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MONETARY POLICY AND THE STATE OF THE ECONOMY

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BEFORE THE

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U.S. HOUSE OF REPRESENTATIVES

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MONETARY POLICY AND THE STATE OF THE ECONOMY

Wednesday, February 15, 2006

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
WASHINGTON, D.C.

The committee met, pursuant to notice, at 10:05 a.m., at 2128 Rayburn Building, Hon. Michael G. Oxley [chairman of the committee] presiding.

Present: Representatives Oxley, Leach, Bachus, Castle, Royce, Lucas, Kelly, Paul, Gillmor, Jones, Biggert, Shays, Kennedy, Garrett, Brown-Waite, Pearce, Price, Fitzpatrick, Davis of Kentucky, McHenry, Frank, Kanjorski, Waters, Sanders, Maloney, Velazquez, Carson, Sherman, Meeks, Lee, Moore of Kansas, Capuano, Ford, Hinojosa, Crowley, Clay, McCarthy, Matheson, Miller of North Carolina, Scott, Davis of Alabama, Green, Cleaver and Bean.

Chairman OXLEY. The committee will come to order. Pursuant to Rule 3(f)(2) of the rules of the Committee on Financial Services for the 109th Congress, the chairman announces he will limit recognition for opening statements to the Chair and ranking minority member of the full committee, and the Chair and ranking minority member of the subcommittee on Domestic and International Monetary Policy, or their respective designees, to a period not to exceed 16 minutes, evenly divided between the majority and minority.

The prepared statements of all members will be included in the record, and the Chair now recognizes himself for an opening statement.

Chairman Bernanke, welcome to the House Financial Services Committee, and on behalf of the entire committee, congratulations on your confirmation as the 14th Chairman of the Federal Reserve Board.

We look forward to getting to know you and gaining a better understanding of how you intend to run the Federal Reserve. Even though this is your first appearance before this committee, we're well familiar with the Fed, your staff, and the work of the Fed in setting monetary policy and supervising banks and financial holding companies.

Based on my brief conversation with you and your amazingly smooth confirmation hearings, I'm confident that you will be successful as your predecessor. I know the setting and this testimony can be intimidating. I hope it puts you at ease to know that you will have numerous opportunities to testify before this committee and the Congress.

As a matter of fact, you're mandated by law to come over here twice each year. I'm sure you're comforted by that.

This morning, the press and the markets will focus on your every word and gesture. This committee will take a long-term view and I hope focus more on public policy, not the fleeting gyrations of the markets.

Your predecessor and over time the members of this committee have come to view this hearing as an ongoing dialogue between an independent Fed and the elected representatives of the American public.

These hearings have become the highlight of our year. I hope they will become the highlight of yours and that like Chairman Greenspan, you will use them as an opportunity to hear a wide range of views and take the temperature of more parts of the country than you can visit in a year.

You are addressing us at a time when there is universal agreement that monetary policy is where it should be and that the economy is thriving. We can report that the U.S. economic growth is steady and strong.

In fact, we are beginning the fifth full year of the current expansion. While we face some uncertainty abroad, and we can be assured of the likelihood that there will always be uncertainty abroad, our national economic performance is the envy of the world.

Americans are well aware of the economy's steady growth, low inflation, and productivity gains. Consumer confidence numbers are optimistic, and economic predictions show annual growth in the three to four percent range for the short and intermediate term.

Alan Greenspan has handed you the wheel of monetary policy at a time of unparalleled growth and prosperity in America. While Federal law requires that the Federal Reserve conduct monetary policy in a way that ensures maximum employment, stable prices, and moderate long-term interest rates, we know that monetary policy is only one tool to achieve that goal.

Another equally important tool is fiscal policy, as set by Congress in the annual budget, and tax policy. As you contemplate the start of your tenure as Chairman of the Fed, I pledge to you to use my influence and the influence of this committee, not only to support you in your work, but also to see to it that Congress conducts fiscal policy with the same acumen as the Fed has shown in monetary policy.

I'm confident that we can maintain the excellent track record of the U.S. economy if we work together and understand each other's goals. We will face challenges together in the future. Some will be self-inflicted, and some will be inflicted upon us.

Let us use this relatively quiet time to begin our dialogue, fine-tune the monetary and fiscal policy, and pledge to work together. Mr. Chairman, it's a pleasure to have you before the committee, your first appearance before our committee on monetary policy, and again congratulations on your outstanding career before here and your confirmation by the Senate.

I now yield to the gentleman from Massachusetts for an opening statement.

[The prepared statement of Hon. Michael G. Oxley can be found on page 62 in the appendix.:]

Mr. FRANK. Thank you, Mr. Chairman and Mr. Chairman, thank you and thank you for the courtesies you've extended to us. You have made yourself very available for the kind of conversations that will be helpful in our having to work together and including be able to articulate those legitimate policy disagreements that are part of a democracy.

I just want to apologize in advance because the Fund Joint bill has been scheduled to come up, and I'm going to go over after I do my questioning, I'm sorry to say to you. But I will be on the floor and come back again. So I apologize for that.

But I want to just talk to the Chairman because I think we are facing a kind of crisis in our economy. I am glad to see that economic growth is steady and solid. I agree with the projections that it will good going forward.

But we face a problem we haven't faced a long time in America. I'm not enough of an economic historian to know when, if ever, that was. There is a decoupling between growth in the gross domestic product and the economic situation of the average American.

The report documents that—the monetary report to Congress. On page nine of the report, page eight, "With profits posting further solid gains in 2005," et cetera, and on page nine, "Corporate profits continue to grow strongly in 2005. The ratio of before-tax profits of domestic non-financial corporations to that sector's gross value added grows to more than 12 percent of its 1997 peak."

"Operating earnings for S&P 500 firms appear to have been nearly 14 percent above their level four quarters earlier. That's explained in part by the growth in productivity. It was not as high last year as it's been, but it will still considerably above trend. If you look productivity over the last 5 years, as has been noted, it has been very high."

Then we get to page 17. "Increases in hourly labor compensation were moderate in 2005." In fact, real wages, wages paid to people who work for other people, taking into account inflation, have not gone up for years. They have been flat.

What we have is an economy in which thanks to increased productivity, gross domestic product goes up and a very, very large share, an excessive share of the increased wealth has gone to a very small number of people who own the capital.

Now obviously for the system to work, there needs to be compensation for those who own capital. No one is, I hope, arguing that that shouldn't happen at all. But in recent years, that has become disproportionate. Your predecessor had acknowledged that on several occasions.

You have wages flat; you have insecurity caused by pensions being underfunded, being abandoned, defined benefits going over to 401(k)s; you have medical care costs increasing, the extent to which workers have to pay them.

The consequence is this, and it's something that people compare. I will tell you when I was in Davos listening to a leader of one our financial institutions lament the fact that the American people seem so unimpressed with globalization, so resistant to the effort

to adapt that very productivity which many believe is so important for the economy, and I share that.

He said, "Recent studies show that globalization adds a trillion dollars a year to the American economy. That's $9,000 per family. Why are Americans so resistant to something that adds $9,000 per family?"

My answer was, "Because they don't have the $9,000. Not only do they not get the $9,000," I said to this individual, "but they think you have their $9,000. In fact, you have the $9,000 for about 2,000 of them or more."

This disparity, this problem is why you now encounter increasing resistance to trade to deregulation, to the very flexibility that many think are important for the economy.

So these numbers are right here. Productivity goes up. The economy is going to go well. But average Americans collectively assert that they are getting little if any of the benefit. And then those people tell you, "Well, you know, some of these things, globalization means that tee shirts are a lot cheaper now than they used to be at Wal-Mart and elsewhere."

But I'm talking about real wages. That factors in the cost of living. So when you talk about real wages being flat, you can't double-count the low prices. Real wages is obviously nominal wages discounted by inflation.

So if we do not do a better job in this country of not getting rid of inequality, which is essential for our society's markets to function, but diminish it, you will continue to have the resistance to many of the policies that people advocate, and that I think is the major test before us.

We have to end this decoupling of growth of the GDP and the economic well-being of the average American.

Chairman OXLEY. The gentleman's time has expired. The gentlelady from Illinois, Ms. Biggert.

Ms. BIGGERT. Thank you, Mr. Chairman and Chairman Bernanke. First, let me associate myself with the chairman's remarks, both in welcoming you to the committee, and in recognizing both the skills you bring to this new job and the enormity of the job.

We are looking forward to your testimony. We want to get to know you and understand the subtle differences, and there will be differences in the way that you will do your job, from the methods of your predecessor.

To date, we have mostly been able to only read about your views. So today, I hope than you will elaborate a little. For example, anyone who had read much about you knows of your interest in real world problems, particularly the Great Depression.

We also know of your reputation as a proponent of inflation targeting, expressly setting a band in which you think inflation should be kept. Naturally, I might like to hear a little bit more on that, both because we have read so much about it recently, but also because of the spin-up in energy prices and the quite welcome drop in unemployment.

Both of these are well-recognized as potential inflation triggers. Most analysts believe that at the first meeting you chair late next

month, the Open Market Committee will continue its measured tightening.

But many are wondering at what point a new Fed Chair will be moved to, as the longest-tenured Chairman, William McChesney Martin famously said, "take away the punch bowl just as the party gets going."

As well I think many members would like to better understand your views on the global saving glut; economists and politicians of all stripes and colors have for years wrung their hands about the alleged low savings rate in the United States.

Many are also puzzled about both the high balance of payments deficit and what your predecessor called the conundrum of low, long-term bond rates as the Fed gradually pushed up short-term rates.

Of course, in classic economics, a trade deficit in theory can be managed and a rate inversion is a thing to be avoided. So I think we'd like to hear if there is a savings glut, what are the implications for capital investment here and in emerging markets; is there more that we should do unlock capital investment? And how much of the current account deficit should we imagine may erode if the economies of other developed and developing countries picks up?

Anyway, I hope you will take some time, either at this hearing or at your next appearance here in July, to talk to us a little bit about the equality of economic data and its impact on the Fed's ability to confront monetary policy.

Doubtless the Fed is awash in data, but it is troublesome to think that in our high tech society in the 21st Century that Federally-collected economic data is sometimes a month out of date and often trails privately-collected data.

I know, I remember a number of members on the committee are interested in this topic, and I hope you'll let us know if and when and where you think there is need for improvement, along with suggestions. With that, Mr. Chairman, I wish you well in a new and very important job. Thank you for your testimony and I yield back the balance of my time.

Chairman OXLEY. The gentlelady yields back. The gentlelady from New York, Ms. Maloney?

Mrs. MALONEY. Thank you, thank you. Thank you, Mr. Chairman and welcome. We on this committee are particularly honored that your first appearance before Congress is before this particular committee, and I might add that the President's choice to fill the shoes of Chairman Greenspan has been greeted with consistent bipartisan applause, and this is a true testament to your reputation as an economist, scholar, and independent thinker.

First of all, I'd like to be associated with the comments of our ranking member, Frank. We are deeply concerned about the growing gap between the haves and have-nots. That is a very troubling trend for our country and I am particularly concerned that the American worker, after inflation in the past 2 years, has taken less home in their paychecks. Again, a very troubling trend.

In your job on the President's Council of Economic Advisors, you were thoroughly immersed in issues of employment, jobs, wages, debts, and deficits, and I hope and expect that those issues will

continue to influence your decisions now that you are on the monetary policy side.

In my opinion, this Administration has made your new job much more difficult through its reckless spending and lack of fiscal discipline. On Friday, we learned that once again, this Administration has set a new record; only it's the wrong kind of record, a record for debts now over eight trillion dollars in deficits.

The trade deficit for 2005 was the highest ever for the fourth year in a row, at over $700 billion. The trade deficit for this year is 18 percent higher than the year before, even though the Administration has been saying all year that it plans to do something to address this imbalance, which our allies have repeatedly said and warned us is unsustainable.

Fully one-third of that debt is our trade deficit with China, which is exploding, and I don't think it's any secret that if China and Japan were to slow its purchases of U.S. debt, the Fed would be forced to tighten monetary policy beyond what the domestic market would be comfortable with.

In fact, the widely discussed concern that Asian banks will slow their investment in U.S. debt because they seek diversification is now a reality. We are now actually seeing that happen. According to the Fed, in the last several, months Asian foreign central banks have shifted their purchases from Treasury debt to Government-sponsored entities and mortgage-backed bonds to such an extent that this new type of debt is now about a third of the U.S. debt held by foreign central banks.

Chairman Greenspan strongly believed that our current account deficit is caused by the fact that America is saving too little and that our huge Federal budget deficit is Exhibit No. 1.

Recently, the Administration has switched to saying that the real problem is that China is saving too much. I don't think that Americans particularly care about this sort of blame game, but are more concerned about the actual impact of our huge Federal budget deficit and our record trade deficit on monetary policy.

American workers have not yet seen the benefits of this economic recovery. They haven't seen it in their paychecks. An international financial crisis could lead to more inflation and higher interest rates that could choke off the recovery before American workers have a chance to share in it.

I hope that you will address these concerns today. We wish you well in your new position and congratulate you on your appointment.

Chairman OXLEY. The gentlelady yields back, and Mr. Chairman, again welcome to the Financial Services Committee, and you may begin your testimony. Thank you.

Mr. BERNANKE. Thank you, Mr. Chairman. I've submitted written testimony. I'd like to excerpt from that testimony.

Chairman OXLEY. Without objection.

STATEMENT OF BEN S. BERNANKE, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. BERNANKE. Mr. Chairman and members of the committee, I am pleased to be here today to present the Federal Reserve's monetary policy report to the Congress. I look forward to working closely

with the members of this committee on issues of monetary policy, as well as on matters regarding the other responsibilities with which the Congress has charged the Federal Reserve system.

The U.S. economy performed impressively in 2005. Real gross domestic product increased a bit more than three percent, building on a sustained expansion that gained traction in the middle of 2003.

Payroll employment rose two million in 2005, and the unemployment rate fell below five percent. Productivity continued to advance briskly.

The economy achieved these gains despite some significant obstacles. Energy prices rose substantially yet again, in response to increasing global demand, hurricane-related disruptions to production, and concerns about the adequacy and reliability of supply.

The gulf coast region suffered through severe hurricanes that inflicted a terrible loss of life, destroyed homes, personal property, businesses and infrastructure on a massive scale, and displaced more than a million people.

The storms also damaged facilities and disrupted production in many industries, with substantial effects on the energy and petrochemical sectors and on the region's ports. Full recovery in the affected areas is likely to be slow.

The hurricanes left an imprint on aggregate economic activity as well, seen in part in the marked deceleration of real GDP in the fourth quarter. However, the most recent evidence, including indicators of production, the flow of new orders to businesses, weekly data on initial claims for unemployment insurance, and the payroll employment and retail sales figures for January suggests that the economic expansion remains on track.

Inflation pressures increased in 2005. Steeply-rising energy prices pushed up overall inflation, raised business costs, and squeezed household budgets. Nevertheless, the increase in prices for personal consumption expenditures, excluding food and energy, at just below two percent, remained moderate, and longer-term inflation expectations appeared to have been contained.

With the economy expanding at a solid pace, resource utilization rising, cost pressures increasing, and short-term interest rates still relatively low, the Federal Open Market Committee over the course of 2005 continued the process of removing monetary policy accommodation, raising the Federal funds rate two percentage points in eight increments of 25 basis points each.

At its meeting on January 31st of this year, the FOMC raised the Federal funds rate another one quarter percentage point, bringing its level to four and a half percent.

At that meeting, monetary policymakers also discussed the economic outlook for the next 2 years. The central tendency of the forecasts of members of the Board of Governors and the presidents of Federal Reserve Banks is for real GDP to increase about three and a half percent in 2006 and three percent to three and a half percent in 2007.

The civilian unemployment rate is expected to finish both 2006 and 2007 at a level of between four and three quarters percent and five percent.

Inflation, as measured by the price index for personal consumption expenditures excluding food and energy, is predicted to be

about two percent this year and one and three quarters percent to two percent next year.

While considerable uncertainty surrounds any economic forecast extending nearly 2 years, I am comfortable with these projections.

In the announcement following the January 31st meeting, the Federal Reserve pointed to risks that could add to inflation pressures.

Among those risks is the possibility that to an extent greater than we now anticipate, higher energy prices may pass through into the prices of non-energy goods and services or have a persistent effect on inflation expectations.

Another factor bearing on the inflation outlook is that the economy now appears to be operating at a relatively high level of resource utilization. Gauging the economy's sustainable potential is difficult, and the Federal Reserve will keep a close eye on all of the relevant evidence and be flexible in making those judgments.

Nevertheless, the risk exists that with aggregate demand exhibiting considerable momentum, output could overshoot its sustainable path, leading ultimately, in the absence of countervailing monetary policy action, to further upward pressure on inflation.

In these circumstances, the FOMC judged that some further firming of monetary policy may be necessary, an assessment with which I concur.

Not only the risks to the economy concern inflation. For example, a number of indicators point to a slowing in the housing market. Some cooling of the housing market is to be expected and would not be inconsistent with continued solid growth of overall economic activity.

However, given the substantial gains in house prices and the high levels of home construction activity over the past several years, prices and construction could decelerate more rapidly than currently seems likely.

Slower growth in home equity in turn might lead households to boost their saving and trim their spending relative to current income by more than is now anticipated.

The possibility of significant further increases in energy prices represents an additional risk to the economy. Besides affecting inflation, such increases might also hurt consumer confidence and thereby reduce spending on non-energy goods and services.

Although the outlook contains significant uncertainties, it is clear that substantial progress has been made in removing monetary policy accommodation. As a consequence, in coming quarters, the FOMC will have to make ongoing provisional judgments about the risks to both inflation and growth, and monetary policy actions will be increasingly dependent on incoming data.

As I noted, core inflation has been moderate, despite sharp increases in energy prices. A key factor in this regard has been confidence on the part of the public and investors in the prospects for price stability.

Maintaining expectations of low and stable inflation is an essential element in the Federal Reserve's effort to promote price stability. Thus far, the news has been good.

Measures of longer-term inflation expectations have responded only a little to the larger fluctuations in energy prices that we have

experienced, and for the most part they were low and stable last year.

Inflation prospects are important, not just because price stability is in itself desirable and part of the Federal Reserve's mandate from the Congress, but also because price stability is essential for strong and stable growth of output and employment.

Stable prices promote long-term economic growth by allowing households and firms to make economic decisions and undertake productive activities with fewer concerns about large or unanticipated changes in the price level and their attendant financial consequences.

Experience shows that low and stable inflation and inflation expectations are also associated with greater short-term stability of output and employment, perhaps in part because they give the central bank greater latitude to counter transitory disturbances to the economy.

Similarly, the attainment of the statutory goal of moderate long-term interest rates requires price stability because only then are the inflation premiums that investors demand for holding long-term instruments kept to a minimum.

In sum, achieving price stability is not only important in itself; it is also central to attaining the Federal Reserve's other mandated objectives of maximum sustainable employment and moderate long-term interest rates.

As always, however, translating the Federal Reserve's general economic objectives into operational decisions about the stance of monetary policy poses many challenges.

Over the past few decades, policymakers have learned that no single economic or financial indicator, or even a small set of such indicators, can provide reliable guidance for the setting of monetary policy.

Rather, the Federal Reserve, together with all modern central banks, has found that the successful conduct of monetary policy requires painstaking examination of a broad range of economic and financial data, careful consideration of the implications of those data for the likely path of the economy and inflation, and prudent judgment regarding the effects of alternative courses of policy action on prospects for achieving our macroeconomic objectives.

In that process, economic models can provide valuable guidance to policymakers, and over the years, substantial progress has been made in developing formal models and forecasting techniques.

But any model is by necessity a simplification of the real world, and sufficient data are seldom available to measure even the basic relationships with precision.

Monetary policymakers must therefore strike a difficult balance, conducting rigorous analysis informed by sound, economic theory and empirical methods, while keeping an open mind about the many factors, including myriad global influences at play in a dynamic, modern economy like that of the United States.

Amid significant uncertainty, we must formulate a view of the most likely course of the economy under a given policy approach, while giving due weight to the potential risks and associated costs to the economy should those judgments turn out to be wrong.

During the nearly 3 years that I previously spent as a member of the Board of Governors and of the Federal Open Market Committee, the approach to policy that I just outlined was standard operating procedure under the highly successful leadership of Chairman Greenspan.

As I indicated to the Congress during my confirmation hearing, my intention is to maintain continuity with this and the other practices of the Federal Reserve in the Greenspan era. I believe that with this approach, the Federal Reserve will continue to contribute to the sound performance of the U.S. economy in the years to come. Thank you, and I'd be happy to take your questions.

[The prepared statement of Hon. Ben. S. Bernanke can be found on page 65 in the appendix.:]

Chairman OXLEY. Thank you, Mr. Chairman. Let me begin by saying there's been a lot written and a lot discussed about, and as a matter of fact your predecessor described it as a conundrum, the whole issue of rate inversion, the conundrum being that when you raise the short-term rates, long-term rates don't respond accordingly.

