MONETARY POLICY AND THE STATE OF THE ECONOMY

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

JULY 18, 2012

Printed for the use of the Committee on Financial Services

Serial No. 112–145

U.S. GOVERNMENT PRINTING OFFICE

76–116 PDF WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

SPENCER BACHUS, Alabama, *Chairman*

JEB HENSARLING, Texas, *Vice Chairman*
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
DONALD A. MANZULLO, Illinois
WALTER B. JONES, North Carolina
JUDY BIGGERT, Illinois
GARY G. MILLER, California
SHELLEY MOORE CAPITO, West Virginia
SCOTT GARRETT, New Jersey
RANDY NEUGEBAUER, Texas
PATRICK T. McHENRY, North Carolina
JOHN CAMPBELL, California
MICHELE BACHMANN, Minnesota
THADDEUS G. McCOTTER, Michigan
KEVIN McCARTHY, California
STEVAN PEARCE, New Mexico
BILL POSEY, Florida
MICHAEL G. FITZPATRICK, Pennsylvania
LYNN A. WESTMORELAND, Georgia
BLAINE LUETKEMEYER, Missouri
BILL HUIZENGA, Michigan
SEAN P. DUFFY, Wisconsin
NAN A. S. HAYWORTH, New York
JAMES B. RENACCI, Ohio
ROBERT HURT, Virginia
ROBERT J. DOLD, Illinois
DAVID SCHWEIKERT, Arizona
MICHAEL G. GRIMM, New York
FRANCISCO "QUICO" CANSECO, Texas
STEVE STIVERS, Ohio
STEPHEN LEE FINCHER, Tennessee

BARNEY FRANK, Massachusetts, *Ranking Member*
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN McCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
GWEN MOORE, Wisconsin
KEITH ELLISON, Minnesota
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
ANDRÉ CARSON, Indiana
JAMES A. HIMES, Connecticut
GARY C. PETERS, Michigan
JOHN C. CARNEY, JR., Delaware

JAMES H. CLINGER, *Staff Director and Chief Counsel*

CONTENTS

MONETARY POLICY AND THE STATE OF THE ECONOMY

Wednesday, July 18, 2012

U.S. House of Representatives,
Committee on Financial Services,
Washington, D.C.

The committee met, pursuant to notice, at 10:02 a.m., in room 2128, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the committee] presiding.

Members present: Representatives Bachus, Hensarling, Royce, Lucas, Paul, Manzullo, Jones, Biggert, Miller of California, Garrett, Neugebauer, McHenry, Campbell, Pearce, Posey, Fitzpatrick, Westmoreland, Luetkemeyer, Huizenga, Duffy, Hayworth, Renacci, Hurt, Dold, Schweikert, Grimm, Canseco, Fincher; Frank, Waters, Maloney, Watt, Sherman, Capuano, Clay, Lynch, Miller of North Carolina, Scott, Green, Perlmutter, Donnelly, Carson, Himes, and Carney.

Chairman Bachus. This hearing will come to order. We meet today to receive the semi-annual report to Congress by the Chairman of the Board of Governors of the Federal Reserve System on monetary policy and the state of the economy. Pursuant to committee rule 3(f)(2), opening statements are limited to the chair and ranking minority member of the full committee, and the chair and ranking minority member of the Subcommittee on Domestic Monetary Policy and Technology, for a period of 8 minutes on each side. Without objection, all Members' written statements will be made a part of the record.

I now recognize myself for 5 minutes for the purpose of making an opening statement. We are honored to have Federal Reserve Chairman Ben Bernanke before us today. Thank you, Chairman Bernanke, for appearing before our committee once again, and for your dedicated service to the country.

As we meet this morning, we continue to find our Nation on a path that is fiscally and economically unsustainable. And some in the Senate, Chairman Bernanke, apparently believe that only you can do something about it. Since the economy is bad and unemployment is high, one of those Senators pointedly told you yesterday that you have to get to work. That leads to an important question: Who is ultimately responsible for the state of our economy? We once had a President who had a sign on his desk in the Oval Office that said, "The buck stops here." I will amend that to say the buck stops with the President of the United States and with Congress, who are the elected leaders of this country.

The President and Congress are the ones who have created America's spending-driven debt crisis by hitting the gas when what was needed was someone stomping on the brakes, and more importantly, the need for reform of our entitlements. Some in the Senate may want to duck responsibility, but the truth is the Federal Reserve cannot rescue Americans from the consequences of failed economic and regulatory policies passed by Congress and signed by the President. The Chairman of the Fed cannot save the economy when those elected leaders decide they are prepared to send our country over a fiscal cliff, as one of those elected leaders in the Senate declared earlier this week.

Chairman Bernanke has warned Congress and the Administration time and time again that without action, growing deficits and the debt will erode our prosperity and leave the next generation of Americans with less opportunity. To avoid this fate, we must start taking action now to tame Washington's appetite for spending, and more importantly, as Chairman Bernanke has said, tackle the difficult but necessary long-term restructuring of our entitlements.

The House, to its credit, has had the courage, in this hyperpartisan attack atmosphere, to begin the long-term process; the Senate has not. So I would like to take this opportunity to tell the Senate that it is time for them to go to work. Our economy is hobbled not only by our deficits and debt, but also by the cumulative weight of Washington overregulation. This committee hears constantly from private sector witnesses who tell us the regulatory burdens being placed on them are, as one small town banker witness said, slowly but surely strangling their ability to do business and create jobs. This is not to argue we don't need regulations. Reasonable regulations provide clear rules of the road for businesses and protect consumers.

Businesses need certainty and to know what to expect. They don't have it under the present regulatory regime. Unfortunately, job creators will tell you that reasonable and clear rules aren't what they are getting from Washington right now. Instead, they tell us the regulators do not coordinate their actions, and the result is businesses are subjected to confusing and often conflicting rules. While many in Washington attack Wall Street and big corporations when they call for more regulation, the reality is the burden of Federal red tape falls disproportionately on small businesses and the small community-based financial institutions that lend to them.

As the Small Business Administration reports, it costs small businesses 36 percent more per employee to comply with Federal rules than large companies. This has driven a consolidation which is evident in our financial services industry. And because small businesses are the engine of job growth in our economy, we can hardly blame the Fed when policies passed by this Congress and signed by the President result in regulatory overkill that makes it harder for small businesses to thrive and hire.

Instead of more regulations, Congress and the President need to do more to eliminate the government roadblocks that stand in the way of small business success and job creation. The President recently said that entrepreneurs and small businesses aren't successful on their own; they can succeed only with the help of the government. That is akin to saying that Apple Computer is a success because of the person who built Steve Jobs's garage. Small businesses succeed in this country in spite of the government, not because of it.

Chairman Bernanke, I know all of us look forward to your testimony and the discussion that we will have today. Again, I thank you for being here, and I yield to the ranking member.

Mr. FRANK. I appreciate that. I am always struck by the ability of my Republican colleagues to engage in a kind of duality of the mind with regard to Federal spending. I listened to the chairman talk about the need to rein in spending, and note that we are going to be given a bill today to vote on that will increase military spending beyond what the President has asked for.

There is this curious notion that somehow military spending is very different from all other government spending. People who tell us how government spending never creates a job become the most militant Keynesians when it comes to military spending, even though a very large percentage of it is spent overseas. We will be asked today to continue a subsidy to NATO so that the wealthy nations of western Europe can continue to spend very little on their military, so that they in turn can have lower retirement ages than we have here in America, and we will then be telling Americans that we have to cut back on their Social Security and their Medicare.

Note when my Republican friends say "entitlement," they mean Social Security and Medicare. And I am proud of those. While we can make them more efficient, I am not prepared to maintain more and more military spending at their expense.

Next, I want to comment on what Chairman Bernanke has told us. And I want to begin by noting that when people look for bipartisanship, it is striking the degree of partisan criticism I have heard from Republicans of Chairman Bernanke, who is singlehandedly the most bipartisan institution in Washington. He was appointed 3 times to important economic positions by George Bush: first, to the Federal Reserve Board of Governors in 2002; second, to be Chairman of the Council of Economic Advisers in 2005; and third, to be Chairman of the Federal Reserve.

It does appear that when Mr. Bush had an important economic appointment to make, he said, get me the usual suspect, which was Chairman Bernanke. And I think that is very important, because he is genuinely bipartisan, and therefore, I look at his analysis of the economy. And it has very little do with the very partisan caricature we hear.

I read the economic report, the Monetary Policy Report; there is a basic statement that our economy has been recovering from the terrible crisis brought about by the complete absence of regulation and consequent, unchecked irresponsibility by some financial institutions, obviously not all, and we are told that it is slowed down by a number of factors. The most important, according to the way it is presented here, is what is going on in Europe. Nothing that we have done is responsible. In fact, the Federal Reserve has tried to be helpful in alleviating the situation in Europe, drawing again partisan criticism from the Republicans for their cooperation with the ECB to ease that situation to our benefit. We are told that there is a problem because there is uncertainty about the tax and spending policies. But those are wholly bipartisan. By the way, I voted against the bill that included the sequester. I think we can substantially cut military spending, but sequestering is a stupid way to do it.

A better way to do it would be to tell western Europe they are on their own, to stop figuring that we have to win a thermonuclear war with a now nonexistent Soviet Union. But the fact is that the uncertainty that Chairman Bernanke talks about, our bipartisan Republican and Democratic-appointed top economic official, is an uncertainty that is bipartisan and has nothing to do with regulation. And I listen to this complaint about regulatory uncertainty. Apparently, maybe there is a part of the Monetary Policy Report I haven't read. I don't see a word in here that says that financial reform or other forms of regulation are part of the problem. It does talk about some other things that are part of the problem, for example, the cutback in hiring and construction by State and local governments. And that is a direct preference of the Republicans.

We began in 2009, when we had a President and a Democratic Congress, to provide funding so State and local governments could continue to be economically active in the face of the crisis that had hit them. We were told by our Republican colleagues that was government spending; it didn't create jobs. Apparently, you couldn't shoot anybody with it. And if you can't shoot anybody with something, or if you can't send it to an overseas base, it has no job creation impact, so they only do it for the military. But in fact, if State and local governments had not been forced to cut back, unemployment would now be below 8 percent, even if they had been able to hold even.

We have lost about 15 percent of the jobs created in the private sector by cutbacks in the public sector. So again, as I read this, there are discussions of what is causing a recovery slower than we want it to be. None of them have to do with what my Republican colleagues have said. And again, this comes from Chairman Bernanke, who was, as I said, was appointed 3 times to important economic positions by George Bush, a man with whom I sometimes disagree, but whose integrity and intellectual honesty ought to be unquestioned. Unfortunately, in this hyperpartisan atmosphere, to quote the chairman, it sometimes isn't.

Chairman BACHUS. I thank the ranking member. Before recognizing Dr. Paul for his statement, I want to note that this may be his last committee meeting with the Chairman of the Federal Reserve. Throughout his time in office, Dr. Paul has been a consistent and strong advocate for sound monetary policy. And his leadership on the committee, especially during these hearings when we have had the Federal Reserve Chairman up here before us, have certainly made the hearings more interesting and provided several memorable YouTube moments.

Mr. FRANK. Mr. Chairman, could I ask unanimous consent just to say that having served for a long time with Ron Paul, with whom I agree on on a number of issues, I am very pleased that I was able to serve one term with him as the chairman, because there were times during our joint service when despite his seniority, I thought he would never get to it. So I am glad that he finally achieved that chairmanship that he should have had long ago.

Chairman BACHUS. Thank you. And let me note that my statement didn't talk about Democrats and Republicans.

Mr. FRANK. Mr. Chairman, if we are going to debate it, I know you talked about the Administration and Obama, and I think most people know what party he is in.

Chairman BACHUS. All right. Thank you. For the record, we do know that. Thank you. Dr. Paul for 3 minutes.

Dr. PAUL. Thank you, Chairman Bachus. And welcome, Chairman Bernanke. I appreciate your comments, Chairman Bernanke and Ranking Member Frank. I am delighted to be here today, but I just want to refresh a few people's memories. I was first elected to Congress in 1976 in April in a special election. And the biggest bill on the docket at that time was the revamping of the IMF. There was a major crisis going on from the breakdown of the Bretton Woods agreement, and they had to rewrite the laws. They wanted to conform the laws with what they had been doing for 5 years. And that was a major piece of legislation. But it was only a consequence of what was predicted in 1945, because when 1945 established that Bretton Woods, it was predicted by the free market economists that it wouldn't work, that it would fail.

This whole idea that they could regulate exchange rates and deal with the balance of payments totally failed. And so, they had to come up with something new. And 1971–1976 is that transition period. Those same economists at that time said this was an unworkable system, too, and it would lead to a major crisis of too much debt, too much malinvestment. It would be worldwide. It would be worse than anything because it would be based on the fiat dollar globally, and many of the problems we have domestically would be worldwide.

That certainly has been confirmed with the crisis that we are in, and it has not been resolved yet. We are still floundering around, and we still have a long way to go.

I have, over the years, obviously been critical of what goes on in monetary policy, but it hasn't been so much of the Chairman of the Federal Reserve, whether it was Paul Volcker or Alan Greenspan or the current Chairman; it has always been the system. I think they have a job that they can't do because it is an unmanageable job. And it is a fallacy, it is a flawed system, and therefore we shouldn't expect good results.

And generally, we are not getting results. Policies never change. We say the same thing. No matter what the crisis is, we still do more of the same. If spending and debt was the problem, spending more and in greater debt and have the Fed just buy more debt doesn't seem to help at all. And here we are doing the same thing. We don't talk about the work ethic and true productions and true savings and why this excessive debt is so bad for us. We talk about solving a worldwide problem of insolvency of nations, including our own, by just printing money, and creating credit.

The Fed, in the last 4 years, tripled the monetary base, and it has $1 trillion more money sitting there, and the banks are sitting with trillions of dollars. Just the creation of money doesn't restore the confidence that is necessary. And until we get to the bottom of this and restore the confidence, I don't think we are going to see economic growth. This whole idea that you have the job of managing money, and we can't even define the dollar—nobody has a definition of the dollar; it is an impossible task.

So I have hoped in the past to try to contribute to the discussion on monetary policy and the business cycle and why it benefits the rich over the poor, and so far, my views have not prevailed. But I have appreciated the opportunity, and I appreciate this opportunity to have served on the Financial Services Committee.

Chairman BACHUS. Thank you. Thank you, Dr. Paul. The gentleman from Missouri, Mr. Clay, is recognized for 3 minutes.

Mr. CLAY. Thank you, Mr. Chairman. And let me thank Chairman Bernanke for appearing at today's hearing. Let me also publicly thank our subcommittee chairman, Dr. Paul, for his honorable service in Congress and to his country. As you know, the Humphrey-Hawkins Act charges the Federal Reserve with a dual mandate: to maintain stable prices, which I understand we have positive news about; and full employment, which is what I would like to talk about today. Full employment means everyone. Currently, the national average unemployment rate is 8.2 percent.

Chairman Bernanke, this has decreased compared with when you were here a year ago, when it was 9.1 percent. Unfortunately, the unemployment rate for African Americans is much higher. For African-American males, it is a too-high 14.2 percent. 12.7 million people in the United States want to work, but cannot find a job. That is down from last year's 14 million. But too many of those 12.7 million are African Americans. Nonfarm payroll employment is continuing to rise by 80,000, but too few of those who are getting jobs are African Americans. Average hourly earnings for all private nonfarm employees rose to $23.50 over the past 12 months, but not for enough African Americans.

Consumer food prices have risen slightly, but consumer price inflation has decreased overall, and energy prices have decreased too. But if you are out of work, you cannot pay your electric bill even if it is slightly lower than it was last year. The disparity in the unemployment between the national average and African Americans is unacceptable, and we have to do more to solve it. Mr. Chairman, it is important to put everyone back to work in this country. But as we look at policies and strategies that will continue the improvement in job numbers, be aware that we as a Nation are only as strong as the weakest link.

So let's make sure we don't leave behind a large and important part of our communities. And I look forward to your statement and continuing this important and ongoing discussion. Mr. Chairman, I yield back.

Chairman BACHUS. Thank you, Mr. Clay. Before I recognize Chairman Bernanke, let me say that because the Financial Stability Oversight Council on which the Chairman serves is meeting today at 1 p.m., the Chair will excuse Chairman Bernanke at 12:45, so that he can fulfill his important obligation with that Council. The Chair also announces that in order to accommodate questioning of Chairman Bernanke by as many Members as possible, we will strictly enforce the 5-minute rule.

Members who wait until the final seconds of their 5 minutes to begin asking their questions to the Chairman should be advised that they will be asked to suspend when the red light comes on so that we can allow all Members to be recognized. I have often said that our freshman class and sophomore class are some of our more capable Members, and I want them to have an opportunity to ask questions.

Chairman Bernanke, your written statement will be made a part of the record, and you are now recognized for a summary of your testimony.

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

Mr. BERNANKE. Thank you, Chairman Bachus, Ranking Member Frank, and members of the committee. I am pleased to present the Federal Reserve's semi-annual Monetary Policy report to the Congress. Let me begin with a discussion of current economic conditions and the outlook, and then I will talk a bit about monetary policy. The U.S. economy has continued to recover, but economic activity appears to have decelerated somewhat during the first half of the year. After rising at an annual rate of 2.5 percent in the second half of 2011, real GDP increased at a 2 percent pace in the first quarter of this year, and available indicators point to a still smaller gain in the second quarter. Conditions in the labor market improved during the latter part of 2011 and early this year, with the unemployment rate falling about a percentage point over that period. However, after running at nearly 200,000 per month during the fourth and first quarters, the average increase in payroll employment shrank to 75,000 per month during the second quarter.

Issues related to seasonal adjustment and the unusually warm weather this past winter can account for a part, but only a part, of this loss of momentum in job creation. At the same time, the jobless rate has recently leveled out at just over 8 percent. Household spending has continued to advance, but recent data indicate a somewhat slower rate of growth in the second quarter. Although declines in energy prices are now providing support to consumers' purchasing power, households remain concerned about their employment and income prospects and their overall level of confidence remains relatively low. One area where we see modest signs of improvement is housing. In part, because of historically low mortgage rates, both new and existing home sales have been gradually trending upward since last summer, and some measures of house prices have turned up in recent months as well.

Construction has increased, especially in the multi-family sector. Still, a number of factors continue to impede progress in the housing market. On the demand side, many would-be buyers are deterred by worries about their own finances or about the economy more generally. Other prospective home buyers cannot obtain mortgages due to tight lending standards, impaired creditworthiness, or because their current mortgages are underwater, that is, they owe more than their homes are worth.

On the supply side, the large number of vacant homes, boosted by the ongoing inflow of foreclosed properties, continues to divert demand from new construction. After posting strong gains over the second half of 2011 and into the first quarter of 2012, manufacturing production has slowed in recent months. Similarly, the rise in real business spending on equipment and software appears to have decelerated from the double digit pace seen over the second half of 2011 to a more moderate rate of growth over the first part of this year. Forward-looking indicators of investment demand, such as surveys of business conditions and capital spending plans, suggest further weakness ahead.

In part, slowing growth in production and capital investment appears to reflect economic stresses in Europe, which together with some cooling in the economies of other trading partners, is restraining the demand for U.S. exports. At the time of the June meeting of the Federal Open Market Committee, or FOMC, my colleagues and I projected that under the assumptions of appropriate monetary policy, economic growth will likely continue at a moderate pace over coming quarters and then pick up very gradually.

Specifically, our projections for growth in real GDP prepared for the meeting had a central tendency of 1.9 to 2.4 percent for this year, and 2.2 to 2.8 percent for 2013. These forecasts are lower than those we made in January, reflecting the generally disappointing tone of the recent incoming data. In addition, financial strains associated with the crisis in Europe have increased since earlier this year, which, as I already noted, are weighing on both global and domestic economic activity.

The recovery in the United States continues to be held back by a number of other headwinds, including still tight borrowing conditions for some businesses and households and, as I will discuss in more detail shortly, the restraining effects of fiscal policy and fiscal uncertainty. Moreover, although the housing market has shown improvement, the contribution of this sector to the recovery is less than has been typical of previous recoveries. These headwinds should fade over time, allowing the economy to grow somewhat more rapidly and the unemployment rate to decline toward a more normal level.

However, given that growth is projected to be not much above the rate needed to absorb new entrants to the labor force, the reduction in the unemployment rate seems likely to be frustratingly slow. Indeed, the central tendency of participants' forecasts now has the unemployment rate at 7 percent or higher at the end of 2014. The committee made comparatively small changes in June to its projections for inflation. Over the first 3 months of 2012, the price index for personal consumption expenditures rose about 3.5 percent at an annual rate, boosted by a large increase in retail energy prices that, in turn, reflected the higher costs of crude oil. However, the sharp drop in crude oil prices in the past few months has brought inflation down.

In all, the PCE price index rose at an annual rate of 1.5 percent over the first 5 months of this year, compared with a 2.5 percent rise over 2011 as a whole. The central tendency of the Committee's projections is that inflation will be 1.2 to 1.7 percent this year, and at or below the 2 percent level that the Committee judges to be consistent with its statutory mandate in 2013 and 2014. Participants at the June FOMC meeting indicated that they see a higher degree of uncertainty about their forecasts than normal, and that the risks to economic growth have increased. I would like to highlight two main sources of risk. The first is the euro-area fiscal and banking crisis, and the second is the U.S. fiscal situation. Earlier this year, financial strains in the euro-area moderated in response to a number of constructive steps by the European authorities, including the provision of 3-year bank financing by the European Central Bank. However, tensions in euro-area financial markets intensified again more recently, reflecting political uncertainties in Greece, and news of losses at Spanish banks, which in turn raised questions about Spain's fiscal position and the resilience of the euro-area banking system more broadly. Euro-area authorities have responded by announcing a number of measures, including funding for the recapitalization of Spain's troubled banks, greater flexibility in the use of the European financial backstops, and movement toward unified supervision of euro-area banks. Even with these announcements, however, Europe's financial markets and economy remain under significant stress, with spillover effects on financial and economic conditions in the rest of the world, including the United States.

Moreover, the possibility that the situation in Europe will worsen further remains a significant risk to the outlook. The Federal Reserve remains in close communication with our European counterparts. Although the politics are complex, we believe that the European authorities have both strong incentives and sufficient resources to resolve the crisis. At the same time, we have been focusing on improving the resilience of our financial system to severe shocks, including those that might emanate from Europe. The capital and liquidity positions of U.S. banking institutions have improved substantially in recent years, and we have been working with U.S. financial firms to ensure that they are taking steps to manage the risks associated with their exposures to Europe.

That said, European developments that resulted in a significant disruption in global financial markets would inevitably pose significant challenges for our financial system and for our economy. The second important risk to our recovery, as I mentioned, is the domestic fiscal situation. As is well known, U.S. fiscal policies are on an unsustainable path, and the development of a credible medium-term plan for controlling deficits should be a high priority.

At the same time, fiscal decisions should take into account the fragility of the recovery. That recovery could be endangered by the confluence of tax increases and spending reductions that will take effect early next year if no legislative action is taken. The CBO has estimated that if the full range of tax increases and spending cuts were allowed to take effect, a scenario widely referred to as the "fiscal cliff," a shallow recession, would occur early next year, and about 1¼ million fewer jobs would be created in 2013. These estimates do not incorporate the additional negative effects likely to result from public uncertainty about how these matters will be resolved.

As you recall, market volatility spiked and confidence fell last summer in part as a result of the protracted debate about the necessary increase in the debt ceiling. Similar effects could ensue as the debt ceiling and other difficult fiscal issues come into clearer view toward the end of the year. The most effective way that Congress could help to support the economy right now would be to work to address the Nation's fiscal challenges in a way that takes into account both the need for long-run sustainability and the fragility of the recovery. Doing so earlier rather than later would help reduce uncertainty and boost household and business confidence.

Finally, on monetary policy, in view of the weaker economic outlook, subdued projected path for inflation, and the significant downside risk to economic growth, the FOMC decided to ease monetary policy at its June meeting by continuing its Maturity Extension Program, or MEP, through the end of this year. The MEP combines sales of short-term Treasury securities with an equivalent amount of purchases of longer-term Treasury securities. As a result, it decreases the supply of longer-term Treasury securities available to the public, putting upward pressure on the prices of those securities and downward pressure on their yields, without affecting the overall size of the Federal Reserve's balance sheet. By removing additional longer-term Treasury securities from the market, the Fed's asset purchases also induced private investors to acquire other longer-term assets such as corporate bonds and mortgage-backed securities, helping to raise their prices and lower their yields, and thereby making broader financial conditions more accommodative.

Economic growth is also being supported by the exceptionally low level of the target range for the Federal funds rate from zero to one-fourth percent and the economy's forward guidance regarding the anticipated path of the funds rate.

As I reported in my February testimony, the FOMC extended its forward guidance in January, noting that it expects 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 for the Federal funds rate at least through late 2014. The Committee has maintained this conditional forward guidance at its subsequent meetings. Reflecting its concerns about the slow pace of progress in reducing unemployment and the downside risk to the economic outlook, the Committee made clear at its June meeting that it is prepared to take further action, as appropriate, to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability. Thank you, Mr. Chairman. I would be happy to answer your questions.

[The prepared statement of Chairman Bernanke can be found on page 54 of the appendix.]

Chairman BACHUS. Thank you, Chairman Bernanke. Next week, the House will be voting on Dr. Paul's bill to audit the Federal Reserve. Would you please give us your views on the legislation?

Mr. BERNANKE. Yes. Thank you. I absolutely agree with Dr. Paul that the Federal Reserve needs to be transparent and it needs to be accountable. I would argue that at this point, we are quite transparent and accountable. On monetary policy, besides our statement, besides our testimonies, we issue minutes after 3 weeks, we have quarterly projections, I give a press conference 4 times a year. There is quite a bit of information provided to help Congress evaluate monetary policy, as well as the public. Also, very importantly, the Federal Reserve's balance sheet, its finances, and its operations are thoroughly vetted. We produce an annual financial statement which is audited by an independent external accounting firm. We provide quarterly updates and a weekly balance sheet. We have an independent Inspector General (IG.)

We have additional scrutiny imposed by the Dodd-Frank Act. And very importantly, and this is, I think, the crux of the matter, the U.S. Government Accountability Office, the GAO, has extensive authority, broad authority to audit essentially all aspects of the Federal Reserve. And the Federal Reserve accepts that, and is cooperative with the GAO's efforts.

There is, however, one important exception to what the GAO is allowed to audit under current law, and that specifically is monetary policy deliberations and decisions. So what the audit of the Fed bill would do would be to eliminate the exemption for monetary policy deliberations and decisions from the GAO audit. So in effect, what it would do is allow Congress, for example, to ask the GAO to audit a decision taken by the Fed about interest rates.

That is very concerning because there is a lot of evidence that an independent central bank that makes decisions based strictly on economic considerations, and not based on political pressure, will deliver lower inflation and better economic results in the longer term.

So, again, I want to agree with the basic premise that the Federal Reserve should be thoroughly transparent, and thoroughly accountable. I will work with everyone here to make sure that is the case. But I do feel it is a mistake to eliminate the exemption for monetary policy and deliberations, which would effectively, at least to some extent, create a political influence or political dampening effect on the Federal Reserve's policy decisions. Thank you, Mr. Chairman.

Chairman BACHUS. Thank you. I will note that bill did not come before the Financial Services Committee, which surprised me. Throughout your tenure as Chairman, you have warned this committee and others about the dangers of the U.S. fiscal position, the annual deficit, and the growing national debt. And now, we are facing what you call correctly a fiscal cliff next January.

I mentioned in my opening statement the need for long-term restructuring of our entitlements. And as the ranking member said, I was talking about Medicaid, Medicare, and to a lesser extent, Social Security. Would you tell us why you are concerned about the fiscal cliff, what will happen to the economy if we don't do anything to address it, and what long-term strategies Congress should be thinking about as we address these issues?

Mr. BERNANKE. Certainly. Thank you. First, I think there is very little disagreement that the U.S. fiscal situation is not sustainable. Under current law, deficits will continue to grow, interest will continue to accumulate, and ultimately we will simply not be able to pay our bills. So it is very important over the long term to make decisions collectively about tax and spending policies that will bring our fiscal situation into a more sustainable configuration.

Now that, I should add, is very much a long-run proposition. Many of the issues that affect our long-term fiscal sustainability are decades rather than months or quarters in the future. And therefore, I think—I would just suggest, if I might, that in looking at these issues, we might want to go beyond the 10-year window which is usually the basis for fiscal decisions, and at least consider implications of actions for even longer horizons.

So it is very important for fiscal stability, for financial stability, for Congress to provide a credible plan for stabilizing our long-term fiscal situation as soon as possible. That is a long run proposition, however. And the way the current law is set up, we are going to have a very, very sharp contraction in the fiscal situation, increased taxes, and cuts in spending, that are very dramatic and that occur almost simultaneously on January 1, 2013.

As I discussed in my remarks, and as the CBO has documented in some detail, if that all happens, it will, no doubt, do serious damage to the recovery, and probably will cost a significant number of jobs. It is not essential to do it that way. I think the best way to address this is to attack the long-run fiscal sustainability issue seriously and credibly, but to do it in a more gradual way that doesn't have such negative effects on the recovery. And I think both of those goals can be met simultaneously, recognizing that it is not politically easy. But I believe that is the correct broad approach for addressing our fiscal situation.

Chairman BACHUS. Thank you. The ranking member is recognized for 5 minutes for questioning.

Mr. FRANK. Mr. Chairman, you say on page 6 that we should address the fiscal challenges in a way that takes into account both the need for long-range sustainability and the fragility of the recovery. There are some in the Congress who have been arguing that it is very important in the appropriations we are now voting on for the fiscal year that begins in a couple of months that we substantially reduce what we are committed to spend. Is that what you are warning us against when you talk about the fragility of the recovery? Is it the timing issue, that we should not be trying to do this in the immediate next fiscal year, but put into place a longer-term situation?

Mr. BERNANKE. I am talking about the collective impact of the tax increases and the spending cuts, which together come something close to 5 percent of GDP, which would, if it all hit at the same time, be very negative for growth. It is important to combine a more gradual approach with, of course, a longer-term plan to address sustainability.

Mr. FRANK. Let me ask you, you have been doing a great deal with your colleagues to try to provide an impetus to economic growth, at least an offset to the headwinds I think would be the way to put it. A number of people from the beginning of your efforts to do this, quantitative easing and the twist and all the other ways that you have been trying to make more money available, have warned that you were risking inflation, and some have said that this might worsen our fiscal condition because you might be losing money. You are aware of the criticisms. This many, I don't know, a couple of years into this, what is the record? Were you wrong?

Mr. BERNANKE. No, we are not wrong. I have a collection of opeds and editorials from 2008 and 2009 about immediate hyperinflation which is right around the corner, collapse of the dollar, those sorts of things. None of that has happened. None of that is going to happen. The Federal Reserve is responsibly using monetary policy to try to support the recovery.

We are very cognizant of our responsibility for price stability, and we have the tools to withdraw the policy stimulus at the appropriate time. But markets, for example as reflected in interest rates and inflation-adjusted Treasury securities, suggest that markets are quite confident that inflation will remain low.

Mr. FRANK. Thank you, Mr. Chairman. I will share with you an insight that I am sure you have already figured out for yourself. But being able to say, "I told you so" is one of the few pleasures that improves with age. And you are certainly entitled to do that with the people who were crying wolf. Part of the problem though, was it was ideologically motivated, some of this criticism. That is there are people, and we have legislation that has been introduced, they are holding it off until after the election because they don't want to, I think, be seen supporting it too popularly, but people will advance it if they can, which would cut in half your dual mandate.

You are mandated by the law under which you appear today to be equally concerned about price stability and employment. And there are some who argue that is inconsistent, and that you have, in fact, been distracted from your focus on price stability by this equal mandate on employment.

I believe, by the way, that is part of what people are trying to get at with the audit. Because as you say, we have put into the law already auditing of all your financial transactions, any activity you have with a private company will sometimes be public. I believe this is part of an effort to undermine the dual mandate indirectly. They will try do it directly if they can later. Have you found any inconsistency between the two parts of the mandate? Has the concern for employment, which I admire you for showing, interfered with your ability to bring about price stability?

Mr. BERNANKE. As you noted, inflation is low. It is in fact a little bit below our 2 percent target, so there has not been an evident inconsistency. And I think the dual mandate has served us well, and we do have the ability to address both sides. That being said, we will do of course whatever Congress tells us to do.

Mr. FRANK. But have you found any inconsistency in meeting both aspects of the dual mandate?

Mr. BERNANKE. Generally speaking, no. In particular, low inflation does contribute to healthy employment in the longer term. So, they are complementary in that respect.

Mr. FRANK. And your efforts to help the economy overcome the headwinds have not led to any inflation?

Mr. BERNANKE. No.

Mr. FRANK. Another argument we have seen is that it is regulation that is slowing things down. You talked about the headwinds. I notice you did not mention the committee meeting you are about to go to as one of those headwinds. Having talked to us about the headwinds, in your judgment the financial reform legislation that we passed, is that one of the headwinds?

Mr. BERNANKE. I wouldn't want to rule out regulatory and tax factors as part of the uncertainty. There are a lot of uncertainties in the economy.

Mr. FRANK. I don't mean in theory; I mean the one that we have adopted.

Mr. BERNANKE. It is possible that some of these regulations have some impact on the cost of credit, but there has been a lot of analysis that suggests that the benefits in terms of reducing the risk of a financial crisis are extremely large, and that whatever costs are involved are worthwhile.

Mr. FRANK. I thank you. I hope, with that analysis from our bipartisan appointee here, that some of my colleagues who preach the virtues of benefit cost analysis will not ignore its benefits as you have just mentioned them. Thank you, Mr. Chairman.

Chairman BACHUS. Thank you. Dr. Paul for 5 minutes.

Dr. PAUL. Thank you, Mr. Chairman. I had a question prepared, but I think I better follow up on the question you asked Chairman Bernanke dealing with the audit of the Fed. Because when the Fed talks about independence, what they are really talking about is secrecy, not transparency. And it is the secrecy that I don't like and that we have a right to know about.

What the GAO cannot audit, and I believe it would be the position of the Chairman, is it cannot audit monetary policy. And you expressed yourself on monetary policy. It would not be able to look at agreements and operations with foreign central banks and governments and other banks, or transactions made under the direction of the FOMC, discussions or communications between the Board and the Federal Reserve system related to all those items.

It is really not an audit without this. It is still secrecy. And why this is important is because of what happened 4 years ago. It is estimated that the amount of money that went in and out of the Fed for the bailout overseas was $15 trillion. How did we ever get into this situation where Congress has nothing to say about trillions and trillions of dollars bailing out certain banks and governments through these currency swaps?

And the Chairman has publicly announced that he is available, there is a crisis going on in Europe, part of this dollar crisis going on that has been building. It is unique to the history of the world of monetary policy. And we stand ready. Who stands ready? The American taxpayer, because we are just going to print up the money. As long as they take our dollars, we will print the money and we will bail them all out and we are going to destroy the middle class. The middle class is shrinking. The banks get richer, and the middle shrinks, they lose their houses, they lose their mortgages.

The system is biased against the middle class and the poor. So I would say that if we protect this amount of secrecy, it is not good policy and it is not good economics at all, and it is very unfair. But my question is, Mr. Chairman, whose responsibility is it under the Constitution to manage monetary policy? Which branch of government has the absolute authority to manage monetary policy?

Mr. BERNANKE. The Congress has the authority, and it has delegated it to the Federal Reserve. That is a policy decision that you have made.

Dr. PAUL. Yes, but they can't transfer authority. You can't amend the Constitution by just saying we are going to create some secret group of individuals and banks. That is amending the Constitution.

You can't do that, and all of a sudden allow this to exist in secrecy. Whose responsibility is it for oversight? Which branch of government has the right of oversight?

Mr. BERNANKE. Congress has the right of oversight. And we certainly fully accept that, and we fully accept the need for transparency and accountability. But it is a well-established fact that an independent central bank will provide better outcomes. There is no constitutional reason why Congress couldn't take over monetary policy. If you want to do that, I guess that is your right to do it. But I am advising you that it wouldn't be very good from an economic policy point of view.

Dr. PAUL. Yes, but if it is allowed to be done in secret, this is the reason why I want to work within the system. What I want to say is Congress ought to get a backbone. They ought to say we deserve to know, we have a right to know, we have an obligation to know because we have an obligation to defend our currency. It is the destruction of the currency that destroys the middle class. There is a principle in free market banking that says if you destroy the value of currency through inflation, you transfer the wealth from the middle class and it gravitates to the very wealthy. The bankers, the government, the politicians, they all love this. It is a fact that the Federal Reserve is the facilitator. You couldn't have big government—if everybody loves big government, loves the Fed, because they can finance the wars and all the welfare you want. But it doesn't work, and it eventually ends up in a crisis. It is a solvency crisis, and it can't be solved by printing a whole lot of money.

So I think the very first step is transparency, and for us to know. We have a right to know. And you may be correct in your assumption, at least I am sure you believe this, but maybe I should be talking to the Congress that we should stand up and say, yes, we demand to know. Trillions and trillions of dollars being printed out of thin air, and bailing out their friends. They stand ready to do it. The crisis is just, as far as I am concerned, my opinion is it is in the early stages. It is far from over. We are in deep doldrums, and we never change policy. We never challenge anything. We just keep doing the same thing.

Congress keeps spending the money. Welfare expands exponentially. Wars never end. And deficits don't matter. And when it comes to cutting spending, Republicans and Democrats get together and say, oh, no, we can't really cut. And if we do cut, we just cut proposed increases.

Mr. FRANK. Mr. Chairman, regular order. Regular order, Mr. Chairman.

Dr. PAUL. And you stand there and facilitate it all.

Chairman BACHUS. Thank you, Dr. Paul. Congressman Clay for 5 minutes.

Mr. FRANK. Can we get the answer in writing to that question, Mr. Chairman?

Mr. BERNANKE. May I just comment, Congressman Paul, your objections are to the structure of the system, as you mentioned. But all of the actions we took during the crisis, the swaps, all of those things are fully disclosed. It is not a question of information. It is a question of whether or not you want to give the Fed those powers. If you don't want to, of course, Congress has the right to take them back.

Mr. CLAY. Thank you.

Mr. FRANK. Will the gentleman yield me 10 seconds?

Mr. CLAY. I yield to the ranking member.

Mr. FRANK. Just to mention that, in fact, in the financial reform bill, I think unanimously, while there were some differences, we repealed Section 13(3) of the Federal Reserve Act, which was the single biggest grant of power to the Federal Reserve to lend any money it wanted if it thought there was a chance to do it. It was the AIG loan. So in fact, this Congress, in 2010, made a substantial reduction in the Federal Reserve's authority.

Mr. CLAY. Chairman Bernanke, the national unemployment rate is 8.2 percent, lower than it was a year ago. And as I said, it is important to put all Americans back to work. But I am troubled by the large disparity between the unemployment rate in the country at large and that of African Americans, which is at 8.2 percent versus 14.2 percent. I think that is a national crisis. Mr. Chairman, to what do you believe this large difference can be attributed?

Mr. BERNANKE. It is a tragedy and a problem, of course. It is a long-standing difference. I don't know how to parse the difference. Some of it is educational and other differences, some of it is discrimination. It is hard to say how much. Age and other demographic factors play a role. Unfortunately, this is not something monetary policy can do much about. We can only hope to address the overall state of the labor market and hope that a rising tide will lift all ships, so to speak. But clearly, African Americans remain disadvantaged in education, in wealth creation, and in opportunity. And those are issues that collectively I hope we can address.

Mr. CLAY. Do you think there is anything that the Federal Reserve, along with Congress, can do to address it?

Mr. BERNANKE. Again, the Federal Reserve's monetary policies are limited. We have a variety of things that bear on this indirectly, such as our Office of Minority and Women Inclusion, which tries to help ensure that in our own employment, we have full diversity. Financial literacy programs that try to help people in lower- to moderate-income communities achieve a better level of savings and wealth. But more broadly, I think to really address these questions, issues of mobility and education, skills, et cetera, are more a function of congressional and State and local efforts than the Federal Reserve.

Mr. CLAY. Thank you for your response. Can the Federal Reserve institute a monetary policy that is strong enough to avoid a double-dip recession?

Mr. BERNANKE. At this point, we don't see a double-dip recession, we see continued moderate growth. But we are very committed to ensuring, or at least doing all we can to ensure that we continue to make progress on the employment side. And we have stated that we are prepared to take action as needed to try to make sure that we see continued progress on employment.

Mr. CLAY. In another area of the economy, how will the Federal Reserve expansion of asset rates for stimulating the economy succeed when many individuals have liquid assets that may lose value?

Mr. BERNANKE. You are talking about various monetary policies of the FOMC?

Mr. CLAY. Yes.

Mr. BERNANKE. Our monetary policies actually generally increase asset values, broadly speaking. The concern has been raised, and I fully understand it and sympathize with it, that low interest rates penalize people who live off the interest earnings of their investments or their savings. And again, I fully appreciate that concern. My response, at least in part, is that if we are going to have good returns on savings and investment overall, we need a healthy economy. And if we raise interest rates prematurely and cause the economy to go into recession, that is not going to be an environment where people can make a good return on their retirement funds or their other investments.

Mr. CLAY. If the United States were to announce it was moving to a gold standard, what would you expect to happen to the price of gold? And how difficult would that make it for the country to fix the value of currency in terms of the price of gold?

Mr. BERNANKE. That is a very complex question. I think there is an issue about whether, at least at current prices, there would be enough gold to set up a global gold standard. But there are more fundamental issues with the gold standard than that which I have addressed on other occasions. And in particular, a gold standard doesn't imply stability in the prices of the goods and services that people buy every day. It implies a stability in the price of gold itself.

Mr. CLAY. Thank you for your response. I yield back.

Chairman BACHUS. Thank you. Let me advise the Republicans on the committee that Mr. Hensarling and Mr. Jones, because of the questioning lineup, go first, and then under the Greenspan rules, Mr. Manzullo and Mr. Fincher, if they are here. And then, we will resume with Mr. Royce. So at this time, I recognize Mr. Hensarling, the vice chairman.

Mr. HENSARLING. Thank you, Mr. Chairman. Good morning, Chairman Bernanke. You are clearly here before us because of your dual mandate. And speaking of maximizing employment, clearly the Fed took a number of dramatic actions in 2008, some of which I consider proper, some of which I still question. 2008 was 4 years ago. I think it is an inescapable conclusion that we have seen the greatest monetary and fiscal stimulus thrown at an economy in our history, and what do we see but 41 months of 8 percent-plus unemployment, 14.9 percent real unemployment, if we look at those who have left the labor force and those who are seeking full-time employment. We have anemic GDP growth, probably half of what it should be by historic standards. And my interpretation of your testimony is you are predicting much of the same. Why shouldn't the American people come to the inescapable conclusion that we have either had a profound failure of monetary policy or a profound failure of fiscal policy, and which is it?

Mr. BERNANKE. I don't think it is the case that there has been no progress. In the last quarter of 2008 and the first quarter of 2009, we almost had a collapse in the economy, a tremendous increase in unemployment. The unemployment rate went about 10 percent. Now, it is true that the recovery has been slower than we would have liked. But clearly, we have made progress in unemployment and in job creation.

Mr. HENSARLING. Isn't it true that if you look at the 10 post-war recessions, we are in the midst of the slowest, weakest recovery of all?

Mr. BERNANKE. There is some evidence that financial crises lead to recessions that are slower to mend. We also had a housing boom and bust, which is also a major factor. So there have been a number of reasons that are consistent with historical experience why the recovery should be slower than average.

