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THE ECONOMIC OUTLOOK

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED THIRTEENTH CONGRESS

SECOND SESSION

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THE ECONOMIC OUTLOOK

WEDNESDAY, MAY 7, 2014

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to call, at 10:09 a.m. in Room 216 of the Hart Senate Office Building, the Honorable Kevin Brady, Chairman, presiding.

Representatives present: Brady of Texas, Amash, Paulsen, Hanna, Carolyn B. Maloney, Cummings, and Delaney.

Senators present: Klobuchar, Casey, Sanders, Murphy, Heinrich, Coats, and Wicker.

Staff present: Douglas Branch, Hank Butler, Conor Carroll, Gail Cohen, Barry Dexter, Connie Foster, Niles Godes, Paige Hallen, Colleen Healy, J.D. Mateus, Patrick Miller, Robert O'Quinn, Andrew Silvia, and Sue Sweet.

OPENING STATEMENT OF HON. KEVIN BRADY, CHAIRMAN, A U.S. REPRESENTATIVE FROM TEXAS

Chairman Brady. Good morning. The Joint Economic Committee hearing on The Economic Outlook for the United States will begin. To start, I congratulate Chair Yellen on her appointment to head the Board of Governors of the Federal Reserve System. I and other Members welcome you to your first appearance as Chair before the Joint Economic Committee and we look forward to many more.

June will mark the fifth anniversary of the end of the Great Recession. By virtually every economic indicator, this recovery ranks as the weakest or near the bottom. This recovery's persistent weakness has created a Growth Gap relative to other recoveries over the last half a century.

For example, if this recovery had been merely average, then the U.S. economy would be $1.4 trillion larger; American Workers would have 5.7 million more private-sector jobs available; and a family of four in America would have over $1,000 more each month in real after-tax income.

Ironically, for an Administration that has repeatedly bemoaned income inequality, the one exception to this weakness is Wall Street—where the S&P 500 Total Return Index, adjusted for inflation, has more than doubled. Last week, the Bureau of Economic Analysis and the Bureau of Labor Statistics released conflicting data about the strength of this recovery. On the one hand, according to the BEA, real GDP growth was basically flat in the first quarter, and according to the BLS the labor force participation rate

fell in April to 62.8 percent, tying a multi-decade low only reached in the Carter and now the Obama Administrations.

Moreover, the employment-to-population ratio is actually lower than when the recession ended, which means there are proportionally less adults working today than when the recovery began. That is headed in the wrong direction.

On the other hand, the BLS reported that for only the fifth time since the recession ended, the monthly growth of non-farm payroll jobs in April exceeded the equivalent average monthly job growth during pat recoveries with the unemployment rate declining to 6.3 percent from its October 2009 peak of 10 percent.

Correctly judging the strength of the labor market is very important because the Federal Open Market Committee has tied the tapering of large-scale asset purchases and the normalization of interest rates to its assessment of the labor market. Members of the FOMC attribute much of the slack in the labor market to cyclical factors and believe that a highly accommodative monetary policy can strengthen economic output and employment.

However, if a substantial portion of the weakness in the labor market is due to structural factors such as an aging population and a skills mismatch, then maintaining a highly accommodative monetary policy could instead create economic bottlenecks that would trigger price inflation.

Addressing structural unemployment requires much different policies, such as reforming education, strengthening job-training programs, and modernizing means-tested entitlement programs to encourage work.

I am encouraged that the FOMC began to taper large-scale asset purchases in December and appears on track to terminate these purchases before the end of the year.

However, I am concerned that the FOMC stated that it will likely maintain its zero-interest rate policy long after QE ends, and at levels below those that "the Committee views as normal in the longer run."

I am equally concerned that the discretionary nature of changes to the FOMC's forward-guidance is undermining the Fed's credibility—weakening the confidence of market participants, and increasing uncertainty.

I believe the Federal Reserve helped to stabilize financial markets after the panic in the fall of 2008, but extraordinarily low interest rates and repeated rounds of quantitative easing have done much more to stimulate Wall Street than help hard-working American families on Main Streets across America.

As I noted earlier, Wall Street is roaring, up 108.2 percent, while for average families and individuals, real after-tax income per capita is only up a mere 4.2 percent.

Chair Yellen, your predecessor was supremely confident that the Fed had the knowledge, tools, and political fortitude to exit smoothly from the Fed's extraordinary monetary actions and normalize interest rates and the size of its balance sheet before an inflationary outbreak could occur.

Yet the Fed—like many central banks—has an unsatisfactory track record over the last century in identifying economic turning points and acting in a timely manner to maintain stable prices.

The task is difficult. So today I am hopeful that you can enlighten the Committee on several points:

First, what is the FOMC's assessment of the strength of the labor market? How much of the weakness in the labor market do you believe is due to cyclical factors? And how much is due to structural ones? What statistics are FOMC members using to judge the health of the labor market and how much weight are they being given?

Secondly, can an overly accommodative monetary policy create asset price inflation that may not be fully captured by the CPI or the PCE Index? Do high stock prices reflect the fundamental strength of our economy? Or are they partially due to a highly accommodative monetary policy?

Three, has the FOMC's failure to abide by its own "communications channel" prescription created more uncertainty and undermined credibility? And when will the FOMC return to a rules-based approach to monetary policy that helped to achieve the good performances of the U.S. economy during the "Great Moderation"?

Fourthly, is the Federal Reserve Bank of San Francisco correct that higher federal taxes—including higher marginal rates on individual income, capital gains, and dividends—are presently the main cause of "fiscal drag" on our economy?

Is there a better way for Congress to address the spending side of our fiscal imbalances than the present sequester enacted as part of the Budget Control Act of 2011?

Finally, is the Fed willing to make its balance sheet more transparent? Specifically, will the Fed provide a consolidated list of holdings that includes not only maturity values but also average purchase prices for each issue and the current market value of each holding?

With that, those are a lot of questions, Chair Yellen, and you do not have to answer all of them, by the way, at this moment. Just so you know.

And with that, I look forward to your testimony. I note, for the Members, that the record will be kept open for one week so Members can submit additional written questions for the record.

With that, I yield to the Vice Chair of the Joint Economic Committee, Senator Klobuchar.

[The prepared statement of Chairman Brady appears in the Submissions for the Record on page 32.]

OPENING STATEMENT OF HON. AMY KLOBUCHAR, VICE CHAIR, A U.S. SENATOR FROM MINNESOTA

Vice Chair Klobuchar. Well thank you very much, Chairman Brady, and thank you for holding this timely hearing.

I will only add 15 questions to his list—no, I won't. I am so pleased you are joining us today, Chair Yellen, for this important discussion on the Federal Reserve and monetary policy.

I look forward to your testimony on the short-term and long-term issues facing our economy. Over the past five years, we have certainly seen the impact, the important impact, that monetary policy can have on economic growth. At a time where Congress has been, I think we all admit, gridlocked on some very important things, whether it is debt reduction, or whether it was the sequestration

policy, or other fights that we have had, the Fed has had to step in several times.

And today's hearing provides a chance to look ahead to policy options in what I hope will be a new environment where we finally have a budget in place, and other things that we will be able to move ahead as the Fed continues to wind down quantitative easing.

Both of us I think would agree, Chairman Brady and myself, that the recovery has not been as fast as we would like, but I will say that after a long, hard winter it is good news that the employment numbers are picking up.

To hit the lowest unemployment rate in 5–1/2 years is a positive sign. It means something, as we move into a summer season that we believe will bring more construction jobs, and especially in my state, more tourism jobs.

As we all know, the economy has added jobs for 50 consecutive months, as you can see from that chart, and has now regained more private-sector jobs than were lost during the recession.

In April alone, almost 300,000 jobs were added. And as you and I discussed, in my State the unemployment rate is down to 4.8 percent. And while I would not say we are roaring, as the Chairman described Wall Street, on the Main Streets of Minnesota, we are moving at a fast clip. Major expansions were announced from Andersen Windows and Kraus Andersen in just the last few days.

The national unemployment rate of 6.3 percent has dropped almost 4 percentage points since the height of the downturn. Inflation is low, as you know, well under 2 percent over the past 12 months, and there is no sign of a risk in inflation in the foreseeable future.

Gross Domestic Product has grown for 12 straight quarters, although growth in the first quarter was slower than anticipated. I believe that actions taken by the Fed helped bring about the economic recovery.

I believe Congress did some good things. I believe we should be doing more. And as the Chairman has outlined some of them.

The Fed lowered the short-term interest rates to near zero at the end of 2008, and stated recently that it will keep rates low for a considerable period of time. Low interest rates have helped strengthen the economy by helping keeping borrowing costs affordable for businesses and consumers.

This has spurred investment and consumer spending. Because the economy has strengthened, the Fed announced in December that it was reducing its purchases under quantitative easing.

Last month, the Fed announced it would further reduce purchases to $45 billion each month. It has always been understood that these efforts would be scaled back as the economy strengthens.

In its announcement of last month's actions, the Federal Open Market Committee changed its assessment of the economy slightly saying that, quote, "economic activity has picked up recently." End quote.

The Fed also highlighted an acceleration in household spending. Even with the economic progress, we all know families who are working several jobs to get by, as well as workers who cannot find a job after months and months of searching.

Though the short-term unemployment rate has fallen to close to its pre-recession level, the long-term unemployment rate is 2.2 percent, more than double the pre-recession level, which is one of the reasons many of us have continued to work on the unemployment compensation issue.

I have been pleased to hear you express your concerns about the long-term unemployed, Chair Yellen, and I am glad to know that addressing this problem is high on your list of priorities. Addressing long-term unemployment has also been a focus of my work on this Committee.

Despite some good news recently about job growth, there are still 3.5 million Americans out of work for longer than six months. I look forward to hearing your thoughts on the dual mandate. I look forward to hearing your thoughts on increased transparency at the Fed. And then of course I would again mention, as I have several times in this Committee when your predecessor was here, that I think that there have been some major issues with Congress in terms of bouncing back and forth, and careening from fiscal crisis to fiscal crisis, which certainly does not help the economy.

I am hoping, with this period of stability, with the budget in place, with the work that we did since the tragic shutdown, that we can now work on these issues that I think will help to build on the stability that we see now in the economy. I would list immigration reform, very important in my state, as we have trouble getting in engineers and spouses of doctors at the Mayo Clinic.

I would also focus on moving forward with exports on the job training that the Chairman talked about; on comprehensive tax reform; and then finally, and last, something that Minneapolis Fed President Kocherlakota brought up to me recently, and that is the issue of the tax incentives and the depreciation incentives for manufacturing equipment, which is part of the tax extension, and something I think gets a good bang for the buck and I will be asking you about that as well.

Thank you, very much, for appearing before us, Chair Yellen.

Chairman Brady. Thank you, Vice Chair.

Dr. Janet Yellen is Chair of the Board of Governors of the Federal Reserve System. She also serves as Chair of the Federal Open Market Committee. Prior to her appointment as Chair, Dr. Yellen served as Vice Chair of the Board of Governors.

She is Professor Emeritus at the University of California at Berkeley, where she is a professor of business and professor of economics, and has been a faculty member for over 30 years.

Dr. Yellen has served as Chair of the Council of Economic Advisers, and as president and chief executive officer of the Federal Reserve Bank of San Francisco. She also served as an economist with the Federal Reserve's Board of Governors, and on the faculty of the London School of Economics and Political Science.

Dr. Yellen graduated summa cum laude from Brown University with a degree in Economics, and received her Ph.D. in Economics from Yale University.

Chair Yellen, welcome to today's hearing.

STATEMENT OF HON. JANET L. YELLEN, CHAIR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WASHINGTON, DC

Chair Yellen. Thank you very much, Chairman Brady.

Chairman Brady, Vice Chair Klobuchar, and other members of the Committee, I appreciate this opportunity to discuss the current economic situation and outlook along with monetary policy before turning to some issues regarding financial stability.

The economy has continued to recover from the steep recession of 2008 and 2009. Real gross domestic product growth stepped up to an average annual rate of about 3¼ percent over the second half of last year, a faster pace than in the first half and during the preceding two years.

Although real GDP growth is currently estimated to have paused in the first quarter of this year, I see that pause as mostly reflecting transitory factors, including the effects of the unusually cold and snowy winter weather.

With the harsh winter behind us, many recent indicators suggest that a rebound in spending and production is already under way, putting the overall economy on track for solid growth in the current quarter.

One cautionary note, though, is that readings on housing activity—a sector that has been recovering since 2011—have remained disappointing so far this year and will bear watching.

Conditions in the labor market have continued to improve. The unemployment rate was 6.3 percent in April, about 1¼ percentage points below where it was a year ago. Moreover, gains in payroll employment averaged nearly 200,000 jobs per month over the past year. During the economic recovery so far, payroll employment has increased by about 8½ million jobs since its low point, and the unemployment rate has declined about 3¾ percentage points since its peak.

While conditions in the labor market have improved appreciably, they are still far from satisfactory. Even with its recent declines, the unemployment rate continues to be elevated.

Moreover, both the share of the labor force that has been unemployed for more than six months and the number of individuals who work part-time but would prefer a full-time job are at historically high levels. In addition, most measures of labor compensation have been rising slowly— another signal that a substantial amount of slack remains in the labor market.

Inflation has been quite low even as the economy has continued to expand. Some of the factors contributing to the softness in inflation over the past year, such as the declines in non-oil import prices, will probably be transitory.

Importantly, measures of longer run inflation expectations have remained stable. That said, the Federal Open Market Committee recognizes that inflation persistently below 2 percent—the rate that the Committee judges to be most consistent with its dual mandate—could pose risks to economic performance, and we are monitoring inflation developments closely.

Looking ahead, I expect that economic activity will expand at a somewhat faster pace this year than it did last year; that the un-

employment rate will continue to decline gradually; and that inflation will begin to move up toward 2 percent.

A faster rate of economic growth this year should be supported by reduced restraint from changes in fiscal policy, gains in household net worth from increases in home prices and equity values, a firming in foreign economic growth, and further improvements in household and business confidence as the economy continues to strengthen. Moreover, U.S. financial conditions remain supportive of growth in economic activity and employment.

As always, considerable uncertainty surrounds this baseline economic outlook. Currently, one prominent risk is that adverse developments abroad, such as heightened geopolitical tensions or an intensification of financial stresses in emerging market economies, could undermine confidence in the global economic recovery.

Another risk—domestic in origin—is that the recent flattening out in housing activity could prove more protracted than currently expected, rather than resuming its earlier pace of recovery. Both of these elements of uncertainty will bear close observation.

Turning to monetary policy, the Federal Reserve remains committed to policies designed to restore labor market conditions and inflation to levels consistent with those that the Committee judges to be consistent with its dual mandate.

As always, our policy will continue to be guided by the evolving economic and financial situation, and we will adjust the stance of policy appropriately to take account of changes in the economic outlook.

In light of the considerable degree of slack that remains in labor markets and continuation of inflation below the Committee's 2 percent objective, a high degree of monetary accommodation remains warranted.

With the federal funds rate, our traditional policy Tool, near zero since late 2008, we have relied on two less conventional tools to provide support for the economy: asset purchases and forward guidance. And because these policy tools are less familiar, we have been especially attentive in recent years to the need to communicate to the public about how we intend to employ our policy tools in response to changing economic circumstances.

Our current program of asset purchases began in September 2012 when the economic recovery had weakened and progress in the labor market had slowed, and we said that our intention was to continue the program until we saw substantial improvement in the outlook for the labor market.

By December 2013, the Committee judged that the cumulative progress in the labor market warranted a modest reduction in the pace of asset purchases. At the first three meetings this year, our assessment was that there was sufficient underlying strength in the broader economy to support ongoing improvement in labor market conditions, so further measured reductions in asset purchases were appropriate.

I should stress that even as the Committee reduces the pace of its purchases of longer term securities, it is still adding to its holdings, and those sizable holdings continue to put significant downward pressure on longer term interest rates, support mortgage

markets, and contribute to favorable conditions in broader financial markets.

Our other important policy tool in recent years has been forward guidance about the likely path of the federal funds rate as the economic recovery proceeds.

Beginning in December 2012, the Committee provided threshold-based guidance that turned importantly on the behavior of the unemployment rate. As you know, at our March 2014, meeting, with the unemployment rate nearing the threshold that had been laid out earlier, we undertook a significant review of our forward guidance.

While indicating that the new guidance did not represent a shift in the FOMC's policy intentions, the Committee laid out a fuller description of the framework that will guide its policy decisions going forward.

Specifically, the new language explains that, as the economy expands further, the Committee will continue to assess both the realized and expected progress toward its objectives of maximum employment and 2 percent inflation.

In assessing that progress, we will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments.

In March and again last month, we stated that we anticipated the current target range for the federal funds rate would be maintained for a considerable time after the asset purchase program ends, especially if inflation continues to run below 2 percent, and provided that inflation expectations remain well anchored.

The new language also includes information on our thinking about the likely path of the policy rate after the Committee decides to begin to remove policy accommodation.

In particular, we anticipate that even after employment and inflation are near mandate-consistent levels, economic and financial conditions may, for some time, warrant keeping the target federal funds rate below levels that the Committee views as normal in the longer run.

Because the evolution of the economy is uncertain, policymakers need to carefully watch for signs that it is diverging from the baseline outlook and respond in a systematic way to stabilize the economy.

Accordingly, for both our purchases and our forward guidance, we have tried to communicate as clearly as possible how changes in the economic outlook will affect our policy stance.

In doing so, we will help the public to better understand how the Committee will respond to unanticipated developments, thereby reducing uncertainty about the course of unemployment and inflation.