I think it was interesting that Chairman Greenspan, at least on more than one occasion, I think, described that as a conundrum. Is it a conundrum or is it a major problem going forward with the economy, or is the economy strong enough to do that?

I know you addressed that in your prepared testimony. I wonder if you could expand on that issue.

Mr. BERNANKE. Mr. Chairman, the conundrum is a very interesting question. The issue is that, unusually, long-term interest rates are lower than short-term interest rates, so we have an inverted yield curve.

There are at least two broad sets of reasons for why that's occurring.

The first is that term premiums, the premiums that investors charge for holding long-term debt, have fallen in recent years, reflecting a variety of influences including, I believe, greater confidence that inflation will be kept low, greater stability in the economy more generally, and additional influences such as demand for duration, the idea that pension funds, for example, are looking for longer-term assets to hold.

So the term premium has come down. Therefore, the normal term structure is going to be flatter now than it was in the past.

The second factor, and one that I've talked about myself in some speeches, is that currently there are a lot of savings in the global capital market looking for returns.

That appears to have driven down, to some extent, the real return to capital around the world. That factor also has contributed to lowering long-term real interest rates. And, as we can see, it's a global phenomenon, and we're seeing inversion. We're seeing low long-term real interest rates in other countries.

The question arises is whether or not this inversion portends a slowdown in the real economy. Historically, there has been some association between inversion of the yield curve and subsequent slowing of the economy.

However, I think at this point in time that the inverted yield curve is not signaling a slowdown. First, the historical relationship has certainly weakened in the last 15 years or so.

But more importantly, in the past, when the inverted yield curve presaged a slowdown in the economy, it was usually in a situation where both long-term and short-term interest rates were actually quite high in real terms, suggesting a good bit of drag on the economy.

Currently, the short term real interest rate is close to its average level, and the long-term real interest rate is actually relatively low compared to historical norms.

So with real interest rates not creating a drag on economic activity, I don't anticipate that the term structure is a signal of oncoming slowing of the economy.

Chairman OXLEY. Well, what effect, if any, will the return of the 30-year bond have on the whole process, in your opinion?

Mr. BERNANKE. Well, the return of the 30-year bond just a few days ago was very welcomed by the investor community because, in part, as I mentioned, there is a demand for long-term assets, for pensions and other reasons.

The arrival of the bond meant that the inversion extends even further out into the future, but I don't think it changes the basic forces. It just suggests that investors are looking for long-term paying assets and that they're willing to accept a relatively low real yield in order to get long-term safe assets.

Chairman OXLEY. In retrospect, do you think it may have been a mistake to suspend the 30-year bond?

Mr. BERNANKE. The suspension of the bond occurred at a time when there predictions that the U.S. Government debt was going to be declining rather than rising and, therefore, considerations of maintaining liquid markets at different horizons suggested the idea of reducing the number of issuances that the Treasury made.

Now with the U.S. Government debt rising again, I think it actually makes good sense for the Treasury to afford itself of the low real interest rates that are available on these long-term bonds, and I think the Treasury is well-served, the American public is well-served, and the investor community is well-served by the reissuance of these bonds.

Chairman OXLEY. The initial issuance was relatively small in overall terms. Is it contemplated that those sales will go on periodically?

Mr. BERNANKE. Those decisions are made by the Treasury, and I know they're concerned about making sure that the market is liquid, and that means they would want to issue sufficient bonds that the secondary market will be deep enough so that they'll be sufficient trading and liquidity in that market.

So my expectation is that they'll continue to issue those securities on a regular basis.

Chairman OXLEY. Thank you. My time is expired. The gentleman from Massachusetts.

Mr. FRANK. Thank you, Mr. Chairman. I'll start my time and give credit where credit is due. As this colloquy about the 30-year bond has occurred, when President Bush came to office, there was some concern, and Mr. Greenspan had it, about how the Federal

Government would deal with this problem with surpluses and a disappearing debt, and the Bush Administration certainly solved that problem.

No one has to worry any more, thanks to our recent fiscal policy about the possibility of surplus and not enough debt. So I did want to acknowledge that accomplishment.

On the question that I began with, Mr. Bernanke, I wonder, Mr. Greenspan did on several occasions lament the increasing inequality that was happening in America. Again, I want to stress inequality is a good thing in a capitalist economy. The economy doesn't work without it.

But it can become excessive in ways that I think don't, are not necessarily for efficiency and can cause other kinds of problems.

Do you feel his concern about inequality, both in the abstract and in terms of how we've been in the last few years?

Mr. BERNANKE. I agree with you, Congressman, that rising inequality is a concern in the American economy. It's important for a society that everyone feels that they have a chance to participate in the opportunities that the economy is creating.

In a situation where incomes are becoming less equal, there will be less support, for example, for free trade, for keeping the markets flexible. So the strength of the economy itself again requires a certain amount of belief on the part of the broad public that they are participants and beneficiaries of the strength of the economy.

Now there's a deep question as to why there have been some indications of rising inequality. There are a number of factors. I don't want to take all your time. I guess I would submit that the most important factor is a long-term trend, which has been going on for a quarter of a century or more, which is the rising school premium, the increase return to education.

We've seen since about 1980 that people with a high school education or lower have seen essentially no increases in their real wages, whereas people with a college education or greater have seen a significant increase.

Mr. BARNEY. Well, and I think that's true. One thing, and then I'll just give you a chance to respond. Committed to the institution which you now have, not even in indirect quotes, but in the financial pages, the saying is attributed to your institution that one of the things that troubles you is the possibility that wages might rise, and we see that the Fed is worried that wages will rise, and this will of course cause terrible things.

We are, of course, delirious when profits rise, but the potential that wages might rise causes concern. Are you worried that wages might rise, Mr. Chairman?

Mr. BERNANKE. Congressman, there's a bit of a misunderstanding there. What would not be desirable would be for nominal wages to rise and for nominal prices to rise even more, leaving workers worse off than when they started.

What is desirable is for real wages, wages measured in terms of purchasing power, to rise. I believe that will happen as the market strengthens, and I have certainly no objection to—

Mr. FRANK. Well, I'm glad to hear you say that because it is the matter. I am quoting some of the financial pages, and that difference you mentioned isn't there.

In fact, as we've noted, productivity has been outstripping wage increases. Real wages have in fact been stagnant, and if you throw in what's happening in health and elsewhere, there are other problems.

Now one other thing I just would note, and I know there's a debate about the cause of this, but it is true that unemployment has dropped, but a significant factor in the drop of unemployment has not been growth in jobs above trend—at least that's a part of it—but a drop in the participation rate.

You've noted this; the Council of Economics has noted this; your report. The participation rate of people in the work force. In January 2006, it was 66 percent, well below the high of 67 and a quarter percent reached in early 2000.

Now there's a debate about what extent it's demographic. The Council of Economic Advisors does say on page 171, it's at least partly cyclical. But in any case, we ought to be clear that the drop in unemployment has been greatly helped not by job growth above trend, but by demographics.

Here's a question. I agree with you that the skill premium has been increasing. Natural trends in the economy, globalization, technological change, productivity; those I agree are exacerbating inequality.

The problem is that I believe public policy has made it worse rather than better. It might be the global public policy in part ought to be to try to mitigate the inequality, not the point where you destroy incentives, but at least mitigate it.

Frankly, I think that is the difference between the approach in the previous Administration and the current one, through tax policy. You know, we read today there's a new assault being launched by very conservative elements on labor unions.

We see a major funded effort to try and undercut labor unions. We see, in my judgment, a budget which cuts back on virtually all of the Federal programs that would go to diminishing the inequality. So the question is—I know I'm out of time, and I'd be glad to take this in writing later—given that we agree that inequality is a problem, and I agree that it is trends in the economy that cause it.

But my problem is that public policy has gone from trying to mitigate that, it seems to me, to exacerbating it, maybe out of the motive that this will promote incentives that lead to growth.

So the question is what do we do about it? What Federal policies would make sense, if we all agree that inequality is increasing beyond what is healthy? What should we do about it?

Chairman OXLEY. The gentleman's time has expired. The Chairman may respond.

Mr. BERNANKE. Well, the discussion we were having a moment ago that turns to skills, suggests that one very positive thing would be to continue to strengthen education and to continue to strength job training and skills acquisition through lifelong learning. I think that's a very important dimension of public policy.

Chairman OXLEY. The gentlelady from Illinois.

Ms. BIGGERT. Thank you, Mr. Chairman. Mr. Chairman, could you discuss the role that you see R&D playing in the future

robustness of our economy, and what sort of incentives you believe are necessary in this area?

I know that the President has talked about research and development and how important that is to our country.

Mr. BERNANKE. Congresswoman, thank you. I believe that research and development are essential to our growth in a technological era. I think there are considerable grounds for optimism.

The United States remains a technological leader. We retain a very substantial share of the world's patents and publications and innovations. That's a position we want to keep.

How to promote that? First on the public side, I think most economists would agree that support by the Government of basic research in a variety of areas is productive. Private companies can't necessarily capture the benefits of basic research and, therefore, Government support in that area is beneficial.

We also have in this country substantial private sector research and research within universities. I don't want to get into any details, really, on tax policy, but I simply note that this Congress will consider extension of the research and development tax credit, which will be one mechanism to support R&D at the private sector level.

So I agree. This is a very high priority for the U.S. economy, and it's needed to keep us technologically at the frontier.

Ms. BIGGERT. Thank you.

We have had a relatively warm winter, a little bit of snow lately in various parts of this country. But there hasn't been any—I don't think any noticeable slowing in the steady rise in the price of energy over the last year or more. But however, the economy is going strong. Why has the economy been able to shrug off such a significant rise in the cost of energy?

Mr. BERNANKE. That's an excellent question. And the Federal Reserve has given a great deal of thought to that question. Part of the answer is that the U.S. economy is less dependent on energy, on oil, than it was 30 years ago. The increase in prices we saw in the '70s did lead to increased efficiency and, therefore, less sensitivity to changes in oil prices.

Secondly, the increase in energy prices, although substantial, with the exception of the hurricane period, has been generally less rapid than occurred in some episodes during the 1970s.

Third, the economy is very resilient. It showed remarkable strength after the hurricanes. It showed remarkable strength after 9/11. So our economy does have a lot of staying power, a lot of ability to deal with shocks.

But the final point that I'd like to make, and it relates to some comments I made in my testimony, is that a big difference between the 1970s and today is that inflation expectations are low and stable. The public has a great deal of confidence that the Federal Reserve will keep inflation low and stable. In the 1970s, that confidence did not exist, and when oil prices rose, wages and prices began to spiral upward. The Federal Reserve had to raise interest rates quite substantially, slowing the economy, in order to keep the inflation rate under control.

Today we see oil prices going up, but we see very little response in wages and prices. We see overall inflation relatively stable. We

don't have to have the same aggressive monetary policy response we had in the '70s, and that's a direct benefit of the improvement in inflation expectations that we've gotten in the last 30, 35 years.

Mrs. BIGGERT. Do you have a crystal ball or a view of what can be done to move energy prices lower?

Mr. BERNANKE. No. I wish I had such a crystal ball. We're in a difficult period because, for the foreseeable future, we are operating close to the margins of available global supply of oil and natural gas. And as a result, prices are likely to stay high, and the risk exists, if there are significant disruptions of supply, that we'll get additional spikes or movements in energy prices.

Now in the longer term, energy prices at the current level should be sufficient to bring forth a number of alternative sources of supply as well as induce significant conservation on the part of consumers and firms. So I'm actually fairly optimistic about 10, 15, 20 years down the road because these high prices will allow the economy to adjust.

But over the next 5 or 10 years, we are in the zone of vulnerability without available alternatives to the extent we would like and with a relatively small margin of error in terms of global supplies.

Mrs. BIGGERT. Thank you very much. I yield back, Mr. Chairman.

Chairman OXLEY. The gentlelady yields back. The gentlelady from New York, Ms. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman. I'd like to follow up on Ranking Member Frank's question. You mentioned that education was very important, but the last time we focused on educating large segments of our unemployed population, those jobs ended up being outsourced.

And what I hear from many of my constituents, particularly women that are middle-aged and possibly older is, ''What jobs are we going to educate them for?'' We live in a changing economy, but what policies, including the Federal Reserve's policies, have played a role in labor's share of economic gains dropping to an unusually low level?

Mr. BERNANKE. Congresswoman, with respect to the Federal Reserve's policies, of course our mandate is maximum sustainable employment. We will strive for that mandate by maintaining a level of employment which is not only high but is also sustainable. In that way, we make it possible for better jobs to be created because we don't have seasonal and fluctuating jobs as we would in a boom/bust kind of cycle. So that's the contribution that the Federal Reserve will make.

With respect to the relationship between productivity and real wages, I have some confidence that there will be some catch-up. During the late 1990s in the previous episode when productivity surged ahead, there was a period where labor's share declined below its long-term average and real wages fell somewhat behind productivity gains.

After a couple of years, as the labor market strengthened, we saw that those gains translated into overall real wages. And I believe that as the market continues to strengthen now that we'll see real wages rising as well. That's a statement about overall real

wages. It doesn't necessarily address the entire distribution of wages, and we've already discussed some of those issues.

With respect to your question about education, I think an important point to make is that education is much more than K-12 and university. It involves continuing education. Community colleges play an important role. So does job training, on-the-job training. I think we need to promote those kinds of activities, and the Government has some role in assisting on that.

Mrs. MALONEY. Many of us are fortunate to represent highly educated people that have lost their jobs in a changing economy, and particularly in the economy in my state, many of our jobs have been outsourced overseas, and there is this troubling trend in distribution of income.

And what policies or change in public policy, including the Fed or other policies, may be needed to move the distribution of income back to a more normal and healthier distribution of income in our country?

Mr. BERNANKE. Well, Congresswoman, I lack a lot of good answers, as many of us do. I think there really is only one fundamental solution, and that is increasing skills. Now there are different ways to increase skills. There's formal education.

Mrs. MALONEY. Mr. Chairman, I'm with highly skilled workers, and they tell me they can't find a job and they've lost their job.

But I would like to go back to the point that Mr. Oxley raised over the great mystery in rates over the past year or so and that the Fed tightening has not yet caused long-term interest rates to budge. And I'd like to ask you to elaborate. And does this disconnect between Fed actions and long-term interest rates have implications for the Fed's ability to control inflation?

Mr. BERNANKE. Congresswoman, if you break up the term structure into short tranches, or term interest rates across the length of the term structure, you'll see that what's happening is that the far out short-term rates, the ones at far maturities, are the ones that have been declining. And this is the phenomena we discussed before, the decline in term premiums and the expectation of low returns to investment.

So that's the reason for the phenomenon. I don't think that it necessarily affects our ability to affect inflation. Short-term interest rates, first of all, directly affect a good bit of economic activity. And secondly, there's also going to be impact on longer-term rates that will feed through into the rest of the economy.

Our strategy is not to pick a magic rate or to pick a magic long-term rate. Rather, we consider alternative paths of future policy rates, and under each alternative path, we try to make a forecast about where the economy is going to go. Based on those forecasts, we try to judge what path will give us the best outcomes in terms of our mandated objectives.

Mrs. MALONEY. I can see you were a former teacher. You're very clear in your responses.

Mr. BERNANKE. Thank you.

Mrs. MALONEY. And finally, this large debt, deficit, and trade deficit—what is the implication for growth for our economy, and isn't this structure bad for economic growth in the long term?

Mr. BERNANKE. Are you referring to the fiscal deficit or to the current account?

Mrs. MALONEY. Current account.

Mr. BERNANKE. Current account deficit. The current account deficit, I should first say, I was asked about it earlier, is a very complicated phenomenon. There are many factors underlying it. And perhaps I'll have an opportunity to talk more about those factors.

The immediate implication, though, is that the U.S. economy is consuming more than it's producing, and the difference is being made up by imports from abroad, which in turn are being financed by borrowing from abroad.

So the concern is that over a period of time, we will be building up a foreign debt to other countries which will lower national wealth and lower our ability to consume in the future. So it is a concern.

I do believe that the current account deficit can and should come down gradually over a period of time. I think it's neither possible nor desirable to have it shift radically in a short period of time.

But over a longer period of time, a combination of higher national savings in the United States, increased demand by our trading partners, and greater exchange rate flexibility, taken together, will allow the current account deficit to come down in a way that I hope would not be disruptive to our economy.

Chairman OXLEY. The gentlelady's time has expired. The gentleman from Iowa, Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman. Mr. Chairman, as you know, there are odd financial entities on the financial landscape called industrial loan companies, which have powers of banks in many different ways. Because they allow the merging of commerce and banking, a number of well known companies have established ILCs or are seeking to establish them. And then, because of their regulatory arbitrage advantages, a number of financial companies have also established ILCs.

In his last communication to the Congress, the former Chairman of the Fed, Mr. Greenspan, endorsed a bill called H.R. 3882 that would subject industrial loan companies to the same laws and principles that apply to financial holding companies.

In this hearing as your first appearance before the Congress, I'm wondering if you would care to present your views on the industrial loan company issue.

Mr. BERNANKE. Yes, Congressman. If I understand your bill correctly, and you should correct me if I'm mistaken, the bill would require any firm acquiring an industrial loan company to take financial holding company status, which in turn could create restrictions on its activities, require consolidated supervision, and indeed would also require that the firm hold its subsidiaries to a somewhat higher standard that might otherwise be the case.

Is my understanding correct?

Mr. LEACH. That's correct. It simply puts ILCs under the Bank Holding Company Act, which has that effect.

Mr. BERNANKE. Congressman, as you know, the Federal Reserve has had concerns about industrial loan companies and the level playing field and the separation of banking and commence. In my view, the bill that you're describing would solve the problem and

would relieve our anxieties considerably about this particular type of organization.

Mr. LEACH. Thank you, sir.

Chairman OXLEY. The gentleman yields back? Mr. Kanjorski.

Mr. KANJORSKI. Mr. Chairman, welcome to your new role. Probably this will be the most entertaining session you'll ever have with this committee. So enjoy.

Ms. Maloney brought up the question of the deficit, and your predecessor used to always indicate that deficits matter a great deal, but it never seemed that the leadership came from the Federal Reserve as to facing the reality of what causes the deficit and what limited policies both the Federal Reserve and the Congress has with fiscal policy to resolve the problem.

But two or three things have come to my attention in the last several months that are to me very frightening. One, the deficit is rising faster than productivity, or what I should say is growth of the American economy. If you take a three percent growth of the American economy at roughly a $12 trillion size, that's about $360 billion a year, and our deficits are far outstripping that.

And, too, as a result of that and the policies over the last 5 years, the debt owed by the United States to foreign entities, it was from 1789 to 2000 it took us that period of time to have a combined borrowing of one trillion, .01 trillion.

Now since 2000 till today under this Administration, we've borrowed 1.05 trillion, which means it exceeds that entire 200-plus year history, more under this Administration than all 42 Presidencies prior to it. And with no end in sight, it seems to me, although we keep hearing that there's a plan of the Administration to reduce the deficit by half at a year beyond this Administration's term in office, which is always interesting. I think the Congress has a tendency to promise action for future Congresses but not to take action in this Congress.

It seems to me we're at a point now that the American people really don't understand deficits, the problems attendant thereto, and the potential long-term problems, particularly the potential since most of this debt is owed to Japan, China, and the United Kingdom, how that will affect our foreign policy in years to come.

At what point is the chairman of China going to be able to call the President of the United States when he disagrees with a policy, foreign policy of the United States, and not threaten war, not threaten retaliation of a military way, but just say, Mr. President, you won't be able to pay your Social Security checks next month if you don't change your policy? I think that's rather dire. That actually could occur today. If we weren't able to fund this deficit with foreign money, we could not meet our Social Security obligations in the next month.

Where do you see your role as a leader and an educator of the American people as to the significance of this and how that policy should change or shouldn't it change?

Mr. BERNANKE. Congressman, I think that in my role as chairman of the Federal Reserve, it is appropriate for me to talk about long-term Government spending, taxes, and deficits. I think that bears on economic stability and financial stability, and I will speak out on those issues.

I am concerned about the prospective path of deficits. I believe that it does reduce national savings, and, therefore, imperils to some extent the future prosperity of our country, and increases the burden that will be faced by our children and grandchildren.

Of particular concern to me is that in the very near term, the demographic changes in our economy are going to lead to increasing promises, increasing entitlement payments associated with the large programs of Social Security, Medicare, and the Federal contribution to Medicaid. Indeed, according to the best estimates we have, the share of GDP going to those three programs will go from about 8 percent today to about 16 percent when my children, who are now in college, are contemplating retirement.

If that were in fact to happen, given that total revenues are now about 18 percent of GDP, that would suggest that either we would have to eliminate all other Government spending, raise taxes considerably, or else take some action to bring entitlement spending under control. I'm not saying which of these things. I'm just pointing out that the implications of these obligations are quite draconian in the long run.