Mr. HENSARLING. Okay, let me move on since you don't agree with the premise of that question. You at least acknowledged in the question from the gentleman from Missouri, I think you used the phrase, there are limits to what monetary policy can achieve. I would like to explore those limits for a moment.

Again, when I look at QE1, QE2, I think we are in our second Operation Twist—and, again, I think it is hard to conclude that we have—that, again, we have seen the greatest monetary stimulus in the history of the country. Obviously, you have a rather unique balance sheet today with asset-backed securities. And, yet, your new data reveals that public companies are sitting on $1.7 trillion of excess liquidity, banks have $1.5 trillion in excess reserves.

And so I am trying to figure out, what is it that—on the Federal Reserve menu, what would two more Operation Twists and two more QEs, even if you supersized them, achieved that haven't already been achieved?

Mr. BERNANKE. First, I think that the previous efforts did have productive effects. QE1, for example, was followed a few months later by the beginning the recovery in the middle of 2009. And QE2 came at a time when we were seeing increased risk of deflation, which was eliminated by the QE2—

Mr. HENSARLING. Then why is all this capital, Mr. Chairman, sitting on the sidelines? And you putting in more to excess reserves, how is that improving our economy?

Mr. BERNANKE. The excess reserves are not the issue. The issue is the state of financial conditions. And we are still able to lower interest rates, improve, broadly speaking, asset prices, and that provides some incentive.

Now, if I might—

Mr. HENSARLING. Are we not essentially in a negative real interest rate environment already?

Mr. BERNANKE. Let me just agree with you on the following, that monetary policy is not a panacea, it is not the ideal tool. Part of the problem is that we hit the zero lower bound, so we can't use the usual practice of cutting short-term interest rates. So I would like to see other parts of the government—

Mr. HENSARLING. In the very limited time I have, Mr. Chairman, I have to tell you, when I am speaking to either Fortune 50 CEOs, world-class investors, small business people in east Texas, here is what I hear: number one, uncertain Federal regulation and certainly harmful Federal regulation is crushing jobs; number two, the threatened single largest tax increase in U.S. history; number three, a Nation on the road to bankruptcy; and number four, rhetoric out of this President that vilifies success in the free enterprise system. And monetary policy is not going to solve that problem.

Chairman BACHUS. Thank you.

Mr. Capuano?

Mr. CAPUANO. Thank you, Mr. Chairman.

Chairman Bernanke, first of all, I want to thank you for your steadfast commitment to taking action as you deem appropriate. I am not any different than anybody else; I haven't agreed with everything you have done. But—and today is another day of it, where everybody gets to criticize everything you have ever done for the last 10 years. And I may take my shot here or there, but I just want to say thank you for not giving up, thank you for not withering under this. We still need you and the Fed to be actively involved, even if there are things you do with which I disagree.

There are so many things I would like to talk about, but in 5 minutes, I can't do it. So I think I am going to talk a little bit first about the Libor situation.

For me—and I am not asking for a decision. I know it is not technically some of the things you are—but one of the things I have heard from the fiscal crisis of 2008 is that so many people walked away scot-free, that the general public thinks that we, the whole government, turned our back on any potential wrongdoing.

And in this particular situation, if it turns up that our largest banks in the world repeatedly, intentionally lied in order to manipulate the market, do you think it is appropriate for them to be held accountable?

Mr. BERNANKE. Of course.

Mr. CAPUANO. Either civilly or criminally, whatever might be—and I am not asking you to make a judgment, but—

Mr. BERNANKE. Let me just—

Mr. CAPUANO. —if others make a determination that is appropriate, would you think that is an appropriate—

Mr. BERNANKE. Currently, there are any number of enforcement agencies, including the Department of Justice, the CFTC, the SEC, and foreign and State regulators looking at this, and I am sure that they will apply the law appropriately.

Mr. CAPUANO. Because I would appreciate and I think the American people would appreciate it very much if somebody who intentionally lied to manipulate a worldwide market on something that affects every one of our daily lives will be held accountable.

I want to shift a little bit to the fiscal cliff item. And, again, I am not asking you to tell us what to do. I respect the difference of opinion. But this whole fiscal cliff thing is revolving around, give or take, $450 billion, $500 billion that will be shifted around, give or take, January of next year. That is round numbers, round dates. Five hundred billion dollars—the Fed itself changed the fiscal situation in this country for over a trillion dollars in a matter of less than a year between 2000 and 2008. And to suggest that $500 billion in an economy that is $15 trillion is going to change the dynamics of the world, I think it is a little concerning to me.

But I guess I would like to ask, if it is not going to be $450 billion, $500 billion—and I am not asking you to tell me whether it should be tax cuts or spending cuts—what is a number, do you think, a general number—to me, that looks like approximately 3 percent of the economy. I think you said 5 percent. Whatever the number is, what do you think is an acceptable number either in tax cuts or tax increases or spending cuts to shift?

Because we are not going to maintain the status quo. We are going to do something. That something may, of course, be the reaction of doing nothing. But something will change. And I am just wondering, what is a number that you think will not dramatically throw us off this cliff?

Mr. BERNANKE. First, the Federal Reserve's actions are buying and selling securities, not spending and taxing. They are very different.

The CBO says that the fiscal cliff is on the order of 4 to 5 percent of GDP, and that big a shift would have a significant effect on real activity in employment. So I am in favor of an aggressive plan over a period of time. The $4 trillion number gets tossed around sometimes over the next decade; I am in favor of that.

And I can't give you a specific number for the short term, but I think there ought to be a more gradual approach. I am not saying that you shouldn't consolidate the budget; I just don't want it all to happen on 1 day, essentially.

Mr. CAPUANO. As I understand this, it may happen in 1 day, but it won't impact in 1 day, like everything else. Federal spending doesn't end that day; we have obligations that we have to continue. Sequestration cuts aren't going to happen like that. Tax increases, I don't all of a sudden give the Federal Government $3,000 more that day; it is a slow, gradual item over a year.

So I think that some of the fiscal cliff thing really needs a dose of reality. I am asking you this because, up until now, I have seen you as a person of reality and a conservative approach toward the real impact of whatever we do.

Mr. BERNANKE. The CBO estimates that it would cost 1¼ million jobs next year, and I don't think that is an unreasonable estimate.

Mr. CAPUANO. Oh, no, I understand. I have read the CBO report. I know exactly what they say. At the same time, the CBO is one source, and you are another. You are not telling me you fully embrace everything the CBO says in that report?

Mr. BERNANKE. I am just saying that order of magnitude, in terms of jobs and GDP, seems reasonable to me.

Mr. CAPUANO. I don't think everybody would like that, but there is a serious question. See, I would argue with the CBO report on other issues, but they are not here today; you are.

It is unrealistic to think that nothing is going to happen. Either we are going to do nothing, which will mean tax increases, which will mean massive spending cuts, or we will do something. We probably will not do everything; probably not kick the ball down the road and just extend all of the tax cuts and get rid of sequestration altogether. We are going to do something in the middle.

The question is, what is in the middle that is a reasonable number?

Chairman BACHUS. Thank you.

Mr. CAPUANO. I am not looking to jeopardize the economy, and—

Chairman BACHUS. Thank you, Mr. Capuano.

Mr. CAPUANO. —I guess I am just looking for some guidance.

Mr. BERNANKE. I don't have a magic number. I just think you should take a smoother approach to obtaining fiscal sustainable.

Chairman BACHUS. Thank you.

Mr. Jones?

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

And, Chairman Bernanke, thank you for being here.

I want to say, two of my worst votes in 18 years were the Iraq war—we didn't have to go to Iraq—and the repeal of Glass-Steagall. And if I was not going to yield my time, I would ask you about reinstating Glass-Steagall. I think I will write you a letter with that question, sir.

But at this time, because he is one of my dearest friends and I supported him for the Republican nomination to be President of the United States, I yield my time to Dr. Ron Paul.

Dr. PAUL. I thank the gentleman from North Carolina.

I wanted to make a very brief statement about our previous discussion about the Audit the Fed bill. That bill has nothing to do with transferring who does monetary policy. It is strictly a transparency bill. Monetary policy reform, I believe, will come, but that is another subject. This is just to know more about what the Federal Reserve is doing.

Mr. Chairman, one of your key points that you have made through your academic career as well as being at the Fed has been the need to prevent deflation. Would you agree with that?

Mr. BERNANKE. Generally, yes, sir.

Dr. PAUL. Right. And you argue that the depression was prolonged by the Federal Reserve not being able to reinflate. So, in that sense, I think you really have achieved—you have had the chance—you were put in a situation that you alone didn't create. It is, as far as I am concerned, the system created it and other managers helped create this. And there was this, what I see as a natural tendency to deflate and liquidate and clear the market. And under your philosophy, you say we can't allow this to happen, we have to prevent it. And I would say you have done a pretty good job. The monetary base has been tripled, and in the last 12 months I think M1 has grown about 16 percent, M2 over 9 percent. So it seems to be like the monetary system, the monetary numbers are still growing.

But the pricing houses—everybody knows there is a bubble. I like to believe that the free-market economists knew about it and other predicted it; others did not. But the prices soared up, everybody knows there was a bubble, and then they collapsed. When those prices of houses collapse, do you call that deflation?

Mr. BERNANKE. No. Deflation is the price of current goods and services. So, inflation doesn't capture house prices. It includes the house or the rental—

Dr. PAUL. Okay. And I think one of the problems even getting a full-fledged discussion out is sometimes the definition of words, about what "inflation" and "deflation" means. Because as far as I am concerned, deflation is when the money supply shrinks, and inflation is when the money supply expands. But just about everybody in the country, especially the financial markets, and the way I think the conventional use of inflation is the CPI. And I think it is a lousy measurement. Because if it is the money supply increase, if prices going down of houses is not deflation, I wonder why it is that inflation is measured by the CPI going up rather than the money supply going up.

Our argument is that once you distort interest rates and increase the supply of money, you end up with this gross distortion that is demanding some correction. So I would—I have worked on this for years, and we are not going to solve it today. The definitions would be much better if we—if prices of houses going down is not deflation, then CPI going up shouldn't be inflation.

But we have had trouble for 5 years. The monetary system, you say this is not the be-all and end-all. You can't solve every problem with monetary policy. We have had this for 5 years, and we are still in a mess.

Is there ever a time—let's say we go 5 more years and we have the same problems but much worse—you might say, I have to reassess my philosophy on monetary policy, or do you think it will be the same no matter what kind of crisis? Can you foresee any kind of problem that we would have that would cause you to reassess your assumptions?

Mr. BERNANKE. I can't conjecture what specifically, but of course, yes. I am evidence-based; I look and see what happens and try to draw conclusions from that. Certainly.

Dr. PAUL. The definitions, obviously, to me are very, very important. And if we don't come to this conclusion and we use these terms—inflation demands corrections, and the market wants to correct. So this is why we believe that we are going to have perpetual doldrums and finally have a big one.

Do you consider this recession that we are facing today something that is significantly different since 1945? Much worse and different in any way?

Mr. BERNANKE. Yes, because of the financial crisis, yes.

Mr. FRANK. Regular order.

Chairman BACHUS. Thank you. Thank you, Dr. Paul. That was a double dose you got. So that was pleasantly unexpected, I guess.

Mr. Miller?

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

Chairman Bernanke, Mr. Capuano has already asked you about the need for accountability if Libor was, in fact, systematically gamed. But we frequently hear, with respect to whatever the latest scandal is and certainly with respect to the conduct that led up to the financial crisis, that the conduct might have been unethical, it might be objectionable, but it probably wasn't illegal, it certainly wasn't criminal, and that the fault was with Congress in not passing tougher laws, for having passed weak laws.

And I have no stake in defending the laws passed by Congress before I got here, but I have read the transcript of the telephone conversation between an employee of the New York Fed and the Barclays trader, and I have examined the criminal fraud statutes. Several transcripts show that Barclays admitted they were filing false reports. They were not filing an honest interest rate. But one transcript sort of set out why. They said that the Financial Times had done a chart that showed that Barclays was consistently paying a higher rate. Folks thought that meant that the other banks knew something about Barclays that was not generally known. And

Barclays' stock went down, their shares went down. And he said that was why they were not filing an honest rate. They were filing a rate that would be kind of like everybody else's, so that it wouldn't call attention to them, like the attention that the Financial Times had called to them, and it wouldn't affect their shares.

The definition of fraud appears to be willful intent—providing false information with the willful intent to deceive. It can be words or acts or the suppression of material facts, again, with intent to deceive. A material fact is one that someone, a shareholder or an investor, would attach importance to in determining whether or not to sell and in determining the price at which to sell those shares.

With respect to the Barclays shares, presumably the traders and many Barclays executives held a substantial number of Barclays shares. They probably had options to buy Barclays shares. They probably were paid bonuses in Barclays shares. So it appears that Barclays was providing information they knew to be false. They were providing information that they knew would affect the share price. They provided it with the intent of affecting the share price. And they personally benefited from the effect on the share price of having provided false information.

What is missing there? What does Congress need to do? If that does not meet the definition of criminal fraud, how does Congress need to change the law?

Mr. BERNANKE. I would recommend—the Federal Reserve is not an enforcement agency. This is currently under the purview of the Department of Justice—

Mr. MILLER OF NORTH CAROLINA. Right.

Mr. BERNANKE. —and other enforcement agencies.

Mr. MILLER OF NORTH CAROLINA. But at the time of those—Mervyn King, the Governor of the Bank of England, and Secretary Geithner are now in a dispute over exactly what Secretary Geithner told him. But there doesn't seem to be any dispute that there was no referral to a U.S. Attorney for criminal prosecution.

Why was there not a referral for criminal prosecution?

Mr. BERNANKE. As I understood, what the information came across was not quite as explicit as you characterized. It was more, sort of, market chatter about—

Mr. MILLER OF NORTH CAROLINA. No. That is directly from the transcript of a conversation between a Barclays employee, a Barclays trader, and an employee of the New York Federal Reserve.

Mr. BERNANKE. The Barclays trader was based in New York and was talking about rumors and things that he had heard. He didn't have explicit information.

But the point, the real point, the relevant point and the important point is that the Federal Reserve Bank of New York did inform the appropriate authorities, and it briefed all of the financial regulators, who, in turn, undertook investigations which began about the same time, including especially the CFTC investigation.

Mr. MILLER OF NORTH CAROLINA. You said yesterday that you did not know, that no one at the Federal Reserve, the New York Fed knew the reports that Barclays was filing false information to affect the Libor rate because it affected their derivative positions, presumably interest rate swaps. There are many reports that there are many banks under investigation. Obviously, that conduct would be much more effective if it was done in concert rather than independently. But it wouldn't make sense to act in concert and it wouldn't really be effective independently if their derivatives position were all over the place.

Is there examination now into whether the derivatives positions, the interest rate swap positions of the various Libor banks, in fact, moved in concert?

Mr. BERNANKE. The CFTC is looking at that kind of issue. That is not under our jurisdiction. The investigations from other agencies are addressing those questions.

Chairman BACHUS. Thank you.

Mr. Manzullo?

Mr. MANZULLO. Thank you for coming, Chairman Bernanke.

What role does uncertainty in the marketplace have to do with our financial recovery?

Mr. BERNANKE. I think uncertainty is—as I have mentioned once or twice in this venue, my Ph.D. thesis was about the effects of uncertainty on investment decisions and suggested that it would impede decisions that would be hard to reverse later when information became available.

So I am sure uncertainty is playing some role. I think where there is some disagreement is on the relative weights of different kinds of uncertainty. No doubt, regulatory and tax uncertainty are part of the broad set of issues that are concerning investors and entrepreneurs. We hear that a lot in our anecdotes. There is also, though, general uncertainty about the recovery itself. Will the recovery be sustained or not? In order to be confident about hiring people, for example, you like to have greater confidence that, in fact, your sales will be—

Mr. MANZULLO. What you are hearing is also what I am hearing. But I am also hearing from a lot of small business people who have around 50 people that they are going to fire people to get below 50 so they are not covered by the President's health care. I could tell you story after story of small manufacturing facilities that are—they are going to fire people because they are not going to tolerate having to put up with the Affordable Health Care Act. And even one major employer back home in Rockford, Illinois, simply told his employees, "I am going to offer you no more health care. I will pay the $2,000 fine because I am well over 50."

Those businesspeople have money. Large corporations have money. And have you heard about the uncertainty out there with the businesspeople over the President's Affordable Health Care Act and the impact that that has on the recovery?

Mr. BERNANKE. We get lots of anecdotes. The Reserve Bank Presidents from around the country come to the meeting and talk about what they are hearing from their contacts, and contacts frequently cite various kinds of uncertainty, including regulatory uncertainty. As I said, though, it is hard to judge whether there is a small factor or a large factor.

Mr. MANZULLO. From what I can tell, it is a very large factor. I spend most of my time in this place working on manufacturing issues. And couple that uncertainty with the weak orders coming from the EU, which I think is our second-largest trading partner besides Canada, and the Institute for Supply Management is now below 50. It dropped, I think, a dramatic 6 points just in 1 month.

If the manufacturing sector isn't going to lead the recovery, what will?

Mr. BERNANKE. I noted in my remarks that manufacturing seems to have slowed somewhat. And part of it is the global economic situation—

Mr. MANZULLO. Demand.

Mr. BERNANKE. —demand, slowing in European and Asia. And that was part of my earlier point. There are multiple factors involved here.

One sector which is doing a little better is housing, and over time that will be a contributing factor. But it is true, as Mr. Hensarling pointed out, for example, that growth has been slow, and part of the reason is that following a financial crisis, some of the factors that normally lead to a strong recovery, like a housing recovery or extension of credit, have been affected to some extent by—

Mr. MANZULLO. What I have been seeing is that those manufacturers involved in mining, oil, and gas exploration, anything dealing with energy, they are actually expanding because they see the need for that. And banks are lending based upon that. But the massive uncertainty in the manufacturing sector, the fact that companies are unwilling to make decisions is, as you said, compounding everything.

I met with a bunch of European Union parliamentarians yesterday. They believe—of course, it is in their best interest to say so, but I really believe that they think that things are stabilizing in Europe. Your opinion of that?

Mr. BERNANKE. I don't think they are close to having a long-term solution that will solve the problem. And until they find those long-term solutions, we are going to continue to see periods of financial market volatility, I think.

Mr. MANZULLO. Okay. Thank you.

I yield back.

Chairman BACHUS. Mr. Scott, I guess. No—

Mr. SCOTT. Thank you, Mr. Chairman. I want to—

Chairman BACHUS. —Mr. Carson. I am sorry.

Mr. Carson?

Mr. CARSON. Thank you, Mr. Chairman.

Chairman Bernanke, in previous testimony before this committee, you have mentioned that one of the best ways to strengthen our labor force is to improve the quality of education, especially in disadvantaged areas suffering from persistent unemployment and underemployment.

Some encouraging news that I found in the new monetary report is that consumer debt has shrunk. It is not clear to me whether our U.S. savings rate is increasing in proportion to the decrease in consumer debt. But I am very interested in your assessment on the role of financial education, particularly for young people and especially students. The disturbing aspect to me of current consumer debt is the alarming increase of student loan debt.

Do you believe, sir, that investments in financial education can help strengthen our economy? And are there any successful models or programs that you see as being effective in this area?

Mr. BERNANKE. The Federal Reserve is very committed to financial education and economic education more generally. I mentioned yesterday that I am, later this summer, going to meet, on video, with teachers from all over the country who are doing financial education to talk about different approaches and the value of that.

It is clearly very important. The crisis showed that many people made bad financial decisions, and that hurt not only them but also hurt the broader economy. So it is extremely important. At the same time, I think on the other side of the ledger it is important that we make sure that financial information, such as credit card statements and the like are understandable, that they are not full of legalese and small print and those kinds of things. So there are really two sides to it.

So, yes, that is very important. There is still a lot of work going on about trying to figure out what works in financial education, and I would say that the record is mixed. One of the things that we have learned, I think, is that financial education should be introduced in school, in high schools and so on, but it is also important to have a lifelong opportunity. And many folks don't pay much attention to these issues until the time comes for them to buy a house or make some other big financial decision, and that is when they are most likely to listen carefully and absorb those lessons.

Mr. CARSON. Thank you, sir.

I yield back.

Chairman BACHUS. Thank you.

Mr. Fincher for 5 minutes.

Mr. FINCHER. Thank you, Mr. Chairman.

Privileges to the lowest-ranking Member, myself: I am close to the action. So thank you for coming in today.

To the chairman's opening question, Chairman Bernanke, about auditing the Fed, none of us are challenging—I am not challenging the transparency that you have given to us in seeing what is happening. But moving forward to the future, not the past, the ranking member's opening comments about playing politics, most of—I know the freshman class, we are not here to play politics. This is about trying to prevent—or hopefully build a better America than we have now. And auditing the Fed, to most of the American people, seems like something that is responsible if the political games wouldn't be played.

Can you just kind of comment? Are you that opposed to auditing the Fed?

Mr. BERNANKE. Very much so, because I think the term "audit the Fed" is deceptive. The public thinks that auditing means checking the books, looking at the financial statements, making sure that you are not doing special deals and that kind of thing. All of those things are completely open. The GAO has complete ability to address all the things we did during the crisis. All of our books are audited by an outside, private—Deloitte & Touche, a private auditor. We have an Inspector General. If there is anything that Congress wants to know about our financial operations, all they have to do is say so.

The one thing which I consider to be absolutely critical, though, about the bill is that it would eliminate the exemption for monetary policy in deliberations. And the nightmare scenario I have is one in which some future Fed Chairman would decide, say, to raise the Federal funds rates by 25 basis points, and somebody in this room would say, "I don't like that decision. I want the GAO to go in and get all the records, get all the transcripts, get all the preparatory materials, and give us an independent opinion on whether or not that was the right decision."

And I think that would have a chilling effect and would prevent the Fed from operating on the apolitical, independent basis that is so important and which experience shows is much more likely to lead to a low-inflation, healthy-currency kind of economy.

Mr. FINCHER. Is there anything that could be done, any kind of compromise, in your opinion, that needs to be done, any more than it is being done now?

Mr. BERNANKE. I think everything in the bill is basically fine except for getting rid of this exemption for monetary policy deliberations and operations. I think that is the part that is critical. And it has nothing to do with our books. That is the thing I hope to convey.

Mr. FINCHER. Okay.

The second question: Since the financial crisis of 2008, the Federal Reserve has put into play several measures to help stimulate an economic recovery, like quantitative easing, Operation Twist, et cetera. Do you see these measures as temporary solutions to stimulating the economy, or would the Federal Reserve continue these measures on a more permanent basis?

Some of us fear that we are just dumping tons of money into the economy, and that sooner or later, with the low interest rates, that things are really going to spin out of control when we do have a recovery.

Mr. BERNANKE. They are, of course, temporary.

The economy grows in the long run because of all kinds of fundamental factors: the skills of the workforce, the quality of the infrastructure, how effective the tax system is, research and development, all of those things. Monetary policy can't do much about longer-term growth.

Mr. FINCHER. Right.

Mr. BERNANKE. All we can try to do is try to smooth out periods where the economy is depressed because of lack of demand. And because of the financial crisis, the economy has been slow to reach back to its potential, and we are trying to provide additional support so the recovery can bring the economy back to its potential.

But in the medium- and long-term, monetary policy can't do anything to make the economy healthier or grow faster except to keep inflation low, which we are committed to doing. Things like education, infrastructure, R&D, Tax Code, all those things, obviously, are the private sector and Congress, not the Federal Reserve.

Mr. FINCHER. Do you fear—last question—that when the economy starts to turn and move—and it is going to move, hopefully when Washington can add certainty and stability and give confidence back to the American people that we are not going to mess things up—there is so much money out there, that this thing is going to really go and inflation is going to be a huge problem?

Mr. BERNANKE. No, it will not. We know how to reverse what we did. We know how to take the money out of the system. We know how to raise interest rates. So it will be a similar pattern to what we have seen in previous episodes where the Fed cut rates, provided support for the recovery, and then when the economy reached a point of takeoff where it could support itself on its own, then the Fed pulled back, took away the punchbowl. And we can do that and we will do that when the time comes.

Mr. FINCHER. Thank you, Chairman Bernanke.

Chairman BACHUS. Mr. Himes for 5 minutes.

Mr. HIMES. Thank you, Mr. Chairman.

And, Chairman Bernanke, thank you for being with us, and thank you for your efforts and work over the course of the last several years to stabilize our economy.

Mr. Chairman, I read very closely and listened to your testimony on the things that are holding back our recovery and read that monetary policy report here. And I want to just dwell on them for a minute or 2. I saw financial strains associated with Europe, still-tight borrowing conditions, the restraining effects of fiscal policy and fiscal uncertainty, and the housing market are the four that you highlighted.

Presuming that we are not, in the near term, going to do a lot about number one and number four, I want to explore with you still-tight borrowing conditions and whether there is anything that Congress could do to assist in that. I know you are hesitant to sort of make prescriptions to the Congress, and I understand that. But, of course, the Federal Reserve has been pretty clear in their message that monetary policy alone is not enough, so I am going to explore that a little bit with you.

In the report, you say that still-tight borrowing conditions are a result of uncertainty in the economic outlook and high unemployment. You did not mention uncertainty associated with Dodd-Frank and the rule-writing process and the new regulations. Can I assume from that omission that you, the Federal Reserve, does not believe that that regulatory uncertainty is, in fact, a material cause of still-tight borrowing conditions? And if it is material, should we be doing something about it?

Mr. BERNANKE. There are a lot of reasons for the problem. Part of it is on the demand side, that borrowers are financially impaired from the crisis and they are not as creditworthy or as attractive to lenders as they were earlier. There are other various factors, including, for example, concerns that banks have about having mortgages put back to them if they go bad, et cetera. So there is a lot of conservatism in lending right now, as well.

I don't think I would say that there was no effect of financial regulatory policy on any of this. For example, as we try to develop rules for mortgage lending, for mortgage securitization, there is still uncertainty about what the playing field will look like when the private-sector securitization market comes back or if it does come back—

Mr. HIMES. No, no, I understand, Mr. Chairman. I am sorry to interrupt, but, again, my question wasn't was there no effect; it was, was it material? I happen to think that the reforms in Dodd-Frank, many of them are terribly, terribly important, and there are obviously things that we will need to change over time.

I am really, sort of, looking for materiality. Because, frankly, you don't mention it in the report. If you were to say that, no, it is a material effect on credit availability, I might rethink my position.

Mr. BERNANKE. I think it is partly on us, the regulators, more than on Congress, in that some of these things have not been resolved one way or the other. A number of people have talked about uncertainty. If we can move to provide clarity about how the regulations will be written and so on, I think that will be helpful.

And I certainly agree that the benefit of financial reform, which is to reduce the threat of another financial crisis, is extremely important to take into consideration.

Mr. HIMES. Thank you.

The second question: In your second reason for headwinds here, "the restraining effects of fiscal policy," I wonder if you could elaborate on what you mean by "the restraining effects of fiscal policy." How is that providing a headwind to our economic recovery?

Mr. BERNANKE. Broadly speaking, fiscal policy both at the Federal and the State and local level is now contractionary—that is, pulling demand out of the system rather than putting it in. And you can see that most clearly at the State and local level, where tight budgets over the last few years have meant that at the same time that we are trying to increase employment in the country as a whole, that, of course, many people are being laid off by the State and local governments.

So I am not making a judgment about that. Obviously, they have fiscal issues they have to deal with. But it is just a fact that fiscal tightening, particularly at the State and local level, has been something of a drag on the recovery in the last few—

Mr. HIMES. Can I conclude from all that, though, that your achieving your mandate of full employment, were we to abide by the policies suggested by some in this institution for more severe austerity now, can I conclude that if we pursued that policy, it would actually not be helpful toward full employment?

Mr. BERNANKE. Again, what I have been advocating is sort of a two-part policy, one which makes strong and credible steps toward achieving sustainability over the medium term, over the next decade, while avoiding sharp cliffs and sharp contractions in the near term, yes.

Mr. HIMES. Last question, drawing on your experience as an economist: There is all sorts of debate around here about the things that we might do—extending safety net programs, unemployment insurance, tax cuts, tax cuts for middle-class families, tax cuts for the wealthy, infrastructure investment. Each of these things, each of these fiscal policies have different multiplier effects, more positive impact on the economy.

Chairman BACHUS. Okay—

Mr. HIMES. I wonder if you might just relatively rank the multiplier effects of those four initiatives that I just laid out.

Mr. BERNANKE. No, I think that would come too close to advocating the different approaches. And each of these things has not only multiplier effects but it has different costs, it has different benefits to the economy, different philosophies about the size of government and so on. So I think, unfortunately, that is a congressional prerogative to figure that out.

Chairman BACHUS. Thank you.

Mr. HIMES. Thank you, Mr. Chairman.

Chairman BACHUS. Mr. Royce for 5 minutes.

Mr. ROYCE. Thank you.

Chairman Bernanke, looking out on the horizon, on the long road ahead of us, there are two studies that seem to indicate the same thing: one recently that came out of the IMF which indicated that a 10-percentage-point fall in the debt-to-GDP ratio typically leads to output rising by 1.4 percent; and a similar conclusion coming from the other direction from Rogoff and Reinhart who say in their paper, "Growth in a Time of Debt," that debt burdens above 90 percent are associated with 1 to 2 percent lower median growth going forward.

Our entitlement obligations will consume all of the average post-war projected tax revenue in a few decades, if we just look at the studies that, frankly, you have shared with us. Will we be able to see strong sustainable economic growth without addressing our entitlement obligations, which you have labeled "unsustainable" in terms of the way they are currently set to compound?

Mr. BERNANKE. On current law, healthcare expenditures are expected to rise very substantially, to the extent that they would be crowding out other parts of the government or, alternatively, requiring significant tax increases. So if you want to avoid those outcomes, it is important to find ways to reduce expenditure. I hope that it can be done in ways that don't involve worse health care but just involve a more efficient delivery of health care.

Mr. ROYCE. Would you like to make any other observations in terms of the deficits or the size of the debt as you look 10 years out, 15 years out?

Mr. BERNANKE. Again, the CBO has done many analyses which show that our fiscal path is unsustainable, even if we avoid some kind of crisis at some point. While I don't necessarily buy exactly into the 90 percent number and so on, I think it is pretty clear that a high level of debt to GDP, both because of future tax obligations, high interest rates, is going to impede growth, all else equal.

Mr. ROYCE. And that will impact employment in the future.

Let me go to another question, regarding Basel III. I think it is a step in the right direction, but at the end of the day, capital is the ultimate buffer that stands between the taxpayer and the systemically risky institutions, right? So under Basel III, my concern is that it continues to rely on internal risk models at financial institutions when you set the capital levels, the requirements there. I don't mind those being used internally for purposes, but to use that to set the capital levels—if I may quote your former colleague, Alan Blinder, he says that, prior to the crisis, these models were gained, is the argument he is making, to avoid raising additional capital. And, of course, what that means is that they had excessive leverage.

And if you look at the Basel committee study: "Capital levels in American banks employing the internal ratings approach would experience a capital reduction of 7 to 27 percent. Those adhering to the standardized approach typically used by the smaller banks would experience a 2 percent increase in capital demands." So we have a recent study which found 83 percent of institutional investors want to get rid of model discretion.

Mr. Chairman, given the history of the gaming of these models in setting capital levels, and given that institutional investors are demanding to move away from model discretion, are you comfortable with continuing to use these models in setting capital calculations? If you just look at the minimum leverage ratio, are you comfortable with that 3 percent level of Tier 1 capital to total assets, or a 33-to-1 total leverage there?

Mr. BERNANKE. Right. So the overall system has been strengthened quite a bit with the international leverage ratio—more capital, higher-quality capital, buffers, liquidity rules, and so on. So I think it is a stronger system.

Your point is well-taken. For those models to be worthwhile, they need to be validated and they need to be good. The Federal Reserve and the other regulators don't just let you use whatever model you want; they have to be approved and validated by the regulators. And I believe that is an adequate—

Mr. ROYCE. But the argument I am making is that the only way to guarantee that doesn't happen is to focus on the old-fashioned minimum leverage ratio—

Chairman BACHUS. Thank you.

Mr. ROYCE. —which, under Basel III, is far too low.

Chairman BACHUS. Thank you, Mr. Royce.

Mr. Carney?

Mr. CARNEY. Thank you, Mr. Chairman.

Chairman Bernanke, thank you for coming in today. By the time you get to me, many of my questions that I have have already been addressed. So I would like to just go back to some of the things that were in your statement and in your report, just to confirm my understanding.

Since I get it that the Fed is doing everything it can, with respect to monetary policy, to address the employment part of your dual mandate—is that correct?

Mr. BERNANKE. We can continue to evaluate the situation, evaluate the outlook, look at the tools that we have, and we are committed to make sure that we continue to have improvement on employment. But I don't want to imply that we have done everything we can. We may do more in the future.

Mr. CARNEY. So there is more that you might do?

Mr. BERNANKE. It is certainly possible that we will take additional action if we conclude that we are not making progress toward higher levels of employment.

Mr. CARNEY. Thank you.

And there seems to be little reason for concern on the price stability side at the moment.

Mr. BERNANKE. For now, inflation seems to be well in check.

Mr. CARNEY. And you also said that progress has been made in terms of the recovery, but unemployment is still too high, and the recovery has stalled and is not as strong as maybe you had hoped at this point.

Mr. BERNANKE. The recovery has decelerated recently. It is sort of a pattern we have seen for the last few years, that things seem to be stronger in the beginning of the year and then the slowdown around spring, spring and summer. So we will try to assess whether this is just a temporary slowdown or whether something more fundamental is happening. Again, we are committed to doing what is necessary to make sure the recovery continues and employment continues to grow.

Mr. CARNEY. At one point, you said that two big risks to economic growth were the European situation and the effects of the U.S. fiscal policy, the so-called fiscal cliff. And in part of your response to that, you said that the most effective thing that Congress could do would be to address the fiscal cliff. And I think you said the sooner we did that, the better.

What do you mean by that, the sooner we did that, the better?

Mr. BERNANKE. One of the issues—and this is not explicitly accounted for in the CBO study—is that, even putting aside the effects on activity of the fiscal cliff, as time passes, as we get closer to the end of the year, we are likely to see increased uncertainty both in financial markets and among people who are making investment and hiring decisions about what programs will be in place, which ones will not, what the tax rates will be, and those kinds of things.

Mr. CARNEY. So certainty and confidence are a big part of that, right?

Mr. BERNANKE. Absolutely.

Mr. CARNEY. And I know—I am going to try not to ask you to suggest things that we should be doing, because I know you won't answer those questions. But I would like to ask you once to go back to the question that Mr. Capuano left you at, which is really a sense of what "gradual" means. Can you describe that numerically in some kind of way, as opposed to prescriptively in terms of policy?

Mr. BERNANKE. I think there is a range that—people would have different views about whether you should be more proactive or just avoid the cliff.

Mr. CARNEY. Right, right, right.

Mr. BERNANKE. There is a range of views there.

Mr. CARNEY. So when you say more proactive, in terms of maybe stimulating?

Mr. BERNANKE. Some folks would want to do more fiscal activity.

Mr. CARNEY. Right.

Mr. BERNANKE. There are different views. What I am taking here is a sort of do-no-harm kind of approach and say that you just want to avoid the impact of the cliff.

Mr. CARNEY. Have we learned anything from the European response? Have they taken through the requirements that the eurozone have imposed on some of the members' fiscal policies that probably aren't the best?

Mr. BERNANKE. I think we have learned that sharp fiscal contractions can slow economic activity. We are seeing that in a number of countries. That is not to say that they have any choice. In the case of Greece, for example, they don't have many options about cutting back on their fiscal deficits. But we have seen countries that have very sharply contracted their fiscal positions experiencing recessions at the same time.

Mr. CARNEY. I only have time for one more question. So, two of the big issues that are in our fiscal situation—and you have talked about healthcare spending, that is the biggest part on the spending side, and of course tax policy. Is certainty more important than the underlying policy or as important?

The Affordable Care Act was intended and will—projections are it will reduce costs in the long term but will create a lot of uncertainty in the short term. Similarly on tax policy. I see my time is running out. Do you have a thought on that?

Mr. BERNANKE. Whenever you can have clarity about your policy intentions—and this applies to the Federal Reserve, too—it is going to be better.

Mr. CARNEY. Thank you.

Mr. LUCAS [presiding]. The gentleman's time has expired.

The Chair now recognizes himself.

Mr. Chairman, press reports have indicated—and let's return to Libor for just a moment—that the New York Fed first learned of possible rigging of Libor in 2008. However, when the CFTC announced the enforcement action and the $200 million fine against Barclays in June, they said the interest rate rigging continued sporadically well into 2009.

Chairman Bernanke, did anyone at the New York Fed inform the Federal Reserve in Washington, D.C., of potential rigging in 2008?

Mr. BERNANKE. Let me be clear. There are two types of behaviors that the CFTC has identified. One is manipulation of the rate by derivatives traders for short-term profit. That information has only recently come to light; none of that was known in 2008–2009.

What the Federal Reserve heard about in 2008 had to do with banks that were members of the panel, the Libor panel, possibly underreporting their borrowing costs in order to avoid appearing weak in the market. This was information that was about that time becoming generally known. There were media reports in April of 2008, for example, talking about widespread chatter in the markets about that kind of behavior.

So that was understood, and it was understood that part of the problem was the structural problems with the Libor system. And so, the New York Fed took two kinds of steps. One was to inform all the relevant regulators what it had learned. But it also took steps to try to make improvements in how Libor is collected and calculated.

Mr. LUCAS. And you can understand the perspective of myself and the Agriculture Committee, since literally thousands of those derivative contracts, which fall under the jurisdiction of the committee, were settled potentially using those what now appear to be rigged rates. The impact is very relevant.

So can I take your answer to say, therefore, that someone from the Federal Reserve did, indeed, tell the CFTC about this potential issue in 2008?

Mr. BERNANKE. Absolutely. As was released in the materials on Friday, the New York Fed made presentations to the President's Working Group, which includes the CFTC, the SEC, the Fed, and the Treasury. It made separate presentations to the Treasury. And it communicated with British authorities about the issues of how to strengthen Libor and address this underreporting problem.

Mr. LUCAS. Thank you, Mr. Chairman.

And, with that, surprisingly enough, I will yield back the balance of my time and recognize the gentlelady from California, Ms. Waters, for 5 minutes.

Ms. WATERS. Thank you very much.

Thank you for being here, Chairman Bernanke. There is so much all of us would like to discuss.

As I recall, in the past year since the passage of Dodd-Frank, we can see that major U.S. banks have managed to make themselves profitable again, but really, the scandals still keep coming, and public trust in the integrity of the financial system, I think is at an end. That is why I have been advocating for the swift implementation of the Wall Street reform law, strong enforcement of existing law, and for adequate funding for our regulators.

But as I did last week at another hearing of this committee, I just want to remind us all, in just the last 2 years we have seen the robo-signing of foreclosure documents, the robo-signing of credit card judgments, billions of dollars of put-back lawsuits over mortgage-backed securities, the failure of two major Futures Commission merchants, municipal bond bid rigging, alleged energy market manipulation, money laundering now for drug cartels, the losses of the "London Whale," and the bungling of the Facebook initial public offering. And this is just a partial list.

And it is capped off by what might be the most far-reaching scandal of all, Libor manipulation. One commentator, Andrew Lo, a professor at MIT, has noted that this Libor fixing scandal dwarfs by orders of magnitude any financial scam in the history of the markets.

I guess in all of this, let me just ask, as it relates to Libor, what are you going to do about primary dealers who we find have been involved in manipulating the information in order to look better? You have that responsibility; you determine, do you not, who the primary dealers are?

Mr. BERNANKE. We determine who the primary dealers are. We don't necessarily regulate them.

This particular issue is now under heavy coverage by the CFTC, the DOJ, the SEC, and authorities from other countries as well. And I am sure that they will follow through with every company involved.

Ms. WATERS. As I understand it, the New York Fed may not regulate primary dealers, but they do set out business standards and technical requirements for primary dealers, and they can fire a primary dealer at any time. Are any going to be fired, do you know?

Mr. BERNANKE. If there are questions raised about the integrity and competence of a primary dealer, yes. It could happen, certainly.

Ms. WATERS. Okay. That is good to know.

Let me just segue into something that perhaps you had not anticipated. Out in California, we have a number of cities that are filing bankruptcy, and a lot of this has to do with the housing crisis and the problems that they have. San Bernardino is one, of course, and Stockton, and some time ago, it was Vallejo.

In San Bernardino, they had some interesting discussions about how to use eminent domain in order to keep people in their homes.

From what I can understand, they would access the properties through eminent domain, and then they would pay the fair market value. But the fair market value is different than the mortgage agreement because they are now underwater. They would keep people in their homes and, of course, try and stabilize the housing.

But what do you think about that?

Mr. BERNANKE. I think it raises legal issues that I am just not qualified to comment on. It is a very difficult set of problems that they are facing, and I am very sympathetic to their attempts to try to address it, but whether this is a good vehicle or not, I am not qualified to answer the question.

Ms. WATERS. Do you believe that these cities are taking action because they are just basically tired of waiting for us to solve the problems of the housing crisis? There is one thing that I think you were involved in with the OCC, and it had to do with the mitigation process for dealing with some of the issues of getting information out to some of the people who had been harmed and getting them compensated up to $125,000, I do believe, but only 8 percent returns?

Former Chairman Frank and I have met with the OCC, and they talked about coming up with new outreach-type programs, et cetera. Have you been in discussion with them about what you could do to do better outreach and get more people involved and responding?

Mr. BERNANKE. We have. We have been trying really hard, done a lot of advertising, Web-based, social-media-type communications. We have taken the GAO commentary and tried to incorporate that. But, most recently, I understand, we are trying to make a more community-based approach to reach out to churches and African-American groups and the like and trying to get their assistance as well, as well as home mortgage counselors. Yes, we are trying to address that.

Mrs. BIGGERT [presiding]. The gentlelady's time has expired.

I recognize myself for 5 minutes.

Chairman Bernanke, could you just talk a little bit about the differences between insurance and banking, as the Federal Reserve looks at it?

Mr. BERNANKE. Sure.

For insurance companies that either own a thrift or should one become designated as a nonbank systemically important firm, the Federal Reserve would have consolidated supervision over those insurance companies' responsibilities.

We recognize there are differences between insurance companies and banks, so a couple of differences in the way we would manage that. One would be, of course, that the insurance companies themselves, the insurance subs, will continue to be, as I understand it, will continue to be regulated by the State, State authorities, and be subject to the insurance company regulatory and capital requirements. The Federal Reserve will impose capital requirements at the holding company level to make sure that overall the company is well-capitalized. But even in doing that, we will try to take into account differences between insurance companies and other types of firms. So, for example, there are certain types of assets that insurance companies have, like not fully guaranteed accounts that some of their customers might have, and we are looking to give those different capital treatments.

So there will be a lot of similarities, admittedly, at the holding company level, but we recognize insurance companies have both a different composition of assets and a different set of liabilities. And appropriate regulation needs to take that into account.

Mrs. BIGGERT. Okay. I think that there have been other Federal regulators that have either signaled or taken action to allow State insurance regulators to continue to do their job, regulating insurance.

There is concern, I think, with the Fed plan that, how are you going to relate to the companies that maybe have only 1 percent or 2 percent of their assets as part of a thrift or a savings and loan, when 98 to 99 percent of their assets are in insurance?

Mr. BERNANKE. As I said, we will try to take into account the differences. Insurance companies have many of the same assets that banks do and, therefore, share the credit and market risks that banks have. And so, for those kinds of assets, it could be appropriate to have similar capital requirements for insurance companies and banks.