In addition to our monetary policy responsibilities, the Federal Reserve works to promote financial stability, focusing on identifying and monitoring vulnerabilities in the financial system and taking actions to reduce them.

In this regard, the Committee recognizes that an extended period of low interest rates has the potential to induce investors to "reach-

for-yield" by taking on increased leverage, duration risk, or credit risk.

Some reach-for-yield behavior may be evident, for example, in the lower rated corporate debt markets where issuance of syndicated leveraged loans and high-yield bonds has continued to expand briskly, spreads have continued to narrow, and underwriting standards have loosened further.

While some financial intermediaries have increased their exposure to duration and credit risk recently, these increases appear modest to date—particularly at the largest banks and life insurers.

More generally, valuations for the equity market as a whole and other broad categories of assets, such as residential real estate, remain within historical norms. In addition, bank holding companies have improved their liquidity positions and raised capital ratios to levels significantly higher than prior to the financial crisis.

For the financial sector more broadly, leverage remains subdued and measures of short-term funding continue to be far below levels seen before the financial crisis.

The Federal Reserve has also taken a number of regulatory steps—mainly in conjunction with other federal agencies—to continue to improve the resiliency of the financial system.

Most recently, the Federal Reserve finalized a rule implementing Section 165 of the Dodd-Frank Act to establish enhanced prudential standards for large banking firms in the form of risk-based and leverage capital, liquidity, and risk-management requirements.

In addition, the rule requires large foreign banking organizations to form a U.S. intermediate holding company, and it imposes enhanced prudential requirements for these intermediate holding companies.

Looking forward, the Federal Reserve is considering whether additional measures are needed to further reduce the risks associated with large, interconnected financial institutions.

While we have seen substantial improvements in labor market conditions and the overall economy since the financial crisis and severe recession, we recognize that more must be accomplished.

Many Americans who want a job are still unemployed, inflation continues to run below the FOMC's longer run objective, and work remains to strengthen our financial system.

I will continue to work closely with my colleagues and others to carry out the important mission that the Congress has given the Federal Reserve.

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

[The prepared statement of Hon. Janet L. Yellen appears in the Submissions for the Record on page 39.]

Chairman Brady. Thank you, Madam Chair.

I would like to get a clear picture of the Fed's comprehensive exit strategy in a number of areas.

Assuming the Fed's economic projections hold, can we expect the QE bond purchasing to end sometime this fall?

Chair Yellen. We have indicated that as long as we continue to see improvements in the labor market, and we believe the outlook is for continued progress, and as long as we continue to believe and see evidence that inflation will move back up over time to our 2

percent longer run objective, we anticipate continuing to reduce the pace of our asset purchases in measured steps.

So the answer is, yes.

Now if something were to change notably about the outlook, we would reconsider that plan. But if those conditions hold, we would continue on our current course, yes.

Chairman Brady. I will leave it to my colleagues to ask about the notably different changes. But just beyond that, the Fed holds $4.7 trillion on the balance sheet, extraordinarily large. When do you expect to begin normalizing the size of the Fed's balance sheet? Is there a range of years?

Chair Yellen. When we complete the asset purchase program, the Committee has indicated that it expects it will be a considerable time before we begin to normalize policy in the sense of beginning to raise our target for short-term interest rates.

Chairman Brady. What range—let's move to that. But before I do, what is the appropriate size? Do you have an appropriate size for the Fed's balance sheet?

Chair Yellen. I can't give you a number that would be an appropriate size. I believe the Committee anticipated that our balance sheet over time will move down to substantially lower levels than it is now.

Whether or not it will ultimately return to pre-crisis levels, or remains somewhat larger, is something that we will determine as we gain experience with exit.

One way that we are likely to turn to to normalize the size of our balance sheet eventually would be to cease reinvestment of principal as it comes due. The Committee has not given definite guidance at this point about when it would take the step of stopping reinvestment of maturing principal, and eventually as we come closer to normalization I expect we will give such guidance.

Chairman Brady. When do you expect—on normalizing interest rates, when do you expect that to begin? Assuming the Fed's economic projections hold.

Chair Yellen. What we have said in our most recent guidance is that in determining when that time is right, we will be looking at how much progress we have actually made in coming close to our mandate from Congress to attain maximum employment and inflation of 2 percent, and we will evaluate the pace at which we expect progress going forward.

Concretely, the Committee indicated that at the time the purchase program ends, it thinks that it will be a considerable time beyond that before it will be appropriate to begin that process.

And the reason is that under its baseline outlook it would like to see, or expects it will need to see, further progress in the labor market. And it has emphasized that the level of inflation will also matter.

Chairman Brady. If the Fed's economic projections hold what is that range? If I were to say you will begin normalizing interest rates in 2015, would I be wrong?

Chair Yellen. There is no mechanical formula or timetable for when that will occur.

Chairman Brady. But I know—I know that you've worked through your projections going forward, and certainly if those were

to hold you have some range of time that you will begin that process. What range is that?

Chair Yellen. The Committee has simply said "a considerable time" without mechanically stating what that time interval is.

Chairman Brady. Is "considerable"—if I were to say this will begin normalizing in 2016, would I be wrong?

Chair Yellen. Again, there is no specific timeline for doing that. Individual members of the Federal Open Market Committee, however, every three months provide their own forecasts for how they see the economy evolving under appropriate monetary policy. And that becomes a basis for discussion in the Committee.

And you can look at those projections that include individual participants' expected paths for normalization. You would see that most members believe that in 2015 or 2016, normalization would begin, under their baseline outlook.

Chairman Brady. Do you, to put it in perspective, what year, what range of years, could we expect the targeted rate to reach 2 percent, for example?

Chair Yellen. I think the answer is that it depends on the evolution of the economy. What we are focused on is adjusting our monetary policy in light of incoming evidence about the evolution of the economy——

Chairman Brady. But if it holds—granted. Obviously all this is dependent from your view on economic performance. But given your projections, you know, how far out are we looking at to just move about halfway back to normalization?

Chair Yellen. Again, I'm afraid I cannot give you a timetable, but the Committee did try to, in its recent statements in March and April, provide some guidance to the public about the pace at which it expects interest rates, short-term rates, to increase once that process is started.

And what they said is that they think it will take some time, even after the economy is in a sense functioning normally—namely, we're operating at full employment, and inflation is around 2 percent—they think it is likely it will take some time to come back to normal or historically average levels of interest rates.

Short-term interest rates they would see as normal levels, based on history, of something on the order of 4 percent. And they have indicated that they think it is going to take some time to reach levels like that.

I would emphasize that that is a forecast. It is not a promise——

Chairman Brady. Sure——

Chair Yellen [continuing]. But we have had headwinds that have acted on the economy, and headwinds in the global economy, and perhaps a slowdown in the pace of growth in the economy. And those are some of the factors that lead them to believe a gradual pace of interest rate increases will prove appropriate.

Chairman Brady. Understood.

The Fed holds about $1.6 trillion in residential mortgage-backed securities, a large amount. So again, assuming the Fed's economic projections hold, when do you expect to begin moving them back into the market, reverse repos, or other approaches? What range of years—and I do worry. I think there will be political resistance

when you take those steps, but what years will you see that occurring?

Chair Yellen. We have indicated that we do not intend to sell mortgage-backed securities from our portfolio, except perhaps when the holdings are very small, to eliminate some residual holdings.

Eventually—and the Committee hasn't decided on the timing of this—we are likely to cease reinvestment of principal. And at that point, our holdings of mortgage-backed securities would begin to decline over time as principal matures.

And so it would take a period of some years for our holdings to diminish, to be worth doing.

Chairman Brady. A final question about bank reserves of $2.6 trillion. For many, including me, it is potential fuel for inflation. When the economy strengthens and banks begin to lend—we hope sooner rather than later—to keep rapid inflation checked, will you raise reserve requirements for the rate of interest paid on the reserves? Do you have a view at this point?

Chair Yellen. It's my expectation that when the time comes to raise the level of short-term interest rates, that we will certainly raise the interest rate that we pay on excess reserves and are likely to use a number of complementary tools that we have developed, including our tool kit that includes overnight reverse repos, term repos, and our term deposit facility. We will use those tools to push up the general level of short-term interest rates. But interest on reserves will be a key tool that we will be using.

Chairman Brady. What impact will that have on economic growth?

Chair Yellen. We will only be taking that step when we have judged that the economy is strong enough that economic growth is sufficient, the labor market has recovered enough, and inflation is moving back toward 2 percent, we will have judged that the time is appropriate to tighten financial conditions in order to make sure that we don't overshoot our inflation objective.

And so the effect that it will have on the economy is to restrain the economy to make sure that we don't allow inflation to rise above our longer term objective.

Chairman Brady. Thank you. I will conclude with this—my main concern, having served on the Committee, in early to mid-2000s your able and very highly respected predecessor sat where you sat and assured the Committee that maintaining low interest rates for an extended period would not cause general price inflation or inflate an unsustainable asset bubble, which did not prove to be the case.

After the credit-fueled housing bubble burst in 2007, your predecessors assured the Committee that the resulting weakness would be confined to the subprime segment of the housing market and the damage would be limited to about $150 billion, roughly the cost of the S&L crisis.

Following the financial crisis in the Fall of 2008, we were repeatedly assured the Fed had the strategy to exit from the large expansion of its balance sheet to normalize monetary policy, including the federal funds target rate. Yet, the goalposts have been moved time and time again, and now re-moved.

Today you have assured the Committee once again, and I so appreciate your testimony, that the Fed is confident it can exit without sparking high inflation. But that we cannot know the details or the timetable, but that the Fed and FOMC have it essentially handled.

I do not expect the Fed to be perfect. Yours is a tough job. Theirs is a tough job. But it just strikes me that over time this "don't worry, be happy" monetary message isn't working, at least in my view for the Committee, certainly not for the economy at this point.

I know my colleagues will ask about today's Wall Street Journal where noted economist, Federal Reserve historian Dr. Alan Meltzer makes the point: Never in history has a country that's financed big budget deficits with large amounts of central bank money avoided inflation. My worry is that the track record of central banks, including the Fed, in identifying these economic turning points and acting quickly to prevent inflation, that track record is not as good as we would like.

So forgive me for being skeptical. I believe we need more specifics, and a clear timetable on the comprehensive exit strategy.

With that, again, thank you so much for being here. Vice Chair Klobuchar.

Vice Chair Klobuchar. Thank you very much, Mr. Chairman. Thank you, Chair.

As the Chairman was talking about with the change to the forward guidance policy, in the past it was tied of course—rising interest rates was tied to the 6.5 percent unemployment rate. And now the Fed says it will consider a wide range of economic indicators and not just the unemployment rate.

And he questioned you a little bit about this with the other indicators, but could you tell me what you see the benefits are of this new approach, and what are the drawbacks of moving away from an exact number?

Chair Yellen. Let me, if I might, explain about the number, the 6.5 percent.

We issued the number 6.5 percent at a time when the unemployment rate was around 8 percent. And we were very far from what anyone could call full employment, which is our goal.

And we wanted to indicate to markets that we would need to see a lot of improvement in the labor market and, assuming inflation was under control, before we would dream of raising our target for short-term interest rates.

And to make that clear, we took the number 6.5 percent. We felt confident that we would not, if inflation was under control, consider it appropriate to begin that process as long as the unemployment rate was over 6.5 percent, the gap would be sufficiently wide that something we shouldn't consider as a possibility.

So we gave the number 6.5, considerable distance from where we were, to the public to say we will wait at least that long.

Now we did not say that we would raise our target for the federal funds rate when we reached the level of 6.5 percent. What we said was, that would be close enough that we need to look very carefully at what—to assess using many different metrics of the labor market: where is it? And what is appropriate policy? And now it's appropriate to really look at many more things.

And we changed our forward guidance only because we were coming close to 6.5 percent and we have now crossed it. And there is no change in the guidance. We are saying: Now that we are there, we want you to understand, we have to develop a more nuanced approach to what is going on in the labor market.

Now, the unemployment rate is a good indicator of the state of the labor market. And if I could only have one, I think that's the metric I would probably choose. But there are different things happening in the labor market we need to take account of.

For example, part-time employment that is involuntary— people working part-time who want full-time jobs, want to work more. It is at exceptionally high levels, 5 percent of the labor market, which is unusually high relative to the unemployment rate.

We have really never seen a situation where long-term unemployment is so large a fraction of total unemployment, around 35 percent. That is very unusual. Other things are happening that we really, in evaluating how much slack is there in the labor market. Labor force participation rate has fallen a lot.

Now there are some structural reasons for that: demographics, Baby Boomers are aging and getting into the years when they retire and their labor force participation naturally declines. So the decline we have seen, it is not entirely because of a weak economy. But I think some of it is because of a weak economy, and in a sense, it is hard to give you a precise number for how much of that decline is cyclical.

But to the extent there is a cyclical decline, that is more slack. And that is what we are looking at and trying to judge. We are also looking at wage developments and the level of payroll employment creation.

Vice Chair Klobuchar. Let me follow up on a few of those things. What do you think the Fed can be doing about long-term unemployment, which we all acknowledge is too high?

Chair Yellen. I think that a stronger economy, as we have growth in the economy, my expectation is that long-term unemployment is going to come down.

Short-term unemployment is around normal levels. But I fully expect long-term unemployment to decline as the economy strengthens.

There is a debate about whether or not long-term unemployment may have less effect on wages and in turn on inflation than short-term unemployment; and that is something that is receiving a great deal of public attention and discussion, rightly so.

But I have very little doubt that if growth in the economy picks up and continues in an above-trend pace, that long-term unemployment will come down, too.

Vice Chair Klobuchar. One of the hearings that I chaired this last year was with Robert Reich, and it was about income inequality. And he talked about how right now we have a situation in our country where the wealthiest 400 have the same amount of wealth as the bottom 50 percent.

And the International Monetary Fund recently warned that income inequality is actually a drag on our country's economy.

Why do you think we have seen this rise? And how does it affect economic growth for the country as a whole? Do you think it is a factor?

Chair Yellen. We have seen a trend toward rising inequality in income, and also in wealth. And I personally view this as a very disturbing trend that policymakers should be looking at and considering what is the appropriate response.

You know, in part a weak economy, the people who are affected by unemployment are disproportionately people at the lower income end of the spectrum. And so a weak economy contributes something to income inequality. And I think what the Fed can do is to promote a stronger economy, a stronger job market generally, and that will help.

But the trends that are responsible for rising inequality go much deeper than the fact that we have had a deep recession. We can see those secular trends in operation at least since the mid-'80s. There is a great deal of discussion about what they are, but they probably have to do with technological change in the way it has increased the demand for skills in the workforce with globalization. And so the return to education, and to skill has gone up dramatically.

There may be institutional changes that are at work, as well. So there are deeper forces that are affecting this that go beyond anything that the Fed can do, but I really do think it is——

Vice Chair Klobuchar. But it is something that we should be taking up in Washington.

Chair Yellen. We should be thinking about it very carefully.

Vice Chair Klobuchar. One of the things that you mentioned in your opening was about how housing had flattened out. And could you expand on that? I think what we have seen, while the housing market has come back with housing prices—and my State is one of the ones where they have gone up the most—residential construction, all moving up, but one thing that has held housing back is the significant drop in household formation, which gets some to the income inequality.

During and after the recession, about 800,000 fewer households were created each year than in the previous 7 years. Young people are not forming households as much, and getting new houses.

Could you comment on this?

Chair Yellen. I agree with the data that you are citing. We have seen very slow household formation. Many young people are living with their parents. It is also very difficult for people who come out of school with heavy burdens of student debt to be able to qualify for mortgages.

Vice Chair Klobuchar. This is very timely since my daughter is arriving tonight at 10:00 p.m., but she is only a first-year in college, but still, yes.

Chair Yellen. My expectation is that as the job market strengthens and the economy strengthens, we will see household formation pick up. But it is hard to note here exactly what the new normal is. And I think we need to see some pickup in household formation in order to see continued recovery in the housing market.

Mortgage rates went up quite a lot over the Spring and Summer. They are still quite low by historical standards. So in that sense,

housing remains affordable. And I expect housing to pick up, but really it has flattened out and a recovery that seemed to be in progress really has now flattened out.

Vice Chair Klobuchar. And you mentioned the cold weather, something near and dear to our heart in Minnesota. The first quarter, that is one of the major reasons we saw a slowdown in the first quarter. So then you would anticipate some improvement in the next few quarters?

Chair Yellen. Yes. Definitely. And we have heard many different pieces of evidence, as well as what we see in broader statistics, that suggest that the weather played a role. And recent data is certainly much more encouraging on a wide range of fronts, from car sales, retail sales, industrial production.

So I am quite hopeful that we will see, and are seeing, a pick up in economic activity.

Vice Chair Klobuchar. And in my opening I talked about how we do not foresee a rise in inflation in the near future, a significant rise in inflation. Do you agree with that?

Chair Yellen. That is my forecast. Inflation has been running under 2 percent. We expect it to move gradually back over time up to 2 percent. There are some transitory things that can give it a boost over the next year or so, but my expectation is that it will be gradually moving back to 2. But obviously this is something we will watch very closely.

Vice Chair Klobuchar. I asked that for a guy that Tweeted me and said I was wrong. So I thought I would maybe have you on my side.

Chair Yellen. I am with you on that.

Vice Chair Klobuchar. So whoever he is out there with his strange handle, he knows the answer now.

Okay, so I mentioned—this is my last question here—I mentioned in my opening about what we can be doing to continue to do in Congress. I mentioned a bunch of things: immigration reform, tax reform to make things more straightforward so we are not playing red-light/green-light every single year with our tax code, and some of these incentives.