We need to be addressing those long-term issues soon. We need to give people the time to prepare for whatever changes might occur in entitlement programs. And, therefore, I think that we do need to think about fiscal deficits and their implications for our national saving and our long-run ability to meet our obligations to our citizens.

Chairman OXLEY. The gentleman's time has expired. The gentleman from Alabama, Mr. Bachus.

Mr. BACHUS. Thank you. Chairman Bernanke, you're known, widely known, as a proponent of greater transparency at the Fed. Now that you're Chairman, would you give us some idea of what specifics you're considering to bring greater transparency to the Fed? And in answering that question, at some point, could you reach a point where too much transparency and too much openness ties your hands in terms of policymaking? And if so, what principles will you use in determining what a proper balance would be?

Mr. BERNANKE. I do believe that transparency is very important for the Federal Reserve for a variety of reasons, including democratic accountability. I also believe that a more transparent Fed is going to be more effective because the public and the markets will have a better understanding of what the Fed is trying to do. Expectations will be better anchored, and I think policy will just work better if the Fed is more transparent.

I don't want to give the impression that I'm coming in with a whole new program. Transparency has been increasing at the Fed over the last decade quite significantly. During the time that I was Governor there, we increased the informativeness of the statements. We moved up the release of the minutes, and generally in speeches and testimonies, I think there was a definite movement towards trying to be more open about the Federal Reserve's strategy and approach.

I would like to continue that direction of increased transparency. Obviously, I'll have to do that in concert with my colleagues on the Federal Open Market Committee. But one of the possibilities that's already been mentioned is providing guidance on the long-term

range of inflation which is most consistent with our objectives of maximum sustainable employment and price stability.

I will also, individually and personally as I come before committees or make speeches, try to be as open and forthcoming as I can in providing information about the Fed's strategy and how we see the economy.

Now you quite correctly ask, is it possible for transparency to go too far. And I think it is possible. We certainly wouldn't want a situation where the transparency is such that it inhibits the discussion, that it inhibits the policymaking process. I would not, for example, favor TV cameras in the FOMC meeting because I think that would not allow a full and frank discussion to take place.

So there are limits, and we have to pay attention to those limits. But I think broadly speaking that fresh air is good for the Federal Reserve, and I want to keep moving us in that direction.

Mr. BACHUS. Thank you. You mentioned today maximum sustainable employment, and I want to commend you in your statement today; you've spent a considerable time talking about energy. One thing that you said because of Hurricane Katrina, but I think it's also true today is we have tremendous restraints on our economy because of the high price of energy. And you go talk to plant owners, you talk to company owners, you talk to even union officials, and they used to complain about low wage subsidized foreign competition, taxes, and regulation, being able to get skilled, educated workforce, which is still—those are all still concerns. But today I hear time and time again the high cost of natural gas and petroleum.

Recently the chemical industry has come out and said we're uncompetitive with the world. In your testimony and in former testimony, the Fed has suggested that the recent energy price increases have not been a major negative impact on the economy. But today I think maybe you've indicated that they may be.

You know, China has just announced plans to build 30 nuclear power plants. We don't even have one in the licensing process today. Japan has built 23 LNG terminals while we've built four. France has built 58 nuclear power plants. We've built none—or one during that time, and that was 1996 or 1997, Watts Bar. So going forward, are you—what is the level of your concern that if we don't do the things our competition is doing that it will affect our sustainable employment? We've lost 150,000 jobs in forestry and paper just recently because of energy.

Mr. BERNANKE. Congressman, when I was responding to the question about the effect on the economy, I was talking about broad aggregates like GDP growth. You're absolutely correct that there are many industries that depend on natural gas, for example, which have suffered quite severely in the recent episode.

Natural gas is unusual because, unlike oil, which is traded freely on a global market, natural gas is a much more regional market because of the difficulties in transportation. And so building LNG terminals is one thing that we, I think that we can do and we should continue to do to create a more global market for natural gas.

I can only just endorse your sentiment that while I was optimistic that in the long run these high prices will call forth alter-

native sources of supply, the Government does have a role in supporting that activity.

I mentioned just two possibilities. One is that the Government has been very helpful in basic research to help develop new designs to find new methods of conservation.

And secondly, certainly there are many legitimate reasons to regulate, say, new refineries, for example, and there's absolutely no reason, you know, to eliminate their regulation. But clearly, one should try to make the regulation as clear and straightforward as possible so that new refineries can meet the appropriate standards and operate.

So by clarifying regulations, by providing additional support for basic research, those are just methods that the Government can undertake to help with the energy situation. Again, I agree it's a very important issue for us in the next 10 years or so.

Chairman OXLEY. The gentleman's time has expired.

Mr. BACHUS. Let me make a closing comment. If I can just say, yeah, we need alternative energy, conservation, but even with all that, we're projected, with all those things, if we do those things, we're still going to have about 40 percent more need for electricity and energy 20 years from now.

And I know Mr. Sanders knows Vermont gets about 78 percent of their electricity from nuclear power plants, but that's the only State in the Union where they are over 50-some.

Chairman OXLEY. The gentleman's time has expired. The gentleman from Vermont, the aforementioned Mr. Sanders.

Mr. SANDERS. Thank you, Mr. Chairman. And Chairman Bernanke, welcome to the Financial Services Committee and very best of luck on your new job.

Mr. Bernanke, there is a great concern in this country that our current economic policies are not working for ordinary Americans. The middle class continues to shrink. Poverty is increasing. The gap between the rich and the poor is now wider than it has been in over 7 years. We have a recordbreaking national debt as well as a recordbreaking trade deficit. And the Bush Administration has the worst record of private job creation since Herbert Hoover.

Meanwhile, while millions of American workers are seeing their real wages decline, or they're using their pensions and their health care, while they can't afford child care or college education, the wealthiest people in this country frankly have never had it so good.

My own view is that the time is long overdue for the Bush Administration and Congress to start making fundamental changes in our economic policies so the Government works for everybody and not just the very wealthy and their lobbyists who descend on Capitol Hill every day. And if we don't, what we are going to see in my view is that for the first time in the modern history of America, our kids are going to have a lower standard of living than we do.

Now I want to just very briefly, because time is limited, solicit your remarks, your thoughts on some very important economic questions. And my first one is the following. Since President Bush has been in office, more than five million Americans have slipped into poverty. Childhood poverty has increased by over 12 percent. We continue to have by far the highest rate of childhood poverty in the industrialized world. American house—average America

household income has declined for the past 4 consecutive years. It's down by more than $1,600. Twenty percent of American jobs now pay less than a poverty level wage for a family four.

My question is a very simple one. All over America, States like the State of Vermont have raised the minimum wage, which now at the Federal level remains $5.15 an hour and in fact has the lowest purchasing power that it has had in over 50 years. Chairman Bernanke, should the Congress raise the minimum wage so that every worker in America who works 40 hours a week escapes from poverty? Very simple question, sir.

Mr. BERNANKE. Well, I'm going to be an economist and give you the one hand and the other hand. On the minimum wage, it's actually a very controversial issue among economists. Clearly, if you raise the minimum wage, then those workers who retain their jobs will get higher income and that, therefore, it helps them.

The concerns that some economists have raised about the minimum wage are first, is it as well targeted as it could be? That is, how much of the increase is going to the teenage children of suburban families, for example? And secondly, does it have an employment effect? That is, do higher wages lower employment of low wage workers?

Mr. SANDERS. And your response is?

Mr. BERNANKE. My response is that I think it does lower employment, that, however, I note that the literature is fairly controversial on this subject, and my colleagues from Princeton, Alan Kruger and David Card, have presented results saying that—

Mr. SANDERS. Should Congress raise—I'm sorry to be abrupt, but we have a limited amount of time. Should Congress raise the minimum wage?

Mr. BERNANKE. I'm very reluctant to comment on specific measures of this sort. But I will say this, that one might consider alternative ways of helping working class Americans, for example, the earned income tax credit, which delivers money to working families—

Mr. SANDERS. Okay. Thank you.

Mr. BERNANKE.—without necessarily the employment effect.

Mr. SANDERS. I'm sorry to be abrupt, but we have just a limited amount of time. This is my second question. Our country now has a recordbreaking $720 billion trade deficit, and our trade deficit with China, as you know, is over 200 billion. Over the past 5 years, the United States has lost almost 3 million good paying manufacturing jobs—industry after industry, good paying jobs, good benefits, hemorrhaging. Many of the new jobs that are being created are low wage, minimal benefits.

To my mind, to more and more Members of Congress and to more and more Americans, it appears clear that our current trade policies—NAFTA, permanent normal trade relations with China—are a disaster, leading us to a race to the bottom, encouraging American companies to throw workers out on the street, move to China, pay people 30 cents an hour.

Question. Do you think that the time is now to rethink our disastrous trade policies which have lost millions of good jobs and run up a recordbreaking trade deficit?

Mr. BERNANKE. Well, Congressman, Ambassador Portman has just released a report on trade with China, and he's pointed out a number of areas where he's concerned about China's adherence to international agreements and to free and fair and open trade. I know he's going to pursue some of these issues and try to make sure that trade with China is on a fair and open basis.

Mr. SANDERS. Well, let me ask you this.

Chairman OXLEY. The gentleman's time has expired. The gentleman's time has expired.

Mr. SANDERS. Just, you know—

Chairman OXLEY. The gentleman may respond. The Chairman may respond.

Mr. SANDERS. Is it a fair—no, you asked—Mr. Bachus was able to continue just for a little bit, okay?

Chairman OXLEY. Your time has expired, Bernie.

Mr. SANDERS. So did other people who were continuing their questioning.

Chairman OXLEY. Make it quick.

Mr. SANDERS. Is it a level playing field when people in China make 30 cents an hour compared to American wages? How can that be a level playing field?

Mr. BERNANKE. Well, again, I think we need to have free and open trade. I think there are many benefits from that. And I don't want to move back from free trade, but I think it's important to make sure that the trade that takes place is done on a fair and open basis and that, for example, that the Chinese respect our intellectual property so that we receive the appropriate compensation for that. I favor free trade, however.

Chairman OXLEY. The gentleman from the first State, Mr. Castle.

Mr. CASTLE. Thank you, Mr. Chairman. Chairman Bernanke, the House-passed GSE reform bill, which is H.R. 1461, you may be familiar with it, consolidates regulations of the three housing GSEs, and for the first time fully empowers a new independent regulator to—and I'll go through it specifically—set minimum and risk-based capital requirements, review and adjust portfolio holdings, establish credential management and operation standards, approve new business programs through public rulemaking, take prompt corrective and enforcement actions, put a failing enterprise into receivership, and fund the agency outside the Congressional appropriations process.

I recognize that our bill does not go as far as some would prefer, but do think that H.R. 1461 is an improvement over current law? Or any other comments you have on that.

Mr. BERNANKE. I think, Congressman, that we have an opportunity now to address the important concerns about GSEs and their potential effects on financial stability.

I understand the good intentions underlying the House bill, but I feel that it does not solve the problem. And, therefore, if we were to go with that bill, we would be missing perhaps the last opportunity we're going to have in many years to really address these problems.

In particular, the House bill does not go as far as the Senate bill or as bank regulatory bills do in giving the GSE regulator power

over capital and setting capital. Secondly, it is not precise in terms of when receivership would be invoked, leaving uncertainty in the market about exactly when that would happen and creating an impression of Government backing for the GSEs.

And thirdly, and I think most important, the point that Chairman Greenspan made extensively in his numerous testimonies on the subject, the portfolios of the GSEs are much larger than can be justified in terms of their fundamental housing mission. And these large portfolios represent a risk to financial stability. And if the taxpayer were to be called upon, also to the FISC.

The House bill does address portfolios, but it doesn't provide, in my opinion, sufficiently strong guidance to the regulator to mandate that the portfolios be limited to an amount needed to serve the true housing mission of those organizations.

Mr. CASTLE. Thank you for a very specific answer. Let me change subjects for a moment, sort of building on some other questions that have been answered here.

But I think we're all becoming increasingly concerned, and maybe it's the baby boomers' fate that we should be concerned about what's happening in the economy. That is, defined benefit pensions going out the window. The borrowing rate, particularly because the borrowing rate seems to be shifting from general borrowing to added mortgages based on the value of housing. The cost of medical care, the medical insurance if not the medical care. All the various aspects that seem to be eroding the assets that people are going to have as they come closer to the end of their lives with the exception of, say Social Security.

Is there anything that we in Congress should be doing? I mean, should we be consolidating the various tax-created savings type plans that we have done, most of which, frankly, are hard to understand? There's a whole lot of them. Are there other things that we should be doing to somehow spur the savings? I mean, every economist you talk to says with both of their hands that we need to have additional savings in the United States of America, but there seems to be a creeping problem where people are not going to have the old standbys, their pensions, their savings accounts, et cetera, that they had in the past.

Do you have any thoughts about anything that we can be doing other than using the bully pulpit to encourage people to save more and to be more careful?

Mr. BERNANKE. Congressman, it's a very tough problem. As I already indicated, one way to address saving at a national level is through fiscal responsibility and in reducing over a period of time the deficit, which adds to national saving.

Mr. CASTLE. Right. But I was trying to go to the individual's level.

Mr. BERNANKE. At the individual level, again, I want to be careful not to endorse specific programs, but there are various ways of providing tax benefits for saving. The evidence on their effects is somewhat mixed. We really haven't found a magic bullet for increasing saving.

There is some view among economists that more consumption-based taxation would be helpful in that regard. That is a pretty

broadly held view, but is one that has not been firmly demonstrated.

I think financial literacy has got to play a role here. People need to understand, first of all, the importance of saving, the importance of planning, and also understand how to utilize the financial markets to accumulate wealth.

You mentioned defined benefit pensions. There really is a problem in that we have seen companies that have promised their workers pensions and now essentially are reneging on those promises. Going forward, I know Congress is considering various pension reform bills. We need to make sure that when companies promise pensions that they fully fund those obligations and that they are sufficiently transparent so that workers can understand that their pensions will be there when they retire.

So, again, I think there are some policies that may help with saving in terms of providing incentives for saving, allowing people to combine savings in a limited number of accounts and the like. But the truth is that there is still some controversy about how effective these incentives will be, and education has got to be part of the effort.

Mr. CASTLE. Thank you, Mr. Chairman, and good luck to you, sir. I yield back.

Chairman OXLEY. The gentleman yields back. The gentlelady from Indiana, Ms. Carson.

Ms. CARSON. Thank you very much, Mr. Chairman, and thank you, Mr. Chairman, for being here today. I have a quick question concerning the housing market. At one point it was just skyrocketing and booming, and now it seems to be on the decline. Could you anticipate what kind of effect, impact that's going to have on the domestic economic growth?

Mr. BERNANKE. Yes, Congresswoman. We discuss it in our report. The housing market has been very strong for the past few years. Housing prices have been up quite a bit. Residential investment has been very strong.

It seems to be the case, there are some straws in the wind, that housing markets are cooling a bit. Our expectation is that the decline in activity or the slowing in activity will be moderate, that house prices will probably continue to rise, but not at the pace that they had been rising.

So we expect the housing market to cool, but not to change very sharply. If the housing market does cool more or less as expected, that would still be consistent with a strong economy in 2006 and 2007. In particular, capital investment and other forms of demand would take up the slack left by residential investment.

Ms. CARSON. Thank you very much, Mr. Chairman.

Mr. BERNANKE. Thank you.

Chairman OXLEY. The gentlelady yields back. The gentleman from Texas, Mr. Paul.

Dr. PAUL. Thank you, Mr. Chairman. Thank you, and welcome, Chairman. Mr. Chairman, I was very pleased with what you said about your support for transparency, and I want to ask a question dealing with that.

Also, at the bottom of page 8, you said something that I thought was very important, where you said that the Federal Reserve, to-

gether with all other central bankers, has found that successful policy depends on painstaking examination of a broad range of economic and financial data, and I also think that's very important.

There is a famous quote by an economist, which I'm sure you're familiar with, that inflation is always and everywhere a monetary phenomenon. And likewise, another famous economist from the 20th Century, and I'll paraphrase this, said that monetary authorities deliberately confuse the issue of inflation by talking only about price increases. Yet it's the price increases which are merely the inevitable consequence of inflation. This is done on purpose to distract from the real cause, which is the increase in the quantity of money and credit.

And I notice in your report to the Congress, you do report M2, and it went up last year at four percent. And M3 was not mentioned, other than the fact that it won't be reported any more. M3, interestingly enough, went up twice as fast, and M3 is going up probably more than two times as fast as the GDP.

And this is information that I consider important and I know a lot of other economists consider important. And I find it rather interesting and ironic that one of the reasons that the Federal Reserve has given—of course, this was before you were the chairman—for this change is the fact that it costs money; it costs too much money.

Now that is really something in this day and age, especially since the Federal Reserve creates their own money and their own budget and they have essentially no oversight, and all of a sudden it costs too much money to give us a little bit of information.

So that to me is a bit ironic that this information will not be available to us. And my question to you is, would you ever reconsider this policy of denying this information to the Congress just so that we have another tool to analyze what's going on with monetary policy? It seems like with your support for transparency, this should be something that you would heartily support.

Mr. BERNANKE. Congressman, first, you're absolutely right. We do look at a wide variety of indicators, and money aggregates are among those indicators. In particular, M2 has proven to have some forecasting value in the past, and I think the slowdown this year is consistent with the removal of accommodation that's been going on.

In regard to your references to M3, a still broader measure of money, we have done, and I'm now speaking about the Federal Reserve before my arrival, but we have done periodic analyses of the various data series that we collect to see how useful they are. And our research department's conclusion was that M3 was not being used by the academic community, nor were we finding it very useful ourselves in our internal deliberations.

Now it's not just a question of our own cost; although, of course, we do want to be fiscally responsible on our own budget, but it's also I think important for us to recognize the burden that's placed on banks that have to report this information.

And so when we can reduce that burden, we would like to do so. And that was one of the considerations in the decision that was made about M3.

Would we reconsider it? If there were evidence that this was an informative series and that it was useful to the public and to the Federal Reserve in forecasting the economy, naturally we would look at it again. There's nothing dogmatic going on here.

Dr. PAUL. If the Congress expressed an interest in receiving this information, would you take that into consideration?

Mr. BERNANKE. If there was broad interest in the Congress in receiving this information, we would look at it. But, again, Congressman, remember, it's a burden on the reporting banks to provide the information, and we are trying to reduce that burden as much as we can.

Dr. PAUL. But, of course, this has been available to the financial community for a lot of years, and for some people it's very important to measure what you're doing. If the money supply is important, which a lot of people believe it is, and it causes the inflation, this to me seems like we're taking information about the money supply and literally hiding it from the people.

And I yield back.

Chairman OXLEY. The gentleman's time has expired. The gentleman from California, Mr. Sherman.

Mr. SHERMAN. Thank you. Chairman Bernanke, I'm the only member of this committee to actively work to thwart your appointment. Nothing personal. I simply authored legislation to extend your predecessor's term limits. You owe your office to that bill's sole and very powerful opponent, Andrea Mitchell.

Speaking of how you get appointed, you are as insulated from politics as anyone in Government. The natural tendency of Congress year in and year out, the pressures on us are to spend more, tax less. It's caused many to wonder whether the U.S. is ready for self-government.

Now can we count on you, being so insulated, to make the tough decisions? I'm going to ask a whole bunch of questions and allow you to respond at the end. And I realize I may be asking too many for you to respond to all of them, and I hope that you'll respond for the record. I also ask unanimous consent that we all be given 5 days to submit additional questions for the record.

Chairman OXLEY. Without objection, that's the standard.

Mr. SHERMAN. But I hope that you would, in your written response, comment on whether we can count on you to urge both spending restraint and restraint on tax cuts and push for adequate revenues. And I'll also be asking you whether you agree with your predecessor and his comments before this committee in response to my question in 2003, that tax cuts do not pay for themselves, that they do reduce revenue; unless through some mysterious legislative process that I've been unable to observe, a tax cut bill leads to spending reductions.

The next series of questions I hope you can respond to is the fact that we have this enormous trade deficit. Several have commented on it.

An adjustment in currency values is inevitable, and I would like you to set forth how we can work with other countries to make sure that any realignment of the value of the dollar compared to other currencies is smooth and does not result in a sudden crash of the dollar where circuit breaker agreements are necessary, et cetera,

but after running trade deficit after trade deficit that are the most enormous of history, we ought to be expecting an eventual decline in the value of the dollar, and we hope it is not sudden. How is the Fed preparing for such a possibility?

Finally, there is the controversy about mixing commerce in banking. We have seen in Japan how that leads to the misdirection of capital and how it can impair the banking system.

More important, just as importantly, we know that mixing banking and commerce is wrong because it's illegal, as we established in the bill that came through this committee.

Yet, I'm troubled that this prohibition, logical as it is, between mixing commerce and finance, is being evaded in part through the device of saying well, any commercial activity is financial if the buyer needs financing.