But in those cases where there are distinctive differences, then I think we need to try and accommodate that the best we can, consistent with the Collins Amendment and other rules in Dodd-Frank.

Mrs. BIGGERT. That brings up—you have the June 7th 800-page proposed capital rules that intend to regulate insurance companies as well as the banks. So do you think there will be a good distinction between those two?

And I am also concerned about the fact that it is a 90-day comment period. Do you think that will be extended for some of these companies to have to come in and really—

Mr. BERNANKE. If the comment period is insufficient to get a full response from the public, we certainly can consider extending it.

Mrs. BIGGERT. Okay. And there is a question then of, do you think that the Federal Reserve has the statutory flexibility to recognize the insurance risk-based capital and leverage requirements? There is the Collins Amendment, and then there is Dodd-Frank, which I think goes through with that. But does the Collins Amendment then prevent a difference?

Mr. BERNANKE. My understanding, and I will be happy to follow up with you on this, is that we have to meet certain requirements at the holding company level. So at the holding company level, there will be a lot of overlap between the regulation of a bank holding company and a thrift holding company. But again, my understanding is that we will not try to impose bank-style capital requirements on individual insurance subs, and that those can still be subject to the State capital requirements.

Mrs. BIGGERT. Okay. I thank you. The gentlelady from New York is recognized for 5 minutes.

Mrs. MALONEY. Thank you, and thank you for your public service. I would like to note that the Consumer Financial Protection Bureau issued its first enforcement action today, ordering a financial institution to pay a fine for what the agency described as deceptive marketing tactics related to credit card products. I wanted to publicly thank you for your leadership and this Congress' leadership on credit card reform, and note that it is good to see that consumers have an agency speaking up and fighting for their protections and financial products.

The Libor problem, really, is readily solvable if we use a different index, one that is objective, public, readily verifiable, and manipulation-resistant by any single bank. So I would like to ask you what are your favorite alternatives to Libor? And have you relayed that to Mr. King at the Bank of England? And if so, what was his response?

Mr. BERNANKE. As I discussed yesterday, I think there still are problems with the current Libor system because it doesn't always reflect an actual market transaction. And the Federal Reserve Bank of New York made some recommendations for reform which have not been fully adopted. So one strategy would be to switch to a market-based indicator. The Federal Reserve has not come out in favor of a specific one. But a number of possibilities include repo rates, the so-called OIS index, and even potentially Treasury bill rates, for example.

So there are a number of possible candidates. I have not addressed this issue to Governor King. I have talked to Mark Carney, who is the governor of the Bank of Canada, who is the head of the Financial Stability Board, which is an international body which looks at issues pertaining to regulation and financial stability. And that body is going to be looking at the Libor controversy, implications for financial stability, and possible ways to move forward. So that will be one international effort to look at alternatives.

Mrs. MALONEY. Okay. Why is the American economy doing better than Europe's? The Europeans seem to be more focused on debt, and working towards austerity, and austerity in their public policy instead of stimulating the economy. And what role do you think stimulating the economy with monetary stimulus and fiscal stimulus, what role do you think that played in the American recovery, which is better so far than the European one?

Mr. BERNANKE. Yes. The U.S. recovery is somewhat disappointing, of course, but it has been stronger than some other areas. In Europe, they are facing a number of challenges, mostly related to the structural problems associated with the common currency and with the structure of the eurozone. So a number of factors contributed to the slowdown in the economy. One of them is the fact that a number of countries, which are under a lot of pressure from markets, are severely cutting their fiscal positions. And that is contributing to the slowing economic activity. But in addition to that, their banking system is having problems, and credit has become very tight in some countries. Moreover, all of the issues related to the possible default of various countries, or the risks borne by financial institutions have led to a lot of volatility in financial markets, which has also been a negative factor. So they really are facing a lot of headwinds there, and it is quite a difficult situation.

Mrs. MALONEY. I am especially worried about the efforts of some of my colleagues on the other side of the aisle to limit the Fed's ability to use monetary stimulus. Long-term unemployment is really high, and I am worried that we don't have enough tools to combat it. And don't you believe that the long-term unemployment would be even higher if the Fed had raised the Federal funds rate and not purchased government securities?

Mr. BERNANKE. I am quite confident of that. We haven't had the recovery we would like, but certainly, monetary policy has contributed to growth and reduction of unemployment in the last 3 years.

Mrs. MALONEY. And I would like to hear your comments on positive signs that you see in the latest U.S. economic data.

Mrs. BIGGERT. The gentlelady's time has expired.

Mr. BERNANKE. I note housing is one area.

Mrs. BIGGERT. The gentleman from California, Mr. Miller, is recognized for 5 minutes.

Mr. MILLER OF CALIFORNIA. Thank you, Madam Chairwoman. Welcome back, Chairman Bernanke. It is good to have you here. In your testimony, you cited low demand and high inventory for houses throughout the country. In California, it is kind of an interesting process. We are kind of going the other way. Inventories overall in California are down to about 3.5 months, down from 4.2 months in May, which is a really good trend. In fact, in the Inland Empire, which was hit very, very hard, San Bernardino County, it is actually down to about 40 days.

It is nice to go into a real estate office and actually see lists of buyers instead of lists of homes for sale. What do you think we can do to keep this trend going? Because I don't believe the economy is going to come back until the housing market recovers.

Mr. BERNANKE. As you say, there is improvement in the market as a whole, and particularly in some areas. I am not sure that this low inventory situation will persist, because there is a pretty big backlog of houses that are in the foreclosure process that may come onto the market. And that will be an issue.

We provided a working paper earlier this year that discussed some of the issues in housing. For example, in order to keep down that inventory, one strategy is to undertake programs that convert REO, real estate owned by banks and other owners, to rental properties. And the GSEs are running a program like that, which has some promise. It is important to do what we can to avoid foreclosure, obviously, where it is possible. Or if that is not possible, to give people a way, through deed-in-lieu or short sales or other mechanisms, to get out of their home and to sell it and to avoid a lengthy process.

Access to credit remains a very significant problem. It is hard to point to specific things that can be done. But one thing I think is promising is that the GSEs, as I understand it, are considering changes in their practices that will reduce the concerns that banks have about so-called put-back risk, so that when banks make a mortgage loan and sell the mortgage to Fannie Mae or Freddie Mac, there is a substantial risk that if the mortgage goes bad, if there is any kind of problem with documentation or anything else, that they will get that mortgage back and be liable to the—

Mr. MILLER OF CALIFORNIA. I like that.

Mr. BERNANKE. There are a number of areas where we could hope to see improvement in the housing market, but unfortunately, there is no single solution. And to some extent, just economic recovery more generally is going to drive the housing market.

Mr. MILLER OF CALIFORNIA. There is a concern about what we are doing. FHFA has developed a pilot program with Freddie and Fannie to sell their REOs on a bulk sale. You saw that program, they are doing a pilot program on it.

Mr. BERNANKE. That is right.

Mr. MILLER OF CALIFORNIA. And the problem I have with that is they are doing it in the Inland Empire, which has a 40-day supply of homes. When they sent the letter out, there was a group of us in our area, 19 of us who represent that region, who wrote a letter objecting to it. And they said, well, these houses have been on the market. When we saw the data, 70 percent of the homes have never even been listed. And my concern is, why would we do that? If we bulk sell them, we are going to sell them for less than market value. If we sold them in the traditional foreclosure process, you would get more money listing with a REALTOR® and selling them out. But we are actually going to cost the taxpayers money starting a pilot program in a part of the country that has a very low amount of homes listed.

Why would we do that? It doesn't make any sense when we should—I agree there are probably some parts of the country where maybe there is a high inventory level and you need to bulk sale them out. But why would they pick the one area of the country that is starting to recover? Maybe it is because the house prices are so depressed. But you are bulk selling them out, costing taxpayers money. Why would we do that?

Mr. BERNANKE. I am not sure it is costing taxpayers money. I hope not. I think one of the reasons they would be doing that is in order to make REO to rental programs work, you want to have a large number of houses close together, foreclosed homes close together so that they can be managed by rental—

Mr. MILLER OF CALIFORNIA. But if you sell them off in bulk, you are going to sell them for less than market value, the way they are selling them off.

Mr. BERNANKE. But more quickly and with less cost.

Mr. MILLER OF CALIFORNIA. But if you have a 40-day supply of inventory, my argument is that there are probably places where 7 months is considered normal. We have a 40-day supply of inventory. And Freddie and Fannie are bulk selling those through FHFA at a reduced price, when those houses could be listed and sold.

Mr. BERNANKE. That is a good point. I hadn't heard that before. And I would urge you to talk to Ed DeMarco about that.

Mr. MILLER OF CALIFORNIA. I did. And the response from Mr. DeMarco was that, "We are afraid we would lose credibility by not selling them now that we have bid them out." And my response was, "I am concerned with losing credibility by costing the taxpayers money selling homes in a region that has no inventory and an abundance of buyers." I just think that is something somebody should talk about when you are in meetings.

Mr. BERNANKE. Okay. Thank you.

Mr. MILLER OF CALIFORNIA. Thank you, sir.

Mrs. BIGGERT. The gentleman's time has expired. The gentleman from Georgia, Mr. Scott, is recognized for 5 minutes.

Mr. SCOTT. Thank you very much, Madam Chairwoman, and welcome, Chairman Bernanke. It is good to have you here. I want to talk about what I think is the core of our issue now dealing with especially unemployment, and that is a very serious paralysis of partisanship that has basically hijacked this Congress. And I say that because I think that you all have done pretty much what you can do. You have reached in the Fed your point of what you call zero lower bound, where you can't go any further with your interest rates.

And everything that we have done here, we talked about, for example, the policies that we made, nowhere is the economy more impacted than health care. The whole issue was the rising costs of that. We passed a health care bill. And that bill has a direct impact on unemployment and employing people. For example, in there we have the Medicaid expansion, which will bring in another 18 million individuals. And most importantly, it will have an extraordinary impact on job creation, maintaining jobs, and other jobs.

Most critical, you find on basically a partisan basis, already those States that have the most to lose, that have the highest rates of uninsured and have the highest rates of unemployed are saying they are going to turn away billions of dollars in Medicaid that will go directly to their largest employers, which are the hospitals. One-third of all the hospitals in this country are facing closure, which means rising unemployment. And so there has to be—what message can you give the Nation and the Congress here on how we can get our act together and how devastating this partisanship—just we will deny the unemployed, we will deny this in these States strictly because of partisanship. How serious is this to this country?

Mr. BERNANKE. Unemployment is an enormous problem. It represents not only wasted resources; it represents hardship. And given the large number of people who have been unemployed for 6 months or more, there are a lot of people who will never really come back to the labor force, or if they do, they will have lost their skills and will not be as employable as they were before. So the costs are very, very high. The Federal Reserve is, as you say, doing our best to try to help the economy recover and put people back to work. But monetary policy isn't a panacea; it doesn't have all the tools that could be used. And so, I would urge Congress to work together as much as possible to address this. It is a very serious problem. And it is not just a temporary cyclical problem, the long-run unemployed could affect our labor force for many, many years because of their loss of skills.

Mr. SCOTT. Let me get to the other point because I know my time is shrinking, thank you very much. But let's talk about what we can do in the future. We have sequestration coming up, for example. How can we formulate our policy dealing with sequestration to shorten and lessen the impact on unemployment? Let's look at defense, for example. We have 50 percent arbitrary we are going to cut. Can we not have some indication of how devastating this is going to be in employment, particularly with many of our defense industries which have huge, huge plants, with huge numbers of employees?

And what impact will sequestration have not just in cutting our defense capabilities, but in employment? Can we not have a direction or leadership where we would be very careful as we move forward with sequestration to make sure we have less of an impact of how that will put people out of work?

Mr. BERNANKE. I cited the CBO number of 1¼ million jobs from the fiscal cliff would be lost, or fewer created than otherwise. So there is a big employment implication. On the other hand, it is very important not just to forget about the long run, we have to make sure we are addressing our long run issues of fiscal sustainability. And so, what I have been recommending is a combination of more moderate fiscal retrenchment in the shorter term to respect the fragility of the recovery, but combined with serious and credible actions, to address fiscal unsustainability in the longer term.

Mr. SCOTT. And very quickly, the other shoe that we have that will drop is the ending of the Bush tax cuts. What is your advice on which way we should go in that direction as far as having a lessening impact on unemployment?

Mr. BERNANKE. I can't advise on specific tax cuts and spending. But in looking at the package overall—

Mrs. BIGGERT. The gentleman's time has expired.

Mr. BERNANKE. —I am concerned about the contraction of the entire program.

Mrs. BIGGERT. The gentleman from New Jersey, Mr. Garrett, is recognized for 5 minutes.

Mr. GARRETT. I thank the chairwoman. So ever since 2009, we have been hearing that the Fed is sort of out of bullets. But we could also argue that you and your colleagues have been pulling the trigger quite a bit since that time, whether it is with 3 rounds of quantitative easing, with 6 years of interest rates being almost 0 percent, balance sheet still stands almost triple its normal size. It is obviously safe to say that we have been, we are, and we continue to be in uncharted territory. Now, through all this, you normally come and you defend yourself on these policy decisions by arguing the counterfactual, that is to say, that things could have been a lot worse had we not taken these actions. But before we go down that line of argument, or discussion, you have to think about where things really are.

With the recent decline in interest rates where we are in the market today, is that the result of what the Fed is doing or is that the result of the marketplace? The real return out there on a 10-year Treasury is roughly negative 5 percent, right? Is that a function of the Fed's action keeping the rates down or is that a function of the market in general? And if it is an action in response to the Fed, then the question would be, what is the appropriate rate that we should have in the market? And if the appropriate rate is where the Fed is trying to keep it and where you have said you are going to keep it for the next foreseeable future, the next couple of years, down near zero, isn't that actually discouraging investment by individuals and businesses at the same time?

If I know as a businessman or individual that the interest rates are going to be this low for this year and next year and beyond, maybe I put off those investment decisions to a later date. So some of these decisions may actually have a negative side to them. In other words, maybe there is a counterfactual to your counterfactual. Maybe there is a risk inherent in the policies that you have taken. And I will close on this: The Fed involves itself all across the economy. You fix the Fed's fund rate; you manipulate the yield curve via Operation Twist; you essentially monetize our national debt; you manipulate the mortgage market along with every other part of the credit market via quantitative easing; you attempt to manipulate the stock market and the prices there through the portfolio balance channel; you involve yourself in every aspect of the economy.

There is not a price in the marketplace that is not subsidized in one sense or another by the Fed. Yesterday at the hearing—I listened to the tape of the hearing—you said you had more bullets that you could pull. You said that there is a range of possibilities, buying Treasuries, MBS, using a discount window, employing additional communication tools, commit to holding rates below even through 2015 or beyond, cutting the rate the Fed pays on excess reserves. So these are all additional bullets that continue to push us into uncharted territory.

What I would ask is, is the Fed being as transparent in all these things in going forward on the downside of all these, on the downside of accommodation? Particularly, what I would say is the failed accommodation. How does QE3 create a single job? Yes, it props up the commodity markets; yes, that is great for those in the commodity market area. But if I am on the other side of that trade, if I am the individual like an airline that is buying these commodities, I may be laying off people. Is there enough transparency in that area to say what the downsides are in the failed portions of your policies?

Mr. BERNANKE. Some years ago, we provided research that showed, based on models and analysis, how easing financial conditions, lowering interest rates—and by the way, it is minus half a percent I think, not minus 5 percent—

Mr. GARRETT. Yes, minus .5 percent.

Mr. BERNANKE. —increases spending and investment, increases the incentive for spend and invest, and that provides extra demand and helps the economy recover. It is certainly not a panacea, it is certainly not without costs and risks which I have talked about, and I agree with that. But I think on the whole, there is evidence that it has provided some support for the recovery. It is not the only solution, but it has had a positive effect.

Mr. GARRETT. My time is limited. I would ask if you could come back to us and just indicate, have you made any mistakes in any of these areas, where you would have liked to seek other actions that you should have taken? And I will ask maybe if you could give us that in writing. But I will just close in the last 30 seconds on the situation with regard to Libor. I saw your testimony in the Senate hearing yesterday. In essence, you said you knew about it in 2008. You said the entire world and the media knew about it in 2008. You sort of point the finger over at London, and said you made some suggestions over to them what they should be doing on this. Isn't there some action both the New York Fed and you could have taken? Aren't there some recommendations that you could have made for Dodd-Frank over the last 4 years when that was coming forward? Isn't there something that you could have done as far as regulations, perhaps with regard to how banks report their information to Libor, perhaps with regard to the requirements in our banks here, perhaps setting up firewalls with regard to the offices within there that they—couldn't you have done something?

Mrs. BIGGERT. The gentleman's time has expired.

Mr. GARRETT. Can I have an answer to what he could have done?

Mr. FRANK. The rule has been that you ask a question. We have people—

Mrs. BIGGERT. The gentleman's time has expired. The gentleman from North Carolina, Mr. Watt, is recognized for 5 minutes.

Mr. WATT. Thank you, Madam Chairwoman. And let me do three things quickly. First of all, I want to apologize for not being here for your testimony, Chairman Bernanke. Unfortunately, I had a hearing on intellectual property in the subcommittee on which I am the ranking member, in the Judiciary Committee. So, I couldn't be here.

Second, I want to follow up on Congresswoman Waters' encouragement to be more aggressive in the outreach on these real estate settlements. There is money there. It seems to me that there is a built-in disincentive for the lenders to go and find the people because they get to keep the money if they don't find the people. So somebody needs to be more aggressively reaching out, even to the point of sending people door to door to find these folks who would be eligible to get the relief. So I want to encourage that. And we will do more encouragement offline on that.

Third, I want to pick up on Mr. Garrett's point and take the counter position. I want to express my thanks to you for shooting all of these bullets. Because if I hear what Mr. Garrett is saying, he would prefer that the Fed be as dysfunctional as Congress has been, and that nothing be done, and that the economy just be allowed to collapse, which I think would have been the result had not the Fed taken some significant actions. And I think you point that out on the bottom of page 5 and the top of page 6 of your abbreviated testimony when you say the important risk to our recovery is the domestic fiscal situation.

As is well known, U.S. fiscal policies are on an unsustainable path. Development of a credible medium-term plan for controlling deficits should be a high priority. And you paint, unfortunately, kind of a doomsday scenario if Congress does not act because—and you lay out the significant dilemma that we are in, because we need to be spending short term to stimulate the economy, keeping tax rates low short term to stimulate the economy, yet we need to be more fiscally responsible.

You can't both spend and keep taxes low without increasing deficits. That is unsustainable. And I guess I am expressing my belief that Congress doesn't seem to be up to that task. Lay out that scenario. I don't want to get you in the politics of this, but talk to us a little bit more about the delicate balance short term about what we ought to be doing versus long term about what we ought to be doing. And maybe at least edify the public about how difficult these choices are going to be, both short and long term.

Mr. BERNANKE. Certainly. They are very difficult choices. If Congress only allows the fiscal cliff to happen and doesn't do anything else, it is actually kind of counterproductive because higher taxes mean that people won't have income to spend. Less spending by the government means layoffs in the defense industries, for example.

So it will slow the economy and actually mean that tax revenues will be less than expected. And the benefits in terms of deficit reduction will be smaller than really was anticipated. And we will see a slower economy and less job creation.

At the same time, if you simply push everything off without any additional comment, then there is the risk that people will become concerned that Congress has no intention ever of addressing the deficit. And you could see, for example, concerns in the bond market about that.

So it is a difficult balancing act, but it is a recommendation that has been made not just by the Fed and the CBO, but the IMF and pretty much every sort of nonpartisan fiscal authority, which is to mitigate, moderate the extent of the fiscal cliff in the short term, avoid destabilizing the weak recovery, but at the same time, work together to establish a framework and a plan, and a credible plan that will, over time, over the 10-year window, and even beyond that, will bring our fiscal situation into balance.

Mrs. BIGGERT. The gentleman's time has expired. The gentleman from Texas, Mr. Neugebauer, is recognized for 5 minutes.

Mr. NEUGEBAUER. Thank you, Madam Chairwoman. And Chairman Bernanke, I want to thank you. Your office was very responsive the other day when we sent you a letter in reference to the Libor issue. I think we will be sending you an additional letter today or tomorrow. One of the things that is kind of interesting to me, 16 banks, I think, report in the Libor dollar index, it would be difficult for just one bank to influence that index, wouldn't it?

Mr. BERNANKE. Generally, yes.

Mr. NEUGEBAUER. So it had to be more than one bank underreporting or not accurately reporting their borrowing. Would you say that is correct?

Mr. BERNANKE. The reason the banks, some of them apparently underreported during the crisis, was not to affect the overall Libor rate necessarily, but rather, because these numbers are reported publicly, they wanted to avoid giving the impression that they were weak and others were strong.

Mr. NEUGEBAUER. But if one bank is reporting differently than the other ones, obviously it wouldn't influence the overall index?

Mr. BERNANKE. If they were in the top four or the bottom four, they would be cut out.

Mr. NEUGEBAUER. That is right. So when the Fed first learned about this, you had some correspondence with the Bank of England, but three domestic banks were involved. Did anybody say, I wonder if anybody else is doing this? Or was all of your focus just on Barclays?

Mr. BERNANKE. Our focus wasn't on a specific bank. Barclays is, after all, a British bank, and not supervised by the Federal Reserve. Our focus was on the general phenomenon. And the New York Fed did two basic things: to inform the relevant regulators here and in the U.K. about this problem so that they could look at it; and to try to address the structural problems in Libor, which were, as you were indicating, incentivizing banks to lowball their rate information. So it was approached as an overall problem.

Mr. NEUGEBAUER. Are you familiar with the term "price fixing?"

Mr. BERNANKE. Of course.

Mr. NEUGEBAUER. So price fixing, if a bunch of us are in the carpet business and we all get together and we decide that we are going to sell carpet at this price, then that is price fixing, right?

Mr. BERNANKE. Yes.

Mr. NEUGEBAUER. So if money is a commodity and pricing of money is a function of that, wasn't this almost price fixing on Libor?

Mr. BERNANKE. It may be. But as you pointed out, there are two issues. One is did the individual reporting, misreporting affect the overall Libor? And it may or may not have. And I think that needs to be investigated. The other is that, in some cases, there were no transactions taking place. So during the crisis, there were mostly just overnight transactions, and yet the banks were asked to report what they would have to pay for money a year out. And so a question is whether or not they were, in fact, misreporting or whether they were simply shading their estimate in some way. So I think there is a question—I think the details need to come out. And we don't have enough details yet to know whether this was deliberate price fixing or whether there was another interpretation.

Mr. NEUGEBAUER. I think the thing that is kind of alarming to some of us is the fact that given how widely used that index is throughout our economy, from just about every area of the financial community, that I felt like the New York Fed's response was a fairly lukewarm response to if, in fact, somebody was manipulating this rate, that could have huge implications. Now, it depends obviously whether you would have benefited from that or if you were penalized from that, whether you were on the buy side or the sell side. But can you explain why you thought—why the Fed thought that wasn't a big deal?

Mr. BERNANKE. I am sure that the Fed thought it was a big deal. The information was widely known. It was reported in the press. And the British Bankers' Association is not subject in any way to U.S. policy. So it was hard to directly affect the calculation of Libor. But surely, it is a very big deal. It affects lots of different financial contracts. And as I mentioned in my comments yesterday, I think that one of the bad effects of all this is that it is going to further erode confidence in financial markets and in financial instruments.

Mr. NEUGEBAUER. Thank you, Chairman Bernanke.

Mr. BERNANKE. Thank you.

Mrs. BIGGERT. The gentleman yields back. The gentleman from Texas, Mr. Green, is recognized for 5 minutes.

Mr. GREEN. Thank you, Madam Chairwoman. And thank you, Chairman Bernanke, for being here today. I would like to yield most of my time to you, because I have something that I would like for you to respond to. I find that we have some very credible people who make some incredible statements. And one of the statements that causes a good deal of consternation is that we are now doing worse than we were in 2009, that the economy is in worse shape today than it was in 2009.

Now, I can give my opinion on it, but I don't think that it will have the impact that a person of your stature, your standing would have. And I am begging that you, if you would, juxtapose the auto industry with the auto industry today with 2009, financial services, lending in general. Just please, if you would, so that we can bring some clarity to what I believe is an incredible statement. Kindly do so.

Mr. BERNANKE. Nobody is satisfied with where we are today, of course. But there certainly has been significant improvement since mid-2009, when the recovery began. We have had economic growth now for about 3 years. The unemployment rate has fallen from about 10 percent to about 8 percent. Obviously, not as far as we would like, but still in the right direction. Banks are much stronger and have much more capital than they did a couple of years ago. Manufacturing is much stronger, has improved considerably, particularly in autos, as you mentioned. We have seen important steps in the energy area in terms of U.S. production and conservation. The housing market, which was completely dead in 2009, is still not where we would like it to be, but is moving in the right direction.

So clearly, there has been improvement. I recognize that many Americans will still feel that the situation is not satisfactory, but it is going in the right direction.

Mr. GREEN. Would you say that it is not worse than it was in 2009, Chairman Bernanke?

Mr. BERNANKE. Clearly not.

Mr. GREEN. It is not currently?

Mr. BERNANKE. Not by all the criteria I just mentioned.

Mr. GREEN. Yes, sir. And I just want to restate a couple of things. We were about to lose the auto industry. We now have the auto industry, and it is coming back. We were about to lose a good portion of the financial services industry. Larger banks were about to go under. They are now stabilizing. AIG was about to go under. We lost Lehman. And it now is better than it was, obviously not what it was prior to the decline. And it just amazes me that credible people will make such incredible statements. And that adds fuel to this flame of confusion that is engulfing us.

People want to have someone with credibility to speak truth about the conditions. And it is just amazing that this line of logic seems to have some degree of credibility in certain circles. Now, if you would respond, just for the record, is the auto industry in better shape now than it was in 2009?

Mr. BERNANKE. It is producing more cars and is more profitable, yes.

Mr. GREEN. Is the banking industry in better shape now than it was in 2009?

Mr. BERNANKE. Yes, it is more profitable, has more capital, and is making more loans.

Mr. GREEN. Is the economy in the main in better shape now than it was in 2009?

Mr. BERNANKE. Again, it is not where we would like it to be, but many parts of the economy have improved, yes.

Mr. GREEN. All right. Now, my next line of questions will have to do with something that we refer to as structural versus cyclical. You can't solve structural problems if you use cyclical solutions, generally speaking. And it is difficult to ascertain what amount of what we are dealing with is structural as opposed to cyclical. Do you have some sense of how much of what we are trying to, for want of a better term fix, what we are trying to fix is structural as opposed to cyclical?

Mr. BERNANKE. That is widely debated, and it is hard to know for certain. But I guess my view, and the view of many economists, is that a good bit of our unemployment problem, for example, remains cyclical, which means it can be addressed in principle by monetary and fiscal policies. But structural problems are probably increasing, and in particular, the very long-term unemployed, the problem is, the risk is they will over time become unemployable, and that they will contribute therefore to a structural issue.

Mr. GREEN. Thank you. I yield back.

Chairman BACHUS. Mr. McHenry for 5 minutes.

Mr. MCHENRY. Thank you, Mr. Chairman. Chairman Bernanke, thank you so much for being here today, and thank you for your service to our government and our people. I certainly appreciate that. Now, with quantitative easing, do you think there is a limit to how much quantitative easing that can be used? And do you think we are approaching that limit right now?

Mr. BERNANKE. There is certainly a theoretical limit, which is the fact that the Federal Reserve can only buy Treasuries and agencies, and moreover, quantitative easing typically involves buying longer-term Treasuries and agencies, as opposed to bills, for example. So there are finite amounts of that available. And moreover, beyond a certain point, if the Federal Reserve owned too much, it would greatly hurt market functioning, which would have the effect of reducing the efficacy of the policy. So I wouldn't say that we are at that point yet, but ultimately, there would be some limit to how much you could do, yes.

Mr. MCHENRY. So there is some limit?

Mr. BERNANKE. Yes.

Mr. MCHENRY. But we are nowhere close to approaching it is what you are saying?

Mr. BERNANKE. I don't have a number for you. But we still have some capacity at this point, yes.

Mr. MCHENRY. Okay. Now, there is a separate question. You said that you have a target inflation number, sort of ideal. And what is that?

Mr. BERNANKE. Two percent.

Mr. MCHENRY. Okay. Now, would the Fed be comfortable with an inflation rate a little higher than that? Maybe 3 percent?

Mr. BERNANKE. I don't know what you mean by "comfortable." If for whatever reason, for example, in the last few years, we have seen oil price shocks which have driven inflation up to 3 percent or higher, that is not a good situation. And it is our objective in that case to try to move inflation gradually down back to 2 percent. So if you are asking would we target 3 percent, would we seek to get 3 percent, the answer is no.

Mr. MCHENRY. Are you more comfortable with 3 percent or 1 percent? A little higher or a little lower? What are you more comfortable—

Mr. BERNANKE. I think both of those are concerns. Both are concerns because 3 percent, of course, means that we are moving towards a more inflationary situation, but 1 percent is closer to the deflation range, which is also not healthy for the economy.

Mr. MCHENRY. Okay. The reason why I am trying to get at this is because there has been a lot of discussion that with a little higher inflation rate, a belief—now, I don't subscribe to this—but a little higher inflation rate that it, de facto, reduces debt burdens and perhaps could spur spending and the perception, more of the perception of less debt and actually the impact of it. And that might spur the economy. It is more consumer spending. Do you think that is desirable or not desirable?

Mr. BERNANKE. I recognize that some people would advocate that we set an inflation target, say at 4 percent, and maintain that for a number of years. I don't think, first, that we could do that without losing control of the inflation process. Second, I am very skeptical that it would increase confidence among businesses and households and increase economic activity. I think it would create a lot of problems in financial markets as well. So I don't think that is a strategy that has a lot of support on the Federal Open Market Committee.

Mr. MCHENRY. So a lower inflation rate, the target inflation rate of around 2 percent, the Fed would have more control than perhaps a higher inflation rate?

Mr. BERNANKE. Because we have maintained inflation near 2 percent for a long time, and there is a lot of confidence in the financial markets that the Fed will keep inflation close to 2 percent.

Mr. MCHENRY. Okay. So it is confidence, but also Fed capacity?

Mr. BERNANKE. The issue is that we currently have very well-anchored inflation expectations. People are strongly accustomed to 2 percent inflation. If we were to say 4 percent, first would be the issue of getting there. Could we get there? And could we get there with some accuracy? But beyond that, people would say, if they said 4 percent, why not 6 percent, why not 8 percent? So in the short run at least, it is not at all clear that people would be confident that this new target of 4 percent would, in fact, be stable and sustainable. Instead, they would wonder where inflation is going to be in the medium term.

Mr. MCHENRY. So right now, in order to—with the Fed contemplating more easing, and then you also have the question of liquidity in the marketplace, making sure that Fed policy enables more liquidity in the marketplace, we also see Europe running counter to that, right? The woes of Europe are making the markets less liquid. Does the Volcker Rule—do you have a concern about the timing of the Volcker Rule that would rein in liquidity?

Mr. BERNANKE. We are paying close attention to issues related to market liquidity and market making, which are exempt activities under the Volcker Rule. In any case, the Volcker Rule doesn't come into effect for a couple more years. So I would say that is not a first order issue right now.

Mr. MCHENRY. Thank you.

Chairman BACHUS. I am now going to recognize Mr. Perlmutter. And let me say this, we have a hard stop at 12:45. So if you want all the time, you can have it. Mr. Pearce would like a minute, if you can work that out.

Mr. PERLMUTTER. I will be quick. Chairman Bernanke, thank you for being here, thank you for maintaining a steady hand through all of this, whether it was kind of the collapse on Wall

Street or some of the clashes that we have here in Congress ideologically that don't give the economy some of the fiscal tools that I think would also help continue to improve our economic situation.

And so I want to ask a couple of specific questions and then see where we are. Can we talk a little bit about Basel III for a second, because it came up in a conversation yesterday with a medium-sized bank that we have back in Colorado. In Dodd-Frank, we established some lower limits as to a lot of the regulations that go in place. And I think either it was a $10 or $15 billion-sized institution, and if you were above it, you had many more things that you had to do, whether it is dealing with derivatives or the like. And as I understand it now, these Basel III regulations, that could potentially become worldwide-type regulations, are going down to a half a billion dollars, $500 million. And it would take into consideration lots of smaller banks. And they are fearful that this will really dry up their capital and make it very difficult for them to continue to operate. Can you comment on that?

Mr. BERNANKE. Yes. Certain parts of Basel III are being proposed to go down to smaller banks, some of the risk weights, for example, some of the basic capital definitions. And the idea here is to try to make sure that small banks as well as large banks are well-capitalized. But I think it is important to note two things. First, many of the aspects of Basel III do not apply to small banks. They simply are—first of all, things like derivatives books and things of that sort just aren't relevant to small banks. And there are other rules such as the international leverage ratio which applies only to the largest internationally active banks.

Mr. PERLMUTTER. But I want to impress on you, if I could, I would like you to take this away, say you are a smaller Colorado bank, you are generally going to have loans on shoppettes and real estate and some home loans and some small business loans. And in my opinion, it wasn't the smaller banks that led us into the deep recession that we suffered in 2008 and 2009. And I would just ask you, as Chairman of our central bank, to make sure that we don't penalize—we were pretty tough in some of the Dodd-Frank regulations that we passed to make sure that the banking system had some restraints, didn't just run amok, that there was capital, and there were certain things that had to be watched closely. But I would ask you, sir, to just keep an eye on that, if you would. My last question, and then I will turn it over to Mr. Pearce, is can you describe for us what has happened with the liquidation of the assets that were in Maiden Lane one, two, and three?

Mr. BERNANKE. They basically have been sold off, and the Federal Reserve and the government and the taxpayer received all their money back with interest and additional profits beyond that. So it has all been sold back into the marketplace.

Mr. PERLMUTTER. So we pretty much liquidated it all or do we hold any of it?

Mr. BERNANKE. We have a little bit left, but we have paid off the loans. So we are, from now on, whatever we sell is pure profit.

Mr. PERLMUTTER. All right. Thank you. Mr. Chairman, I will yield back.

Chairman BACHUS. Thank you. And Mr. Pearce for 1 minute.

Mr. PEARCE. I thank the gentleman for his consideration. Mr. Chairman, thank you for your service. I am looking at page 4, where you talk about the great risks to us financially. And I assume that is because of their size and because of the underfunding of them. But when I look at that size, I consider the pension systems. And just yesterday, the California pension system said that they only got a 1 percent rate of return. Their projection, in order to be solvent, is up in the 7¾. Maybe just in that one system, the $500 billion shortfall now just on the teachers. And then that is the smaller of the two. Nationwide, maybe a $3 trillion shortfall. I didn't see that, but I do see Spain talked about, and yet Spain is only $1 trillion exposure. Could you kind of tell us what the risk is associated with the unfunded pensions?

Mr. BERNANKE. Low interest rates do put some stress on pension funds and life insurance companies for the reasons that you described. I think our goal, basically, is to get the economy strong enough that returns will rise and that things will normalize over time. Obviously, pension funds can't be underfunded forever. But if the economy strengthens and returns go back to a more normal level, then these underfunding problems will not disappear, of course, but they will be mitigated.

Mr. PEARCE. Thank you, Mr. Chairman. I yield back.

Chairman BACHUS. Thank you. Chairman Bernanke, the committee appreciates your testimony today. And you are dismissed.

I am going to ask the audience to remain in your seats until Chairman Bernanke and his staff exit.

Mr. Schweikert is recognized for a unanimous consent request.

Mr. SCHWEIKERT. Mr. Chairman, I request unanimous consent to place a letter into the record. It is just some concerns and wanting some additional visibility on the PCCRAs, the premium capture reserve accounts, and where we are going on that policywise.

Chairman BACHUS. Without objection, it is so ordered.

The Chair notes that some Members may have additional questions for Chairman Bernanke, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to Chairman Bernanke and to place his responses in the record.

This hearing is adjourned.

[Whereupon, at 12:49 p.m., the hearing was adjourned.]

A P P E N D I X

July 18, 2012

United States House of Representatives
Committee on Financial Services
Hearing on Monetary Policy and the State of the Economy
July 18, 2012

Congressman Ron Paul
Statement for the Record

Mr. Chairman, I thank you for calling this hearing today on monetary policy and the state of the economy. For the past few years the Federal Reserve has received criticism from all sides of the political spectrum, and rightly so, for its unprecedented intervention into the economy and its bailouts of large Wall Street banks and foreign central banks. Yet this criticism risks losing sight of the most insidious result of the Fed's actions, which is to enable the growth of government.

For nearly the first 40 years of its existence, the Fed operated as an adjunct of the Treasury Department, tasked with purchasing government debt in order to keep the government's borrowing costs low. Even after gaining its vaunted "independence" from Treasury in 1951, the Fed never shrank from enabling the growth of government. The extraordinary monetary policy of the last four years has reaffirmed that the Fed, its protestations to the contrary notwithstanding, is only too willing to enable growing government spending and massive fiscal deficits.

For centuries, banks have received special privileges from government in exchange for funding the government's wars. The creation of the Federal Reserve System in 1913 formalized and centralized this arrangement in the United States. From the very beginning, the Fed was intended to provide a more liquid market for federal government debt, enabling the growth of big government.

What we've seen over the last century is nothing less than the remaking of American government, thanks in large part to the Fed. Its loose monetary policy gave rise to: (i) the welfare state, encouraging dependency on government largesse and destroying the work ethic and family life of lower-income Americans; (ii) the warfare state, allowing the U.S. government to involve itself in wars of aggression around the world; and (iii) the regulatory state, the mammoth bureaucracy that relentlessly grinds away at the rights of the American people.

Little more than a decade ago, Fed economists were wringing their hands over the prospect that the federal government might pay off the national debt. Nothing could be worse for the Fed, because the Fed's monetary policy operations require the existence of government debt. Treasury debt is purchased from or sold to banks on the open market in order to influence interest rates. Without government debt, the Fed would have no idea how to conduct monetary policy. From a free market perspective this would be wonderful, as it is Fed monetary policy which largely creates the booms and busts of the business cycle. Unfortunately, the federal government has run up the national debt to unprecedented levels over the past decade, and the Federal Reserve has been right there, monetizing that debt to ensure that none of it goes unsold.

While the desire of foreign countries and private investors to purchase Treasuries was drying up, the Federal Reserve was only too willing to step in and enable the government to continue its deficit spending. The Fed's balance sheet exploded as it purchased over one trillion dollars in Treasury debt over the past few years. And before it did that, the Fed also purchased over a trillion dollars of overrated mortgage-backed securities from Wall Street banks, giving those banks the cash they needed to purchase Treasury debt of their own. Were it not for the Federal Reserve's actions, the federal government would not have been able to run trillion-dollar deficits for the past several years.

In fact, had the Federal Reserve never been created, the federal government never would have been able to run up a $16 trillion debt. No market actor would lend money to such a major debtor at such low interest rates. The only reason that banks are willing to buy Treasury debt at such low interest rates is because they can easily resell that debt to the Fed.

Without the Fed, interest rates would rise to such levels that the federal government would have no choice but to curtail its expenditures and focus only on doing what is truly necessary. With market discipline allowed to prevail, the size of the federal government would be drastically smaller. If Congress were really serious about limiting the size of government, it would eliminate the most important enabler of government profligacy by ending the Fed.

For release on delivery
10:00 a.m. EDT
July 18, 2012

Statement by

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

July 18, 2012

Chairman Bachus, Ranking Member Frank, and other members of the Committee, I am pleased to present the Federal Reserve's semiannual *Monetary Policy Report to the Congress*. I will begin with a discussion of current economic conditions and the outlook before turning to monetary policy.

The Economic Outlook

The U.S. economy has continued to recover, but economic activity appears to have decelerated somewhat during the first half of this year. After rising at an annual rate of 2-1/2 percent in the second half of 2011, real gross domestic product (GDP) increased at a 2 percent pace in the first quarter of 2012, and available indicators point to a still-smaller gain in the second quarter.

Conditions in the labor market improved during the latter part of 2011 and early this year, with the unemployment rate falling about a percentage point over that period. However, after running at nearly 200,000 per month during the fourth and first quarters, the average increase in payroll employment shrank to 75,000 per month during the second quarter. Issues related to seasonal adjustment and the unusually warm weather this past winter can account for a part, but only a part, of this loss of momentum in job creation. At the same time, the jobless rate has recently leveled out at just over 8 percent.

Household spending has continued to advance, but recent data indicate a somewhat slower rate of growth in the second quarter. Although declines in energy prices are now providing some support to consumers' purchasing power, households remain concerned about their employment and income prospects and their overall level of confidence remains relatively low.

We have seen modest signs of improvement in housing. In part because of historically low mortgage rates, both new and existing home sales have been gradually trending upward since last summer, and some measures of house prices have turned up in recent months. Construction has increased, especially in the multifamily sector. Still, a number of factors continue to impede progress in the housing market. On the demand side, many would-be buyers are deterred by worries about their own finances or about the economy more generally. Other prospective homebuyers cannot obtain mortgages due to tight lending standards, impaired creditworthiness, or because their current mortgages are underwater--that is, they owe more than their homes are worth. On the supply side, the large number of vacant homes, boosted by the ongoing inflow of foreclosed properties, continues to divert demand from new construction.

After posting strong gains over the second half of 2011 and into the first quarter of 2012, manufacturing production has slowed in recent months. Similarly, the rise in real business spending on equipment and software appears to have decelerated from the double-digit pace seen over the second half of 2011 to a more moderate rate of growth over the first part of this year. Forward-looking indicators of investment demand--such as surveys of business conditions and capital spending plans--suggest further weakness ahead. In part, slowing growth in production and capital investment appears to reflect economic stresses in Europe, which, together with some cooling in the economies of other trading partners, is restraining the demand for U.S. exports.

At the time of the June meeting of the Federal Open Market Committee (FOMC), my colleagues and I projected that, under the assumption of appropriate monetary policy, economic growth will likely continue at a moderate pace over coming quarters and then pick up very gradually. Specifically, our projections for growth in real GDP prepared for the meeting had a central tendency of 1.9 to 2.4 percent for this year and 2.2 to 2.8 percent for 2013.[1] These forecasts are lower than those we made in January, reflecting the generally disappointing tone of the recent incoming data.[2] In addition, financial strains associated with the crisis in Europe have increased since earlier in the year, which--as I already noted--are weighing on both global and domestic economic activity. The recovery in the United States continues to be held back by a number of other headwinds, including still-tight borrowing conditions for some businesses and households, and--as I will discuss in more detail shortly--the restraining effects of fiscal policy and fiscal uncertainty. Moreover, although the housing market has shown improvement, the contribution of this sector to the recovery is less than has been typical of previous recoveries. These headwinds should fade over time, allowing the economy to grow somewhat more rapidly and the unemployment rate to decline toward a more normal level. However, given that growth is projected to be not much above the rate needed to absorb new entrants to the labor force, the reduction in the unemployment rate seems likely to be frustratingly slow. Indeed, the central tendency of participants' forecasts now has the unemployment rate at 7 percent or higher at the end of 2014.

The Committee made comparatively small changes in June to its projections for inflation. Over the first three months of 2012, the price index for personal consumption expenditures (PCE) rose about 3-1/2 percent at an annual rate, boosted by a large increase in retail energy prices that in turn reflected the higher cost of crude oil. However, the sharp drop in crude oil

[1] See table 1, "Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, June 2012," of the Summary of Economic Projections, available at the Board of Governors of the Federal Reserve System (2012), "Federal Reserve Board and Federal Open Market Committee Release Economic Projections from the June 19-20 FOMC Meeting," press release, June 20, www.federalreserve.gov/newsevents/press/monetary/20120620b.htm; table 1 is also available in Part 4 of the July *Monetary Policy Report to the Congress*.