One of the things I mentioned to you about the head of the Minneapolis Federal Reserve talked to me about in my office just last week was the Section 179 deduction limits for depreciation of business investment; that they were increased to $500,000 in 2010, but the increased depreciation deduction expired at the end of 2013.

And ironically, after I met with him, I met with a bunch of small businesses through the next few days and, as they had said to me during the height of the downturn, they thought this was a very useful thing to stimulate investment and add more jobs.

And I wanted to get your thought about that, as we look at these tax extenders.

Chair Yellen. I think the cost of capital is an important factor that influences investment. Although the state of the economy and business confidence and optimism about growth is a very important role as well. And the tax provision that you mentioned is something that was put into effect at a time when investment spending was very weak.

And I cannot quantify what its impact was, but it probably played a role in having it pick up. There are a number of different tax provisions that affect the cost of capital. And so tax policy generally, including the provision you mentioned, are definitely relevant to the strength of investment spending.

Vice Chair Klobuchar. Thank you very much, Chair Yellen.

Chairman Brady. Thank you. Members should note, we have been very generous to make sure the Chair has plenty of time to answer questions. We will be returning to the five-minute questioning period.

Representative Hanna.

Representative Hanna. Thank you very much. Thank you for being here.

I want to follow up on something that Chairman Brady talked about briefly. Milton Friedman once said that inflation is always and everywhere. And today we see that the United States Department of Agriculture estimates that food costs may go up as much as 3–1/2 percent this year; and that is the highest potential rate in the last I think three years.

In this morning's Wall Street Journal, Alan Meltzer, a distinguished Federal Reserve historian, writes: The Fed focuses far too much attention on distracting monthly and quarterly data, while ignoring the long-term effects of money growth. Beyond the pure inflationary concerns, he says, some side effects of the Fed policies have ugly consequences. One of the worst is the ultra low interest rates for retired persons to take—that forces them to take substantially greater risks than bank CDs, and that many of them relied on in the past.

He goes on to say: This ends usually in tears for a lot of people. And we see people that planned on a retirement and simply, based on historic rates, and they are just not there for them anymore.

Is maintaining an extraordinarily low interest rate for a decade creating market distortions that will have long-term effects on the economy?

And, you know, it is nice to talk about being able to control inflation going forward, and that you will respond to it and keep it below 2 percent, but last year it was a percent-and-a-half.

So can the Federal Reserve identify, you think, accurately a change in economic conditions and execute an exit strategy before inflation occurs? Since, as Mr. Brady said and Mr. Meltzer said, never at any time in history of this country that financed big budget deficits with large amount of central bank money avoided inflation.

Chair Yellen. I do believe that we have the tools and absolutely the will and the determination to remove monetary accommodation at an appropriate time to avoid overshooting our inflation objective.

Everybody on the Committee, a formative experience for them was the 1970s when we saw very high inflation and a huge effort by Chairman Volcker to tighten monetary policy to bring it down.

We lived through a period in which Fed policy was not sufficiently tight, and high inflation led to a rise in inflation expectations. We saw that those inflation expectations could become a persistent source of high inflation, and that it could be very costly to lower inflation.

Representative Hanna. And of course——

Chair Yellen. Hence, the lessons from that period are very real for all of us, and none of us want to make that mistake again.

I do believe we have the tools and the determination to avoid that. We indicate inflationary developments and inflationary expectations are part of our focus as we watch what the likely evolution of inflation is. And I can't say that we will get it perfect. But I can tell you that the Committee has adopted a 2 percent inflation objective in order to make clear our commitment to achieving that objective, and to be held accountable for it. And we are determined to have that happen.

Representative Hanna. And of course if we raise interest rates, our debt payments, our interest payments, will exceed our national defense budget I think within 7 or 8 years, I think 2021 is the estimate.

So all of that working together, we really need to grow our economy to afford to be able to manage that.

Chair Yellen. We want to be able to, and we expect as the economy recovers that a point will come when it will be appropriate to raise short-term interest rates. Long-term interest rates are likely to be rising over time as that occurs, and this is something I think Congress should certainly be taking into account as you look at what fiscal burdens will be down the road.

Representative Hanna. Thank you. My time has expired.

Chairman Brady. Thank you.

Representative Delaney.

Representative Delaney. Thank you, Mr. Chairman.

And thank you, Chair Yellen, for being here. And I also want to comment. I was stunned at how remarkably clear and linear your remarks have been here today. It should not be a surprise, but it is quite impressive to observe it first-hand. So thank you for that.

You touched on something a few minutes ago about some deeper structural trends going on in the employment market and the job market. And you tied those, I think very appropriately, to the trends, or the macro trends of globalization and technology, which as we all know have benefitted people with terrific educations, or with access to capital, or with highly refined skills, but they have been very disruptive to the average American.

And in my judgment, this is the root cause of some of the concerns that we have around income inequality and job creation, and particularly job creation of jobs that have a decent standard of living. We are creating high-skill jobs and low-skill jobs, but not a lot of middle-skill jobs.

Is it possible—and you hate to use those four words that people always regret, quote, "this time is different," is it possible that these trends as they continue to play out in our economy and in our job market, put us in a position that we have, the Fed would have accommodating monetary policy for a sustained period of time, as we work through these things, and particularly absent Congress doing things like immigration reform, greater investment in infrastructure, a more targeted way to work through these challenges, is it possible that that is the new norm and that the size of the Federal Reserve's balance sheet in fact stays quite large for a reasonable period of time?

Which I do not necessarily think is a problem—which will be my second question—but I am just curious about your thoughts on that.

Chair Yellen. I think these longer term trends have to do with relative wages of different groups in the labor force, and they have been going on for a long time for the reasons you stated.

I do not think that those trends are ones that the Federal Reserve can really address.

Representative Delaney. Right.

Chair Yellen. The appropriate policies lie elsewhere. They may have to do with education and training. So in that sense, when the labor market has returned to normal in the sense that most people who were looking for work are able to find work for which they are suited and skilled in a reasonable period of time, there really will not be much more that is in our domain that we can do——

Representative Delaney. Got it.

Chair Yellen [continuing]. So we would not keep our balance sheet large, or refrain from raising interest rates for that reason. But there——

Representative Delaney. But——

Fed Chair Yellen [continuing]. Are some people who have suggested that the distribution of income and rising inequality are pulling down spending——

Representative Delaney. Right.

Chair Yellen [continuing]. And holding down spending growth. And it is hard to get clear evidence on that. To the extent that that is true, it would be a way in which inequality would be slowing the pace of recovery back to full employment. In that sense, it would affect how long we would hold interest rates where they are.

Representative Delaney. And my second question is around—and you mentioned in your testimony about how you think about certain financial indicators—asset bubbles, in particular. Because we have definitely seen in the last couple of years a de-linking that has gone on between leveraged spreads and leverage, right? Which is as leverage goes up, spreads normally widen; as leverages go down, spreads normally tighten.

We have seen that de-linked, just as we have seen the de-linking of equity market values with corporate earnings. So this de-linking, I think of it more as froth as opposed to formation of asset bubbles.

How do you think about these things? Or what kind of benchmarks do you use to indicate that we may in fact be creating asset bubbles in different markets?

Chair Yellen. We can't detect with any certainty whether or not there is an asset bubble, but we can look at a variety of different valuation metrics akin to price earnings ratios and the stock market, a variety of ways of measuring those. And we can look to see, have valuations in that sense moved out of historically normal ranges.

And I would say for the equity market as a whole, the answer is that valuations are in historically normal ranges. Now interest rates, long-term interest rates are low, and that is one of the factors that feeds into equity market valuations. So there is that linkage.

So there are pockets where we could potentially see misvaluations in smaller cap stocks, but overall those broad metrics do not suggest that we are in obviously bubble territory. But we do not have targets for equity prices and can't detect if we are in a bubble with certainty.

Representative Delaney. Thank you, very much.

Chairman Brady. Great. Thanks.

Senator Coats.

Senator Coats. Thank you, Mr. Chairman, and thank you, Chair, for your presentations here today.

I want to just ask you if you would be willing to step aside for a moment in terms of just responding as representing the Fed, and give us some of your personal thoughts, as appropriate, relative to a couple of—well, this question in particular:

As I travel throughout Indiana and talk to businesses, large, small, and everything in between, so many of the CEOs and owners of those businesses indicate that they are underperforming. They are underperforming because of the uncertainty that they face relative to fiscal policies, relative to prospects of uncertainty about what their tax and regulatory policies are going to be.

Now essentially they say it is a disincentive to their private-sector business investment, which as we know is the foundation of job creation. I asked your predecessor the question what his opinion was relative to the policies that really fall in our bucket up here. His answer was: You know, we have pretty much exhausted the major tools that we have to address some of these problems. He agreed that these were disincentives for investment, and sitting on an awful lot of unused capital. But, he said, that really is a function for you people at the other end of Constitution Avenue.

He is right. It is. But my question is, I think it was in your statement to the New York Fed you made reference to the fact that it is going to be, and I quote "... a gradual return over the next two to three years of economic conditions consistent with the Fed mandate."

And given that, would you be willing to give us some direction relative to what legislative policies we could take, or not take? And the consequences of either accelerating that movement to where we want to get to, beyond the two- or three-year period? Or disincentivizing and perhaps pushing that even further out?

What recommendation would you give to us in terms of dealing with this uncertainty that is basically causing a lot of businesses to underperform?

Chair Yellen. I agree with you. In my own discussions with businesses, I hear exactly the same things that you're citing: concern about regulations, about taxation, about uncertainty, about fiscal policy.

I guess one recommendation that I would give you is that long-term budget deficits, we can see in for example CBO's very long-term projections, that they remain. There is more work to do to put fiscal policy on a sustainable course; that progress has been made over the last several years in bringing down deficits in the short term, but with a combination of demographics, the structure of entitlement programs, and historic trends in health care costs, we can see that over the long term deficits will rise to unsustainable levels

relative to the economy and putting in place a package of reforms—I know these are very controversial matters—but that would probably help confidence.

As regulators ourselves in the aftermath of a financial crisis, we also can see very clearly, for example, that the kinds of regulations we are putting in place and during the process of doing that, create uncertainty and burdens. We hear this, for example, from community banks all the time.

And, here I would say to some extent the regulations, we are doing this for a very good reason. We had a financial crisis. It is important to make the financial system safer and sounder. And for our own part, we will try to make sure that we worry about regulatory burden. We try to design regulations that are different and appropriate for different sectors of the economy.

I think it is important for us, too, to be sensitive to regulatory burden in order to minimize its impact on the economy, but we are doing things that are important to make the economy safer and sounder.

Senator Coats. Well thank you for that answer. And in closing here, because I have been noticed that my time is up, you join a long list of very responsible Americans who have the experience and the expertise to give us some warnings about what may happen in the future, and the consequences of our inability to act over the last several years now in addressing these major problems that are going to have significant consequences on the economy of this country, and on future generations.

I do not know what it is going to take for us to summon the will to do what we all know we need to do, but I appreciate you adding your name to that long list saying Congress has a responsibility up here and is not fulfilling that responsibility.

Thank you.

Chairman Brady. Senator Casey.

Senator Casey. Thanks very much, Mr. Chairman.

Madam Chair, thank you and welcome. It is good to be with you this morning.

I wanted to ask you a couple of questions about jobs and manufacturing. I will start with that. And then I will ask you a question about the preparation for job growth and some of the investments I think we are not making in our children.

But I will start with the job picture. We have a lot to be positive about with all of the cautionary notes that your testimony articulates. When I think about it from the national perspective, both good job numbers in the last couple of months and even the recent report, a lot less in the way of good news in terms of the labor participation rate which I am told is at a 35-year low.

I noted though in your testimony that you said on page 1 and I'm quoting: "During the economic recovery so far, payroll employment has increased by about 8½ million jobs since its low point, and the unemployment rate has declined about 3¾ percentage points since its peak." End quote.

So that is good news both in terms of the recent news, as well as over a number of years, but we have still got a long way to go. I guess the real cautionary note though, or the reason for concern,

or the main reason for concern, would be on labor force participation.

Can you speak to that in terms of what you had hoped to see, or what you are concerned about with regard to that number?

Chair Yellen. We have seen a substantial decline, especially over the last year or so, in labor force participation. And I think it is clear that part of it is demographic, secular, and will continue. And it purely reflects the fact that we have an aging population and, as people move into that 60-plus age bracket, the amount that they work declines notably in spite of the fact that current vintages of retirees are working more and participating more in the labor force than earlier vintages.

But nevertheless, if we had a strong economy, even for that group, it would not surprise me at all if we didn't see more participation in the labor force by retirees.

In addition, we are seeing for all age groups, prime age workers and younger people, a reduction in labor force participation. For young people, it is partly related to going back to school. But eventually of course those people will enter the labor force and seek jobs.

And especially in those non-retiree demographic groups, to me it is clear that the weak state of the labor market partly explains why we have seen a decline in labor force participation.

So I will be looking very carefully at trends in labor force participation as the economy strengthens, as the unemployment rate comes down. We need to really figure out what portion of the labor force participation decline is secular and what portion is cyclical, and that is what we are going to be looking at very closely.

But I guess I would expect, as the economy recovers, we might see labor force participation strengthen rather than continue to decline.

Senator Casey. One thing that we talk about a lot is the skills gap and the disconnect there between the jobs that we need to fill, or that need to be created in the future, and the skill level of folks that are seeking those jobs or looking for work in the marketplace.

And I guess one of the questions that I have for you is: You look at trends all the time. You look at the economic impact of policies that we put in place here. And you see those trends and the kind of skills that folks would need for the jobs of the future. And I guess I would ask:

My youngest daughter is a junior in high school. If she were three, or say two or three years old right now, what would you hope that she would get to be placed in one of those high-skill jobs that we hope we are creating and we hope that we have policies that undergird a strategy to get us to the point where we no longer have that kind of skills gap? What would you hope that either I or society at large could provide her in terms of a healthy or smart start?

Chair Yellen. I hope that you and society at large will make sure that she has access to a good college education. The gap in earnings between those with a college degree and those with less education has increased enormously, and good opportunities to get advanced training and skills I think will clearly—every bit of evi-

dence suggests that they will make a difference to her lifelong earnings.

Senator Casey. I will send you some questions for the record, as well. Thank you, very much.

Chair Yellen. Thank you.

Chairman Brady. And don't worry, Madam Chair, knowing Senator Casey she will get a good education.

Chair Yellen. I have no doubt.

Chairman Brady. Senator Wicker.

Senator Wicker. Thank you, Dr. Yellen. This has been very enlightening.

Let me first just try to clean up a few things. In his very fine opening statement Chairman Brady got to a point where he said he was hopeful you would enlighten the Committee on six specific points.

There is no time for you to answer those. I would like to submit those questions as my questions for the record and ask you if you will answer them on the record. Will you do that?

Chair Yellen. I would be glad to.

Senator Wicker. And the last point is about the transparency, which I think is a very fine question. Also, I understand your reluctance to be tied down to specific predictions of when this or that will happen, but I do think we got a "yes" from you on one thing. And that is, when the asset purchase program will end.

As I understand it, you have a set of expectations for the rest of the year. And if those expectations are met, you expect the asset purchase program to end this fall.

Is that a "yes"?

Chair Yellen. It is correct, if the labor market continues to recover and we continue to see the evidence as pointing to inflation moving up over time to 2, the Committee is likely to continue taking further steps that would end the program next Fall.

Senator Wicker. In the Fall of this year?

Chair Yellen. Correct.

Senator Wicker. Okay. And Senator Klobuchar said she saw no sign of a rise in inflation for the foreseeable future. You do not agree with that. And ideally, inflation should increase to 2 percent, and that would be a better result as far as you are concerned?

Chair Yellen. Two percent is the Committee's longer term objective. And we would not want to see a persistent deviation either below or above 2 percent.

Senator Wicker. Okay. Good.

Chair Yellen. So it will not be at that level at every moment, but we expect it to move up gradually over time back toward 2 percent.

Senator Wicker. Great. You mentioned during your testimony today "maximum employment" and "full employment." Would you just define those for the Committee?

Chair Yellen. I am using those terms interchangeably. "Maximum employment" is the wording that is used in the Federal Reserve Act. It is our goal that Congress has defined for us, and I am using the term "full employment"——

Senator Wicker. And that is—what is—could you reduce that to a percentage rate? What is "maximum employment"?

Chair Yellen. So I interpret "maximum employment" as meaning a level of employment in the labor market where people are able in a reasonable amount of time to gain work for which they are qualified.

Senator Wicker. For today's purposes, you are not going to put a percentage point?

Chair Yellen. I am not going to put a percentage point on that.

Senator Wicker. Now in terms of economic income inequality, and let's get back to the Meltzer article in today's Wall Street Journal, he suggests that actually the policies of the Obama Administration and the Federal Reserve are responsible for the income inequality. And he says, ironically, despite often repeated demands for increased redistribution to favor middle and lower income groups, that policies pursued by the Obama Administration and supported by the Federal Reserve have accomplished the opposite.

He goes on to say: Voters should recognize that goosing the stock market through very low interest rates, not to mention the subsidies and handouts to cronies, have contributed to that result.

We will leave the subsidies for another discussion, but don't you acknowledge, Dr. Yellen, that the interest rates which you have achieved have driven people to the stock market, therefore goosing the stock market and contributing to this maldistribution of income?

Chair Yellen. I would not deny that the level of interest rates affects the stock market. I would hardly endorse the term "goosing the stock market." We have no target for stock prices. The policies that we have undertaken are meant to ease financial conditions in a whole variety of ways that will be conducive to generating greater spending, and greater spending means that we create jobs throughout the economy.

