FEDERAL RESERVE AID TO THE EUROZONE: ITS IMPACT ON THE U.S. AND THE DOLLAR

HEARING

BEFORE THE

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DOMESTIC MONETARY POLICY
AND TECHNOLOGY

OF THE

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FEDERAL RESERVE AID TO THE EUROZONE: ITS IMPACT ON THE U.S. AND THE DOLLAR

Tuesday, March 27, 2012

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY
POLICY AND TECHNOLOGY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:03 a.m., in room 2128, Rayburn House Office Building, Hon. Ron Paul [chairman of the subcommittee] presiding.

Members present: Representatives Paul, McHenry, Luetkemeyer, Huizenga, Schweikert; Clay, Maloney, and Green.

Chairman PAUL. This hearing will now come to order.

Without objection, all Members' opening statements will be made a part of the record.

I will now recognize myself for 5 minutes to make an opening statement.

First, I would like to thank Dr. Kamin and Dr. Dudley for appearing today to discuss a very important subject that the world is looking at constantly: a major debt crisis that exists around the world.

It has a great deal of significance not only for world finance, but also for the American taxpayer and the value of the U.S. dollar, and indirectly, the deficits that are run up because they are all interconnected.

The crisis we face right now is a crisis in debt and how we handle this debt. Who gets stuck with the debt? Who gets the bailout? How does the debt get defaulted on? How do you liquidate the debt?

And there are different ways of liquidating debt. When you can't pay the bills and you write them off the books, that is liquidating debt and that helps to solve the problem.

Other times, governments and central banks participate in liquidating debt by diminishing real debt, and that is by purposely devaluing the currency and, of course, that has been used historically many, many times and is one of the most common ways of liquidating debt.

So if you can devalue a currency by 50 percent, you can get rid of real debt by half if your prices go up. And there certainly seems to be a concerted effort around the world, and even within our own country, to handle debt in that fashion.

But in the process, the question really is: Who gets stuck with it? Who gets the most penalties? And if you happen to be on the receiving end of being too-big-to-fail and you get some benefits from the system, but the debt is not liquidated, it is passed on, it is transferred from one group of individuals to another. Nevertheless, it is still a pain. But it is just a matter of picking and choosing who will receive the most harm.

The problem I see right now in dealing with this debt crisis is can the U.S. dollar and the U.S. economy and the U.S. taxpayer bear the burden? And this is the way it seems because now, the European Central Bank (ECB) is asking us to continue to do what we have done over these last few years, to use the dollar to actually bail them out.

On paper, it looks like the balance sheet is better with the Europeans. Their assets-to-capital ratio is better than our bank. And yet, the dependency is for the United States to bail them out and it seems like it is working.

Of course, we have the advantage of issuing the reserve currency of the world which has given us, in a deceptive way, some advantages over many, many decades. But the big question is: How long can that happen? Will we always have the benefits? Will other countries finally get together, as they talk about constantly, and replace the dollar? And certainly, the dollar isn't getting to be a stronger reserve currency; if anything, it is getting slightly weaker. And someday, there may be some real challenges to the dollar, so there has to be a limit to this.

We talk about the Greek crisis, which is major and significant, and we are dealing with it on a daily basis. This might just be the beginning of a much bigger crisis when you look at the different countries, whether it is Portugal or Spain or Italy. And this thing could—it is much bigger than we are willing to admit. In many, many ways, I think we are in denial of how serious this problem is.

So we have to face up to the fact that there is a cost. I see it is going to be a cost against the value of the dollar. Some people say, "This is good. We want a weaker dollar because it is going to help our trade; it is going to help our exports."

And now, there are currency wars going on. All we do is complain about the Chinese having too weak a currency. At the same time, we triple our balance sheet and triple the monetary base.

Now, that is deliberately trying to weaken a currency too. So there will be limits on that. I think we are facing that. We are up against the wall on this. And very soon, I think we are going to have to admit that you can't solve the problem of debt with more debt.

You can't solve the problem of a weak currency by making the currency even weaker. You can't solve the problem by having the moral hazard of a guaranteed bailout that people—there is always going to be a lender of last resort, and if you are too-big-to-fail, you are going to be taken care of. Some people may suffer, but others will be taken care of.

I think there are limits. I think we are facing that. I think we are in denial. We won't admit how serious it is; but I believe that we will be forced to, not because of the politics of it as much as because of the economics.

I complain about the power of governments and central banks, but ultimately, there are economic rules and laws—economic laws probably much stronger than all of us. And you can't dictate and mandate forever. You can kid people for a long time. But right now, it is an illusion that we can trust the dollar to bail out the world. And soon, we are going to see the end of that and that is why many of us believe that the crisis is far from over and that we have to face up to those facts.

Now, I would like to recognize Mr. Clay for his opening statement.

Mr. CLAY. Thank you, Chairman Paul, and thank you for holding this hearing to examine the Federal Reserve's assistance to the Eurozone and the effect of that assistance on the U.S. economy, monetary system, and the dollar.

The focus of this hearing is to examine the Federal Reserve's Central Bank's currency swap-line arrangements with central banks of Europe, England, Switzerland, Japan, and Canada.

Also, I want to thank the witnesses for appearing before us today.

When the new Greek government came into power in late 2009, they revealed that the previous Greek government had not been reporting the budget deficit accurately. This has led to major economic challenges and concerns to other parts of Europe and the United States.

The first concern is the high levels of public debt in some Eurozone countries. Three Eurozone major governments—Greece, Ireland and Portugal—have had to borrow money from the European Central Bank and the International Monetary Fund in order to avoid defaulting on their debt.

Currently, the Greek government is negotiating losses on bonds held by private creditors. Investors have started to demand higher interest rates for buying and holding Italian and Spanish bonds. The Italian government debt is forecast to be $2.8 billion in 2012, which is greater than Spain, Portugal, Greece, and Ireland combined.

The second concern is the lack of growth and the high unemployment in the Eurozone. In January of this year, the IMF downgraded its growth forecast for the Eurozone from growing by 1.1 percent in 2012 to contracting by 0.5 percent.

The third concern is the weakness of the Eurozone's banking system, which holds high levels of public debt. In December of last year, the European Banking Authority estimated that European banks need about $152 billion of additional capital in order to withstand a range of shocks and still maintain adequate capital.

The fourth concern is persistent trade imbalances within the Eurozone. The Eurozone core countries tend to run trade surpluses with the Eurozone periphery countries. And the periphery countries tend to run trade deficits with the core countries.

To help ease the financial crisis in the Eurozone, the Federal Reserve opened the currency swap line. Under a swap line with the European Central Bank, the ECB temporarily receives U.S. dollars and the Federal Reserve temporarily receives euros.

After a fixed period of time, the transaction is reversed. Interest on swaps is paid to the Federal Reserve at the rate that the foreign central bank charges to its dollar borrower. The temporary swaps are repaid at the exchange rate prevailing at the time of the original swap, meaning that there is no downside risk for the Federal Reserve if the dollar appreciates in the meantime.

All of these concerns have raised questions about the economic stability of the Eurozone countries. I look forward to the witnesses' comments regarding these concerns and actions taken by the Federal Reserve Bank to address these concerns.

And again, thank you for conducting this hearing. I yield back.

Chairman PAUL. I thank the gentleman.

Now, I will recognize Mr. Luetkemeyer for his opening statement.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. Over the past several years, many of my colleagues and I have expressed serious concerns regarding U.S. exposure to the Eurozone.

Like many of my colleagues, my concerns have been met at times with cynicism and assurance of an efficient recovery with little or no contagion. Yet here we sit today, continuing to talk about the Eurozone crisis, and hearing once again that our Nation won't be dramatically impacted.

Certain scholars and fellow officials said that the crisis wouldn't spread. It has now impacted several European nations with effects ranging from default and upheaval in Greece to bank failures and increased risk in the perceived financial stalwart of France. This hasn't badly taken a toll on U.S. markets. I believe it has a potential to take a toll on our Nation's economy as a whole.

Chairman Bernanke testified recently in this committee that the two greatest threats to our economy are rising gas prices and the Eurozone problems. Secretary Geithner testified in this committee just last week, and seemed concerned as well about the possibility of a eurozone contagion, although he was optimistic things would work themselves out.

Regardless of what we hear today, we are in fact exposed. Our financial institutions, industries, and government are all exposed, and as a result, so are the taxpayers. Our economies are and always will be deeply connected. It is our responsibility to ensure that this exposure is managed thoughtfully and to ensure that the U.S. taxpayers are not again on the hook for the failure of the financial institutions not only domestic but foreign as well.

Mr. Chairman, I look forward to an enlightened discussion with our panel. This is an important topic and one that merits great transparency and attention. I thank you, and I yield back.

Chairman PAUL. I thank the gentleman.

Now, I would like to introduce our witnesses for today. Dr. William Dudley is the President of the Federal Reserve Bank of New York. Before taking over as President of the New York Fed in 2009, Dr. Dudley had been Executive Vice President of the Markets Group at the New York Fed, where he managed the System's open market account for the Federal Open Market Committee.

Prior to joining the New York Fed in 2007, Dr. Dudley was a partner and managing director at Goldman Sachs and company, and was Goldman's chief U.S. economist for a decade. Dr. Dudley also serves as chairman of the Committee on Payments and Settlement Systems of the Bank for International Settlements and as a member of the Board of Directors of the Bank for International Settlements. Dr. Dudley received his bachelor's degree from New College of Florida and received his Ph.D. in economics from the University of California, Berkeley.

Dr. Steven Kamin is the Director of the Division of International Finance for the Board of Governors of the Federal Reserve System. He joined the Federal Reserve System Board in 1987, and was appointed to the official staff in 1999.

Prior to taking over the Division of International Finance in December of 2011, Dr. Kamin was Deputy Director of the Division. He has also served as a visiting economist at the Bank for International Settlements, a senior economist for international financial affairs at the Council of Economic Advisors, and as a consultant for the World Bank.

Dr. Kamin received his bachelor's degree from the University of California, Berkeley and received his Ph.D. in economics from the Massachusetts Institute of Technology.

Without objection, your full written statements will be made a part of the record. You will now each be recognized for a 5-minute summary of your testimony.

Dr. Dudley?

STATEMENT OF WILLIAM C. DUDLEY, PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. DUDLEY. Thank you. Chairman Paul, Ranking Member Clay, and members of the subcommittee, my name is Bill Dudley and I am the President of the Federal Reserve Bank of New York. It is an honor to testify today about the economic and fiscal challenges facing Europe and the Federal Reserve's effort to support financial stability in the United States.

Let me preface these remarks by stating that the views expressed in my written and oral testimony are solely my own and do not represent the official views of the Federal Reserve Board, the Federal Open Market Committee or any other part of the Federal Reserve System.

Additionally, because I am precluded by law from discussing confidential supervisory information, I will not be able to speak about the financial condition or regulatory treatment or rating of any individual financial institution.

The economic situation in Europe has been unsettled for the better part of 2 years with pressure on sovereign debt markets and local banking systems. The strains in European markets have affected the U.S. economy.

The euro area has the capacity, including the fiscal capacity, to overcome its challenges. However, the politics are very difficult, both because the problem has many dimensions and because many different countries and institutions in the euro area have to coordinate their actions in order to achieve a coherent and effective policy response.

Europe's leadership has affirmed its commitment to the European Union and a single-currency union on numerous occasions. And the leadership is working harder than ever to achieve greater policy coordination in areas such as fiscal policy. A more robust and resilient European Union would be a welcome development for the United States. Three recent developments are especially encouraging in that regard.

First, liquidity concerns have eased significantly following the European Central Bank's long-term financing operations in December and February. Through this program, the ECB provides 3-year loans to European banks at low rates, accepting a wider range of collateral in return.

Second, earlier this month the Greek government worked with European leaders and its largest creditors to restructure the bulk of its 206 billion euros of outstanding privately held bonds. This not only helped reduce Greeks' total indebtedness, it also helped calm persistent worries that a disorderly Greek default could become the trigger for a global economic crisis.

Third, leaders in most euro-area countries have approved a new treaty designed to increase fiscal coordination. The new rules already appear to be making a difference. While difficult work still lies ahead, countries in the euro area have made meaningful progress towards achieving long-term fiscal sustainability.

Looking to the future, the difficult work that remains also presents special risks, both for Europe and for the United States. If Europe fails to chart an effective course forward, this could have a number of negative implications here. In particular, there are three areas of potential risk that I would like to highlight for the subcommittee today.

First, if economic conditions in Europe were to weaken significantly, the demand for U.S. exports would decrease. This would hurt domestic growth and have a negative impact on U.S. jobs. It is important to recognize that the euro area is the world's second largest economy after the United States, and it is an important trading partner for us. Also, Europe is a significant investor in the U.S. economy and vice versa.

Second, deterioration in the European economy could put pressure on U.S. banking systems. As the recent round of stress tests reveals, U.S. banks are much more robust and resilient than they were a few years ago. They have bolstered their capital significantly, built up their loan loss reserves, and have significantly higher liquidity bumpers.

The good news in the United States means that we are better able to handle bad news from Europe. With that said, the exposures of U.S. banks climb sharply when one also considers their exposures to the core European countries and to the overall European banking system.

Third, severe stresses in European financial markets would disrupt financial markets here, which could harm the real economy. Stress in the financial markets causes banks to more carefully husband their balance sheets. When that phenomenon occurs, the availability of credit to U.S. households and businesses becomes constrained.