We are told that sellling homes or cars is a financial activity. I would say I've been paying the bank for this suit ever since, well, it's been let out and let in again. I'm still paying for it on that credit card.

We can argue that my tailor is engaged in a financial as well as a frustrating activity.

In December, the Office of the Controller of the Currency issued several legal opinions. Many think that existing law allows banks to own real estate to accommodate their banking business, and now that seems to be interpreted to allow them to build luxury hotels, to develop residential condominiums for sale.

This sounds like speculative real estate investment of the very type that brought down the savings and loans.

Do you think the OCC is giving the banks too much freedom so as to create a risk to the deposit insurance system?

I'm particularly concerned about a recent opinion that allows a national bank to own a 70 percent ownership stake in a wind mill farm, and that means that the deposit insurance fund is dependent upon which way the wind blows.

I know that others have already asked you about the ILC loop hole, so I hope that you will be able to address the mixing of banking and commerce and what steps the Fed should take to protect our financial system from both a violation of the spirit of Gramm/Leach/Bliley and also from what has imperiled and really held back the growth of the Japanese economy as well as imperiling its financial system.

Chairman OXLEY. The gentleman's time has expired. The gentleman from California, Mr. Royce.

Mr. ROYCE. Chairman Bernanke, congratulations to you on your new position.

In April of 2005, Chairman Greenspan delivered testimony at that time to the Senate Banking Committee outlining the Federal Reserve's view on reforming regulation of the Nation's three housing GSEs, and as I recall at that time, you were a member of the Federal Reserve Board.

I'd like to know if there are any notable differences between your views on GSE reform and the views presented by Chairman Greenspan in April of 2005 in that Senate speech that he gave.

Mr. BERNANKE. Congressman, as you point out, I was a member of the Board, and the testimony that Chairman Greenspan gave I believe was an official Board position.

I was there during the evolution of these issues, during the staff presentations, during discussions. I had discussions myself with Chairman Greenspan.

I find his economic arguments persuasive, in particular, the concerns about the portfolio, the risks they present to financial stability and potentially to the taxpayer.

I want to just also reiterate that I agree with Chairman Greenspan that the GSEs do perform a very important service in securitizing mortgages and providing/creating a secondary market, a liquid secondary market for those mortgages.

I have no vendetta against the GSEs by any means. I think they are very positive institutions and they do some very important things for housing in the United States.

I am concerned, as Chairman Greenspan was, about the size of the portfolios and the risks that are inherent in trying to hedge them in a dynamic market with rapidly moving financial conditions.

Mr. ROYCE. I agree totally with your assessment. Do you generally agree with the Treasury Department's GSE regulatory reform recommendation that we have seen that calls on Congress to limit the GSE's portfolio assets to those necessary for the GSEs to fulfill their statutory housing mission?

Mr. BERNANKE. I do agree. The question is why they are allowing the portfolios to exist when they have as much inherent risk as they do.

The question is how much of the portfolio is necessary to fulfill the mission. That is something that may require some judgment and analysis, but it seems clear it's a much smaller number than currently being held by the large GSEs.

Mr. ROYCE. Thank you. May it be that the rise in home ownership and the rise in housing wealth that went along with it over the past several years has enabled many consumers to dip into savings from current income, and thus, maintain spending even in the face of these high energy prices, as there are some signs that housing demand is slow, which you mentioned in your testimony, and the rise in home prices clearly are leveling off or starting to dip, in your view, how big of a risk to consumer spending from what might occur, a rapid downward adjustment in home prices, and are there possible offsetting factors in terms of how this will play out in the economy?

Mr. BERNANKE. Our expectation is that if and when the housing market slows, that savings rates will tend to rise.

We have built into the forecast, so to speak, some increase in personal savings.

As home values grow more slowly, then consumers can rely less on the increase in equity as a source of wealth building and, therefore, must save more out of their current income. Again, that's to be expected.

As I've indicated, our current expectation is that process will be gradual and is consistent with continued strong growth in the economy.

However, as I also indicated, the housing market and the consumer response to any changes in the housing market is one of the risks to the forecasts and one we will be monitoring closely as we try to assess the state of the economy in the coming year.

Mr. ROYCE. Mr. Chairman, I yield back.

Chairman OXLEY. The gentleman yields back. The gentle lady from California, Ms. Waters.

Ms. WATERS. Thank you very much, Mr. Chairman. I'm pleased to be here with you, Mr. Bernanke. I welcome you to this committee. We are going to miss Mr. Greenspan. No one talks like him, and we don't want you to.

I had a great relationship with him. He's been to my district. I'm going to invite you.

I want to continue this discussion this morning about rising inequality in two ways. I'm going to talk about housing a little bit more.

It's been alluded to any number of ways this morning. I want to talk about the fact that many Americans are priced out of the market. They are not able to buy homes because of the rising cost. I am going to talk about this in relationship to affordable housing and what the Government can or cannot do.

Some of the policies of this Administration are such that we don't have support for low- or moderate-income housing that we thought we had, and the cuts that are being made will eliminate the opportunities for first time home buyers and others to get into the housing market.

We are concerned about this iddur. I'm also concerned about the bubble. The fact is that some people are stretched to buy a house. It cost too much. They got the special product loans, interest only loans, et cetera. And what is that going to mean to the economy if in fact this bubble does burst?

I'd like you to give us a little discussion about housing and housing affordability in relationship to some of the things to which I've alluded and the rising interest rates.

Secondly, I want to talk about investment in poor and minority communities. I used to have this conversation with Mr. Greenspan all the time. When I invited him to my district, it was to engage entrepreneurs and business persons and the financial services community in conversation about investment in poor communities.

We know we have things like the new markets initiative that's been very helpful and could be even more helpful if in fact we could do more of that.

What do you envision? What advice could you give us about how we could spur investment in these poorer communities, where investment can be the only possibility for growing these communities and expanding opportunities for jobs, et cetera?

Do you have any ideas about this issue? What can you advise us? What can you work on that would help to expand the idea of the new market tax credit initiative in order to grow these poor communities?

Mr. BERNANKE. Congresswoman, I'm very much in favor of home ownership. I think it's a positive thing that we now have close to 70 percent home ownership rates in this country.

I think when people have their own home, it makes them more involved in their communities. It makes them more interested in participating in the democratic process. I'm very much in favor of supporting that.

Over the recent years, financial markets have opened up to the extent that there now is a much more extensive housing credit market. There is more access than there was before. There still remain problems.

As you may know, the Federal Reserve's analysis of Home Mortgage Disclosure Act data suggests there are still differences in access and pricing between minorities and others in the housing market.

It is still important for us to continue to make sure that there is fair treatment in those markets.

There is always a tradeoff between giving people access and making sure they don't take on more debt than they can sustain.

If the housing market does slow down, we want to see how strong the mortgage market is and whether or not we will see any problems in that market. That's an issue.

I'd like to say my very first trip as a Governor of the Federal Reserve was to Brownsville, Texas, to see how a set of non-profit organizations were using funds provided under the Community Reinvestment Act from banking institutions to re-develop or develop housing for immigrants to that area.

It was a very interesting experience. It suggested to me that the financial institutions themselves also become more informed about low- and moderate-income communities, about immigrant communities. They can find new opportunities there.

In fact, those investments that the banks were making under the CRA through the non-profits in Brownsville were quite profitable. They were good for the banks. They were good for the immigrants who were buying homes, and good, I think, for our economy.

I don't want to comment specifically on fiscal programs to support housing. Again, I think that's something that really is up to Congress.

From my perspective at the Federal Reserve, I'm certainly going to maintain an ongoing interest in the financial markets for low-and-moderate income people, making sure they are fair and open.

Chairman OXLEY. The gentle lady's time has expired. The gentleman from Connecticut, Mr. Shays.

Mr. SHAYS. Thank you, Mr. Chairman, for being here and for responding so thoughtfully to our questions.

I want to know if you believe that we have primarily a revenue problem or a spending problem as it relates to the Federal budget.

Mr. BERNANKE. The key problem is that the Congress at some point needs to decide what the appropriate size of the Federal Government is. That is really the first essential question, and it's a question based on values. Therefore, it is really the elected representatives that have to make that decision.

Those Members of Congress who are in favor of low tax rates and continuing tax cuts have to accept also that in order for those low tax rates to be sustained, ultimately, they have to find savings on the spending side to avoid exploding deficits.

Likewise, those who would like to see a more expansive role of the Government need to understand and accept that commensurate tax revenues are going to be necessary to support those activities.

It's not up to me to decide what the size of Government is—

Mr. SHAYS. Do you think our tax rates are low?

Mr. BERNANKE. They are relatively low compared to other industrial countries. They are not at a historical low. The current tax rate of 35 percent is higher than, for example, the 28 percent rate that was agreed upon—

Mr. SHAYS. You are talking about rates. Are we not getting enough revenue?

Mr. BERNANKE. The question is, compared to what? It's a question of how big the Government is going to be. There is a deficit. I'd like to see it lowered, but it's up to the Congress to decide whether that should be done by higher taxes, lower spending, or some combination.

Mr. SHAYS. When the Congress lowered the dividends and capital gains tax, did we get more revenue from it or less?

Mr. BERNANKE. I think most economists would agree that a well constructed tax cut does not lose as much revenue as a purely static analysis would suggest. In particular, the dividend and capital gains tax cut led to some increased realizations and, therefore, more revenue, or less revenue loss, at least, than a purely arithmetic analysis would suggest.

Mr. SHAYS. When we talk about the size of the Government, I think of our Government in two ways. I think of the way Government spends money on entitlements. Do you call that the size of Government or do you call the size of Government how many employees we have and so on?

Mr. BERNANKE. I'm thinking of Federal outlays, which includes entitlements, because it's the entire amount of outlays that has to be financed by tax revenues.

Mr. SHAYS. We could have large entitlements, but that doesn't increase the size of Government. That increases the budget of the Government. Correct?

Mr. BERNANKE. If you like, I could say it's the budget of the Government that ultimately the Congress has to choose the size.

Mr. SHAYS. In regard to inflation, what is the impact of dollars held overseas? Is there any impact?

Mr. BERNANKE. I think the effect on inflation of dollars held overseas is modest to negligible. Clearly, in determining the domestic money supply, the Federal Reserve has to take into account the share of currency and other forms of money that are held abroad, but we do that, and we essentially offset those overseas holdings in order to achieve the domestic inflation objective that we are trying to reach.

Mr. SHAYS. I'm not clear about that. How do you control the supply of money overseas?

Mr. BERNANKE. We don't. We can't directly control how much money is held overseas, but we can estimate how much is held overseas, compare that to the amount of money which has been issued, and, therefore, determine how much money is being held domestically.

Mr. SHAYS. Are you concerned about counterfeiting overseas? Do you think it is a serious problem, a relatively serious problem, not all that serious?

Mr. BERNANKE. I believe there is a joint report coming out soon by the Federal Reserve and some other agencies, which has found at least in a few cases, some fairly serious issues of counterfeiting. I'm not sufficiently familiar with that report or its contents to be very helpful at this point.

Mr. SHAYS. Let me conclude by just making this comment. I'm very concerned about data security. I've been notified by my own bank that tens of thousands of records have been misplaced. I'm hoping that your office will be paying a tremendous amount of attention to this issue.

Finally, I just want to thank you for your short answers, which gives us more time to ask questions. It is very appreciated.

Thank you, Mr. Chairman.

Chairman OXLEY. The gentleman's time has expired. The gentleman from New York, Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman. Both Mr. Chairmans.

Let me just ask you real quickly as a follow up to some of the questions that Mr. Royce was indicating, talking about the lack of individuals with savings now and a possible cool down of the housing market.

My question to you is what effects will this have with the money that's available for investment, and most importantly, in the short term, the short term interest rates?

Mr. BERNANKE. Congressman, I would say in terms of capital investment, there is currently plenty of funding available. Corporations have retained a lot of these profits they have earned in recent years, and they have very liquid balance sheets.

There have been actually relatively low rates of bank borrowing by corporations because they have sufficient internal funds to finance their investment spending.

Moreover, the general credit conditions still appear to be quite positive. Spreads are low. That is, bankruptcy risk appears to be relatively low.

My sense is that we will continue to see strong growth in capital investment in the U.S. economy, and that is going to be beneficial both in terms of generating demand in the short run, but also in terms of expanding our capacity to produce and our productivity in the longer term.

Mr. MEEKS. Short term interest rates?

Mr. BERNANKE. I can't comment directly on short term interest rates. Obviously, we are still 6 weeks away from the next meeting, and I will have to discuss the state of monetary policy with my colleagues at that meeting.

Mr. MEEKS. I want to ask you two quick questions both related somewhat to trade. One of the major concerns of the Federal Reserve Board is to keep inflation under control, and according to the Bureau of Labor Statistics, the average annual rate of growth of import prices has been only 0.6 percent versus 2.2 percent for overall consumer prices.

My first question is what is the perspective on the role of free trade agreements in controlling inflation? My second question is

there has been growing concern about our trade deficit and current account deficit and its long term effects on our economy.

However, as we say in the Financial Services Committee, financial services has become increasingly a greater share of the U.S. GDP, with almost five percent experiencing a trade surplus of approximately 2.5 to 1.

Some like myself are concerned that trade agreements being negotiated don't focus enough on trade in services, particularly financial services.

My second question to you is are we coming up short in the liberalization of trade in financial services?

Mr. BERNANKE. With respect to your first question, I think free trade has moderated inflation to some extent because of the additional competition, because, as you point out, with a stronger dollar, import prices have been moderate. It has been a positive factor.

With respect to trade, I think there is enormous opportunity to improve trade or increase trade in services. The DOHA round, which is still ongoing, has been working somewhat sequentially. It's been focused initially on agriculture trade, access, terrorists and the like, then on manufacturing, and trade in services has brought up the rear to some extent.

In the United States' case, we are net exporters of services. We are the primary producer of internationally traded services in the world. It's very much in our interest, both bilaterally and multilaterally, to try to increase trade in services and to work towards freer trade in financial services and other types of services as well.

I endorse that sentiment.

Chairman OXLEY. The gentleman's time has expired. Ms. Kelly.

Ms. KELLY. Thank you, Mr. Chairman. Chairman Bernanke, I welcome you here today, and you have been very patient with us.

I'd like to bring up a topic. I unfortunately had to go to another meeting. I don't know if it has been brought up yet. I'd like to ask you about something that your predecessor stated, and that is that markets can only work when participants in the market are not subject to attack and that in his view the market for terrorism insurance should not exist without Government assistance because of the risk of a terrorist attack.

I noticed in your testimony here today you don't discuss unexpected events that could affect the Treasury.

The Treasury study last year confirmed that for high risk cities, they have lowered premiums and improved rates for terrorism insurance.

Since you did not address the question of high risk cities directly in your 2005 testimony on the subject, do you agree with Chairman Greenspan that for these high risk areas, Government provisions for the terrorism insurance market will be necessary for the foreseeable future?

Mr. BERNANKE. Congresswoman, I think it's important to begin by noting that the Terrorism Risk Insurance Act does not contemplate any attacks with costs exceeding $100 billion.

Clearly, there are enormous events that could occur and we hope will never occur, but they could occur, in which there would be no plausible possibility that private insurance could cover that cost,

and, therefore, Congress and the Government would have to try to address the aftermath of that attack as best as possible.

The more difficult question is what about attacks, still large, but nevertheless, more moderate in size, perhaps of similar size to the Katrina event, for example. Again, enormous, but still within the range of historical experience.

My view is that the country is best served by as much as possible developing private sector insurance capability, to the extent that we can, develop capacity in terms of ability to risk rate, to write insurance and to provide reimbursement in the case of an attack. Should an attack occur, we would be better off in that we would have both the private sector insurance and Government resources to fall back on.

Therefore, my view is that we should be working, as the last bill has done, to try over time to increase private sector participation in terrorism risk insurance.

I leave open for now to what extent or how long Government participation will be necessary. I agree that beyond a certain point, there will be no alternative to having Government involvement.

I do think we are moving in the right direction in trying to build private sector participation in this market by increasing the copays and deductibles and the like.

Ms. KELLY. If I understand you correctly, by implication, you are saying that the presence of TRIA as sort of a carrot to the market would allow the market to further pick up some of the risk that otherwise would be borne by the Federal Government in the event of a terrorism attack.

Do I understand that correctly?

Mr. BERNANKE. My objective here is to continue to increase the capacity of the private sector to contribute to terrorist risk insurance and to create resources that will be available in case a major attack were to occur.

I agree that the existing law is moving in the right direction in increasing private sector participation and, on the other hand, I'm comfortable with the fact that Government support still remains at this juncture.

Ms. KELLY. If I understand you correctly, what you are saying is that having TRIA available so that the Federal Government is not the insurer of first resort is an important factor in allowing the private market to cover as much as possible prior to the Federal Government stepping in, in the event of a terrorism attack.

Mr. BERNANKE. I think I agree with what you are saying, the point being that we want to have cooperation between the private and public sectors, with an increasing role for the private sector over time.

Ms. KELLY. Chairman Bernanke, this committee has taken an active role in fighting terrorist use of our financial system. Working with Federal regulators, we have exposed Riggs Bank, the Arab Bank, violations of the law, and we have worked with other agencies to improve the effectiveness of examinations.

Unfortunately, we have seen several cases of banks subject to Federal Reserve supervision who have been violating the law for years without being discovered, particularly, in the more recent case of ABM.

I'd like you to explain to the committee, if you will, how you would strengthen the Federal Reserve's ability to defend our financial system against terrorists who want to use it for their advantage.

I want to know if you think the Federal Reserve has enough staff resources and puts them into the enforcement of the BSA versus its other activities. I'm concerned especially about ABM deliberately violating U.S. laws by trading with Iran for 7 years.

I wonder if you would be willing to address that.

Chairman OXLEY. The gentle lady's time has expired. The Chairman may respond.

Mr. BERNANKE. I just agree it's a very important issue and we are going to work harder and we are going to be particularly focused on the banks' internal mechanisms for making sure that their counterparties are legitimate.

Chairman OXLEY. The gentle lady from California, Ms. Lee.

Ms. LEE. Thank you, Mr. Chairman. Welcome, Mr. Chairman. Congratulations to you.

Let me say a couple of things. First, I'm glad to hear you say that you recognize that a rise in inequality is a concern and a problem, but you also indicated that part of this had to do with the fact that lower wage workers haven't received a higher level of income, those at least who have no more education than a high school education.

I think I heard you correctly, you don't support an increase in the minimum wage. You indicated your policies would be very consistent to Chairman Greenspan. I believe that's probably about where he was. I'm quite frankly very disappointed.

I know you do support the tax cuts and making those tax cuts permanent, and it seems to me if you are really concerned about this rise in inequality, somehow you as our new Federal Reserve Chair would say something about increasing the minimum wage for very low wage workers.

Secondly, part of this rise in inequality has to do with discrimination in mortgage lending. If you look at the home ownership rates, you have approximately 70 percent nationwide with regard to the Caucasian population, yet you have 46 percent African American, 46/47 percent Latino.

There is a huge disparity there. With Mr. Greenspan, we were trying to talk with him about how to make sure that financial institutions provided more mortgage lending to African Americans and Latino's.

Right now, conventional loans, I believe probably most banks provide maybe one to two percent of their conventional loans to African Americans. That is just down right shameful.

Yet, on the other hand again, going back to Mr. Greenspan and if you are going to be consistent with much of his policies and his work, I have to raise these issues with you.

CRA, for example. Many of these banks that receive an A or B on their CRA ratings probably lend one to three percent of their mortgages to African Americans and Latino's. I don't know for the life of me how they can get an outstanding and satisfactory CRA rating, when again, they are not in good faith lending to minority communities.

Finally, just with regard to prime loans and sub-prime loans, the data that came out in October of last year, we have a report, and Mr. Chairman, I'd like to put this in the record.

Chairman OXLEY. Without objection.

Ms. LEE. Thank you, Mr. Chairman. It indicated first of all, taken together, sub-prime loans make up about six percent of all loans to African Americans and Latino's as opposed to two percent to all white borrowers.

We looked at this and decided that FICO scores should be revised and possibly take into account rent, utilities, telephone service as a sign of creditworthiness.

I'm wondering if you would work with us to help improve the scoring process so we can improve this inequality in mortgage lending to minorities in our country.

As you know, and you said earlier, home ownership is really the key to the accumulation of wealth. It's the only way people can send their kids to college, start a small business, and yet you have huge, I mean massive discrimination in mortgage lending to people of color and to minorities in our country. Yet, these financial institutions get off the hook each and every time.

Chairman Greenspan wasn't able to help us figure out a way to rectify this and close this gap. Maybe you can.

Could you respond and tell us what you think we can do?

Mr. BERNANKE. I will comment. Part of the discrepancy relates to the underlying discrepancies in wealth and income, which I agree are a serious problem.

That affects people's ability to afford homes. In some sense, part of the issue goes back to our earlier discussion about helping people build wealth and build income through training and through other methods.

Ms. LEE. An increase in the minimum wage.