So to think of that as something that is promoting an increase in income inequality I would take issue with. I think a stronger economy brings benefits to a wide variety of households throughout the economy, including lower income households who are gaining jobs.

We do probably have an impact on the stock market. We also have an impact on house prices. And house prices have come back up again. And for so many households, middle income households, that is their most important asset. And that return of house prices to more normal levels I think has been a major benefit to many, many American households. They have seen themselves move from situations where they are underwater on their mortgages, to being back in the black. And it also helps give them access to credit, if they want to send a kid to school, or have an emergency, or want to start a small business.

And so there have been benefits in this policy, in the policies we have pursued for Main Street as well as for those who hold the equities in their portfolios.

Senator Wicker. Thank you.

Chairman Brady. Thank you.

Senator Sanders.

Senator Sanders. Thank you, Mr. Chairman.

And, Dr. Yellen, welcome and good luck on your new endeavor here.

Chair Yellen. Thank you.

Senator Sanders. Mr. Chairman, with your permission I would like to put into the record a recent BBC article entitled "Study: U.S. is an oligarchy not a democracy."

Mr. Chairman, is that all right? Mr. Chairman? Can I place that into the record?

Chairman Brady. Excuse me, Senator. Without objection.

[The article titled "Study: U.S. is an oligarchy not a democracy" appears in the Submissions for the Record on page 42.]

Senator Sanders. Thank you.

Madam Chair, in the U.S. today the top 1 percent own about 38 percent of the financial wealth of America; the bottom 60 percent own 2.3 percent.

One family, the Walton family, is worth over $140 billion. That is more wealth than the bottom 40 percent of the American people.

In recent years we have seen a huge increase in the number of millionaires and billionaires, while we continue to have the highest rate of childhood poverty in the industrialized world.

Despite this, as many of my Republican friends talk about the oppressive Obama economic policies, in the last year Charles and David Koch struggled under these policies and their wealth increased by $12 billion in one year—despite the oppressive Obama economic policies.

In terms of income, 95 percent of new income generated in this country in the last year went to the top 1 percent. Now a study, which I have just introduced into the record, by two professors from Princeton University, Professor Martin Gillins and Northwestern University Professor Benjamin Page, basically suggest that while historically we have considered our society to be a capitalist democracy, we may now have entered into a phase where we are an oligarchic form of society.

In your judgement, given the enormous power held by the billionaire class and their political representatives, are we still a capitalist democracy? Or have we gone over into an oligarchic form of society in which incredible economic and political power now rests with the billionaire class?

Chair Yellen. All of the statistics on inequality that you have cited are ones that greatly concern me. And I think for the same reason that you are concerned about them.

They can determine the ability of different groups to participate equally in a democracy, and have grave effects on social stability over time. And so I don't know what to call our system, I would prefer not to give labels—but there is no question that we have had the trend toward growing inequality, and I personally find it a very worrisome trend that deserves the attention of policymakers.

Senator Sanders. Thank you. I mean, I think the point that the professors are making, and others have made, is that there comes a point where the billionaire class has so much political power, where the Koch brothers are now because of Citizens United able to buy and sell politicians, they have so much political power, at what point is that reversible? And that is a great concern to me.

I want to go to another point. Some of my colleagues, especially in the House, believe that we can improve lives for the middle class and create jobs by completely repealing the estate tax, which ap-

plies now to perhaps less than 1/10th of 1 percent of the wealthiest families in this country.

Would it make sense to you to give enormous tax breaks to the families of the top 1 percent of people in this country?

Chair Yellen. I have indicated that I share your concern with inequality, but I guess I am going to say on this that it is up to the Congress to decide what is appropriate. And there are a number of different ways to address it; that certainly is on the list.

Senator Sanders. All right. Well let me ask you another question.

Some of my friends in the House, on the Ryan budget and so forth, suggest that one way to stimulate the economy to create decent-paying jobs is to give more tax breaks to the wealthiest people in this country, and the largest corporations, despite the massive wealth and income inequality we have right now.

If we give tax breaks to the Koch brothers, who are worth $80 billion, do you think that is going to create a whole lot of jobs in this country?

Chair Yellen. I would say most of the evidence that we have suggests that transfers to lower income people tend to be spent, a larger fraction of the dollar is spent, than when there is a transfer to a wealthy individual, but changes in tax policy—so that is from the demand side; tax policy also has supply side effects that one should take into account.

Senator Sanders. Thank you, Mr. Chairman.

Chairman Brady. Thank you.

Representative Paulsen.

Representative Paulsen. Thank you, Mr. Chairman. Dr. Yellen, thank you for being here and offering your testimony today. You have mentioned several times that the unemployment rate is still too high, and clearly we as elected officials representing our constituencies would agree with that.

Now, in April you made some remarks to the Economic Club of New York. At that time you said that the central tendency of the Federal Open Market Committee participant projections for the unemployment rate at the end of 2016—so this is still out a year-and-a-half—would be 5.2 to 5.6 percent. And for inflation, the central tendency is 1.7 to 2 percent. You mentioned the 2 percent again today.

If this forecast was to become a reality the economy would be approaching what my colleagues and I view as maximum employment and price stability for the first time in nearly a decade.

I guess I am wondering, because you did not want to put a number on maximum or full employment today but you referenced this in April. In light of the unemployment rate being around 4–1/2 percent in the middle part of the last decade, you are indicating that maybe full employment or maximum employment is significantly higher, that 5.2 to 5.6 percent range.

Is that the new normal that you are potentially targeting for "full employment"?

Chair Yellen. This is a number that is purely a guess based on empirical evidence that each member of our Committee is asked to make every three months.

What they are trying to write down is the level of the unemployment rate that they think would be consistent with stable inflation, rather than gradually rising inflation over time. And based on the evidence that they see, their current read—and these are again just estimates and something that changes from time to time—but their best assessment, most of them are in a range of 5.2 to 5.6 percent.

Now when unemployment was as low as 4 percent previously, to some extent that may have involved overshooting. It's nothing that says that 5.2 to 5.6 is a floor on how low unemployment can go. For example, in the late 1990s unemployment fell well below those levels.

But there may have been special factors, an increase in productivity growth, and a strong dollar appreciation of the dollar that was holding inflation down and made that happy coincidence of very low unemployment and stable inflation possible.

So at the moment, this is their best guess. And it is where they envision the economy as being in 2016.

Representative Paulsen. You mentioned, too, that with the April jobs numbers that came out, it was nice to see the unemployment level fall to 6.3 percent. But you said you wanted to look at the details of that labor force participation rate, which fell to essentially tying a low of 62.8 percent. That was one of the most concerning numbers for me, 800,000 people that have now left the work force, right? Or the labor force has declined by 800,000. That is a pretty significant number.

What do you envision the labor force participation rate might actually be if we hit that 5.2 to 5.6 percent full employment rate?

Chair Yellen. It's a little bit hard for me to give you an estimate of that. We had a huge move. It is very unusual to see a 4/10ths percent decline in the unemployment rate in a single month with a comparable move in labor force participation.

We always tell ourselves, and I'll state, I think one should not make too much of any single month's numbers. My preference would be to look at those labor force and labor market statistics over three or six months to get a read on things.

If we do that, what we see is the unemployment rates come down. For the last six months, job growth has been, employment has been gaining about 200,000 jobs a month, and somewhat higher over the last 3 months.

The labor force participation rate has bounced around, but it has been roughly stable. So it came down. It had gone up previously. Over the last six months, it has been roughly stable, which is—I think there is a declining labor force participation rate as a trend—so a stable labor force participation rate could signify that some cyclical slack in the labor market is gradually diminishing over time.

So looking over three to six months, I would say that the patterns we are seeing are consistent with improvement in the labor market.

Representative Paulsen. Thank you.

Chairman Brady. Thank you.

Representative Cummings.

Representative Cummings. Chair Yellen, in February Senator Elizabeth Warren and I wrote to you urging that a formal vote of

the Board of Governors be required before the Fed enters into consent orders over a million dollars.

My staff reviewed all Fed enforcement actions between 1997 and 2013 and found that only about 2 percent resulted in penalties over $1 million.

During the hearings before the Senate Banking Committee on February 27, Senator Warren asked whether you agreed with our proposal.

You answered, and I quote: "I do think it's appropriate for us to make changes, and I fully expect that we will." End of quote.

Yesterday, Senator Warren and I received the response letter from you—thank you—in which you wrote: "I agree that it is appropriate for the Board of Governors to be fully involved in important decisions relating to the enforcement and supervisory matters." You went on to say: "Steps are already underway to develop new processes and procedures for review and approval of significant enforcement actions."

My question is this: Can you tell me what specific steps are underway for the Board procedures to be changed to require formal votes on all major enforcement actions? And if so, by what date will that occur? And if this is not the procedural change you anticipate making, what new processes and procedures for review and approval of enforcement actions will be introduced?

Chair Yellen. We have met and it is in the public record that we have had a number of meetings at this point over the last couple of months to discuss enforcement actions.

We are participating in those discussions with our staff early so that we can guide their handling of these matters. I think this is fully appropriate, and I pledge that we will continue to do so.

We have taken a vote on at least one very important enforcement matter. And I want to take a little bit more time working with the staff to decide exactly what the guidelines will be for when we should delegate and when Board action is required.

You suggested a particular cutoff, and I want to think more carefully about how to define precisely which actions should require Board votes, when it's appropriate for us to vote. But what I do want to pledge is that the Board will be very involved, discuss, and meet to discuss major enforcement actions.

Representative Cummings. Thank you.

Chair Yellen. And we have done so.

Representative Cummings. You were Vice Chair of the Board of Governors when the Fed and the OCC terminated the Independent Foreclosure Review and agreed to a settlement with the mortgage servicing companies in January 2013.

Did the Board formally approve the amendments to the consent decrees that terminated the IFR?

Chair Yellen. The Board did not vote on that agreement. Under the procedures in place, this was a matter that was delegated to the staff. But the staff consulted closely with members of the Board before they took those actions. And so the Board did have input in an informal way when those decisions were made. But there was no formal vote.

Representative Cummings. On March 4th, I joined with Oversight Chairman Darrell Issa in a letter requesting that both the

Fed and the OCC produce documents relating to this decision. The OCC produced its documents several weeks ago. We received the Fed's documents yesterday. Thank you. And we are still reviewing them.

The documents produced by the OCC showed that there were no reliable data or error rates at the time you terminated the IFR, but there are preliminary data showing double-digit error rates in some categories and some services.

Deep dives were planned to identify the full extent of harm, but they could not be completed because the IFR was terminated. Did you know this when the IFR was terminated? Did you know that?

Chair Yellen. The IFR was terminated because it was decided that the process was too slow in terms of its time frame and its ability to get money into the pockets of homeowners who had been harmed.

It was a decision that the OCC took the lead in, and the Federal Reserve went along with, after consulting closely with community groups and looking at the process that was in—that was taking place with the independent consultants reviewing these files.

It was not a happy outcome. It was a——

Representative Cummings. It was a horrible outcome.

Chair Yellen. It was horrible——

Representative Cummings. It was horrible. I mean—and I don't know whether you have looked into it, but it is a very sad commentary on what happened here.

Chair Yellen. It is.

Representative Cummings. I know I am out of time, but I will send you some follow-up questions along with Senator Warren.

Chair Yellen. Yes. I'd be happy to answer them.

Chairman Brady. Thank you, Representative.

Madam Chair, thank you for being here today and for your testimony and answering the questions. You have a difficult job. We wish you well, and we look forward to future hearings to come.

The hearing is adjourned.

(Whereupon, at 11:49 a.m., Wednesday, May 7, 2014, the hearing was adjourned.)

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF HON. KEVIN BRADY, CHAIRMAN, JOINT ECONOMIC COMMITTEE

To start, I congratulate Chair Yellen on her appointment to head the Board of Governors of the Federal Reserve System. I welcome you to your first appearance before the Joint Economic Committee and look forward to many more.

June will mark the fifth anniversary of the end of the "Great Recession." By virtually every economic indicator, this recovery ranks as the weakest or near the bottom. This recovery's persistent weakness has created a Growth Gap relative to other recoveries over the last half century. For example, if this recovery had merely been average, then:

- The U.S. economy would be $1.4 trillion larger (Figure 1);
- American workers would have 5.7 million more private-sector jobs available (Figure 2); and
- A family of four would have over $1,000 per month in additional real after-tax income (Figure 3).

Ironically, for an Administration that has repeatedly bemoaned income inequality, the one exception to this weakness is Wall Street—where the S&P 500 Total Return Index, adjusted for inflation, has more than doubled.

Last week, the Bureau of Economic Analysis (BEA) and the Bureau of Labor Statistics (BLS) released conflicting data about the strength of this recovery. On the one hand, according to the BEA, real GDP growth was basically flat in the first quarter, and according to the BLS, the labor force participation rate fell in April to 62.8 percent, tying a multi-decade low only reached in the Carter and Obama Administrations. Moreover, the employment-to-population ratio is actually lower than when the recession ended, which means there are proportionally less adults working today than when the recovery began. That's headed the wrong direction.

On the other hand, the BLS reported that, for only the fifth time since the recession ended, the monthly growth of non-farm payroll jobs in April exceeded the equivalent average monthly job growth during past recoveries with the unemployment rate declining to 6.3 percent from its October 2009 peak of 10 percent.

Correctly judging the strength of the labor market is very important because the Federal Open Market Committee has tied the tapering of large-scale asset purchases and the normalization of interest rates to its assessment of the labor market.

Members of the FOMC attribute much of the slack in the labor market to cyclical factors and believe that a highly accommodate monetary policy can strengthen economic output and employment. However, if a substantial portion of the weakness in the labor market is due to structural factors such as an aging population and a skills mismatch, then maintaining a highly accommodative monetary policy could instead create economic bottlenecks that would trigger price inflation.

Addressing structural unemployment requires much different policies such as reforming education, strengthening job-training programs, and modernizing means-tested entitlement programs to encourage work.

I am encouraged that the FOMC began to taper large-scale asset purchases in December and appears on track to terminate these purchases before the end of this year. However, I am concerned that the FOMC stated that it will likely maintain its zero-interest rate policy long after QE ends, and at levels below those that "the Committee views as normal in the longer run."

I am equally concerned that the discretionary nature of changes to the FOMC's forward-guidance is undermining the Fed's credibility—weakening the confidence of market participants and increasing uncertainty.

I believe the Federal Reserve helped to stabilize financial markets after the panic in the fall of 2008, but extraordinarily low interest rates and repeated rounds of quantitative easing have done more to stimulate Wall Street than help hard-working American families on Main Streets across America. As I noted earlier, since the recession ended the S&P 500 Total Return Index, adjusted for inflation, is up 108.2 percent, while real after-tax income per capita is only up 4.2 percent.

The Fed has Wall Street roaring, but has left middle-class families and Main Street business behind.

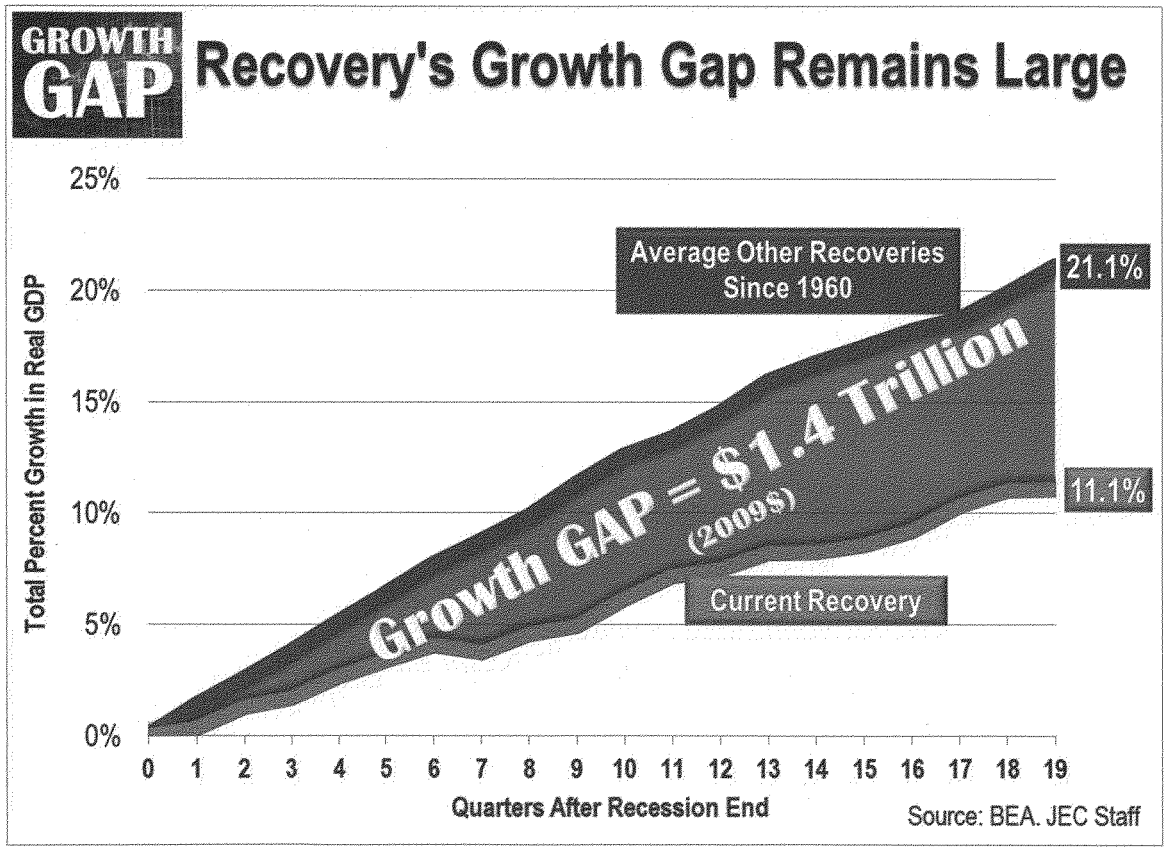
Chair Yellen, your predecessor was supremely confident that the Fed had the knowledge, tools, and political fortitude to exit smoothly from the Fed's extraordinary monetary actions and normalize interest rates and the size of its balance sheet before an inflationary outbreak could occur.