Such conditions could also cause equity prices to fall, impairing the value of American pension and 401(k) holdings. This would damage the U.S. recovery and result in slower output growth and less job creation. At a time when the U.S. employment rate is very high, this is a particularly unacceptable outcome.

In the extreme, U.S. financial markets could become so impaired that the flow of credit to households and businesses could dry up. In today's globally integrated economy, banks headquartered abroad play an important role in providing credit and other financial services in the United States. About $1 trillion in worldwide dollar financing comes from foreign banks; $700 billion in the form of loans within the United States.

For these banks to provide U.S. dollar loans, they have to maintain access to U.S. dollar funding. At a time when it is already hard enough for American families and businesses to get the credit they need, they have a strong interest in making sure these banks continue to be active in the U.S. dollar markets.

It is in our national interest to make sure that non-U.S. banks remain able to access the U.S. dollar funding that they need to be able to continue to finance their U.S. dollar assets. If access to dollar funding were to become severely impaired, this could necessitate the abrupt forward sales of dollar assets by these banks, which could seriously disrupt U.S. markets and adversely affect American businesses, consumers, and jobs.

One way we can help to support the availability of dollar funding and ensure that credit continues to flow to American households and businesses is by engaging in currency swaps with other central banks. Such swaps are a policy tool that the Federal Reserve has used to support dollar liquidity for nearly 50 years.

More recently, the Federal Reserve established dollar-swap lines with major central banks during the global financial crisis of 2008, and reactivated them in May 2010. The swaps are intended to create a credible backstop to support but not supplant private markets. Banks with surplus dollars are more likely to lend to banks in need of dollars if they know that the borrowing bank will be able to obtain the dollars it needs to repay the loan if necessary from its central bank.

Our principal aim is to protect U.S. banks, businesses, and consumers from adverse economic trends abroad. I am pleased that the swaps seem to be working. In conjunction with ECB's long-term refinancing operations, the swaps have helped European banks avoid the significant liquidity pressures we feared a few months ago. And they have reduced the risks that they would need to sell off their U.S. dollar assets abruptly.

In conclusion, I am hopeful that Europe can effectively address its current fiscal challenges. The Federal Reserve is actively and carefully assessing the situation and the potential impact on the U.S. economy.

At this time, although I do not anticipate further efforts by the Federal Reserve to address the potential spillover effect of Europe on the United States, we will continue to monitor the situation closely.

Thank you for your invitation to testify today and I look forward to answering your questions.

[The prepared statement of Dr. Dudley can be found on page 36 of the appendix.]

Chairman PAUL. Thank you, Dr. Dudley.

Dr. Kamin?

STATEMENT OF STEVEN B. KAMIN, DIRECTOR, DIVISION OF INTERNATIONAL FINANCE, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. KAMIN. Thank you, Chairman Paul, and members of the subcommittee, for inviting me to talk about the economic situation in Europe and actions taken by the Federal Reserve in response to this situation.

In the past several months, European authorities have provided additional liquidity to banks, bolstered bank capital requirements, developed rules to strengthen fiscal discipline, and explored means of enlarging the euro-area financial backstop.

Stresses in financial markets have eased, but these markets remain under strain. The fiscal and financial strains in Europe have spilled over to the United States by restraining our exports, depressing confidence, and adding to the pressure on U.S. financial markets.

Of note, foreign financial institutions, especially those in Europe, have found it more difficult to borrow dollars. These institutions make loans to U.S. households and firms as well as to borrowers in other countries who use those loans to purchase U.S. goods and services.

While strains have eased somewhat of late, difficulties borrowing dollars by European institutions may make it harder for U.S. households and firms to get loans and for U.S. businesses to sell their products abroad. Moreover, these disruptions could spill over into U.S. money markets, raising the cost of funding for U.S. financial institutions.

To address these risks to the United States, on November 30th, the Federal Reserve announced, jointly with the European Central Bank or ECB, and the central banks of Canada, Japan, Switzerland, and the United Kingdom that it would revise, extend, and expand its swap lines with these institutions.

The measures were motivated by the need to ease strains in global financial markets which, if left unchecked, could impair the supply of credit to households and businesses in the United States and impede our economic recovery.

Three steps were described in the announcement.

First, we reduced the pricing of the dollar swap lines from a spread of 100 basis points over the overnight index swap rate to 50 basis points over that rate. This has enabled foreign central banks to reduce the cost of the dollar loans they provide to financial institutions in their jurisdictions. This, in turn, has helped alleviate global financial strains and put foreign institutions in a better position to maintain their supply of credit, including to U.S. residents.

Second, we extended the closing date for these lines from August 1, 2012, to February 1, 2013, demonstrating that central banks are prepared to work together for a sustained period to support global liquidity conditions.

Third, we agreed to establish swap lines in the currencies of other participating central banks. These lines would allow the Federal Reserve to draw foreign currencies and provide them to U.S.

financial institutions on a secured basis. U.S. financial institutions are not experiencing any foreign currency liquidity pressures at present, but we judged it prudent to make such arrangements should the need arise in the future.

Information on the swap lines is fully disclosed on the Web sites of the Federal Reserve Board and the Federal Reserve Bank of New York. I also want to underscore that the swap transactions are safe and secure.

First, the swap transactions present no exchange rate or interest rate risk because the terms of each drawing and repayment are set at the time the draw is initiated.

Second, each drawing on the swap lines must be approved by the Fed, providing us with control over the use of the facility.

Third, the foreign currency held by the Fed during the term of the swap provides an important safeguard.

Fourth, our counterparties are the foreign central banks, not the private institutions to which the central banks lend. The Fed's history of close interaction with these central banks provides a track record justifying a high degree of trust and cooperation.

Finally, the short tenor of the swaps means that positions could be wound down relatively quickly were it judged appropriate to do so. Notable, the Fed has not lost a penny on these swap lines since they were established in 2007. In fact, fees on these swaps have added to the earnings that the Fed remits to taxpayers.

To conclude, following the changes that we made to our swap line arrangements last November, the amount of dollar funding for the swap lines increased substantially. Subsequently, as measures of dollar funding costs declined, usage of the swap lines has fallen back.

Ultimately, however, a sustained further easing of financial strains here and abroad will require European authorities to follow through on their policy commitments in the months ahead. We are closely monitoring events in Europe and their spillovers to the U.S. economy and financial system.

Thank you, again, for inviting me to appear before you today. I would be happy to answer any questions you may have.

[The prepared statement of Dr. Kamin can be found on page 43 of the appendix.]

Chairman PAUL. Thank you, Dr. Kamin.

I will start off with the questioning.

For Dr. Dudley, I wanted to see if we could start off by seeing if we could agree with what the problem is—in my opening statement, I emphasize that the debt is the problem; that we are in a worldwide debt crisis.

Do you generally agree with that and how serious to you think it is?

Mr. DUDLEY. I think you are certainly correct that there is a question of debt sustainability in Europe in terms of the fiscal budget deficit path for some countries—not all countries, some countries—and there is also—and that is also implicated some of the European banks to have large exposures to that sovereign debt.

And so what is important is that these countries have an opportunity to undertake the fiscal consolidations that they need to demonstrate to the market that they can actually be on a sustainable path.

ECB's long-term refinancing operations and, I think, the dollar swaps have helped create some time for this to take place, but for this to work out well, these countries still have to take the appropriate steps.

Chairman PAUL. So far, if we date the crisis back to 2008 and 2009, and if it was a debt crisis that was a problem, if you look at everybody's debt, it is exploding, including ours. How do you solve the problem of debt with exponentially increasing the debt? It seems like our problems are just compounded.

How do you get around to either stop accumulating more debt or do you believe you have to liquidate debt? Some people believe you have to get rid of the debt in order to get growth again because the debt will consume us and interest rates are bumping up already.

And as I said in my opening statement, the Fed will have some ability to manipulate interest rates in the economy, but ultimately, the economic laws are pretty powerful, so interest rates are liable to go up.

So how can we solve the problem of debt with more debt, and what is your opinion of liquidating that? Is that important?

Mr. DUDLEY. I think that you are right, obviously, more debt does not solve the problem of too much debt. I think the good news in the United States, and I will speak about the United States, is that there has actually been a significant amount of deleveraging that has taken place among U.S. households over the last few years.

Debt-to-income ratios have come down. Debt service relative to income has come down. So U.S. households, I think, are in significantly better shape than they were a few years ago.

The second area where we see a pretty big change in terms of deleveraging of the United States is in the state of health of the U.S. banking system. U.S. banks, compared to 5 or 6 years ago, have much more capital and much bigger liquidity buffers.

So while I think it is too soon to say that the deleveraging process in the United States is over, we have made a considerable amount of progress in working our way out of the problems that we faced in 2007 and 2008.

Chairman PAUL. But isn't it true that mortgage debt is still on the books? It has been transferred; maybe the Fed owns that debt. We don't even know what the real value is of most of it.

And banks still hold some mortgage debt and it might be at a nominal value so in that sense of that debt being liquidated, maybe some individuals have straightened out their bank accounts, but there are still millions of people—if they really were improving, they could make their payments again, but debt is still the problem.

You say that some are deleveraged, but has there been any real liquidation of debt when it comes to mortgage and the derivatives because governments are involved in that—either the Central Bank or some of our programs are involved. It seems like none of that has been deleveraged. If anything, that looks like it is getting worse.

Mr. DUDLEY. On the mortgage front, there has been some deleveraging, because banks have taken mortgage losses. Also, in certain cases, especially among private holders of mortgage debt, there has been some principal forgiveness, principal reductions.

So you have actually seen, for example, last year, total household debt outstanding, according to the flow of funds, which is the broadest measure of household credit, was roughly flat last year; so nominal GDP was growing. Debt that was held by households was flat. So you are actually seeing the debt burden become less overwhelming.

Chairman PAUL. Yes. The promises that we made and the involvement we have with Europe that our finances are so good with our debt and our dollar that we have been standing and saying, "Yes, we will be there."

The Chairman of the Fed has said, "We are not ignoring this. If necessary, we have been there before, we will be back again."

What is the limit to this? What is the limit to us making these promises that we can always be available? Isn't there a limit to what the dollar will sustain?

Won't it eventually have to stop or do you think we can do this—if another crisis hits and there is a big downturn, and you have to inject trillions of dollars again, what is the limiting factor to the dollar and the United States economy bailing out the world?

Mr. DUDLEY. I think that, from my perspective, we want to make the decisions based on what is in our self-interest, what is best for U.S. households and businesses.

And, in that calculation, if we decide that intervention can help U.S. household and businesses, at higher benefits than cost, then we want to proceed. If we don't reach that calculation, if we think that there is too much risk involved in the program or that the program is going to lead to moral hazard and is going to be counterproductive, then we don't want to undertake it.

So I don't think that the Federal Reserve has made any decisions about what future interventions we would or would not do, except that we will do interventions that are consistent with our dual mandate, as set by Congress, to achieve maximum employment and price stability, sustain financial stability in the United States, and do what is best for households and businesses here.

That is why we are doing this program; not for Europe, but for ourselves.

Chairman PAUL. Dr. Kamin, did you want to make a comment?

Mr. KAMIN. Yes, do you mind? Could I add a few words, Chairman Paul?

Just to add to the comments that President Dudley made—our purpose in the swap lines, in particular, is not to, in some sense, fully back or to make whole all the debts that have accumulated around the world. That is very far from our purpose.

Our key strategy and our key intent in this regard is to make sure that foreign financial institutions could maintain the flow of credit, both to U.S. households and firms, and to firms and households around the world that in turn buy U.S. goods and services.

So the intent was mainly to help alleviate the liquidity pressures that could lead these foreign institutions to wind down their assets too quickly, and thus injure the U.S. recovery.

Thank you.

Chairman PAUL. Thank you.

Mr. Clay?

Mr. CLAY. Thank you, Chairman Paul.

Let me follow Chairman Paul's line of questioning.

Dr. Dudley, in your opening statement you mention that severe stress in European markets will create stress in the U.S. economy. Are we that tied to the European economy and that married to that system that it would have that kind of reaction, a chain reaction?

Mr. DUDLEY. I think we live in a global economy, and what happens in the other big economies of the world definitely affects us. As I noted in my testimony, there are sort of three channels by which Europe could affect us in a negative fashion. One, if the European economy is in recession or very weak, that is going to reduce the demand for our exports. So that has effects on U.S. production and employment here in the United States.

Two, if Europe were to be in a difficult position, and the European banking system were to worsen, that would have consequences for U.S. banks that have exposure to the European banks.

And three, if Europe were to perform badly, that would have negative effects on financial markets around the world. And that would have implications for our financial markets, and therefore, investment and growth here in the United States.

So there are definitely significant channels by how Europe can affect the United States.

Mr. CLAY. Dr. Dudley, have actions taken by the Federal Reserve regarding the currency swap line arrangements been beneficial or detrimental to the U.S. economy?

Mr. DUDLEY. We think that the swap lines have had their desired effects, because they have basically given a source of a backstop to other sources of funding to European banks. So as a consequence of them having this backstop available, if they were to need it, they don't have to be as fearful about their ability to obtain funding. And therefore, they can manage their dollar loans to U.S. businesses and households in a more orderly fashion.

