. We have also further strengthened our commitment to consumer protection. And we have strongly advocated financial regulatory reforms, such as the creation of a systemic risk council, with responsibility to identify emerging systemic risks and coordinate an appropriate policy response across the supervisory agencies.

4. What is the Federal Reserve's position on a Tobin tax, on currency transactions or on all financial instruments? Do you believe that such a tax, if efficiently administered, would bring stability to the financial system? Setting aside the effect of stability on the financial system, which means of taxation do you regard as the most economically efficient?

The Federal Reserve does not have a position on a Tobin tax, but it has been much discussed by economists. The Tobin tax is an ad valorem tax on foreign exchange trading, and as typically proposed, it would be in the range of 0.05 to 0.5 percent. It would apply to spot currency trades and, presumably, close substitutes. By construction, it taxes short-term capital flows at a higher rate than long-term flows.

Three arguments are usually made in support of the Tobin tax. First, Professor Tobin's main argument was that such a tax would break the link between exchange rates and interest rates, creating more autonomy for domestic monetary policy. Second, the tax would reduce volatility in foreign exchange markets. Third, the tax would be a source of revenue.

Quite a few economists discount the first argument because exchange rate considerations play only a small role in policy decisions for large economies such as the United States. The second argument has received a fair amount of attention lately, but the academic literature raises questions about the tax's ability to reduce volatility. The tax discourages all trades, both volatility-reducing ones (for example, purchasing a currency that has recently depreciated on the view that the depreciation would be reversed) and volatility-increasing ones (for example, purchasing a currency that has recently appreciated on the view that the appreciation would continue) so that the net effect is uncertain. Possibly the tax could raise revenue, but that is also debatable because of the tax's potential effect on trading patterns. Opponents of such a tax point out that trading would move to untaxed jurisdictions unless the tax were imposed globally and that trading would shift from taxed instruments to substitutes. Finally, opponents note that the tax would impair the functioning of foreign exchange markets, reducing liquidity and the information contained in price signals.

With regard to advocating a specific tax policy, I have avoided taking a position on explicit budget issues during my tenure as Chairman of the Federal Reserve Board. Instead, I have attempted to articulate a general economic principle of taxation: the economic efficiency of a tax system can usually be enhanced if tax rates can be kept as low as possible while at the same time broadening the tax base in order to raise the desired amount of revenue. However, reforming the tax structure to improve efficiency is not easy as it involves not only setting tax rates but also the difficult decision of how to broaden the tax base. Changes to the structure of the tax system that may improve its efficiency may not be judged to be equitable.

5. One of the explicit statutory policy goals of the Federal Reserve is full employment. The past 18 months have seen a substantial rise in unemployment. What steps did the Federal Reserve take to prevent that? Why were they unsuccessful? What should the Federal Reserve do in the next 18 months to restore full employment? In your opinion, what can Congress and the President do in the next 18 months to restore full employment?

Although the intensification of the financial crisis in fall 2008 pushed the global economy into a severe contraction, aggressive policy actions here and abroad helped avert the collapse of the global financial system and hence avoided much more extreme adverse and protracted consequences for U.S. economic activity and employment. The Federal Reserve brought its target for the federal funds rate to a historically low range of 0 to 1/4 percent and has maintained that target range since late 2008. To provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve purchased a total of \$1.25 trillion in agency mortgage-backed securities, \$300 billion in Treasuries, and about \$175 billion in agency debt. We also implemented a number of emergency programs to improve liquidity in financial markets and to encourage the flow of credit to households and businesses; most of those programs have now been closed in light of the improved functioning of financial markets.² Partly as a result of these actions, a recovery in economic activity began in the second half of last year, while the recent readings on labor market conditions offer some encouraging signs that employment is beginning to turn up. Looking ahead, the Federal Reserve will continue to monitor economic and financial developments and will employ its policy tools as necessary to promote economic recovery and price stability. Indeed, despite the recent upturn in economic activity, we anticipate that economic conditions--including low rates of resource utilization, subdued inflation trends, and stable inflation expectations--are likely to warrant exceptionally low levels of the federal funds rate for an extended period.