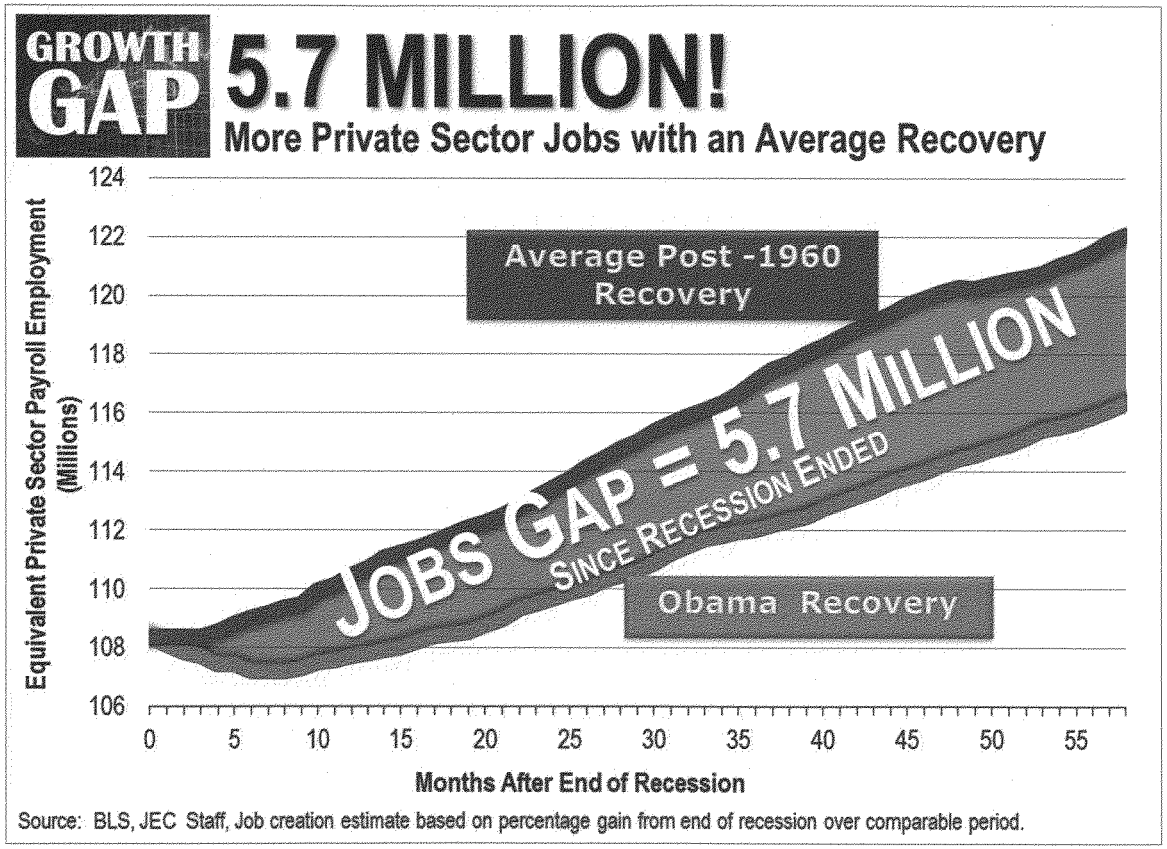
Yet the Fed—like many central banks—has an unsatisfactory track record over the last century in identifying economic turning points and acting in a timely manner to maintain stable prices.

So today, I am hopeful that you can enlighten this Committee on several points:

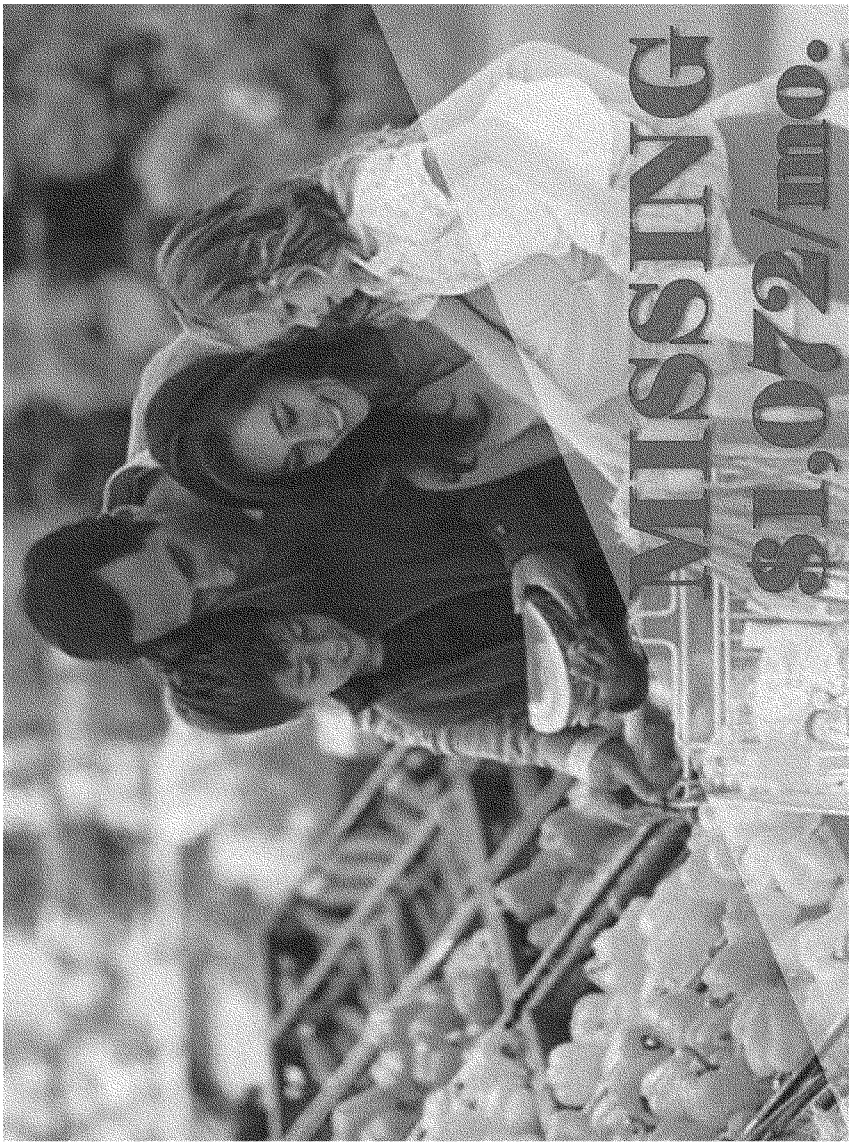
1. What is the FOMC's assessment of the strength of the labor market? How much of the weakness in the labor market do you believe is due to cyclical factors and how much is due to structural factors? What statistics are FOMC members using to judge the health of the labor market and how much weight are they being given?
2. Can an overly accommodative monetary policy create asset price inflation that may not be fully captured by the CPI or the PCE index? Do high stock prices reflect the fundamental strength of our economy, or are they partially due to a highly accommodative monetary policy?
3. Has the FOMC's failure to abide by its own "communications channel" prescriptions created more uncertainty and undermined the FOMC's credibility? And, when will the FOMC return to a rules-based approach to monetary policy that helped to achieve the good performance of the U.S. economy during the "Great Moderation"?
4. Is the Federal Reserve Bank of San Francisco correct that higher federal taxes—including higher marginal rates on individual income, capital gains, and dividends—are presently the main cause of "fiscal drag" on our economy?
5. Is there a better way for Congress to address the spending side of our fiscal imbalances than the present sequester enacted as part of the Budget Control Act of 2011?
6. Is the Fed willing to make its balance sheet more transparent? Specifically, will the Fed provide a consolidated list of holdings that includes not only maturity values, but also average purchase prices for each issue and the current market value of each holding?

With that, Chair Yellen, I look forward to your testimony. And, I note that the record will be kept open for one week so that Members can submit additional written questions for the record.


GROWTH GAP
Recovery's Growth Gap Remains Large
25%
20%
15%
10%
5%
0%
Total Percent Growth in Real GDP
Average Other Recoveries Since 1960
21.1%
11.1%
Growth GAP = $1.4 Trillion
(2009$)
Current Recovery
0 1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19
Quarters After Recession End
Source: BEA. JEC Staff



Source: BLS, JEC Staff, Job creation estimate based on percentage gain from end of recession over comparable period.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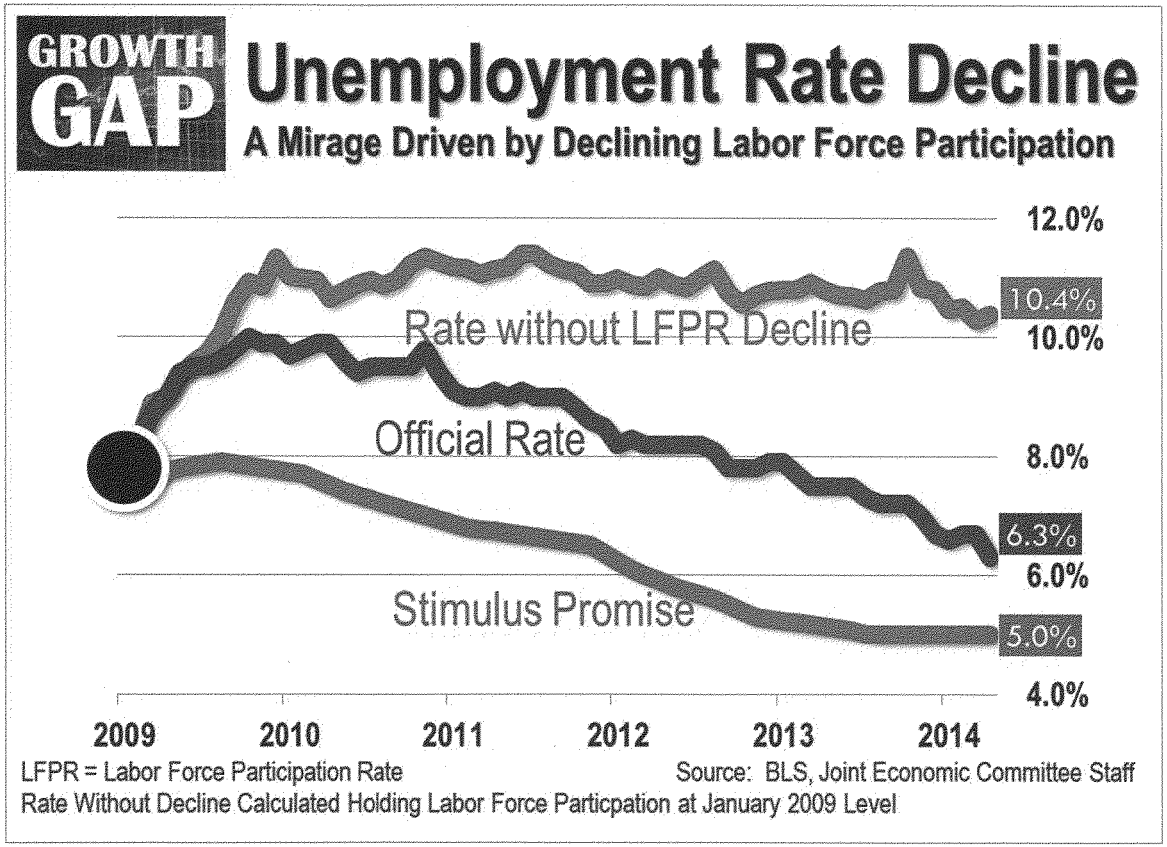
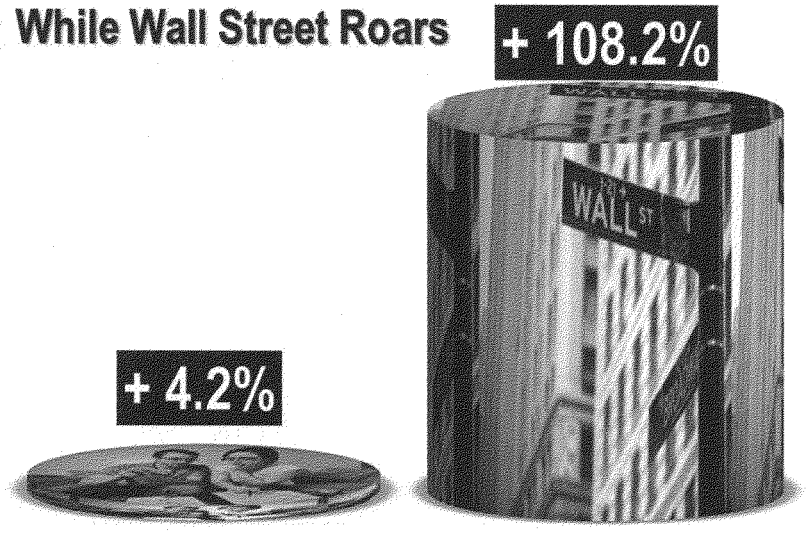

GROWTH GAP
Unemployment Rate Decline
A Mirage Driven by Declining Labor Force Participation
12.0%
10.4%
Rate without LFPR Decline
10.0%
Official Rate
8.0%
6.3%
6.0%
Stimulus Promise
5.0%
4.0%
2009
2010
2011
2012
2013
2014
LFPR = Labor Force Participation Rate
Source: BLS, Joint Economic Committee Staff
Rate Without Decline Calculated Holding Labor Force Particpation at January 2009 Level

GROWTH GAP

American Families Suffer, While Wall Street Roars



Main Street Familes **Wall Street**

Change in real disposable income per capita since end of recession (June 2009) vs. change in S&P 500 Total Return, 2009 dollars. Source: BEA, S&P/Haver Analytics, JEC Staff Calculations

STATEMENT OF JANET L. YELLEN, CHAIR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Chairman Brady, Vice Chair Klobuchar, and other members of the Committee, I appreciate this opportunity to discuss the current economic situation and outlook along with monetary policy before turning to some issues regarding financial stability.

CURRENT ECONOMIC SITUATION AND OUTLOOK

The economy has continued to recover from the steep recession of 2008 and 2009. Real gross domestic product (GDP) growth stepped up to an average annual rate of about 3¼ percent over the second half of last year, a faster pace than in the first half and during the preceding two years. Although real GDP growth is currently estimated to have paused in the first quarter of this year, I see that pause as mostly reflecting transitory factors, including the effects of the unusually cold and snowy winter weather. With the harsh winter behind us, many recent indicators suggest that a rebound in spending and production is already under way, putting the overall economy on track for solid growth in the current quarter. One cautionary note, though, is that readings on housing activity—a sector that has been recovering since 2011—have remained disappointing so far this year and will bear watching.

Conditions in the labor market have continued to improve. The unemployment rate was 6.3 percent in April, about 1¼ percentage points below where it was a year ago. Moreover, gains in payroll employment averaged nearly 200,000 jobs per month over the past year. During the economic recovery so far, payroll employment has increased by about 8½ million jobs since its low point, and the unemployment rate has declined about 3¾ percentage points since its peak.

While conditions in the labor market have improved appreciably, they are still far from satisfactory. Even with recent declines in the unemployment rate, it continues to be elevated. Moreover, both the share of the labor force that has been unemployed for more than six months and the number of individuals who work part time but would prefer a full-time job are at historically high levels. In addition, most measures of labor compensation have been rising slowly—another signal that a substantial amount of slack remains in the labor market.

Inflation has been quite low even as the economy has continued to expand. Some of the factors contributing to the softness in inflation over the past year, such as the declines seen in non-oil import prices, will probably be transitory. Importantly, measures of longer-run inflation expectations have remained stable. That said, the Federal Open Market Committee (FOMC) recognizes that inflation persistently below 2 percent—the rate that the Committee judges to be most consistent with its dual mandate—could pose risks to economic performance, and we are monitoring inflation developments closely.

Looking ahead, I expect that economic activity will expand at a somewhat faster pace this year than it did last year, that the unemployment rate will continue to decline gradually, and that inflation will begin to move up toward 2 percent. A faster rate of economic growth this year should be supported by reduced restraint from changes in fiscal policy, gains in household net worth from increases in home prices and equity values, a firming in foreign economic growth, and further improvements in household and business confidence as the economy continues to strengthen. Moreover, U.S. financial conditions remain supportive of growth in economic activity and employment.

As always, considerable uncertainty surrounds this baseline economic outlook. At present, one prominent risk is that adverse developments abroad, such as heightened geopolitical tensions or an intensification of financial stresses in emerging market economies, could undermine confidence in the global economic recovery. Another risk—domestic in origin—is that the recent flattening out in housing activity could prove more protracted than currently expected rather than resuming its earlier pace of recovery. Both of these elements of uncertainty will bear close observation.

MONETARY POLICY

Turning to monetary policy, the Federal Reserve remains committed to policies designed to restore labor market conditions and inflation to levels that the Committee judges to be consistent with its dual mandate. As always, our policy will continue to be guided by the evolving economic and financial situation, and we will adjust the stance of policy appropriately to take account of changes in the economic outlook. In light of the considerable degree of slack that remains in labor markets and the continuation of inflation below the Committee's 2 percent objective, a high degree of monetary accommodation remains warranted.