[2] Ben S. Bernanke (2012), "Semiannual *Monetary Policy Report to the Congress*," statement before the Committee on Financial Services, U.S. House of Representatives, February 29, www.federalreserve.gov/newsevents/testimony/bernanke20120229a.htm.

prices in the past few months has brought inflation down. In all, the PCE price index rose at an annual rate of 1-1/2 percent over the first five months of this year, compared with a 2-1/2 percent rise over 2011 as a whole. The central tendency of the Committee's projections is that inflation will be 1.2 to 1.7 percent this year, and at or below the 2 percent level that the Committee judges to be consistent with its statutory mandate in 2013 and 2014.

Risks to the Outlook

Participants at the June FOMC meeting indicated that they see a higher degree of uncertainty about their forecasts than normal and that the risks to economic growth have increased. I would like to highlight two main sources of risk: The first is the euro-area fiscal and banking crisis; the second is the U.S. fiscal situation.

Earlier this year, financial strains in the euro area moderated in response to a number of constructive steps by the European authorities, including the provision of three-year bank financing by the European Central Bank. However, tensions in euro-area financial markets intensified again more recently, reflecting political uncertainties in Greece and news of losses at Spanish banks, which in turn raised questions about Spain's fiscal position and the resilience of the euro-area banking system more broadly. Euro-area authorities have responded by announcing a number of measures, including funding for the recapitalization of Spain's troubled banks, greater flexibility in the use of the European financial backstops (including, potentially, the flexibility to recapitalize banks directly rather than through loans to sovereigns), and movement toward unified supervision of euro-area banks. Even with these announcements, however, Europe's financial markets and economy remain under significant stress, with spillover effects on financial and economic conditions in the rest of the world, including the United States.

Moreover, the possibility that the situation in Europe will worsen further remains a significant risk to the outlook.

The Federal Reserve remains in close communication with our European counterparts. Although the politics are complex, we believe that the European authorities have both strong incentives and sufficient resources to resolve the crisis. At the same time, we have been focusing on improving the resilience of our financial system to severe shocks, including those that might emanate from Europe. The capital and liquidity positions of U.S. banking institutions have improved substantially in recent years, and we have been working with U.S. financial firms to ensure they are taking steps to manage the risks associated with their exposures to Europe. That said, European developments that resulted in a significant disruption in global financial markets would inevitably pose significant challenges for our financial system and our economy.

The second important risk to our recovery, as I mentioned, is the domestic fiscal situation. As is well known, U.S. fiscal policies are on an unsustainable path, and the development of a credible medium-term plan for controlling deficits should be a high priority. At the same time, fiscal decisions should take into account the fragility of the recovery. That recovery could be endangered by the confluence of tax increases and spending reductions that will take effect early next year if no legislative action is taken. The Congressional Budget Office has estimated that, if the full range of tax increases and spending cuts were allowed to take effect--a scenario widely referred to as the fiscal cliff--a shallow recession would occur early next year and about 1-1/4 million fewer jobs would be created in 2013.[3] These estimates do not

[3] Congressional Budget Office (2012), *Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013* (Washington: CBO, May), available at www.cbo.gov/publication/43262. The effect of the fiscal cliff on real GDP is shown in table 2 (p. 6). The effect of the fiscal cliff on employment, relative to a less restrictive *alternative fiscal scenario* that assumes that most expiring tax provisions are extended and that the spending sequestration does not take effect, is shown in table 3 (p.7).

incorporate the additional negative effects likely to result from public uncertainty about how these matters will be resolved. As you recall, market volatility spiked and confidence fell last summer, in part as a result of the protracted debate about the necessary increase in the debt ceiling. Similar effects could ensue as the debt ceiling and other difficult fiscal issues come into clearer view toward the end of this year.

The most effective way that the Congress could help to support the economy right now would be to work to address the nation's fiscal challenges in a way that takes into account both the need for long-run sustainability and the fragility of the recovery. Doing so earlier rather than later would help reduce uncertainty and boost household and business confidence.

Monetary Policy

In view of the weaker economic outlook, subdued projected path for inflation, and significant downside risks to economic growth, the FOMC decided to ease monetary policy at its June meeting by continuing its maturity extension program (or MEP) through the end of this year. The MEP combines sales of short-term Treasury securities with an equivalent amount of purchases of longer-term Treasury securities. As a result, it decreases the supply of longer-term Treasury securities available to the public, putting upward pressure on the prices of those securities and downward pressure on their yields, without affecting the overall size of the Federal Reserve's balance sheet. By removing additional longer-term Treasury securities from the market, the Fed's asset purchases also induce private investors to acquire other longer-term assets, such as corporate bonds and mortgage backed-securities, helping to raise their prices and lower their yields and thereby making broader financial conditions more accommodative.

Economic growth is also being supported by the exceptionally low level of the target range for the federal funds rate of 0 to 1/4 percent and the Committee's forward guidance regarding the anticipated path of the funds rate. As I reported in my February testimony, the FOMC extended its forward guidance at its January meeting, noting that it expects 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 for the federal funds rate at least through late 2014. The Committee has maintained this conditional forward guidance at its subsequent meetings. Reflecting its concerns about the slow pace of progress in reducing unemployment and the downside risks to the economic outlook, the Committee made clear at its June meeting that it is prepared to take further action as appropriate to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability.

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

Congress of the United States
Washington, DC 20515

July 18, 2012

Chairman Spencer Bachus
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Bachus:

I submit the enclosed letter and respectfully request its inclusion in the record for the July 18, 2012 Financial Services Committee hearing entitled, "Monetary Policy and the State of the Economy."

An area of the Dodd-Frank Act that has been subject to major rulemaking by regulatory agencies has been section 941, Risk Retention. Included in the risk retention proposed rule is the Premium Capture Cash Reserve Account (PCCRA), which places securitization profits in a first-loss position of a securitization. As proposed, the PCCRA would eliminate the financial incentive for issuing structured securities, including both private-label residential and all commercial mortgage-backed securities.

The PCCRA was not part of the Dodd-Frank Act or even contemplated by Congress and was created entirely by the regulators. In separate letters, both House and Senate members have strongly expressed to regulators that the PCCRA was not part of Congressional intent for the Dodd-Frank Act and have urged them to remove it from the final rule.

The enclosed is the Senate letter that speaks to this issue, dated June 19, 2012, signed by a bipartisan coalition of twelve Senators. I submit the enclosed for inclusion in the record for today's hearing, "Monetary Policy and the State of the Economy."

Respectfully Yours,

David Schweikert

United States Senate
WASHINGTON, D.C. 20510

June 19, 2012

The Honorable Shaun Donovan
Secretary
Department of HUD
451 7th Street, SW
Washington, DC 20551

The Honorable Ben Bernanke
Chairman
The Federal Reserve System
20th Street and Constitution Ave, NW
Washington, DC 20429

The Honorable Mary Schapiro
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

The Honorable Marty Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

The Honorable Tom Curry
Comptroller
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Mr. Edward DeMarco
Acting Director
Federal Housing Finance Agency
400 7th Street, SW
Washington, DC 20024

Dear Secretary Donovan, Chairmen Bernanke, Schapiro, Acting Chairman Gruenberg, Comptroller Curry, and Acting Director DeMarco:

We are writing to you with concerns regarding the risk retention proposal issued by your agencies pursuant to Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203). Rather than promoting the flow of credit in the commercial real estate and residential mortgage sector, the proposed rule goes in the wrong direction and takes away the flexibility Congress intended by applying a rigid approach and adding extraneous features, such as the Premium Capture Cash Reserve Account and an excessively rigid down-payment requirement in the Qualified Residential Mortgage exclusion.

On March 31, 2011, the joint risk retention rule proposal was released for comment. Since then, the six federal financial services regulators have received 13,000 letters in response to the proposal.

Congress specifically rejected a one-size fits all risk retention rule for well-underwritten qualified residential mortgages ("QRM") and commercial-mortgage backed securities ("CMBS"). Section 941 recognized that QRM and CMBS, were unique, treated them uniquely under the law, and required that they be distinguished under the proposed rules. The merits of this approach was reinforced by the Federal Reserve's October 2010 study, which recommended "crafting credit risk retention requirements that are tailored to each major class of securitized assets" and "to ensure that the regulations promote the purposes of the Act without unnecessarily reducing the supply of credit."

In the area of CMBS and residential mortgage-backed securities ("RMBS") we are concerned that regulators included a requirement for the establishment of Premium Capture Cash Reserve Accounts ("PCCRAs") in the proposed rule that would negatively impact capital formation. The PCCRA, which was not envisioned by Congress, would require securitizers to set aside the premium from the sale of securities in separate account for the life of the security. This account would occupy the first loss position and would be in addition to the 5% risk retention requirement. The end result would be that securitizers could not recognize compensation until the security matures many years later and would be forced to bear all downside risk associated with interest rate exposure while waiting years to recognize any potential profit from that risk. The alternatives to creating the PCCRA are not appealing to those investors the rules are designed to protect and would require a significant restructuring of CMBS and RMBS deals.

This approach fundamentally alters the existing securitization model, conflicting with the Financial Stability Oversight Council's own report on the objectives for risk retention which noted in objective one to, "align incentives without changing the basic structure and objectives of securitization transactions." We believe that the PCCRA goes well beyond Congressional intent and we urge you to reconsider its inclusion in the risk retention proposal.

We have also expressed concerns about the rigid QRM definition in the past. The QRM exclusion to risk retention is key to attracting private capital to the mortgage securitization market and restoring confidence to consumers, lenders and investors. The down-payment restriction of the proposed regulation goes beyond the intent and language of the statute and would increase consumer costs and reduce access to affordable credit.

Despite Congressional direction on these issues, the proposed rule uses a homogenized approach that takes away the asset-specific flexibility provided by Congress. We are concerned this will cut off or greatly reduce a vital source of capital across all asset classes. Congress crafted a statute that was designed to provide the appropriate balance between strong standards that align the interests of lenders, issuers and investors with the ability of the securitization process to work. The proposed rule does not accomplish this goal. We urge you to modify the proposed risk retention rule to follow Congressional intent by eliminating the PCCRA and the unnecessarily tight down payment restrictions on QRM.

Sincerely,

Mike Crapo   Kay R. Hagan

Jerry Moran

Herb Kohl

For use at 10:00 a.m., EDT
July 17, 2012

Monetary Policy Report to the Congress

July 17, 2012

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

Submitted pursuant to section 2B of the Federal Reserve Act

July 17, 2012

Board of Governors of the Federal Reserve System

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

Washington, D.C., July 17, 2012

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES

The Board of Governors is pleased to submit its *Monetary Policy Report to the Congress* pursuant to section 2B of the Federal Reserve Act.

Sincerely,

Ben Bernanke, Chairman

Contents

Part 1
Overview:
Monetary Policy and the Economic Outlook

The pace of economic recovery appears to have slowed during the first half of this year, with real gross domestic product (GDP) likely having risen at only a modest pace. In the labor market, the rate of job gains has diminished recently, and, following a period of improvement, the unemployment rate has been little changed at an elevated level since January. Meanwhile, consumer price inflation over the first five months of 2012 was lower, on net, than in 2011, and longer-term inflation expectations have remained stable. A number of factors will likely restrain economic growth in the period ahead, including weak economic growth abroad and a fiscal environment that looks set to become less accommodative. Uncertainty about these factors may also restrain household and business spending. In addition, credit conditions are likely to improve only gradually, as are still-elevated inventories of vacant and foreclosed homes. Moreover, the possibility of a further material deterioration of conditions in Europe, or of a particularly severe change in U.S. fiscal conditions, poses significant downside risks to the outlook.

Against this backdrop, the Federal Open Market Committee (FOMC) took steps to provide additional monetary policy accommodation during the first half of 2012. In particular, the Committee changed its forward guidance regarding the period over which it anticipates the federal funds rate to remain at exceptionally low levels and announced a continuation of its maturity extension program (MEP) through the end of the year. These policies put downward pressure on longer-term interest rates and made broad financial conditions more accommodative than they would otherwise be, thereby supporting the economic recovery.

The European fiscal and banking crisis has remained a major source of strain on global financial markets. Early in the year, financial stresses within the euro area moderated somewhat in light of a number of policy actions: The European Central Bank (ECB) provided ample liquidity to the region's banks, euro-area leaders agreed to increase the lending capacity of their rescue facilities, and a new assistance package for Greece was approved following a restructuring of Greek sovereign debt. However, tensions within the euro area increased again in the spring as political uncertainties rekindled fears of a disorderly Greek exit from the euro area and mounting losses at Spanish banks renewed questions about the sustainability of Spain's sovereign debt and the resiliency of the euro-area banking system. As yields on the government debt of Spain and other vulnerable European countries rose toward new highs, euro-area leaders responded with additional policy measures in late June, including increasing the flexibility of the region's financial backstops and making progress toward greater cooperation in the supervision and, as necessary, recapitalization of Europe's banks. Many critical details, however, remain to be worked out against a backdrop of continued economic weakness and political strain.

Financial markets were somewhat volatile over the first half of 2012 mostly due to fluctuating views regarding the crisis in the euro area and the likely pace of economic growth at home and abroad. As investors' concerns about the situation in Europe eased early in the year and with data releases generally coming in to the upside of market expectations, broad equity price indexes rose and risk spreads in several markets narrowed. Subsequently, however, market participants pulled back from riskier assets amid renewed concerns about the euro area and evidence of slowing global economic growth. Reflecting these developments but also owing to the lengthening of the forward rate guidance, continuation of the MEP, and increased expectations by market participants of additional balance sheet actions by the Federal Reserve, yields on longer-term Treasury securities and corporate debt as well as rates on residential mortgages declined, on net, and reached historically low levels at times during the first half of the year. On balance since the beginning of the year, broad equity prices rose as corporate earnings remained fairly resilient through the first quarter.

After rising at an annual rate of 2½ percent in the second half of 2011, real GDP increased at a 2 percent pace in the first quarter of 2012, and available indicators point to a still smaller gain in the second quarter. Private spending continues to be weighed down by a range of factors, including uncertainty about developments in Europe and the path for U.S. fiscal policy, concerns about the strength and sustainability of the recovery, the still-anemic state of the housing market, and the difficulties that many would-be borrowers continue to have in obtaining credit. Such considerations have made some businesses more cautious about increasing investment or materially expanding their payrolls and have led households to remain quite pessimistic about their income and employment prospects. Smoothing through the effects of unseasonably warm weather this past winter, activity in the housing sector appears to have been a little stronger so far this year. However, the level of housing activity remains low and continues to be held down by tight mortgage credit. Meanwhile, the drag on real GDP growth from government purchases is likely to persist, as budgets for state and local governments remain strained and federal fiscal policy is likely to become more restrictive in 2013.

In the labor market, gains in private payroll employment averaged 225,000 jobs per month in the first quarter, up from 165,000 jobs per month in the second half of last year, but fell back in the second quarter to just 90,000 jobs per month. Although the slowing in the pace of net job creation may have been exaggerated by issues related to swings in the weather and to seasonal adjustment difficulties associated with the timing of the sharpest job losses during the recession, those factors do not appear to fully account for the slowdown. The unemployment rate declined from about 9 percent last summer to a still-elevated 8¼ percent in January, and it has remained close to that level since then. Likewise, long-term joblessness has shown little net improvement this year, with the share of those unemployed persons who have been jobless for six months or longer remaining around 40 percent. Further meaningful reductions in unemployment are likely to require some pickup in the pace of economic activity.

Consumer price inflation moved down, on net, during the first half of the year. The price index for overall personal consumption expenditures (PCE) rose rapidly in the first three months of the year, reflecting large increases in oil prices, but inflation turned down in the spring when oil prices more than reversed their earlier run-ups. In all, the PCE price index increased at an annual rate of about 1½ percent over the first five months of the year, compared with a rise of 2½ percent during 2011. Excluding food and energy, consumer prices rose at about a 2 percent rate over the first five months of the year, close to the pace recorded over 2011. In addition to the net decline in crude oil prices over the first half of the year, factors contributing to low consumer price inflation this year include the deceleration of non-oil import prices in the latter part of 2011, subdued labor costs associated with the weak labor market, and stable inflation expectations.

In the household sector, credit conditions have generally remained tight for all but highly rated borrowers; among other factors, this tightness reflects the uncertain economic outlook and the high unemployment rate. Total mortgage debt decreased further as the pace of mortgage applications to purchase a new home was sluggish. Refinancing activity increased over the course of the second quarter but remained below levels reached in previous refinancing booms despite historically low mortgage interest rates. The increase in refinancing was partially attributable to recent enhancements made to the Home Affordable Refinance Program that appeared to boost refinancing activity somewhat for borrowers with underwater mortgages—that is, for those who owed more on their mortgages than their homes were worth. Consumer credit expanded moderately mainly because of growth in federal student loans.

Firms in the nonfinancial corporate sector continued to raise funds at a generally moderate pace in the first half of the year. Those with access to capital markets took advantage of low interest rates to refinance existing debt. As a result, corporate debt issuance was solid over the first part of the year, although issuance of speculative-grade corporate bonds weakened notably in June as investors pulled back from riskier assets. Commercial and industrial loans on the books of banks expanded briskly, but borrowing conditions for small businesses have improved more slowly than have those for larger firms. Financing conditions for commercial real estate stayed relatively restrictive, and fundamentals in that sector showed few signs of improvement.

Market sentiment toward major global banks fluctuated in the first half of 2012. In March, the release of the results from the Comprehensive Capital Analysis and Review, which investors interpreted as indicating continued improvements in the health of domestic banks, provided a significant boost to the equity prices of U.S. financial institutions. Those gains partially reversed when market sentiment worsened in May, driven in large part by concerns about Europe and potential spillovers to the United States and its financial institutions. On balance, however, equity prices of banks rose significantly from relatively low levels at the start of the year. An index of credit default swap spreads for the large bank holding companies declined about 60 basis points, but those spreads remained at a high level. Despite the swings in market sentiment about global banking organizations, conditions in unsecured short-term dollar funding markets were fairly stable in the first half of 2012. European financial institutions have reduced their demand for dollar funding over recent quarters, and general funding pressures apparently were alleviated by the ECB's longer-term refinancing operations.

With the Committee anticipating only slow progress in bringing unemployment down toward levels that it judges to be consistent with its dual mandate and strains in global financial markets continuing to pose significant downside risks to the economic outlook, the FOMC took additional steps to augment the already highly accommodative stance for monetary policy during the first half of 2012. In January, the Committee modified its forward rate guidance, noting that economic conditions were likely to warrant exceptionally low levels for the federal funds rate at least through late 2014. And in June, the FOMC decided to continue the MEP until the end of the year rather than completing the program at the end of June as previously scheduled.

The June Summary of Economic Projections is presented in Part 4 of this report. At the time of the Committee's June meeting, FOMC participants (the 7 members of the Board of Governors and the presidents of the 12 Federal Reserve Banks) saw the economy expanding at a moderate pace over coming quarters and then picking up gradually under the assumption of appropriate monetary policy. Most participants marked down their projections for economic growth in 2012 and 2013 relative to what they anticipated in January and April largely as a result of the adverse developments in Europe and the associated effects on financial markets. Moreover, headwinds from the fiscal and financial situation in Europe, from the still-depressed housing market, and from tight credit for some borrowers were cited as likely to hold back the pace of economic expansion over the forecast period.

FOMC participants also projected slower progress in reducing unemployment than they had anticipated in January and April. Committee participants' projections for the unemployment rate had a central tendency of 8.0 to 8.2 percent in the fourth quarter of this year and then declined to 7.0 to 7.7 percent at the end of 2014; those levels are still generally well above participants' estimates of the longer-run normal rate of unemployment. Meanwhile, participants' projections for inflation had a central tendency of 1.2 to 1.7 percent for 2012 and 1.5 to 2.0 percent for both 2013 and 2014; these projections are lower, particularly in 2012, than participants reported in January and April, in part reflecting the effects of the recent drop in crude oil prices.

With the unemployment rate expected to remain elevated over the projection period and inflation generally expected to be at or under the Committee's 2 percent objective, most participants expected that, under their individual assessments of appropriate monetary policy, the federal funds rate would remain extraordinarily low for some time. In particular, 11 of the 19 participants placed the target federal funds rate at 0.75 percent or lower at the end of 2014; only 4 of them saw the appropriate rate at 2 percent or higher. All participants reported levels for the appropriate target federal funds rate at the end of 2014 that were well below their estimates of the level expected to prevail in the longer run. In addition to projecting only slow progress in bringing down unemployment, most participants saw the risks to the outlook as weighted mainly toward slower growth and higher unemployment. In particular, participants noted that strains in global financial markets, the prospect of reduced fiscal accommodation in the United States, and a general slowdown in global economic growth posed significant risks to the recovery and to a further improvement in labor market conditions.

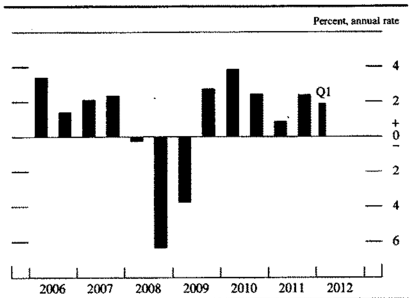
Part 2
Recent Economic and Financial Developments

Economic activity appears to have expanded at a somewhat slower pace over the first half of 2012 than in the second half of 2011. After rising at an annual rate of 2½ percent in the second half of 2011, real gross domestic product (GDP) increased at a 2 percent pace in the first quarter of 2012, and available indicators point to a still smaller gain in the second quarter (figure 1). An important factor influencing economic and financial developments this year is the unfolding fiscal and banking crisis in Europe. Indeed, the economic outlook for the second half of 2012 depends crucially on the extent to which current and potential disruptions in Europe directly reduce U.S. net exports and indirectly curtail private domestic spending through adverse spillover effects on U.S. financial markets and institutions and on household and business confidence. At the same time, the economy continues to face other headwinds, including restricted access to some types of household and small business credit, a still sizable inventory of vacant homes, and less-accommodative fiscal policy.

The labor market remains weak. Private payroll employment stepped up early in the year but then slowed in the second quarter (though those moves may have been exaggerated by issues related to swings in the weather and to seasonal adjustment), and the unemployment rate hovered around 8¼ percent after a significant decrease over the latter months of 2011 and in January. Meanwhile, consumer price inflation, in part buffeted by sharp swings in the price of gasoline, stepped up early in the year but subsequently turned down, and longer-term inflation expectations remained stable (figure 2).

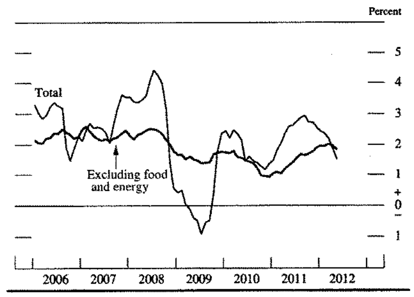
Financial markets were somewhat volatile over the first half of 2012 mostly due to fluctuating views regarding the crisis in the euro area and the likely pace of economic growth at home and abroad. Yields on longer-term Treasury securities have declined significantly, reflecting greater monetary policy accommodation, the weaker outlook, and safe-haven flows. Broad indexes of U.S. equity prices rose, on net, risk spreads on corporate bonds were generally unchanged or slightly lower, and unsecured short-term dollar funding markets were fairly stable. Debt issuance by U.S. corporations was solid, and bank lending to larger firms was brisk. In the household sector, consumer credit expanded and mortgage refinancing activity increased modestly, reflecting the decline in mortgage rates to historically low levels as well as recent changes to the Home Affordable Refinance Program (HARP).

1. Change in real gross domestic product, 2006–12



Note: Here and in subsequent figures, except as noted, change for a given period is measured to its final quarter from the final quarter of the preceding period.
Source: Department of Commerce, Bureau of Economic Analysis.

2. Change in the chain-type price index for personal consumption expenditures, 2006–12



Note: The data are monthly and extend through May 2012; changes are from one year earlier.
Source: Department of Commerce, Bureau of Economic Analysis.

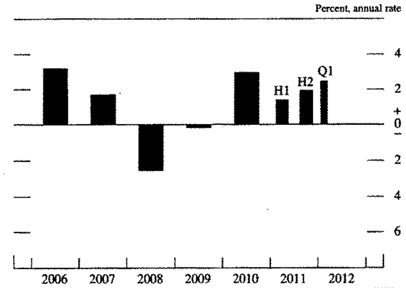
Domestic Developments

The Household Sector

Consumer Spending and Household Finance

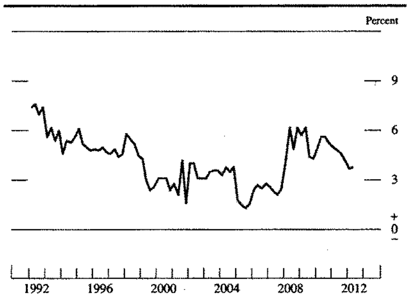
After rising at an annual rate of about 2 percent in the second half of 2011, real personal consumption expenditures (PCE) increased 2½ percent in the first quarter, but available information suggests that real PCE decelerated some in the second quarter (figure 3). The first-quarter increase in spending occurred across a broad array of goods and services with the notable exception of outlays for energy services, which were held down by reduced demand for heating because of the unseasonably warm winter. Spending on energy services appears to have rebounded in the second quarter as the temperate winter gave way to a relatively more typical spring. In contrast, the pace of motor vehicle sales edged down in the second quarter, and reports on retail sales suggest that consumer outlays on a wide range of items rose less rapidly than they did in the first quarter. The moderate rise in consumer spending over the first half of the year occurred against the backdrop of the considerable economic challenges still facing many households, including high unemployment, sluggish gains in employment, tepid growth in income, still-stressed balanced sheets, tight access to some types of credit, and lingering pessimism about job and income prospects. With increases in spending outpacing growth in income so far this year, the personal saving rate continued to decline, on net, though it remained well above levels that prevailed before the recession (figure 4).

3. Change in real personal consumption expenditures, 2006–12



NOTE: The data are quarterly and extend through 2012:Q1.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

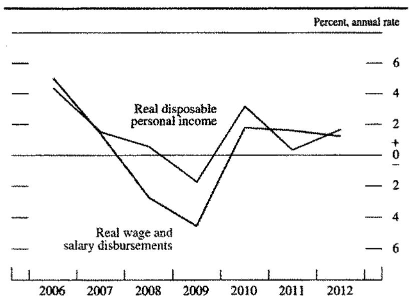
4. Personal saving rate, 1992–2012



NOTE: The data are quarterly and extend through 2012:Q2; the reading for 2012:Q2 is the average for April and May.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Aggregate real disposable personal income (DPI)—personal income less personal taxes, adjusted for changes in prices—rose more rapidly over the first five months of the year than it did in 2011, in part because of declining energy prices (figure 5). The wage and salary component of real DPI, which reflects both the number of hours worked and average hourly wages adjusted for inflation, rose at an annual rate of nearly 1¼ percent through May of this year after having increased at a similar pace in 2011. The increase in real wage and salary income so far in 2012 is largely attributable to the modest improvement in employment and

5. Change in real disposable personal income and in real wage and salary disbursements, 2006–12



NOTE: Through 2011, change is from December to December; for 2012, change is from December to May. The real wage and salary disbursements series is nominal wage and salary disbursements deflated by the personal consumption expenditures deflator.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

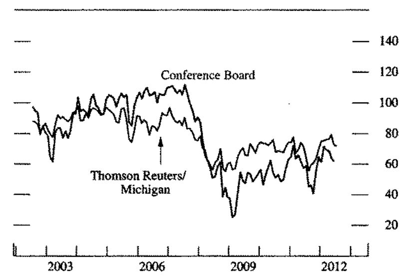
hours worked; real average hourly earnings are little changed thus far this year.

The ratio of household net worth to income, in the aggregate, moved up slightly further in the first quarter, reflecting increases in both house prices and equity prices (figure 6). Taking a longer view, this ratio has been on a slow upward trend since 2009, and while it remains far below levels seen in the years leading up to the recession, it is about equal to its average over the past 20 years. Household-level data through 2010 indicate that wealth losses were proportionately larger for the middle portion of the wealth distribution—not a surprising result, given the relative importance of housing among the assets of those households. Meanwhile, indicators of consumer sentiment are above their lows from last summer but have yet to return to pre-recession levels (figure 7).

Household debt—the sum of mortgage and consumer debt—edged down again in the first quarter of 2012 as the continued contraction in mortgage debt was almost offset by solid expansion in consumer credit. With the reduction in household debt, low level of most interest rates, and modest growth of income, the debt-service ratio—the aggregate required principal and interest payments on existing household debt relative to income—decreased further, and, at the end of the first quarter, it stood at a level last seen in 1994 (figure 8).

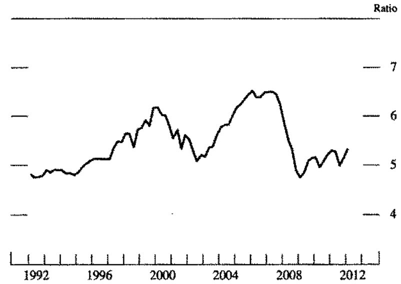
Consumer credit expanded at an annual rate of about 6¼ percent in the first five months of 2012, driven by an increase in nonrevolving credit. This component accounts for about two-thirds of total consumer credit and primarily consists of auto and student loans. The rise in nonrevolving credit so far this year was primarily due to the strength in student loans, which were almost entirely originated and funded by the federal government. Meanwhile, auto loans maintained a steady pace of increase. Revolving consumer credit (primarily credit card lending) remained much more subdued in the first five months of the year in part because nonprime borrowers continued to face tight underwriting standards. Overall, the increase in consumer credit is consistent with recent responses to the Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) indicating that demand

7. Consumer sentiment indexes, 2002–12



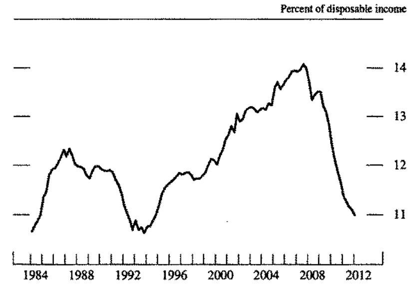
NOTE: The Conference Board data are monthly and extend through June 2012; the series is indexed to equal 100 in 1985. The Thomson Reuters/University of Michigan data are monthly and extend through a preliminary estimate for July 2012; the series is indexed to equal 100 in 1966.
SOURCE: The Conference Board and Thomson Reuters/University of Michigan Surveys of Consumers.

6. Wealth-to-income ratio, 1992–2012



NOTE: The data are quarterly and extend through 2012:Q1. The wealth-to-income ratio is the ratio of household net worth to disposable personal income.
SOURCE: For net worth, Federal Reserve Board, flow of funds data; for income, Department of Commerce, Bureau of Economic Analysis.

8. Household debt service, 1984–2012



NOTE: The data are quarterly and extend through 2012:Q1. Debt service payments consist of estimated required payments on outstanding mortgage and consumer debt.
SOURCE: Federal Reserve Board, "Household Debt Service and Financial Obligations Ratios," statistical release.

had strengthened and standards had eased, on net, for all consumer loan categories.[1]

Interest rates on consumer loans generally edged down in the first half of 2012, and spreads on these loans relative to Treasury securities of comparable maturity held fairly steady. In particular, interest rates on new auto loans continued to be quite low. However, the spread of rates on credit card loans relative to the two-year Treasury yield has remained wide since the end of 2008 in part because of pricing adjustments made in response to provisions included in the Credit Card Accountability Responsibility and Disclosure Act of 2009.[2]

Aggregate indicators of consumer credit quality improved further in the first quarter of 2012. The delinquency rate on credit card loans registered its lowest level since the series began in 1991. The recent improvement importantly reflects an ongoing compositional shift in total credit card balances toward borrowers with higher credit scores, due in part to tighter lending standards. Charge-offs on credit card loans also declined, reaching levels last seen at the end of 2007. Delinquencies and charge-offs on nonrevolving consumer loans at commercial banks also edged lower, to levels slightly below their historical averages. In addition, the delinquency rate on auto loans at finance companies decreased slightly to a level that is near the middle of its historical range.

Issuance of consumer asset-backed securities (ABS) in the first half of 2012 exceeded issuance for the same period in 2011 but was still below pre-crisis levels (figure 9). Issuances of securities backed by auto loans dominated the market for most of the first half, while student loan ABS issuance was about the same as in the past two years. In contrast, issuance of credit card ABS remained weak for most of the first half of 2012 as growth of credit card loans continued to be somewhat subdued and most major banks have chosen to fund such loans on their balance sheets. Yields on ABS and their spreads over comparable-maturity swap rates were little changed, on net, over the first half of 2012 and held steady in the low ranges that have prevailed since early 2010.

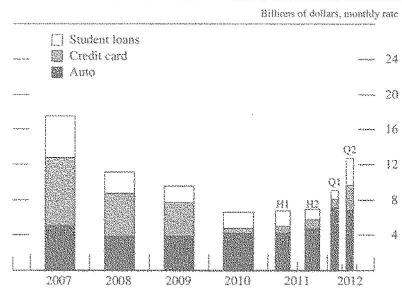
Housing Activity and Housing Finance

Activity in the housing sector appears to be on a gradual uptrend, albeit from a very depressed level.

1. The SLOOS is available on the Federal Reserve Board's website at www.federalreserve.gov/boarddocs/SnLoanSurvey.

2. The act includes some provisions that place restrictions on issuers' ability to impose certain fees and to engage in risk-based pricing.

9. Gross consumer asset-backed security issuance, 2007–12

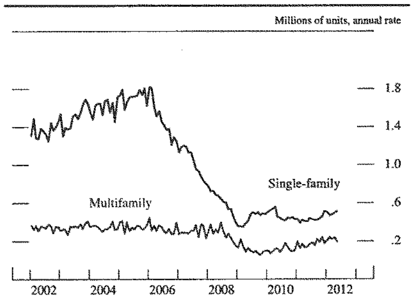


SOURCE: Bloomberg.

Sales of new and existing homes have risen so far this year, likely supported by the low level of house prices and by low interest rates for conventional mortgages. Nonetheless, the factors that have restrained demand for owner-occupied housing in recent years have yet to dissipate. Many potential buyers are reluctant to purchase homes because of ongoing concerns about future income, employment, and the direction of house prices. In addition, tight mortgage finance conditions preclude many borrowers from obtaining mortgage credit. Much of the home purchase demand that does exist has been channeled to the abundant stock of vacant houses, thereby limiting the response of new construction activity to such expansion of demand as has occurred. Given the large numbers of properties still in, or at risk of being in, foreclosure, this overhang seems likely to continue to weigh on new construction activity for some time.

Despite these factors, housing starts have risen gradually so far this year (figure 10). From January to May, single-family houses were started at an annual rate of about 495,000 units, up from 450,000 in the second half of 2011 but less than half of the average pace of the past 50 years. Although the unseasonably warm winter may have contributed to the increase, the underlying pace of activity likely rose some as well. Indeed, data on single-family permit issuance, which is less likely to be affected by weather, also moved up a little from its level late last year. In the multifamily sector, demand has remained robust, as many individuals and families that are unable or unwilling to purchase homes have sought out rental units. As a result, the vacancy rate for rental housing has fallen to its lowest level since 2002, putting upward pressure on rents and spurring new construction. Over the first five months

10. Private housing starts, 2002–12

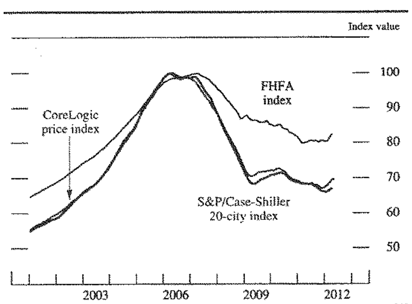


NOTE: The data are monthly and extend through May 2012.
SOURCE: Department of Commerce, Bureau of the Census.

of the year, new multifamily projects were started at an average annual rate of about 225,000 units, up from about 200,000 in the second half of 2011 but still below the 300,000-unit rate that prevailed for much of the previous decade.

House prices, as measured by several national indexes, turned up in recent months after edging down further, on balance, in 2011 (figure 11). For example, the CoreLogic repeat-sales index rose 4 percent (not an annual rate) over the first five months of the year. This recent improvement notwithstanding, this measure of house prices remains 30 percent below its peak in 2006.

11. Prices of existing single-family houses, 2001–12



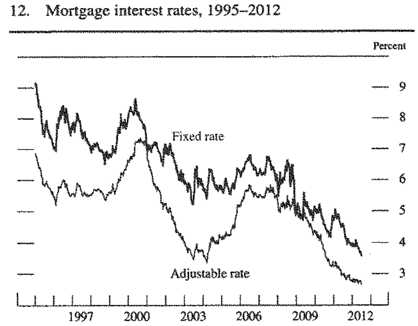
NOTE: The S&P/Case-Shiller and FHFA data are monthly and extend through April 2012. The CoreLogic data are monthly and extend through May 2012. Each index has been normalized so that its peak is 100. Both the CoreLogic price index and the FHFA index (formerly calculated by the Office of Federal Housing Enterprise Oversight) include purchase transactions only. The S&P/Case-Shiller index reflects all arm's-length sales transactions in selected metropolitan areas.
SOURCE: For CoreLogic, CoreLogic; for FHFA, Federal Housing Finance Agency; for S&P/Case-Shiller, Standard & Poor's.

The same factors that are restraining single-family housing construction also continue to weigh on house prices, including the large inventory of vacant homes, tight mortgage credit conditions, and lackluster demand.

Mortgage rates declined to historically low levels during the first half of 2012 (figure 12). While significant, the drop in mortgage rates generally did not keep pace with the declines in the yields on Treasury and mortgage-backed securities (MBS), probably reflecting still-elevated risk aversion and some capacity constraints among mortgage originators. Despite the drop in mortgage rates, many potentially creditworthy borrowers have had difficulty obtaining mortgages or refinancing because of tight standards and terms (see the box "The Supply of Mortgage Credit"). Another factor impeding the ability of many borrowers to refinance, or to sell their home and purchase a new one, has been the prevalence of underwater mortgages. Overall, refinancing activity increased in the second quarter but was still less than might be expected, given the level of interest rates, and the pace of mortgage applications for home purchases remained sluggish. However, refinancing activity attributed to recent changes to the HARP—one of which eliminated caps on loan-to-value ratios for those who were refinancing mortgages already owned by government-sponsored enterprises (GSEs)—has picked up over the first half of the year.

Indicators of credit quality in the residential mortgage sector continued to reflect strains on homeowners confronting depressed home values and high unemployment. The fraction of current prime mortgages becoming delinquent remained at a high level but

12. Mortgage interest rates, 1995–2012



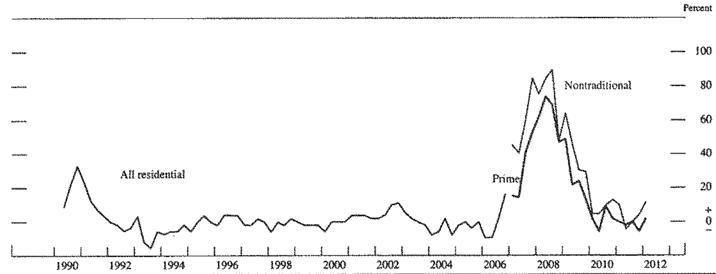
NOTE: The data, which are weekly and extend through July 11, 2012, are contract rates on 30-year mortgages.
SOURCE: Federal Home Loan Mortgage Corporation.

The Supply of Mortgage Credit

Access to mortgage credit is among the important factors that affect the demand for housing and thus the recovery in the housing sector. Lending standards appear to be considerably tighter than they were even before the housing boom, likely preventing many households from purchasing homes.

According to the Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS), from mid-2007 into 2009, many lenders tightened their standards for residential mortgages originated to borrowers with prime credit scores, and very few have eased standards since then (figure A). Moreover, the market for nontraditional mortgages continues to be impaired, while the market for subprime mortgages remains effectively closed. Similarly, the range of credit scores on newly originated prime mortgages has remained elevated since lenders shifted toward higher-rated borrowers in 2008 (figure B). The upward shift in credit scores is also evident for prime borrowers who refinanced their mortgages and for Federal Housing Administration mortgages.

A. Net percentage of domestic respondents tightening standards for residential mortgage loans, 1990–2012



Note: For data starting in 2007:Q1, changes in standards for prime and nontraditional mortgage loans are reported separately. Data are quarterly; the last observation is from the April 2012 survey, which covers 2012:Q1.
Source: Federal Reserve Board, Senior Loan Officer Opinion Survey on Bank Lending Practices.

inched lower, on net, over the first five months of the year, likely reflecting in part stricter underwriting of more-recent originations. Additionally, measures of late-stage mortgage delinquency, such as the inventory of properties in foreclosure, continued to linger near the peak in the first quarter of 2012 (figure 13).

Gross issuance of MBS guaranteed by GSEs remained moderate in the first half of 2012, consistent with the slow pace of mortgage originations. In contrast, the securitization market for mortgage loans not guaranteed by a housing-related GSE or the Federal Housing Administration—an important source of funding before the crisis for prime-grade mortgages that exceeded the conforming loan size limit—continued to be essentially closed.

The Business Sector

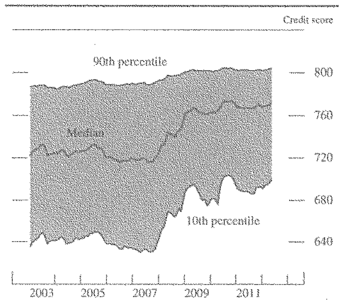
Fixed Investment

Real business spending for equipment and software (E&S) rose at an annual rate of 3½ percent in the first quarter of 2012 after having risen at a double-digit pace, on average, in the second half of 2011 (figure 14). The slowdown in E&S investment growth in the first quarter was fairly widespread across categories of equipment and software. This deceleration in E&S spending along with the recent softening in indicators of investment demand, such as surveys of business sentiment and capital spending plans, may signal some

Mortgage credit standards were clearly too lax in the middle of the previous decade, and some tightening of lending policies was warranted. Nonetheless, industry data indicate that only about one-half of lenders currently even so much as offer a mortgage to borrowers with credit scores and loan-to-value ratios toward the lower ends of the ranges allowed by the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. That fraction has improved only slightly from 2010.

Respondents to the April SLOOS were asked to identify reasons for their lack of willingness to originate some GSE-eligible mortgages. The factor most frequently cited as "most important" or "very important" was the elevated risk of "putbacks" of delinquent mortgages by the GSEs—that is, the possibility that the GSEs might require originators to repurchase loans with any underwriting irregularities—suggesting that the incomplete transfer of credit risk to the GSEs is an important consideration. Two other factors were cited as most important or very important by almost one-half of respondents: (1) issues related to private mortgage insurance, including the greater difficulty that borrowers faced in obtaining coverage or the higher premiums that they paid for it, and (2) the outlook for house prices. Greater concern about their bank's existing exposure to residential real estate loans and increased concerns about effects of legislative changes, supervisory actions, or changes in accounting standards were also cited relatively frequently as very important factors.

B. Credit scores on new prime mortgages, 2003–12



NOTE: Includes purchase mortgages only. The data are monthly and extend through May 2012.
SOURCE: LPS Applied Analytics.

An additional constraint hindering households' access to mortgage credit is negative equity that has resulted from the decline in house prices in recent years. Roughly one in four mortgage borrowers is underwater on his or her mortgage—nearly 13 million households in all. Underwater borrowers are restricted in their ability to refinance into a lower mortgage rate; they may also find their mobility limited by the difficulty of selling their current home.