The policy measures enacted by the Congress over the past two years played a crucial role in containing the financial crisis and in curtailing its impact on the economy, but those measures also incurred very substantial budgetary costs. Moreover, the economic downturn was associated with a sharp drop in tax receipts and a steep jump in spending on income support programs. All told, by the end of the current fiscal year, the federal debt held by the public is now projected by the CBO to exceed 60 percent of the nation's gross domestic product (GDP)--a debt burden not seen since the period immediately following World War II. Looking beyond the cyclical pressures on the budget deficit, the structural deficit remains substantial and the nation will face significant fiscal challenges associated with continued increases in the costs of Medicare and Medicaid and with the retirement of the baby-boom generation. Therefore, moving promptly to establish a sustainable path for the federal budget might well yield considerable economic benefits in the form of lower long-term interest rates and increased consumer and business confidence.

² The only remaining active program that was created to support markets during the crisis, the Term Asset-Backed Securities Loan Facility (TALF), is scheduled to close on June 30 for loans backed by new-issue commercial mortgage backed securities; the TALF was closed on March 31 for loans backed by all other types of collateral.

6. Do you believe that the statutory goals of price stability and full employment are compatible? If not, does the Federal Reserve seek to be relieved of one or the other? If so, which one, and why?

I support the Federal Reserve's dual mandate of maximum employment and stable prices. Although at times there may be temporary tradeoffs between these goals, they are generally complementary and appropriate, because price stability helps moderate the short-term variability of employment and contributes to the economy's employment prospects over the longer run.

7. If, at the end of each of the currency swaps in which the Federal Reserve has engaged in the past few years, the Federal Reserve had closed out the swap by buying dollars and selling foreign currency in the open market, rather than by closing the swap at the prearranged price, would the Fed have received more dollars or fewer dollars in toto? How many more or fewer? If possible, please itemize this information by swap, or if such a breakdown is not feasible, then by currency.

Under the assumption that the Federal Reserve resold all the foreign currency purchased in a particular swap transaction at the spot exchange rate prevailing at the maturity of the swap transaction rather than at the initial (prearranged) exchange rate, the net quantity of dollars received by the Federal Reserve on the combined transaction (abstracting from any dollar interest receipts) could have been positive or negative. If the exchange value of the dollar had risen against the foreign currency over the period of time between the initiation and the termination of a particular swap drawing, the net flow of dollars to the Federal Reserve would have been negative under this hypothetical arrangement. Alternatively, if the dollar had declined against the foreign currency over that period, the net flow of dollars to the Federal Reserve would have been positive. Of course, if the exchange rate had been unchanged, the net flow of dollars would have been zero--identical to that under the actual swap arrangements, where the Federal Reserve received in the second leg of the swap transaction exactly the same quantity of dollars that it sold in the first leg (again, abstracting from any dollar interest receipts.)

Such counterfactual increases and decreases in the net dollar flows can only be estimated, as market exchange rates vary throughout the day and we cannot know the exact timing over a given day of the hypothetical sales by the Federal Reserve of its holdings of foreign currency.

8. Regarding these currency swaps, how much interest did foreign central banks earn on the dollars that they borrowed? How much interest did the Federal Reserve earn on the foreign currency which it borrowed?

The foreign central banks distributed the U.S. dollars they drew via their swap lines with the Federal Reserve through a variety of methods, including variable-rate tenders, fixed-rate tenders, bilateral transactions, and foreign exchange swap tenders. In each case, the arrangement was between the foreign central bank and the institutions obtaining the funding in these operations. The foreign central banks determined the acceptability of the collateral offered and the eligibility of the institutions to participate in the operations they conducted. The Federal Reserve's contractual relationship was with the foreign central bank and not with the institutions obtaining dollar funding in these operations.