With the federal funds rate, our traditional policy tool, near zero since late 2008, we have relied on two less conventional tools to provide support for the economy: asset purchases and forward guidance. And, because these policy tools are less familiar, we have been especially attentive in recent years to the need to communicate to the public about how we intend to employ our policy tools in response to changing economic circumstances.

Our current program of asset purchases began in September 2012 when the economic recovery had weakened and progress in the labor market had slowed, and we said that our intention was to continue the program until we saw substantial improvement in the outlook for the labor market. By December 2013, the Committee judged that the cumulative progress in the labor market warranted a modest reduction in the pace of asset purchases. At the first three meetings this year, our assessment was that there was sufficient underlying strength in the broader economy to support ongoing improvement in labor market conditions, so further measured reductions in asset purchases were appropriate. I should stress that even as the Committee reduces the pace of its purchases of longer-term securities, it is still adding to its holdings, and those sizable holdings continue to put significant downward pressure on longer-term interest rates, support mortgage markets, and contribute to favorable conditions in broader financial markets.

Our other important policy tool in recent years has been forward guidance about the likely path of the federal funds rate as the economic recovery proceeds. Beginning in December 2012, the Committee provided threshold-based guidance that turned importantly on the behavior of the unemployment rate. As you know, at our March 2014 meeting, with the unemployment rate nearing the threshold that had been laid out earlier, we undertook a significant review of our forward guidance. While indicating that the new guidance did not represent a shift in the FOMC's policy intentions, the Committee laid out a fuller description of the framework that will guide its policy decisions going forward. Specifically, the new language explains that, as the economy expands further, the Committee will continue to assess both the realized and expected progress toward its objectives of maximum employment and 2 percent inflation. In assessing that progress, we will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. In March and again last month, we stated that we anticipated the current target range for the federal funds rate would be maintained for a considerable time after the asset purchase program ends, especially if inflation continues to run below 2 percent, and provided that inflation expectations remain well anchored. The new language also includes information on our thinking about the likely path of the policy rate after the Committee decides to begin to remove policy accommodation. In particular, we anticipate that even after employment and inflation are near mandate-consistent levels, economic and financial conditions may, for some time, warrant keeping the target federal funds rate below levels that the Committee views as normal in the longer run.

Because the evolution of the economy is uncertain, policymakers need to carefully watch for signs that it is diverging from the baseline outlook and respond in a systematic way to stabilize the economy. Accordingly, for both our purchases and our forward guidance, we have tried to communicate as clearly as possible how changes in the economic outlook will affect our policy stance. In doing so, we will help the public to better understand how the Committee will respond to unanticipated developments, thereby reducing uncertainty about the course of unemployment and inflation.

FINANCIAL STABILITY

In addition to our monetary policy responsibilities, the Federal Reserve works to promote financial stability, focusing on identifying and monitoring vulnerabilities in the financial system and taking actions to reduce them. In this regard, the Committee recognizes that an extended period of low interest rates has the potential to induce investors to "reach for yield" by taking on increased leverage, duration risk, or credit risk. Some reach-for-yield behavior may be evident, for example, in the lower-rated corporate debt markets, where issuance of syndicated leveraged loans and high-yield bonds has continued to expand briskly, spreads have continued to narrow, and underwriting standards have loosened further. While some financial intermediaries have increased their exposure to duration and credit risk recently, these increases appear modest to date—particularly at the largest banks and life insurers.

More generally, valuations for the equity market as a whole and other broad categories of assets, such as residential real estate, remain within historical norms. In

addition, bank holding companies (BHCs) have improved their liquidity positions and raised capital ratios to levels significantly higher than prior to the financial crisis. Moreover, recently concluded stress tests mandated by the Dodd-Frank Act have provided a level of confidence in our assessment of how financial institutions would fare in an extended period of severely adverse macroeconomic conditions or a sharp steepening of the yield curve alongside a moderate recession. For the financial sector more broadly, leverage remains subdued and measures of wholesale short-term funding continue to be far below levels seen before the financial crisis.

The Federal Reserve has also taken a number of regulatory steps—many in conjunction with other federal agencies—to continue to improve the resiliency of the financial system. Most recently, the Federal Reserve finalized a rule implementing section 165 of the Dodd-Frank Act to establish enhanced prudential standards for large banking firms in the form of risk-based and leverage capital, liquidity, and risk-management requirements. In addition, the rule requires large foreign banking organizations to form a U.S. intermediate holding company, and it imposes enhanced prudential requirements for these intermediate holding companies. Looking forward, the Federal Reserve is considering whether additional measures are needed to further reduce the risks associated with large, interconnected financial institutions.

While we have seen substantial improvements in labor market conditions and the overall economy since the financial crisis and severe recession, we recognize that more must be accomplished. Many Americans who want a job are still unemployed, inflation continues to run below the FOMC's longer-run objective, and work remains to further strengthen our financial system. I will continue to work closely with my colleagues and others to carry out the important mission that the Congress has given the Federal Reserve.

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

BBC NEWS

ECHO CHAMBERS

17 April 2014 Last updated at 17:09 ET

Study: US is an oligarchy, not a democracy

What in the world?
Pieces of global opinion

A review of the best commentary on and around the world...

Today's must-read

The US is dominated by a rich and powerful elite.

So concludes a **recent study** by Princeton University Prof Martin Gilens and Northwestern University Prof Benjamin I Page.

This is not news, you say.

Perhaps, but the two professors have conducted exhaustive research to try to present data-driven support for this conclusion. Here's how they explain it:

Multivariate analysis indicates that economic elites and organised groups representing business interests have substantial independent impacts on US government policy, while average citizens and mass-based interest groups have little or no independent influence.

In English: the wealthy few move policy, while the average American has little power.

The two professors came to this conclusion after reviewing answers to 1,779 survey questions asked between 1981 and 2002 on public policy issues. They broke the responses down by income level, and then determined how often certain income levels and organised interest groups saw their policy preferences enacted.

"A proposed policy change with low support among economically elite Americans (one-out-of-five in favour) is adopted only about 18% of the time," they write, "while a proposed change with high support (four-out-of-five in favour) is adopted about 45% of the time."

On the other hand:

When a majority of citizens disagrees with economic elites and/or with organised interests, they generally lose. Moreover, because of the strong status quo bias built into the US political system, even when fairly large majorities of Americans favour policy change, they generally do not get it.

They conclude:

Americans do enjoy many features central to democratic governance, such as regular elections, freedom of speech and

association and a widespread (if still contested) franchise. But we believe that if policymaking is dominated by powerful business organisations and a small number of affluent Americans, then America's claims to being a democratic society are seriously threatened.

Eric Zuess, **writing** in Counterpunch, isn't surprised by the survey's results.

"American democracy is a sham, no matter how much it's pumped by the oligarchs who run the country (and who control the nation's "news" media)," he writes. "The US, in other words, is basically similar to Russia or most other dubious 'electoral' 'democratic' countries. We weren't formerly, but we clearly are now."

This is the "Duh Report", **says** Death and Taxes magazine's Robyn Pennacchia. Maybe, she writes, Americans should just accept their fate.

"Perhaps we ought to suck it up, admit we have a classist society and do like England where we have a House of Lords and a House of Commoners," she writes, "instead of pretending as though we all have some kind of equal opportunity here."

South Korea
Ferry tragedy was a manmade disaster - The death toll from the sinking of the Sewol off the south-eastern tip of South Korea could have been greatly reduced if the passengers had been properly instructed in safety procedures and the crew hadn't been among the first to abandon the ship, write the editors of South Korea's Joongang Daily.

The South Korean government also shares blame, they write. "It failed to grasp the seriousness of the accident from the start and didn't know how many were rescued or missing."

The government, they continue, should conduct a thorough investigation and prepare a report on how to upgrade the nation's "safety systems and procedures".

Argentina
Cristina Kirchner's sham populism - The government of Cristina Kirchner touts a populism that "redistributes wealth to benefit the poor", writes Luis Alberto Romero in Agentina's Clarin (translated by WorldCrunch).

In reality, he says, "the outcome has been greater wealth concentrations and more social polarisation, helped by subsidy policies".

The Kirchner regime, he argues, has been "built on two foundations: concentration of power and accumulation of wealth".

Algeria
Presidential vote endorses status quo - It seems clear that President Abdelaziz Bouteflika will win a fourth term in this week's election despite looking "more dead than alive", writes University of Houston Prof Robert Zaretsky in the Los Angeles Times.

Mr Bouteflika "is entrenched, propped up by generals and an uneasy status quo", he says.

"The question is," he writes, "how long will the government manage to impose scripted elections on a population ready for the risks and rewards of an unscripted future?"

Ukraine
Nato football v Russian chess - The Ukrainian crisis has taken Nato planners by surprise, writes Prof David Murphy of National University of Ireland, Maynooth, in the Irish Times. This, he says, is because of "fundamental cultural, strategic and political differences" between Russia and the West.

"Nato operates at a huge disadvantage as it needs consensus and co-operation within its member states in order to act," he writes. "President Vladimir Putin and his political and military staffs do not face such limitations and have the freedom to act quickly."

Russia has formulated a plan and is executing it, he concludes. It is up to the members of Nato to work together to stop it.

BBC Monitoring's quotes of the day
Ukrainian media respond to **high-level meetings** *between officials from the US, EU, Ukraine and Russia in Geneva aimed resolving the crisis in Ukraine.*

"There is an illusory hope for the conference in Geneva. Ukraine will be presented there as a pie which will be divided. Everything ... shows the signs of a grand plot, where big geopolitical players resolved their issues at Ukraine's expense. It will be like that this time around too." - Editorial in **Glavkom**.

"Today's meeting will show if the West can counter [Vladimir] Putin's plans to impose his 'world order'." - Editorial in **Den**.

"International talks will hardly improve the situation in Ukraine until people inside the country start talking. So the only thing the Geneva meeting could influence is to facilitate the beginning of talks inside the country between representatives of the east and the central authorities. If the meeting provides this impetus it will be a positive result." - Volodymyr Fesenko in **Komsomolskaya Pravda v Ukraine**.

Have you found an interesting opinion piece about global issues that we missed? Share it with us via email at echochambers (at) bbc.co.uk.

BBC

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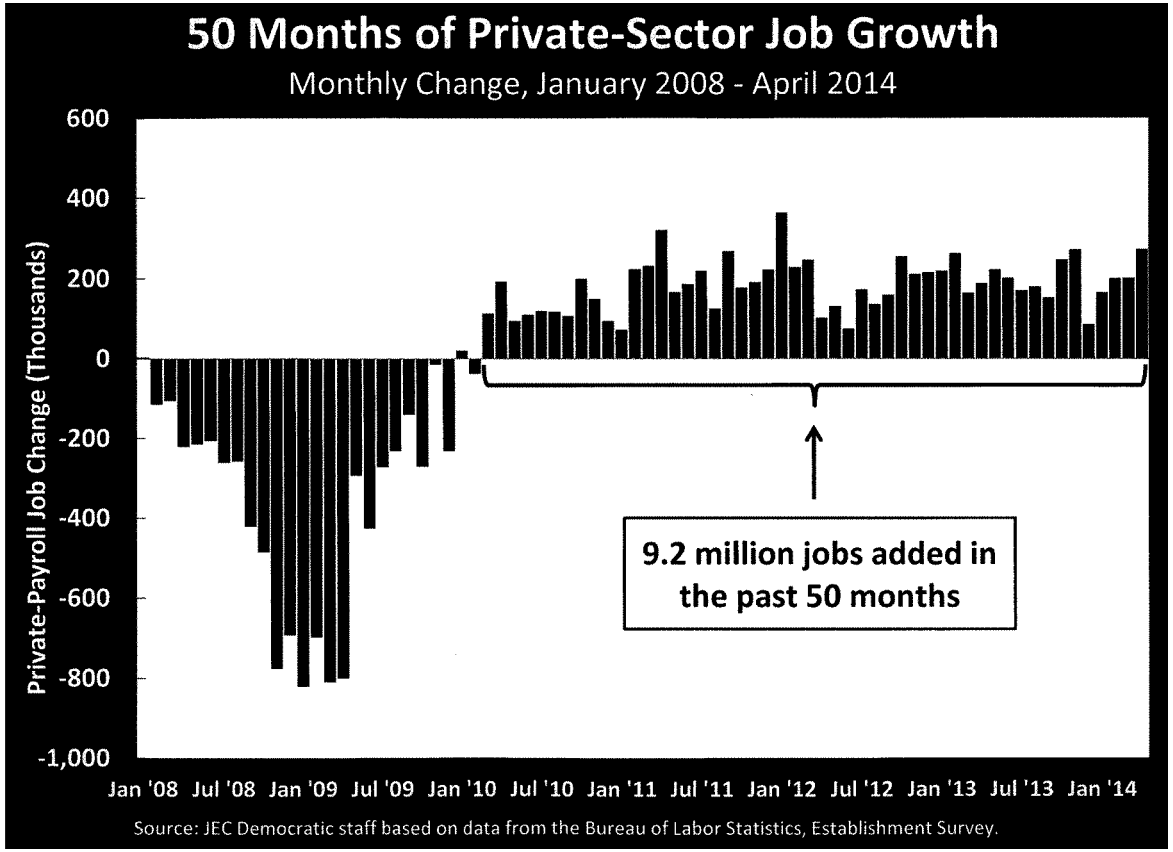
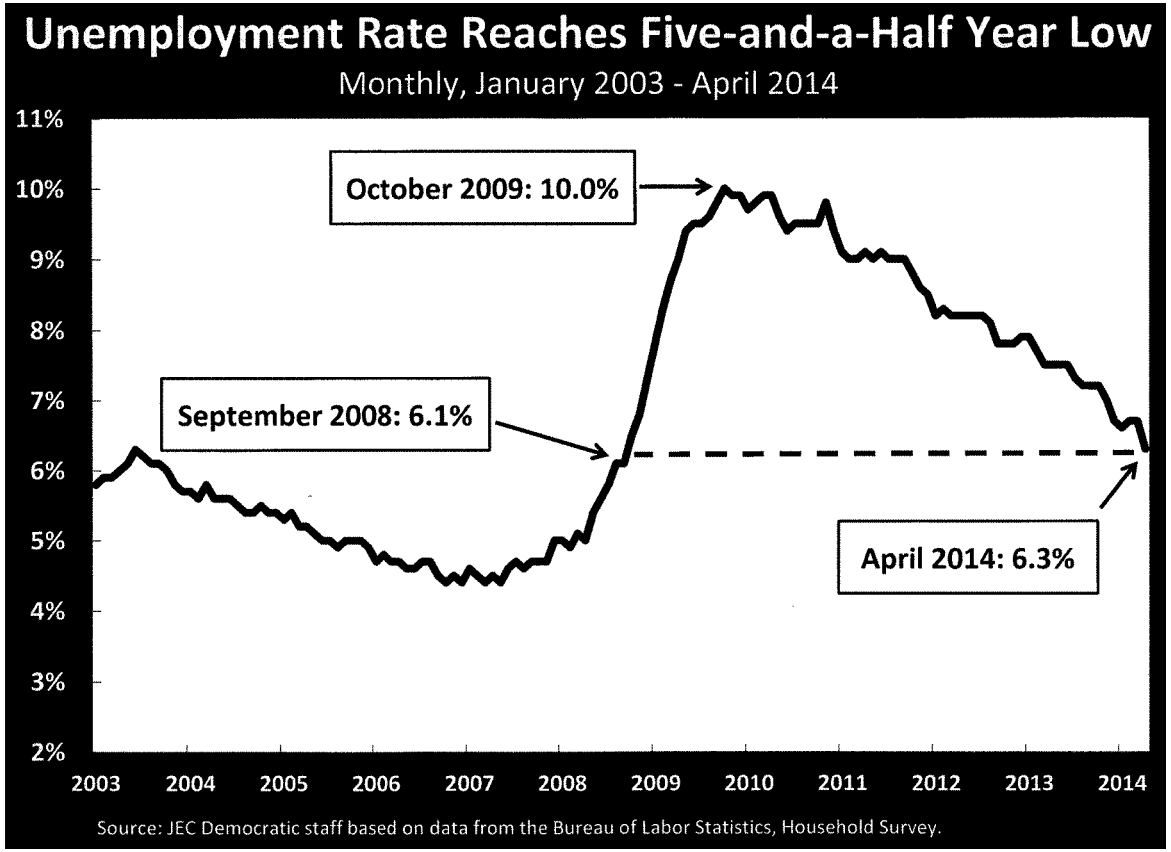

50 Months of Private-Sector Job Growth
Monthly Change, January 2008 - April 2014
Private-Payroll Job Change (Thousands)
600
400
200
0
-200
-400
-600
-800
-1,000
Jan '08
Jul '08
Jan '09
Jul '09
Jan '10
Jul '10
Jan '11
Jul '11
Jan '12
Jul '12
Jan '13
Jul '13
Jan '14
9.2 million jobs added in the past 50 months
Source: JEC Democratic staff based on data from the Bureau of Labor Statistics, Establishment Survey.


Unemployment Rate Reaches Five-and-a-Half Year Low
Monthly, January 2003 - April 2014
11%
10%
9%
8%
7%
6%
5%
4%
3%
2%
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
October 2009: 10.0%
September 2008: 6.1%
April 2014: 6.3%
Source: JEC Democratic staff based on data from the Bureau of Labor Statistics, Household Survey.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Chairman Brady:

1. As you know, declining labor force participation has contributed significantly to recent declines in the unemployment rate. While the unemployment rate has declined from its October 2009 peak of 10.0% to 6.3%, over the same period the employment-to-population ratio has only increased by 0.4 percentage point. At this point in time, which measure, changes in the unemployment rate or the employment-to-population ratio is a better guide to the overall health of the labor market?