Mr. BERNANKE. The minimum wage affects a very small number of workers actually. I don't think it would affect a great majority of people that you are concerned about.

Be that as it may, I just want to say that I do support very strongly fair lending. I will be actively involved in making sure that our fair lending policies are actively prosecuted.

I would also agree with you on the inappropriateness in some circumstances of using FICO scores for evaluating creditworthiness. I know some banks are experimenting with non-standard approaches that take into account people's relatively short credit histories, for example, or alternative backgrounds.

I think that is good banking. I think it is good for the society and the Federal Reserve will work with banks to look at those kinds of alternative approaches.

Chairman OXLEY. The gentle lady's time has expired. The gentleman from New Jersey, Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman, and thank you, Mr. Chairman. I appreciate your being with us on your maiden voyage before this committee. I echo Mr. Shays' comments about the conciseness of your answers in a manner that we can actually understand.

I will be interested as others will be just to see after we are all done in here, as we check the markets, to see how they will respond to all your answers as well.

On that note, I don't know if you saw the article in USA Today, I think it was earlier this week, regarding your predecessor and the impact that your predecessor continues as he goes out and speaks publicly and privately, and then I guess when he speaks privately, rumors swirl around as to exactly what he said privately, and I guess in some cases, allegations are that the dollar actually rose or failed because of his comments.

I just wondered if you had a comment on that as to how the markets are impacted by your comments and by your predecessor's comments still to this day.

Mr. BERNANKE. My only comment on Chairman Greenspan is that according to Government ethics rules and to FOMC rules, it's permissible for a retired Governor to speak in public about the economy, so long as he or she does not divulge confidential information.

I have no indication that he has violated that rule. I have no further comment on that.

Mr. GARRETT. Getting to the questions on the GSEs, just a couple more points, I appreciate your comments as to the importance of them.

I'm just curious, in your mind, whether you think that Fannie and Freddie are really the soundest and the best way that we have to assist homeowners in financing, or is there something else that Congress can do, as we always like to say, to level the proverbial playing field, to provide methods for S&Ls and banks and other financial institutions to get into the market on the same level field as Fannie and Freddie are right now to address the issues that have been already raised as far as increasing the housing market and to provide liquidity.

Is there something else we could be doing aside from Fannie and Freddie?

Mr. BERNANKE. I'd have to hear your specific suggestions. As I indicated before, Fannie and Freddie did a very important service to us, to the economy, to the country, by creating the secondary mortgage markets. They are no longer the only participants. Obviously, there are now large financial institutions which are also involved in creating and servicing these markets.

I think what they do is very valuable. I have no desire to—

Mr. GARRETT. I'll follow up with some of the other models that are out there. I would appreciate your comments as to whether Congress can explore some of these other avenues as well to either supplement or eventually go down the road to a different direction.

Another thing that the House did, it passed this committee, and the House passed the GSE reform legislation. As you know, one of the aspects was what I will call the five percent tax or five percent diversion, always with the laudable goal of trying to provide revenue to those most in need in the housing market.

The question on the other side of that equation comes, and this involves your concerns and mine as well, with regard to portfolio size and limitations. I think we are on the same page. I was fight-

ing for that when your predecessor was here, to try to put those stronger limitations in place.

What is your comment on what the House has done in that area by diverting revenue from the normal revenue stream? Does this put an additional burden on the GSEs to basically go in the other direction that we would want them to into, and that is to increase the portfolio to make up for the lost income?

Mr. BERNANKE. I'm afraid, Congressman, that is out of my purview. It's really up to Congress to decide how they want to manage these kinds of funds.

My main concerns are about financial stability and, therefore, about the fact that we have such a large portfolio which has to be hedged in a complicated dynamic fashion.

Mr. GARRETT. Does it affect their financial stability if there is a pressure on them to increase their portfolio size?

Mr. BERNANKE. I honestly don't know the magnitude of the effect.

Mr. GARRETT. Changing subjects a little bit but keeping the whole area as far as your earlier comments with your concern, also mine, as far as whether it's the size of the Government question, as you were saying, it's actually the size of the budget that we have.

I will be going down to Louisiana in a couple of days again to see what the situation is there now, 7 months or longer after the fact.

Congress has already passed some legislation, appropriations for that measure. As you know, the Administration is talking about additional legislation. There are some proposals out there to go even broader, providing a framework for substantial additional monies for that area.

Can you address if we go in those areas whether that acts as a positive or a negative drag on the economy as the additional size increases for expenditures of the Government for those recovery efforts?

Chairman OXLEY. The gentleman's time has expired. The Chairman may respond.

Mr. BERNANKE. Mechanically, and I'm not endorsing any particular program for Katrina recovery, but building and reconstruction do add to economic activity, and it's one of the reasons why 2006 may be a bit stronger than we otherwise thought.

Chairman OXLEY. The gentleman from Kansas, Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman.

Mr. Chairman, welcome to the committee. In a speech you gave last March of 2005 before the Virginia Association of Economists, you stated that reducing the Federal budget deficit is still a good idea. You said that reducing the deficit would reduce "debt obligations that will have to be serviced by taxpayers in the future."

I have six grandchildren. A lot of us here have children and grandchildren whom I believe would be affected, as you have indicated, by what we do as a country in the future.

I believe Congress should be doing what we can to relieve our children and grandchildren of the burdens we are imposing on them today. One way I think we can do that is to address the deficit/debt issue, to reinstate a rule called pay/go.

In 2002, the pay/go rule in Congress was allowed to expire. It has not been renewed. In fact, former Chairman Greenspan and a group in Congress called the Blue Dog Coalition, which believes in fiscal responsibility, has advocated reinstatement of pay as you go, pay/go rules, that would require Congress to pay for spending increases and revenue reductions.

Should pay/go in your estimation be reinstated? Should it apply to new spending as well as new revenue reductions or tax cuts?

Mr. BERNANKE. First, Congressman, I stand by my statement from my speech from last year. I think reducing the fiscal deficit is very important.

Mr. MOORE. Good.

Mr. BERNANKE. Doing so increases national saving and reduces the burden on our grandchildren.

I'm sorry that I don't feel it is appropriate for me to make recommendations to Congress about their procedures. I do hope Congress will be thinking about the long-term implications of spending and tax programs so that we are looking not just at the very near term, but the very long term implications.

I think that is very sensible. I think in my role as head of the central bank, I should not be involved in making specific recommendations about your internal decision making process.

Mr. MOORE. Are you aware of a pending request for an increase in the debt limit?

Mr. BERNANKE. Yes, I am.

Mr. MOORE. How much is that, sir, if you know?

Mr. BERNANKE. Eight trillion plus.

Mr. MOORE. It would take us up to eight trillion plus. It was at about $900 billion, the request for the debt increase is supposed to come by February of next year. Is that correct?

Mr. BERNANKE. I don't recollect exactly.

Mr. MOORE. I believe about 4 years ago, our Federal debt in this country stood at about $5.7 trillion. Is that your recollection?

Mr. BERNANKE. I don't recollect exactly.

Mr. MOORE. It is now, as you understand, $8.2 trillion. Is that correct?

Mr. BERNANKE. Yes.

Mr. MOORE. We are just digging ourselves a deeper and deeper hole. Is that correct?

Mr. BERNANKE. The deficit is certainly adding to the national debt. The total debt includes a lot of debt which is held by trust funds and the like, so that the so-called debt held by the public is more in the vicinity of $4.5 to $5 trillion. Some of this debt is accounting money held within Government trust funds.

Mr. MOORE. At some point in the future, taxpayers in this country are going to have to make good on this. Isn't that correct, sir?

Mr. BERNANKE. That's correct. I agree with you that we have a very serious long term fiscal problem and we need to begin to address that.

Mr. MOORE. One way to address that would be to reduce substantially the amount of deficit that we incur each year. Isn't that correct?

Mr. BERNANKE. That's correct.

Mr. MOORE. Would it be helpful in your estimation, Mr. Chairman, if we were to go back to the way things were 20 plus years ago before Congress passed a law that allowed the unified budget to include not only tax revenues but Social Security revenues?

Mr. BERNANKE. I think it's important to make the distinction, which is not made so clearly now, between the current budget and the payroll contributions to social insurance.

Mr. MOORE. I have a bill that in fact would do that and take Social Security revenues out of the unified budget. I approached one of my colleagues on the other side of the aisle, and I said I know you believe in fiscal responsibility, and I said you should be on my bill, and he said, Dennis, there's one problem with your bill.

I said what is that. He said it would make our deficits look even larger. I call that telling the truth to the American people, and I think we need to start doing that again.

Thank you, Mr. Chairman.

Chairman OXLEY. The gentleman's time has expired. The gentleman from Ohio, Mr. Gillmor.

Mr. GILLMOR. Thank you, Mr. Chairman.

Let me ask you, in terms of what has been happening in housing, and some people think we have a housing bubble, some don't. I think the Fed position is we don't.

One of the things that has been happening is a great proliferation in zero percent down loans, adjustment of rate mortgages, and that was happening in a time of very low short term rates. Now, those are going up.

Do you see any dangers to the system and what impact is this going to have on those borrowers?

Mr. BERNANKE. Congressman, you are correct that the incidence of these so-called non-traditional mortgage products has been increasing. There are some customers for whom these products are appropriate, but there are also some customers for whom they are probably not appropriate.

The Federal Reserve and the other banking agencies have issued guidance for comment to the banks, asking them first to re-think their underwriting standards, to make sure that when they make a loan of this type, the recipient is able to finance not only their first payment but also the payments that may come later if interest rates adjust, for example.

Secondly, the guidance asks banks to be sure their disclosure to consumers is adequate so the consumers fully understand these complex financial instruments and understand what they are getting into.

Third, that the banks themselves are adequately managing the risks inherent in making these kinds of loans.

We are addressing these issues. These loans are quite popular in terms of new credit extensions. They remain a fairly modest portion of the outstanding mortgages.

This goes back to a question that was asked earlier. I think the one area where they may pose some risks if the housing market slows down might be in the sub-prime area where they have been popular and it's more likely in those cases that they are inappropriate for the borrower.

Mr. GILLMOR. Let me ask you. We have had a pretty good economy for a couple of years after we came out of a recession, a fairly mild one, at the beginning of the decade.

Since the tax relief package of 2003, growth in the GDP has gone up from about 1.3 percent before that to over four percent since then. I think a logical person would conclude that tax relief probably had something to do with it.

The tax relief was temporary. My question is if the tax relief expires, which would amount to basically a tax increase at that point, what if any impact do you think that would have on the economy, jobs, and growth?

Mr. BERNANKE. Congressman, I do agree, and I think most economists would agree that the tax relief earlier this decade was helpful in helping the economy recover from the recession in 2001.

I am going to try to stick to the principle of not directly or indirectly endorsing specific tax or spending programs. I hope you will forgive me for that.

Mr. GILLMOR. You're forgiven.

Mr. BERNANKE. Thank you.

Mr. GILLMOR. I heard what I wanted to hear.

One other question. We have talked a lot about the global savings glut. I guess the question is, is this really a glut or is there a lack of investment demand? Certainly, that glut, the United States is not contributing to the savings glut. If you could comment on that, I would appreciate it.

Mr. BERNANKE. Yes, Congressman. Perhaps the terminology ″savings glut″ was unfortunate. The issue is the amount of global savings relative to the amount of global investment opportunities.

The most striking change in the past 10 or 12 years has been in emerging markets, particularly East Asia, which 10 to 12 years ago were large net borrowers on international capital markets, and now are even much larger net lenders.

If you try to take apart the reasons for that change, it's partly their very high rate of savings, but the change itself is due more to declines in investment outside of China.

Part of the cause of this so-called global savings glut, I believe, is the financial crisis of the late 1990s which reduced in-flows of investment capital expenditure in some of these emerging market economies.

The oil producers also are playing a role here because they are receiving all this oil money. They don't have sufficient opportunities at home for investment. Therefore, they, too, are recycling these funds into the global capital markets.

Mr. GILLMOR. Has my time expired?

Chairman OXLEY. Mr. Ford.

Mr. FORD. Chairman Oxley, thank you.

I know you indicated, Chairman Bernanke, and congratulations. I know they trained you well and you come highly regarded from just about everybody.

I'm from Memphis, and we have a small banking center there. We like to think of it as a big banking center. And all of my supporters and friends and even opponents think very highly of you, so I congratulate you today.

I guess you have indicated you're not going to endorse particular tax packages or not, but if they did do one, would it be in the interest to look at some kind of AMT reform outside of—let me step back.

Is AMT reform something that you think will allow you and the board, as you all make determinations about tightening or loosening a policy, would the AMT relief help as you move forward, or would it hinder, or is it hard to say?

Mr. BERNANKE. Well, AMT reform is reducing revenues.

Looking forward, we would factor that into our projections of Government spending and revenues.

Relevant to some of the issues we were talking about before, with no other change being made, and I'm speaking here arithmetically, AMT reform is going to increase the deficit because it's going to lower tax revenues. So that's an issue.

I'm not commenting on the AMT as a tax. I understand that many Congresspeople have considerable concerns about the AMT as a tax, and so it's really your choice as to how you proceed with that tax.

Mr. FORD. Let me ask you this.

You've mentioned the deficit, then, and so forth, so in light of what Mr. Moore said, would that mean—I don't want to put words in your mouth, but we're going to probably have a vote here soon on raising the debt ceiling. Is that something Congress should do?

Mr. BERNANKE. When Congress passes a spending act or a tax act, that has implications for the amount of debt.

Arithmetically, that has implications for the amount of debt the Government is going to take on. And therefore, I think that the debt ceiling doesn't really provide much additional value.

The Congress ought to be contemplating the effects of its spending and tax actions on the debt and the deficit as it goes along, with each determination, both in the short run and in the long run.

Mr. FORD. In our most recent budget, or the budget that Congress is considering now, and Mr. Moore and I serve on the Budget Committee, in the President's numbers, there was no inclusion of any monies for the war in Iraq and Afghanistan.

If we do a budget, when Congress puts its budget together, would you recommend that at a minimum we put everything in there, so at least you're working with either X deficit or X-plus deficit, at least you know what you're working with, before your colleagues and you convene here in the near future? Would you recommend we include those numbers in the budget?

Mr. BERNANKE. At the Federal Reserve, when we make forecasts of budgets, we try to make the most realistic forecasts we can, and we try to take into account all features of what Congress is likely to do, both on the tax side, say AMT, and on the spending side.

So yes, clearly, good planning requires you to think hard about what you believe actual spending needs are going to be.

Mr. FORD. Thank you.

Let me ask you one or two other quick questions, Mr. Chairman, just as relates to some of the concerns that those in my district have about a variety of things.

Despite an unemployment rate of 4.7 percent, both the employment cost index and average hourly earnings suggest that labor

costs remain quite well behaved due to the strong productivity growth.

Corporate profit margins remain robust, giving firms a cushion against price shocks and competition, sustaining a strong bias toward cost control that has short-circuited the field inflationary spiral.

Is it simply fear of rising inflationary expectations rather than actual inflation that will drive further Fed tightening or other factors?

Mr. BERNANKE. Congressman, when we make policy, we have to take into account the fact that monetary policy works with a lag. It doesn't affect the economy in a day or a week or a month. It has its effects over 6 months, a year, or 18 months.

And so we have to think about the forecast. We have to think about how the economy is likely to evolve over the next year or two.

In addition, inflation expectations are important as an independent factor because, as I was indicating earlier, when inflation expectations themselves, as measured by surveys, for example, are low and stable, the economy itself will be more stable when it's hit by other kinds of shocks.

So we do care about both inflation and inflation expectations.

Mr. FORD. And finally, as Congress considers a variety of not only tax reform packages but even reform packages as relates to how we spend on pork spending here in the Congress or earmarks, as we like to call them, but the public calls them pork spending, you would recommend that as we look at spending and tax policies that we try our hardest—now let me say, I hate to put you on the record, Mr. Chairman, but I think it's important for all of us here who like to spend and who like to cut taxes to understand that they have real implications as the debt continues to rise.

Is that fair to say? If our policies cause the debt to rise, that has real implications on what you do and what you don't do?

Mr. BERNANKE. Increased deficits are a negative for the economy, certainly.

Mr. FORD. Huge deficits are a negative for the economy?

Mr. BERNANKE. Yes.

Mr. FORD. So those who continue to cite the debt as a small percentage of, or they cite it as 2.5 or 3.5, only 4.5 percent of all that we spend, you think the number itself, so 8 trillion versus this number compared to the economy, is as important as the percentage of our overall spending?

Mr. BERNANKE. Well, I think it is important to look at the percentage of the deficit as a share of GDP because that gives some indication of how big it is relative to the size of the economy.

The point I tried to make earlier is that my particular concern is about the long run obligations of the Federal Government on the entitlements side, in particular, which are going to be putting a lot of pressure on the Federal deficit and the Federal budget in the long run.

In the short run, we need to begin to plan ahead for those contingencies, and that means trying to be as efficient as possible in our spending and tax policies in the near term, as well.

Mr. FORD. Thank you, Mr. Chairman, for the indulgence.

Chairman OXLEY. The gentleman from Georgia, Dr. Price.

Mr. PRICE. Thank you, Mr. Chairman.

And I welcome you, Mr. Chairman and wish you the very best in your new role, and I want to echo some others and thank you for the responsiveness that you have given this morning to your questions.

There are some benefits to coming late in the questioning, and one of them is that oftentimes we have an opportunity to clarify the record.

There have been some things said that I'd like to just get your comment on.

It's been said that the economic policies that we currently have are, quote, "not working for the average American," unquote.

Would you say that our economic policies are not working for the average American?

Mr. BERNANKE. The economy as a whole has recovered very strongly from the slow period earlier this decade, and I think that's very positive.

We have strong GDP growth. We have low inflation. We have strong productivity growth.

Compare our economy to many other industrial economies. We see that we've had a very good run.

Mr. PRICE. All those things are positive for the average American?

Mr. BERNANKE. All those things are quite positive.

The issue, the specific issue which we've been discussing is the fact that there has been some indication of increased inequality in wages and incomes, and a point I tried to make is that this is a relatively long-term—

Mr. PRICE. Correct.

Mr. BERNANKE.—feature of the economy that goes back probably at least to about 1980, when we began to see the increased return to skills and education leading to a greater—

Mr. PRICE. I would agree. I would agree.

It's also been stated that we have as a Nation, quote, "disastrous trade policies," unquote.

Would you say that we had disastrous trade policies in place?

Mr. BERNANKE. No, I wouldn't say that.

Mr. PRICE. Thank you.

Mr. BERNANKE. I think we—

Mr. PRICE. I want to go on because I've got some other questions. I appreciate that response.

Regarding home ownership, it's been stated by some folks on the other side that, quote, "There is massive discrimination," unquote, in the provision of mortgages.

It's my understanding that home ownership for our Nation is at an all-time high, and that for comparable levels of wealth and income, do you believe that there's, quote, "massive discrimination," unquote, in the provision of home mortgages for those comparable levels of wealth and income?

Mr. BERNANKE. I tried to make the point in my answer to that question that I thought a large part of the difference had to do with the differences in income and wealth between different groups in

the population, which in itself is an issue that, you know, we hope to address over time.

Mr. PRICE. Indeed.

Mr. BERNANKE. I don't think that there is massive discrimination, but I think that it does exist, and I think it's important for the Federal Reserve and other agencies to look carefully and make sure that banks and other lenders obey the law in their mortgage extension.

Mr. PRICE. Okay. Thank you.

I want to switch gears, if I may, because I think it's appropriate and important that you brought up the demographic changes that we have occurring in our Nation.

And I think you said that those things needed to be addressed soon, and I would agree with that.

Some have suggested in the area of Social Security that everything is fine, that we don't need to do anything right now, that, in fact, we may not need to do anything until 2042 or 2052.

What's your view on the speed at which Congress should address the issue of Social Security reform?

Mr. BERNANKE. I would just raise the point that people who are 35 years old today will not be retiring until 30 years from now, and the sooner we can address these issues and make whatever changes we are going to make, if we do make changes, the fairer it is to those people, because then they can better make their own plans, change their savings behavior, for example, so the sooner we can address these issues, the better.

Moreover, from the point of view of financial markets and the like, the more confidence they have that Government is going to address these long-term deficits, probably the better the terms that we'll be able to borrow on and the more confidence there will be in those markets.

Mr. PRICE. Thank you.

There are some proposals that we ought to price index Social Security payments.

Do you have any view as to that?

Mr. BERNANKE. I don't think I'll go into that issue.

Mr. PRICE. I want to switch to the savings rate. I have, as I know that you do, real concerns about our level of individual personal savings.

Do you have a sense as to what the appropriate level is for personal savings in terms of retirement security for an individual?

Mr. BERNANKE. It depends very much on the person's expectations in retirement, when they expect to retire, will they continue to work, and the like.

I mean, one of the things which makes all this so difficult to forecast is that lifestyles are changing.

