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

October 26, 2010

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

Dear Chairman Bernanke:

Numerous press reports, as well as the comments of prominent economists and financial market participants, suggest that the Federal Open Market Committee (FOMC) may decide to initiate a second round of quantitative easing during its upcoming November meeting. While fully respecting the independence of the Federal Reserve within the U.S. Government to determine monetary policy, I would like to share with your my concerns about another round of quantitative easing.

In the *Full Employment and Balance Growth Act of 1978*, Congress established a "dual mandate," directing the Federal Reserve to give equal weight to the goals of stable prices and the maximum level of employment when conducting monetary policy.[1] You discussed the dual mandate on October 15, 2010, in remarks at a Federal Reserve Bank of Boston conference entitled "Revisiting Monetary Policy in a Low-Inflation Environment." You stated, "Given the Committee's objectives, there would appear – all else being equal – to be a case for further action."

Your case for a new round of quantitative easing rests on two premises: (1) the current rate of inflation is too low and threatening deflation, and (2) the unemployment rate of 9.6 percent is too high. In a number of speeches, you have reasoned that a policy of quantitative easing (e.g., buying Treasury notes and bonds when the federal funds rate is near the zero lower bound) may reduce long-term interest rates through the portfolio balance channel even if commercial banks do not expand their lending. You have expressed your confidence that lower long-term interest rates will then help to reduce the unemployment rate by stimulating job-creating business investment. You have also assured the nation that the Federal Reserve has the necessary tools to reverse this policy without triggering general price inflation.

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[1] Specifically, Section 2A of the *Federal Reserve Act* as amended states: "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

I am concerned that these premises are weak and do not address the current barriers to economic recovery most cited by job creators. Regarding the first premise, the most recent backward-looking price indices are consistent with price stability. For the twelve months ending in September 2010, the Consumer Price Index (CPI-U) increased by 1.1 percent, while the core CPI edged up by only 0.8 percent. Similarly, for the twelve months ending in August 2010, the Personal Consumption Expenditure (PCE) chain price index increased by 1.5 percent, while the core PCE chain price index grew by 1.4 percent. It is obvious that neither the core CPI nor the core PCE chain price index is decelerating into deflation.

At the same time, a number of inflation-sensitive, forward-looking, market-determined prices are beginning to flash warnings for a possible acceleration of price inflation in the near future. For example, during the twelve months ending in September 2010, the Reuters/Jefferies Commodity Research Bureau Index rose by 9.6 percent, while gold prices were up by an incredible 28.4 percent.

Regarding your second premise, Nobel laureate Robert Mundell said, "For every policy goal, you need a policy lever." I agree that the United States needs a higher rate of real GDP growth than the seasonally adjusted annual rate of 1.7 percent in the second quarter of 2010 to reduce the unemployment rate. In my opinion, however, monetary policy is not right lever to accelerate output and employment growth over the medium term.

The most volatile component of GDP is private business investment. Firms invest in new equipment, software, and structures based on their expectations of the financial return and risk. There is a clear relationship between aggregate business investment and the expected risk-adjusted real after-tax rate of return on capital. Indeed, the risk-adjusted real rate of return on capital has been remarkably stable at about 3 percent. Exogenous events or policy changes that boost the expected risk-adjusted real rate of return on capital foster a surge in business investment that increases the capital stock, bringing the risk-adjusted rate of return on capital in line with its long-term average.

A surge in business investment increases real GDP and employment over the medium term as new capital comes into service. Historically, most of this surge occurs in the first two years after the event or policy change. An increase in the capital stock boosts productivity over the long term. In turn, higher productivity raises the real income of both the owners of capital and their workers, further increasing real GDP and employment.

Budget, regulatory, and tax policies have far larger effects on expectations of financial return and risk from new business investment than monetary policy. Indeed, the budget, regulatory, and taxes policies of President Obama and this Congress have simultaneously lowered the expected returns from new business investment and increased the risk associated with such returns. It is not surprising that most businesses are reluctant to invest in new projects or hire more workers.