No single indicator can perfectly summarize the state of the labor market, and we look at a broad range of labor market measures when assessing the labor market's overall health and the degree of recent improvement. The unemployment rate is probably the best single indicator of current labor market conditions and a decent predictor of future labor market developments. Nevertheless, the unemployment rate may at times understate or overstate the health of the labor market. Indeed, if some portion of its decline in recent years is attributable to a decline in labor force participation that is related to labor market weakness (e.g. as discouraged job seekers drop out of the labor force), then declines in the unemployment rate may overstate the degree of overall labor market improvement.

Currently, however, at least some of the reasons for the exceptionally low levels of labor force participation and employment are because of structural factors that would be relevant even absent the recession and subsequent experience. Indeed, many researchers have argued that a primary contributor to the decline in labor force participation since 2007 is the movement of the large baby-boom cohort into their retirement years.[1] This puts downward pressure on the aggregate participation rate and the employment-to-population ratio because, even in the best of times, adults near or at retirement age have lower participation and employment rates than younger adults. The unemployment rate avoids these structural issues by only including people who currently want a job, and is therefore a better measure of the health of the labor market.

2. Since the recession ended in June 2009, the inflation-adjusted S&P 500 Total Return Index has more than doubled while real disposable income per capita has only increased by 4.2%. Do high stock prices reflect the fundamental strength of our economy? To what extent are they due to a highly accommodative monetary policy?

The substantial gains logged by equity prices since the middle of 2009 appear to have been driven by a sharp recovery in corporate profits and improved sentiment among market participants. Both of these factors have likely been supported by the accommodative stance of monetary policy.

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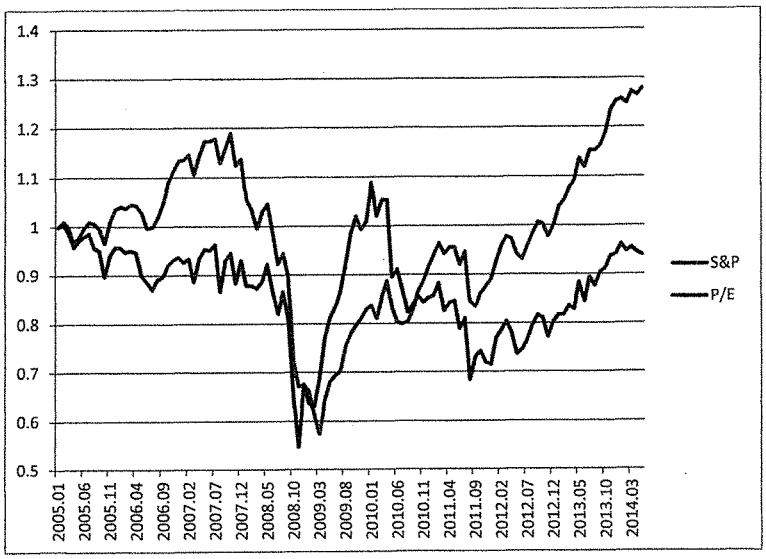
[1] See for example, Fujita, Shigeru. "On the Causes of Declines in the Labor Force Participation Rate." Federal Reserve Bank of Philadelphia *Research Rap Special Report*, November 2013; revised February 6, 2014; http://philadelphiafed.org/research-and-data/publications/research-rap/2013/on-the-causes-of-declines-in-the-labor-force-participation-rate.pdf.
Aaronson, Daniel; Davis, Jonathan and Hu, Luojia. "Explaining the Decline in the U.S. Labor Force Participation Rate." Federal Reserve Bank of Chicago *Chicago Fed Letter*, No. 296, March 2012; http://www.chicagofed.org/digital_assets/publications/chicago_fed_letter/2012/cflmarch2012_296.pdf.

The inflation-adjusted level of the S&P 500 index has more than doubled since the end of the recession. However, real earnings for firms in the S&P 500 index now stand at a record high level of over 100 dollars per share, having recovered from a low of 10 in early 2009, largely due to higher productivity levels and improved profit margins. Therefore, on an earnings-adjusted basis, the increase in equity prices has been more moderate. For example, the price-to-earnings ratio for the S&P 500 index has moved up about 40 percent since the early 2009.

Second, the reduced uncertainty and enhanced sentiment on the part of equity investors seem to have contributed to the rise in stock prices. For instance, the option-implied volatility on the S&P 500 index, as measured by the VIX index, has dropped significantly since the end of the recession and now stands near historically low levels.

Accommodative monetary policy has likely helped to bolster stock prices by stabilizing the macroeconomic outlook and reducing investor uncertainty. It has also created a low interest rate environment, driving up stock prices as investors tilt their portfolios toward higher-yielding asset such as equities.



Source: all series are scaled to 1 at the beginning of 2005. The real S&P 500 level from the online database of Robert Shiller. http://www.econ.yale.edu/~shiller/data.htm; 12-month backward P/E ratio from S&P, Thomson Financial.

3. The Fed noted in its recent policy statement that "Fiscal policy is restraining economic growth, although the extent of restraint is diminishing." There is a real tendency for casual observers and many in the media to think of this statement only in the context of spending restraint. However, higher taxes, especially those on capital, also impose a fiscal drag on growth. Last June, the Federal Reserve Bank of San Francisco noted in its *Economic Letter* that the primary source of fiscal drag going forward was because of higher taxes, not because of spending restraint or sequestration. Do you agree or disagree with that assessment? And if not, why not?

The Congressional Budget Office (CBO) has estimated that real gross domestic product (GDP) growth last year was roughly 1-1/2 percentage points less than it would have been otherwise because of changes in fiscal policy that increased taxes and reduced federal government purchases. The CBO expects that the fiscal policy changes already in place for this year, which again includes both tax increases and spending reductions, will restrain GDP growth by about 1/4 percentage point. These estimates of the effects of fiscal policy restraint on economic growth are consistent with the Federal Open Market Committee's (FOMC) recent statement. Moreover, the CBO's analysis notes that fiscal restraint in recent years has come from both higher taxes and reductions in federal spending.

The analysis in the *Economic Letter* (June 3, 2013) published by the Federal Reserve Bank of San Francisco uses a different methodology than the CBO for calculating fiscal drag, and that study is focused on projecting the fiscal drag implicit in the CBO's forecast for the federal budget over the next several years compared to the historical norm for fiscal policy during an economic recovery. Even with these methodological differences, one of their main conclusions is that fiscal policy has become more restrictive for economic growth in recent years, which is consistent with the CBO's analysis.

4a. Your predecessor Ben Bernanke often cited "fiscal drag" as both an economic problem and as part of the justification for Quantitative Easing. He said in July of 2013, "The risks remain that tight federal fiscal policy will restrain economic growth over the next few quarters by more than we currently expect or that the debate concerning other fiscal policy issues, such as the status of the debt ceiling, will evolve in a way that could hamper the recovery." In response to a question regarding the sequester enacted as part of the *Budget Control Act of 2011*, he added "we're focusing too much on the short run and not enough on the long run." What if Congress created an across-the-board cap on non-interest spending tied to potential GDP, so federal spending could grow but grow at a slower pace than the economy?

I believe that it is appropriate for decisions about the details of fiscal policy to be made by the Congress and the Administration.

4b. Do you believe that this type of approach would be preferable to the current sequester in that it would put a focus on tying the aggregate growth of all programs to GDP instead of constraining a limited few?

Although I will not comment on specific fiscal policy proposals, I believe that it is appropriate to not impose additional near-term fiscal restraint while our economy is not yet back to full employment. Nevertheless, fiscal policymakers should put in place a credible plan to set fiscal policy on a sustainable path in the longer run while not restraining the economic recovery in the short run. If current federal budget policies do not change, the CBO projects that the further aging of the population, rising health care costs, and growing interest payments on federal debt will all contribute importantly to rising budget deficits after next year. To promote economic growth and stability in the longer term, it will be essential for fiscal policymakers to put the federal budget on a sustainable long-run path.

4c. Is it appropriate for the Federal Reserve to use monetary policy to counteract legislatively enacted policies?

Our monetary policy decisions are undertaken independent from the fiscal policy decisions implemented by the Congress and the Administration. The Federal Reserve's monetary policy decisions are made in the context of judging what is the most appropriate in order to help achieve our mandated goals of maximum sustainable employment and stable prices. Nevertheless, monetary policy cannot carry the entire burden of promoting a more robust economic recovery and speedier return to full employment.

5. Is the Fed willing to make its balance sheet more transparent? Specifically, will the Fed provide a consolidated list of holdings that includes not only maturity values, but also average purchase prices for each issue and the current market value of each holding?

The Federal Reserve provides a substantial amount of information about our securities holdings. In particular, the Federal Reserve Bank of New York publishes the results of each purchase on the day of the operation (including the security purchased and the par amount accepted at the auction) as well as individual transaction data (including Committee on Uniform Securities Identification Procedures (CUSIP), price, and counterparty) with a two-year lag, as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Federal Reserve also publishes CUSIP-level data on system open market account holdings at par value (Treasuries) or current face value (for mortgaged backed securities) on a weekly basis. This and the above information are available to the public on the following website: http://www.newyorkfed.org/markets/OMO_transaction_data.html. Lastly, the Federal Reserve also publishes quarterly financial reports that show (among other information) the fair market value of its securities holdings as well as their amortized cost--and the difference between the two. That information, and additional information about the Federal Reserve's finances, is available to the public on the Federal Reserve Board's website from links on the following page: http://www.federalreserve.gov/monetarypolicy/bst_fedfinancials.html.

6a. In your April 16, 2014 remarks to the Economics Club of New York, you said, "The FOMC strives to avoid inflation slipping too far below its 2 percent objective because, at very low inflation rates, adverse economic developments could more easily push the economy into deflation. The limited historical experience with deflation shows that, once it starts, deflation can become entrenched and associated with prolonged periods of very weak economic performance."

Was it not a similar deflationary concern, which proved unfounded, that led the Fed at the close of the Great Moderation, to keep interest rates too low for too long, fueling the housing bubble and leading to the 2008 financial crisis and recession?

The data in hand at the time of the May 2003 FOMC meeting indicated that 12-month consumer price inflation excluding food and energy had declined to 1-1/2 percent, and the three-month change in these prices to an annual rate of 1 percent. In these circumstances, the FOMC expressed in its post-meeting statement the view that "the probability of an unwelcome substantial fall in inflation, though minor, exceeds that of a pickup in inflation from its already low level." The FOMC reiterated its concerns about inflation becoming undesirably low in its statements through October 2003. During this period, the FOMC reduced its target federal funds rate from 1-1/4 percent to 1 percent. In the event, consumer price inflation excluding the volatile food and energy components picked up to 2 percent by early 2004, and the FOMC began raising the federal funds rate target beginning in June of that year. Although the contribution of the low level of the federal funds rate target in 2003 and early 2004 to the leveling off of inflation in 2003 and its subsequent return to 2 percent is difficult to quantify with precision, statistical models suggest that deflationary concerns appear in hindsight as "unfounded" because monetary policy acted in a timely manner to forestall deflation.

The contribution of the low level of the federal funds rate to the house price boom, by contrast, was most likely only modest. Most observers date the beginning of rapid house price increases to 1998, well before the period of low short-term interest rates from late 2001 to 2004.[2] During the latter period, monetary policy was focused on preventing a sharper increase in the unemployment rate and a further decline in inflation. While low interest rates raise house prices, all else equal, the increase in prices during the mid-2000s was much larger than the historical relationship between interest rates and house prices suggest. More likely is an important role of a substantial loosening in terms and standards for mortgage credit.[3] Finally, rapid house price increases in the early 2000s were not confined to the United States, but were experienced in a number of advanced economies. There seems to be little relation between the stance of monetary policy in these countries and their respective rates of inflation-adjusted house price increases; by

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[2] Robert J. Shiller (2007), "Understanding Recent Trends in House Prices and Homeownership," in *Proceedings of the symposium "Housing, Housing Finance, and Monetary Policy."* Kansas City: Federal Reserve Bank of Kansas City, pp. 89-123.

[3] Jane Dokko, Brian M. Doyle, Michael T. Kiley, Jinill Kim, Shane Sherlund, Jae Sim, and Skander J. Van den Heuvel (2011), "Monetary Policy and the Global Housing Bubble," *Economic Policy*, vol. 26, no. 66, pp. 233-283.

contrast, countries that experienced larger capital inflows, the U.S. among them, tended to see stronger house price appreciation.[4]

6b. How is some deflation risk worse than risking inflation through asset prices, another bubble and a financial crisis?

Both deflation and financial crises pose serious risks to economic performance. In pursuing its dual mandate, the FOMC takes into consideration financial market developments that could pose a threat to financial stability. The risk of deflation is particularly pernicious in a situation like the current one, in which the federal funds rate and other short-term interest rates are already constrained by the effective lower bound on these rates while there remains slack in labor markets. In this situation, the ability of monetary policy to respond to any adverse shock to economic activity is severely limited. If, in such a scenario, inflation were to decline or even turn into deflation, this would push up real interest rates, thereby further weakening aggregate demand.

While the housing bubble demonstrated how dangerous credit-financed asset price bubbles can be, it seems more promising to address such bubbles, if they were to become evident, through regulatory and supervisory tools rather than by raising short-term interest rates. Apart from the question, discussed before, how effective short-term interest rate increases are in reining in asset price growth, it is an open question whether in current circumstances an increase in short-term interest rates would reduce risks to financial stability. With the economic recovery still incomplete, a premature increase in short-term interest rates could risk weakening the economy to the point that households', firms', and thereby banks' balance sheets would deteriorate, which might lead to an increase in financial fragility rather than a reduction.

6c. As you note, there is limited historical experience with deflation—and while we agree that deflation should be avoided—because of the limited data, is it possible that our fears could be somewhat overblown?

In the latest Survey of Professional Forecasters conducted by the Federal Reserve Bank of Philadelphia, the median forecast for consumer price inflation in 2014 is 1.6 percent. Moreover, forecasters assign only negligible probability to the event that consumer price inflation in 2014 will be negative, and only about 10 percent probability that it will be less than 1 percent. However, our ability to forecast inflation or, for that matter, deflation is limited. For example, the typical historical forecast errors reported in the FOMC's Summary of Economic Projections for consumer price inflation one year ahead is on the order of 1 percentage point. In addition, recent research has highlighted the fact that economic models tend to underestimate the likelihood of severe economic events, such as the financial crisis and the Great Recession.[5] Moreover, as mentioned before, with short-term interest rates already close to their effective

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[4] Ben S. Bernanke (2010), "Monetary Policy and the Housing Bubble," speech delivered at the Annual Meeting of the American Economic Association, Atlanta, GA, January 3.

[5] See for example, Hess Chung, Jean-Philippe Laforte, David Reifschneider, and John C. Williams (2012), "Have we Underestimated the Likelihood and Severity of Zero Lower Bound Events?" *Journal of Money, Credit, and Banking,* vol. 44, pp. 47-82.

lower bound, the risks to economic performance from unexpectedly low versus unexpectedly high inflation are asymmetric. Whereas monetary policy would be able to respond to indications that inflation will exceed 2 percent by raising short-term interest rates, it would at present not be able to respond to unexpectedly low inflation or outright deflation by reducing interest rates further.

7a. One effect of Quantitative Easing has been that the Fed has purchased massive amounts of longer-term Treasuries. Treasury pays the interest on these securities to the Fed, which uses the funds to pay its operating costs—a relatively small amount—and then returns the majority of the proceeds right back to the Treasury.

Is the effect of this to monetize indirectly the debt, and then provide the government with an interest-free loan?

The FOMC's decisions are made in the context of judging the stance of monetary policy most appropriate to achieving its goals of maximum employment and stable prices, and assessments about monetary policy are made independent from fiscal policy decisions. The large-scale asset purchases that the FOMC has conducted do not constitute a monetization of U.S. federal government debt.

One important distinction is that decisions by the FOMC to increase the size of its balance sheet have been in response to temporarily weak economic conditions, and the current large balance sheet is not anticipated to be permanent. Once the current degree of monetary policy accommodation is no longer necessary, the FOMC will reduce the size of its balance sheet. Another important distinction is that the Federal Reserve is required to make its security purchases in the open market. This restriction has served the public well by ensuring that the Federal Reserve's purchases of Treasury securities are not a special source of funding at below-market prices.

7b. While we are running large federal deficits, the fact that—for now—the Fed basically returns the interest on these loans, makes our deficit situation look a little less bad. Are you concerned that Quantitative Easing may serve as an enabler of bad fiscal policy?

The Federal Reserve's large-scale asset purchase program has temporarily increased the size of our remittances to the Treasury, and, more importantly, monetary policy has helped to support faster economic growth and more employment than there would be otherwise, which also contributes to narrower federal budget deficits. However, even after the economy is back to full employment and the Federal Reserve's remittances have returned to normal, the CBO still projects that federal fiscal policy is not on a sustainable path over the longer run because of population aging, rising health care costs, and growing interest payments on federal debt, and the temporary surge in remittances does not meaningfully change that projection. We believe that it is essential for fiscal policymakers to put the federal budget on a sustainable long-run path in order to promote economic growth in the longer term.

8a. Economist Robert Higgs determined that regime uncertainty—uncertainty with respect to the nation's fiscal, monetary and regulatory policies—was one of the reasons the United States was one of the last countries to emerge out of the Great Depression.

Has the Federal Reserve's current departure from a rule-based monetary policy heightened uncertainty in the economy?