We no longer have people retiring to Florida 100 percent of the time necessarily. Many people continue to work part-time, or work longer. My predecessor worked a bit beyond age 65, for example.

So the amount of savings that people, individuals, have to do depends a lot on their plans and expectations.

I think that it's arguable that a large share of the population is not saving enough to significantly augment Social Security and, therefore, to guarantee a comfortable retirement.

Chairman OXLEY. The gentleman's time has expired.

Mr. PRICE. Thank you, Mr. Chairman.

Chairman OXLEY. The gentleman from Texas, Mr. Hinojosa.

Mr. HINOJOSA. Thank you, Mr. Chairman.

Chairman Bernanke, thank you for coming before our committee to testify.

I realize that many have discussed the issue of China's yaun, the currency exchange rate, with you and that you're likely more familiar with all the models and mechanics that go into it than I am.

Some have likely expressed concern about the decision of the Chinese to create a controlled float of their currency based on a basket of certain foreign currency exchange rates, including the dollar, the Euro, and other currencies.

Other Members may have expressed support for China's decision, especially in light of what some have said to be its arguably unstable banking system.

I understand further that many U.S. institutions are taking certain actions, such as making investments in China's financial services sector, to bolster the Chinese banking system and its economy.

However, in economics, there truly is no black and white, but only shades of gray.

In light of that perspective, how do you think the economies of the U.S. and China will fare in the future?

Are they as interdependent as many claim? If so, do you foresee any potential conflicts arising between these two countries in the near or distant future in light of China's amazingly fast growth and its ever-increasing economic demand for raw materials, including iron, steel, and petrol?

Chairman OXLEY. Congressman, as we've seen in earlier episodes, such as the emergence of the Asian tigers or the emergence of Japan, when a new economic power comes into the global scene, it can produce lots of stresses and strains, and we have observed some of those stresses and strains.

I think, though, that one of the stresses and strains that you already alluded to is the competition for global resources.

Certainly one of the reasons that oil prices have gone up as much as they have is the increased demand for petroleum products by China.

I do believe that there's an enormous amount of opportunity for cooperation between the United States and China in terms of trade, in terms of foreign investment, and I hope that will proceed positively, although I think I can safely predict there are going to be bumps in the road as these stresses and strains manifest themselves.

I hope we'll continue to work positively with China and that when we have disagreements, that we'll work through international agencies like the World Trade Organization or others to try to resolve them as effectively as possible.

Mr. HINOJOSA. Since 9/11, we have reduced the number of student visas from China and many other foreign countries, and yet when you combine China, India, and Taiwan, they're producing about 700,000 engineers and technicians, and we're only producing about 70,000.

So this worries me because we don't seem to have the mindset here in Congress to really invest heavily to be able to get more students into that pipeline in early years—third, fourth, fifth, sixth grade—so that they can get into those stem careers—science, technology, engineering, math.

And it worries me that we just continue to increase the amount that we're importing from China and we're falling behind in producing those engineers.

What do you recommend to those of us who have a responsibility to correct the acute shortage of scientists and engineers that I've mentioned to you?

Mr. BERNANKE. Congressman, a theme that's come up a few times in this hearing is education, and I agree a lot could be done for American K-12 education and for universities, as well, and Congress has a role to play there, and I hope that you'll continue to play a positive role in that area.

On the number of engineers being produced, sometimes it's a question of apples and oranges. I'm not sure that an engineer is an engineer is an engineer. There are obviously different levels of qualifications and skills.

And I think the United States, while we have to always be careful and look to our position in the world, remains a technological leader in terms of our skills, in terms of our technology and our research and development, so that's positive.

I'd make one suggestion, or give one thought on the issue of engineers and scientists, which is that simply producing more engineers and scientists may not be the answer because the labor market for those workers will simply reflect lower wages or perhaps greater unemployment for those workers.

Currently, there's not an obvious shortage of scientists and engineers in terms of the labor market indicators. That is, wages for engineers are not rising more rapidly than other professionals.

So I think one way to address this issue is to ask, are there ways in which the Government can support basic research and in some sense produce a demand side that strengthens the market, that therefore brings people into science and engineering because there are opportunities there, not simply creating a bigger supply, which will then compete and drive down the wages in that category.

Chairman OXLEY. The gentleman's time has expired.

Mr. PRICE. Thank you, Mr. Chairman.

Chairman OXLEY. The gentleman from New Mexico, Mr. Pearce.

Mr. PEARCE. Thank you, Mr. Chairman.

Chairman Bernanke, thank you very much.

In the responses to inflationary pressures of energy, the idea of a supply increase, current supply increase of oil and gas, did not come up. Isn't that the easiest way to stem the price?

Mr. BERNANKE. Certainly. It is a way, certainly, to respond. And high prices in themselves of course provide an incentive to produce more supply.

Unfortunately, a very large part of the world's oil reserves are located in areas—

Mr. PEARCE. In the U.S., we're artificially restricting through regulation and through restriction of access to the outer continental shelf and the—

Mr. BERNANKE. I argued earlier for regulation that accomplishes its purposes, that's sensible and predictable so that people will meet the standards being set but will not be arbitrarily delayed by ongoing port challenges, for example.

Mr. PEARCE. You had mentioned the appropriate size of the Federal Government was the function of Congress.

Looking at Germany and the stagnation that they've had because it appears that there's a relationship between the high percent of Government spending to GDP. What is the target range where an economy will stay vital and growing versus stagnant?

Mr. BERNANKE. I don't have a target range to give you. If you have a higher share of Government spending in the economy, I think a lot depends on how well the money is spent. Is it being spent in ways that promote growth, for example, by creating skills or supporting research?

If it's being spent in wasteful ways, obviously, that's a heavy burden on the economy, not only because of the resources being directly used, but because higher taxes in themselves will distort economic decisions and make the economy less efficient.

Mr. PEARCE. Looking 10 years into the future, when we're in the depth of the baby boom retirement and the number of skilled workers available, and again setting aside skilled versus unskilled on immigration, do you see enough reason that we'd need workers to come into the country, or do you think we can solve our internal problems with the people who are available in the next generations?

Mr. BERNANKE. Well, I think first of all that immigrants are an important source of energy, vitality, and work ethic, so I think immigrants are very positive for the economy, and I wouldn't make it an either/or proposition.

I think we should allow legal immigrants, but I think we should also make sure that our own citizens are well educated, well prepared, and able to—

Mr. PEARCE. But as far as the quantity of workers, you don't have an opinion?

Mr. BERNANKE. No. The economy grows along with the quantity of workers available, so if there are more workers, the economy will just be correspondingly bigger.

Mr. PEARCE. There is speculation, Mr. Chairman, that you would encourage a transition from the dual mission of price stability and full employment mission of the Fed to a single mission of inflation targeting.

Do you intend to lobby for that change or to encourage that change to occur?

Mr. BERNANKE. Absolutely not, Congressman. I completely subscribe to the dual mandate of price stability and maximum sustainable employment.

The modest and incremental changes which I have discussed and which I will continue to discuss with my colleagues are intended solely to allow the Federal Reserve to meet both parts of its mandate more effectively and more efficiently.

Mr. PEARCE. The idea of surpluses as far as the eye could see back at the end of the Clinton time, was that a real phenomenon or was that a fictitious phenomenon?

In other words, what we've heard testimony as the dotcom ramp-up and the associated capital gains off those stocks that were valued at zero and went very high, that the entire increase of revenues and projection of revenues was simply those imaginary increases which then deflated back down, and actually the revenues, when they sank, sank back to where they were consistent with the increase before—was that a fictitious thing or were those—should we have increased the size of our budget based on those surpluses?

Mr. BERNANKE. The share of GDP that took the form of revenues in 2000 was about 21 percent, which was the post-war high, and certainly in retrospect, we can say that a good bit of that was due to the unsustainably high level of the stock market, in particular, capital gains, bonuses, and stock options, and the fact that firms did not have to contribute so much to their pension plans because their valuations were rising with the stock market and, therefore, they reported higher profits.

So a significant portion of the tax collection clearly was related to the stock market boom of that period.

Chairman OXLEY. The gentleman's time has expired.

The gentleman from New York, Mr. Crowley.

Mr. CROWLEY. Thank you, Mr. Chairman.

Thank you, Mr. Chairman, and welcome to the committee on the first of many, many visits to this room and before this committee.

I have a question dealing with some of the legislative proposals being recommended by the President and Republican Congress with respect to the health insurance that's provided to American workers and to their families.

And I'd like to begin by pointing out some what I believe are very scary facts about the Bush administration and this Congress with respect to the care of American workers.

The fact is that between 2000 and 2004, the number of Americans lacking health insurance grew by 6 million to almost 46 million Americans, and that number is growing; it is not shrinking.

Another fact is that in 2004, the percentage of people with employer-provided health insurance declined for the fourth year in a row; 3.7 fewer people had it in 2004 than had it in 2000.

Now as a so-called remedy, the President, in the 2000 budget, is calling for the expansion of health savings accounts.

The Administration's budget would give greater tax breaks to people who shift health insurance plans with a high annual deductible from $1,050 or more, compared to the $300 to $400 of deductible found commonly among employer-sponsored insurance plans.

At least 3 million people have high deductible health insurance, but this still represents a small segment of the about 195 million Americans with private health coverage.

I believe the HSA plan would encourage employers to opt out of traditional health insurance plans they offer to workers and their families and place them with these HSAs, allowing workers to save under these plans for their own health care choices, albeit paying far, far more than they would in the annual deductibles that they have in their present plans, three or four times more.

The Administration touts studies showing that HSAs would appeal to higher-income workers, as it allows individuals to accumulate money tax free in accounts that they can take with them from

job to job, but studies also show that low-income and middle-income people have little if any leeway in their own budgets to accumulate or save money in HSAs. We can't get them to save in bank accounts.

And this is something that was reinforced in this year's Economic Report of the President drafted by the Council of Economic Advisors, which you chaired until you assumed this new position.

This report shows the U.S.A. has a negative savings rate, something we haven't seen since the Great Depression.

So seeing the President's plan for HSAs, which are based on workers saving money for their own health care, and your own council's report that workers have a negative savings rate in our country, and that other tax incentives for savings have could you tell me how can workers, especially middle-income and lower-income workers, actually save the funds to create so-called health savings accounts when they haven't taken advantage of IRAs and other savings mechanisms? Can you give us an example?

Mr. BERNANKE. Congressman, first of all, let me just acknowledge the very important problem of the rising cost of health care.

I mean, that is the underlying reason that the price of insurance remains high, why employers are either dropping plans or increasing the share that they require their employees to pay.

So that is the underlying problem, and I urge Congress to make this a very high priority because it's something that bears not only on the efficiency and competitiveness of our economy today, but obviously, through Medicare and Medicaid, it has an important implication for our long-term fiscal stability.

Unfortunately, as you've mentioned before, I had a different hat. I've changed hats. I'm now at the central bank.

And I think again, as I've mentioned, in my current role, I'd like to stay away from endorsing, either directly or indirectly, specific plans.

I guess a question I'm not really even sure of the answer to is exactly what the 3 million HSAs have been taking up.

I don't know precisely, but I don't think that it's been entirely upper-income people who have taken those up. I don't know that—

Mr. CROWLEY. I'm not asking you for an endorsement, Mr. Chairman, for this plan or for any plan at this point in time.

But what I'm asking for I guess is do you think it's realistic if lower-income Americans and middle-income Americans are not taking advantage of tax incentives to save right now, or fully taking advantage of them, how can we expect them to then now save for health care when they don't have the resources to save for themselves, for health care and a higher deductible than they are right now?

I mean, where's the incentive for them to do that?

Mr. BERNANKE. My understanding of the President's budget is that it includes tax credits and other assistance to lower-income people who—

Mr. CROWLEY. If they're not using those right now for other forms of savings, how are we to believe they're going to use them for their own health?

I mean, it just goes to show they live paycheck to paycheck. How can they then therefore afford to pay for their health if they're not even paying for their future?

Chairman OXLEY. The gentleman's time has expired.

Mr. CROWLEY. I thank the chairman.

Chairman OXLEY. The gentleman from Pennsylvania, Mr. Fitzpatrick.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

Good afternoon, Chairman Bernanke, and welcome.

I represent Southeastern Pennsylvania, including Bucks County, which is near to your old neighborhood, and we appreciate your service in this way.

We also value education very highly. A number of questions today about education.

I'm proud to see that, especially in the area of science, the nations of China and India are investing very heavily now, we've had that discussion, in science and technology and engineering.

The New York Times journalist, Thomas Friedman, wrote a book called, "The World is Flat" which stands for the proposition that as we lose this race in education—science, technology, engineering, and math—this is not only bad for the economy, but it also may rise to the level of a national security threat.

I was wondering if you shared that opinion.

Mr. BERNANKE. I think it's somewhat overstated at this point in time.

The United States is still a far richer country than China, for example, and we still have a very substantial world leadership in technology and in high-tech skills and high-tech industries.

Having said that, I agree absolutely that it's important that we work hard to maintain that leadership, and that should take place through continued support of research and development, education, and all the things that you mentioned.

Mr. FITZPATRICK. I appreciated your comments earlier that it's important not just to train in these areas of science and technology but also to make sure that there are jobs available and there's opportunity and opportunity for wage increases in those areas.

The President recently has made quite a number of comments about the need to invest in alternative fuels.

Do you feel as though this new area, this new area of investment, this area that we need to go to as a Nation, will provide opportunity for scientists and engineers in the future here in America?

Mr. BERNANKE. There is a case, I think, for the Government to be involved in basic research, that is, research that private companies would not find it in their interest to undertake because they would not feel able to capture the financial benefits of that research.

Energy has been an area where the Government has played a very important role in developing new technologies, so my general answer is yes, but I would say that the Government's role should be more at the upstream end, ant more basic levels, because more downstream, the corporations will have sufficient incentive from the market to implement these new technologies and to develop them.

Mr. FITZPATRICK. Yes, sir, and I want to associate—I appreciate your comments earlier regarding technical education and community colleges.

This is a town with a lot of programs, a lot of programs about education create at different times, and disparate kind of treatment of these programs.

Do you have any—would you have any public policy suggestions on ways to better coordinate the way we here in the Nation's capital deal with funding education?

Mr. BERNANKE. I can make one suggestion, which is that what we think about funding the student rather than the school, that is, that we provide individuals with the choice where they want to go and how they want to use money, rather than necessarily funding the institution.

So in that respect, we utilize the market and choice as a way of creating competition among different schools and institutions.

So that's one strategy, a general strategy that one might consider.

Mr. FITZPATRICK. Thank you, I appreciate that. I yield back.

Chairman OXLEY. The gentleman yields back.

The gentleman from Utah, Mr. Matheson. Congratulations to your constituent on a gold medal.

Mr. MATHESON. We appreciate your acknowledging that, Mr. Chairman. Winter sports capital, you know.

Chairman OXLEY. Yeah, we don't have too many skiers in Ohio.

Mr. MATHESON. You're welcome to come and spend all the money in skiing in Utah that you want.

Mr. Chairman, thank you and welcome to your first hearing before the committee.

I do want to reiterate what a couple of my colleagues said about the importance of getting our fiscal house in order, and I appreciate your comments on stating the case for why, over a prolonged period, continued deficit spending creates some concerns, and I encourage you to be forceful on that.

And while I don't expect you to come up with a specific spending cut or tax issue or whatnot on that, I would suggest that Congress had budget enforcement rules in place they enacted in 1990; they expired at the end of 2001; they were an important structural component of what allowed us to get our arms—Congress to get its arms around what I thought was an out-of-control deficit and actually move to a surplus, and I think that that would be something that I would suggest you might want to advocate for going forward, as putting in some of those structural components that help move us to more of a reasonable fiscal policy at the Congressional level.

I think that would be real helpful if you would do that, and I want to associate myself with the comments of Mr. Moore, who raised those issues.

A question I wanted to ask you is, I know the Federal Reserve has expressed, and some folks on this committee for that matter, have expressed concerns about the mixing of banking and commerce, when the commercial entity is owned by a corporation.

And I wanted to ask you about that issue in the context of many independent banks that are owned by businesspeople who also own other local businesses, commercial businesses, for example.

Does the Federal Reserve's concern about mixing banking and commerce extend to the common individual or family ownership of banks and non-financial commercial businesses?

Mr. BERNANKE. I don't believe so, as long as the businesses are legally separate. I may be mistaken, but that's my understanding.

Mr. MATHESON. But I am talking about common ownership in terms of a local bank and—so you're not concerned about the mixing of banking and commerce with the same ownership?

Mr. BERNANKE. I don't think so, but I would like to think about it a bit more.

Mr. MATHESON. Okay. I would encourage that, as we hear these discussions about banking and commerce, and obviously you've heard from other colleagues on the committee related to the industrial loan companies there may be a broader issue out there in other constituencies that, you know, those same discussions maybe should be looking at.

And in terms of the industrial loan company discussions, you know, the state I'm from is the State of Utah.

What I would suggest is that we have an even-handed approach in looking at this issue, in trying to make sure that when it comes to the information that is put out about the issue that it is accurate, and we can tone down some of the rhetoric.

I think an even-handed approach of looking at this serves everybody, both this committee and the Federal Reserve and everybody in the best way possible, and I encourage the tone of that discussion to take on that.

That would be my other suggestion for you, as you take your role as chairman.

With that, Mr. Chairman, I yield back the balance of my time.

Chairman OXLEY. The gentleman yields back.

The gentleman from Georgia, Mr. Scott.

Mr. SCOTT. Thank you.

Thank you, Mr. Chairman.

Mr. Chairman, I certainly want to welcome you to your new position, and you come with such great credentials from Harvard, MIT, Princeton.

It seems like the only one you're missing is the Wharton School of Finance at the University of Pennsylvania.

Of course, that's where I graduated from, but I won't hold that against you, because you have the one sterling criterion, which is you're a native of my home state of Georgia, so as a fellow Georgian, I welcome you.

Let me start out by first of all reading something you said, which I think is very interesting, concerning your independence. You made a very, very good statement.

You said in your hearings, you stated, "I will be strictly independent of all political influences and will be guided solely by my mandate from Congress and the public interest"—which is very good.

I want to give you this opportunity to begin that process.

This deals with our tax relief package, the tax cuts, the permanency of tax cuts at a time of great uncertainty and great demands.

You're looking at one here who supported the tax cuts, the earlier tax cut relief because I thought they did well in stimulating the economy, and they did so.

But permanency at a time when our fiscal health is in dire straits, at a time of great uncertainty—we don't know what energy costs are going to be; we don't understand and fully grasp the meaning of what the war on terror is going to be; we've not been able to adequately even respond to natural disasters like Katrina at a time when global warming says there are going to be more of these. In order to offset these tax cuts, we're going to have to cut dire programs of the American people—Medicare, Medicaid, 45 million Americans have no health insurance at all; on top of that, we are borrowing 45 percent of our debt from foreign countries, over half of it from China, India, and Japan, at extraordinary interest rates in and of themselves, and that debt has gone, just to our foreigners, from 1 to 20 trillion dollars in just the last 2 years.

My point is, if you're going to really respond to the mandate of Congress and the public interest, I urge you to speak independently.

When the President asks you, "Is this the time," not whether tax cuts are good, not whether making them permanent is good, but given the crisis, the situation that our financial health is in, "This is not the time to make them permanent, Mr. President."

Would you do that?

Mr. BERNANKE. I stand by my earlier statement that I'm going to be independent and nonpartisan, and I think making a specific recommendation as to a specific tax—

Mr. SCOTT. Well, would you make the recommendations? Would you make the case?

You are our number one economist. You are the person that we all look to for that advice.

You can't just sit there and say, "I'm not going to." I mean, you're not there to just sit on the middle of the fence and not do anything.

Mr. BERNANKE. No, but—

Mr. SCOTT. These are serious issues, and I believe that given your background and your interest—and I've read your background very thoroughly—I'm just urging you—and I'll take back; I'm not going to put you on the spot, and I understand where you're coming from on that.

But I just urge you to use your position to speak to the critical nature of the financial health we're in, that it would be foolhardy to make a permanent tax cut on issues at times when this Nation is in such a perilous state with our financial health and our debt and all the other things that I had mentioned.

Now, before my time is up, I do want to go to another point that you talked earlier about, the dual mission of fighting inflation and growing employment. Those are the two dual missions of your mission.

And you spoke earlier about your affection for targeting inflation, or targeted inflation, and you said that that would not take away from the other side of the mission of employment.

What I'd like to urge you to do is to target employment. If you're going to have a targeting of inflation as a part of your portfolio as you come in, which is good, I urge you to have a targeting of em-

ployment, because again, let me just tell you or show you just a few of the statistics here, and I'll be very brief—

Chairman OXLEY. The gentleman's time has expired. Will you wrap up?

Mr. SCOTT. Yes, I will—that there are 37 million people who are classified as poor now that were not in 2000, and over that same period, there was a 24 percent increase in the number of families considered desperately poor, and that there is another burgeoning class of folks who have just given up, who are discouraged, and are not even seeking employment.