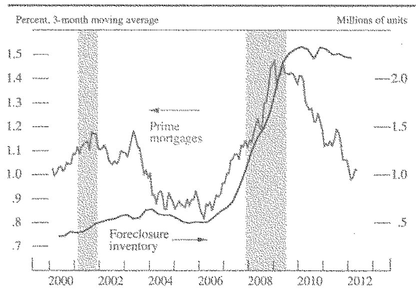
renewed caution on the part of businesses, perhaps related to the situation in Europe.

After posting robust gains throughout much of 2011, investment in nonresidential structures edged up in the first quarter of this year. A drop in outlays for drilling and mining structures was probably related to the low level of natural gas prices. Outside of the drilling and mining segments, investment increased at an annual rate of 7 percent in the first quarter, broadly similar to its gain in the fourth quarter of 2011. Although financing conditions for existing properties have eased some, they remain tight; moreover, high vacancy rates, low commercial real estate prices, and difficult financing conditions for new construction will likely weigh on building activity for the foreseeable future.

Inventory Investment

Firms accumulated inventories in the first quarter at about the same pace as in the fourth quarter of last year (figure 15). Motor vehicle inventories surged in the first quarter, as automakers rebuilt dealers' inventories to comfortable levels after natural disasters disrupted global supply chains in 2011. Stockbuilding outside of motor vehicles moderated somewhat from the fourth-quarter pace of accumulation. Inventory-to-sales ratios for most industries covered by the Census Bureau's book-value data, as well as surveys of private inventory satisfaction and plans, generally suggest that stocks are fairly well aligned with the pace of sales.

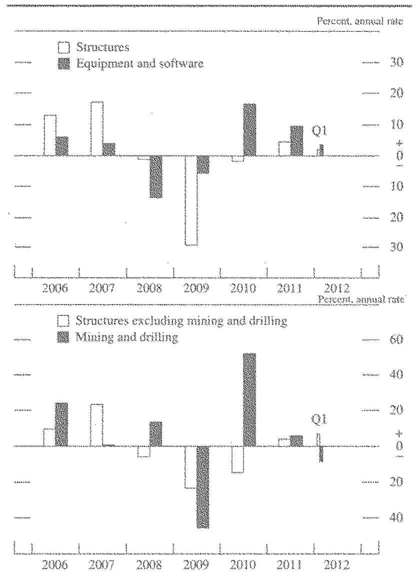
13. Current prime mortgages becoming delinquent and foreclosure inventory, 2000–12



NOTE: The data for prime mortgages are monthly and extend through May 2012. The data for foreclosure inventory are quarterly and extend through 2012:Q1. Percentage of mortgages that transition from being current to being at least 30 days delinquent each month. The shaded bars indicate periods of business recession as defined by the National Bureau of Economic Research.

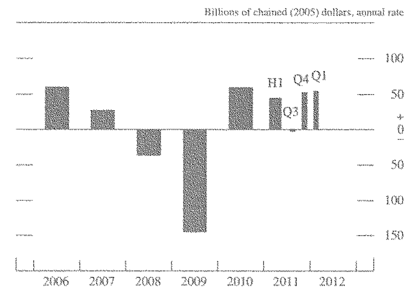
SOURCE: For prime mortgages, LPS Applied Analytics; for foreclosure inventory, Federal Reserve Board staff calculations based on data from Mortgage Bankers Association.

14. Change in real business fixed investment, 2006–12



SOURCE: Department of Commerce, Bureau of Economic Analysis.

15. Change in real business inventories, 2006–12



SOURCE: Department of Commerce, Bureau of Economic Analysis.

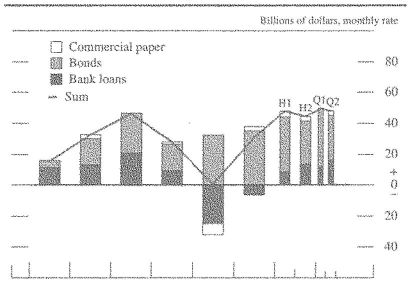
Corporate Profits and Business Finance

Aggregate operating earnings per share for S&P 500 firms rose about 7 percent at a seasonally adjusted quarterly rate in the first quarter of 2012. Financial firms accounted for most of the gain, while profits for firms in the nonfinancial sector were about unchanged from the high level seen in the fourth quarter of last year. As of the end of June, private-sector analysts projected moderate earnings growth through the end of the year.

The ratio of corporate profits to gross national product in the first quarter of 2012 hovered around its historical high, and cash flow remained solid. In addition, the ratio of liquid assets to total assets continued to be near its highest level in more than 20 years, and the share of corporate cash flow needed to cover interest expenses remained low. Against this backdrop of generally strong corporate earnings and balance sheets, credit rating upgrades continued to outpace downgrades for nonfinancial corporations, and the bond default rate for nonfinancial firms remained low in the first half of the year. The delinquency rate on commercial and industrial (C&I) loans decreased further in the first quarter and approached the lower end of its historical range.

With corporate credit quality remaining robust, nonfinancial firms were able to continue to raise funds at a generally strong pace in the first half of the year (figure 16). So far this year, nonfinancial commercial paper (CP) outstanding was about unchanged. Bond issuance by both investment- and speculative-grade nonfinancial firms was strong over the first four months of the year, but speculative-grade issuance weakened some in May and notably further in June.

16. Selected components of net financing for nonfinancial businesses, 2005–12

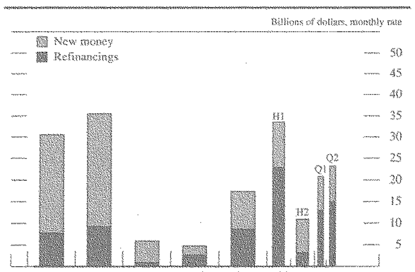


NOTE: The data for the components except bonds are seasonally adjusted.
SOURCE: Federal Reserve Board, flow of funds data.

The institutional segment of the syndicated leveraged loan market remained solid in the first half of the year, reportedly supported by continued demand for loans from nonbank investors, such as pension plans and insurance companies (figure 17). In addition, the volume of newly established collateralized loan obligations so far this year has already surpassed 2011 levels. Much of the bond and loan issuance was reportedly used to refinance, and likely also to extend the maturity of, existing debt, given the low level of long-term interest rates.

C&I loans outstanding at commercial banking organizations in the United States expanded at a brisk pace in the first half of 2012 despite declines in the holdings of such loans by U.S. branches and agencies of European institutions. The strength is consistent with a relatively large number of banks, on balance, that have reported stronger demand for C&I loans in the recent SLOOS (figure 18). Moreover, in the April SLOOS, banks continued to report having eased both price and nonprice terms for C&I loans, largely in response to strong competition from other banks and nonbank lenders. The extent of easing generally has been greater for large and middle-market firms. That said, according to the Survey of Terms of Business Lending (STBL), spreads on C&I loans over banks' cost of funds, while continuing to trend down gradually in the February and May surveys, are still quite high in historical terms. Spreads on newly issued syndicated loans have also remained somewhat wide.

17. Issuance of institutional leveraged loans, 2006–12

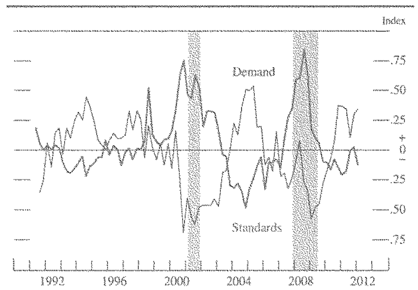


NOTE: The reading for 2012:Q2 is the average for April and May. New money loans are new syndicated loans. Refinancing loans are syndicated loans that are used to repay existing debt.
SOURCE: Reuters Loan Pricing Corporation.

Borrowing conditions for small businesses generally have improved over the past few years but have done so much more gradually than have conditions for larger firms; moreover, the demand for credit from small firms apparently remains subdued. C&I loans with original amounts of $1 million or less—a large share of which likely consists of loans to small businesses—were about unchanged in the first quarter.[3] According to results from surveys conducted by the National Federation of Independent Business during the first half of this year, the fraction of firms with borrowing needs stayed low (figure 19). The net percentage of respondents that found credit more difficult to obtain than

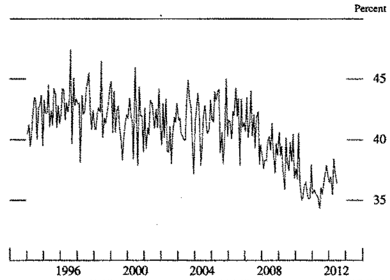
3. The original amount for a C&I loan is defined in the Call Report as the maximum of the amount of the loan or the amount of the total commitment.

18. Change in standards and demand for commercial and industrial loans, 1991–2012



NOTE: The data are drawn from a survey generally conducted four times per year; the last observation is from the April 2012 survey, which covers 2012:Q1. Each series represents the net percent of commercial and industrial loans held by surveyed banks that reported a tightening of standards or stronger demand over the past three months. The shaded bars indicate periods of business recession as defined by the National Bureau of Economic Research.
SOURCE: Federal Reserve Board, Senior Loan Officer Opinion Survey on Bank Lending Practices, and Call Reports.

19. Net percentage of firms with borrowing needs, 1994–2012



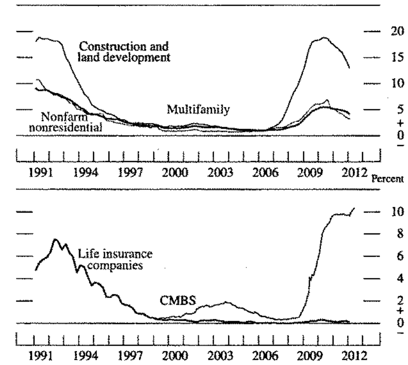
NOTE: The data are drawn from a survey conducted monthly and are seasonally adjusted; the last observation is from the June 2012 survey. The data represent the proportion of businesses with borrowing needs over the past three months regardless of whether those needs were satisfied or not satisfied. This number is seasonally adjusted.
SOURCE: National Federation of Independent Business.

three months earlier and that expected tighter credit conditions over the next three months have both declined, but they remained at relatively high levels in the June survey. In addition, recent readings from the STBL indicate that the spreads charged by commercial banks on newly originated C&I loans with original amounts less than $1 million remained quite high, even on loans with the strongest credit ratings.

Financial conditions in the commercial real estate (CRE) sector have eased some but stayed relatively tight amid weak fundamentals. According to the April SLOOS, some domestic banks reported having eased standards on CRE loans and, on balance, a significant number of domestic banks reported increased demand for such loans. While banks' holdings of CRE loans continued to contract in the first half of this year, they did so at a slower pace than in the second half of last year. The weakest segment of CRE lending has been the portion supporting construction and land development; some other segments have recently expanded modestly. Issuance of commercial mortgage-backed securities (CMBS) has also increased recently from the low levels observed last year. Nonetheless, the delinquency rate on loans in CMBS pools continued to set new highs in June, as some five-year loans issued in 2007 at the height of the market were unable to refinance at maturity because of their high loan-to-value ratios (figure 20). While delinquency rates for CRE loans at commercial banks improved slightly in the first quarter, they remained elevated, especially for construction and land development loans.

In the corporate equity market, gross public equity issuance by nonfinancial firms was strong in the first

20. Delinquency rates on commercial real estate loans, 1991–2012



NOTE: The data for commercial banks and life insurance companies are quarterly and extend through 2012:Q1. The data for commercial mortgage-backed securities (CMBS) are monthly and extend through June 2012. The delinquency rates for commercial banks and CMBS are the percent of loans 30 days or more past due or not accruing interest. The delinquency rate for life insurance companies is the percent of loans 60 days or more past due or not accruing interest.
SOURCE: For commercial banks, Federal Financial Institutions Examination Council, Consolidated Reports of Condition and Income (Call Report); for life insurance companies, American Council of Life Insurers; for CMBS, Citigroup.

five months of 2012, boosted by a solid pace of initial public offerings (IPOs).[4] Data for the first quarter of 2012 indicate that share repurchases and cash-financed mergers by nonfinancial firms remained robust, and net equity issuance remained deeply negative (figure 21). However, fewer mergers and new share repurchase programs were announced in the second quarter.

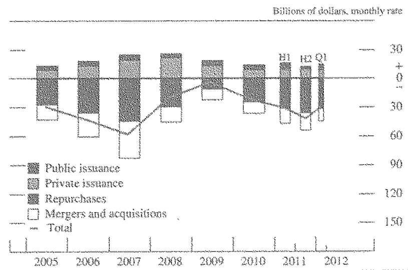
The Government Sector

Federal Government

The deficit in the federal unified budget remains elevated. The Congressional Budget Office projects that the deficit for fiscal year 2012 will be close to $1.2 trillion, or about 7½ percent of nominal GDP. Such a deficit would be a narrower share of GDP than those recorded over the past several years though still

4. Indeed, the second largest IPO on record began trading in mid-May. However, the price performance of those shares in the days following that offering was sharply negative on net, and IPO activity subsequently weakened significantly.

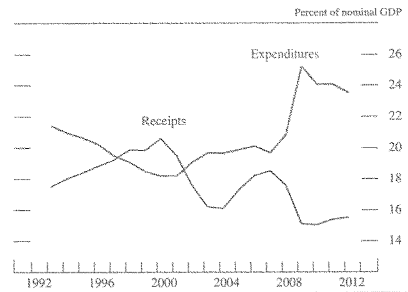
21. Components of net equity issuance, 2005–12



NOTE: Net equity issuance is the difference between equity issued by domestic companies in public or private markets and equity retired through share repurchases, domestic cash-financed mergers, or foreign takeovers of U.S. firms. Equity issuance includes funds invested by private equity partnerships and stock option proceeds.

SOURCE: Thomson Financial, Investment Benchmark Report; Money Tree Report by PricewaterhouseCoopers, National Venture Capital Association, and Venture Economics.

22. Federal receipts and expenditures, 1992–2012



NOTE: Through 2011, receipts and expenditures are for fiscal years (October through September); gross domestic product (GDP) is for the four quarters ending in Q3. For 2012, receipts and expenditures are for the 12 months ending in June, and GDP is the average of 2011:Q4 and 2012:Q1. Receipts and expenditures are on a unified-budget basis.

SOURCE: Office of Management and Budget.

sharply higher than those recorded in the few years prior to the onset of the financial crisis and recession. The narrowing of the budget deficit expected to occur in the current fiscal year mostly reflects increases in tax revenues as the economy continues to recover, although the growth in outlays is being held back by the winding down of expansionary fiscal policies enacted in response to the recession, as well as some budgetary restraint in defense and other discretionary spending programs.

Federal receipts increased 5 percent in the first nine months of fiscal 2012 compared with the same period in fiscal 2011. Receipts were bolstered thus far this fiscal year by a robust rise in corporate tax revenues that is largely attributable to a scaling back in the favorable tax treatment of some business investment. In addition, individual income and payroll tax receipts have moved higher, reflecting increases in nominal wage and salary income. Nonetheless, at only about 15½ percent, the ratio of federal receipts to national income is near the lowest reading for this ratio over the past 60 years (figure 22).

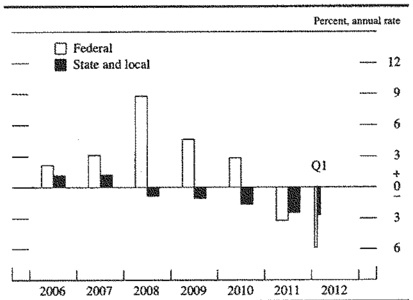
Total federal outlays moved sideways in the first nine months of fiscal 2012 relative to the comparable year-earlier period. Outlays were reduced by the winding down of stimulus-related programs (including the American Recovery and Reinvestment Act of 2009), lower payments for unemployment insurance, and falling defense expenditures. In addition, outlays for Medicaid so far this fiscal year were unusually weak, apparently reflecting in part the implementation of cost-containment measures by many state governments to reduce spending growth for that program. In contrast, Social Security outlays rose in part because of the first cost-of-living adjustments since 2009, and outlays for financial transactions were boosted by the revaluation of the expected cost of previous Troubled Asset Relief Program transactions and an increase in net outlays for deposit insurance.[5] Net interest payments increased moderately, reflecting the rising level of the federal debt.

As measured in the national income and product accounts (NIPA), real federal expenditures on consumption and gross investment—the part of federal spending included in the calculation of GDP—fell at an annual rate of close to 6 percent in the first quarter (figure 23). Defense spending, which tends to be erratic from quarter to quarter, contracted more than 8 percent, and nondefense purchases edged down.

Federal debt held by the public rose to about 72 percent of nominal GDP in the second quarter of 2012, 3½ percentage points higher than at the end of last year (figure 24). Treasury auctions generally continued to be well received by investors. Indicators of demand at Treasury auctions, such as bid-to-cover ratios and indirect bidding ratios, were within their historical ranges.

5. The subsidy costs of outstanding Troubled Asset Relief Program assistance are reestimated annually by updating cash flows for actual experience and new assumptions about the future performance of the programs; any changes in these estimated subsidy costs are recorded in the federal budget in the current fiscal year.

23. Change in real government expenditures on consumption and investment, 2006–12



SOURCE: Department of Commerce, Bureau of Economic Analysis.

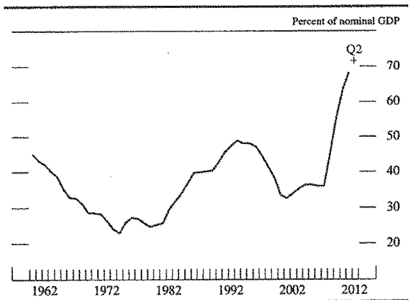
State and Local Government

State and local government budgets remain strained, but overall fiscal conditions for these governments may be slowly improving. In particular, state and local tax receipts appeared to increase moderately over the first half of this year. Census Bureau data indicate that state revenue collections rose 4 percent in the first quarter relative to a year earlier, and anecdotal evidence suggests that collections during April and May were well maintained. Moreover, only a few states reported budget shortfalls during fiscal 2012 (which ended on June 30 in most states). The improvement is less evident at the local level, where property tax receipts—the largest source of tax revenue for these governments—were roughly flat in 2011 and early 2012, reflecting the crosscutting effects of the earlier declines in home prices and increases in property tax rates. Moreover, federal aid to both state and local governments has declined as stimulus-related grants have been almost completely phased out.

One of the ways that state and local governments have addressed their tight budget situations has been through cuts in their employment and construction spending. After shedding jobs at an average pace of 19,000 per month in 2011, these governments reduced their employment over the first half of the year at a slower pace by trimming 3,000 jobs per month on average. However, real construction expenditures fell sharply in the first quarter after having edged down in the latter half of 2011, and available information on nominal construction spending through May points to continued declines in recent months. The decreases in employment and construction are evident in the Bureau of Economic Analysis (BEA) estimate for real state and local purchases, which fell at an annual rate of 2¾ percent in the first quarter, about the same pace as in 2011.

Gross issuance of bonds by states and municipalities picked up in the second quarter of 2012. Credit quality in the sector continued to deteriorate over the first half of the year. For instance, credit rating downgrades by Moody's Investors Service substantially outpaced upgrades, and credit default swap (CDS) indexes for municipal bonds rose on net. Yields on long-term general obligation municipal bonds were about unchanged over the first half of the year.

24. Federal government debt held by the public, 1960–2012



NOTE: The data for debt through 2011 are as of year-end, and the corresponding values for gross domestic product (GDP) are for Q4 at an annual rate. The observation for 2012:Q2 is based on an estimate for debt in that quarter and GDP in the first quarter. Excludes securities held as investments of federal government accounts.

SOURCE: Federal Reserve Board, flow of funds data.

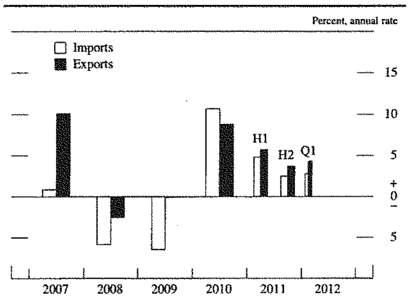
The External Sector

Exports and Imports

Both real exports and imports grew moderately in the first quarter of 2012 (figure 25). Real exports of goods and services rose at an annual rate of 4¼ percent, supported by relatively strong foreign economic growth. Exports of services, automobiles, computers, and aircraft expanded rapidly, while those of consumer goods declined. The rise in exports was particularly strong to Canada and Mexico. Data for April and May suggest that exports continued to rise at a moderate pace in the second quarter.

Real imports of goods and services rose a relatively modest 2¾ percent in the first quarter, reflecting slower growth in U.S. economic activity. Imports of services, automobiles, and computers rose significantly, while

25. Change in real imports and exports of goods and services, 2007–12



SOURCE: Department of Commerce, Bureau of Economic Analysis.

those of petroleum, aircraft, and consumer goods fell. The rise in imports was broadly based across major trading partners, with imports from Japan and Mexico showing particularly strong growth. April and May data suggest that import growth picked up in the second quarter.

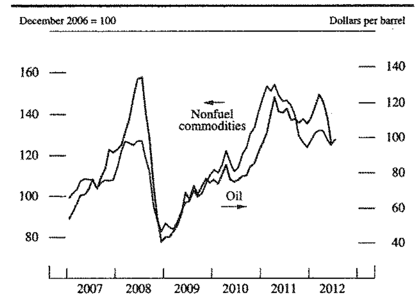
Altogether, net exports made a small positive contribution of one-tenth of 1 percentage point to real GDP growth in the first quarter.

Commodity and Trade Prices

After increasing earlier in the year, oil prices have subsequently fallen back (figure 26). Over much of the first quarter, an improved outlook for the global economy and increased geopolitical tensions—most notably with Iran—helped spur a run-up in the spot price of oil, with the Brent benchmark averaging $125 per barrel in March, about $15 above its January average. Since mid-March, however, oil prices have more than retraced their earlier gains amid an intensification of the crisis in Europe and increased concerns over the strength of economic growth in China. An easing of geopolitical tensions and increased crude oil supply—production by Saudi Arabia has been running at near-record high levels—have also likely contributed to the decline in oil prices. All told, the price of Brent has plunged $25 a barrel from March to about $100 per barrel in mid-July.

Prices of many nonfuel commodities followed a path similar to that shown by oil prices, albeit with less volatility. Early in 2012, commodity prices rallied, as global economic prospects and financial conditions improved

26. Prices of oil and nonfuel commodities, 2007–12



NOTE: The data are monthly. The oil price is the spot price of Brent crude oil, and the last observation is the average for July 1–13, 2012. The price of nonfuel commodities is an index of 45 primary-commodity prices and extends through June 2012.

SOURCE: For oil, the Commodity Research Bureau; for nonfuel commodities, International Monetary Fund.

along with a temporary abatement of stresses in Europe. However, as with oil prices, broader commodity prices fell in the second quarter, reflecting growing pessimism regarding prospects for the global economy.

Prices for non-oil imported goods increased less than ¼ percent in the first quarter, with the modest pace of increase likely reflecting the lagged effects of both the appreciation of the dollar and the decline in commodity prices that occurred late last year. Moving into the second quarter, import price inflation appears to have remained subdued, consistent with a further appreciation of the dollar.

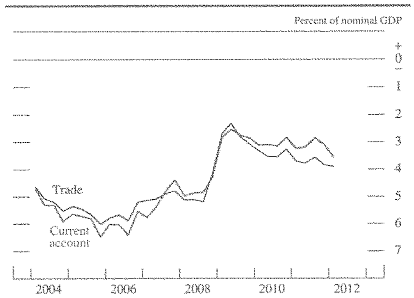
The Current and Financial Accounts

Largely reflecting the run-up in oil prices early in the year, the nominal trade deficit widened slightly in the first quarter (figure 27). In addition, as the net investment income balance continued to decline, the current account deficit deteriorated from an annual average of $470 billion in 2011 to $550 billion in the first quarter, or 3½ percent of GDP.[6]

The financial flows that provide the financing of the current account deficit reflected the general trends in financial market sentiment and in reserve accumulation

6. In 1999, the BEA—while revisiting its methodology for the balance of payments accounts—redefined the current account to exclude capital transfers. In the process, the capital account was renamed the financial account, and a newly defined capital account was created to include capital transfers as well as the acquisition and disposal of nonproduced nonfinancial assets.

27. U.S. trade and current account balances, 2004–12



Note: The data are quarterly and extend through 2012:Q1. GDP is gross domestic product.
Source: Department of Commerce, Bureau of Economic Analysis.

by emerging market economies (EMEs). Consistent with a temporary improvement in the tone of financial markets in the first quarter, foreign private investors slowed their net purchases of U.S. Treasury securities and resumed net purchases of U.S. equities, although they continued to sell other U.S. bonds (figure 28). However, the tentative increase in foreign risk appetite abated early in the second quarter and foreign private investors showed renewed demand for U.S. Treasury securities and less demand for other U.S. securities.

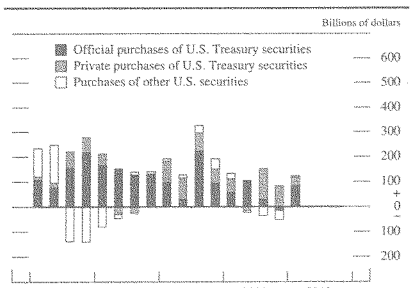
U.S. investors' demand for foreign securities was flat, on net, in the first quarter and the early part of the second quarter, but this outcome nonetheless represents an increase relative to net sales of foreign securities in the fourth quarter of 2011 (figure 29).

Inflows from foreign official institutions strengthened in the first quarter as emerging market governments bought dollars to counter upward pressure on their currencies, resulting in increased accumulation of dollar-denominated reserves, which were then invested in U.S. securities (figure 30). Partial data for the second quarter suggest that foreign official inflows remained strong despite renewed dollar appreciation against emerging market currencies. U.S. official assets registered a $51 billion inflow during the first quarter as drawings on the Federal Reserve's dollar swap lines with the European Central Bank (ECB) and the Bank of Japan (BOJ) were partially repaid.

National Saving

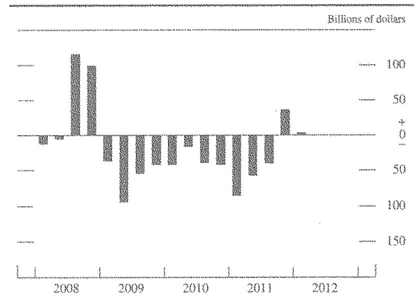
Total U.S. net national saving—that is, the saving of U.S. households, businesses, and governments, net of depreciation charges—remains extremely low by historical standards (figure 31). Net national saving fell from 4 percent of nominal GDP in 2006 to negative 2 percent in 2009, as the federal budget deficit widened. The national saving rate subsequently increased to near zero, where it remained as of the first quarter of 2012 (the latest quarter for which data are available). The relative flatness of the saving rate over the past couple of years reflects the offsetting effects of a narrowing in the federal budget deficit as a share of nominal GDP

28. Net foreign purchases of U.S. securities, 2008–12



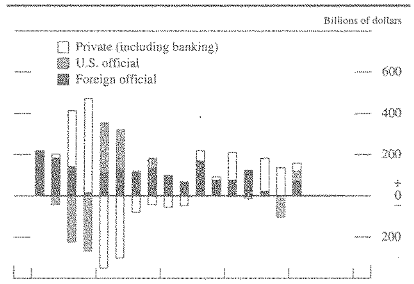
Note: Other U.S. securities include corporate equities and bonds, agency bonds, and municipal bonds.
Source: Department of Commerce, Bureau of Economic Analysis.

29. Net U.S. purchases of foreign securities, 2008–12



Note: Negative numbers indicate a balance of payments outflow, generated when U.S. residents, on net, purchase foreign securities. Positive numbers indicate a balance of payment inflow, generated when U.S. residents, on net, sell foreign securities.
Source: Department of Commerce, Bureau of Economic Analysis.

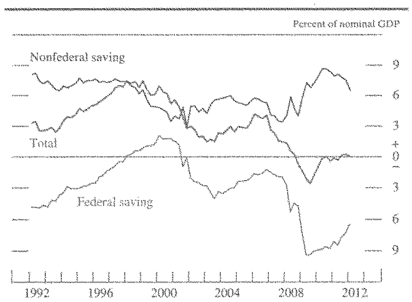
30. U.S. net financial inflows, 2008–12



NOTE: U.S. official flows include the foreign currency acquired when foreign central banks draw on their swap lines with the Federal Reserve.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

and a downward movement in the private saving rate. National saving will likely remain low this year in light of the continuing large federal budget deficit. A portion of the decline in federal savings relative to precrisis levels is cyclical and would be expected to reverse as the economy recovers. However, if low levels of national saving persist over the longer run, they will likely be associated with both low rates of capital formation and heavy borrowing from abroad, limiting the rise in the standard of living for U.S. residents over time.

31. Net saving, 1992–2012



NOTE: The data are quarterly and extend through 2012:Q1. Nonfederal saving is the sum of personal and net business saving and the net saving of state and local governments. GDP is gross domestic product.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

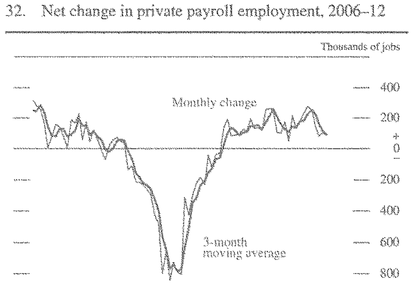
The Labor Market

Employment and Unemployment

Labor market conditions remain weak. After averaging 165,000 jobs per month in the second half of 2011, private payroll employment gains increased to 225,000 jobs per month over the first three months of the year and then fell back to 90,000 jobs per month over the past three months (figure 32). The apparent slowing in the pace of net job creation may have been exaggerated by issues related to swings in the weather and to seasonal adjustment difficulties associated with the timing of the sharpest job losses during the recession. Moreover, employment gains during the second half of last year and into the early part of this year may have reflected some catch-up in hiring on the part of employers that aggressively pared their workforces during and just after the recession. The recent deceleration in employment may suggest that much of this catch-up has now taken place and that, consequently, more-rapid gains in economic activity will be required to achieve significant further increases in employment and declines in the unemployment rate.

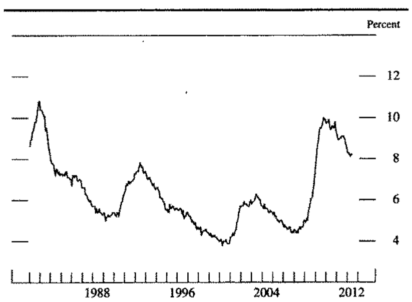
The unemployment rate, though down from around 9 percent last summer, has held about flat at 8¼ percent since early this year and remains elevated relative to levels observed prior to the recent recession (figure 33). Moreover, long-term unemployment also remains elevated. In June, around 40 percent of those unemployed had been out of work for more than six months (figure 34). Meanwhile, the labor force participation rate has fluctuated around a low level so far this year after having moved down 2 percentage points since 2007.

32. Net change in private payroll employment, 2006–12



NOTE: The data are monthly and extend through June 2012.
SOURCE: Department of Labor, Bureau of Labor Statistics.

33. Civilian unemployment rate, 1982–2012



NOTE: The data are monthly and extend through June 2012.
SOURCE: Department of Labor, Bureau of Labor Statistics.

Other labor market indicators were consistent with little change in overall labor market conditions during the first half of the year. Initial claims for unemployment insurance were not much changed, on net, although their average level over the first half of the year was lower than in the second half of 2011. Measures of job vacancies edged up, on balance, and households' labor market expectations largely reversed the steep deterioration from last summer. However, indicators of hiring activity remained subdued.

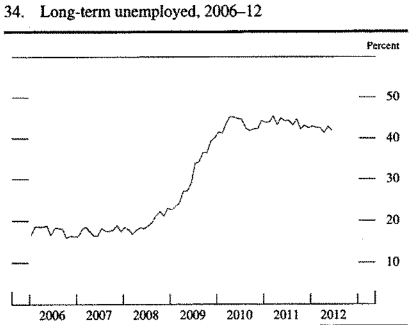
Productivity and Labor Compensation

Gains in labor productivity have continued to slow recently following an outsized increase in 2009 and a solid gain in 2010. According to the latest published data, output per hour in the nonfarm business sector rose just ½ percent in 2011 and declined in the first quarter of 2012 (figure 35). Although these data can be volatile from quarter to quarter, the moderation in productivity growth over the past two years suggests that firms have been adding workers not only to meet rising production needs but also to relieve pressures on their existing workforces, which were cut back sharply during the recession.

Increases in hourly compensation continue to be restrained by the very weak condition of the labor market. The 12-month change in the employment cost index for private industry workers, which measures both wages and the cost to employers of providing benefits, has been about 2 percent or less since the start of 2009 after several years of increases in the neighborhood of 3 percent (figure 36). Nominal compensation per hour in the nonfarm business sector—a measure derived from the labor compensation data in the NIPA—also decelerated significantly over the past few years; this measure rose just 1¼ percent over the year ending in the first quarter of 2012, well below the average increase of about 4 percent in the years before the recession. Similarly, average hourly earnings for all employees—the timeliest measure of wage developments—rose about 2 percent in nominal terms over the 12 months ending in June. According to each of these measures, gains in hourly compensation failed to keep up with increases in consumer prices in 2011 and again in the first quarter of this year.

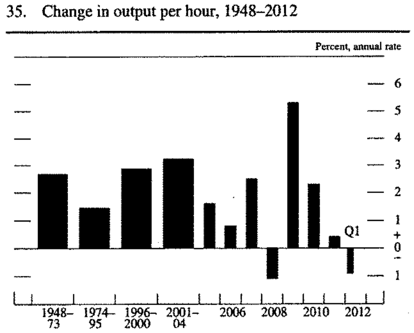
The change in unit labor costs faced by firms—which measures the extent to which nominal hourly

34. Long-term unemployed, 2006–12



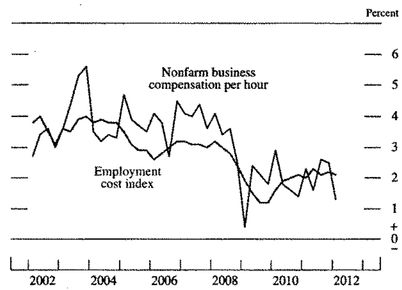
NOTE: The data are monthly and extend through June 2012. The series shown is the percentage of total unemployed persons who have been unemployed for 27 weeks or more.
SOURCE: Department of Labor, Bureau of Labor Statistics.

35. Change in output per hour, 1948–2012



NOTE: Nonfarm business sector. Change for each multiyear period is measured to the fourth quarter of the final year of the period from the fourth quarter of the year immediately preceding the period.
SOURCE: Department of Labor, Bureau of Labor Statistics.

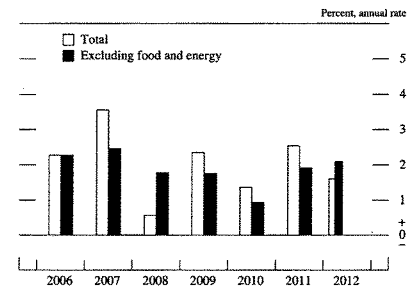
36. Measures of change in hourly compensation, 2002–12



NOTE: The data are quarterly and extend through 2012:Q1. For nonfarm business compensation, change is over four quarters; for the employment cost index (ECI), change is over the 12 months ending in the last month of each quarter. The nonfarm business sector excludes farms, government, nonprofit institutions, and households. The sector covered by the ECI used here is the nonfarm business sector plus nonprofit institutions.

SOURCE: Department of Labor, Bureau of Labor Statistics.

37. Change in the chain-type price index for personal consumption expenditures, 2006–12



NOTE: Through 2011, change is from December to December; for 2012, change is from December to May.

SOURCE: Department of Commerce, Bureau of Economic Analysis.

compensation rises in excess of labor productivity—remained subdued. Unit labor costs in the nonfarm business sector rose 1 percent over the year ending in the first quarter of 2012. Over the preceding year, unit labor costs increased 1½ percent.

Prices

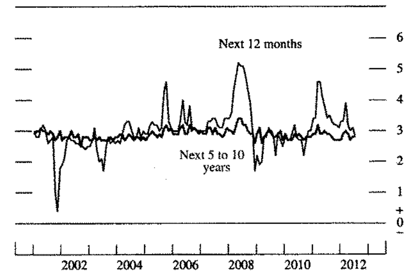
Consumer price inflation moved down, on net, during the first part of 2012. Overall PCE prices rose rapidly in the first three months of the year, reflecting large increases in oil prices, but inflation turned down in the spring as oil prices more than reversed their earlier run-ups. The overall chain-type PCE price index increased at an annual rate of about 1½ percent between December 2011 and May 2012, compared with a rise of 2½ percent over 2011 (figure 37). Excluding food and energy, consumer prices rose at a rate of about 2 percent over the first five months of the year, essentially the same pace as in 2011. In addition to the net decline in crude oil prices over the first half of the year, factors contributing to low consumer price inflation this year include the deceleration of non-oil import prices in the latter part of 2011, subdued labor costs associated with the weak labor market, and stable inflation expectations.

Consumer energy prices surged at an annual rate of over 20 percent in the first three months of 2012, as higher costs for crude oil were passed through to gasoline prices. In April, the national-average price for gasoline at the pump approached $4 per gallon. Since then, crude oil prices have tumbled, and gasoline prices have declined roughly in line with crude costs, more than reversing the earlier run-up. Consumer prices for natural gas plunged over the first five months of the year after falling late last year; this drop is attributable, at least in part, to the unseasonably warm winter, which reduced demand for natural gas. More recently, spot prices for natural gas have turned up as production has been cut back, but they still remain substantially lower than they were last summer.

Consumer food price inflation has slowed noticeably so far this year, as the effect on retail food prices from last year's jump in farm commodity prices appears to have largely dissipated. Indeed, PCE prices for food and beverages only edged up slightly, rising at an annual rate of about ½ percent from December to May after increasing more than 5 percent in 2011. Although farm commodity prices were tempered earlier this year by expectations of a substantial increase in crop output this growing season, grain prices rose rapidly in late June and early July as a wide swath of the Midwest experienced a bout of hot, dry weather that farm analysts believe cut yield prospects considerably.

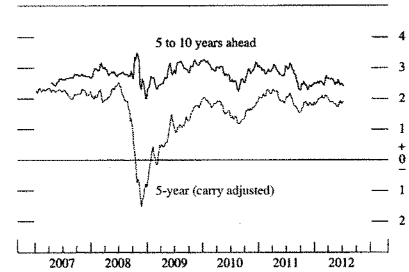
Survey-based measures of near-term inflation expectations have changed little, on net, so far this year. Median year-ahead inflation expectations, as reported in the Thomson Reuters/University of Michigan Surveys of Consumers (Michigan survey), rose in March when gasoline prices were high but then fell back as those prices reversed course (figure 38). Longer-term expectations remained more stable. In the Michigan survey, median expected inflation over the next 5 to

38. Median inflation expectations, 2001–12



NOTE: The data are monthly and extend through a preliminary estimate for July 2012.
SOURCE: Thomson Reuters/University of Michigan Surveys of Consumers.

39. Inflation compensation, 2007–12



NOTE: The data are weekly averages of daily data and extend through July 13, 2012. Inflation compensation is the difference between yields on nominal Treasury securities and Treasury inflation-protected securities (TIPS) of comparable maturities, based on yield curves fitted by Federal Reserve staff to off-the-run nominal Treasury securities and on- and off-the-run TIPS. The 5-year measure is adjusted for the effect of indexation lags.
SOURCE: Federal Reserve Bank of New York; Barclays; Federal Reserve Board staff estimates.

10 years was 2.8 percent in early July, within the narrow range of the past 10 years. In the Survey of Professional Forecasters, conducted by the Federal Reserve Bank of Philadelphia, expectations for the increase in the price index for PCE over the next 10 years remained at 2¼ percent, in the middle of its recent range.

Measures of medium- and longer-term inflation compensation derived from nominal and inflation-protected Treasury securities—which not only reflect inflation expectations, but also can be affected by changes in investor risk aversion and by the different liquidity properties of the two types of securities—were little changed, on net, so far this year (figure 39). These measures increased early in the period amid rising prices for oil and other commodities, but they subsequently declined as commodity prices fell back and as worries about domestic and global economic growth increased.

Financial Developments

Financial markets were somewhat volatile over the first half of 2012. Early in the year, broad equity price indexes rose and risk spreads in several markets narrowed as investor sentiment regarding short-term European prospects and the economic outlook improved. Those gains partially reversed when market participants became more pessimistic about the European situation and global growth prospects in May and June. Yields on longer-term Treasury securities declined, on balance, over the first half of the year. Conditions in unsecured short-term dollar funding markets generally remained stable as European financial institutions reduced their demand for dollar funding and general funding pressures were alleviated by the longer-term refinancing operations of the ECB. In the domestic banking sector, the release of the results from the Comprehensive Capital Analysis and Review (CCAR) in March provided a significant boost to the equity prices of U.S. financial institutions (see the box "The Capital and Liquidity Position of Large U.S. Banks").

Monetary Policy Expectations and Treasury Rates

In response to the steps taken by the Federal Open Market Committee (FOMC) to provide additional monetary policy accommodation, and amid growing anxiety about the European crisis and a worsening of the economic outlook, investors pushed out further the date when they expect the federal funds rate to first rise above its current target range of 0 to ¼ percent. In addition, they apparently scaled back the pace at which they expect the federal funds rate subsequently to be increased. Market participants currently anticipate that the effective federal funds rate will be about 50 basis points by the middle of 2015, roughly 55 basis points lower than they expected at the beginning of 2012.

Yields on longer-term nominal Treasury securities declined, on balance, over the first half of 2012 (figure 40). Early in the year, longer-term Treasury yields rose, reflecting generally positive U.S. economic data, improved market sentiment regarding the crisis in Europe, and higher energy prices. More recently, however, longer-term yields have more than reversed their earlier increases. Investors sought the relative safety and liquidity of Treasury securities as the crisis in Europe intensified again and as weaker-than-expected economic data releases raised concerns about the pace of economic recovery both in the United States and abroad. In addition, those developments fostered expectations that the Federal Reserve would provide additional accommodation. And the Treasury yield curve flattened further following the FOMC's decision at its June meeting to continue the maturity extension program (MEP) through the end of 2012. On balance, yields on 5-, 10-, and 30-year nominal Treasury securities declined roughly 20, 40, and 35 basis points, respectively, from their levels at the start of this year. The Open Market Desk's outright purchases and sales of Treasury securities under the MEP did not appear to have any material adverse effect on Treasury market functioning.

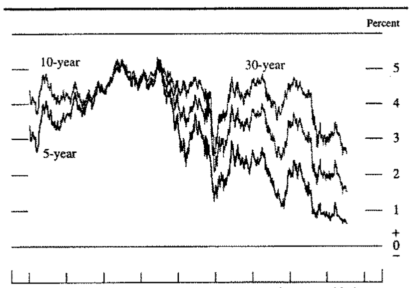
Short-Term Funding Markets

Despite the reemergence of strains in Europe, conditions in unsecured short-term dollar funding markets have remained fairly stable in the first half of 2012. Measures of stress in short-term funding markets have eased somewhat, on balance, since the beginning of the year. A few factors seem to have contributed to the relative stability of those markets. European institutions apparently reduced their demand for funds in recent quarters by selling dollar-denominated assets and exiting from business lines requiring heavy dollar funding. In addition, European banks reportedly switched to secured funding supported by various types of collateral. Further, the availability of funds from the ECB through its longer-term refinancing operations likely helped reduce funding strains and the need to access interbank markets more generally. Reflecting these developments, the amount of dollar swaps outstanding between the Federal Reserve and the ECB has declined substantially from its peak earlier this year.