Uncertainty in the economy is reduced when the FOMC conducts policy in a manner that is guided by unchanging objectives and when the FOMC is transparent so that its objectives and strategies for achieving those objectives are well understood. As stipulated by Congress, the FOMC's policy objectives are stable prices and maximum employment; those objectives are well known and have not changed since the Congress first provided them in 1977. In addition, the Federal Reserve is arguably the most transparent central bank in the world, so its strategies for achieving its objectives are well understood. In particular, each year the FOMC reaffirms and publishes on the Federal Reserve website a "Statement on Longer-Run Goals and Monetary Policy Strategy," which specifies how the FOMC interprets the goals set by Congress and the strategies it will follow to achieve its goals including when the goals are in conflict. Twice a year, the Federal Reserve provides Congress a comprehensive report on monetary policy and the state of the economy, and the Chair testifies before Congress on that report. After every other meeting (once a quarter), the FOMC publishes participants' projections for the economy and the federal fund rate – the FOMC's primary policy tool – and the Chair answers questions on those forecasts and the FOMC's monetary policy decisions at a press conference. Finally, after each meeting the FOMC issues a statement describing its monetary policy decision and the reasons for that decision followed three weeks later by comprehensive minutes of the meeting.

Of course, each situation is different in unpredictable ways, so when the FOMC responds to an unexpected economic development, its actions will necessarily also be unexpected to some extent. Nevertheless, because the FOMC's objectives and strategies for achieving those objectives are well understood, the extent to which monetary policy contributes to economic uncertainty is kept to a minimum.

8b. The Federal Reserve's current mandate requires it to take monetary actions that seek price stability and maximum employment—the so-called dual mandate. Can monetary policy have a direct, positive, and lasting effect on the number of jobs, or is any effect of monetary policy simply a short, temporary spurt?

When employment is below its maximum sustainable level, appropriate monetary policy can help achieve a faster return to full employment. But the economy's maximum sustainable level of employment in the longer run is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market.

8c. Rules-based monetary policy, as we saw during the Great Moderation (1983-2000), was associated with positive economic growth and job creation. Why is this?

One striking feature of the U.S. economy during the period from 1983 to 2000 or so was a substantial decline in macroeconomic volatility. Three types of explanations have been

suggested for this significant change in the U.S. macroeconomic environment: changes in the structure of the economy; improved macroeconomic policies, and good luck (meaning that the shocks or unexpected events hitting the economy in that particular period were smaller and less frequent than before or after).

The second explanation includes monetary policy. In basic form, monetary policy rules relate the Federal Reserve's policy instrument (the overnight federal funds interest rate, during those years) to the deviations of inflation and output from the central bank's desired levels for those variables. There is a general agreement among economists and policymakers that monetary policy performed poorly during much of the 1970s, a period of high volatility in both output and inflation. Researchers who estimate monetary policy rules tend to find a weaker response of the policy rate to inflation and (in some studies) a relatively stronger response to the output gap during the 1960s and 1970s than in more recent periods. Their results suggest that an insufficiently strong policy response to rising inflation during the 1960s and 1970s let inflation and inflation expectations get out of control and added to the economy's volatility. What we now understand, in retrospect, was that overly large estimates of the output gap contributed to the relatively weak policy response to rising inflation.

In more recent decades, monetary policy took a more balanced approach to inflation and employment. The observation that output volatility declined in parallel with inflation volatility, both in the United States and abroad, suggests that better monetary policy may have contributed to the decline in macroeconomic volatility.

While the rules' prescriptions sometimes differ appreciably over time, they do a reasonable job of capturing the broad characteristics of the FOMC's historical behavior covering the Great Moderation. Nevertheless, it is important to bear in mind that the available theory and evidence on simple monetary policy rules bears largely on the implications of following such rules when the policy rate is far from the effective lower bound. Unfortunately, several important considerations suggest that simple rules that are reliable in normal times will be less reliable under conditions such as those we face now. In particular, in the present context with the economy still recovering from the financial crisis and the federal funds rate still at its effective lower bound, it is likely that mechanical policy rules based on conditions during normal times would provide inadequate support for the recovery. As a consequence, use of such rules in today's economy could threaten both price stability and maximum employment.

8d. How would you expect today's economy to respond if the Fed were to adopt a rule-like monetary policy--that is, predictable and stable--such as the Taylor Rule?

Policy rules such as the well-known Taylor rule provide a mechanical rule linking the setting of the federal funds rate to a small number of economic variables, such as the inflation rate and an estimate of resource slack in the economy.

In normal times, a variety of rules of this type have been shown to be fairly reliable guides to the setting of the federal funds rate target. However, while policy rules can provide useful guides or indicators, in the present context with the economy still recovering from the financial crisis and the federal funds rate still at its effective lower bound, it is likely that mechanical policy rules

based on conditions during normal times would provide inadequate support for the recovery. As a consequence, use of such rules in today's economy could threaten both price stability and maximum employment.

That said, the FOMC is committed to being as transparent as possible in informing the public about how it makes its policy decisions and about its longer-run goals. Toward this purpose, the FOMC has provided considerable guidance about its planned use of its policy tools in FOMC statements, including information on the economic determinants of its decisions. It has also provided guidance about its longer-run objectives in its "Statement on Longer-Run Goals and Monetary Policy Strategy," which is reaffirmed annually.

8e. In January 2012, the Fed acknowledged, "The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable." If this is the case, why should the Federal Reserve focus its monetary policy on attempting to achieve things it cannot control—such full employment?

The Federal Reserve's statutory mandate includes promoting "maximum employment" as well as "price stability." As we have noted, "The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable." However, it does not follow from this observation that in pursuing maximum employment the Federal Reserve is "attempting to achieve things it cannot control." It means that it will be difficult to be certain when the objective of maximum employment has been satisfied. In other words, while the level of employment that might be deemed consistent with maximum employment might evolve over time, it is still incumbent on the Federal Reserve to attempt to generate economic conditions under which actual employment will reach maximum employment over time. Economists, including the staff of the Federal Reserve, use a variety of models and a wide range of labor market indicators to assess when conditions in the labor market might be consistent with maximum employment. These indicators include not only the unemployment rate but the proportion of long-term unemployed, the labor force participation rate, and the share of part-time employees who would prefer to work full time, among other measures. Taken together, these variables signal the extent labor utilization.

Trying to achieve maximum employment, properly defined, together with price stability, is important for at least two reasons: first, underutilization of labor is a social waste that imposes costs on the unemployed themselves as well as their families and communities, particularly when spells of un- or underemployment are lengthy; second, establishing and maintaining maximum employment is generally regarded as a necessary condition for sustained periods of price stability. Indeed, the level of maximum employment is frequently, if imperfectly, inferred from the presence or absence of stable price inflation.

9a. At several points in your May 7, 2014 testimony before the Joint Economic Committee, you express possible alarm over "flattening out in housing activity" and what this could portend for economic growth. Also on May 7, 2014 in the Wall Street Journal, Allan

Meltzer observes "the Fed should have noticed in recent years that instead of a strong housing-market recovery, not many individuals were taking out first mortgages. Many of the sales were to real-estate speculators who financed their purchases without mortgages and are now renting the houses, planning to resell them later."

Is there a connection between your concern over housing activity and the points raised by Dr. Meltzer?

As I stated in my testimony, we at the Federal Reserve are carefully watching developments in the housing market, where the recovery in housing activity that began in 2012 seems to have stalled recently. Starts and permits of single-family homes have flattened out over the past year, while existing home sales have declined more than 10 percent from their peak last summer. The most obvious potential causal factor was the sharp increase in long-term interest rates last spring, but the effects on the housing market have been larger and more prolonged than might have been expected, especially since rates have declined since then, on net.

Even from a broader perspective, the recovery in residential investment has been much more gradual than in past housing recoveries, with total housing starts remaining well below their pre-recession trend. Although low long-term interest rates have improved housing affordability and supported the labor market, there have also been significant headwinds: household formation has been very slow, mortgage credit remains tight, especially for households with lower credit scores, and student debt may be weighing down housing demand among young adults. In addition, the relatively rapid recovery of house prices, even as construction has remained low, suggests that it is taking some time to draw resources back into the construction sector.

One way that the housing market has adjusted to the new environment of supply and demand is through a relative increase in construction of multifamily units, which are usually rented. Another form of adjustment, noted by Dr. Meltzer, has been the increase in purchases of single-family homes by investors, both large and small, who then rent out the homes. Federal Reserve economists have been studying the role of investors in the single-family rental market for some time.[6] They find that the share of home sales made to business investors rose to roughly 6 percent in 2012, although there is considerable heterogeneity in this share across cities. Investor activity was particularly concentrated in cities like Atlanta, Phoenix, and Las Vegas, where large numbers of properties were available at relatively low prices. A number of analysts have speculated that the slowdown in housing activity since the summer of 2013 might be related to a cooling of investor demand.[7] This possibility is certainly a topic that we will be monitoring going forward.

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[6] See for example, the FEDS Notes post "Business Investor Activity in the Single-Family Market" from December, 2013 by Raven Molloy and Rebecca Zarutskie: http://www.federalreserve.gov/econresdata/notes/feds-notes/2013/business-investor-activity-in-the-single-family-housing-market-20131205.html.

[7] See for example, some recent analysis by the Federal Reserve Bank of San Francisco: http://www.frbsf.org/economic-research/publications/economic-letter/2014/may/existing-home-sales-slowdown/?utm_source=mailchimp&utm_medium=email&utm_campaign=economic-letter-2014-05-19.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Senator Klobuchar:

1. At its March 2014 meeting, the Federal Open Market Committee presented the economic projections of the Federal Reserve Board members and Federal Reserve Bank presidents. Minutes of the meeting indicate that most members believe the basic measure of inflation will be 1.5 to 1.6 percent this year, 1.5 to 2.0 percent in 2015, and 1.7 to 2.0 percent at the end of 2016. In addition, most members believe that the longer run (3 years and beyond) rate of inflation will be 2.0 percent- just one-half a percentage point above where it is today.

I noted in my opening statement that inflation is relatively low and is expected to remain low for the foreseeable future. Senator Wicker stated that you and I differ on our views of inflation, but I was simply citing what you and the Federal Open Market Committee have said publicly: that inflation projections are consistent with low and stable inflation now and for the foreseeable future.

Is there any indication that Federal Reserve Board members and Federal Reserve Bank presidents have changed their views on inflation since the March meeting?

As you noted, the March Summary of Economic Projections showed that most FOMC participants expect both headline and core inflation to rise gradually over the next few years to 2 percent, supported by the stability in longer-run inflation expectations, as well as steadily diminishing resource slack. The more recent Summary of Economic Projections from June showed a similar projected path for inflation. Consistent with this outlook, the FOMC indicated in its March, April, and June post-meeting statements that inflation has been running below the FOMC's longer-run objective, but that longer-term inflation expectations remain stable.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Duffy:

1. Former Federal Reserve Board Chairman Bernanke publicly acknowledged that insurance companies have unique business models that make them different from banks, as have you, and that a bank-centric regulatory model would not work for insurance companies. At the same time, however, the Financial Stability Board (FSB) and the International Association of Insurance Supervisors (IAIS) in Europe have begun the process of preparing international capital standards very similar to the capital bank requirements coming out of Basel, Switzerland. The implication is that they would be applicable to U.S. insurance companies, including those that have not been designated systemically important financial institutions under Dodd-Frank or globally systemically important institutions. Given the Fed's role as a member of the FSB, what concerns have you voiced on this move toward bank-like capital standards for U.S. insurance groups? Is it the position of the Federal Reserve that a quantitative capital standard is needed for U.S.-based insurers who also happen to do business overseas?

The international capital standards under development by the International Association of the Insurance Supervisors (IAIS) are not bank-centric. Moreover, they are not contemplated to replace existing insurance risk-based capital standards at U.S. domiciled insurance legal entities within the broader firm.

A goal of the standards being developed by the IAIS is to achieve greater comparability of the capital requirements of internationally active insurance groups (IAIGs) across jurisdictions at the group-wide level. This should promote financial stability, provide a more level playing field for firms and enhance supervisory cooperation and coordination by increasing the understanding among group-wide and host supervisors. It should also lead to greater confidence being placed on the group-wide supervisors' analysis by host supervisors.

Any IAIS capital standard would supplement existing legal entity risk-based capital requirements by evaluating the financial activities of the firm overall rather than by individual legal entity. Once developed by the IAIS, each national supervisor would determine the extent and manner in which any capital standards developed by the IAIS would be applied to firms regulated by that national supervisor.

2. Have you consulted with the state regulators on this subject? If you have, please provide details on those discussions, how their recommendations and concerns were incorporated into your actions, and if they were not, why they were dismissed or ignored.

State insurance supervisors, the National Association of Insurance Commissioners (NAIC), the Federal Insurance Office (FIO), and more recently, the Federal Reserve, are members of the IAIS. All three organizations are actively participating in the work of the IAIS to develop global insurance capital standards.

Federal Reserve staff meet with NAIC leadership, staff and state insurance regulators as well as with Federal Insurance Office staff on a regular basis to discuss IAIS activities.

3. How is US policy on insurance at these international forums decided on and presented? Are you, the industry, their state regulators, and other Federal representatives like the Secretary of the Department of Treasury speaking with a unified voice?

State insurance supervisors, the NAIC, the FIO, and more recently, the Federal Reserve, are members of the IAIS. As noted above, state insurance regulators, the FIO and the Federal Reserve actively communicate on matters related to the IAIS.

4. I've heard concerns that Section 616 of Dodd-Frank relating to the Federal Reserve's "Source of Strength" authorities could negatively impact insurance policyholders of savings and loan holding companies if their premium dollars could be raided to provide support to the holding company. It's my understanding that in a Bank Holding Company, the state insurance regulators would have to sign off on any funds leaving the insurance entities, but it's not clear how this works for insurers within savings and loan holding companies. I understand that rules have yet to be proposed by the banking agencies implementing that provision. When you do plan to issue such rules? Do you plan to consult with insurance regulators to ensure insurance policyholders are protected?

Section 616(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) provides that the Federal Reserve must require each bank holding company and savings and loan holding company to serve as a source of strength to its subsidiary depository institutions. This requirement applies to all savings and loan holding companies, including those that are insurance companies. As noted in your letter, in the case of bank holding companies, the Bank Holding Company Act provides that the appropriate state insurance regulator may object to any Federal Reserve order requiring that a bank holding company, that itself is an insurance company or an insurance company subsidiary that is an affiliate of a depository institution, provide funds or other assets to an affiliated depository institution.[1] The Home Owners Loan Act does not contain such a restriction; however, the Federal Reserve appreciates your concerns and will carefully consider them as it works with the other agencies to move forward with its rulemaking process under section 616 of the Dodd-Frank Act. Any proposal the Federal Reserve puts forth to implement section 616(d) would be subject to a notice and comment process. We welcome your input as well as that of state insurance regulators and the public, and will carefully consider all comments received over the course of the rulemaking.

5. I understand that in the United States the Fed is still in the process of developing capital standards for Savings and Loan Holding Companies and SIFIs that predominantly engage in insurance operations. To what degree have you consulted with state insurance regulators in developing such standards? What comfort can you provide that insurers won't be subject to bank-like capital rules that do not fit their business model?

The Federal Reserve is taking additional time to evaluate the appropriate capital framework for insurance nonbank systematically important financial institutions (SIFIs) and saving and loan holding companies (SLHCs) that are significantly engaged in insurance activities. We have been carefully evaluating public comments (including industry feedback) on how to design such a

[1] 12 U.S.C. §§ 1844(g)(1) and (2).

capital framework. The business model and associated risk profile of insurance companies can differ materially from those of banking organizations, and the Federal Reserve is taking these differences into account. The Federal Reserve is committed to taking the necessary amount of time to develop workable capital requirements for insurance-related firms. It is important that we have strong consistent capital requirements for all depository institution holding companies, that we have a treatment for insurance risks that is economically sensible, and that we comply with the Collins amendment.

We do not have a specific deadline for issuing a proposal, but once we have developed a proposal, we will issue it for public notice and comment. We will provide insurance nonbank SIFIs and SLHCs, that are significantly engaged in insurance activities, with a reasonable amount of time to come into compliance with the final capital rules that we issue.

6. Former Fed staffers Joe Gagnon and Brian Sack have authored a paper that is getting a lot of attention in some circles. They argue that the Fed should replace the so-called federal funds rate target with a new operating framework. Specifically, they propose that the FOMC use the interest rate on its reverse repo program (or RRP) as the main policy instrument. You and other Fed officials have stated that tools have been developed that will allow the central bank to effectively manage short term interest rates despite the presence of a very large Fed balance sheet. Does the Fed plan to follow the recommendations laid out by Gagnon & Sack and transition to a new operating regime that relies on the RRP as a key target?

Decisions regarding policy normalization have not been made at this time. As noted in the minutes to the April meeting of the Federal Open Market Committee (FOMC) (http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20140430.pdf), as part of its prudent planning, the Federal Reserve is considering different approaches to raising short-term interest rates when it becomes appropriate to do so, and to controlling the level of short-term interest rates once they are above the effective lower bound during a period when it will have a very large balance sheet. The FOMC is considering different approaches to accomplish these goals using different combinations of policy tools, including the rate of interest paid on excess reserves balances, fixed rate overnight reverse repurchase operations, term reverse repurchase agreements, and the Term Deposit Facility. Because the Federal Reserve has not previously tightened the stance of policy while holding a large balance sheet, most FOMC participants judge that the FOMC should consider a range of options and be prepared to adjust the mix of its policy tools as warranted. Accordingly, the Federal Reserve is currently testing its various tools, including the Term Deposit Facility as well as fixed rate overnight reverse repurchase agreements.

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