We follow the activities of European banks in the United States through their U.S. branches and subsidiaries, and they are definitely reducing their exposure in the United States. But I think because of the dollar swaps, this is happening in an orderly way, rather than a disorderly way.

And so, we don't see that their reduction in the business that they are doing in the United States is having any damaging effects on the U.S. economy, which is really what our goal is; to prevent any damaging effects on the U.S. economy.

Mr. CLAY. Okay.

Dr. Kamin, would you like to add something?

Mr. KAMIN. Yes, thank you, if I could just add to those remarks.

Over the past couple of years, as the crisis in Europe has progressed, we have seen several periods when the financial situation in Europe deteriorated fairly dramatically. And during those periods, we could see some very obvious spillovers to financial markets, both in the United States and around the world.

During those periods of deterioration, investors became worried, and around the world they retreated from assets they perceived to be more risky. And what that led to, both in Europe and the United States and elsewhere, was sharp declines in stock prices, increases in interest rates line of credits, and other developments that were associated with retreats from risk and flights to quality. So, we have seen those episodes very clearly.

Now, more recently, since we changed the pricing of our swap lines, since the ECD introduced many measures to add liquidity to banks, and since European leaders have taken other actions, we have seen financial conditions in Europe—this is more or less since December—improve quite markedly. And that has been an important contributing factor to the improvement to the tone in financial markets in the United States. So those connections are definitely there.

Mr. CLAY. Dr. Kamin, share with us the effects that the rise in gasoline prices around the world and in the United States—what effects will this rise in gas prices have on the economies of Europe and the United States?

Mr. KAMIN. The effects that higher oil prices will have on both the United States and on Europe are, in broad qualitative terms, relatively similar. Both broad economies import oil. There is a greater dependence on imported oil in Europe than in the United States, but both do.

So, when oil prices rise, that acts as a tax on consumers of oil in both countries. And as a result, that diminishes the purchasing power that consumers in those counties have to basically spend on other goods. So, it basically acts as a brake on economic recovery and all else being equal, may make it more difficult to create jobs.

In addition to the effects on unemployment and economic activity, increases in oil prices have the effect of raising at least some portion of the consumer basket of prices. As long as oil prices will continue to rise, that should lead to a temporary increase in inflation. But that also poses concerns.

So obviously, recent increases in oil and gasoline prices are something that we monitor very carefully.

Mr. CLAY. Thank you.

And my time is up.

Chairman PAUL. I thank the gentleman.

Now, I recognize Mr. Luetkemeyer from Missouri.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Gentlemen, correct me if I am wrong, but I believe that the swap dollars that are—I guess euros—that are on the other end with the European Central Bank, they secure those, do they not, whenever they loan them back out on their other end?

And would you agree that there is a problem from the standpoint that what we have been told and what we find recently is they are taking a little more exposure, a little more risk, with some of the investments that they are taking as collateral for those? Would that be a fair statement?

Mr. DUDLEY. They have broadened out the collateral eligibility, but they also have significant haircuts for that collateral. So, they take more collateral than the value of the money that they are actually lending out.

Mr. LUETKEMEYER. Instead of one-to-one, it may be two-to-one, as they take additional collateral?

Mr. DUDLEY. They adjust for what they perceive to be the quality of the collateral.

Mr. LUETKEMEYER. Because I know that former executive board member Juergen Stark recently said that the balance sheet of the ECB is not only gigantic in dimension, but also alarming in its quality. Would you agree with that statement?

Mr. DUDLEY. I don't have enough information to assess the quality of the ECB balance sheet. But my dealings with the ECB suggest that they are quite prudent in terms of how they run their operations.

Mr. LUETKEMEYER. Yes, but aren't you one of the leading experts on swaps between the United States and Europe?

Mr. DUDLEY. But I do not conduct the daily operations of the ECB in lending money to their banks, versus collateral that they take.

Mr. LUETKEMEYER. Okay.

One of the concerns that I have is with regard to the quality of the economies over there. We keep talking saying, "They have dodged the bullet. They are getting better. They are improving."

And yet, we see, and we had Secretary Geithner here just last week, and he acknowledged that the European continent as a whole is still struggling. I think the comment was made in testimony today that it is a negative position as far as the growth of the economy yet. Greece is probably 4/10ths or 4 percent negative growth.

It is fine to sit here and go through a workout and restructure your debt, but if you don't have the ability to repay it, because you don't have an economy that grows fast enough to repay it, what do you have? I think we have to look at the revenue side.

We may be able to restructure the debt so that it can work. But if you don't have enough cash flow, enough revenue coming in, we are still in trouble. Where do you see that going?

Mr. DUDLEY. I certainly accept your observation that the European economy is very weak, and that weakness is going to persist for a while as these governments engage in further fiscal actions to get their budget deficits on a sustainable course.

But that fact I think in no way creates risk for us in terms of our swap agreements with the European Central Bank. We think we are very well secured in those transactions. We fully anticipate being fully repaid.

During the depths of the financial crisis in 2008 and 2009, a far worse economic environment than the one in which we are today, with far greater amounts of swaps outstanding, we were fully repaid. We didn't lose a penny. In fact, the total profit to the U.S. taxpayers for the swaps that were engaged in during that period was about $4 billion of profit to the U.S. taxpayer.

Mr. LUETKEMEYER. The point I am getting to, though, is if you have weak collateral for the European Central Bank swap lines and their economy is not going anywhere, that even gets—to me, that makes the debt that is—or the collateral that is securing that line—even weaker.

And so therefore, whether we may have two-to-one or three-to-one, if you have nothing supplying—you have 2 or 3 times nothing securing the debt, that is pretty concerning to me.

Quick question for you—do you think that the swap lines enhance the dollar as the world reserve currency, or do you think it hurts it?

Mr. DUDLEY. I think—

Mr. LUETKEMEYER. I would like a comment from both of you, please.

Mr. DUDLEY. I don't think it is a major factor, but I think at the margin it probably enhances the dollar as a reserve currency. In other words, the fact that the Federal Reserve is willing to engage in dollar swaps probably makes people more comfortable to use the dollars to finance international transactions around the world.

I don't think this is a major factor though in terms of why we are engaging in swaps, or should be a major factor in terms of why we are engaging in swaps. I think the main reason why we are engaging in swaps is we don't want European banks to quickly exit their dollar lending business here in the United States, with that exit causing harm to U.S. households and businesses.

Mr. LUETKEMEYER. Dr. Kamin?

Mr. KAMIN. If I could add to that, clearly, key factors that are underpinning the dollar's status as a global reserve currency are the breadth and depth of U.S. financial markets. And in particular, including but not limited to the status of U.S. Treasuries. All that is underpinned by the vitality of the U.S. economy and its consistent record of being able to innovate and grow.

The purpose of the swap lines is ultimately focused on continuing to preserve the vitality of the American economy and by making sure that foreign financial institutions have the funding they need to continue the flow of credit to American households and firms.

Insofar, then, as the swap lines can contribute to the continued vitality, the continued recovery of the U.S. economy, it undoubtedly is a plus as far as the dollar's reserve status. Although, as President Dudley has pointed out, it is probably one of many factors and not necessarily the most important.

Mr. LUETKEMEYER. Okay. Thank you very much. I see my time has expired.

Thank you, Mr. Chairman.

Chairman PAUL. Thank you.

I now recognize the gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you.

I want to welcome both of the panelists, particularly Dr. William Dudley, who is the President of the Federal Reserve Banks of New York. So welcome, Dr. Dudley.

And I would like to begin questioning by asking you, regarding the Federal Reserve's foreign exchange swap lines, can you tell me what your track record has been with these programs? Have they been successful? Have there been any losses to the taxpayers? Have there been any gains for the taxpayers; and if so, how much? And welcome.

Mr. DUDLEY. Thank you.

Mrs. MALONEY. Thank you for your service, both of you. Thank you.

Mr. DUDLEY. Thank you, Congressman Maloney. The track record is excellent, in two dimensions. One, the swap lines that we have engaged with have accomplished the goal that we set for them, which is basically to support U.S. financial markets and ensure the flow of credit to U.S. households and businesses.

And two, we have managed to do so in a way that has been extraordinarily safe. As I noted earlier, there have been no losses on any swap programs that we have ever engaged in, going back to 1962; and in terms of the swaps that we enacted during the financial crisis in 2008 and 2009 and ongoing, total profits for the taxpayers of about $4 billion.

So no losses, profit for the taxpayers; has had the beneficial effect that we wanted in terms of supporting the financial system and supporting the flow of credit to U.S. households and businesses. So I think that they have worked very well. Thank you.

Mrs. MALONEY. Thank you very much.

And I would like to ask Dr. Kamin about a statement that Treasury Undersecretary Brainard has stated; that the Administration's position in Europe is not to seek additional funding for the IMF. And to quote her directly, she said, "The challenge Europe faces is within the capacity of the Europeans to manage."

Europe accounts for roughly 16 percent of our exports; in my opinion, and correct me if I am wrong, accounting for the stabilization of many jobs here in the United States, probably thousands of jobs. What occurs abroad is going to have a direct effect on the recovery here at home in the United States.

Do you believe the stabilization of European markets is critical to our economic recovery here at home, making systems like the Federal Reserve foreign exchange swap lines crucial?

Mr. KAMIN. Thank you, Congresswoman Maloney.

In response to your questions, first of all, I absolutely agree that it is critical that the Europe financial and economic situation be stabilized. As you have pointed out, Europe is a major trading partner of the United States. And as we discussed earlier, its financial conditions in Europe are highly intertwined with those in the United States.

So a stabilization of the European situation really is very important, both for the United States financial conditions as well as the continued growth of exports and the real economy, and thus jobs. Now, as regards the issue of IMF policy, the Treasury Department is our liege on that, on the issue of IMF policy, so I can't speak directly to their statements.

But I will note, as Treasury officials have noted as well, as well as Federal Reserve officials, that Europe is a very—the euro area is a very large and comparatively wealthy economy relative to many others in the world. And they do have very many substantial resources that could be brought to bear on their situation. And so it is critical for them to do so. Thank you.

Mrs. MALONEY. Thank you.

And Dr. Dudley, I would like to ask you, as countries and international markets form individual firewalls to stave off residual financial distress, are we always and likewise creating firewalls through various other areas in policies involving capital and liquidity requirements that could have an effect on our economy here in the United States?

Mr. DUDLEY. We think it is very important to have a financial system that is resilient and robust. And towards that end, Congress, the Administration, and the regulatory community in the United States have been working hard to bolster the capital and liquidity among U.S. financial firms.

I have to say that we are in much better shape than we were a few years ago in both those regards. And I think that is good news because it means that if there are shocks emanating from abroad or emanating in the United States, that U.S. banks are in much better shape to absorb those shocks and to continue to function and supply credit to U.S. households and businesses.

Mrs. MALONEY. Could I ask for an additional 10 seconds?

Do you believe that we should do everything we can to contain the European crisis, to ensure that there is no spillover here in the United States, and to stabilize that region and our own economy? Yes or no?

Mr. DUDLEY. I think we should do everything that is prudent to stabilize the European economy. Obviously, we should do what is in our self-interest in terms of what is best for the United States; and all our policies are enacted through that prism.

Mrs. MALONEY. Okay.

Dr. Kamin?

Mr. KAMIN. Yes. That was exactly my thought. Definitely everything that is prudent and appropriate.

Mrs. MALONEY. Okay. Thank you.

I yield back. Thank you, Mr. Chairman.

Chairman PAUL. Thank you.

Did Mr. Luetkemeyer have a unanimous consent request?

Mr. LUETKEMEYER. Yes, Mr. Chairman. I would like to ask unanimous consent to place in the record the article which I referred to this morning. It is a MarketWatch article by Andrea Thomas with regards to the comment of executive board member Juergen Stark.

Chairman PAUL. Without objection, it is so ordered.

Mr. LUETKEMEYER. Thank you, sir.

Chairman PAUL. I now recognize Mr. Schweikert from Arizona.

Mr. SCHWEIKERT. Thank you, Mr. Chairman. Congressman Luetkemeyer stole one of the number-one questions I was interested in pursuing, and that was the credit quality of what is being pledged.

Can I get into something that is a little more conceptual? But this one actually really does bother me.

I am trying to get my head around the interconnectivity of euro-yen, euro's relationship to Singapore. And ultimately, as we are providing interlocking swap facilities, what happens when the debt cascade happens somewhere else in the world? Does that cascade end up tagging Europe, which tags us?

And how much ultimately is there in true net reserves in central banks around the world when you start looking at the net borrowing compared to the net savings countries? Dr. Kamin, I would love it if you would start with that one.

Mr. KAMIN. Thank you. I will be happy to.

So to start with, as we have come to recognize only too well, we have a very globalized financial system. And disturbances that occur in one part of the world are transmitted around the world through numerous channels and through numerous markets.

That was quite evident during the global financial crisis of 2008 and 2009. And we have seen it more recently with the European fiscal and financial crisis as deteriorations there—

Mr. SCHWEIKERT. Can I beg of you to pull the microphone a little closer to you?

Mr. KAMIN. Thank you. We have seen it more recently during the European financial crisis in the last couple of years. So—

Mr. SCHWEIKERT. And almost to the—what I am somewhat hunting is I have been tracking some data coming out of Japan, and there are some very worrisome signs in the net debt. How does that play into this interconnectivity?

