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COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
2157 RAYBURN HOUSE OFFICE BUILDING
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August 1, 2012

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

Dear Chairman Bernanke:

Thank you very much for your letter dated September 16, 2011, in which you responded to a number of my concerns regarding monetary policy.[1] Since that time, the economy has continued to struggle. In response to this persistent weakness, the Federal Reserve has taken repeated actions to purchase bonds, purchase mortgage-backed securities, and adjust the shape of the yield curve through implementation of "Operation Twist."[2] Despite the efforts of the Federal Reserve, the country is in even worse financial shape as the economy continues to step sideways. This will only be exacerbated as Europe deals with its sovereign debt crisis and China's robust economic growth teeters due to global weakness, excess industrial capacity and an apparent real estate bubble.

For these reasons, I am asking further questions about our nation's monetary policy and seek an update as to the state of finances and potential actions of the Federal Reserve. Of particular concern to me is the persistent drumbeat of highly reputed academics, former government executives, and market participants who express great concern with regard to the actions of the Federal Reserve, its apparent use of monetary policy to generate short term solutions, and the resulting risky balance sheet that weakens the Federal Reserve's ability to withstand the next financial crisis. Three of these highly reputed individuals, Professor Allan Meltzer, David Stockman, and Andy Kessler, have stated their concerns in a particularly clear manner. Throughout this letter I cite their statements, seeking your response so that the Committee and the public can better understand the costs and benefits of the actions of the Federal Reserve.

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[1] Letter from Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, to the Darrell Issa, Chairman, H. Comm. on Oversight and Gov't Reform, Sept. 16, 2011.
[2] *See, e.g.,* Board of Governors of the Federal Reserve System, Current FAQs: Informing the public about the Federal Reserve, "What is the Federal Reserve's maturity extension program (referred to by some as "operation twist" and what is its purpose?", *available at* http://www.federalreserve.gov/faqs/money_15070.htm.

Professor Meltzer, of Carnegie Mellon University, in an opinion piece in the *Wall Street Journal* dated July 9, 2012, criticized the Federal Reserve's current monetary policy.[3] His central concern was the short-term focus of the Federal Reserve and its apparent inability to refuse requests for more quantitative easing by financial institutions. Professor Meltzer stated:

> Consider the response to last week's employment report for June—a meager 80,000 net new jobs created, and an unemployment rate stuck at 8.2%. Day traders and speculators immediately clamored for additional monetary easing. Even the President of the Federal Reserve Bank of Chicago joined in. To his credit, Mr. Bernanke did not immediately agree. But he failed utterly to state the obvious: The country's sluggish growth and stubbornly high unemployment rate was not caused by, nor could it be cured by, monetary policy. Market interest rates on all maturities of government bonds are the lowest since the founding of the republic. Banks have $1.5 trillion in cash on their balance sheet in excess of their legally required reserves—far more than enough to meet any unsatisfied demand for loans that bankers regard as prudent.[4]

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

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

Professor Meltzer continued:

> Consider also how, in the summer of 2010, the Fed allowed itself to be spooked by cries about a double-dip recession and deflation. It added $600 billion to banks' reserves by buying up federal Treasurys and mortgage-backed securities. Today, $500 billion of those reserves remain on bank balance sheets, and most of the rest of the dollars are held by foreign central banks. Not much help to the U.S. economy. By early autumn 2010, it had become clear that fears of a double-dip recession and deflation were just short-term hysteria.[5]

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

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

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[3] Allan Meltzer, *What's Wrong With the Federal Reserve?*, WALL ST. J., July 9, 2012.
[4] *Id.*
[5] *Id.*

Professor Meltzer then discusses the Federal Reserve's excessive focus on short term data:

> One of the Fed's big mistakes is excessive attention to the short term, over which it has little influence. As I researched the central bank for my "History of the Federal Reserve," I was dismayed to find hardly any discussions in the minutes of its policy arm, the Federal Open Market Committee, about what members expect to happen a year from now as a result of whatever actions it is taking today…
>
> The problem with the short term is that data reported today are subject to revision, or reflect only transitory changes. The better economic data last winter are one of many examples. Would the reported improvement in the economy persist? We didn't learn the answer until weaker data reported this spring. Is the slowdown persistent or temporary? We can only guess.
>
> Executing monetary-policy changes in response to transitory data is a mistake. The late Nobel laureate economist Milton Friedman taught that monetary policy operates with long lags. Actions today have their main effects much later. By then the data often support a very different story.
>
> With mortgage rates lower than ever and housing showing very sluggish recovery, what can be gained by dropping the mortgage rate another small fraction? Business investment is held back by uncertainty. No one can reliably calculate tax rates, health-care costs, and the regulatory burden until after the election, if then. How can corporate officers calculate expected return when they cannot know these future costs? How is more monetary stimulus today supposed to help?[6]

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

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

Professor Meltzer then remarked on prior Federal Reserve policy and compared that to today:

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[6] *Id.*

> From about 1985 to 2003, the Fed achieved relatively stable growth, short, mild recessions, and low inflation by more or less following the Taylor Rule, which specifies (to simplify) what interest rate the Fed should establish in response to the expected inflation rate and the unemployment rate. Rule-based monetary policy brought us a far better economic outcome than discretionary ups and downs. The Fed should commit to that rule and follow it.
>
> One of the many costs of the Fed's excessive attention to the near-term is that it will wait until after the inflation is upon us before it does anything to stop it. The Fed's view is that by raising interest rates enough, it can stop any inflation. True, but not entirely relevant. Will the politicians, the public, business and labor accept the necessary level of interest rates? Much history says: "Don't count on it." Better to adopt something like the Taylor Rule and begin gradually reducing the banking system's excess reserves now.[7]

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

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

David Stockman, formerly the Director of the Office of Management and Budget under President Reagan, raises even more critical and concerning points regarding Federal Reserve policy in a recent interview reported in *The Gold Report* on May 4, 2012. His concerns primarily relate to the risks inherent in the Federal Reserve's balance sheet and its manipulation of the Treasury yield curve. An excerpt from the interview summarizing his key concern provides:

> The Fed is destroying the capital market by pegging and manipulating the price of money and debt capital. Interest rates signal nothing anymore because they are zero. The yield curve signals nothing anymore because it is totally manipulated by the Fed. The very idea of "Operation Twist" is an abomination.[8]

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

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[7] *Id.*

[8] Karen Roche and J.T. Long, *The Emperor is Naked: Interview with David Stockman*, THE GOLD REPORT, May 4, 2012.

David Stockman further explained that "[c]apital markets are at the heart of capitalism and they are not working. Savers are being crushed when we desperately need savings. The federal government is borrowing when it is broke."[9]

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

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

Mr. Stockman goes into some detail regarding the actions of the banks as they respond to the actions of the Federal Reserve:

> …Wall Street is arbitraging the Fed's monetary policy by borrowing overnight money at 10 basis points and investing it in 10-year treasuries at a yield of 200 basis points, capturing the profit and laughing all the way to the bank. The Fed has become a captive of the traders and robots on Wall Street…
>
> Because of Fed management and interest-rate pegging, the market is artificially medicated. All of the rates and spreads are unreal. The yield curve is not market driven. Supply and demand for savings and investment, future inflation risk discounts by investors—none of these free market forces matter. The price of money is dictated by the Fed, and Wall Street merely attempts to front-run its next move.[11]
>
> As long as the hedge fund traders and fast-money boys believe the Fed can keep everything pegged, we may limp along. The minute they lose confidence, they will unwind their trades.[12]

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

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[9] *Id.*
[10] Letter from Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, to the Darrell Issa, Chairman, H. Comm. on Oversight and Gov't Reform, Sept. 16, 2011.
[11] Karen Roche and J.T. Long, *The Emperor is Naked: Interview with David Stockman*, THE GOLD REPORT, May 4, 2012.
[12] *Id.*

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

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

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

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

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

    David Stockman continues:

    > On the margin, nobody owns the Treasury bond; you rent it. Trillions of treasury paper is funded on repo: You buy $100 million (M) in Treasuries and immediately put them up as collateral for overnight borrowings of $98M. Traders can capture the spread as long as the price of the bond is stable or rising, as it has been for the last year or two. If the bond drops 2%, the spread has been wiped out.
    >
    > If that happens, the massive repo structures—that is, debt owned by still more debt—will start to unwind and create a panic in the Treasury market. People will realize the emperor is naked.[13]

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

David Stockman then describes his view of things to come. The following is an excerpt of his interview that reflects a complicated and concerning potential scenario:

> [David Stockman]: In 2008 we had a dry run of what happens when a class of assets owned on overnight money goes into a tailspin. There is a thunderous collapse. Since then, the repo trade has remained in the

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[13] *Id.*

Treasury and other high-grade markets because subprime and low-quality mortgage-backed securities are dead.

[Interviewer]: Walk us through a hypothetical. What happens when the fast-money traders lose confidence in the Fed's ability to keep the spread?

[David Stockman]: They are forced to start selling in order to liquidate their carry trades because repo lenders get nervous and want their cash back. However, when the crisis comes, there will be insufficient private bids—the market will gap down hard unless the central banks buy on an emergency basis: the Fed, the European Central Bank (ECB), the people's printing press of China and all the rest of them.

The question is: Will the central banks be able to do that now, given that they have already expanded their balance sheets? The Fed balance sheet was $900 billion (B) when Lehman crashed in September 2008. It took 93 years to build it to that level from when the Fed opened for business in November 1914. Bernanke then added another $900B in seven weeks and then he took it to $2.4 trillion … during the initial 13 weeks after Lehman. Today it is nearly $3 trillion. Can it triple again? I do not think so. Worldwide it's the same story: the top eight central banks had $5 trillion of footings shortly before the crisis; they have $15 trillion today. Overwhelmingly, this fantastic expansion of central bank footings has been used to buy or discount sovereign debt. This was the mother of all monetizations.