We have a terrible problem in unemployment in this country. It is not a rosy picture.

And what I urge to you would be, just as you target inflation, let's have some targeting of employment.

Chairman OXLEY. The gentleman from Alabama, Mr. Davis.

Mr. DAVIS. Thank you, Mr. Chairman.

Chairman Bernanke, welcome to the committee and thank you for being indulgent enough to stay past your allotted and appointed time.

Let me come at Mr. Scott's first question from a slightly different angle.

As you've, I think, already figured out about Washington, D.C., most of our policy arguments tend to get reduced to very stark either/or propositions.

People on my side of the aisle tend to be very skeptical of the tax cuts and tend to say that, all things being equal, we'd just as soon repeal them.

People on the other side of the aisle say that the tax cuts in their entirety are indispensable to the health of the economy.

There obviously is a middle ground in which a significant portion of the tax cuts would be retained, but there would be some adjustment in the marginal rates.

For example, if my numbers are right, the average person earning over $1 million gets roughly $103-105,000 in tax relief a year.

You could shave that number down slightly by making a few adjustments to the marginal rate go down to say 85 to 90. That person will still get a substantial tax cut.

The budget would recoup enough money to altogether pay for the cost of some of the budget cuts that have been debated the last few years.

I fully understand that your function is not to weigh into given disputes about policy choices, but let me ask you a broader question.

Can we make marginal readjustments to the tax rate without doing violence to the economic recovery?

Mr. BERNANKE. Again, if I may address the former question as well, I do think it's very important for me to talk about the broad issues here, and I think again the fundamental issue is the size of the Government budget.

Now, you asked me if you could make marginal changes to the tax.

You can make marginal changes probably to anything. You could also make marginal changes to spending, of course, you know.

And my point only is that while it's up to me, I think, to point out the necessity of maintaining fiscal discipline over the long period, I just don't want to be injecting myself into the specifics of how to do that. I think that's Congress's prerogative.

Mr. DAVIS. And I fully agree with you and understand that, but I just want to isolate that point and don't want to stretch out things by asking you to repeat it.

But it seems you agree that of course, as with anything, you can make marginal changes without doing violence.

That is not a minor observation in the context of these debates because, as you know, people on one side of the debate tend to say, "No, we need every single dime from these Medicaid cuts; we need every dime from these Medicare cuts; and we can't forego one inch of the tax cuts because it would slow down the economy." That's the way the argument plays out.

Let me ask you a secondary question.

Mr. Frank asked you a number of questions earlier about the phenomenon of income and equality, and I understood you to endorse Chairman Greenspan's observations that we have a problem in that area.

Once again, we put it in context. There's an interesting phenomenon that we see in our budget debates.

It's the phenomenon of cuts that are inconsequential as far as the deficit goes, but are enormously significant to the affected individuals.

Classic example: the Congress, by a very narrow margin a few weeks ago, approved a budget reconciliation package that saves about $3.5 billion worth of Medicaid, as you know, a fractional amount in a $2.9 trillion discretionary budget.

At the same time, even that small amount it's estimated will raise costs and premiums for 13 million Medicaid recipients. CBO estimates that the effect of that will be 60,000 people losing their Medicaid coverage.

So the question that I would pose to you is, should we be concerned, or what's your reaction to this phenomenon of budget cuts that are frankly inconsequential as far as the deficit goes but that could widen the economic inequality which you decry?

Mr. BERNANKE. Well, every cut is going to be painful to somebody.

I mean, it's really, you know—

Mr. DAVIS. But some could widen the inequality, couldn't they?

Mr. BERNANKE. I think that, again, without being too specific, I think the question is what is the best way to use the money, and there may be different programs that are more effective than others.

Mr. DAVIS. But the last point, as my time runs out, you would acknowledge that some policy choices by the Congress could have the effect of actually exacerbating the income inequality which you were concerned about?

Obviously, making poor people pay more for health care takes more of their discretionary income away and that could tend to widen the gulf between rich and poor. You would agree with that, I assume?

Mr. BERNANKE. There may be different ways of paying for a cut, though.

There could be ways you could transfer from some other program, so—

Mr. DAVIS. Right, but there are ways of paying for it that widen inequality.

Mr. BERNANKE. This is why these are value judgments, and there's no scientific way to answer your question.

It's up to the Congress to decide what are the priorities that we want to address, be it on the tax side or on the spending side.

This is what the people have elected you to do, and clearly it's your responsibility.

Mr. DAVIS. Thank you—

Chairman OXLEY. The gentleman's time has expired.

And batting cleanup, the gentleman from Missouri, Mr. Cleaver.

Mr. CLEAVER. Thank you, Mr. Chairman.

Mr. Bernanke, Mr. Chairman, do you support the seniority system in Congress that made me the last person to have the chance to discuss with you, and do you believe that it contributes to, let's say, inflation of the bladder if—

Go ahead, Mr. Chairman.

Mr. BERNANKE. I'm very interested in hearing your question, sir.

Mr. CLEAVER. I am extremely concerned about the debt, as I think many of my colleagues have expressed, with China, Japan, and the U.K. holding $1.3 trillion of that debt.

What impact on the U.S. economy would take place if China made the decision that they would invest internally or in Europe rather than the U.S.? If they called in their debt, what happens to the U.S. economy?

The Chinese hold like $255 billion of our debt. What happens if they call it in?

Mr. BERNANKE. Congressman, China is not holding our debt because they want to be nice to us.

They're holding it because they value the fact that this debt is being traded in deep, liquid, and safe financial markets, and so their own interest is in holding this debt.

And despite occasional rumors of diversification and the like, generally speaking, there's not been, as far as I know, any significant changes in the amount of debt, U.S. debt or U.S. dollar-denominated assets being held by China, and any sharp change really would not be in their interest to undertake.

I think that the financial markets are really very deep and liquid for U.S. dollar assets.

If you include not only U.S. Government debt, GSE debt, but also highly rated corporate debt, for example, the size of the market for high-rated U.S. dollar credit instruments is perhaps $40 trillion, something along those lines, which means that China is only holding a few percentage points of that debt.

So I'm not deeply concerned about this issue. I think that realistic changes in China's portfolio are not going to have major impacts on U.S. asset prices or interest rates.

The issue is not so much the change in China's portfolio. The issue really is the fact that we are consuming more than we are producing domestically.

That means that foreign debt is increasing, and there may come a period or a time when foreigners are not willing to continue to add to their holdings of U.S. dollar assets, and that will in turn lead to perhaps an uncomfortable adjustment in the current account.

Mr. CLEAVER. That's where I'm going.

Mr. BERNANKE. Right. It has not so much to do with the portfolio choices in the short run.

It's really whether over the long period, are foreigners willing to keep financing our consumption, our imports. So I think it's important, and we're probably in agreement, I think, it's important over a period of time for us to begin to bring down that current account deficit, and I think that a combination of increased U.S. national savings, greater demand in other countries, and more flexibility in exchange rates, put all together, will allow us over a period of time to bring the current account deficit down to a somewhat lower level.

Mr. CLEAVER. This is my final point here.

So if OPEC and China and whomever else made a decision that they would in fact discontinue buying U.S. paper, you're saying that it would have little consequence on the U.S. economy right now, today?

Mr. BERNANKE. You envision them selling everything they currently own?

You've got to sell to somebody.

Mr. CLEAVER. Yes.

Mr. BERNANKE. Somebody else has to hold those assets.

No, I think it's less to do with the dollar portfolio than it has to do with the fact that over a period of time, we have to rely on foreign financing for the current account deficit. I don't think that foreigners will in some sense refuse to finance it, but they may charge a higher price, and that higher price in turn would feed back on the U.S. economy in ways that might be uncomfortable.

Chairman OXLEY. The gentleman's time has expired.

Mr. CLEAVER. Thank you.

Chairman OXLEY. Before dismissing our distinguished witness, the Chair notes that some members may have additional questions for the Chairman 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 the witness and to place his response in the record.

Mr. Chairman, we have been most appreciative of your time and the quality of the responses that you gave to our committee.

You can tell by the variety of questions from the members from all over the country that this is a worthwhile exercise and your participation is most appreciated.

The committee stands adjourned.

[Whereupon, at 1:18 p.m., the committee was adjourned.]

A P P E N D I X

February 15, 2006

Opening Statement

Chairman Michael G. Oxley

House Financial Services Committee

Semi-annual Monetary Policy Report and Testimony of Ben Bernanke
Chairman of the Federal Reserve Board of Governors

February 15, 2006

Chairman Bernanke, welcome to the House Financial Services Committee, and on behalf of the entire Committee; congratulations on your confirmation as the 14th Chairman of the Federal Reserve Board.

We look forward to getting to know you and gaining a better understanding of how you intend to run the Federal Reserve. Even though this is your first appearance before this Committee we are well familiar with the Fed, your staff, and the work of the Fed in setting monetary policy and supervising banks and financial holding companies. Based on my brief conversation with you and your amazingly smooth confirmation hearings, I am confident that you will be as successful as your predecessor.

I know this setting and this testimony can be intimidating. I hope it puts you at ease to know that you will have numerous opportunities to testify before this Committee and Congress.

This morning the press and the markets will focus on your every word and gesture. This Committee will take a long-term view and I hope focus more on public policy; not the fleeting gyrations of the markets.

Your predecessor, and over time the Members of this Committee, have come to view this hearing as an ongoing dialogue between an independent Fed and the elected representatives of the American public. These hearings have become the highlight of our year. I hope they will become the highlight of yours and that like Chairman Greenspan; you will use them as an opportunity to hear a wide range of views and take the temperature of more parts of the country than you can visit in a year.

You are addressing us at a time when there is universal agreement that monetary policy is where it should be and that the economy is thriving. We can report that U.S. economic growth is steady and strong. In fact, we are beginning the fifth full year of the current expansion. While we face some uncertainty abroad – and we can be assured of the likelihood that there will always be uncertainty abroad – our national economic performance is the envy of the world.

Americans are well aware of the economy's steady growth, low inflation, and productivity gains. Consumer confidence numbers are optimistic and the economic predictions show annual growth in the three-to four-percent range for the short and intermediate term.

Alan Greenspan has handed you the wheel of monetary policy at a time of unparalleled growth and prosperity in America. While Federal law requires that the Federal Reserve conduct monetary policy in a way that ensures maximum employment, stable prices, and moderate long-term interest rates, we know that monetary policy is only one tool to achieve this goal.

Another equally important tool is fiscal policy, as set by Congress in the annual budget, and tax policy. As you contemplate the start of your tenure as Chairman of the Fed, I pledge to you, to use my influence and the influence of this Committee, not only to support you in your work, but also to see to it that Congress conducts fiscal policy with the same acumen as the Fed has shown in monetary policy. I am confident that we can maintain the excellent track record of the U.S. economy if we work together and understand each other's goals.

We will face challenges together in the future. Some will be self inflicted and some will be inflicted upon us. Let us use this relatively quiet time to begin our dialogue, fine tune the monetary and fiscal policy, and pledge to work together.

Mr. Chairman, I look forward to beginning our dialogue and as one of the more famous Humphrey Bogart movie lines goes, "I think this is the beginning of a beautiful friendship!"

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Opening Statement

Congressman Paul E. Gillmor (R-OH)

Committee on Financial Services

February 15, 2006

Hearing to receive the testimony of the Chairman of the Federal Reserve Board of Governors

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Thank you, Chairman Oxley, for holding this important hearing. The "Humphrey-Hawkins" hearing remains one of the most effective ways for the Congress to question the Chairman of the Fed on issues related to the economy and I join with my colleagues in welcoming Chairman Bernanke to the Committee.

There is little doubt that our economy is on a steady path of economic growth with near-full employment and historically low inflation. Some of the credit for the four years of nearly-constant 3%+ GDP growth can be attributed to the leadership of former Chairman Greenspan and I look forward to hearing Chairman Bernanke discuss his intended approach to targeting inflation to accomplish the mandate of the Federal Reserve and continue the low inflation of the Greenspan-era.

During your testimony today, Chairman Bernanke, I hope you will give the Committee your thoughts on a wide range of issues that are sure to affect the future economic growth potential for our nation, including: energy prices, the declining national savings rate, the trade deficit and the long-term solvency problems with Medicare, Medicaid and Social Security. The solvency of these three programs will be severely tested in the very near future as the first of the baby-boomers begin to draw off their benefits.

I look forward to working with you in your new capacity as the steward of U.S. monetary policy and I welcome you to the Committee. I look forward to an informative session.

For release on delivery
10:00 a.m. EST
February 15, 2006

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

February 15, 2006

Mr. Chairman and members of the Committee, I am pleased to be here today to present the Federal Reserve's Monetary Policy Report to the Congress. I look forward to working closely with the members of this Committee on issues of monetary policy as well as on matters regarding the other responsibilities with which the Congress has charged the Federal Reserve System.

The U.S. economy performed impressively in 2005. Real gross domestic product (GDP) increased a bit more than 3 percent, building on the sustained expansion that gained traction in the middle of 2003. Payroll employment rose 2 million in 2005, and the unemployment rate fell below 5 percent. Productivity continued to advance briskly.

The economy achieved these gains despite some significant obstacles. Energy prices rose substantially yet again, in response to increasing global demand, hurricane-related disruptions to production, and concerns about the adequacy and reliability of supply. The Gulf Coast region suffered through severe hurricanes that inflicted a terrible loss of life; destroyed homes, personal property, businesses, and infrastructure on a massive scale; and displaced more than a million people. The storms also damaged facilities and disrupted production in many industries, with substantial effects on the energy and petrochemical sectors and on the region's ports. Full recovery in the affected areas is likely to be slow. The hurricanes left an imprint on aggregate economic activity as well, seen, in part, in the marked deceleration of real GDP in the fourth quarter. However, the most recent evidence--including indicators of production, the flow of new orders to businesses, weekly data on initial claims for unemployment insurance, and the payroll employment and retail sales figures for January--suggests that the economic expansion remains on track.

Inflation pressures increased in 2005. Steeply rising energy prices pushed up overall inflation, raised business costs, and squeezed household budgets. Nevertheless, the increase in prices for personal consumption expenditures excluding food and energy, at just below 2 percent, remained moderate, and longer-term inflation expectations appear to have been contained.

With the economy expanding at a solid pace, resource utilization rising, cost pressures increasing, and short-term interest rates still relatively low, the Federal Open Market Committee (FOMC) over the course of 2005 continued the process of removing monetary policy accommodation, raising the federal funds rate 2 percentage points in eight increments of 25 basis points each. At its meeting on January 31 of this year, the FOMC raised the federal funds rate another 1/4 percentage point, bringing its level to 4-1/2 percent.

At that meeting, monetary policymakers also discussed the economic outlook for the next two years. The central tendency of the forecasts of members of the Board of Governors and the presidents of Federal Reserve Banks is for real GDP to increase about 3-1/2 percent in 2006 and 3 percent to 3-1/2 percent in 2007. The civilian unemployment rate is expected to finish both 2006 and 2007 at a level between 4-3/4 percent and 5 percent. Inflation, as measured by the price index for personal consumption expenditures excluding food and energy, is predicted to be about 2 percent this year and 1-3/4 percent to 2 percent next year. While considerable uncertainty surrounds any economic forecast extending nearly two years, I am comfortable with these projections.

In the announcement following the January 31 meeting, the Federal Reserve pointed to risks that could add to inflation pressures. Among those risks is the possibility that, to an extent greater than we now anticipate, higher energy prices may pass through into the prices of non-energy goods and services or have a persistent effect on inflation expectations. Another factor

bearing on the inflation outlook is that the economy now appears to be operating at a relatively high level of resource utilization. Gauging the economy's sustainable potential is difficult, and the Federal Reserve will keep a close eye on all the relevant evidence and be flexible in making those judgments. Nevertheless, the risk exists that, with aggregate demand exhibiting considerable momentum, output could overshoot its sustainable path, leading ultimately--in the absence of countervailing monetary policy action--to further upward pressure on inflation. In these circumstances, the FOMC judged that some further firming of monetary policy may be necessary, an assessment with which I concur.

Not all of the risks to the economy concern inflation. For example, a number of indicators point to a slowing in the housing market. Some cooling of the housing market is to be expected and would not be inconsistent with continued solid growth of overall economic activity. However, given the substantial gains in house prices and the high levels of home construction activity over the past several years, prices and construction could decelerate more rapidly than currently seems likely. Slower growth in home equity, in turn, might lead households to boost their saving and trim their spending relative to current income by more than is now anticipated. The possibility of significant further increases in energy prices represents an additional risk to the economy; besides affecting inflation, such increases might also hurt consumer confidence and thereby reduce spending on non-energy goods and services.

Although the outlook contains significant uncertainties, it is clear that substantial progress has been made in removing monetary policy accommodation. As a consequence, in coming quarters the FOMC will have to make ongoing, provisional judgments about the risks to both inflation and growth, and monetary policy actions will be increasingly dependent on incoming data.

In assessing the prospects for the economy, some appreciation of recent circumstances is essential, so let me now review key developments of 2005 and discuss their implications for the outlook. The household sector was a mainstay of the economic expansion again last year, and household spending is likely to remain an important source of growth in aggregate demand in 2006. The growth in household spending last year was supported by rising employment and moderate increases in wages. Expenditures were buoyed as well by significant gains in household wealth that reflected further increases in home values and in broad equity prices. However, sharply rising bills for gasoline and heating reduced the amount of income available for spending on other consumer goods and services.

Residential investment also expanded considerably in 2005, supported by a strong real estate market. However, as I have already noted, some signs of slowing in the housing market have appeared in recent months: Home sales have softened, the inventory of unsold homes has risen, and indicators of homebuilder and homebuyer sentiment have turned down. Anecdotal information suggests that homes typically are on the market somewhat longer than they were a year or so ago, and the frequency of contract offers above asking prices reportedly has diminished. Financial market conditions seem to be consistent with some moderation in housing activity. Interest rates on thirty-year, fixed-rate mortgages, which were around 5-3/4 percent over much of 2005, rose noticeably in the final months of the year to their current level of around 6-1/4 percent. Rates on adjustable-rate mortgages have climbed more considerably. Still, despite the recent increases, mortgage rates remain relatively low. Low mortgage rates, together with expanding payrolls and incomes and the need to rebuild after the hurricanes, should continue to support the housing market. Thus, at this point, a leveling out or a modest softening of housing activity seems more likely than a sharp contraction, although significant uncertainty

attends the outlook for home prices and construction. In any case, the Federal Reserve will continue to monitor this sector closely.

Overall, the financial health of households appears reasonably good. Largely reflecting the growth in home mortgages, total household debt continued to expand rapidly in 2005. But the value of household assets also continued to climb strongly, driven by gains in home prices and equity shares. To some extent, sizable increases in household wealth, as well as low interest rates, have contributed in recent years to the low level of personal saving. Saving last year was probably further depressed by the rise in households' energy bills. Over the next few years, saving relative to income is likely to rise somewhat from its recent low level.

In the business sector, profits continued to rise last year at a solid pace, boosted in part by continuing advances in productivity. Strong corporate balance sheets combined with expanding sales and favorable conditions in financial markets fostered a solid increase in spending on equipment and software last year. Investment in high-tech equipment rebounded, its increase spurred by further declines in the prices of high-tech goods. Expenditures for communications equipment, which had fallen off earlier this decade, showed particular strength for the year as a whole. In contrast, nonresidential construction activity remained soft.

Although the financial condition of the business sector is generally quite strong, several areas of structural weakness are evident, notably in the automobile and airline industries. Despite these problems, however, favorable conditions in the business sector as a whole should encourage continued expansion of capital investment.

For the most part, the financial situation of state and local governments has improved noticeably over the past couple of years. Rising personal and business incomes have buoyed tax revenues, affording some scope for increases in state and local government expenditures. At the

federal level, the budget deficit narrowed appreciably in fiscal 2005. Outlays rose rapidly, but receipts climbed even more sharply as the economy expanded. However, defense expenditures, hurricane relief, and increasing entitlement costs seem likely to worsen the deficit in fiscal 2006.

Outside the United States, economic activity strengthened last year, and at present global growth seems to be on a good track. The economies of our North American neighbors, Canada and Mexico, appear to be expanding at a solid pace. Especially significant have been signs that Japan could be emerging from its protracted slump and its battle with deflation. In the euro area, expansion has been somewhat modest by global standards, but recent indicators suggest that growth could be strengthening there as well. Economies in emerging Asia generally continue to expand strongly. In particular, growth in China remained vigorous in 2005.

Expanding foreign economic activity helped drive a vigorous advance in U.S. exports in 2005, while the growth of real imports slowed. Nonetheless, the nominal U.S. trade deficit increased further last year, exacerbated in part by a jump in the value of imported petroleum products that almost wholly reflected the sharply rising price of crude oil.