Mr. KAMIN. What we have seen, then, is that in situations that occur like this, some dollar-funding problems, which is to say problems with banks getting funding in dollars in order to continue their flow of financing, they tend not to basically stay in one part of the world. There is a very easy capacity for those problems to spill out all over the world.

And it was in large part for that reason that we didn't just establish the swap lines with the ECB. We also established them with central banks around the world so that problems as they arose in different parts of the world could be addressed.

And as is evident from the data on the swap lines that we publish on our Web site, the take-up of these swap lines, in other words the distribution of funds to institutions in different regions, has not been limited exclusively to the euro area, although that is where most of the money has gone.

Mr. SCHWEIKERT. Dr. Dudley?

Mr. DUDLEY. I certainly agree with Dr. Kamin's answer to that. The world is very interconnected, and problems in one part of the world can definitely have ripple effects through the other parts of the world.

That is why we did set up these swap lines with five central banks rather than just the European Central Bank. And there are some draws on those swap lines from some of these other central banks.

Mr. SCHWEIKERT. Dr. Dudley, as to that concept, help me get my head around it.

Considering the nature of our balance sheets today after the 2008 crisis, both Europe and the United States, some of our partners in Japan, around other places in the world, if today Europe—this became a very hard recession and we had something like the Tequila Crisis from 15 years ago or some sort of cascade out there, do we have enough capacity, particularly if we also had different regions of the world competing for access to those swap lines? Do you believe our balance sheets are capable of stabilizing?

Mr. DUDLEY. It is hard to know what would happen in a given scenario, so it is hard to speculate.

One thing that I think is important though is that the foreign countries around the world are a bit better protected themselves in terms of sharp changes in capital inflows to capital outflows in the sense that they have very large foreign exchange reserves compared to what they had 20 or 30 years ago.

So, the ability of countries to bear a reversal from capital inflows to capital outflows is much better generally around the world than it was 20 or 30 years ago.

And part of that is my concern over the interest-rate spike, particularly with our net debt coverage; the interest rate spike and where our WAM is on our U.S. sovereign debt. A couple of years of higher interest rates would be devastating budget-wise. So, I am fearful of a cascade somewhere else truly affecting us.

Mr. SCHWEIKERT. I talked in a recent speech about debt service problems for the United States that are not really visible yet because U.S. interest rates are so low.

And if the United States does not get its fiscal house in order over the medium term, there is a chance that U.S. interest rates will rise. And that debt interest burden on the U.S. fiscal position will become quite significant. So, this is just another reason why the United States does need to get its fiscal house in order over the medium to longer term.

Thank you for your tolerance, Mr. Chairman. Thank you.

Chairman PAUL. I thank the gentleman.

Now, I recognize the gentleman from North Carolina, Mr. McHenry.

Mr. MCHENRY. Thank you, Mr. Chairman.

And thank you both for being here. We had a similar hearing in my subcommittee of the Committee on Oversight and Government Reform. And the times have changed slightly in the last couple of months, so I do want to touch on some of the things that I raised then, just to see if things have changed.

Dr. Dudley, can you explain under what circumstances the Fed would consider purchasing European sovereigns directly?

Mr. DUDLEY. The Federal Reserve has a small foreign exchange reserve portfolio that we manage for ourselves and for Treasury. And so we do actually own a very small amount of European sovereign debt as part of that foreign exchange reserve portfolio.

With the exception of that portfolio, which we periodically roll over maturing securities, I think the bar, as I said in our hearing a few months ago, was extraordinarily high for the Federal Reserve to actually go out and buy foreign sovereign debt for its own portfolio apart from these very small foreign exchange reserves holdings that we have.

Mr. MCHENRY. So, roughly what dollar amount do we have?

Mr. DUDLEY. I think it is on the order of $20 billion, $25 billion total. It consists of cash, sovereign debt of a couple countries, and then there are some reversed repurchase agreements where we basically have executed against dealers and taken—

Mr. MCHENRY. So, for context—

Mr. DUDLEY. It is a tiny—and it is based—

Mr. MCHENRY. $25 billion to what of your total holdings, just so we have—

Mr. DUDLEY. The total portfolio is about almost $3 trillion, not quite $3 trillion.

Mr. MCHENRY. Okay. So, it is de minimis—

Mr. DUDLEY. It is de minimis and it hasn't changed in size or composition over—

Mr. MCHENRY. Do you have statutory authority to expand that? Could you ramp it up to $500 billion?

Mr. DUDLEY. We have legal authority under the Federal Reserve Act to buy foreign sovereign debt. I don't see the circumstances under which we would ever be willing to do that, except with the exception of managing this foreign exchange reserve portfolio.

Mr. MCHENRY. Okay. Now, in terms of the long-term refinancing operation the European Central Bank has undertaken with the 3-year notes, in essence it looks similar in concept to TARP, doesn't it?

Mr. DUDLEY. It is a little different in the sense that TARP was money that Congress appropriated and then was used by the Treasury as capital to put into banks or put into other entities to recapitalize them.

The long-term refinancing operation is a loan from the European Central Bank to its banks against collateral that they pledged. So, it is a lending operation, not a capital investment.

Mr. MCHENRY. So, the TARP really wasn't a lending operation so you had to pay it back with fines and penalties and interest? It seems to me—

Mr. DUDLEY. TARP could be used for many purposes. It could be lent out and it could be used as capital. But if you look at how the TARP money was used and the bulk of it, the bulk of it was used for capital investments.

Mr. MCHENRY. I think we are battling semantics here because in essence they are similar in dollar amounts, similar in terms of their intent.

Now, really at the root, what is the European problem? Is it a problem of indebted countries? Is that the root of what we are contending with right now?

Mr. DUDLEY. I think that is part of it. Part of it is you have some countries in Europe that have budget deficits that are unsustainably high and debt burdens that are continuing to climb. So, that is problem number one.

But problem number two is they are doing so in a system of 17 countries with a common currency where the individual countries don't have control over their own monetary policy. They don't have their own currency and there is a lack of fiscal transfers within Europe to support countries that are in a weaker position relative to those that are in a stronger position.

So, there are some things that are very special about Europe's that are part of the European Union, the system of how the system is arranged that are very different than anything that applies to the United States.

Mr. MCHENRY. So, what happened with much of this long-term refinancing operation, that capital; it flowed into sovereign debt of a few countries and in large part that is where much of this flowed.

But Dr. Kamin, in terms of what that actually did—we have actually bought some time and space for a few highly indebted countries. Is that basically what has happened?

Mr. KAMIN. I think that it is possible that the sect of the Long-Term Refinancing Operations (LTRO), in combination with the other measures that have been taken, basically might have some somewhat longer-term benefits.

To be specific about that, it is true, as you say, that probably some of the LTRO money did flow to the purchase of sovereign bonds. But perhaps the more important thing that the LTRO funds did was alleviate many concerns by the market about the liquidity position and the financial position more generally of European banks.

And so the way in which that may have led to reductions in the sovereign yields of some embattled European governments was not just directly—they had the funds and they could use them; but indirectly because European banks felt more solid in their financial position and more comfortable being able to buy these bonds.

In turn, that improved situation in terms of European banks in the eyes of the markets may have led investors to believe that, therefore, European governments would not in turn be called upon to support banks. So, there was sort of a virtuous circle in process here, which has so far been very beneficial in terms of improving the tenor of markets.

Now, all that said, you are absolutely right that the LTRO is the provision of liquidity by itself cannot be the only thing that will solve the European crisis. It is very important that European leaders work on a number of more lasting fundamental issues.

One of them is they need to actually make the financial backstops for European governments higher and stronger, and that is a discussion they are having. They also need, quite obviously, and this is very challenging, to actually follow through on their many commitments to improve their fiscal situation.

And finally, as we have discussed here today, improved fiscal performance must be buttressed by improved growth performance, and that is particularly challenging for the peripheral European economies. And so, they are going to have to follow through on a lot of fairly rigorous structural reforms.

Thank you.

Mr. MCHENRY. Thank you.

It sounds like psychology and economics are getting closer and closer in these current crisis times.

Mr. KAMIN. I think they always have been.

Chairman PAUL. I thank the gentleman.

I want to follow up on this issue about how it is going to help our consumers here at home when we make these loans overseas. And I think, Dr. Dudley, you indicated that you already have some evidence that it has been helpful? Or are you just saying that if we do it, it could be helpful?

Mr. DUDLEY. The evidence is—it is soft evidence rather than hard evidence. But we have been monitoring the performance of the European banks who do business in the United States quite closely because they were having trouble getting dollar funding.

Money market mutual funds which were providing dollar funding to the European banks during the summer and fall were pulling back. Other lenders, large asset managers, were also pulling back from the European banks. And this was causing those banks to start to get out of their dollar book of business. They were trying to sell off loans and pull back in terms of their willingness to provide credit.

This was going on at a pretty feverish pitch through the late fall and in through the early winter. And I wouldn't say that it stopped, but the sense we get is it is happening now in a much more orderly way and not leading to the fire sale of assets at low prices; not leading to downward pressure on financial markets; not leading to a constraint in credit availability of U.S. households and businesses.

So, from what I can tell, we are seeing that the leveraging of the European banks is continuing. But it is happening in an orderly way rather than a disorderly way, which is what our objective is.

Chairman PAUL. You don't actually have a quantity, a number that you can—

Mr. DUDLEY. No, we don't have—

Chairman PAUL. —to say that they did such and such to the consumers back here at home?

Mr. DUDLEY. We don't have the details or data on that. But we do have discussions with those banks.

Chairman PAUL. It seems like there is a conflict, at least in my mind, of the need to send more currency swaps over there when the banks—I think the top eight banks in Europe actually had a tremendous increase in their reserves, a 50 percent increase in 1 year. So, why do they need more money? Why do they need more? It is already there.

What about our banks? Our banks have $1.5 trillion. If it is a good deal and it needs these bailouts or these purchases that you want them to do by having these currency swaps to help the banks—give the central banks to help buy some of this debt. If it is a good deal for anybody, why wouldn't some of our banks—they have $1.5 trillion?

It seems like you are doing something that the market doesn't want you to do. And there is a reason. Maybe it is way too risky. And if we are sending money over to the European banks with the hope, but no evidence, actually, of some of this money coming back and actually stimulating our economy, why is it that just more credit and more money in the system is going to work if our banks are holding $1.5 trillion?

There is something more to it than the lack of the ability or the lack of the willingness of the Fed to just endlessly create more and more credit. Why is it going to work better by just pumping more into, say, a European bank if the goal—see, you emphasized the help it is going to—you do it out of the interest of the American consumer.

You diminish the possibility that it might be done to just prop up the banks because they are in over their heads—that they may have credit default swaps. And the banks over there are—it is global. They have branches over there. It is just to prop up a system that is not viable.

So why is there a disconnect? There seems to be a lot of money there. Why do you feel compelled that we have to keep sending more in order that hopefully it will help our consumers here at home?

Mr. DUDLEY. I think that the U.S. banking system is a very different place than the European banking system. The U.S. banks have plenty of dollar assets that they can—monies that they can lend. They gather deposits through their retail branch networks here. So they don't have any shortage of dollar funds which they can lend.

The European banks were in a different position because they were dependent on the wholesale funding market providing them with dollars. And as the European situation deteriorated last summer and fall, U.S. investors that had been providing dollars to these European banks were pulling back.

And it was that pulling back and that difficulty for European banks to gain access to the wholesale dollar funding markets which was forcing them to pull back in terms of their willingness to lend to U.S. households and businesses. U.S. banks don't need dollar liquidity right now, so there is no—and they are not deleveraging.

The issue is the European banks, their dollar book of business. They were having trouble funding that book of business, and that is why they were pulling back.

Chairman PAUL. But they are holding all the reserves. If it were any advantage at all, they would do it. Obviously, there is no advantage to even helping out Europe. There is no law against them loaning the money, is there? Why do you feel compelled that you have to do something that the banks that are holding all this money won't do?

Mr. DUDLEY. I think that the European situation was creating a lot of anxiety about the health of the European banking system because the health of the European banking system was tied up with the health of the individual national economies in terms of their fiscal positions. And the ECB basically has been trying to find a way to cut that tie.

I think that long-term refinancing operations and the dollar swaps have sort of calmed down the anxiety in the market. And what we have actually seen now since the long-term refinancing operations have been put in place by the ECB and the dollar swaps have been put in place by us, is we have actually seen financing pressures in Europe subside.

So the rates that the European banks have to borrow from other European banks or to borrow from U.S. banks in dollars, those rates have actually been coming down. So that is actually a beneficial consequence of the long-term refinancing operations and the dollar-swap programs. The pressure on the markets is abating, which I think is a good thing.

Chairman PAUL. I will recognize Mr. Luetkemeyer from Missouri.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

I am kind of curious. Who determines the rate for the swap lines, the interest rate?

Mr. DUDLEY. The interest rate is established by the Federal Open Market Committee in discussions with the foreign central banks. Obviously, they have to agree to the rate that we are willing to—

Mr. LUETKEMEYER. How often is it reviewed to go up or down? How often do you review that: quarterly; semi-annually; once a year?

Mr. DUDLEY. The swap lines are outstanding. For example, the current set of swap lines are outstanding until February 1, 2013. But we certainly could review them at any—

Mr. LUETKEMEYER. The rate doesn't float?