Conditions in the CP market were also fairly stable. On net, 30-day spreads of rates on unsecured A2/P2 CP over comparable-maturity AA-rated nonfinancial CP declined a bit. The volume outstanding of unsecured financial CP issued in the United States by institutions with European parents decreased slightly in the first half of the year. The average maturity of unsecured financial CP issued by institutions with both U.S. and European parents is about 50 days, a level that is near the middle of its historical range (figure 41).

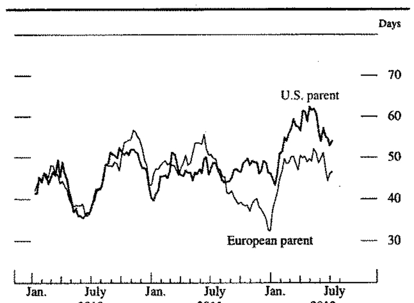
Signs of stress were also largely absent in secured short-term dollar funding markets. In the market for repurchase agreements, bid–asked spreads for most collateral types were little changed. However, short-term interest rates continued to edge up from the level observed around the turn of the year, likely reflecting in part the financing of the increase in dealers' inventories of shorter-term Treasury securities that resulted

40. Interest rates on Treasury securities at selected maturities, 2004–12



Note: The data are daily and extend through July 13, 2012.
Source: Department of the Treasury.

41. Average maturity for unsecured financial commercial paper outstanding in the United States, 2010–12



Note: The data are weekly and extend through July 11, 2012.
Source: Federal Reserve Board staff calculations based on data from the Depository Trust and Clearing Corporation.

The Capital and Liquidity Position of Large U.S. Banks

In mid-March, the Federal Reserve announced the results of the Comprehensive Capital Analysis and Review (CCAR) 2012. This program evaluated the capital planning processes and capital adequacy of 19 of the largest banks, a subset of those that will be required to undergo annual stress-testing exercises by the Board of Governors under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).[1] These 19 bank holding companies (BHCs) also participated in the 2009 Supervisory Capital Assessment Program and the CCAR in 2011. The supervisory stress tests under CCAR 2012 evaluated whether the banks' proposed capital distribution plans would allow them to maintain sufficient capital to support lending to households and businesses even in the event of an extended period of highly adverse economic and financial conditions. The stress scenario incorporated a peak unemployment rate of 13 percent, a drop in equity prices of more than 50 percent, and a decline in house prices of 21 percent. The results indicated that 15 of the 19 BHCs would continue to meet supervisory expectations for several measures of capital adequacy through the end of 2013 despite large projected losses under this extremely adverse hypothetical scenario, given the firms' proposed capital distribution plans.[2]

These results reflect the significant steps these BHCs have taken to improve their capital positions over the past three years. In particular, the aggregate Tier 1 common ratio for these 19 firms has doubled from about 5½ percent in the first quarter of 2009 to close to 11 percent in the first quarter of 2012 (figure A). Much of the improvement over the intervening period can be attributed to increased retained earnings and issuance of common stock during a period of limited growth in risk-weighted assets.

The 19 BHCs subject to the CCAR have also reduced their vulnerabilities to disruptions in funding markets. For instance, they have significantly reduced their reliance on short-term wholesale liabilities relative to total assets since the height of

1. Board of Governors of the Federal Reserve System (2012), *Comprehensive Capital Analysis and Review 2012: Methodology and Results for Stress Scenario Projections* (Washington: Board of Governors, March 13), www.federalreserve.gov/newsevents/press/bcreg/bcreg20120313a1.pdf. The Dodd-Frank Act requires the Board, in coordination with the appropriate primary financial regulatory agencies and the Federal Insurance Office, to conduct annual analyses of nonbank financial companies supervised by the Board and bank holding companies with total consolidated assets equal to or greater than $50 billion to determine whether such companies have the capital necessary to absorb losses that might result from a period of adverse economic conditions. All other financial companies that have total consolidated assets of more than $10 billion and are regulated by a primary federal financial regulatory agency are required to conduct annual internal stress tests. Smaller community banks are not required to undertake stress tests, but any bank's primary regulator may subject the bank to a stress test if conditions warrant. See Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation (2012), "Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets," Supervision and Regulation Letter SR 12-7 (May 14), www.federalreserve.gov/bankinforeg/srletters/sr1207.htm.

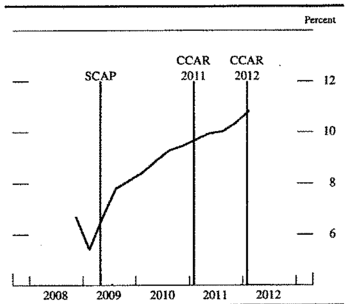
2. The development of sound models is crucial to the credibility of any type of stress-testing exercise. As a result, the Federal Reserve has developed formal procedures by which teams of staff members from around the Federal Reserve System validate the supervisory models used by the Federal Reserve during the CCAR process. Furthermore, in April 2012, the Board announced the formation of the Model Validation Council, composed of outside experts, which will provide the Federal Reserve with independent advice on the processes used for model assessment. See Board of Governors of the Federal Reserve System (2012), "Federal Reserve Board Announces the Formation of the Model Validation Council," press release, April 20, www.federalreserve.gov/newsevents/press/bcreg/20120420a.htm.

from the ongoing MEP and higher-than-expected bill issuance by the Treasury Department earlier in the year. In asset-backed commercial paper (ABCP) markets, volumes outstanding declined for programs with European sponsors, and spreads on ABCP with European bank sponsors remained a bit above those on ABCP with U.S. bank sponsors.

Respondents to the Senior Credit Officer Opinion Survey on Dealer Financing Terms (SCOOS) in both March and June indicated that credit terms applicable to important classes of counterparties have been relatively stable since the beginning of the year.[7] In addition, dealers reported that the use of financial leverage among hedge funds had decreased somewhat since the beginning of 2012. Moreover, respondents to the June SCOOS noted an increase in the amount of resources and attention devoted to the management of concentrated exposures to dealers and other financial interme-

7. The SCOOS is available on the Federal Reserve Board's website at www.federalreserve.gov/econresdata/releases/scoos.htm.

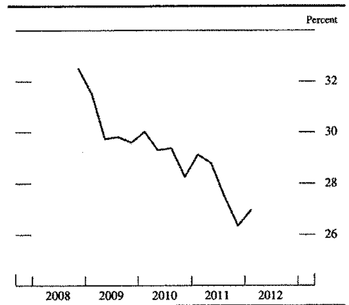
A. Aggregate Tier 1 common ratio of the CCAR institutions, 2008–12



Note: The data are quarterly and extend through 2012:Q1. For the definition of Tier 1 common capital and the list of the 19 Comprehensive Capital Analysis and Review (CCAR) institutions, see Board of Governors of the Federal Reserve System (2012), "Comprehensive Capital Analysis and Review 2012: Methodology for Stress Scenario Projections," paper, March 12, www.federalreserve.gov/newsevents/press/bcreg/bcreg20120312a1.pdf. SCAP is the Supervisory Capital Assessment Program.

Source: Federal Reserve Board, FR Y-9C, Consolidated Financial Statements for Bank Holding Companies.

B. Reliance on wholesale funding by CCAR institutions, 2008–12



Note: The data are quarterly and extend through 2012:Q1. Reliance on wholesale funding is measured as short-term wholesale liabilities to total assets. CCAR is Comprehensive Capital Analysis and Review. Short-term wholesale liabilities is defined as the sum of large time deposits with maturity less than one year, federal funds purchased and securities sold under agreements to repurchase, deposits in foreign offices, trading liabilities (excluding revaluation losses on derivatives), and other borrowed money with maturity less than one year.

Source: Federal Reserve Board, FR Y-9C, Consolidated Financial Statements for Bank Holding Companies.

the financial crisis (figure B). In addition, these BHCs have experienced significant inflows of relatively stable core deposits, owing in part to the availability of unlimited deposit insurance on noninterest-bearing transaction accounts from the Federal Deposit Insurance Corporation until the end of 2012, as well as the generally high demand for safe and liquid assets in the current environment.

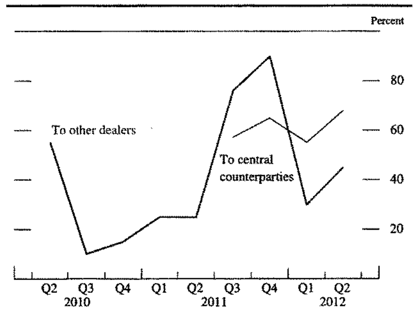
Overall, major U.S. financial institutions are much better positioned to weather an economic downturn while meeting the credit needs of potential borrowers than they were a few years ago, having substantially increased their capital buffers and improved their liquidity positions over the past several years. That said, a significant disruption in global financial markets, such as might occur if the European situation were to worsen markedly, would still pose considerable challenges to the U.S. banking and financial systems.

diaries as well as central counterparties and other financial utilities (figure 42). In response to a special question in the June SCOOS, dealers reported that despite the persistently low level of interest rates, only moderate fractions of their unlevered institutional clients had shown an increased appetite for credit risk or duration risk over the past year.

Financial Institutions

Market sentiment toward the banking industry fluctuated in the first half of 2012. Early in the year, after the actions of the European authorities to ease the euro-area crisis and the release of the results from the CCAR, equity prices for bank holding companies (BHCs) increased and their CDS spreads declined. In late spring—as investors reacted to concerns about Europe—equity prices reversed some of those gains, and CDS spreads rose for large BHCs, especially those with substantial investment-banking operations. More recently, Moody's downgraded the long- and short-term credit ratings of five of the six largest U.S. banks, but none of the banks lost their investment-grade status on long-term debt. The short-term debt ratings of

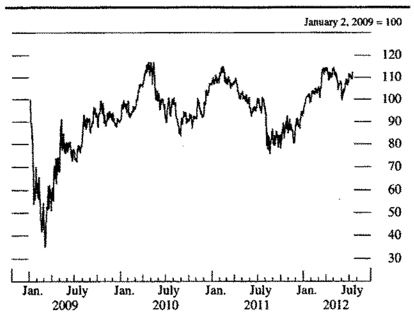
42. Net percentage of dealers reporting increased attention to management of exposures, 2010–12



NOTE: The data are drawn from a survey conducted four times per year; the last observation is from the June 2012 survey, which covers 2012:Q2. Net percentage equals the percentage of institutions that reported increasing attention ("increased considerably" or "increased somewhat") minus the percentage of institutions that reported decreasing attention ("decreased considerably" or "decreased somewhat").
SOURCE: Federal Reserve Board, Senior Credit Officer Opinion Survey on Dealer Financing Terms.

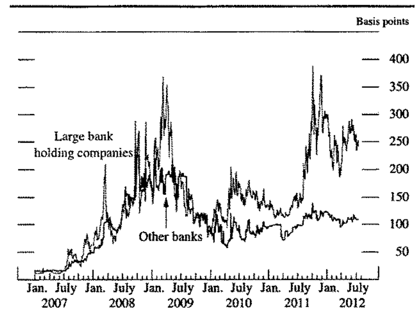
some banks were downgraded to Prime-2, which may affect the ability of some to place significant amounts of CP with money market funds, but the market effect appears to have been muted so far, as those banks currently have limited demand for such funding. On balance, equity prices of banks rose significantly from relatively low levels at the start of the year (figure 43); an index of CDS spreads for large BHCs declined about 60 basis points but remained at a high level (figure 44).

43. Equity price index for banks, 2009–12



NOTE: The data are daily and extend through July 13, 2012.
SOURCE: Standard & Poor's.

44. Spreads on credit default swaps for selected U.S. banking organizations, 2007–12

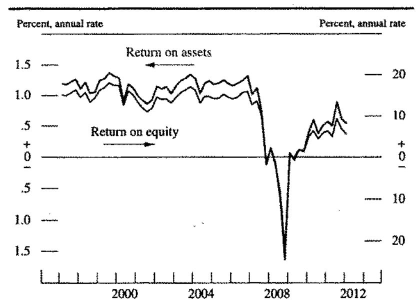


NOTE: The data are daily and extend through July 13, 2012. Median spreads for six large bank holding companies and nine other banks.
SOURCE: Markit.

The profitability of BHCs decreased slightly in the first quarter of 2012 and remained well below the levels that prevailed before the financial crisis (figure 45). Litigation provisions taken by some large banks in connection with the mortgage settlement reached earlier this year accounted for some of the downward pressure on bank profitability. The variability in earnings due to accounting gains and losses related to changes in the market value of banks' own debt amplified recent swings of bank profits.[8] Smoothing through

8. Under fair value accounting rules, changes in the creditworthiness of a BHC generate changes in the value of some of its liabilities. Those changes are then reflected as gains or losses on the income statement.

45. Profitability of bank holding companies, 1997–2012

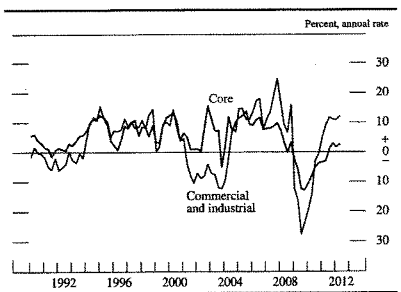


NOTE: The data are quarterly and extend through 2012:Q1.
SOURCE: Federal Reserve Board, FR Y-9C, Consolidated Financial Statements for Bank Holding Companies.

these special factors, profitability has been about flat in recent quarters. Net income continued to be supported by the release of loan loss reserves, albeit to a lesser extent than in the previous year, as charge-off rates decreased a bit further across most major asset classes. Still-subdued dividend payouts and share repurchases as well as reductions in risk-weighted assets pushed regulatory capital ratios higher in the first quarter of 2012 (see the box "Implementing the New Financial Regulatory Regime").

Credit provided by commercial banking organizations in the United States increased in the first half of 2012 at about the same moderate pace as in the second half of 2011. Core loans—the sum of C&I loans, real estate loans, and consumer loans—expanded modestly; as noted earlier, the upturn in lending was particularly noticeable for C&I loans (figure 46). The expansion in C&I lending has been broad based outside of U.S. branches and agencies of European banks and has been particularly evident at large domestic banks. This pattern is consistent with SLOOS results suggesting that a portion of the increase in C&I lending observed at large domestic banks reflected decreased competition from European banks and their affiliates and subsidiaries for either foreign or domestic customers. Banks' holdings of securities rose moderately, with purchases concentrated in Treasury securities and agency-guaranteed MBS. Given the still-depressed housing market, banks continued to be attracted by the government guarantee on agency securities, and some large banks may also have been accumulating government-backed securities to improve their liquidity positions.

46. Change in commercial and industrial loans and core loans, 1990–2012



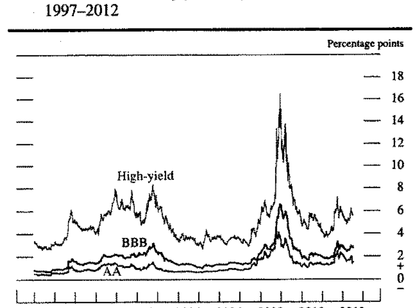
NOTE: The data, which are seasonally adjusted, are quarterly and extend through 2012:Q2. Core loans consist of commercial and industrial loans, real estate loans, and consumer loans. Data have been adjusted for banks' implementation of certain accounting rule changes (including the Financial Accounting Standards Board's Statements of Financial Accounting Standards Nos. 166 and 167) and for the effects of large nonbank institutions converting to commercial banks or merging with a commercial bank.
SOURCE: Federal Reserve Board, Statistical Release H.8, "Assets and Liabilities of Commercial Banks in the United States."

Corporate Debt and Equity Markets

Yields on investment-grade bonds reached record lows in June, partly reflecting the search by investors for relatively safe assets in light of rising concerns about Europe as well as the weakness in the domestic and global economic data releases. However, yields on speculative-grade corporate debt, which had reached record-low levels in February, rose somewhat in the second quarter reflecting those same concerns. The spread on investment-grade corporate bonds was about unchanged, on net, relative to the start of the year. Despite the backup in yields over the second quarter, spreads on speculative-grade corporate bonds decreased some, on balance, over the same period (figure 47). Prices in the secondary market for syndicated leveraged loans have changed little, on balance, since the beginning of the year; demand from institutional investors for these mostly floating-rate loans has remained strong despite the reemergence of anxiety about developments in Europe (figure 48).

Broad equity price indexes were boosted early in the year by improved sentiment stemming in part from relatively strong job gains as well as actions taken by major central banks to mitigate the financial strains

47. Spreads of corporate bond yields over comparable off-the-run Treasury yields, by securities rating, 1997–2012



NOTE: The data are daily and extend through July 13, 2012. The spreads shown are the yields on 10-year bonds less the 10-year Treasury yield.
SOURCE: Derived from smoothed corporate yield curves using Merrill Lynch bond data.

Implementing the New Financial Regulatory Regime

The Board of Governors is involved in approximately 250 initiatives–including rulemakings, associated guidance, studies of various financial issues, and design of internal processes–related to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). The Board is the lead agency responsible for implementing a significant number of rulemakings required under the act and is also, on many of these initiatives, working in conjunction with other federal agencies. For example, as a member of the Financial Stability Oversight Council (FSOC), the Board has contributed to FSOC studies mandated by the act and has assisted the FSOC with proposed and final rulemakings.

A number of the rulemakings are directed at enhancing bank supervision and prudential standards. In one recent action, the Board and the other federal bank regulatory agencies issued a final rule on June 7, 2012, that implements changes to the market risk capital rule. These changes bring it into conformance with international standards and replace agency credit ratings with alternative standards of creditworthiness in accordance with the requirements of section 939A of the Dodd-Frank Act.[1] In addition, "living wills" were prepared by bank holding companies with assets of $50 billion or more based on a final rule issued in October 2011.[2] On June 29, 2012, the Board and the Federal Deposit Insurance Corporation announced the process they will use to review, during the second half of 2012, the first set of these plans from some of the largest internationally active banking organizations.[3]

Also, several key notices of proposed rulemakings (NPRs) implementing the Dodd-Frank Act have been issued thus far in 2012. In particular, on June 7, 2012, the Board issued for comment three proposed rules that, taken together, integrate the capital provisions of section 171 of the act with those of Basel III capital standards in order to enhance financial stability while minimizing the burden on affected institutions.[4]

1. Board of Governors of the Federal Reserve System (2012), "Federal Reserve Board Approves Final Rule to Implement Changes to Market Risk Capital Rule," press release, June 7, www.federalreserve.gov/newsevents/press/bcreg/20120607b.htm.

2. Board of Governors of the Federal Reserve System (2011), "Federal Reserve Board Approves Final Rule Implementing the Resolution Plan Requirement of the Dodd-Frank Act," press release, October 17, www.federalreserve.gov/newsevents/press/bcreg/20111017a.htm.

3. Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation (2012), "Federal Reserve Board and Federal Deposit Insurance Corporation Announce Process for Receiving and Evaluating Initial Resolution Plans, Also Known as Living Wills," joint press release, June 29, www.federalreserve.gov/newsevents/press/bcreg/20120629b.htm.

4. With the encouragement and support of the U.S. bank regulatory agencies, the Basel Committee on Banking Supervision has strengthened global capital requirements: raising risk weightings for traded assets, improving the quality of loss-absorbing capital through a new minimum common equity ratio standard, creating a capital conservation buffer, and introducing an international leverage ratio requirement. See Basel Committee on Banking Supervision (2010), *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Basel, Switzerland: Bank for International

emanating from Europe. However, equity price indexes subsequently reversed a portion of their earlier gains as concerns about the European banking and fiscal crisis intensified again and economic reports suggested slower growth, on balance, at home and abroad (figure 49). The spread between the 12-month forward earnings–price ratio for the S&P 500 and a real long-run Treasury yield—a rough gauge of the equity risk premium—widened a bit more in the first half of 2012, and is now closer to the very high levels it reached in 2008 and again last fall (figure 50). Implied volatility for the S&P 500 index, as calculated from option prices, spiked at times this year but is currently toward the bottom end of the range that this indicator has occupied since the onset of the financial crisis (figure 51).

In the current environment of very low interest rates, mutual funds that invest in higher-yielding debt instruments (including speculative-grade corporate bonds and leveraged loans) continued to have significant inflows for most of the first half of 2012, while money market funds experienced outflows (figure 52). Equity mutual funds also recorded modest outflows early in the year and, as market sentiment deteriorated, both equity and high-yield mutual funds registered outflows in May.

The first NPR would increase the quantity and quality of capital by, in part, requiring a new minimum common equity Tier 1 ratio of 4.5 percent, instituting a common equity Tier 1 capital conservation buffer of 2.5 percent, and raising the minimum for the broader Tier 1 capital ratio from 4 percent to 6 percent.[5] The NPR does not address specific Basel III liquidity standards, which have not been finalized by the Basel Committee on Banking Supervision.[6]

The second NPR revises certain aspects of the risk-based capital requirements in order to enhance risk sensitivity and address weaknesses in the calculation of risk-weighted assets that have been identified over the past several years. The third NPR requires internationally active banks to improve the risk sensitivity of parts of their current advanced approaches to risk-based capital processes to better address counterparty credit risk and interconnectedness among financial institutions.

Several other actions taken with regard to the Dodd-Frank Act provided additional clarity to proposed rulemakings. For example, on April 2, 2012, the Board published an amendment to a proposed rulemaking clarifying the activities that are deemed to be financial for purposes of title I of the Dodd-Frank Act. This rulemaking is designed to provide clarity regarding firms that may be designated for enhanced supervision by the FSOC.[7] In addition, the Board, along with other regulatory agencies, is reviewing about 19,000 comment letters on the proposal to implement section 619 of the act, commonly known as the Volcker rule. The rule generally prohibits banking entities from engaging in proprietary trading or acquiring an ownership interest in, sponsoring, or having certain other relationships with a hedge fund or private equity fund. On April 19, the Board issued a clarification regarding the Volcker rule conformance period, stating that a banking entity has the full two-year period provided by statute (that is, until July 21, 2014), unless extended by the Board, to fully conform its activities and investments to the requirements of the Volcker rule.[8]

Settlements, December; rev. June 2011), www.bis.org/publ/bcbs189.htm.

5. The Tier 1 capital ratio is the ratio of Tier 1 capital to risk-weighted assets. Tier 1 capital consists primarily of common equity (excluding intangible assets such as goodwill and excluding net unrealized gains on investment account securities classified as available for sale) and certain perpetual preferred stock.

6. Basel Committee on Banking Supervision (2010), *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring* (Basel, Switzerland: Bank for International Settlements, December), www.bis.org/publ/bcbs188.htm.

7. Under title I of the Dodd-Frank Act, a company generally can be designated for Board supervision by the FSOC only if 85 percent or more of the company's revenues or assets are related to activities that are financial in nature under the Bank Holding Company Act.

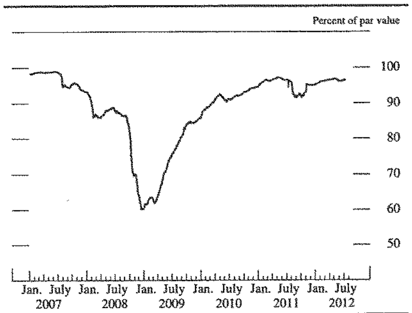
8. Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Securities and Exchange Commission (2012), "Volcker Rule Conformance Period Clarified," joint press release, April 19, www.federalreserve.gov/newsevents/press/bcreg/20120419a.htm.

Monetary Aggregates and the Federal Reserve's Balance Sheet

The growth rate of M2 slowed in the first half of 2012 to an annual rate of about 7 percent (figure 53).[9] However, the levels of M2 and its largest component, liquid deposits, remain elevated relative to what would have been expected based on historical relationships with nominal income and interest rates, likely reflecting investors' continued preference to hold safe and liquid assets. Currency in circulation increased robustly, reflecting solid demand both at home and abroad. Retail money market funds and small time deposits continued to contract. At the same time as currency in circulation was increasing, reserve balances held at the Federal Reserve were decreasing; as a result, the monetary base—which is equal to the sum of these two

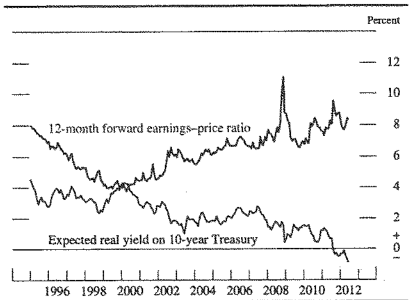
9. M2 consists of (1) currency outside the U.S. Treasury, Federal Reserve Banks, and the vaults of depository institutions; (2) traveler's checks of nonbank issuers; (3) demand deposits at commercial banks (excluding those amounts held by depository institutions, the U.S. government, and foreign banks and official institutions) less cash items in the process of collection and Federal Reserve float; (4) other checkable deposits (negotiable order of withdrawal, or NOW, accounts and automatic transfer service accounts at depository institutions; credit union share draft accounts; and demand deposits at thrift institutions); (5) savings deposits (including money market deposit accounts); (6) small-denomination time deposits (time deposits issued in amounts of less than $100,000) less individual retirement account (IRA) and Keogh balances at depository institutions; and (7) balances in retail money market mutual funds less IRA and Keogh balances at money market mutual funds.

48. Secondary-market bid prices for syndicated loans, 2007–12



NOTE: The data are daily and extend through July 13, 2012.
SOURCE: LSTA/Thomson Reuters Mark-to-Market Pricing.

50. Real long-run Treasury yield and 12-month forward earnings–price ratio for the S&P 500, 1995–2012



NOTE: The data are monthly and extend through June 2012. The expected real yield on 10-year Treasury is defined as the off-the-run 10-year Treasury yield less the Philadelphia Fed 10-year expected inflation.
SOURCE: Standard & Poor's; Federal Reserve Board.

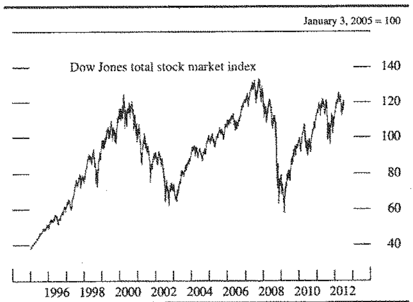
items—changed little, on average, over the first half of the year.

Total assets of the Federal Reserve decreased to $2,868 billion as of July 11, 2012, about $60 billion less than at the end of 2011 (table 1). The small decrease since December largely reflects lower usage of foreign central bank liquidity swaps and declines in the net portfolio holdings of the Maiden Lane LLCs. The composition of Treasury security holdings changed over the course of the first half of this year as a result of the implementation of the MEP. As of July 13, 2012, the Open Market Desk at the Federal Reserve Bank of New York (FRBNY) had purchased $283 billion in Treasury securities with remaining maturities of 6 to 30 years and sold or redeemed $293 billion in Treasury securities with maturities of 3 years or less under the MEP.[10] Total Federal Reserve holdings of agency MBS increased about $18 billion as the policy of reinvesting principal payments from agency debt and agency MBS into agency MBS continued.

In the first half of 2012, the Federal Reserve continued to reduce its exposure to facilities established dur-

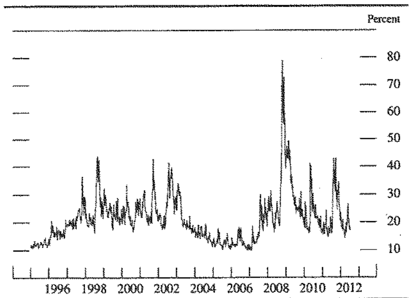
10. Between the MEP's announcement in September 2011 and the end of that year, the Desk had purchased $133 billion in longer-term Treasury securities and had sold $134 billion in shorter-term Treasury securities.

49. Stock price index, 1995–2012



NOTE: The data are daily and extend through July 13, 2012.
SOURCE: Dow Jones Indexes.

51. Implied S&P 500 volatility, 1995–2012



NOTE: The data are weekly and extend through the week ending July 13, 2012. The series shown—the VIX—is the implied 30-day volatility of the S&P 500 stock price index as calculated from a weighted average of options prices.
SOURCE: Chicago Board Options Exchange.

1. Selected components of the Federal Reserve balance sheet, 2010–12

Millions of dollars

Balance sheet item	Dec. 28, 2011	Feb. 22, 2012	July 11, 2012
Total assets	**2,928,485**	**2,935,149**	**2,868,387**
Selected assets			
Credit extended to depository institutions and dealers			
Primary credit	42	3	8
Central bank liquidity swaps	99,823	107,959	29,708
Credit extended to other market participants			
Term Asset-Backed Securities Loan Facility (TALF)	9,013	7,629	4,504
Net portfolio holdings of TALF LLC	811	825	845
Support of critical institutions			
Net portfolio holdings of Maiden Lane LLC, Maiden Lane II LLC, and Maiden Lane III LLC[1]	34,248	30,822	15,388
Credit extended to American International Group, Inc.	...	...	...
Preferred interests in AIA Aurora LLC and ALICO Holdings LLC	...	...	...
Securities held outright			
U.S. Treasury securities	1,672,092	1,656,581	1,663,949
Agency debt securities	103,994	100,817	91,484
Agency mortgage-backed securities (MBS)[2]	837,295	853,045	855,044
Total liabilities	**2,874,686**	**2,880,556**	**2,813,713**
Selected liabilities			
Federal Reserve notes in circulation	1,034,520	1,048,004	1,073,732
Reverse repurchase agreements	88,674	89,824	89,689
Deposits held by depository institutions	1,569,267	1,622,800	1,527,556
Of which: Term deposits	0	0	0
U.S. Treasury, general account	91,418	36,033	75,287
U.S. Treasury, Supplementary Financing Account	0	0	0
Total capital	**53,799**	**54,594**	**54,674**

NOTE: LLC is a limited liability company.

1. The Federal Reserve has extended credit to several LLCs in conjunction with efforts to support critical institutions. Maiden Lane LLC was formed to acquire certain assets of The Bear Stearns Companies, Inc. Maiden Lane II LLC was formed to purchase residential mortgage-backed securities from the U.S. securities lending reinvestment portfolio of subsidiaries of American International Group, Inc. (AIG). Maiden Lane III LLC was formed to purchase multisector collateralized debt obligations on which the Financial Products group of AIG has written credit default swap contracts.

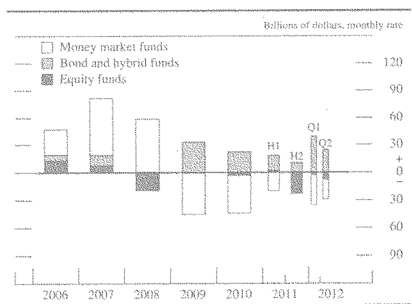
2. Includes only MBS purchases that have already settled.

. . . Not applicable.

SOURCE: Federal Reserve Board, Statistical Release H.4.1, "Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks."

ing the financial crisis to support specific institutions. The portfolio holdings of Maiden Lane LLC, Maiden Lane II LLC, and Maiden Lane III LLC—entities that were created during the crisis to acquire certain assets from The Bear Stearns Companies, Inc., and American International Group, Inc. (AIG), to avoid the disorderly failures of those institutions—declined, on net, primarily as a result of asset sales and principal payments. Of note, proceeds from the sales of all of the remaining assets in the Maiden Lane II LLC portfolio

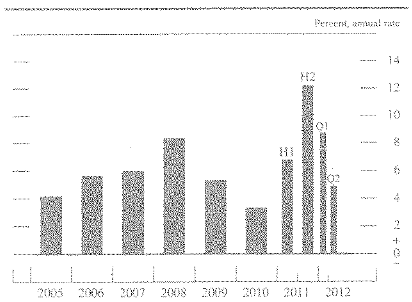
52. Net flows into mutual funds, 2006–12



NOTE: The reading for 2012:Q2 is the average for April and May. The data exclude reinvested dividends and are not seasonally adjusted.

SOURCE: Investment Company Institute.

53. M2 growth rate, 2005–12



NOTE: For definition of M2, see text note 9.

SOURCE: Federal Reserve Board, Statistical Release H.6, "Money Stock Measures."

in January and February enabled the repayment of the entire remaining outstanding balance of the senior loan from the FRBNY to Maiden Lane II LLC in March, with interest and a $2.8 billion net gain. In addition, proceeds from the sales of assets from Maiden Lane LLC and Maiden Lane III LLC in April and May enabled the repayment, with interest, of the entire remaining outstanding balances of the senior loans from the FRBNY to Maiden Lane LLC and Maiden Lane III LLC in June. Proceeds from further asset sales from Maiden Lane III in June enabled repayment of the equity position of AIG in July. A net gain on the sale of the remaining assets in Maiden Lane III LLC is likely during the next few months. Sales of most of the remaining assets in Maiden Lane LLC should be completed by the end of the year, but a few legacy assets may take longer to dispose of. Loans outstanding under the Term Asset-Backed Securities Loan Facility (TALF) were slightly lower, reflecting, in part, the first maturity of a TALF loan with a three-year initial term.

On the liability side of the Federal Reserve's balance sheet, deposits held by depository institutions declined about $42 billion in the first half of 2012, while Federal Reserve notes in circulation increased roughly $39 billion. As part of its ongoing program to ensure the readiness of tools to drain reserves when doing so becomes appropriate, the Federal Reserve conducted a series of small-scale reverse repurchase transactions involving all eligible collateral types with its expanded list of counterparties. In the same vein, the Federal Reserve also continued to offer small-value term deposits through the Term Deposit Facility.

On March 20, the Federal Reserve System released its 2011 combined annual comparative audited financial statements. The Federal Reserve reported net income of about $77 billion for the year ending December 31, 2011, derived primarily from interest income on securities acquired through open market operations (Treasury securities, federal agency and GSE MBS, and GSE debt securities). The Reserve Banks transferred about $75 billion of the $77 billion in comprehensive income to the U.S. Treasury in 2011; though down slightly from 2011, the transfer to the U.S. Treasury remained historically very large.

International Developments

The European fiscal and banking crisis continued to affect international financial markets and foreign economic activity during the first half of 2012. Early in the year, aggressive action by the ECB and some progress in addressing the crisis by the region's leaders contributed to a temporary easing of financial stresses. (See the box "An Update on the European Fiscal and Banking Crisis.") However, amid ongoing political uncertainty in Greece and increased concerns about the health of Spanish banks, financial conditions deteriorated again in the spring. Foreign economic growth picked up in the first quarter, but this acceleration largely reflected temporary factors, and recent data point to widespread slowing in the second quarter.

International Financial Markets

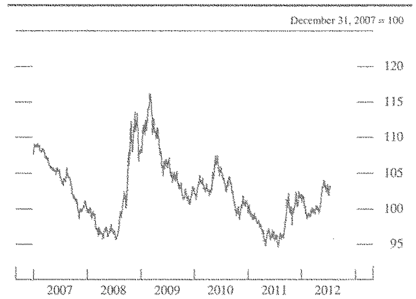
Foreign financial markets have been volatile. Initially in the first quarter, encouraging macroeconomic data and some easing of tensions within the euro area led to an improvement in global financial conditions. This improvement was reversed in the spring as the boost from previous policy measures, including the ECB's longer-term refinancing operations, faded and political and banking stresses in vulnerable European countries resurfaced. Euro-area leaders responded to the worsening of the crisis by announcing additional measures at a summit on June 28–29. The market reaction was positive but short-lived.

Increased uncertainty and greater volatility have pushed up the foreign exchange value of the dollar about 4¼ percent on a trade-weighted basis against a broad set of currencies since its low in early February, with most of the appreciation occurring in May (figure 54). Typical of periods of flight to safety, the dollar has appreciated against most currencies but depreciated against the Japanese yen for most of the period (figure 55). The Swiss franc has moved very closely with the euro as the Swiss National Bank has intervened to maintain a ceiling for the franc relative to the euro.

During the second quarter of this year, flight-to-safety flows and the deteriorating global economic outlook helped push government bond yields for Canada, Germany, and the United Kingdom to record lows (figure 56). Likewise, Japanese yields on 10-year bonds fell well below 1 percent. By contrast, Spanish sovereign spreads over German bunds rose more than 250 basis points between February and June due to escalating concerns over Spain's public finances (figure 57). Italian sovereign spreads moved up as well over this period.

Equity prices abroad declined significantly in the second quarter, more so than in the United States. Indexes tumbled in the nations at the center of the euro-area fiscal and banking crisis, and the fall in value

54. U.S. dollar nominal exchange rate, broad index, 2007–12

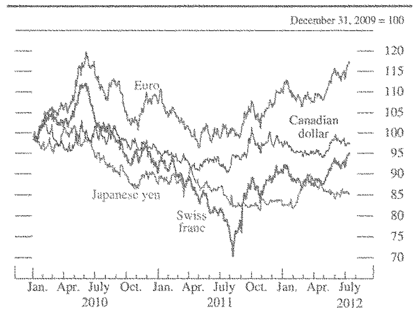


NOTE: The data, which are in foreign currency units per dollar, are daily. The last observation for the series is July 13, 2012. The broad index is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of the most important U.S. trading partners. The index weights, which change over time, are derived from U.S. export shares and from U.S. and foreign import shares.
SOURCE: Federal Reserve Board, Statistical Release H.10, "Foreign Exchange Rates."

from their March peaks was more than 10 percent across the advanced foreign economies (AFEs) (figure 58). This fall was attenuated toward the end of the second quarter by the positive market reaction to the June summit. Equity markets in the EMEs were also markedly down in the second quarter (figure 59).

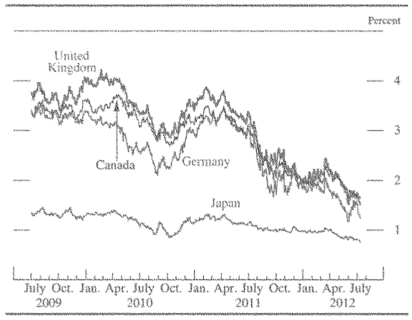
European banks faced renewed stresses in recent months. In Greece, after inconclusive elections in early May, deposit outflows from banks accelerated, generat-

55. U.S. dollar exchange rate against selected major currencies, 2010–12



NOTE: The data, which are in foreign currency units per dollar, are daily. The last observation for each series is July 13, 2012.
SOURCE: Federal Reserve Board, Statistical Release H.10, "Foreign Exchange Rates."

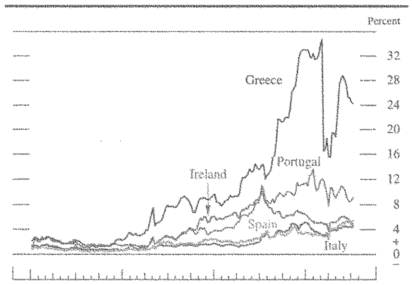
56. Yields on benchmark government bonds in selected advanced foreign economies, 2009–12



NOTE: The data, which are for 10-year bonds, are daily. The last observation for each series is July 13, 2012.
SOURCE: Bloomberg.

ing concerns that deposit flight could spread to banking systems in the rest of the euro area. News that Spain had partly nationalized the troubled lender Bankia and would need to inject an additional €19 billion into the bank and its holding company added to unease about the region, eventually leading to plans for an official aid package of up to €100 billion to recapitalize Spanish banks. Apprehension about bank health was widespread, with major institutions in Italy, Germany, and several other European countries receiving credit ratings downgrades. As a result, European bank stock prices have tumbled since mid-March (figure 60). At the same time, reflecting market views of increased

57. Government debt spreads for peripheral European economies, 2009–12



NOTE: The data are weekly. The last observation for each series is July 13, 2012. The spreads shown are the yields on 10-year bonds less the 10-year German bond yield.
SOURCE: Bloomberg.

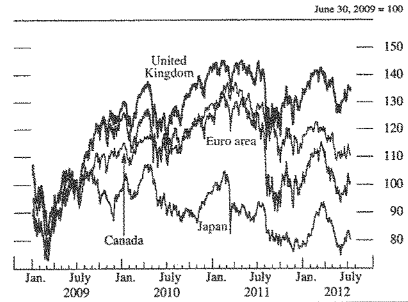
An Update on the European Fiscal and Banking Crisis

Over the past several months, the crisis in Europe has waxed and waned as stresses related to financing sovereigns and the condition of banking sectors have forced significant, but not definitive, policy responses. Late last year, the ongoing difficulties in the region, combined with deteriorating economic conditions, led to acute funding pressures for European financial institutions and a number of sovereigns. In response, the European Central Bank took actions in early December to ease credit conditions, including the provision of three-year refinancing to banks, and euro-area leaders agreed to strengthen fiscal rules and expand their rescue facilities. Those actions, along with the re-pricing and duration extension of the dollar liquidity swap lines with the Federal Reserve, reduced funding costs in euros and dollars for European banks and contributed to a marked improvement in financial conditions in the first few months of this year.

Early in 2012, euro-area authorities followed through on their commitment to put Greek finances on a more sustainable footing and to review the adequacy of the financial backstops for other vulnerable European countries. The Greek government concluded a restructuring of its privately held bonds, which reduced the face value of that debt by slightly more than half, and negotiated a second program with the European Union (EU) and the International Monetary Fund (IMF) worth about €170 billion. Around the same time, euro-area authorities lifted the ceiling on the combined lending of the region's rescue facilities, the European Financial Stability Facility and its successor, the European Stability Mechanism (ESM), from €500 billion to €700 billion, and they accelerated the schedule for capitalizing the ESM. In addition, leaders of the Group of Twenty countries and other IMF shareholders pledged about $450 billion in new financing to the IMF, which should enable the IMF to substantially increase its lending capacity.

Notwithstanding these initiatives, events in Greece and Spain during the spring again heightened financial stresses throughout the region. Political uncertainty in Greece increased considerably, and market concerns grew over the possibility of a Greek exit from the euro area, after the country's inconclusive parliamentary elections in early May. Amid increasing political fragmentation and strong electoral support for parties calling for a major renegotiation of the second EU-IMF program, elected representatives were unable to form a majority government and another round of elections was held on June 17. In the weeks leading up to the second election, withdrawals of deposits from Greek banks reportedly increased, adding to pressures on the domestic financial system. Ultimately, the two major parties that had negotiated the second EU-IMF program obtained sufficient votes to form the core of a coalition government. Uncertainty remains, however, over possible

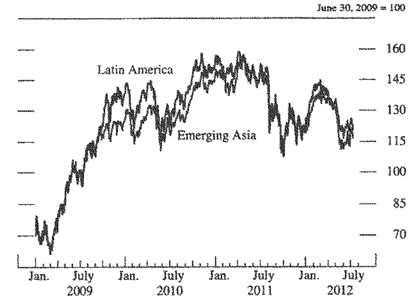
58. Equity indexes in selected advanced foreign economies, 2009–12



NOTE: The data are daily. The last observation for each series is July 13, 2012.

SOURCE: For Canada, Toronto Stock Exchange 300 Composite Index; for the euro area, Dow Jones Euro STOXX Index; for Japan, Tokyo Stock Exchange (TOPIX); and, for the United Kingdom, London Stock Exchange (FTSE 350); all via Bloomberg.

59. Aggregate equity indexes for emerging market economies, 2009–12



NOTE: The data are daily. The last observation for each series is July 13, 2012. The Latin American economies are Argentina, Brazil, Chile, Colombia, Mexico, and Peru; the emerging Asian economies are China, India, Indonesia, Malaysia, Pakistan, the Philippines, South Korea, Taiwan, and Thailand.

SOURCE: Bloomberg.