Precise information on the interest ultimately received by the foreign central banks on their U.S. dollar operations would have to be provided by the foreign central banks themselves. However, in general, when a foreign central bank drew on its swap line to fund its dollar tender operations, it paid interest to the Federal Reserve in an amount equal to the interest the foreign central bank earned on its tender operations. As a result, the interest received by the foreign central banks is not likely to be much different from that received by the Federal Reserve.

The table below shows the interest that flowed to the Federal Reserve. The figures for 2007 and 2008 were published in the Board's Annual Report for 2008 and the figure for the first three quarters of 2009 was published in the Federal Reserve System Monthly Report on Credit and Liquidity Programs and the Balance Sheet (March 2010). In addition, we estimate that between end-September 2009 and the end of the program, the Federal Reserve earned an additional \$50 million to \$100 million in interest. An unaudited accounting of earnings during the entirety of 2009 will be published later in April.

Interest Earnings on Swaps (millions of dollars)	
2007	28
2008	3,606
01/2009 through 09/2009*	2,093
Total	5,727
Memo:	
10/2009 through 02/2010**	50 to 100
*unaudited; **estimated	

9. Did the foreign central banks that engaged in currency swaps with the Federal Reserve use the proceeds to buy U.S. Government debt? If so, please provide all of the available details, e.g., when, where, how, etc.

The foreign central banks did not use the proceeds of their swap transactions with the Federal Reserve to buy U.S. Government debt.

10. More generally, in the past 18 months, has the Federal Reserve provided funds to anyone that were used to purchase U.S. Government debt? If so, please explain who, what, when, where and why. (This question excludes the Federal Reserve's own transactions in U.S. Government debt.)

In establishing various lending and asset-purchase programs during the financial crisis, the Federal Reserve's objectives were to stabilize the financial system and provide economic stimulus in order to prevent an even worse economic outcome from developing than actually occurred. The Federal Reserve's objective in extending credit was not to facilitate borrowing by the U.S. Treasury.

Because money is fungible, in general it is not possible to determine whether a counterparty used funds obtained from loans or through other transactions for a specified purpose. However, in at least one situation over the past 18 months, a linkage can be drawn between the extension of credit by the Federal Reserve and the purchase of U.S. government debt. Specifically, the Term Asset-Backed Securities Loan Facility extends credit to finance the purchases of Small Business Administration (SBA) Pool Certificates and Development Company certificates (in addition to other asset-backed securities). As of February 24, 2010, \$2 billion in TALF loans were backed by such SBA securities.

In other cases, it is not possible to specifically connect the extension of particular loans by the Federal Reserve with the acquisition of U.S. government debt.

11. According to information published by the Federal Reserve, the net worth of the United States declined from \$62 trillion to \$50 trillion between July 2007 and December 2008. In both nominal terms and in real terms, how does this decline compare to other periods of decline?

Based on data in the most recent statistical release for the *Flow of Funds Accounts of the United States* (dated March 11, 2010), household net worth dropped from \$65.9 trillion at the end of the second quarter of 2007 to \$51.4 trillion at the end of the fourth quarter of 2008. After adjusting for inflation, the decrease was from \$62.8 trillion in the second quarter of 2007 to \$47.2 trillion in the fourth quarter of 2008. The cumulative decrease in household net worth over this period was larger--both in nominal and in real terms--than any prior decrease since 1947 (when the Flow of Funds Accounts begin).

12. In the past twelve months, what has the Federal Reserve spent to influence the decisions of Congress and the Executive Branch? With respect to each such expenditure, please identify who, what, when, where and why, including how much.

The Federal Reserve Board, like other federal agencies, maintains a Congressional Liaison Office staffed by salaried Board employees that, together with other members of the Board's staff, prepares Congressional testimony for Board members and senior staff and coordinates responses to inquiries from Congressional committees and individual members. The cost of staff resources resulting from these efforts varies widely with the level of requests, testimonies, and reports provided in response to Congressional interest.