Mr. DUDLEY. —at any point in time. The rate is set essentially at the Federal funds rate plus 50 basis points. So right now, it is about 0.6 percent of the interest rate.

Mr. LUETKEMEYER. Okay, but the amount above the Fed funds rate—that stays constant for the entire length of the swap? Or do you float that or adjust that as well?

Mr. DUDLEY. It had been at 100 basis points over the Federal funds rate up until last fall. And then, we lowered that spread from 100 basis points to 50 basis points. And the reason why we lowered that rate is that European banks were reluctant to use the swaps because they felt that using the swaps at that rate would be a sign of weakness.

The swaps were actually not being very effective in containing pressure in financial markets. So a decision was made by us and the foreign central banks in which we have engaged with the swaps to lower the rate from 100 basis points over the Federal funds rate to 50 basis points over the Federal funds rate.

Mr. LUETKEMEYER. If the European banks felt it was in their own best interests not to borrow money, not to swap because the rate was too high, why would you want to entice them into this with a lower rate?

Mr. DUDLEY. They were reluctant to use the swap because they felt that if they used it, it would be a sign that they were particularly weak institutions.

Mr. LUETKEMEYER. Why are they not viewed as weak now because they are using it now?

Mr. DUDLEY. Because when the swap rate was lowered from 100 basis points over the Federal funds rate to 50 basis points over the Federal funds rate, it became broadly attractive to the rates that were then in place in markets.

Mr. LUETKEMEYER. It made them look like better investors?

Mr. DUDLEY. Pardon?

Mr. LUETKEMEYER. It made them look like better investors, better money managers?

Mr. DUDLEY. There was an economic rationale for borrowing from the swap lines at the lower rate, so lots of banks participated. And since lots of banks participated, there was very little stigma from participating in that program.

Mr. LUETKEMEYER. This whole thing is held together by confidence and the perception that everybody is doing okay, isn't it?

Mr. DUDLEY. I think we have seen both in the case of the swaps and in the case of our own discount window in the United States, that there are times that banks don't want to use liquidity facilities, backstop facilities, because they are afraid that it is going to show that they are weak relative to other institutions. And that is just a problem in terms of these type of liquidity facilities.

Mr. LUETKEMEYER. I am just kind of curious. I will follow up on Chairman Paul's line of questioning with regards to the ECB loaning it to the banks, and the banks turning around and loaning it to our American, I guess, companies and investors here.

Why would they do that? Why are they not borrowing the money from us directly, our banks here?

Mr. DUDLEY. The European banks have big books of business in the United States, especially in areas like trade finance, project finance, and reserve energy. They lend against oil-and-gas drilling, energy reserves. And they have specialized expertise in these areas. And so, that is why they undertake this business around the world.

And in the United States, when they partake in this business, they do it in terms of lending dollars because obviously that is what the currency that we do business here in the United States. And so, they have a need for dollars to be able to sustain that business.

Mr. LUETKEMEYER. So what you are saying is that there are banks in Europe that are better experts at lending in certain areas, certain fields, than we have lending institutions in this country. Is that what you just said?

Mr. DUDLEY. I am saying that there are European banks that are specialized in certain areas. Now whether they are better or worse than U.S. banks that participate in the same areas, there is some overlap in the areas of competition.

But there are certain areas where European banks historically have concentrated their lending. Project finance, trade finance, and energy reserve lending are probably three of the most predominant examples.

Mr. LUETKEMEYER. Do the American corporations or entities that borrow from them, are they buying goods and services from Europe then, or are they buying goods and services from someplace else in the world, or the United States? Or is it kind of—does it kind of work like our export-import bank here, or how does that work?

Mr. DUDLEY. I would presume that if you are borrowing in dollars, you are using those dollars to buy U.S. goods and services. Otherwise, you wouldn't need the dollars. You would need some other form of currency.

Mr. KAMIN. Congressman, if I could add—this is a very global financial system, and we are in the middle of a very global economic system.

So, large banks operate all around the world and compete with each other. And that actually ends up being beneficial to non-financial—

Mr. LUETKEMEYER. I understand that, Dr. Kamin, but I am trying to get at—I am kind of concerned here because we have foreign banks that are apparently competing against American banks, which is what you just said, yet we are loaning money to the ECB, to those banks, to be able to loan back and compete against our banks. Is that what you just said?

Mr. KAMIN. What I said was just that both financial institutions and non-financial institutions compete with each other all around the world.

Mr. LUETKEMEYER. Yes, but my concern is that if we, through these swap lines, are funding these international banks, and they are in turn competing against our banks, I don't think we need to be doing that. Do you?

Mr. KAMIN. The primary concern of the Federal Reserve in setting up the swap lines was to maintain the flow of credit to American households and firms. That was key because that is what is needed in order to maintain the economic recovery and to move toward achieving our dual mandate of both price stability and maximum sustainable employment.

So, that was the critical factor that motivated.

Mr. DUDLEY. I think the U.S. banks also are interested in having a healthy U.S. economy, just like the European banks are. And I think that they probably broadly recognize that a forced liquidation of assets by Europeans banks would have negative consequences for the U.S. economy and for their banks.

Mr. LUETKEMEYER. I see my time is up. Thank you, Mr. Chairman.

Chairman PAUL. I now recognize Mr. McHenry for 5 minutes.

Mr. MCHENRY. Thank you, Mr. Chairman. To follow up on the earlier question I had about the long-term refinancing operation, it is interesting to me, Dr. Kamin—you did walk through the whole thought process. And I do appreciate that, the willingness of a witness from an independent institution the Congress oversees to walk through in sort of a very broad form; your thinking on this is rather impressive, and, dare I say, revolutionary.

But it was very much appreciated because this is really just about trying to make sure policymakers on the Hill have an awareness of what the Fed is doing. And I don't have to explain to the Fed the chairman of this subcommittee's vigorous intention of oversight of the Federal Reserve. That may be the understatement of the day.

So with this injection of funds, of low-interest-rate loans for an extended period of time, much of this capital—a large portion of this capital, I should say—of all the categories has gone to sovereign debt.

Mr. KAMIN. This is the LTROs?

Mr. MCHENRY. Yes.

Mr. KAMIN. Thank you.

Mr. MCHENRY. Yes. I am sorry.

So in that operation, money is flowed to sovereign debt. So it has had one of the intended effects from the ECB, it appears. The question is, of course, "What is our exposure to Europe?" Right? In terms of a quantifiable dollar amount, by our private sector; that is one question.

But really the bigger question here for policymakers is what is our exposure as a government, and the Federal Reserve's exposure to Europe?

Mr. KAMIN. Thank you, Congressman McHenry, for your kind remarks earlier, and for these questions.

The Federal Reserve exposure to Europe would be basically encompassed by the value of our swap lines, which is around $50 billion or so, to the ECB, and then a very small amount to the Swiss National Bank.

As we have discussed earlier, we think that those exposures are very secure. We have provided them with dollars. In exchange, they have provided us with their currency. And we appreciate the prudent management and the strong financial position of the ECB.

The exposure of our private financial institutions to Europe is obviously much, much larger, both our banks and our money market funds. Those exposures to the most embattled so-called countries in Europe, particularly like Greece and Portugal and Ireland, are really very small; the exposures to Spain and Italy—somewhat larger. But we have had many discussions with the banks that we supervise, and those are viewed to be quite manageable. Obviously, the exposures to core European banks which are, in turn, exposed to peripheral Europe are much larger.

But we are, in terms of thinking about the channels of spillover and how this exposure really works—what is probably more of concern is not so much these direct financial exposures to European institutions, but rather the fact that if the situation in Europe took a turn for the worse, there will be these ancillary channels that we have talked about before; the disruptions of financial markets; the retreat from risk-taking that could disrupt financial markets around the world.

And that is really the matter of greater concern, and that is where we focus a lot of our efforts in working with the banks that we supervise, and other regulatory institutions taking the same standpoint that the banks—

Mr. MCHENRY. Sir, explain to me how the swap lines benefit the American economy. Just in layman's terms.

Mr. KAMIN. Sure. To begin with, many European financial institutions, as we have discussed, are engaged in direct extensions of credit to U.S. households and firms. Any situation where these European banks were unable to get the dollar funding they needed, they would be forced to pull back on lending from U.S. households and firms. They might be forced to sell assets, which would then depress asset values in the U.S. economy more generally. And both of those effects would directly affect the ability of the U.S. households and firms to grow and prosper.

On top of that, funding difficulties by these European banks would lead to their cutback on credit, in terms of dollar lending, to other firms around the world; firms which buy a lot of the U.S. exports. And so, that would be an additional channel through which a funding shortage could hurt the U.S. economy. And that is what we hope to alleviate through the provision of these funds.

Finally, in the event that the dollar funding was not available—say in the absence of our swaps lines—and European banks ran into more severe difficulties, this could be a contributing factor to a further and renewed deterioration of European financial conditions, that not only could severely impact the European economy and prolong the recession, but lead to distressed conditions around the world.

So there might be larger, more ancillary effects from dollar funding problems then, again, the dollar swap lines are intended to alleviate.

Mr. MCHENRY. Thank you, Mr. Chairman.

Chairman PAUL. Thank you.

I recognize the gentleman from Michigan, Mr. Huizenga.

Mr. HUIZENGA. Thank you, Mr. Chairman.

I appreciate the opportunity, and I thank the witnesses for coming in. I want to maybe touch on a couple of quick things and continue on the currency swaps.

How far are we going to bring this along, I guess would be part of my question? How long are we going to stick into this game and be part of it? If Europe remains dependent on currency swaps, these same swaps become increasingly risky. Are you prepared to allow these currency swaps to wind down? Or what is going to happen there?

And then, the short-term dollar funding in Europe seemed to be the discussion point; right? How would you define short term versus medium term and long term?

Mr. KAMIN. I will start. Or, why don't you go ahead?

Mr. DUDLEY. Okay.

What we would hope is that the European countries do the right thing in terms of getting their fiscal houses in order and improving their competitiveness, so that investors start to have more confidence in the sustainability of the European Union and how all these countries are going to persist.

If that happens, and at the same time, the European banks are shown to have good earnings, liquidity, and capital, then I think that the willingness of private lenders to provide dollar liquidity to the European banks will emerge very much intact.

And in that situation, our swaps will be at rates that are actually higher than the market, and the swap programs will just sort of wind down automatically.

This is what we saw during 2007, 2008, 2009, during the first big wave of swaps; that as market conditions normalized, the swap usage came down pretty automatically.

Mr. HUIZENGA. I am kind of curious about that, because I am looking at some information in front of me here that says interest rates on dollar loans from the ECB are around 0.6 percent; interest rate on ECB charges for its euro loans is 1 percent. I don't have my Ph.D. in economics, however, I can see the incentive there. Why by making dollar financing cheaper than euro financing, how are they ever going to get out of that cycle?

Mr. DUDLEY. I am not sure that I would agree with that, if that is the right comparison. The 1 percent is to borrow euros. The 0.6 percent is to borrow dollars. And the alternative is to borrow dollars from a U.S. bank when the Federal Reserve is paying 25 basis points on the interest rate that we pay on excess reserves.

There is quite a bit of room between the 25 basis points we pay on the reserves here in the United States, and the 0.6 percent on the dollar swaps. So we would expect that if the conditions in Europe were to continue to improve, that the rate at which European banks could borrow dollars would be somewhat north of 25 basis points perhaps, but below that 0.6 percent. So we would think that there is plenty of room in that difference for the European banks to obtain credit from private entities.

And, in fact, we have actually seen private suppliers of dollars to the European banks return subsequently to the large, long-term refinancing operations and the dollar swap programs. So it looks like—

Mr. HUIZENGA. But doesn't that—

Mr. DUDLEY. —the market is already starting to normalize the dollar swaps.

Mr. HUIZENGA. But doesn't that weaken the value of the euro, what they are doing?

Mr. DUDLEY. I think the euro has really basically been trading in line with how the situation in Europe looks. As the European situation worsens, the euro depreciates. As the European situation improves, the euro appreciates. So it is really based on the outlook for Europe, of course relative to the outlook in the United States.

Mr. HUIZENGA. Help me to understand how if it is a weaker euro, doesn't that mean a typically a weaker Eurozone, since we have sort of flagged this off as a European issue, and trying not to get dragged into it here from the U.S. side?

Mr. DUDLEY. You are certainly right that if the European outlook were to deteriorate, the euro would probably weaken as a consequence. The good news is that over the last 4 or 5 months, the euro has actually strengthened a bit, because Europe has actually made some progress in terms of addressing some of their issues.

Mr. HUIZENGA. Okay.

And then, my time is almost up, and I will—Dr. Kamin, do you want to say something as well?

But I am just curious: What keeps you up at night? What other countries? You specifically—I think in Dr. Kamin's testimony, he talked briefly about Greece.

And then, you just were touching on Spain and Portugal. But where are we at with Italy and Ireland? Are we on solid footing—are they on solid footing in France and Germany and some of those other countries that have been leading this?

Mr. KAMIN. Certainly, the euro crisis in general is what keeps me up at night, and what occupies much of my thinking time during the day as well.

Obviously, the situation in Greece has been very difficult. And we have been following that very closely. We also, obviously, are very focused on, basically, Ireland and Portugal, which are the recipients of IMF funds. And we think it is critically important that these problems not move further into Spain and Italy, which have also been the focus of market attention.