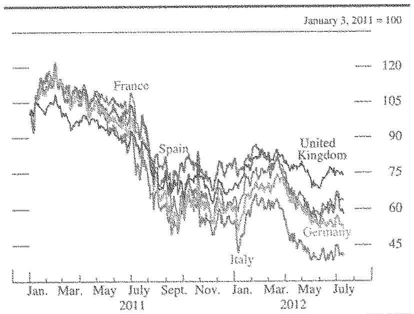
renegotiation of the terms of the EU–IMF program for Greece. Regardless of the outcome of those discussions, the Greek government must still implement difficult austerity measures to continue receiving official financing under the program.

Financial stresses also increased sharply in Spain as concerns about its public finances and the cost of stabilizing the banking system mounted. With economic activity declining, unemployment on the rise, and the budgets of regional governments under considerable strains, the Spanish government missed its 2011 budget deficit target by a wide margin and raised the country's deficit target for 2012 after contentious negotiations with euro-area authorities. Meanwhile, the ongoing bust in the Spanish real estate sector and the depressed economic conditions more generally continued to weigh on the profitability of regional and local banks, prompting market speculation that the public debt could be significantly boosted by further bank bailouts. As market pressures increased, in June the Spanish government requested European financial assistance of up to €100 billion for its banking system. Markets remained concerned, however, in part because the assistance would have the effect of increasing Spain's sovereign debt.

As pressures on Spain mounted and spilled over to Italy, there were renewed calls for euro-area countries to move toward greater fiscal and financial union. At their June 28–29 summit, EU officials announced additional measures toward that goal. Leaders pledged to further integrate the supervision of European banks, to allow the euro-area financial backstop facilities to directly recapitalize banks (as opposed to requiring sovereigns to borrow to support their banks), and to provide greater lending through the European Investment Bank in support of growth and employment. Essential details about implementation of such initiatives, however, have yet to be resolved.

All told, European economies still face significant challenges. In the near term, euro-area policymakers must restore confidence in the region's banks and in the sustainability of sovereign finances. Policy measures, including the steps to improve the availability of dollar and euro funds late last year, are supporting access to funding for European banks, but risks to the stability of domestic financial systems remain. The region must also find ways to stimulate economic growth and improve competitiveness in the most vulnerable countries even as they undertake major fiscal consolidations. Over the longer term, euro-area policymakers need to establish an effective institutional framework to foster economic, financial, and fiscal integration and, ultimately, to increase the resilience of the monetary union.

60. Bank stock price indexes for selected European countries, 2011–12



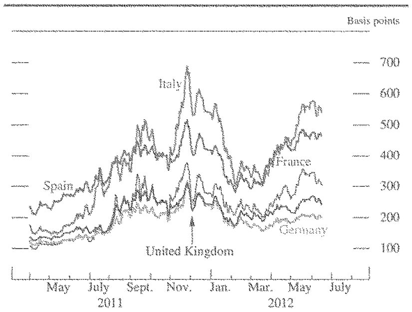
NOTE: The data are daily. The last observation for each series is July 13, 2012.
SOURCE: Bloomberg.

risk of default, the CDS premiums on the debt of many large banks in Europe have risen substantially (figure 61), while issuance of unsecured bank debt, which had previously recovered, has fallen. Notwithstanding these developments, funding market stresses have remained relatively muted, as many banks accessed funds from the Eurosystem—the system formed by the ECB and the national central banks of the euro-area member states—rather than interbank markets. A standard measure of the cost of this interbank funding, the implied basis spread from euro–dollar swaps, was little changed at shorter maturities.

Advanced Foreign Economies

The European fiscal and banking crisis was at the center of economic developments in the AFEs. Euro-area real GDP was flat in the first quarter of 2012 following a contraction in late 2011. Within the euro area, out-

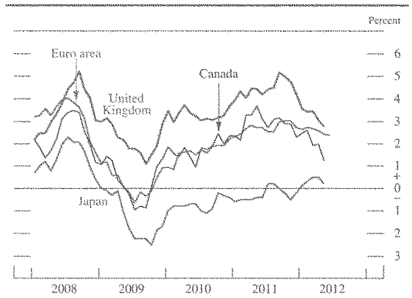
61. Credit default swap premiums for banks in selected European countries, 2011–12



NOTE: The data are daily. The last observation for each series is July 13, 2012. Credit default swaps are on bank senior debt and weighted by bank total assets.

SOURCE: Markit; Bloomberg; Federal Reserve Board staff calculations.

62. Change in consumer prices for major foreign economies, 2008–12



NOTE: The data are monthly and extend through May 2012, except for the euro area for which the data extend through June 2012; the percent change is from one year earlier.

SOURCE: For the euro area, the European Central Bank; for the United Kingdom, the U.K. Office for National Statistics; for Japan, the Japan Statistics Bureau; and, for Canada, Statistics Canada; all via Haver Analytics.

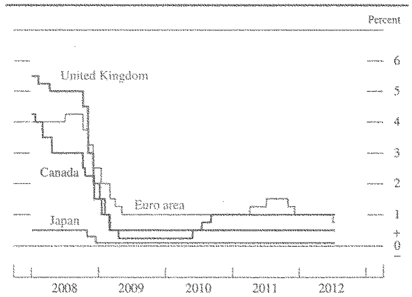
put fell sharply in more vulnerable countries, including Italy and Spain, whereas other countries, especially Germany, performed better. Mounting financial tensions and fiscal austerity measures appear to have further restrained the euro-area economy in the second quarter, as evidenced by declining business confidence and a further drift of purchasing managers indexes into contractionary territory.

Economic performance in the other AFEs has been uneven. In the United Kingdom, real GDP continued to fall early in the year, and indicators point to further weakness fueled by tight fiscal policy and negative spillover effects from the euro area. In Japan, output rose at a robust pace in the first quarter, reflecting fiscal stimulus measures as well as a recovery from the shortage of parts supplies caused by the floods in Thailand last year, but recent data suggest that activity decelerated in the second quarter. The Canadian economy continued to expand moderately in the first three months of the year, supported by solid domestic demand and a resilient labor market.

In most AFEs, headline inflation rates—measured on a 12-month change basis—continued to decline in the first half of the year as the effects of the large run-up in commodity prices in early 2011 waned. The smaller run-up in energy prices that took place early this year exerted a less marked effect on consumer prices, though it helped keep 12-month inflation rates above 2 percent in the euro area and in the United Kingdom (figure 62). Japan appears to be emerging from several years of deflation, but Japanese inflation remains below the 1 percent inflation goal introduced by the BOJ in February.

Several central banks eased further their monetary policy stances. The BOJ increased the size of its asset purchases from ¥30 trillion to ¥40 trillion in April, and then to ¥45 trillion in July. The ECB, after having conducted the second of its three-year longer-term refinancing operations in late February, cut its policy interest rates to record lows in early July (figure 63). In late June, the Bank of England (BOE) activated its

63. Official or targeted interest rates in selected advanced foreign economies, 2008–12



NOTE: The data are daily and extend through July 13, 2012. The data shown are, for Canada, the target for the overnight rate; for the euro area, the minimum bid rate on main refinancing operations; for Japan, the target for the call rate; and, for the United Kingdom, the official Bank Rate.

SOURCE: The central bank of each area or country shown.

Extended Collateral Term Repo facility, offering six-month funds against a wide set of collateral. In addition, in July, the BOE increased the size of its asset purchase program from £325 billion to £375 billion, and, together with the U.K. Treasury, introduced a new Funding for Lending Scheme designed to boost lending to households and firms.

Emerging Market Economies

Following a disappointing performance at the end of last year, real GDP growth rebounded in the first quarter in most EMEs. Economic activity expanded especially briskly in emerging Asia, largely reflecting the reconnection of supply chains damaged by the floods in Thailand. Economic growth, however, continued to slow in China and India. Moreover, recent indicators suggest that the pace of economic activity decelerated in most EMEs going into the second quarter amid headwinds associated with the European crisis and relatively subdued growth in China.

In China, real GDP increased at about a 7 percent pace in the first half of the year, down from an 8½ percent pace in the second half of last year. The slowdown reflected weaker demand for Chinese exports as well as domestic factors, including moderating consumer spending and the restraining effects on investment of previous government measures to cool activity in the property sector. Macroeconomic data for May and June suggest that economic activity was picking up a bit toward the end of the second quarter, with growth of investment, retail sales, and bank lending edging higher. Headline 12-month inflation fell to 2.2 percent in June, led by additional moderation in food prices. As inflationary pressures eased and concerns about growth mounted, the People's Bank of China lowered banks' reserve requirements by 50 basis points in both February and May and then reduced the benchmark one-year lending rate by 25 basis points in June and 31 basis points in July, the first changes in that rate since an increase in July of last year. Over the first half of the year, the renminbi was little changed, on net, against the dollar, but it appreciated about 1½ percent on a real trade-weighted basis, as the renminbi followed the dollar upward against China's other major trading partners.

In India, economic growth has also moderated as slow progress on fiscal and structural reforms and previous monetary tightening stalled investment. Noting rising vulnerabilities from the country's twin fiscal and current account deficits, some credit rating agencies warned that India's sovereign debt risks losing its investment-grade status.

In Mexico, economic activity rebounded briskly in the first quarter as the agricultural sector rebounded from the fourth-quarter drought, domestic demand gained momentum, and exports to the United States picked up. Economic indicators, however, suggest that growth moderated somewhat in the second quarter. On July 1, Enrique Peña Nieto of the Institutional Revolutionary Party, or PRI, won the Mexican presidential election, promising to pursue market-oriented reforms to bolster economic growth.

In Brazil, real GDP—restrained by flagging investment and weather-related problems in the agricultural sector—increased slightly in the first quarter, making it the fourth consecutive quarter of below-trend growth. Industrial production, which has been on a downward trend since early 2011, continued to fall through May, suggesting that economic activity in Brazil remained weak in the second quarter.

Headline inflation generally moderated in the EMEs reflecting lower food price pressures and weaker economic growth. In addition to China, several other central banks in the EMEs also loosened monetary policy, including those in Brazil, Chile, India, Indonesia, the Philippines, South Korea, and Thailand.

Part 3
Monetary Policy: Recent Developments and Outlook

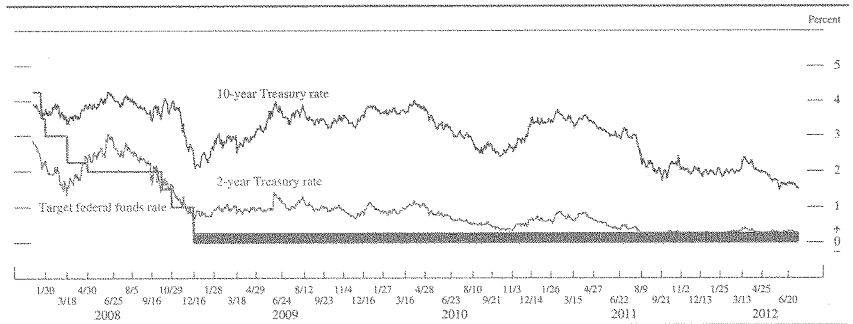
Monetary Policy over the First Half of 2012

To promote the Federal Open Market Committee's (FOMC) objectives of maximum employment and price stability, the Committee maintained a target range for the federal funds rate of 0 to ¼ percent throughout the first half of 2012 (figure 64).[11] With the incoming data suggesting a somewhat slower pace of economic recovery than the Committee had anticipated, and with inflation seen as settling at levels at or below those consistent, over the long run, with its statutory mandate, the Committee took steps during the first half of 2012 to provide additional monetary accommodation in order to support a stronger economic recovery and to help ensure that inflation, over time, runs at levels consistent with its mandate. These steps included lengthening the horizon of the forward rate guidance regarding the Committee's expectations for the period over which economic conditions will warrant exceptionally low levels for the federal funds rate, continuing the Committee's maturity extension program (MEP) through the end of this year rather than completing the program in June as previously scheduled, retaining its existing policies regarding the reinvestment of principal payments on agency securities in agency-guaranteed mortgage-backed securities (MBS), and continuing to reinvest the proceeds of maturing Treasury securities.

The information reviewed at the January 24–25 meeting indicated that U.S. economic activity had expanded moderately, while global growth appeared to be slowing. Labor market indicators pointed to some further improvement in labor market conditions, but progress was gradual and the unemployment rate remained elevated. Household spending had continued to advance at a moderate pace despite diminished growth in real disposable income, but growth in business fixed investment had slowed. The housing sector remained depressed. Inflation had been subdued in recent months, and longer-term inflation expectations had remained stable. Meeting participants observed that financial conditions had improved and financial market stresses had eased somewhat during the intermeeting period, in part because of the European Central Bank's (ECB) three-year refinancing operation.

11. Members of the FOMC in 2012 consist of the members of the Board of Governors of the Federal Reserve System plus the presidents of the Federal Reserve Banks of Atlanta, Cleveland, New York, Richmond, and San Francisco. As of the June FOMC meeting, Governors Jerome H. Powell and Jeremy C. Stein joined the Board of Governors increasing the number of FOMC members to 12.

64. Selected interest rates, 2008–12



NOTE: The data are daily and extend through July 13, 2012. The 10-year Treasury rate is the constant-maturity yield based on the most actively traded securities. The dates on the horizontal axis are those of regularly scheduled Federal Open Market Committee meetings.
SOURCE: Department of the Treasury and the Federal Reserve.

Nonetheless, participants expected that global financial markets would remain focused on the evolving situation in Europe, and they anticipated that further policy efforts would be required to fully address the fiscal and financial problems there.

With the economy facing continuing headwinds and growth slowing in several U.S. export markets, members generally expected a modest pace of economic growth over coming quarters, with the unemployment rate declining only gradually. At the same time, members thought that inflation would run at levels at or below those consistent with the Committee's dual mandate. Against this backdrop, members agreed to keep the target range for the federal funds rate at 0 to ¼ percent, to continue the program of extending the average maturity of the Federal Reserve's holdings of securities as announced in September, and to retain the existing policies regarding the reinvestment of principal payments from Federal Reserve holdings of securities. In light of the economic outlook, most members also agreed to indicate that the Committee anticipates that economic conditions are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014, longer than had been indicated in recent FOMC statements. The Committee also stated that it is prepared to adjust the size and composition of its securities holdings as appropriate to promote a stronger economic recovery in a context of price stability.

The data in hand at the March 13 FOMC meeting indicated that U.S. economic activity had continued to expand moderately. Although the unemployment rate remained elevated, it had declined notably in recent months and payroll employment had increased. Household spending and business fixed investment had advanced. Signs of improvement or stabilization emerged in some local housing markets, but overall housing activity continued to be restrained by the substantial inventory of foreclosed and distressed properties, tight credit conditions for mortgage loans, and uncertainty about the economic outlook and future home prices. Inflation continued to be subdued, although prices of crude oil and gasoline had increased substantially. Longer-term inflation expectations had remained stable.

Many participants believed that policy actions in the euro area, notably the Greek debt swap and the ECB's longer-term refinancing operations, had helped ease strains in financial markets and reduced the downside risks to the U.S. and global economic outlook. Against that backdrop, equity prices had risen and conditions in credit markets improved, leading many meeting participants to see financial conditions as more supportive of economic growth than at the time of the January meeting.

Members viewed the information on U.S. economic activity as suggesting that the economy would continue to expand moderately. However, despite the easing of strains in global financial markets, members continued to perceive significant downside risks to economic activity. Members generally anticipated that the recent increase in oil and gasoline prices would push up inflation temporarily, but that inflation subsequently would run at or below the rate that the Committee judges most consistent with its mandate. As a result, the Committee decided to keep the target range for the federal funds rate at 0 to ¼ percent, to reiterate its anticipation that economic conditions were likely to warrant exceptionally low levels for the federal funds rate at least through late 2014, to continue the program of extending the average maturity of the Federal Reserve's holdings of securities that it had adopted in September, and to maintain the existing policies regarding the reinvestment of principal payments from Federal Reserve holdings of securities. The Committee again stated that it is prepared to adjust the size and composition of its securities holdings as appropriate to promote a stronger economic recovery in a context of price stability.

By the time of the April 24–25 FOMC meeting, the data again indicated that economic activity was expanding moderately. Payroll employment had continued to move up, and the unemployment rate, while still elevated, had declined a little further. Household spending and business fixed investment had continued to expand. The housing sector showed signs of improvement but from a very low level of activity. Mainly reflecting the increase in the prices of crude oil and gasoline earlier this year, inflation had picked up somewhat; however, measures of long-run inflation expectations remained stable. Meeting participants judged that, in general, conditions in domestic credit markets had improved further, but noted that investors' concerns about the sovereign debt and banking situation in the euro area intensified during the intermeeting period. Many U.S. financial institutions had been taking steps to bolster their resilience, including expanding their capital levels and liquidity buffers and reducing their European exposures.

Members expected growth to be moderate over coming quarters and then to pick up over time. Strains in global financial markets stemming from the sovereign debt and banking situation in Europe as well as uncertainty about U.S. fiscal policy continued to pose significant downside risks to economic activity both here and abroad. Most members anticipated that the increase in inflation would prove temporary and that subsequently inflation would run at or below the rate that the Committee judges to be most consistent with its mandate. Against this backdrop, the Committee members reached the collective judgment that it would be appropriate to maintain the existing highly accommodative stance of monetary policy. In particular, the Committee agreed to keep the target range for the federal funds rate at 0 to ¼ percent, to continue the program of extending the average maturity of the Federal Reserve's holdings of securities as announced last September, and to retain the existing policies regarding the reinvestment of principal payments from Federal Reserve holdings of securities. The Committee left the forward guidance for the target federal funds rate unchanged at this meeting. Members emphasized that their forward guidance was conditional on expected economic developments, but they preferred adjusting the forward guidance only once they were more confident that the medium-term economic outlook or the risks to that outlook had changed significantly.

Data received over the period leading up to the June 19–20 FOMC meeting indicated that economic activity was expanding at a somewhat more modest pace than earlier in the year. Improvements in labor market conditions had slowed in recent months, and the unemployment rate seemed to have flattened out. Household spending appeared to be rising at a somewhat slower rate, and business investment had continued to advance. Despite some ongoing signs of improvement, the housing sector remained depressed. Consumer price inflation had declined, mainly reflecting lower prices of crude oil and gasoline, and longer-term inflation expectations remained well anchored. Meeting participants observed that financial markets were volatile over the intermeeting period and that investor sentiment was strongly influenced by the developments in Europe and evidence of slowing economic growth at home and abroad.

In the discussion of monetary policy, most members agreed that the outlook had deteriorated somewhat relative to the time of the April meeting, and that significant downside risks were present, importantly including the financial stresses in the euro area and uncertainty about the degree of fiscal restraint in the United States, and its effects on economic activity over the medium term. As a result, the Committee decided that providing additional monetary policy accommodation would be appropriate to support a stronger economic recovery and to help ensure that inflation, over time, was at a level consistent with the Committee's dual mandate. Specifically, the Committee agreed to continue the MEP through the end of the year, instead of ending the program in June as had been planned. In doing so, the Federal Reserve will purchase Treasury securities with remaining maturities of 6 years to 30 years and sell or redeem an equal par value of Treasury securities with remaining maturities of approximately 3 years or less. This continuation of the MEP will proceed at about the same pace as had been executed through the first phase of the program, increasing the Federal Reserve's holdings of longer-term Treasury securities by about $267 billion while reducing its holdings of shorter-term Treasury securities by the same amount. For the duration of this program, the Committee directed the Open Market Desk to suspend its current policy of rolling over maturing Treasury securities into new issues at auction (and instead purchase only additional longer-term securities with the proceeds of maturing securities). The Committee expected the continuation of the MEP to put downward pressure on longer-term interest rates and help make broader financial conditions more accommodative. In addition, the Committee decided to continue reinvesting principal payments from its holdings of agency debt and agency MBS in agency MBS. The Committee also decided to keep the target range for the federal funds rate at 0 to ¼ percent and to reaffirm its anticipation that economic conditions were likely to warrant exceptionally low levels for the federal funds rate at least through late 2014. In its statement, the Committee noted that it was prepared to take further action as appropriate to promote stronger economic recovery and sustained improvement in labor market conditions in a context of price stability.

FOMC Communications

Transparency is an essential principle of modern central banking because it contributes to the accountability of central banks to the government and to the public and because it can enhance the effectiveness of central banks in achieving their macroeconomic objectives. To this end, the Federal Reserve provides to the public a considerable amount of information concerning the conduct of monetary policy. Following each meeting of the FOMC, the Committee immediately releases a statement that lays out the rationale for its policy decision and issues detailed minutes of the meeting about three weeks later. Lightly edited transcripts of FOMC meetings are released to the public with a five-year lag.[12] Moreover, beginning in April

12. FOMC statements, minutes, and transcripts, as well as other related information, are available on the Federal Reserve Board's website at www.federalreserve.gov/monetarypolicy/fomc.htm.

2011, the Chairman has held press conferences on an approximately quarterly basis. At the press conferences, the Chairman presents the current economic projections of FOMC participants and provides additional context for the Committee's policy decisions.

The Committee continued to consider further improvements in its communications approach in the first half of 2012. At the January meeting, the FOMC released a statement of its longer-run goals and policy strategy in an effort to enhance the transparency, accountability, and effectiveness of monetary policy and to facilitate well-informed decisionmaking by households and businesses.[13] The statement did not represent a change in the Committee's policy approach, but rather was intended to help enhance the transparency, accountability, and effectiveness of monetary policy. The statement emphasizes the Federal Reserve's firm commitment to pursue its congressional mandate to promote maximum employment, stable prices, and moderate long-term interest rates. To clarify its longer-term objectives, the FOMC stated 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 the Federal Reserve's statutory mandate. While noting that the Committee's assessments of the maximum level of employment are necessarily uncertain and subject to revision, the statement indicated that the central tendency of FOMC participants' current estimates of the longer-run normal rate of unemployment is between 5.2 and 6.0 percent. It stressed that the Federal Reserve's statutory objectives are generally complementary, but when they are not, the Committee will follow a balanced approach in its efforts to return both inflation and employment to levels consistent with its mandate.

In addition, in light of a decision made at the December meeting, the Committee provided, starting in the January Summary of Economic Projections (SEP), information about each participant's assessment of appropriate monetary policy. Specifically, the SEP included information about participants' estimates of the appropriate level of the target federal funds rate in the fourth quarter of the current year and the next few calendar years, and over the longer run; the SEP also reported participants' current projections of the likely timing of the appropriate first increase in the target federal funds rate given their assessments of the economic outlook. The accompanying narrative described the key factors underlying those assessments and provided some qualitative information regarding participants' expectations for the Federal Reserve's balance sheet.

At the March meeting, participants discussed a range of additional steps that the Committee might take to help the public better understand the linkages between the evolving economic outlook and the Federal Reserve's monetary policy decisions, and thus the conditionality in the Committee's forward guidance. Participants discussed ways in which the Committee might include, in its postmeeting statements and other communications, additional qualitative or quantitative information that could convey a sense of how the Committee might adjust policy in response to changes in the economic outlook. However, participants also observed that the Committee had introduced several important enhancements to its policy communications over the past year or so; these included the Chairman's postmeeting press conference as well as changes to the FOMC statement and the SEP. Against this backdrop, some participants noted that additional experience with the changes implemented to date could be helpful in evaluating potential further enhancements.

At the April meeting, the Committee discussed the relationship between the postmeeting statement, which expresses the collective view of the Committee, and the policy projections of individual participants, which are included in the SEP. The Chairman asked the subcommittee on communications to consider possible enhancements and refinements to the SEP that might help clarify the link between economic developments and the Committee's view of the appropriate stance of monetary policy. Following up on this issue at the June meeting, participants discussed several possibilities for enhancing the clarity and transparency of the Committee's economic projections as well as the role they play in policy decisions and policy communications. Many participants indicated that if it were possible to construct a quantitative economic projection and associated path of appropriate policy that reflected the collective judgment of the Committee, such a projection could potentially be helpful in clarifying how the outlook and policy decisions are related. However, many participants noted that developing a quantitative forecast that reflects the Committee's collective judgment could be challenging, given the range of their views about the economy's structure and dynamics. Participants agreed to continue to explore ways to increase clarity and transparency in the Committee's policy communications, but many emphasized that further changes in those communications should be considered carefully.

13. The FOMC statement of longer-run goals and policy strategy is available on the Federal Reserve Board's website at www.federalreserve.gov/monetarypolicy/fomccalendars.htm.

Part 4
Summary of Economic Projections

The following material appeared as an addendum to the minutes of the June 19–20, 2012, meeting of the Federal Open Market Committee.

In conjunction with the June 19–20, 2012, Federal Open Market Committee (FOMC) meeting, meeting participants—the 7 members of the Board of Governors and the 12 presidents of the Federal Reserve Banks, all of whom participate in the deliberations of the FOMC—submitted their assessments, under each participant's judgment of appropriate monetary policy, of real output growth, the unemployment rate, inflation, and the target federal funds rate for each year from 2012 through 2014 and over the longer run. These assessments were based on information available at the time of the meeting and participants' individual assumptions about the factors likely to affect economic outcomes. The longer-run projections represent each participant's judgment of the rate to which each variable would be expected to converge, over time, under appropriate monetary policy and in the absence of further shocks to the economy. "Appropriate monetary policy" is defined as the future path of policy that participants deem most likely to foster outcomes for economic activity and inflation that best satisfy their individual interpretations of the Federal Reserve's objectives of maximum employment and stable prices.

Overall, the assessments that FOMC participants submitted in June indicated that, under appropriate monetary policy, the pace of economic expansion over the 2012–14 period would likely continue to be moderate and inflation would remain subdued (see table 1 and figure 1). Participants judged that the growth rate of real gross domestic product (GDP) would pick up gradually and that the unemployment rate would edge down very slowly. Participants projected that inflation, as measured by the annual change in the price index for personal consumption expenditures (PCE), would run close to or below the FOMC's longer-run inflation objective of 2 percent.

As shown in figure 2, most participants judged that highly accommodative monetary policy was likely to be warranted over the forecast period. In particular, 13 participants thought that it would be appropriate for the first increase in the target federal funds rate to occur during 2014 or later. A majority of participants judged that appropriate monetary policy would involve an extension of the maturity extension program (MEP) through the end of 2012.

Overall, participants judged the uncertainty associated with the outlook for real activity and the unemployment rate to be unusually high relative to historical norms, with the risks weighted mainly toward slower economic growth and a higher unemployment rate.

Table 1. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, June 2012

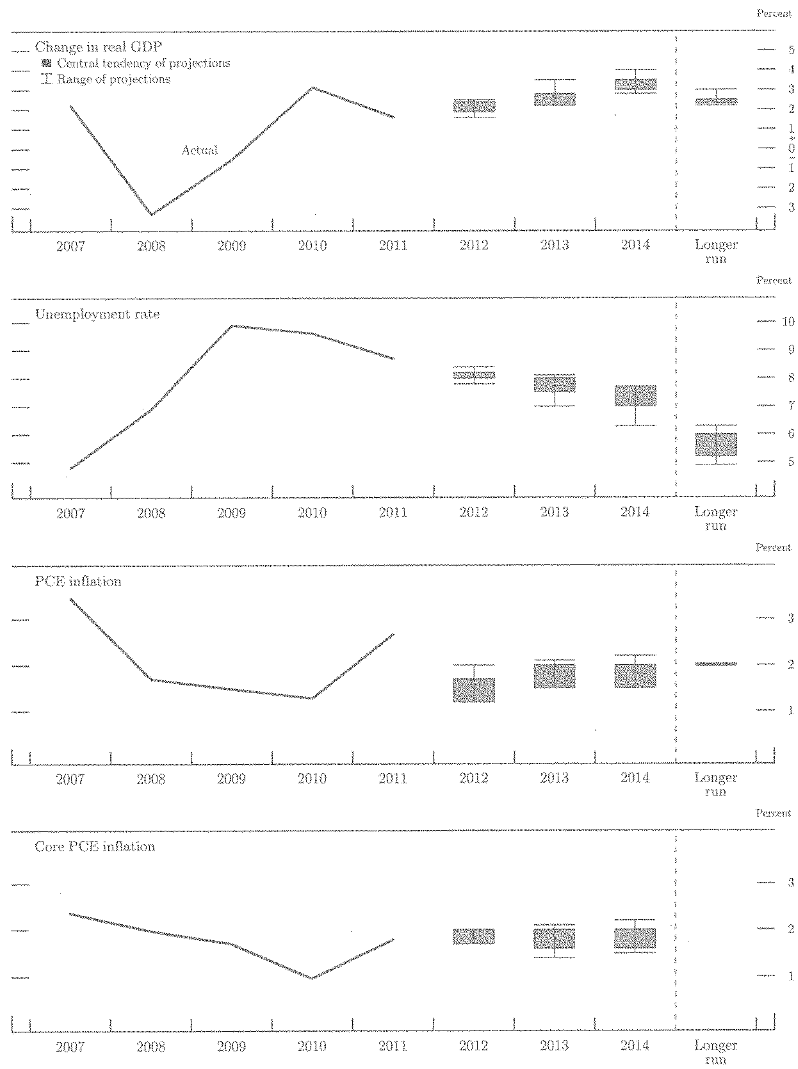
Percent

Variable	Central tendency[1]				Range[2]			
	2012	2013	2014	Longer run	2012	2013	2014	Longer run
Change in real GDP	1.9 to 2.4	2.2 to 2.8	3.0 to 3.5	2.3 to 2.5	1.6 to 2.5	2.2 to 3.5	2.8 to 4.0	2.2 to 3.0
April projection	2.4 to 2.9	2.7 to 3.1	3.1 to 3.6	2.3 to 2.6	2.1 to 3.0	2.4 to 3.8	2.9 to 4.3	2.2 to 3.0
Unemployment rate	8.0 to 8.2	7.5 to 8.0	7.0 to 7.7	5.2 to 6.0	7.8 to 8.4	7.0 to 8.1	6.3 to 7.7	4.9 to 6.3
April projection	7.8 to 8.0	7.3 to 7.7	6.7 to 7.4	5.2 to 6.0	7.8 to 8.2	7.0 to 8.1	6.3 to 7.7	4.9 to 6.0
PCE inflation	1.2 to 1.7	1.5 to 2.0	1.5 to 2.0	2.0	1.2 to 2.0	1.5 to 2.1	1.5 to 2.2	2.0
April projection	1.9 to 2.0	1.6 to 2.0	1.7 to 2.0	2.0	1.8 to 2.3	1.5 to 2.1	1.5 to 2.2	2.0
Core PCE inflation[3]	1.7 to 2.0	1.6 to 2.0	1.6 to 2.0		1.7 to 2.0	1.4 to 2.1	1.5 to 2.2	
April projection	1.8 to 2.0	1.7 to 2.0	1.8 to 2.0		1.7 to 2.0	1.6 to 2.1	1.7 to 2.2	

Note: Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The April projections were made in conjunction with the meeting of the Federal Open Market Committee on April 24–25, 2012.

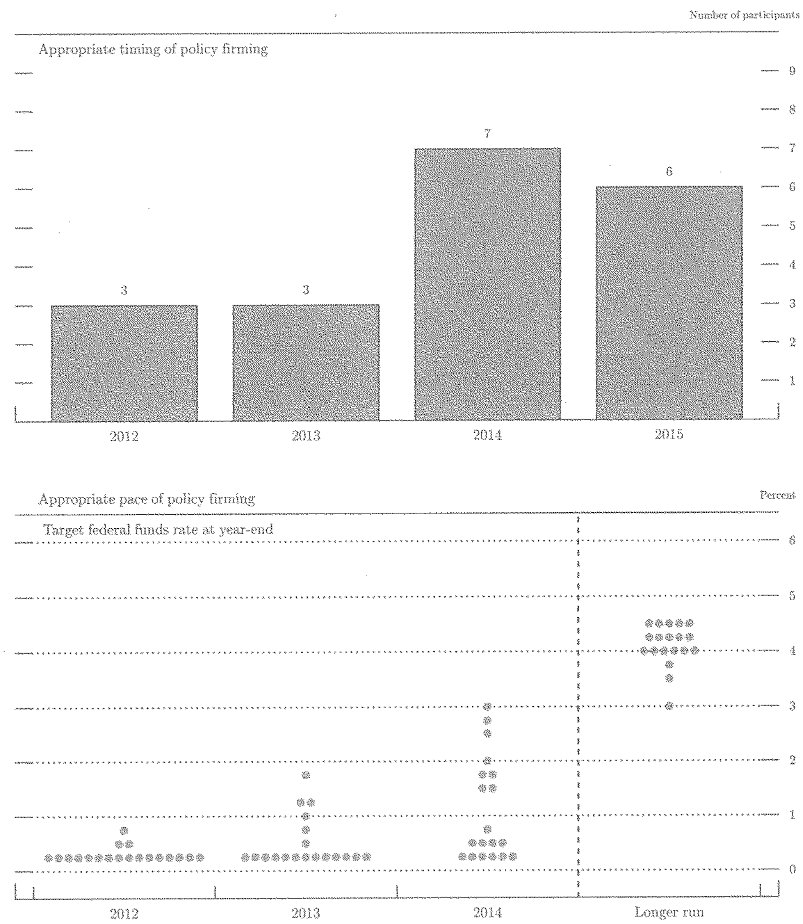
1. The central tendency excludes the three highest and three lowest projections for each variable in each year.
2. The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.
3. Longer-run projections for core PCE inflation are not collected.

Figure 1. Central tendencies and ranges of economic projections, 2012–14 and over the longer run



NOTE: Definitions of variables are in the general note to table 1. The data for the actual values of the variables are annual.

Figure 2. Overview of FOMC participants' assessments of appropriate monetary policy, June 2012



NOTE: In the upper panel, the height of each bar denotes the number of FOMC participants who judge that, under appropriate monetary policy, the first increase in the target federal funds rate from its current range of 0 to 1/4 percent will occur in the specified calendar year. In April 2012, the numbers of FOMC participants who judged that the first increase in the target federal funds rate would occur in 2012, 2013, 2014, and 2015 were, respectively, 3, 3, 7, and 4. In the lower panel, each shaded circle indicates the value (rounded to the nearest 1/4 percentage point) of an individual participant's judgment of the appropriate level of the target federal funds rate at the end of the specified calendar year or over the longer run.

Many participants also viewed the uncertainty surrounding their projections for inflation to be greater than normal, but most saw the risks to inflation to be broadly balanced.

The Outlook for Economic Activity

Conditional upon their individual assumptions about appropriate monetary policy, participants judged that the economy would continue to expand at a moderate pace in 2012 and 2013 before picking up in 2014 to a pace somewhat above what participants view as the longer-run rate of output growth. The central tendency of their projections for the change in real GDP in 2012 was 1.9 to 2.4 percent, lower than in April. Many participants characterized the incoming data—especially for household spending and the labor market—as having been weaker than they had anticipated in April. In addition, most noted that the worsening situation in Europe was leading to a slowdown in global economic growth and greater volatility in financial markets. Compared with their April submissions, most participants lowered their medium-run projections of economic activity somewhat. The central tendencies of participants' projections of real economic growth in 2013 and 2014 were 2.2 to 2.8 percent and 3.0 to 3.5 percent, respectively. The central tendency for the longer-run rate of increase of real GDP was 2.3 to 2.5 percent, little changed from April. Participants cited several headwinds that were likely to hold back the pace of economic expansion over the forecast period, including the difficult fiscal and financial situation in Europe, a still-depressed housing market, tight credit for some borrowers, and fiscal restraint in the United States.

Consistent with the downward revisions to their projections for real GDP growth in 2012 and 2013, nearly all participants marked up their assessments for the rate of unemployment. Participants projected the unemployment rate at the end of 2012 to remain at or slightly below recent levels, with a central tendency of 8.0 to 8.2 percent, somewhat higher than their April submissions. Participants anticipated gradual improvement in labor market conditions by 2014, but even so, they generally thought that the unemployment rate at the end of that year would still lie well above their individual estimates of its longer-run normal level. The central tendencies of participants' forecasts for the unemployment rate were 7.5 to 8.0 percent at the end of 2013 and 7.0 to 7.7 percent at the end of 2014. The central tendency of participants' estimates of the longer-run normal rate of unemployment that would prevail under the assumption of appropriate monetary policy and in the absence of further shocks to the economy was 5.2 to 6.0 percent, unchanged from April. Most participants projected that the gap between the current unemployment rate and their estimates of its longer-run normal rate would be closed in five or six years, a couple judged that less time would be needed, and one thought more time would be necessary because of the persistent headwinds impeding the economic expansion.

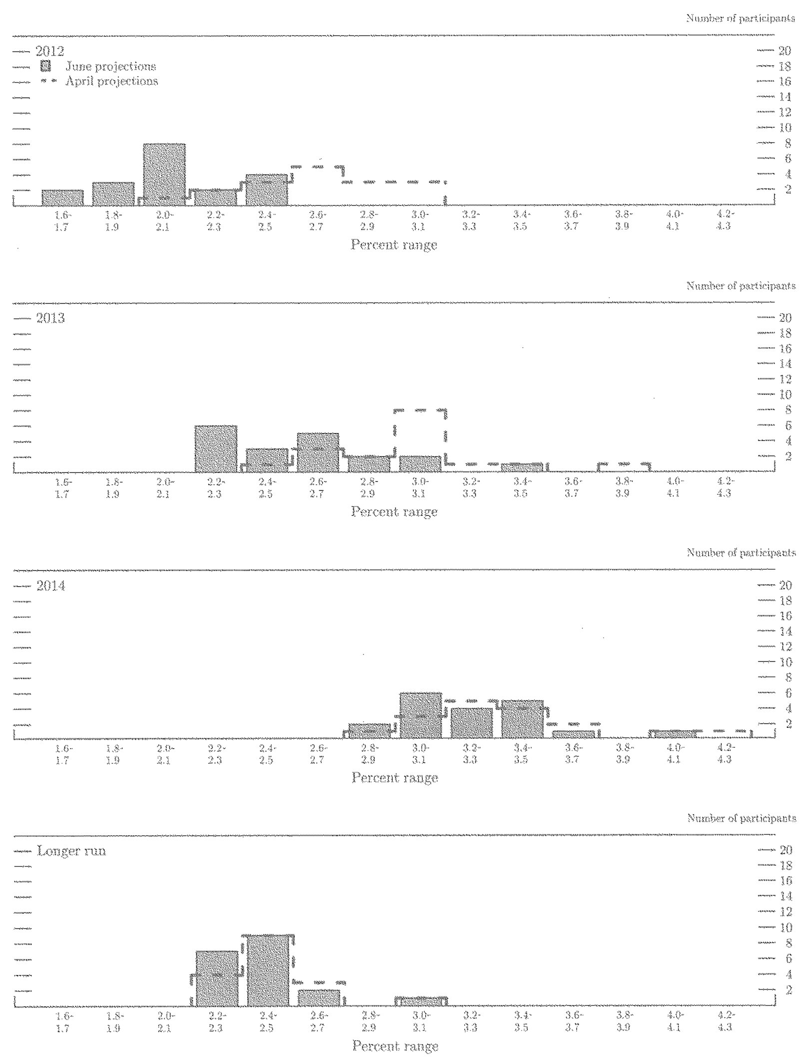
Figures 3.A and 3.B provide details on the diversity of participants' views regarding the likely outcomes for real GDP growth and the unemployment rate over the next three years and over the longer run. The dispersion in these projections reflects differences in participants' assessments of many factors, including appropriate monetary policy and its effects on the economy, the underlying momentum in economic activity, the spill-over effects of the fiscal and financial situation in Europe, the prospective path for U.S. fiscal policy, the extent of structural dislocations in the labor market, and the likely evolution of credit and financial market conditions. Compared with their April assessments, the range of participants' forecasts for the change in real GDP in 2012 and 2013 shifted lower, while the dispersion of individual forecasts for growth in 2014 was about unchanged. Consistent with the downward shift in the distribution of forecasts for economic growth, the distribution of projections for the unemployment rate shifted up in 2012 and 2013 and, to a lesser extent, in 2014. As in April, the dispersion of estimates for the longer-run rate of output growth was fairly narrow, generally in a range of 2.2 to 2.7 percent. In contrast, participants' views about the level to which the unemployment rate would converge in the longer run were more diverse, reflecting, among other things, different views on the outlook for labor supply and the structure of the labor market.

The Outlook for Inflation

Participants' views about the medium-run outlook for inflation under the assumption of appropriate monetary policy were little changed from April. However, nearly all of them marked down their assessment of headline inflation in the near term, pointing to recent declines in the prices of crude oil and gasoline that were sharper than previously projected. Almost all participants judged that both headline and core inflation would remain subdued over the 2012–14 period, running at rates at or below the FOMC's longer-run objective of 2 percent. Some participants noted that

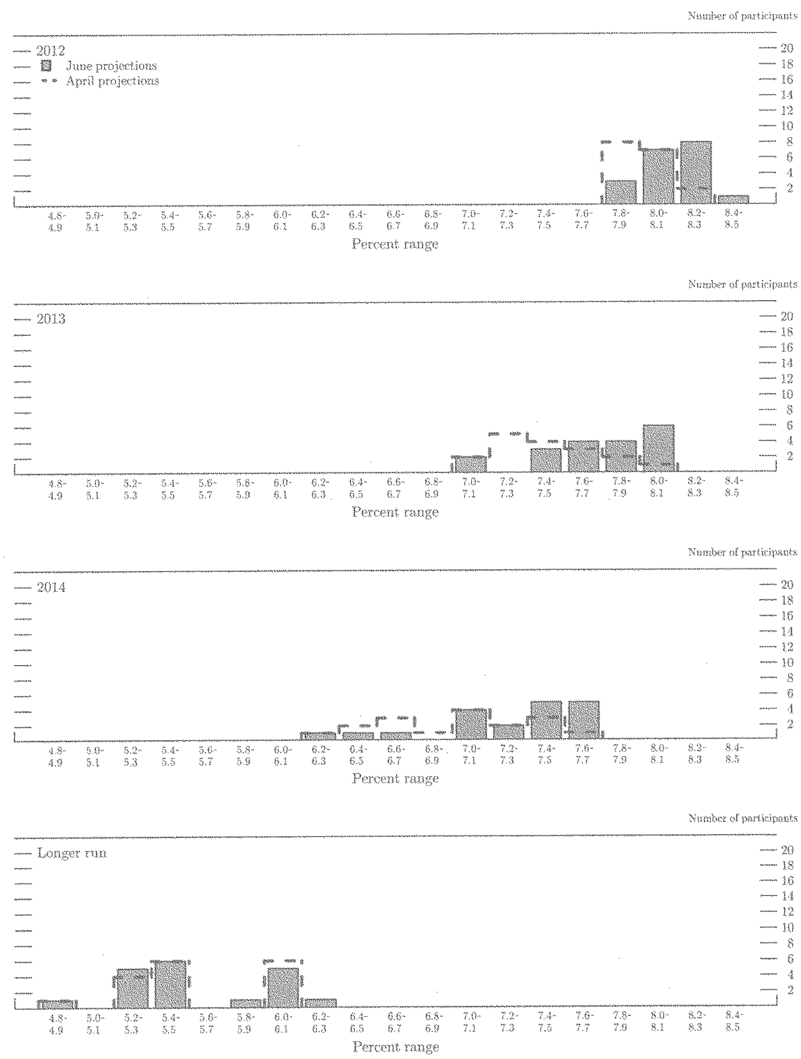
115

Figure 3.A. Distribution of participants' projections for the change in real GDP, 2012–14 and over the longer run



NOTE: Definitions of variables are in the general note to table 1.