The empirical evidence that quantitative easing can significantly reduce long-term interest rates and stimulate real GDP growth through the portfolio balance channel or any other channel is mixed. In general, the size of this effect is quite small. Joseph Gagnon, Matthew Raskin, Julie Remache, and Brian Sack contended, "By reducing the net supply of assets with long duration, the Federal Reserve's LSAP (i.e., Large-Scale Asset Purchase) programs appear to have been successful in reducing the term premium. The overall size of the reduction in the 10-year term premium appears to be somewhere between 30 and 100 basis points, with most estimates in the lower and middle thirds of this range."[2] Looking at the same programs, however, Johannes Stroebel and John Taylor found that after controlling for changes in risk, quantitative easing had statistically insignificant or small effects.[3]

In discussions in my district in Texas and around the country, no entrepreneur has told me that high interest rates are deterring his or her firm from making investments or hiring new workers. Instead, it is the uncertainty over the impact of federal budget deficits, new mandates and regulations, barriers to commercial mortgage lending erected, in part, by the overreaction of bank regulators to stress in the commercial real estate market, and tax policies that deter new investment and job creation. In my view, the minimal effect that a new round of quantitative easing may have on long-term interest rates is unlikely to overcome this uncertainty.

In a speech on October 18, 2010, Federal Reserve Bank of Atlanta President Dennis Lockhart described the decision to engage in a new round of quantitative easing as "a form of risk management."[4] I agree this decision involves a balance of risk, but unlike President Dennis, I fear the risk from a new round of quantitative easing far exceeds the potential reward.

A new round of quantitative easing poses significant inflationary risk over the medium term. In your remarks on October 15, 2010, you emphasized your confidence that the Federal Reserve has the necessary tools to unwind quantitative easing before an inflationary outbreak. I agree that the Federal Reserve has this technical ability through a combination of asset sales, higher Treasury balances, reverse repos, and higher interest paid on reserve deposits. However, the willingness of the FOMC to implement these measures in a timely manner remains untested.

I fear that concerns over the weak housing market from both policymakers and the public may deter the Federal Reserve from selling federal agency mortgage-backed securities and federal agency debt securities in sufficient quantities to keep inflation in check. The necessity that the Treasury must borrow from the public to increase Treasury deposits at the Federal Reserve limits how much the Federal Reserve can rely on this tool to counter a large monetary accommodation from a new round of quantitative easing. Likewise, the size of the repo market limits the effectiveness of reverse repos. Thus, the Federal Reserve may have to rely primarily on the unproven tool of increasing the interest rate on reserve deposits when it becomes time to withdraw this monetary expansion.

I worry that the Federal Reserve is embarking on an unwise policy of additional quantitative easing, in large part, to offset the drag on real GDP growth created by the budget, regulatory, and tax policies of President Obama and this Congress. However, the election on November 2 is likely to change the composition of Congress. The newly elected Congress

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[2] Gagnon, et al., Large-Scale Asset Purchases by the Federal Reserve: Did They Work? (Mar. 2010), p. 28, *available at* http://www.ny.frb.org/research/staff_reports/sr441.pdf.
[3] Stroebel, Johannes C. and Taylor, John B., Estimated Impact of the Fed's Mortgage-Backed Securities Purchase Program (Dec. 2009), *available at* http://www.stanford.edu/~johntayl/ST%20Paper%20-%20December%2020.pdf.
[4] Lockhart, Dennis, The Challenges of Monetary Policy in Today's Economy (Oct. 2010), *available at* http://www.frbatlanta.org/news/speeches/lockhart_101810.cfm.

should have the opportunity to change these anti-growth policies before the Federal Reserve resorts to quantitative easing.

I do not envy the challenges that you face in charting the course of monetary policy under current economic circumstances. I look forward to a wide-ranging discussion of these issues.

Sincerely,

Kevin Brady
Senior House Republican Member