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"
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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.