Figure 3.B. Distribution of participants' projections for the unemployment rate, 2012–14 and over the longer run



NOTE: Definitions of variables are in the general note to table 1.

inflation expectations had remained stable, and several pointed to resource slack and moderate increases in labor compensation as sources of restraint on prices. Specifically, the central tendency of participants' projections for inflation, as measured by the PCE price index, moved down in 2012 to 1.2 to 1.7 percent and was little changed in 2013 and 2014 at 1.5 to 2.0 percent. The central tendencies of the forecasts for core inflation were broadly the same as those for the headline measure in 2013 and 2014.

Figures 3.C and 3.D provide information about the diversity of participants' views about the outlook for inflation. Relative to the assessments compiled in April, the projections for headline inflation shifted down in 2012, reflecting the declines in energy prices. The distributions of participants' projections for headline and core inflation in 2013 and 2014 were slightly lower than those reported in April.

Appropriate Monetary Policy

As indicated in figure 2, most participants judged that exceptionally low levels of the federal funds rate would remain appropriate at least until late 2014. In particular, seven participants thought that it would be appropriate to commence policy firming in 2014, while another six participants thought that the first increase in the target federal funds rate would not be warranted until 2015 (upper panel). Eleven participants indicated that the appropriate federal funds rate at the end of 2014 would be 75 basis points or lower (lower panel), and those who judged that policy liftoff would not occur until 2015 thought the federal funds rate would be 1½ percent or lower at the end of that year. As in April, six participants judged that economic conditions would warrant an increase in the target federal funds rate in either 2012 or 2013 in order to achieve the Committee's statutory mandate. Those participants judged that the appropriate value for the federal funds rate would range from 1½ to 3 percent at the end of 2014.

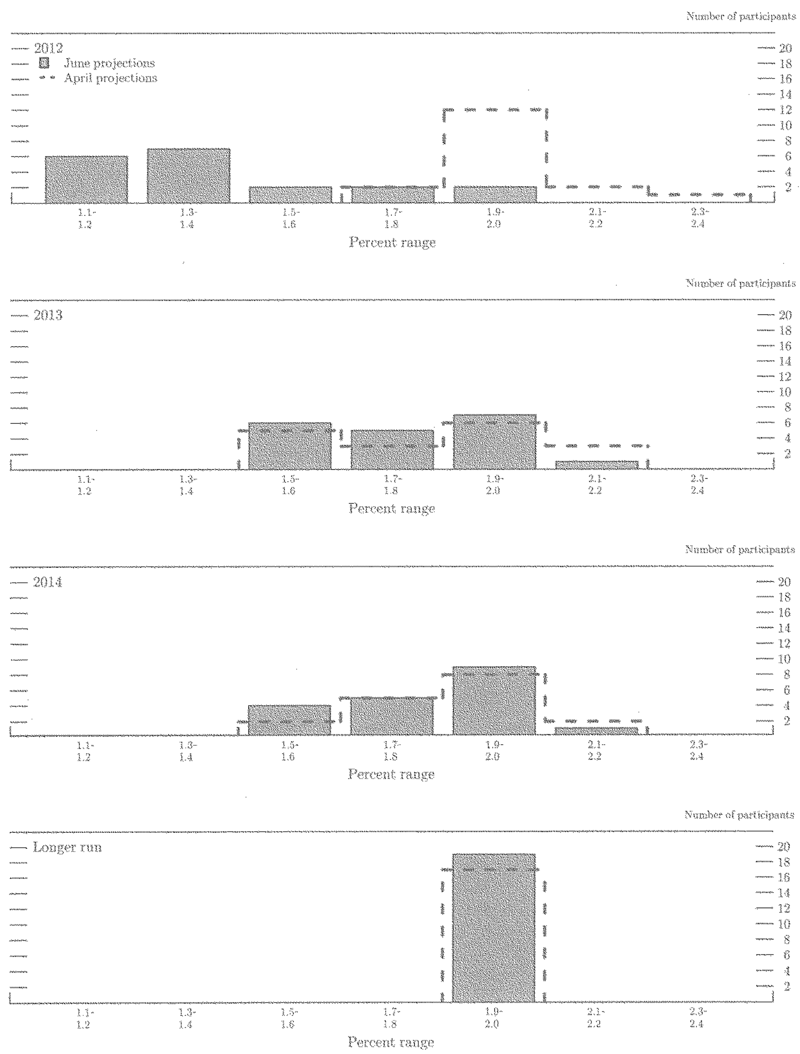
All participants reported levels for the appropriate target federal funds rate at the end of 2014 that were well below their estimates of the level expected to prevail in the longer run. Estimates of the longer-run target federal funds rate ranged from 3 to 4½ percent, reflecting the Committee's inflation objective of 2 percent and participants' judgments about the longer-run equilibrium level of the real federal funds rate.

Participants also provided qualitative information on their views regarding the appropriate path of the Federal Reserve's balance sheet. Of the 12 participants whose assessments of appropriate monetary policy included additional balance sheet policies, 11 indicated that their assumptions incorporated an extension through the end of 2012 of the MEP, and 2 participants conditioned their economic forecasts on a new program of securities purchases. Two indicated that they would consider such purchases in the event that the economy did not make satisfactory progress in improving labor market conditions or in the event of a significant deterioration in the economic outlook or a further increase in downside risks to that outlook. Almost all participants assumed that the Committee would carry out the normalization of the balance sheet according to the principles approved at the June 2011 FOMC meeting. That is, prior to the first increase in the federal funds rate, the Committee would likely cease reinvesting some or all principal payments on securities in the System Open Market Account (SOMA), and it would likely begin sales of agency securities from the SOMA sometime after the first rate increase, aiming to eliminate the SOMA's holdings of agency securities over a period of three to five years. In general, participants linked their preferred start dates for the normalization process to their views for the appropriate timing for the first increase in the target federal funds rate. One participant who thought that the liftoff of the federal funds rate should occur relatively soon indicated that the reinvestment of maturing securities should continue for a time after liftoff.

The key factors informing participants' individual assessments of the appropriate setting for monetary policy included their judgments regarding the maximum level of employment, the extent to which current conditions had deviated from mandate-consistent levels, and participants' projections of the likely time horizon necessary to return employment and inflation to such levels. Several participants noted that their assessments of appropriate monetary policy reflected the subpar pace of the economic expansion and the persistent shortfall in aggregate demand since the 2007–09 recession, and two commented that the neutral level of the federal funds rate was likely somewhat below its historical norm. One participant expressed concern that a protracted period of very accommodative monetary policy could lead to a buildup of risks in the financial system. Participants also noted that because the appropriate stance of monetary policy depends importantly on the evolution of real activity and inflation over time, their assessments of the appropriate future path of the federal funds rate and the balance sheet could change if economic conditions were to evolve in an unexpected manner.

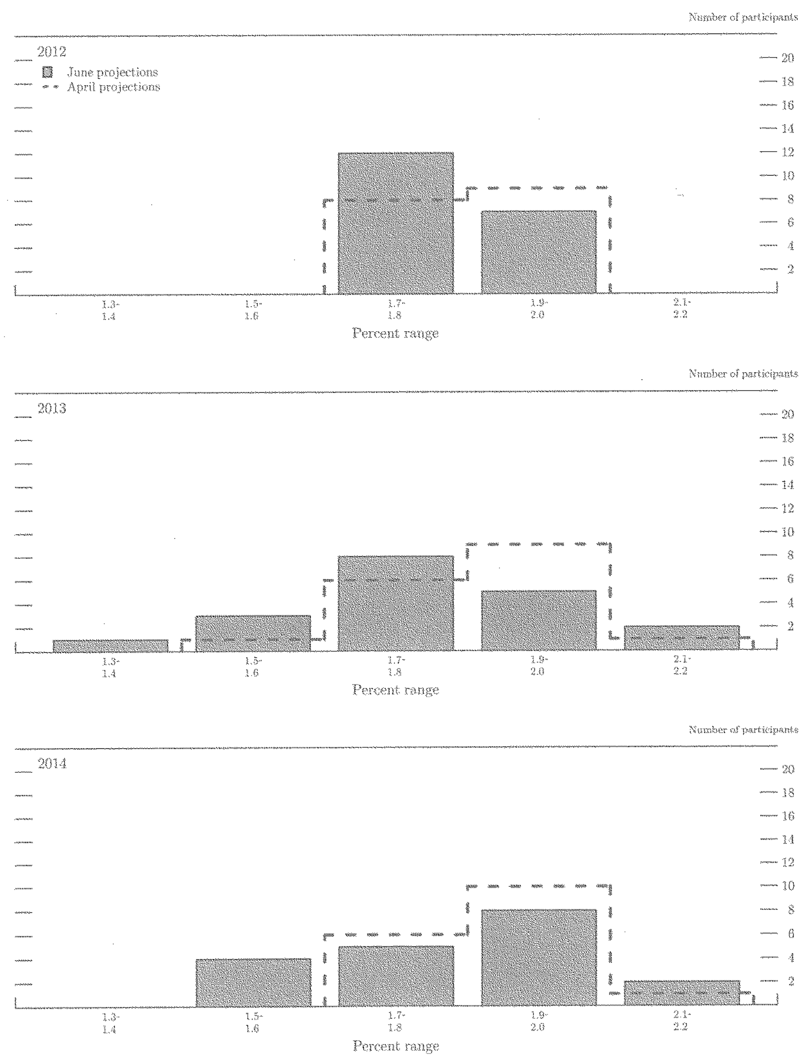
Figure 3.E details the distribution of participants' judgments regarding the appropriate level of the target

Figure 3.C. Distribution of participants' projections for PCE inflation, 2012–14 and over the longer run



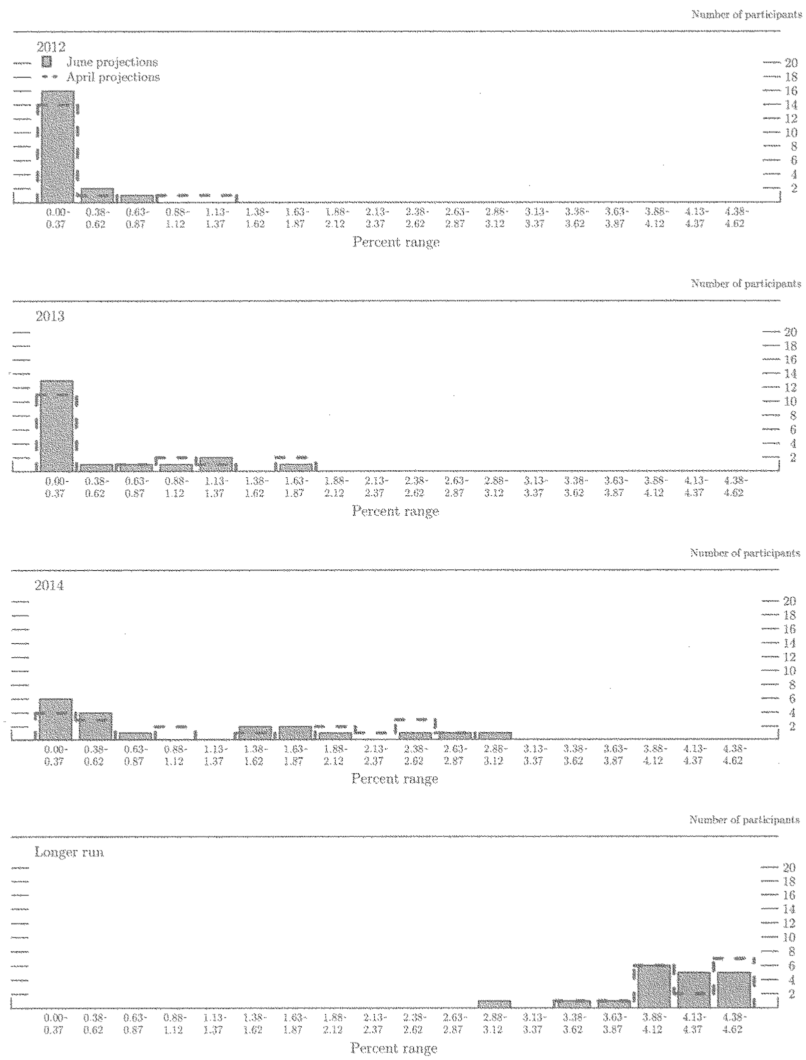
NOTE: Definitions of variables are in the general note to table 1.

Figure 3.D. Distribution of participants' projections for core PCE inflation, 2012–14



NOTE: Definitions of variables are in the general note to table 1.

Figure 3.E. Distribution of participants' projections for the target federal funds rate, 2012–14 and over the longer run



NOTE: The target federal funds rate is measured as the level of the target rate at the end of the calendar year or in the longer run.

federal funds rate at the end of each calendar year from 2012 to 2014 and over the longer run. Most participants judged that economic conditions would warrant maintaining the current low level of the federal funds rate through the end of 2013. Views on the appropriate level of the federal funds rate at the end of 2014 were more widely dispersed, with 11 participants seeing the appropriate level of the federal funds rate as ¾ percentage point or lower and 4 of them seeing the appropriate rate as 2 percent or higher. Those who judged that a longer period of very accommodative monetary policy would be appropriate generally projected that the unemployment rate would remain further above its longer-run normal level at the end of 2014. In contrast, the 6 participants who judged that policy firming should begin in 2012 or 2013 indicated that the Committee would need to act soon to keep inflation near the FOMC's longer-run objective of 2 percent and to prevent a rise in inflation expectations.

Uncertainty and Risks

Nearly all participants judged that their current level of uncertainty about GDP growth and unemployment was higher than was the norm during the previous 20 years (figure 4).[14] About half of all participants judged the level of uncertainty associated with their inflation forecasts to be higher as well, while another eight participants viewed uncertainty about inflation as broadly similar to historical norms. The main factors cited as underlying the elevated uncertainty about economic outcomes were the ongoing fiscal and financial situation in Europe, the outlook for fiscal policy in the United States, and a general slowdown in global economic growth, including the possibility of a significant slowdown in China. As in April, participants noted the difficulties associated with forecasting the path of the U.S. economic recovery following a financial crisis and recession that differed markedly from recent historical experience. Several commented that in the aftermath of the financial crisis, they were more uncertain about the level of potential output and its trend rate of growth.

A majority of participants reported that they saw the risks to their forecasts of real GDP growth as weighted toward the downside and, accordingly, the risks to their projections of the unemployment rate as tilted to the upside. The most frequently identified sources of risk were the situation in Europe, which many participants thought had the potential to slow global economic activity, particularly over the near term, and the fiscal situation in the United States.

Most participants continued to judge the risks to their projections for inflation as broadly balanced, with several highlighting the recent stability of inflation expectations. However, five participants saw the risks to inflation as tilted to the downside, a larger number than in April; a couple of them noted that slack in resource markets could turn out to be greater or could put more downward pressure on inflation than they were anticipating. Two participants saw the risks to inflation as weighted to the upside, in light of concerns about U.S. fiscal imbalances, the current highly accommodative stance of monetary policy, or the Committee's ability to effectively remove policy accommodation when it becomes appropriate to do so.

Table 2. Average historical projection error ranges
Percentage points

Variable	2012	2013	2014
Change in real GDP[1]	±1.0	±1.6	±1.7
Unemployment rate[1]	±0.4	±1.2	±1.7
Total consumer prices[2]	±0.8	±1.0	±1.1

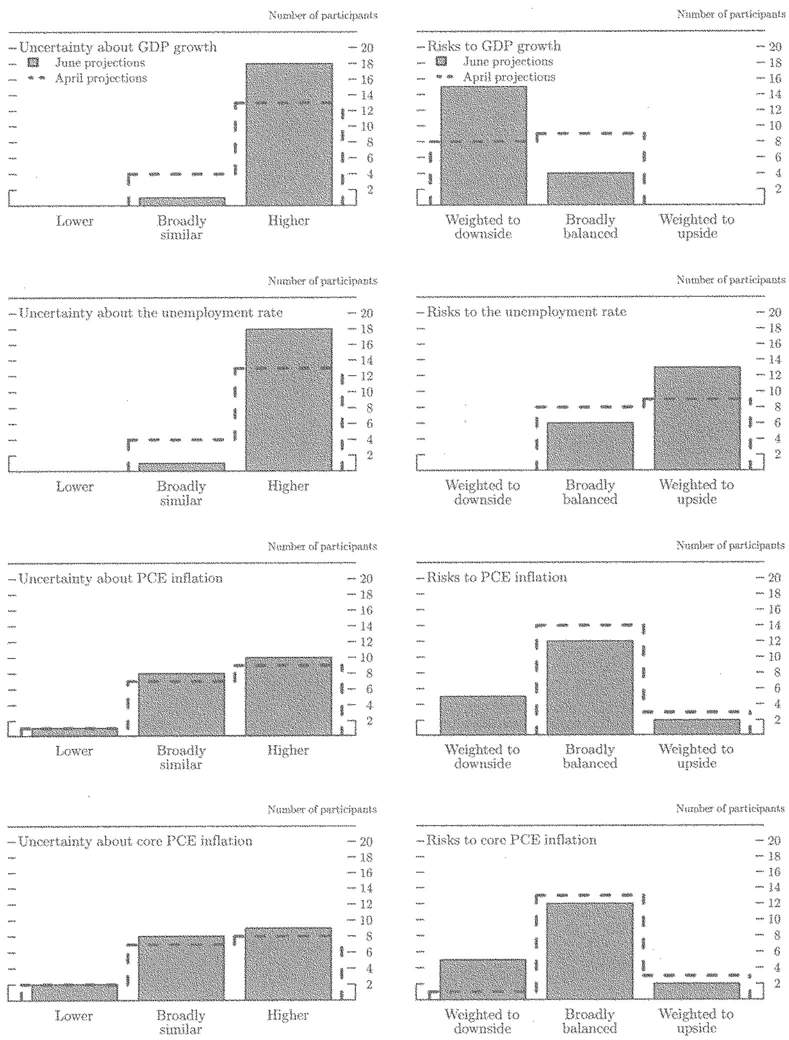
Note: Error ranges shown are measured as plus or minus the root mean squared error of projections for 1992 through 2011 that were released in the summer by various private and government forecasters. As described in the box "Forecast Uncertainty," under certain assumptions, there is about a 70 percent probability that actual outcomes for real GDP, unemployment, and consumer prices will be in ranges implied by the average size of projection errors made in the past. Further information is in David Reifschneider and Peter Tulip (2007), "Gauging the Uncertainty of the Economic Outlook from Historical Forecasting Errors," Finance and Economics Discussion Series 2007-60 (Washington: Board of Governors of the Federal Reserve System, November).

1. Definitions of variables are in the general note to table 1.

2. Measure is the overall consumer price index, the price measure that has been most widely used in government and private economic forecasts. Projection is percent change, fourth quarter of the previous year to the fourth quarter of the year indicated.

14. Table 2 provides estimates of the forecast uncertainty for the change in real GDP, the unemployment rate, and total consumer price inflation over the period from 1992 to 2011. At the end of this summary, the box "Forecast Uncertainty" discusses the sources and interpretation of uncertainty in the economic forecasts and explains the approach used to assess the uncertainty and risks attending the participants' projections.

Figure 4. Uncertainty and risks in economic projections



NOTE: For definitions of uncertainty and risks in economic projections, see the box "Forecast Uncertainty." Definitions of variables are in the general note to table 1.

Forecast Uncertainty

The economic projections provided by the members of the Board of Governors and the presidents of the Federal Reserve Banks inform discussions of monetary policy among policymakers and can aid public understanding of the basis for policy actions. Considerable uncertainty attends these projections, however. The economic and statistical models and relationships used to help produce economic forecasts are necessarily imperfect descriptions of the real world, and the future path of the economy can be affected by myriad unforeseen developments and events. Thus, in setting the stance of monetary policy, participants consider not only what appears to be the most likely economic outcome as embodied in their projections, but also the range of alternative possibilities, the likelihood of their occurring, and the potential costs to the economy should they occur.

Table 2 summarizes the average historical accuracy of a range of forecasts, including those reported in past *Monetary Policy Reports* and those prepared by the Federal Reserve Board's staff in advance of meetings of the Federal Open Market Committee. The projection error ranges shown in the table illustrate the considerable uncertainty associated with economic forecasts. For example, suppose a participant projects that real gross domestic product (GDP) and total consumer prices will rise steadily at annual rates of, respectively, 3 percent and 2 percent. If the uncertainty attending those projections is similar to that experienced in the past and the risks around the projections are broadly balanced, the numbers reported in table 2 would imply a probability of about 70 percent that actual GDP would expand within a range of 2.0 to 4.0 percent in the current year, 1.4 to 4.6 percent in the second year, and 1.3 to 4.7 percent in the third year. The corresponding 70 percent confidence intervals for overall inflation would be 1.2 to 2.8 percent in the current year, 1.0 to 3.0 percent in the second year, and 0.9 to 3.1 percent in the third year.

Because current conditions may differ from those that prevailed, on average, over history, participants provide judgments as to whether the uncertainty attached to their projections of each variable is greater than, smaller than, or broadly similar to typical levels of forecast uncertainty in the past, as shown in table 2. Participants also provide judgments as to whether the risks to their projections are weighted to the upside, are weighted to the downside, or are broadly balanced. That is, participants judge whether each variable is more likely to be above or below their projections of the most likely outcome. These judgments about the uncertainty and the risks attending each participant's projections are distinct from the diversity of participants' views about the most likely outcomes. Forecast uncertainty is concerned with the risks associated with a particular projection rather than with divergences across a number of different projections.

As with real activity and inflation, the outlook for the future path of the federal funds rate is subject to considerable uncertainty. This uncertainty arises primarily because each participant's assessment of the appropriate stance of monetary policy depends importantly on the evolution of real activity and inflation over time. If economic conditions evolve in an unexpected manner, then assessments of the appropriate setting of the federal funds rate would change from that point forward.

Abbreviations

ABCP	asset-backed commercial paper
ABS	asset-backed securities
AFE	advanced foreign economy
AIG	American International Group, Inc.
BEA	Bureau of Economic Analysis
BHC	bank holding company
BOE	Bank of England
BOJ	Bank of Japan
CCAR	Comprehensive Capital Analysis and Review
CDS	credit default swap
C&I	commercial and industrial
CMBS	commercial mortgage-backed securities
CP	commercial paper
CRE	commercial real estate
DPI	disposable personal income
ECB	European Central Bank
EME	emerging market economy
E&S	equipment and software
ESM	European Stability Mechanism
EU	European Union
FOMC	Federal Open Market Committee; also, the Committee
FRBNY	Federal Reserve Bank of New York
FSOC	Financial Stability Oversight Council
GDP	gross domestic product
GSE	government-sponsored enterprise
HARP	Home Affordable Refinance Program
IMF	International Monetary Fund
IPO	initial public offering
MBS	mortgage-backed securities
MEP	maturity extension program
Michigan survey	Thomson Reuters/University of Michigan Surveys of Consumers
NIPA	national income and product accounts
NPR	notice of proposed rulemaking
PCE	personal consumption expenditures

PRI	Institutional Revolutionary Party
SCOOS	Senior Credit Officer Opinion Survey on Dealer Financing Terms
SEP	Summary of Economic Projections
SLOOS	Senior Loan Officer Opinion Survey on Bank Lending Practices
SOMA	System Open Market Account
S&P	Standard & Poor's
STBL	Survey of Terms of Business Lending
TALF	Term Asset-Backed Securities Loan Facility

<u>Question for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Cleaver:</u>

1. The LIBOR by virtue of the manner in which it is calculated seems to be open to distortion. What proposals would you put forward in order to improve the credibility and validity of the rate?

A number of efforts are under way to examine the issues surrounding the calculation of LIBOR and to determine the appropriate next steps for reform of LIBOR and potentially other financial market benchmarks. These efforts include work being done by authorities in the United Kingdom, the Bank for International Settlements, the International Organization of Securities Commissions, and other international agencies. The Federal Reserve Board has taken part in discussions of possible reforms of LIBOR in international forums including the Economic Consultative Committee, a group of central bank governors, and the Financial Stability Board. Domestically, the Board and other Financial Stability Oversight Council agencies have cooperated in studying the risks surrounding the current LIBOR framework and the alternatives that are being considered.

Authorities are still grappling with a number of issues. For example, if the decision is made to fix the current system, then governance of the process, both within rate-submitting banks and within the body that oversees the calculation, must be improved. In addition, changes in the calculation may also be desirable. If, on the other hand, the decision is made to replace LIBOR with an alternative benchmark, there are a host of other issues to address. For example, how to transition to the alternative, whether the alternative will be transaction based or will remain an indicative quote, and how to handle legacy contracts.

Finally, an important question is who should oversee the reform process. Because LIBOR and other similar benchmarks were developed by, and are primarily used by, the private sector, the private sector will likely play a major role in the LIBOR reform efforts, though UK regulators will also play a key role in ensuring the reforms are adequate and in the public interest. The Federal Reserve, like other central banks, has an interest in the outcome of the reform efforts, given our monetary policy and financial stability responsibilities. We will continue to carefully monitor risks arising from and options to reform LIBOR and other benchmarks, and we will be prepared to provide support to reform efforts as necessary and appropriate.

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

1. While I understand that the Federal Reserve does not have internal mechanisms for measuring the creditworthiness of intellectual property held in general intangible lines, is the Federal Reserve taking any steps for these assets to be included in measuring overall reserve capital by means of impacting risk weighted asset calculations? Of investment grade counterparties were willing to monetize the liquid value of these collateral pools, does the Federal Reserve believe that these knowledge economy assets could be included in assessments of banking capital adequacy?

Consistent with the practice of the other federal banking agencies, the Board recognizes only limited forms of collateral in the calculation of a banking organization's risk-weighted assets for risk-based capital purposes. The Board may take other forms of collateral into consideration in evaluating the risks inherent in a banking organization's exposures and assessing its capital adequacy more generally.

Revisions to the regulatory capital framework recently proposed by the federal banking agencies would provide for greater recognition of financial collateral. See 77 Federal Register 52888, 52909, 52958 (August 30, 2012). The proposal would expand the list of eligible forms of collateral under the agencies' risk-based capital rules to include additional liquid and readily marketable instruments, such as certain types of debt securities and publicly-traded equity securities. Banking organizations would be required to meet certain prudential requirements to recognize the collateral, such as having a perfected, first priority interest in the collateral. The expanded definition of financial collateral under the proposed rules does not include intellectual property held in general intangible liens as a potential form of financial collateral.

The Board is in the process of reviewing carefully the comments on the proposal. The Board is not aware that intellectual property rights held in general intangible liens currently take the form of liquid and readily marketable instruments. We will continue to monitor developments in this market.

2. During your appearance before the House Committee on Financial Services in March 2011, you answered one of my questions by stating that we know from experience that small banks are often the ones that are best situated to provide credit to small businesses so they can expand and create jobs, especially in rural communities.

Based on the Federal Reserve and other regulators recent proposal to extend the Basel III capital requirements to all banks, do you foresee any disproportionate effects on smaller banks and the communities they serve? Has the Federal Reserve or another regulatory authority performed an analysis on how these capital thresholds for smaller institutions will affect access to capital and job creation in rural communities?

Many requirements in the Basel III proposal are focused on larger organizations and would not be applicable to community banking organizations. These requirements include the proposed countercyclical capital buffer, the proposed supplementary leverage ratio, proposed enhanced disclosure requirements, proposed enhancements to the advanced approaches risk-based capital framework, stress testing requirements, a systemically important financial institution capital surcharge, and market risk capital reforms. These changes, along with other recent regulatory capital enhancements, would require large, systemically important banking organizations to hold significantly higher levels of capital relative to other organizations.

In developing the Basel III-based capital requirements, the Board and the other federal banking agencies conducted an impact analysis based on regulatory reporting data to estimate the change in capital that banking organizations would be required to hold to meet the proposed minimum capital requirements. Based on the agencies' analysis, the vast majority of banking organizations currently would meet the fully phased-in minimum capital requirements, and those organizations that would not meet the proposed minimum requirements would have time to adjust their capital levels by the end of the transition period. More specifically with regard to smaller banking organizations, for bank holding companies with less than $10 billion in assets that meet the current minimum regulatory capital requirements, the analysis indicated that more than 90 percent of organizations would meet the new 4.5 percent minimum common equity tier 1 ratio today. In addition, quantitative analysis by the Macroeconomic Assessment Group, a working group of the Basel Committee on Banking Supervision, found that the stronger Basel III capital requirements would lower the probability of banking crises and their associated economic output losses while having only a modest negative impact on gross domestic product and lending costs, and that the potential negative impact could be mitigated by phasing in the requirements over time.

Nonetheless, the Board is concerned about the potential effect of the Basel III proposals on community banks. The Board is still in the process of reviewing the comments it has received on the proposal, including those regarding the likely impact on smaller institutions. The Board will be mindful of these comments when considering potential refinements to the proposal and will work to appropriately balance the benefits of a revised capital framework against its potential costs, including further tailoring the requirements for smaller institutions as appropriate.

3. Additionally, during your appearance in March 2011, we spoke about what the Federal Reserve has done to curb perceived micromanagement by bank examiners and regulators. Can you provide details on what steps the Federal Reserve has taken over the past two years to tailor its regulatory requirements and examination process based on recommendations and concerns that you have heard from community banks?

In recent years, the Board has taken a number of steps to reduce regulatory burden on, and enhance its communication with, community banks. In 2009, the Board established a subcommittee to focus on supervisory approaches to community and regional banks to ensure that their views on the supervisory process are considered. This subcommittee is led by Board Governors Elizabeth Duke and Sarah Bloom Raskin. A primary goal of the subcommittee is to ensure that the development of supervisory guidance is informed by an understanding of the unique characteristics of community and regional banks and consideration of the potential for excessive burden and adverse effects on lending. In addition, in 2010, the Board established the

Community Depository Institutions Advisory Council (CDIAC) to provide input on the economy, lending conditions, and other issues of interest to community banks. Members include representatives of banks, thrift institutions, and credit unions serving on local advisory councils at the 12 Federal Reserve Banks. One member of each of the Reserve Bank councils is selected to serve on the CDIAC, which meets twice a year with the Board in Washington, D.C.

Feedback from community bankers has consistently pointed to increasing regulatory burden as a concern and threat to the viability of the community bank model. Last year, the Board's subcommittee on community and regional banks asked that a series of initiatives be developed to clarify regulatory expectations, alleviate regulatory burdens where possible, and reduce the potential that regulatory actions could curtail lending. In response, Federal Reserve staff initiated a number of projects to enhance supervision practices for community banks and alleviate some of the burdens that have been of the most immediate concern.

Several of these projects aim to revise or clarify guidance. These have included the development and issuance of guidance to reiterate when supervisory rating upgrades may be considered for community banks recovering from the effects of the recent crisis, to enhance the transparency and consistency of assessments of the adequacy of banks' allowances for loan and lease losses, and to clarify capital planning expectations for community banks. Others projects are intended to improve our examination processes by reviewing exam preparation procedures to ensure that report findings are clearly communicated and fully consistent with information provided to bankers during exit meetings, developing and adopting common technology tools across the System to improve efficiency and potentially reduce burden on supervised companies, and evaluating applications-processing procedures to enhance transparency and identify opportunities for streamlining. Overall, these efforts are intended to ensure a rigorous, but balanced, approach to safety and soundness supervision that fosters a stable, sound, and vigorous community bank population.

<u>Questions for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative McCarthy:</u>

1. The recent CFTC and DOJ Settlements reached with Barclays regarding their manipulation of the LIBOR index, still leaves outstanding issue of ensuring that such manipulation foes not occur again. Recognizing this is an international issue and will require cooperation from European regulators,

- **What changes do you feel are necessary to better detect and ultimately avoid future manipulation of the LIBOR index?**

A number of efforts are under way to examine the issues surrounding the calculation of LIBOR and to determine the appropriate next steps for reform of LIBOR and potentially other financial market benchmarks. These efforts include work being done by authorities in the United Kingdom, the Bank for International Settlements, the International Organization of Securities Commissions, and other international agencies. The Federal Reserve Board has taken part in discussions of possible reforms of LIBOR in international forums including the Economic Consultative Committee, a group of central bank governors, and the Financial Stability Board. Domestically, the Board and other Financial Stability Oversight Council agencies have cooperated in studying the risks surrounding the current LIBOR framework and the alternatives that are being considered.

Authorities are still grappling with a number of issues. For example, if the decision is made to fix the current system, then governance of the process, both within rate-submitting banks and within the body that oversees the calculation, must be improved. In addition, changes in the calculation may also be desirable. If, on the other hand, the decision is made to replace LIBOR with an alternative benchmark, there are a host of other issues to address. For example, how to transition to the alternative, whether the alternative will be transaction based or will remain an indicative quote, and how to handle legacy contracts.

Finally, an important question is who should oversee the reform process. Because LIBOR and other similar benchmarks were developed by, and are primarily used by, the private sector, the private sector will likely play a major role in the LIBOR reform efforts, though UK regulators will also play a key role in ensuring the reforms are adequate and in the public interest. The Federal Reserve, like other central banks, has an interest in the outcome of the reform efforts, given our monetary policy and financial stability responsibilities. We will continue to carefully monitor risks arising from and options to reform LIBOR and other benchmarks, and we will be prepared to provide support to reform efforts as necessary and appropriate.

2. In a recent Wall Street Journal article "Fed Wrestles With How Best to Bridge U.S. Credit Divide," June 19, 2012, the point is made that the Federal Reserve's low interest rate policy has not improved access to credit for those who need it most – Americans of modest means and lower credit scores, and has not influenced the credit divide in this country.

- **What is the Fed's responsibility in achieving a more equitable spread of the benefits from the policies put in place to spur economic growth?**

The Federal Reserve has multiple responsibilities in this regard. First, the Federal Reserve has responsibility for pursuing the monetary policy mandates given to it by the Congress, namely price stability and maximum sustainable employment. The experience of the last several years also demonstrates conclusively how critical financial stability is to the achievement of its monetary policy mandate. The Federal Reserve also has important supervisory responsibilities. As important as these policy responsibilities are, they are not a panacea. The economy faces multiple important challenges, and all economic policymakers should ensure that they are using every available tool to work toward a more rapid return of a durable and broadly shared prosperity.

- **What policy changes can be made to bridge the credit divide, while still preserving safety and soundness?**

The Federal Reserve has long been oriented toward promoting these objectives. We do that through our microprudential supervision of financial institution; through our development and conduct of macroprudential policy; and through our conduct of monetary policy. As I have said many times, the recovery is proceeding too slowly for anyone's satisfaction, and I can assure you that the Federal Reserve will not stint in its efforts toward the achievement of our various policy objectives.

3. In addition to the liquidity support the Federal Reserve has provided the European Central Bank, what more do you feel could or should the United States do to encourage or support the Eurozone financial crisis response?

European leaders have recently taken some important steps toward resolving their crisis, including an agreement on additional aid to Greece and some progress toward banking union. The Europeans will need to build on that progress by working to fulfill their commitments to support growth, financial stability, and fiscal and financial integration in the region. The Federal Reserve and the Treasury are in contact with our counterparts in Europe to remain apprised of the situation there, to consult as appropriate, and to assist in monitoring of potential spillovers to the U.S economy. In the event that financial stresses in Europe were to worsen and threaten the U.S. economic recovery or U.S. financial stability, the Federal Reserve is prepared to use its policy tools as necessary to address strains in financial markets and support the flow of credit to households and firms. The Federal Reserve and several other major central banks have already established swap lines that allow the foreign central banks to provide dollar liquidity to banks in their jurisdictions. These facilities should help reduce pressure on dollar funding markets in the United States, which are important for U.S. households and businesses. In addition to the liquidity support that the Federal Reserve has supplied, we believe that the United States can also contribute to the health of the European economies, and thus support the Eurozone financial crisis response, by bolstering our own economic recovery.

<u>Questions for The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Paul:</u>

1. What items constitute the "Other Federal Reserve assets" line item in Table 1 of the weekly Federal Reserve Statistical Release H.4.1 Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks? Please provide as detailed a categorized list as possible?

"Other Federal Reserve assets" ("other assets") include assets denominated in foreign currencies; premiums paid on securities bought; accrued interest on other accounts receivable; Reserve Bank premises and operating equipment less allowances for depreciation; and, until recently, float-related as-of adjustments.[1] Until January 2009, "other assets" also included the currency swaps with other central banks. For reference, the Board of Governors' Credit and Liquidity Programs and the Balance Sheet public website presents a summary of the H.4.1 statistical release with an interactive guide (http://www.federalreserve.gov/monetarypolicy/bst_fedsbalancesheet.htm).

2. The "Other Federal Reserve assets" line item increased from approximately $40 billion in early 2009 to roughly $100 billion in early 2010, remaining at that level throughout 2010. What were the causes for the increase in the "Other Federal Reserve assets" line items over the 2009-2010 period?

You noted that between 2009 and early 2010, "other assets" increased. Indeed, between January 28, 2009, and the present, "other assets" have increased by roughly $150 billion. The increase primarily reflects an increase in unamortized premiums on securities held in the Federal Reserve's System Open Market Account portfolio. The Federal Reserve purchases securities in the open market at market-determined prices. The market price of a security can be expressed as the face value of that security plus a premium or a discount, depending on whether the market price of the security is above or below the face value on the date of purchase. On the H.4.1 statistical release, we report the face value of the securities, and the premium or discount at the time of purchase is separately reported under "other assets." This accounting treatment has been in place for decades.

Since early 2009, the Federal Reserve has engaged in large-scale asset purchases in an effort to ease overall financial conditions and to provide support for the economic recovery. Because the market prices of most of the securities that were purchased were greater than the face value of those securities, "other assets" have increased reflecting the accumulation of premiums as our holdings of securities have increased.[2]

---

[1] As one part of an effort to simplify the administration of reserve requirements and thereby reduce burden on the banking sector, the Federal Reserve eliminated as-of adjustments on July 12, 2012. Additional information about reserves simplifications can be found at http://www.federalreserve.gov/newsevents/press/other/20120405a.htm

[2] The Federal Reserve publishes the details of all of its securities holdings on the public website of the Federal Reserve Bank of New York (http://www.newyorkfed.org/markets/soma/sysopen_accholdings.html).

3. The "Other Federal Reserve assets" line item has nearly doubled since early 2011, increasing from roughly $100 billion to almost $200 billion. What is (are) the cause(s) for this increase in the "Other Federal Reserve assets" line item?

Please see the response to question 2.

4. Is the increase in the line item "Other Federal Reserve assets" related in any way to the dollar swap lines with foreign central banks or to other assistance to foreign central banks, commercial banks, or governments?

The central bank liquidity swaps that the Federal Reserve has with other central banks have been reported separately since January 2009. As a result, the increase in "other assets" since then is not related to those swaps, nor is it related to assistance to foreign institutions.

5. The central bank liquidity swap lines when first drawn upon in 2007 were published in the H.4.1 release with the "Other Federal Reserve assets" line item before being broken out into a separate line item in early 2009. Are there some specific facilities, asset types, or other categories that could be given their own line item now that the "Other Federal Reserve assets" line items had grown so large?

Although the security premiums at the date of purchase are largely a technical accounting item, we are considering whether to report the premiums on securities separately from other items included in the "other assets" category.

Questions for The Honorable Ben S. Bernanke, ~~Chairman,~~ Board of Governors of the Federal Reserve System, from Representative Schweikert:

1. In light of the current Weighted Average Maturity of U.S. sovereign debt, what is your position on encouraging policy makers, particularly those at the Treasury Department, to begin issuing extended durations bonds, such as 50-, 75-, and 99-year bonds? Wouldn't this direction in monetary policy be consistent with the design and intent of Operation Twist, and at the same time reduce U.S. exposure at future refinancing?

The Treasury Department makes all decisions regarding the issuance of U.S. Treasury debt. As an independent agency, the Federal Reserve does not offer advice regarding debt issuance matters to the Treasury Department.

2. At a recent hearing held by the Capital Markets Subcommittee I asked the witnesses which issue in the proposed Dodd-Frank rules would most hinder liquidity and a return of the securitization markets. Every one of them raised the same concern: the Premium Capture Cash Reserve Account, or PCCRA, that's part of your proposed risk retention rule.

Economist Mark Zandi of Moody's Analytics has written that the PCCRA and the Qualified Mortgage rule, when taken together – have "the potential to significantly restrict the amount of credit available for borrowers without qualified residential mortgages." He estimates the mortgage rate impact to borrowers would be between 1 and 4 percent.

Last month a bipartisan group of six Republicans and six Democrat Senators wrote to you, among others, saying that "The PCCRA ... was not envisioned by Congress" and would "negatively impact capital formation." I have submitted the letter for the record. My question to you, Mr. Chairman, is: given that the PCCRA was not a part of Dodd-Frank and was never even contemplated by Congress, don't you think the Fed – which is the only one of the six regulators pushing this proposal – should defer to Congress and drop this harmful idea?

On March 31, 2011, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the U.S. Securities and Exchange Commission, the Director of the Federal Housing Finance Agency, and the Department of Housing and Urban Development (collectively, the "Agencies") invited public comment on a proposal that would implement the risk retention requirements under section 941(b) of the Dodd-Frank Act. Section 941 of the Dodd-Frank Act generally requires the securitizer of asset-backed securities ("ABS") to retain not less than 5 percent of the credit risk of the assets that collateralize those securities. The statute also requires that the risk retention regulations prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset.

As the Agencies explained in the joint proposed rulemaking to implement section 941 (the "Proposed Rule"), the securitizer may sell premium income from assets collateralizing ABS that is expected to be generated over the life of a transaction at the inception of a transaction, thereby potentially negating or undermining the securitizer's retention of risk pursuant to the requirement.[1] The Agencies proposed the premium capture cash reserve account ("PCCRA") as a way to address this issue and promote meaningful risk retention by prohibiting sponsors from receiving compensation at the inception of a securitization transaction for premium income that would be generated by the securitized assets over time. As explained in the Proposed Rule, it was expected that the PCCRA would better align the interests of securitizers and investors by disallowing such upfront compensation and thereby potentially promote sound underwriting. It was also expected that the PCCRA would promote simpler and more coherent securitization structures. In the Proposed Rule, the Agencies specifically requested comment on the PCCRA and sought input on alternative methodologies for achieving similar goals.[2]

The Board and the other Agencies received numerous comments on the PCCRA, as well as suggestions for modification of the PCCRA and alternative methods for ensuring economically meaningful risk retention. In addition, Federal Reserve staff has met with industry groups and other commenters to better understand their concerns about the PCCRA, along with the other Agencies. The Board is carefully considering all comments and suggestions on the PCCRA in determining how to move forward with the rulemaking.

3. Our committee's chairman, Spencer Bachus, and my subcommittee chairman, Scott Garrett, have repeatedly asked the Fed and the other regulators for an economic analysis of PCCRA. Is that forthcoming? When can we expect it?

The Board has long been committed to considering the costs and benefits of its rulemaking efforts and takes into account all comments and views from the public on the costs and benefits of a proposed rulemaking. Indeed, the Board and the other Agencies specifically invited comment on the costs and benefits of the risk retention proposal and the PCCRA. As it reviews the comments submitted regarding the proposal, including comments on the PCCRA, the Board will carefully weigh the costs and benefits of the PCCRA and other alternatives for implementing risk retention rules that are consistent with the statutory mandate and purpose.

4. Does the Federal Reserve intend to produce any kind of impact study on a potential increase in mortgage rates for borrowers if PCCRA is codified into law?

As it reviews the comments regarding the proposal, including comments on the PCCRA, the Board is carefully considering the potential effects of the PCCRA, including on mortgage rates for borrowers, in determining how to move forward with the rulemaking. This is consistent with the Board's rulemaking practice and the Board has incorporated economic impact information into its final rule notices where appropriate.

---

[1] See 76 FR 24113-24114 (April 29, 2011).

[2] See id.