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July 19, 2007

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Key Questions for the Chairman

- **Question 1:** What Will Convince the Fed That Inflation Has Been Tamed?
- **Question 2:** Will Declining Home Prices Impact Consumer Spending?
- **Question 3:** Should the Ratings Agencies be Regulated?
- **Question 4:** Is China a Currency Manipulator?
- **Question 5:** Do Sovereign Wealth Funds Pose Risks to Financial Markets?

Fed Chairman's Testimony Part II: Less Politics, More Economics

Today, Fed Chairman Ben Bernanke appeared before the Senate Banking Committee for his second day of testimony on the outlook for the US economy and monetary policy. There was less grandstanding by the Senators compared to yesterday when Mr. Bernanke testified before the House Financial Services Committee.

The written testimony was exactly the same, but the Q&A addressed several key issues including the US trade deficit with China, the housing market, inflation, and sovereign wealth funds (SWFs). Mr. Bernanke was quite candid on most economic issues, but he did avoid commenting on political issues, such as the legitimacy of taxing hedge funds. This distinguishes Mr. Bernanke from his predecessor Alan Greenspan who often blurred the line between economic and political issues.

Question 1: What Will Convince the Fed That Inflation Has Been Tamed?

Senator Jim Bunning quoted the Feds June 28th policy statement, which said that "a sustained moderation in inflation had yet to be convincingly demonstrated." The Senator then asked Mr. Bernanke what it would take for Fed officials to be convinced that inflation was tamed.

Mr. Bernanke responded that the month-to-month readings on inflation are very noisy and that a couple good numbers does not imply that the inflation problem has gone away. He said that, in part, the Fed needs to see more data confirming the recent downtrend. However, he also noted that there are still important risks, including high resource utilization as well as elevated food and energy prices, which might feed through to inflation expectations and core inflation.

Question 2: Will Declining Home Prices Impact Consumer Spending?

Senator Jack Reed questioned whether declining home prices and a drop in home equity withdrawal will negatively impact consumer spending.

The Fed Chairman was quick to point out that while home prices are rising more slowly, they have not yet declined on a national basis and thus we have not seen a significant impact on consumption. Mr. Bernanke also noted that, in the past, when home prices have fallen, Americans have reduced their spending by four to nine cents per dollar decline in home values.

Question 3: Should the Ratings Agencies be Regulated?

Senator Reed also questioned whether it might be a good idea to have government oversight of the ratings agencies (S&P, Moodys, and Fitch) given the recent problems in the collateralized debt and loan markets (CDO/CLO)?

Mr. Bernanke felt that the financial markets were equipped to solve these problems on their own without government intervention. He pointed out that while CDO and CLO securities are not particularly liquid, the indexes based on them are freely traded and give some indication for the value of the underlying securities. In other words, this is not a market failure and financial innovation will solve the problem more efficiently.

Question 4: Is China a Currency Manipulator?

Senator Christopher Dodd asked for the Fed Chairman's opinion on the US trade deficit with China as well as proposed legislation that would label the country as a currency manipulator and permit the Fed to intervene against the Chinese currency (though it is not clear just how this would work since China's currency is not freely traded in the open market).

Mr. Bernanke responded that it would be better to engage the Chinese government rather than take a confrontational stance. He noted that the floating currency by itself is not going to solve the problems associated with the bilateral US-China trade deficit. Instead he recommended a two-pronged approach of increased currency flexibility and structural change to bolster Chinese consumer spending. Some of the reforms the Fed Chairman suggested included improving the social safety net and increasing household access to credit to lift consumer spending in China.

Question 5: Do Sovereign Wealth Funds Pose Risks to Financial Markets?

Senator Wayne Allard brought up the topic of sovereign wealth funds (SWFs). He mentioned that these government sponsored entities are flush with cash and asked how they are impacting the US economy and financial markets.

The Fed Chairman provided some background on SWFs, discussing how countries such as China and some of the major oil producers had accumulated massive foreign exchange reserves through international trade and investment and are now looking to invest these assets in global financial markets.

On net, Mr. Bernanke sees SWFs as beneficial. He noted that most of their assets are managed passively and are not switched back and forth between asset classes. He said most SWFs are simply looking for return and trying to manage their current windfall so that is available for future generations.