And we think it is absolutely critical to make sure that you don't have further contagion beyond that. So far, things have been looking on the brighter side. There have been improvement in markets. But we have continued to monitor the situation as closely as ever.

And then, while most of my thinking lately is focused on Europe, obviously I am thinking about oil prices as well, because that is another area that poses a potential threat at least down the road.

Mr. HUIZENGA. Thank you.

Chairman PAUL. Thank you.

I have a couple of additional questions I would like to ask.

I am interested in one line on the Federal Reserve sheet at each week on other assets, other Federal Reserve assets. And it has been growing a bit. It used to be a small number, but even in recent years, it has gone up. I think it is about $160 billion now.

What does that include? Does that include anything foreign? Is there any type of a foreign asset or a swap or anything involved in there that would help me understand this international financial crisis that we are in?

Mr. KAMIN. Chairman Paul, we definitely put on our balance sheet—we list our holdings of foreign assets. I don't recall offhand if that is where the "other assets" are. I don't think so. The "other assets" have, as you point out, risen over time. And there is one main contributing factor to that, which is when we buy securities in the markets, sometimes we buy them at a value that is above their par or face value, because interest rates had declined since they were first issued. That raises the value of those securities.

So then, we place the par value of the securities in one line on our balance sheet, and then that additional part that is over the par value, the premium, that is placed in our "other assets" line. So as we have continued to purchase securities in the market, the amount of the premium part of our purchases, which has gone into the "other assets" line, has continued to rise.

Chairman PAUL. So you say you are buying securities. Would this be like mortgage securities?

Mr. DUDLEY. This would be predominantly the maturity extension program, in which we are selling short-dated Treasury securities and buying long-dated Treasury securities. We are also buying mortgage-backed securities, but with emphasis to rolling over existing maturing mortgage-backed securities, so the size of the mortgage-backed securities portfolio is pretty constant.

Chairman PAUL. So, the significant increase of $160 billion of just saying they are "other," it is definitely related to the international financial crisis that we are involved in right now?

Mr. DUDLEY. As Steve related, it is related to the expansion of the Fed's balance sheet and the types of assets that we are buying in the market. The maturity extension program—we are selling short-dated Treasuries; we are buying long-dated Treasuries. To the extent that we are buying Treasuries that are selling above par because interest rates has declined, that is different than what Steve was saying is booked in the other assets category.

Chairman PAUL. What does this mean, if this were to continue to grow at the rate it is growing now?

Mr. DUDLEY. No. I would expect that once the maturity extension program or other asset purchase programs are ended, then I would expect the other assets category actually to probably come down over time as that premium was amortized over time. So, I would view this as a temporary phenomenon.

Chairman PAUL. But there is no one place in the Federal Reserve reports that would give me a full explanation of exactly what the $160 billion is? You don't send out a report each month and say exactly what that is made up of?

Mr. KAMIN. There is an interactive portion of our Web site that offers more analysis of the different lines. That is the first thing.

The second thing I want to follow up on is having checked, the "other assets"—I just think the "other assets" category does indeed, as you suggest, also include foreign currency denominative assets, but not the swap lines. It is the other European and the undenominated securities that we hold.

Chairman PAUL. Okay.

The other thing I have noticed since 2008 is if you look at a long-term chart of currency in circulation, it is a steady increase and very predictable. But since 2008, it has been going up much more rapidly. This is cash as currency. Where is the demand for more cash? Do you know exactly where that goes? Does that end up overseas? Is that in circulation here? Or is it in a shoebox someplace?

Mr. DUDLEY. Probably in both places. With interest rates this low, the opportunity costs of holding more currency obviously is very low. If you hold the currency, you get a 0 percent return. But if you have gone to your bank these days, you don't get much more than that.

So, people probably are carrying around more currency in their pockets because there is less cost of holding the currency versus holding it in a bank. This may also be true internationally, although I am not familiar with how much currency is held here versus abroad. I know historically, it has been about one third here, and two thirds abroad. But I don't know how that has been changing recently.

Chairman PAUL. I have one quick question for both of you. You can probably answer this rather easily.

You are very much involved in dealing with the value of our money, the value of our dollar and our financial system. But I have trouble finding the legal definition for the unit of account that we have as a dollar. Can you tell me your definition of—what is a dollar?

Mr. DUDLEY. I view the dollar as the legal tender in the United States, so that if someone pays a dollar as payment, the shopkeeper has to accept that dollar for that transaction.

Mr. KAMIN. Also the classic definition of money, I think of it as three things. It is store value, which it is a medium of transaction.

Mr. DUDLEY. And usually has portability.

Mr. KAMIN. Yes. And then it is a medium of accounts. In other words, you measure value by using a dollar.

Chairman PAUL. But you do realize there was a more precise definition of a dollar most of our history where you could actually know what it meant. But it seems like there is no definition at all. You say it is just a unit of account. And that is probably the reason why we have lost about 98 percent of the value of that dollar since 1913, since it has been the responsibility of the Federal Reserve to protect the value of our currency.

So, I have trouble believing that we will be able to solve any of our problems financially or even fiscally if we can create money endlessly and out of thin air and accommodate the politicians who spend money, who spend money overseas, who spend money on foreign policy that indirectly you have to deal with. Look how the sanctions and the threat of war in Iran affects the finances of the world, not only perception-wise in trade and pushing up oil prices, but also the need to keep monetizing this debt.

Federal Reserve Chairmen endlessly, for all the years I have been here, have said, "If the Congress would quit spending so much money and didn't have so much debt, we wouldn't have such a tough problem managing the currency." At the same time, the debt wouldn't be there if the Federal Reserve wasn't there willing to monetize the debt, because you are the lender of last resort.

You guarantee the moral hazard that politicians are going to spend money. And it seems like to coordinate the two and have a sound economic system instead of a financial bubble that is based on debt and a monetary standard based on debt with the world awash in an exploding amount of debt. I don't know how we will ever get out of this unless we finally come up with a definition, once again, of what the unit of account is and what a dollar means.

This hearing is now adjourned.

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

[Whereupon, at 11:42 a.m., the hearing was adjourned.]

A P P E N D I X

March 27, 2012

United States House of Representatives
Committee on Financial Services
Subcommittee on Domestic Monetary Policy and Technology
Hearing on "Federal Reserve Aid to the Eurozone: Its Impact on the U.S. and the Dollar"
March 27, 2012

Congressman Ron Paul
Statement for the Record

The Federal Reserve has recently begun to engage in an ongoing bailout of the European monetary system. Under the guise of providing dollar liquidity to strained European financial markets, the Fed is creating hundreds of billions of dollars out of thin air to prop up the euro. While still well under their 2008 peak, these latest dollar swap agreements are nonetheless a thinly-disguised bailout. Congress has been far too lenient in allowing the Fed to engage in unprecedented monetary policy operations without informing or explaining its actions to Congress. The American people need to understand the effects these actions have on the dollar so that the Fed can be held accountable. I hope that this hearing will get much-needed answers to the very important questions surrounding the Fed's involvement in bailing out Europe.

For over 40 years, the Fed has been creating money out of thin air, propping up Wall Street while destroying the value of the dollar. This excessive money creation is what caused the financial crisis, yet just as a dog returns to its vomit, the Fed thinks that continuing to print money will somehow end the crisis. The trillions of dollars the Fed has created have eviscerated the purchasing power of American consumers, as anyone who has set foot inside a grocery store can see. While the government's official inflation rate is hovering around three percent, the original method of calculating the price index indicates that price inflation is over ten percent, which is more in line with what consumers are experiencing.

Despite a world awash in dollars, the Fed continues to view the cause of every financial problem as a dearth of liquidity. When the banks say they do not have enough money, the Fed unquestionably believes them and provides them with new dollars created from nothing. But a bank saying that there is not enough money is like a broke college student saying that there are not enough Ferraris. What he really means is that there are not enough Ferraris for sale at a price that he can afford. The same is true with banks; there are plenty of dollars available for banks to borrow, but the banks don't want to pay the going interest rate on loans, so they run to the central bank for cheap money.

Much of the Fed's intervention in the U.S. has been undertaken in an attempt to reflate the housing market. Rather than allowing house prices to fall so that supply and demand will re-equilibrate, the Fed has pumped liquidity into the system in an attempt to keep prices elevated. The federal funds rate has been kept artificially low for over three years now, and according to the Fed will be kept near zero for at least three years more. Because the Federal Reserve is so used to manipulating interest rates, it fails to see that interest rates are a price, the price of money and credit. While American banks may not be willing to lend dollars short-term to ailing European banks at 0.25 or 0.50%, you can bet that there would be a lot more dollars available to loan at 2, 3, or 4%. But in order for the markets to adjust and price loans at a market-clearing rate, the Fed needs to abstain from intervening to short-circuit this price discovery process.

The Federal Reserve has pumped trillions of dollars into the American financial system, with banks now holding $1.5 trillion of excess reserves at the Fed, money which is literally just sitting there. The Fed pays an 0.25% interest rate on those excess reserves, which lessens the incentive of the banks to loan those funds to anyone, regardless of how safe the loan might be. This leads to a lessened availability of credit both domestically and abroad, with the result that credit markets are more contracted than they otherwise might be. The Fed views this credit market contraction as having its root in insufficient liquidity, which it then attempts to counteract by creating more money.

This time around, the newly created dollars are being loaned through swap lines to the European Central Bank (ECB) in exchange for euros. The ECB loans the dollars to struggling European banks in exchange for collateral. Once those loans are repaid and the swap lines expire, the ECB returns the dollars to the Fed and takes back its euros. The interest rate on these loans is about 0.6%, so it is not surprising that American banks are keeping their excess reserves safe at the Federal Reserve. After all, why loan dollars to weak and risky European banks at 0.6% when you can get a guaranteed 0.25% from the Federal Reserve? So the dollar markets dry up and the Fed steps in to "fix" the problem it created.

We have to question what will happen if these loans from the ECB to European banks go bad. What happens if a major bank fails? If the ECB cannot return dollars to the Fed, does the Fed keep the euros it received from the ECB? Does it receive European government bonds, perhaps Greek bonds? Does it have recourse to the ECB's gold, as Chairman Bernanke alluded to last week?

Even more importantly, what is the impact of these programs on the dollar and on the U.S. economy? While the Fed seems to think that these swap lines eventually will be drawn back down to zero, what happens in the meantime? These hundreds of billions of dollars may be created out of thin air, but their effects on the real economy are anything but ephemeral. And the Fed has failed to consider the possibility that these swap lines may rise even higher than the $600 billion level that was reached in 2008. Given the still precarious position of European governments and the European financial system, it would not be surprising to see a few hundred billion dollars more being created to continue the bailout of the euro.

The Fed's continued intervention in financial markets creates a climate of uncertainty. For almost five years, financial institutions have had to wonder from one day to the next what the Fed will do. Will it continue with more asset purchases under its policy of quantitative easing? Will it bailout large firms in danger of collapse or allow them to fail? Will it allow markets to function or continue its intervention? In such uncertain times it is only natural for firms to sit back and wait to see what happens. And every action by the Fed, every attempt at stimulus, rather than placating that uncertainty, instead exacerbates it. The Fed's actions destroy markets, erode the earnings and savings of Americans, and sow the seeds for the next great crisis. I hope that this hearing is yet another step in holding the Fed accountable and will help both Members and the American people reconsider the necessity of a central bank.

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Statement by

William Dudley

President

Federal Reserve Bank of New York

before the

Subcommittee on Domestic Monetary Policy and Technology

Committee on Financial Services

United States House of Representatives

March 27, 2012

I. Introduction

Chairman Paul, Ranking Member Clay, and members of the Subcommittee, my name is Bill Dudley, and I am President of the Federal Reserve Bank of New York. It is an honor to testify today about the economic and fiscal challenges facing Europe, and the Federal Reserve's efforts to support financial stability in the United States. Financial stability enables U.S. businesses and households to maintain their access to credit and ensures sustained economic growth. This is why promoting financial stability is an important objective of the Federal Reserve, and other central banks around the world.

Let me preface these remarks by stating that the views expressed in my written and oral testimony are solely my own and do not represent official views of the Federal Reserve Board, the Federal Open Market Committee ("FOMC") or any other part of the Federal Reserve System. Additionally, because I am precluded by law from discussing confidential supervisory information, I will not be able to speak about the financial condition or regulatory treatment or rating of any individual financial institution.

The U.S. economy is currently expanding at a moderate pace, and strains in global financial markets, although having eased recently, continue to pose significant downside risks to the economic outlook. Because developments in Europe will have an important bearing on the prospects for growth and jobs here in the U.S., the Federal Reserve is monitoring the situation there closely. This is also why we have taken special steps in recent months, together with other central banks, to support the flow of credit to households and businesses.

II. Europe

The economic situation in Europe has been unsettled for the better part of two years, with pressure on sovereign debt markets and local banking systems. High debts, large deficits, and slow growth in several European countries have called into question the sustainability of the entire euro area. The resulting strains in European markets have affected the U.S. economy.

The euro area has the capacity, including the fiscal capacity, to overcome its challenges. However, the politics are very difficult, both because the problem has many dimensions, and because many different countries and institutions in the euro area have to coordinate their actions in order to achieve a coherent and effective policy response.