13. In the past twelve months, has the Federal Reserve engaged in self-promotion? With respect to each such expenditure, please identify who, what, when, where and why, including how much.

In connection with the functions assigned to the Federal Reserve under applicable law, Board members and senior staff make frequent speeches and provide written materials and public testimony on monetary policy, the economy, banking supervision and regulation, consumer protection, and related matters.

14. Does the Federal Reserve believe that it serves any purpose for the U.S. Government (including the Federal Reserve) to maintain a large stock of gold? If so, then how much gold should the Government hold, and how does that amount compare to what the Government actually holds? If not, then what should be done to disburse it?

The Federal Reserve does not own or control any part of the U.S. gold stock. The U.S. Treasury controls the gold owned by the U.S. government and is responsible for policy toward this stock.

Many countries hold gold as part of their international reserves assets, reflecting its long-standing status as a store of value and as well as for reserve diversification reasons. These considerations are balanced against the fact that gold is expensive to maintain and typically earns a relatively low real rate of return over the long run.

There is no commonly accepted metric for the amount of reserves a country should hold, let alone how much should be held in gold. Therefore it is extremely difficult to determine whether the U.S. government holds too much or too little gold. The fact that our economy is the world's largest economy suggests that we should hold a large quantity of reserves relative to other economies. However, because the U.S. dollar serves as the world's primary reserve currency and U.S. government debt is the global benchmark, there are reasons for the United States to hold substantially less in reserves than other countries. To put U.S. gold holdings in perspective, the U.S. government currently owns gold with a market value of almost \$300 billion. Combined with the roughly \$100 billion held in other international reserve assets, U.S. total foreign reserves are sizable but they are still below the level of reserves held by a number of countries, especially relative to the size of the economy.

Finally, irrespective of any determination of the amount of gold that should be held, it should also be noted that any change in the level of U.S. gold holdings, or even the expression of interest in such a move, would result in a change in the market price of gold and could be disruptive to financial markets more broadly.

15. Please provide copies of all correspondence between Time Magazine and the Federal Reserve, including but not limited to the Chairman and anyone acting on behalf of the Federal Reserve, regarding Time Magazine's decision to name the Chairman "Man of the Year." To be clear, this request includes correspondence on the subject before Time Magazine made its decision. Also please provide notes of conversations between Tim Magazine and anyone acting on behalf of the Federal Reserve on this subject.

Time Magazine has detailed for the public why it chose to designate Chairman Bernanke as its Person of the Year. See http://www.time.com/time/specials/packages/article/0,28804,1946375_1947930_1947943,00.html The full transcript of the on-the-record conversation between Time Magazine and the Chairman may be found at http://www.time.com/time/specials/packages/printout/0,29239,1946375_1948023_1947253,00.html

16. Does the Federal Reserve believe that the current configuration of Regional Banks is optimal? If not, what changes would the Federal Reserve like to see? For instance, would the Federal Reserve like to see shifts in boundaries, or additional Regional Banks, reflecting the large shifts in population and business activity since the lines were drawn? (The disparity in population, for instance, is now as high as six to one.)

The Federal Reserve has not proposed any change in the number or configuration of the Federal Reserve Banks at this time. The system of 12 Reserve Banks provides a broad geographic presence across the nation for an institution that often has to make difficult decisions. Over time, this structure has provided the Federal Reserve with grassroots connections, local insights, and diverse perspectives necessary in order for the Federal Reserve to fulfill its statutory responsibilities for monetary policy, financial stability, supervision, consumer protection, and other areas.

17. In testimony before Congress, Chairman Bernanke has said that he is open to changes in Fed governance. Which changes is he open to?

The Federal Reserve continues to review and consider appropriate changes in Federal Reserve governance, and looks forward to working with Congress on these matters.