[Interviewer]: Following that path, what happens if there are no buyers? Do the governments go into default?

[David Stockman]: The U.S. Treasury needs to be in the market for $20B in new issuances every week. When the day comes when there are all offers and no bids, the music will stop. Instead of being able to easily pawn off more borrowing on the markets—say 90 basis points for a 5-year note as at present—they may have to pay hundreds of basis points more…[14]

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

David Stockman then goes into greater detail on the anticipated decline of the Treasury bond market and how this decline will affect other markets:

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[14] *Id.*

> Once the bond market starts unraveling, all the other risk assets will start selling off like mad, too .... If the bond market goes into a dislocation, it will spread like a contagion to all of the other asset markets. There will be a massive selloff.
>
> I think everything in the world is overvalued—stocks, bonds, commodities, currencies. Too much money printing and debt expansion drove the prices of all asset classes to artificial, non-economic levels. The danger to the world is not classic inflation or deflation of goods and services; it's a drastic downward re-pricing of inflated financial assets....
>
> The Fed is now at the end of a $3 trillion limb. It has been taken hostage by the markets the Federal Open Market Committee was trying to placate. People in the trading desks and hedge funds have been trained to front run the Fed. If they think the Fed's next buy will be in the belly of the curve, they buy the belly of the curve. But how does the Fed ever unwind its current lunatic balance sheet? If the smart traders conclude the Fed's next move will be to sell mortgage-backed securities, they will sell like mad in advance; soon there would be mayhem as all the boys and girls on Wall Street piled on. So the Fed is frozen; it is petrified by fear that if it begins contracting its balance sheet it will unleash the demons.[15]

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

As previously mentioned, the Fed's intervention ultimately redistributes wealth, from savers to debtors. This redistribution costs our economy by taxing the most productive capital. As Andy Kessler recently commented in a Wall Street Journal Op-ed:

> Did Mitt Romney and Bain Capital help office-supply retailer Staples create 88,000 jobs? 43,000? 252? Actually, Staples probably destroyed 100,000 jobs while creating millions of new ones.
>
> Since 1986, Staples has opened 2,000 stores, eliminating the jobs of distributors and brokers who charged nasty markups for paper and office supplies. But it enabled hundreds of thousands of small (and not so small) businesses to stock themselves cheaply and conveniently and expand their operations.
>
> It's the same story elsewhere. Apple employs just 47,000 people, and Google under 25,000. Like Staples, they have destroyed many old jobs, like making paper maps and pink "While You Were Out" notepads. But by lowering the cost of doing business they've enabled innumerable

[15] *Id.*

> entrepreneurs to start new businesses and employ hundreds of thousands, even millions, of workers world-wide—all while capital gets redeployed more effectively.
>
> This process happens during every business cycle and always, always creates jobs. Yet is ignored by policy mavens....
>
> The mechanism to decide the most effective use for this capital is profits. The stock market bundles profits and is the divining rod of productivity, allocating capital in cycle after cycle toward the economy's most productive companies and best-compensated jobs. And it does so better than any elite economist or politician picking pork-barrel projects and relabeling them as "investments."
>
> The productive use of capital is not an automatic process, of course. It is all about constant experimentation. And it is never permanent: Railroads were once tremendously productive, so were steamships and even Kodachrome. It takes work, year in and year out—update, test, tweak, kill off. Staples is under fire from Amazon and other productive online retailers. Its stock has halved since its 2010 peak and is almost at a 10-year low. So be it.
>
> With all the iPads and Facebook and cloud-computing growth, why is unemployment still 8.2% and job creation stalled? My theory is that productivity is always happening but swims upstream against those that fight it. Unions, regulations and a bizarre tax code that locks in the status quo.[16]

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

22. Is productivity enhanced through creative destruction?

The Committee on Oversight and Government Reform is the principal oversight committee of the House of Representatives and may at "any time" investigate "any matter" as set forth in House Rule X.

We request that you provide the requested information as soon as possible, but no later than 5:00 p.m. on August 15, 2012. When producing information to the Committee, please deliver production sets to the Majority Staff in Room 2157 of the Rayburn House Office Building and the Minority Staff in Room 2471 of the Rayburn House Office Building. The Committee prefers, if possible, to receive all documents in electronic format.

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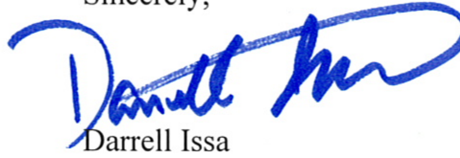
[16] Andy Kessler, *The Incredible Bain Jobs Machine*, WALL ST. J., July 17, 2012.

If you have any questions about this request, please contact Peter Haller or Brian Daner of the Committee Staff at 225-5074. Thank you for your attention to this matter.

Sincerely,



Darrell Issa
Chairman

cc: The Honorable Elijah E. Cummings, Ranking Minority Member
Committee on Oversight and Government Reform