Europe's leadership has affirmed its commitment to the European Union and its single currency union on numerous occasions. And the leadership is working harder than ever to achieve greater coordination in areas such as fiscal policy. A more robust and resilient European Union would be a welcome development for the United States. Three recent developments are especially encouraging in that regard.

First, liquidity concerns have eased significantly following the European Central Bank's long-term refinancing operations in December and February. Through this program, the ECB provides three-year loans to European banks at low rates, accepting a wide array of collateral in return. Hundreds of banks accessed the program in each operation, and the ECB lent nearly €1 trillion in total. As a result, the cost of funding throughout Europe has declined since the program began, the Euro has stabilized, and the sovereign bond market has improved. Changes in the ECB's collateral rules and reserve requirements have also had a positive impact.

Second, earlier this month, the Greek government worked with European leaders and its largest creditors to restructure the bulk of its €206 billion of outstanding privately-held bonds.

This not only reduced Greece's total indebtedness, it helped calm persistent worries that a disorderly Greek default could become the trigger for a global economic crisis. Shortly after the debt restructuring, the EU approved a €130 billion aid package for Greece. Together, these measures will provide key support to Greek leaders as they pursue the difficult fiscal reforms that are essential over the long term.

Third, leaders in most euro area countries have approved a new treaty designed to increase fiscal coordination. The new rules already appear to be making a difference. Both Spain and Italy recently completed 2012 budgets that move their deficits closer to EU targets. Further, Spain and Italy took their fiscal actions in close consultation with finance ministers from other countries in the euro area, demonstrating a healthy ability to work together. While difficult work still lies ahead, countries in the euro area have made meaningful progress toward achieving long-term fiscal sustainability.

Looking to the future, the difficult work that remains also presents special risks – both for Europe and the United States. If Europe fails to chart an effective course forward, this could have a number of negative implications here. In particular, there are three areas of potential risk that I would like to highlight for the Subcommittee today.

First, if economic conditions in Europe were to weaken significantly, demand for U.S. exports would decrease. This would hurt domestic growth and have a negative impact on U.S. jobs. It is important to recognize that the euro area is the world's second largest economy after the U.S. and an important trading partner for us. Also, Europe is a significant investor in the U.S. economy, and vice versa. Thus, what happens in Europe has significant implications for our economy.

Second, deterioration in the European economy could put pressure on the U.S. banking system. As the recent round of stress tests revealed, U.S. banks are much more robust and resilient than they were a few years ago. They have bolstered their capital significantly, built up their loan loss reserves, and have significantly larger liquidity buffers. The direct net exposures of U.S. banks to the so-called "peripheral" European countries are actually quite modest. The good news in the United States means that we are better able to handle bad news from Europe.

With that said, the exposures of U.S. banks climb sharply when one also considers their exposures to the core European countries and to the overall European banking system. U.S. money market mutual funds, in particular, have significant European holdings. This means that if the crisis were to broaden further and intensify, it would put pressure on the capital and liquidity buffers of U.S. banks and other financial institutions.

Third, severe stresses in European financial markets would disrupt financial markets here, which could harm the real economy. Stress in the financial markets causes banks to more carefully husband their balance sheets. When that phenomenon occurs, the availability of credit to U.S. households and businesses becomes constrained. Such conditions could also cause equity prices to fall, impairing the value of Americans' pension and 401(k) holdings. This would damage the U.S. recovery and result in slower output growth and less job creation. At a time when U.S. unemployment is very high, this is a particularly unacceptable outcome. In the extreme, U.S. financial markets could become so impaired that the flow of credit to households and businesses would dry up.

III. U.S. Dollar Swaps

In today's globally integrated economy, banks headquartered abroad play an important role in providing credit and other financial services in the United States. About $1 trillion in worldwide dollar financing comes from foreign banks, $700 billion in the form of loans within the U.S. For these banks to provide U.S. dollar loans, they have to maintain access to U.S. dollar funding. At a time when it is already hard enough for American families and firms to get the credit they need, we have a strong interest in making sure that these banks can continue to be active in the U.S. dollar markets.

Banks headquartered outside the U.S. make extensive use of dollars in their financing activities. In part, this results from the fact that the U.S. dollar is the world's number one currency – a status that brings with it many benefits for our country. It is in our national interest to make sure that non-U.S. banks remain able to access the U.S. dollar funding they need to continue financing their U.S. dollar assets. If access to dollar funding were to become severely impaired, this could necessitate the abrupt, forced sales of dollar assets by these banks, which could seriously disrupt U.S. markets and adversely affect American businesses, consumers, and jobs.

One way we can help to support the availability of dollar funding, and ensure that credit continues to flow to American households and businesses, is by engaging in currency swaps with other central banks. Such swaps are a policy tool the Federal Reserve has used to support dollar liquidity for nearly fifty years. Most recently, the Federal Reserve established dollar swap lines with major central banks during the global financial crisis of 2008, and reactivated them in May 2010. Last November, the FOMC, cooperating with five other central banks, reduced the rate being charged on these swaps to increase usage.

The swaps are intended to create a credible backstop to support – but not supplant – private markets. Banks with surplus dollars are more likely to lend to banks in need of dollars if they know that the borrowing bank will be able to obtain the dollars it needs to repay the loan, if necessary, from its central bank.

Ultimately, these dollar swaps are designed to support financial stability, and avoid an unnecessary tightening in financial conditions, so that economic activity and job creation in the United States can continue to recover. Our principal aim is to protect U.S. banks, businesses, and consumers from adverse economic trends abroad. I am pleased that the swaps seem to be working. In conjunction with the ECB's long-term refinancing operations, the swaps have helped European banks avoid the significant liquidity pressures we feared a few months ago and have reduced the risk that they would need to sell off their U.S. dollar assets abruptly.

IV. Conclusion

In sum, I am hopeful that Europe can effectively address its current fiscal challenges. The Federal Reserve is actively and carefully assessing this situation and the potential impact on the U.S. economy. At this time, although I do not anticipate further efforts by the Federal Reserve to address the potential spillover effects of Europe on the United States, we will continue to monitor the situation closely.

Thank you for your invitation to testify today, and I look forward to answering your questions.

For release on delivery
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March 27, 2012

Statement by

Steven B. Kamin

Director

Division of International Finance

Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy and Technology

Committee on Financial Services

U.S. House of Representatives

March 27, 2012

Thank you, Chairman Paul, Ranking Member Clay, and members of the Subcommittee for inviting me today to talk about the economic situation in Europe and actions taken by the Federal Reserve in response to this situation.

For two years now, developments in Europe have played a critical role in shaping the tenor of global financial markets. The combination of high debts, large deficits, and poor growth prospects in several European countries using the euro has raised concerns about their fiscal sustainability. Such concerns were initially focused on Greece but have since spread to a number of other euro-area countries, leading to substantial increases in their sovereign borrowing costs. Pessimism about these countries' fiscal situation, in turn, has helped to undermine confidence in the strength of European financial institutions, increasing the institutions' borrowing costs and threatening to curtail their supply of credit. These developments have strained global financial markets and weighed on global economic activity.

In the past several months, European leaders have taken a number of policy actions that have helped reduce financial market stresses. In early December, the European Central Bank (ECB) reduced its policy interest rate, cut its reserve requirement, eased collateral rules for its lending, and, perhaps most important, began providing three-year secured loans to banks. Second, euro-area leaders, the Greek government, and private-sector holders of Greek debt are taking steps to put that country on a more sustainable fiscal path. Additionally, European leaders announced and have started to implement proposals to strengthen fiscal rules and European fiscal coordination. Discussions to expand the euro-area financial backstop are on-going. These steps are positive developments and signify the commitment of European leaders to alleviate the crisis.

Since early December, borrowing costs for several vulnerable European governments have declined, funding pressures for European banks have eased, and the tone of investor sentiment has improved. However, financial markets remain under strain. Europe's authorities continue to face difficult challenges as they seek to stabilize their fiscal and financial situation, and it will be critical for them to follow through on their policy commitments in the months ahead.

Here at home, the financial stresses in Europe have undoubtedly spilled over to the United States by restraining our exports, weighing on business and consumer confidence, and adding to pressures on U.S. financial markets and institutions. Of note, as concerns about the financial system in Europe mounted, many foreign banks, especially those in Europe, faced a rise in the cost of dollar funding and a decline in its availability. A great deal of trade and investment the world over is financed in dollars, so many foreign financial institutions have heavy borrowing needs in our currency. These institutions also borrow heavily in dollars because they are active in U.S. markets, purchasing government and corporate securities and lending to households and firms. While strains have eased somewhat of late, difficulty acquiring dollar funding by European and other financial institutions could ultimately make it harder and more costly for U.S. households and businesses to get loans. Moreover, disruptions to European access to dollar funding could spill over into the market for borrowing and lending in U.S. dollars more generally, raising the cost of funding for U.S. financial institutions. Although the breadth and size of all of these effects on the U.S. economy are difficult to gauge, it is clear that the situation in Europe poses a significant risk to U.S. economic activity and bears close watching.

Swap Lines with Other Central Banks

To address these potential risks to the United States, as described in an announcement on November 30, the Federal Reserve agreed with the ECB and the central banks of Canada, Japan, Switzerland, and the United Kingdom to revise, extend, and expand its swap lines with these institutions.[1] The measures were taken to ease strains in global financial markets, which, if left unchecked, could significantly impair the supply of credit to households and businesses in the United States and impede our economic recovery. Such strains were particularly evident in Europe, and these actions were designed to help prevent them from spilling over to the U.S. economy.

Three steps were described in the November 30 announcement. First, we reduced the pricing of drawings on the dollar liquidity swap lines. The previous pricing had been at a spread of 100 basis points over the overnight index swap rate.[2] We reduced that spread to 50 basis points. The lower cost to the ECB and other foreign central banks enabled them to reduce the cost of the dollar loans they provide to financial institutions in their jurisdictions. Reducing these costs has helped alleviate pressures in U.S. money markets generated by foreign financial institutions, strengthen the liquidity positions of European and other foreign institutions, and boost confidence at a time of considerable strain in international financial markets. Through all of these channels, the action should help support the continued supply of credit to U.S. households and businesses.

Second, we extended the authorization for these lines through February 1, 2013. The previous authorization had been through August 1, 2012. This extension demonstrated that central banks are prepared to work together for a sustained period, if needed, to support global liquidity conditions.

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[1] See Board of Governors of the Federal Reserve System (2011), "Coordinated Central Bank Action to Address Pressures in Global Money Markets," press release, November 30, www.federalreserve.gov/newsevents/press/monetary/20111130a.htm. Similar announcements appeared on the web sites of the other participating central banks.

[2] The dollar overnight index swap rate is the fixed rate that one party agrees to pay in exchange for the average of the overnight federal funds rates over the life of the swap. As such, it is a measure of the average federal funds rate expected over the term of the swap.

Third, we agreed to establish, as a precautionary measure, swap lines in the currencies of the other central banks participating in the announcement. (The Federal Reserve had established similar lines in April 2009, but they were not drawn upon and were allowed to expire in February 2010.) These lines would permit the Federal Reserve, if needed, to provide euros, Canadian dollars, Japanese yen, Swiss francs, or British pounds to U.S. financial institutions on a secured basis, much as the foreign central banks provide dollars to institutions in their jurisdictions now. U.S. financial institutions are not experiencing any foreign currency liquidity pressures at present, but we judged it prudent to make arrangements to offer such liquidity should the need arise in the future.

I would like to emphasize that information on the swap lines is fully disclosed on the Federal Reserve's website--through our weekly balance sheet release and other materials--and information on swap transactions each week is provided on the website of the Federal Reserve Bank of New York.[3]

I also want to underscore that these swap agreements are safe from the perspective of the Federal Reserve and the U.S. taxpayer, for five main reasons:

- First, the swap transactions themselves present no exchange rate or interest rate risk to the Fed. Because the terms of each drawing and repayment are set at the time that the draw is initiated, fluctuations in exchange rates and interest rates that may occur while the swap funds are outstanding do not alter the amounts eventually to be repaid.

[3] For the outstanding amount of dollar funding through the swap lines as it appears each week in the Federal Reserve balance sheet, see www.federalreserve.gov/releases/h41. For other relevant information and materials on the Federal Reserve's website, see www.federalreserve.gov/monetarypolicy/bst_liquidityswaps.htm. For weekly information on the Federal Reserve's swap transactions with other central banks, see www.newyorkfed.org/markets/fxswap/fxswap.cfm. Finally, for copies of the agreements between the Federal Reserve and other central banks, as well as other information, see www.newyorkfed.org/markets/liquidity_swap.html.

- Second, each drawing on the swap lines must be approved by the Federal Reserve, which provides the Federal Reserve with control over use of the facility by the foreign central banks.
- Third, the foreign currency held by the Federal Reserve during the term of the swap drawings provides added security.
- Fourth, our counterparties in these swap agreements are the foreign central banks. In turn, it is they who lend the dollars they draw from the swap lines to private institutions in their own jurisdictions. The foreign central banks assume the credit risk associated with lending to these institutions. The Federal Reserve has had long and close relationships with these central banks, and our interactions with them over the years have provided a track record that justifies a high degree of trust and cooperation.
- Finally, the short tenor of the swap drawings, which have maturities of at most three months, also offers some protection, in that positions could be wound down relatively quickly were it judged appropriate to do so.

The Federal Reserve has not lost a penny on any of the swap line transactions since these lines were established in 2007, even during the most intense period of activity at the end of 2008. Moreover, at the maturity of each swap transaction, the Federal Reserve receives the dollars it provided plus a fee. These fees add to overall earnings on Federal Reserve operations, thereby increasing the amount the Federal Reserve remits to taxpayers.

Conclusion

The changes in swap arrangements that I have discussed have had some positive effects on dollar funding markets. After the announcement of the changes at the end of November, draws on the swap lines increased considerably, peaking at $109 billion in mid-February, and measures of the cost of dollar funding declined. In recent weeks, reflecting the improvement in market conditions, usage of the swap lines has fallen back to about $65 billion.

That being said, many financial institutions, especially those from Europe, continue to find it difficult and costly to acquire dollar funding, in large part because investors remain uncertain about Europe's economic and financial prospects. Ultimately, the easing of strains in U.S. and global financial markets will require concerted action on the part of European authorities as they follow through on their announced plans to address their fiscal and financial difficulties. The situation in Europe is continuously evolving. Thus, we are closely monitoring events in the region and their spillovers to the U.S. economy and financial system.

Thank you again for inviting me to appear before you today. I would be happy to answer any questions you may have.

FEDERAL RESERVE BANK *of* NEW YORK

33 LIBERTY STREET, NEW YORK, NY 10045-0001

WILLIAM C. DUDLEY
PRESIDENT

July 11, 2012

BY E-MAIL

The Honorable Ron Paul
Chairman
Subcommittee on Domestic Monetary Policy and Technology
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Re: Hearing Entitled "Federal Reserve Aid to the Eurozone: Its impact on the U.S. and the dollar," March 27, 2012

Dear Chairman Paul:

I respectfully submit the following responses to questions you posed in a letter dated April 27, 2012. I understand that these responses will be included in the record for the above-captioned hearing.

Question 1:

The Federal Reserve receives no appropriations from Congress and is completely dependent on funding itself through its own operations. During your testimony you stated that the Federal Reserve made a $4 billion profit from the central bank liquidity swap arrangements during 2008 and 2009. Considering that the Federal Reserve's annual operating budget is roughly $4 billion, and money is fungible, could it be said that the Fed is funded by foreign central banks rather than through returns on its portfolio of Treasuries?

Response:

While the Federal Reserve's current operating budget and the profit to date on our liquidity swaps are roughly the same, it would not be accurate to say that the Federal Reserve is funded by foreign central banks. Profits on the liquidity swaps did not come in the regular course of the Federal Reserve's operations, and, unlike income derived from our portfolio of government securities, are not a typical source of revenue for the Federal Reserve System.

FEDERAL RESERVE BANK *of* NEW YORK

Question 2:

With respect to the swap lines with the European Central Bank (ECB), you stated during the hearing that, "We think we are very well secured in those transactions. We fully anticipate to be fully repaid." You also stated that you "don't have enough information to assess the quality of the ECB balance sheet."

a. ***How does the Federal Reserve consider the ECB swap transactions well secured if the Fed does not assess the condition of the ECB's balance sheet?***

b. ***Why would the Fed lend dollars to a bank without assessing the balance sheet and financial position of the bank, especially when the sole purpose of lending those dollars is for them to be re-lent to unstable banks in exchange for collateral of questionable value?***

c. ***Does the fact that the Fed has not assessed the ECB's balance sheet and that the ECB has been lending dollars to unstable banks for collateral of questionable quality belie the Fed's assertion that the ECB is a safe counterparty?***

Response:

As I stated in my testimony, we believe that these swap transactions are secure. First, at the initiation of each transaction, the Federal Reserve takes ownership of foreign currency that it holds for the duration of the trade. This provides an important safeguard: if a central bank failed to repay us, we could sell the currency into the market for dollars, which would limit the consequences to the Fed's balance sheet and to the taxpayer of a failure to repay.

Second, fluctuations in exchange or interest rates between initiation and maturity do not alter the contractual repayment amounts. At the end of each swap transaction, the Federal Reserve gets back all the dollars it provided plus a fee.

Third, the Federal Reserve must agree to any request to draw on the swap lines. We are in frequent contact with our counterparts at each foreign central bank regarding developments abroad. If we became uncomfortable with our exposure at any time, we could stop further swap transactions with the central bank (or central banks) in question.

Fourth, with respect to the ECB, the Federal Reserve has a long track record of conducting successful operations not only with the ECB itself, but also with the national central banks of the euro area countries. Those national central banks – and their national governments behind them – are shareholders in the ECB and would be expected to backstop the ECB's obligations in the highly unlikely event that the ECB failed to repay us.

Question 3:

> ***Has the Federal Reserve provided any other assistance either financial or technical in nature, aside from the central bank liquidity swap lines, to help mitigate the financial crisis in Europe? If so, please provide a thorough list and explanation of such assistance.***

Response:

I respectfully refer you to the response to this question provided by Steven Kamin, Director of the Division of International Finance at the Federal Reserve Board of Governors, and my co-panelist at the March 27th hearing.

Question 4:

> ***Does the Federal Reserve have the ability and authority to provide financial assistance to Europe, aside from the central bank liquidity swap lines? If so, under what statute(s) does the Federal Reserve have such authority and what form(s) could such assistance take?***

Response:

The Federal Reserve derives its authority exclusively from the Federal Reserve Act, and all of our operations and actions are conducted pursuant to that statute.

The Federal Open Market Committee (FOMC) established central bank liquidity swap arrangements with five foreign central banks, including the ECB, between 2007 and 2008 and reauthorized them in successive votes from May 2010 through the present. The current authorization runs through February 1, 2013. I am not aware of any additional plans or intentions within the Federal Reserve to provide financial assistance to European central banks or governments.

Question 5:

> ***The International Monetary Fund (IMF) is not permitted to accept funds directly from the Federal Reserve. Notwithstanding the restraint on the IMF, does the Federal Reserve have the authority to provide funding directly to the IMF? If so, please cite the legal statute(s).***

Response:

I respectfully refer you to the response to this question provided by Steven Kamin, Director of the Division of International Finance at the Federal Reserve Board of Governors, and my co-panelist at the March 27th hearing.

Question 6:

What would the ramifications be to the Federal Reserve if the ECB is unable to repay the dollars it has borrowed? Does the Federal Reserve have a contingency plan in the event the ECB does not repay the dollars? If so, what is this plan?

Response:

The dollars involved in our swaps with the ECB are not borrowed; they are swapped in exchange for euros provided by the ECB. The ECB is bound by contract to return any dollars it draws from the swap line, and we believe it will uphold its obligation in every instance. Our expectation that the ECB will repay us the dollars we have swapped for euros is based on the financial strength of that institution and its shareholders – the national central banks of the euro area countries. As mentioned above, the Federal Reserve has a long history of conducting successful operations with the ECB and with the national central banks of the euro area countries.

Question 7:

Payment transactions in the Eurozone are settled using the TARGET 2 system, a settlement system owned and operated by the Eurosystem, which is comprised of the 17 national central banks of the European monetary union and the ECB. Under TARGET 2, the various national central banks accumulate assets and liabilities amongst themselves.

- ***a.*** ***Is there a credit risk between the various national central banks of Europe as a result of the TARGET system?***
- ***b.*** ***If so, under what circumstances could a national central bank incur a write-down or loss on its TARGET 2 assets?***
- ***c.*** ***If such losses could occur, how does the Federal Reserve assess credit risk to the Federal Reserve's loans to the ECB?***

Response:

I respectfully refer you to the response to this question provided by Steven Kamin, Director of the Division of International Finance at the Federal Reserve Board of Governors, and my co-panelist at the March 27th hearing.

Respectfully yours,

William C. Dudley

William C. Dudley
President

<u>**Questions for Mr. Steven B. Kamin, Director of the Division of International Finance, Board of Governors of the Federal Reserve System, from Chairman Ron Paul:**</u>

1. Has the Federal Reserve provided any other assistance either financial or technical in nature, aside from the central bank liquidity swap lines, to help mitigate the financial crisis in Europe? If so, please provide a thorough list and explanation of such assistance.

The Federal Reserve has no programs in place other than the central bank liquidity swaps that involve financial institutions in Europe. I would note that the main purpose of the swap lines is to protect financial markets in the United States from disruptions in foreign markets and to help support the flow of credit to U.S. households and businesses.

We have of course been in continual contact with our European counterparts and have closely monitored the situation, with an eye toward minimizing the potential spillovers to the U.S. economy.

2. Does the Federal Reserve have the ability and authority to provide financial assistance to Europe, aside from the central bank liquidity swap lines? If so, under what statute(s) does the Federal Reserve have such authority and what form(s) could such assistance take?

As noted above, the Federal Reserve has no programs in place that involve financial institutions in Europe other than the central bank liquidity swaps, and participates in these swaps in order to protect U.S. financial markets and maintain the flow of credit in the U.S. economy. The Federal Reserve operates its swap lines under the authority of Section 14 of the Federal Reserve Act, which permits the Federal Reserve Banks to conduct operations in foreign exchange and to open and maintain accounts in foreign currency with foreign central banks. Any other action taken in response to the situation in Europe would be the decision of the Federal Reserve Board or the FOMC and would be taken in accordance with relevant statutes.

3. The International Monetary Fund (IMF) is not permitted to accept funds directly from the Federal Reserve. Notwithstanding the restraint on the IMF, does the Federal Reserve have the authority to provide funding directly to the IMF? If so, please cite the legal statute(s).

No, the Federal Reserve System would be prohibited by statute from extending credit to the Fund without Congressional approval.

The Bretton Woods Agreements Act (BWA) reserves for Congress the ability to authorize certain actions to be taken on behalf of the United States with respect to the IMF. Under the Act, "[u]nless Congress by law authorizes such action, neither the President nor any person or agency shall on behalf of the United States. . .make any loan to the Fund. . .". For purposes of the BWA, a reserve bank would likely be considered a "person" and may be considered an "agency", to the extent that it would be acting at the request of the Board or the FOMC.

4. What would the ramifications be to the Federal Reserve if the ECB is unable to repay the dollars it has borrowed? Does the Federal Reserve have a contingency plan in the event the ECB does not repay the dollars? If so, what is this plan?

The dollars involved in our swaps with the ECB are not borrowed, they are swapped in exchange for euros provided by the ECB. The ECB is bound by contract to return any dollars it draws from the swap line, and we believe it will uphold its obligation in every instance. Our expectation that the ECB will repay us the dollars we have swapped for euros is based on the financial strength of that institution and its history of prudent decision-making: the Federal Reserve has a long track record of conducting successful operations not only with the ECB, but also with the national central banks of the euro area countries. As shareholders of the ECB, the national central banks – and their national governments behind them – would be expected to further backstop the ECB's obligations.

5. Payment transactions in the Eurozone are settled using the TARGET 2 system, a settlement system owned and operated by the Eurosystem, which is comprised of the 17 national central banks of the European monetary Union and the ECB. Under TARGET 2, the various national central banks accumulate assets and liabilities amongst themselves.

a. Is there a credit risk between the various national central banks of Europe as a result of the TARGET system?

The TARGET2 system settles domestic and cross-border interbank payments in the euro area by crediting and debiting banks' reserve accounts at their respective national central banks. Any accumulation of assets and liabilities in the TARGET2 system by the various national central banks are claims on and liabilities to the ECB, not one another. The ECB and euro-area national central banks control for credit risk in their operations with monetary and financial institutions by applying haircuts in valuing the collateral they receive and by requiring their counterparties to adjust the marketable assets they post as collateral as the prices of those assets change.

b. If so, under what circumstances could a national central bank incur a write-down or loss on its Target 2 assets?

In the event that there is a credit loss despite these precautions, then according to Eurosystem rules, capital losses are allocated according to the respective capital shares of the national central banks in the Eurosystem, not according to TARGET2 balances.

c. If such losses could occur, how does the Federal Reserve assess credit risk to the Federal Reserve's loans to the ECB?

The credit standing of the ECB is of the highest caliber, it has a very strong financial position, and we continue to view our swap lines with the ECB as safe. TARGET2 losses would not diminish either the effectiveness or the safety of the Federal Reserve's swap operations with the ECB.

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MarketWatch

March 8, 2012, 2:16 a.m. EST

Ex-ECB Stark: Bank's balance sheet 'alarming'

By Andrea Thomas

BERLIN (MarketWatch) -- The quality of the European Central Bank's balance sheet is "alarming," former European Central Bank Executive Board Member Juergen Stark told Thursday's Frankfurter Allgemeine Zeitung newspaper.

"The Eurosystem's balance sheet is not only gigantic in its dimension but also alarming in its quality," Stark was quoted as saying. He added the structure of the balance sheet is a cause for concern because increasingly short-term debt claims are being replaced by long-term ones and this will make it more difficult for the bank to reverse its loose monetary policy.

With his comments, the bank's former hawk Stark is backing Germany's central bank president Jens Weidmann. The head of the Bundesbank told Der Spiegel weekly magazine over the weekend that requirements for banks' cheap loans have been "very generous" and the program calms the situation in the short term, but this calm could be deceptive. He was concerned about the collateral requirements that the banks had to provide.

The ECB's balance sheet soared past the EUR3 trillion level last week partly because the bank has flooded markets with over EUR500 billion in cheap loans for banks.

Newspaper Web site: http://www.faz.de