Surging energy prices also were the dominant factor influencing U.S. inflation last year. For the second year in a row, overall consumer prices, as measured by the chain-type index for personal consumption expenditures, rose about 3 percent. Prices of consumer energy products jumped more than 20 percent, with large increases in prices of natural gas, gasoline, and fuel oil. Food prices, however, rose only modestly. And core consumer prices (that is, excluding food and energy) increased a moderate 1.9 percent.

The relatively benign performance of core inflation despite the steep increases in energy prices can be attributed to several factors. Over the past few decades, the U.S. economy has become significantly less energy intensive. Also, rapid advances in productivity as well as

increases in nominal wages and salaries that, on balance, have been moderate have restrained unit labor costs in recent years.

Another key factor in keeping core inflation low has been confidence on the part of the public and investors in the prospects for price stability. Maintaining expectations of low and stable inflation is an essential element in the Federal Reserve's effort to promote price stability. And, thus far, the news has been good: Survey measures of longer-term inflation expectations have responded only a little to the larger fluctuations in energy prices that we have experienced, and for the most part, they were low and stable last year. Inflation compensation for the period five to ten years ahead, derived from spreads between nominal and inflation-indexed Treasury securities, has remained well anchored.

Restrained inflation expectations have also been an important reason that long-term interest rates have remained relatively low. At roughly 4-1/2 percent at year-end, yields on ten-year nominal Treasury issues increased only slightly on balance over 2005 even as short-term rates rose 2 percentage points. As previous reports and testimonies from the Federal Reserve indicated, a decomposition of long-term nominal yields into spot and forward rates suggests that it is primarily the far-forward components that account for the low level of long rates. The premiums that investors demand as compensation for the risk of unforeseen changes in real interest rates and inflation appear to have declined significantly over the past decade or so. Given the more stable macroeconomic climate in the United States and in the global economy since the mid-1980s, some decline in risk premiums is not surprising. In addition, though, investors seem to expect real interest rates to remain relatively low. Such a view is consistent with a hypothesis I offered last year--that, in recent years, an excess of desired global saving over

the quantity of global investment opportunities that pay historically normal returns has forced down the real interest rate prevailing in global capital markets.

Inflation prospects are important, not just because price stability is in itself desirable and part of the Federal Reserve's mandate from the Congress, but also because price stability is essential for strong and stable growth of output and employment. Stable prices promote long-term economic growth by allowing households and firms to make economic decisions and undertake productive activities with fewer concerns about large or unanticipated changes in the price level and their attendant financial consequences. Experience shows that low and stable inflation and inflation expectations are also associated with greater short-term stability in output and employment, perhaps in part because they give the central bank greater latitude to counter transitory disturbances to the economy. Similarly, the attainment of the statutory goal of moderate long-term interest rates requires price stability, because only then are the inflation premiums that investors demand for holding long-term instruments kept to a minimum. In sum, achieving price stability is not only important in itself; it is also central to attaining the Federal Reserve's other mandated objectives of maximum sustainable employment and moderate long-term interest rates.

As always, however, translating the Federal Reserve's general economic objectives into operational decisions about the stance of monetary policy poses many challenges. Over the past few decades, policymakers have learned that no single economic or financial indicator, or even a small set of such indicators, can provide reliable guidance for the setting of monetary policy.

Rather, the Federal Reserve, together with all modern central banks, has found that the successful conduct of monetary policy requires painstaking examination of a broad range of economic and financial data, careful consideration of the implications of those data for the likely

path of the economy and inflation, and prudent judgment regarding the effects of alternative courses of policy action on prospects for achieving our macroeconomic objectives. In that process, economic models can provide valuable guidance to policymakers, and over the years substantial progress has been made in developing formal models and forecasting techniques. But any model is by necessity a simplification of the real world, and sufficient data are seldom available to measure even the basic relationships with precision. Monetary policymakers must therefore strike a difficult balance--conducting rigorous analysis informed by sound economic theory and empirical methods while keeping an open mind about the many factors, including myriad global influences, at play in a dynamic modern economy like that of the United States. Amid significant uncertainty, we must formulate a view of the most likely course of the economy under a given policy approach while giving due weight to the potential risks and associated costs to the economy should those judgments turn out to be wrong.

During the nearly three years that I previously spent as a member of the Board of Governors and of the Federal Open Market Committee, the approach to policy that I have just outlined was standard operating procedure under the highly successful leadership of Chairman Greenspan. As I indicated to the Congress during my confirmation hearing, my intention is to maintain continuity with this and the other practices of the Federal Reserve in the Greenspan era. I believe that, with this approach, the Federal Reserve will continue to contribute to the sound performance of the U.S. economy in the years to come.

Rep. Barney Frank Submissions for the Record for February 15, 2006 FSC hearing with Fed Chairman Bernanke

Excerpts from **Monetary Policy Report to Congress**, February 2006

Pg. 8 – "With profits posting further solid gains in 2005 and ample liquid assets on corporate balance sheets, nonfinancial businesses were able to finance much of their capital expenditures out of internal funds, pay record sums to shareholders in the form of share buybacks, and still maintain strong balance sheets."

Pg. 9 – "Corporate profits continued to grow strongly in 2005. The ratio of before-tax profits of domestic nonfinancial corporations to that sector's gross value added rose to more than 12 percent, near its 1997 peak…In the fourth quarter of 2005, operating earnings per share for S&P 500 firms appear to have been nearly 14 percent above their level four quarters earlier."

Pg. 17 – "Increases in hourly labor compensation were moderate in 2005…"

Pg. 16 – "The participation rate in January 2006 was 66 percent, well below the high of 67 ¼ percent reached in 2000 but not far from its trend, which has been declining in recent years as a consequence of demographic forces."

Excerpt from **Analytical Perspectives, Budget of the U.S. Government, 2007**

Pg. 171 – "The extraordinary fall-off in the labor force participation, from 67.1 percent of the U.S. population in 1997-2000 to 66.0 percent in 2004-2005, appears to be at least partially cyclical in nature, and most forecasters are assuming some rebound in the labor force participation as the expansion continues."

THE PRICE OF CREDIT:
Prime and Subprime Lending in California 2004

By

Peter Gee
Graduate Student
John F. Kennedy School of Government
Harvard University

EXECUTIVE SUMMARY

The purpose of this report is to summarize the distribution of prime and higher cost subprime home loans[1] in California, by race and ethnicity for 2004. For the first time ever, the Home Mortgage Disclosure Act (HMDA) data includes information on the pricing of higher cost loans by race and ethnicity therefore allowing researchers to detect patterns in pricing and lending by different borrower characteristics, such as income, race, ethnicity, and geography.

This study does not claim that discrimination necessarily accounts for the higher concentration of subprime loans among minority borrowers. Rather, the report criticizes the lending industries' over reliance on so-called "objective" measures of credit risk that can unfairly discriminate against minority borrowers. The report calls for a) an overhaul of FICO scoring methods b) personal involvement by the CEOs of the major home lenders and c) rigorous adoption of "referral up" programs that ensure that prime rate borrowers are not given subprime loans and d) the abolishment of any incentives for employees to sell subprime mortgages.

Key Findings of this Report:

- When compared to white borrowers, African American borrowers are **four times** more likely to receive a high cost subprime home loan and Latinos are over **twice** as likely to receive a high cost subprime loan compared to white borrowers.[2]
- Together, African Americans and Latinos are **three times** more likely to receive a high cost subprime home loan in California compared to White borrowers.[3]
- Overall, African Americans and Latinos received 36% of all subprime loans made in California for 2004.
- African Americans, Native Americans, Latinos, and Pacific Islanders are less likely to receive a home loan in California compared to their White and Asian American counterparts. Overall, they make up only 28.74% of the total loans given in 2004.
- Similar disparities of home loans also exist within all of the major Metropolitan Statistical Areas (MSA) in California.

[1] The home loans analyzed in this study include originated conventional home purchase and refinance home loans made in 2004.

[2] While high cost subprime loans made up just 2.2% of all originated home loans going to white borrowers in California, African Americans had a 9% share of such subprime loans and Latinos had a 5% share.

[3] Taken together, high cost subprime loans make up 6% of all loans to African Americans and Latinos. In contrast, such loans just make up 2% of all loans to white borrowers.

Recommendations:

To address some of the findings of this report, the following recommendations are made to lending institutions, policy advocates, government regulators, and community advocates:

- **Overhaul FICO Scoring Process:** With the goal of establishing a credit scoring system that effectively captures other measures of credit worthiness (e.g. payments for rent, utilities, telephone and cable service, remittances, etc.) the four federal regulators should convene a meeting with community groups, Freddie Mac, Fannie Mae and the nation's largest home mortgage companies including Wells Fargo, Countrywide, Bank of America, JP Morgan Chase, World Savings and Citibank. With leadership from the regulators coupled with the insight from community groups and financial institutions, the industry can radically change its underwriting process to ensure that there is parity in the distribution of higher cost home loans to minority borrowers.
- **Banking and Lending Institutions Need to have a Stronger Mechanism for Referral Ups and Assist with Repairing Credit:** The Consumers Federation of America found that over 40% of borrowers are misclassified into the subprime market.[4] Lending institutions need to work more on a case by case basis with potential borrowers to find ways to get move them into the prime loan market, or be more proactive and give borrowers more concrete suggestions to improve their credit.
- **Eliminate Incentives to Employees for Subprime Lending:** Home mortgage lenders must eliminate any incentive system for executives and for baseline employees to make subprime loans. Many institutions give their employees an incentive to sell a higher interest rate loan to a borrower. Institutions must create internal mechanisms to prevent predatory lending and regulators should create stronger safeguards to ensure this practice is abolished.
- **Personal attention by the CEO:** Responsibility for innovation and a commitment to best practices in the mortgage lending industry belongs at the top. The CEO of all mortgage lenders must ensure public confidence to their industry by making a personal commitment to reforming their institution's lending practices to ensure that more minority borrowers are not unfairly discriminated against in paying for their home loans.

[4] Consumer Federation of America. "Credit Score Accuracy and Implications for Consumers." December 17, 2002.

For use at 10:00 a.m., EST
Wednesday
February 15, 2006

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

February 15, 2006

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

Submitted pursuant to section 2B of the Federal Reserve Act

February 15, 2006

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 15, 2006

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress pursuant to section 2B of the Federal Reserve Act.

Sincerely,

Ben Bernanke, Chairman

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Monetary Policy Report to the Congress

Report submitted to the Congress on February 15, 2006, pursuant to section 2B of the Federal Reserve Act

Monetary Policy and the Economic Outlook

The U.S. economy delivered a solid performance in 2005 despite a further sharp increase in energy prices and devastating hurricanes that claimed many lives, destroyed homes and businesses, and displaced more than 1 million persons. Real gross domestic product is estimated to have risen a little more than 3 percent over the four quarters of 2005 even though growth slowed significantly in the fourth quarter as a result of storm-related disruptions and other factors that are likely to prove transitory. The increase in real GDP in 2005 was sufficient to add 2 million new jobs, on net, to employers' payrolls and to further reduce slack in labor and product markets. As in 2004, overall consumer price inflation was boosted by the surge in energy prices. Core consumer price inflation (as measured by the price index for personal consumption expenditures excluding the direct effects of movements in food and energy prices) picked up early in the year, but it subsequently eased and totaled less than 2 percent over the year as a whole. The dollar appreciated against most major currencies in 2005, and, with domestic demand expanding strongly, the U.S. current account deficit widened further.

In 2005, energy prices were up substantially for a second year in a row. Crude oil costs climbed further, on net, and prices of refined petroleum products and natural gas came under additional upward pressure for a time after supplies were curtailed by hurricane damage to production facilities in the Gulf Coast region. As a result, households in the United States faced steep increases in gasoline and home heating expenses, and many firms were likewise burdened with rising energy costs.

The resilience of the U.S. economy in the face of these major shocks likely reflects, in part, improvements in energy efficiency over the past several decades. A number of other factors also helped to keep economic activity moving forward in 2005. For one, the rapid gain in real estate values in the past few years, in combination with the rise in stock prices since 2002, has encouraged households to sustain their spending through a period of relatively weak growth in real income. For another, credit conditions remained supportive for businesses last year, facilitating a brisk expansion of capital spending. In addition, labor productivity has been on a strong uptrend in recent years, which has fostered substantial growth in the economy's productive capacity and no doubt lifted households' and businesses' assessments of their long-term income prospects.

In light of elevated inflation pressures and shrinking margins of unutilized resources, and with short-term interest rates relatively low, the Federal Open Market Committee (FOMC) continued to remove monetary policy accommodation gradually in 2005, raising the target federal funds rate 25 basis points at each of its eight meetings. This cumulative policy firming of 2 percentage points was substantially greater than market participants had expected at the start of the year. But each action was anticipated by the time of the meeting at which it was taken, as the Committee's communications, policy strategy, and responses to incoming economic data appear to have been well understood. At its meeting in January 2006, the FOMC increased the target federal funds rate another 25 basis points, bringing it to 4½ percent. The Committee indicated that possible increases in resource utilization as well as elevated energy prices had the potential to add to inflation pressures and that, as a result, some further policy tightening may be needed.

The U.S. economy should continue to perform well in 2006 and 2007. To be sure, higher energy prices will probably exert some restraint on activity for a while longer. But so long as energy price increases slow, as is suggested by futures prices, this restraint should diminish as 2006 progresses. In addition, economic activity should receive some impetus from post-hurricane recovery efforts. Although progress to date has been uneven in the affected regions, the reopening of facilities shut down by the hurricanes is already being reflected in a rebound in industrial production. Federal assistance will buttress rebuilding activity in coming quarters.

More broadly, the major factors that contributed to the favorable performance of the U.S. economy in 2005 remain in place. Long-term interest rates are low, and conditions in corporate credit markets are generally positive. The household sector is also in good financial shape overall and should stay so even if—as expected—the housing sector cools. In addition, the improved outlook for economic growth abroad bodes well for U.S. exports. How-

ever, the effects of the cumulative tightening in monetary policy should keep the growth in aggregate output close to that of its longer-run potential.

Core inflation is likely to remain under some upward pressure in the near term from rising costs as the pass-through of higher energy prices runs its course. But those cost pressures should wane as the year progresses. Moreover, strength in labor productivity should continue to damp business costs more generally. With little evidence to date that resource utilization has put appreciable upward pressure on prices, and with longer-run inflation expectations continuing to be well anchored, core inflation should remain contained in 2006 and 2007.

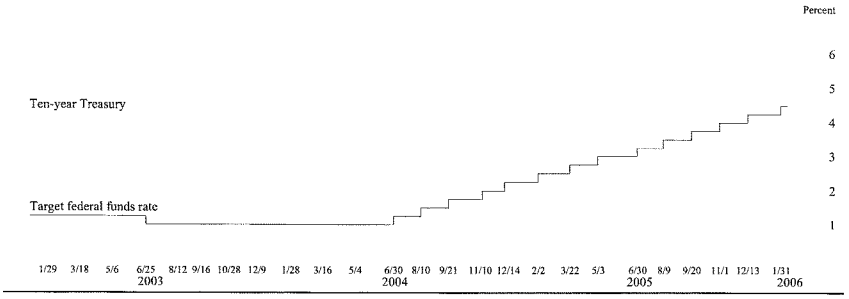
Nonetheless, significant risks attend this economic outlook. Some of the uncertainty is centered on the prospects for the housing sector. On the one hand, some observers believe that home values have moved above levels that can be supported by fundamentals and that some realignment is warranted. Such a realignment—if abrupt—could materially sap household wealth and confidence and, in turn, depress consumer spending. On the other hand, if home values continue to register outsized increases, the accompanying increment to household wealth would stimulate aggregate demand and raise resource utilization further. With the economy already operating in the neighborhood of its productive potential, this higher resource utilization would risk adding to inflation pressures. Another major source of uncertainty is the price of energy, which continues to be buffeted by concerns about future supply disruptions. Additional steep increases in the price of energy would intensify cost pressures and weigh on economic activity.

Monetary Policy, Financial Markets, and the Economy in 2005 and Early 2006

The year 2005 opened with the target federal funds rate at 2¼ percent, a level that Federal Reserve policymakers judged to be quite accommodative. During the first few months of the year, output appeared to be growing at a solid pace despite rising energy prices. Improving labor market conditions and favorable financing terms were providing considerable support to consumer outlays and homebuilding activity, while reasonably bright sales prospects and strong profitability were buoying business investment. Pressures on inflation appeared to be mounting, however, partly owing to increasing energy prices. Measures of inflation compensation derived from securities markets were on the rise as well. In these circumstances, the Committee firmed policy 25 basis points at both its February and March meetings and signaled that, if economic conditions progressed as anticipated, it would need to continue to remove policy accommodation gradually to keep inflation pressures contained.

In the spring, policymakers perceived some signs of softness in spending, which they attributed in part to the earlier step-up in energy prices. Nonetheless, the federal funds rate was still relatively low, and robust underlying growth in productivity was providing ongoing support to economic activity. Accordingly, the Committee anticipated some strengthening of activity, and it reduced policy accommodation further in May by lifting the target federal funds rate another quarter percentage point, to 3 percent.

Selected interest rates, 2003–06



NOTE: The data are daily and extend through February 8, 2006. The ten-year Treasury rate is the constant-maturity yield based on the most actively traded securities. The dates on the horizontal axis are those of FOMC meetings.
SOURCE: Department of the Treasury and the Federal Reserve.

In the event, the signs of softness proved transitory. Incoming data suggested that output, employment, and spending were growing moderately through midyear. Inflation expectations seemed to be well contained, but pressures on inflation remained elevated. With the stance of policy still accommodative, the Committee added another 25 basis points to the target federal funds rate at both its June and August meetings.

Subsequently, the devastation caused by Hurricane Katrina increased uncertainty about the vitality of the economic expansion in the near term. The destruction in the Gulf Coast region, the associated dislocation of economic activity—including considerable disruption of energy production—and the accompanying further boost to energy prices were expected to impose some restraint on spending, production, and employment in the near term. Although the region had been dealt a severe blow, the Committee did not see these developments as posing a more persistent threat to the overall economic expansion. Consequently, it decided to firm policy another 25 basis points at its September meeting.

Over the following weeks, the Gulf Coast region absorbed further setbacks from Hurricanes Rita and Wilma. The growth of economic activity dipped for a time—hiring slowed, consumer spending softened, and confidence declined. At the same time, however, soaring energy prices fed through to top-line consumer price inflation and pushed some survey measures of inflation expectations upward. With employment and growth expected to be supported by accommodative financial conditions, the FOMC continued the process of policy tightening at its November meeting.

By December, incoming data indicated that the overall expansion remained on track, although recovery from the damage in the hurricane-affected areas would apparently require considerable time. The Committee judged that possible increases in resource utilization as well as elevated energy prices had the potential to add to inflation pressures. Accordingly, policy was firmed another 25 basis points, bringing the target federal funds rate to 4¼ percent. In the accompanying statement, monetary policy was no longer characterized as "accommodative" because the federal funds rate had been boosted substantially and was now within the broad range of values that, in the judgment of the Committee, might turn out to be consistent with output remaining close to its potential. Indeed, because policy actions over the previous eighteen months had significantly reduced the degree of monetary accommodation, Committee members thought that the outlook for their near-term policy actions was becoming considerably less certain. In such an environment, policy decisions would increasingly depend on incoming data and their implications for future economic growth and inflation. Nonetheless, the Committee indicated that some further measured policy firming was likely to be needed to keep the risks to the attainment of its goals of sustainable economic growth and price stability roughly in balance.

Over the period leading up to the January 2006 meeting, incoming data on economic activity were uneven. The advance estimate of real GDP pointed to a slowing in the growth of output in the fourth quarter, but the underlying strength in consumer and business spending suggested that the economic expansion remained on solid footing. With the potential for added pressures on inflation still evident, the FOMC raised the target federal funds rate another 25 basis points, bringing its level to 4½ percent. In its statement after the meeting, the Committee indicated that some further policy firming may be necessary and again noted that it would respond to changes in economic prospects as needed.

Economic Projections for 2006 and 2007

In conjunction with the FOMC meeting in January, the members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, provided economic projections for 2006 and 2007. The central tendency of the

Economic projections of Federal Reserve Governors and Reserve Bank presidents for 2006 and 2007

Percent

Indicator	Memo 2005 actual	2006		2007	
		Range	Central tendency	Range	Central tendency
Change, fourth quarter to fourth quarter[1]					
Nominal GDP	6.2	5¼–6½	5½–6	5–6	5–5¾
Real GDP	3.1	3¼–4	About 3½	3–4	3–3½
PCE price index excluding food and energy	1.9	1¾–2½	About 2	1¾–2	1¾–2
Average level, fourth quarter					
Civilian unemployment rate	5.0	4½–5	4¾–5	4½–5	4¾–5

1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.

FOMC participants' forecasts for the increase in real GDP is about 3½ percent over the four quarters of 2006 and 3 percent to 3½ percent in 2007. The civilian unemployment rate is expected to lie between 4¾ percent and 5 percent in the fourth quarter of 2006 and to remain in that area in 2007. As for inflation, the FOMC participants expect that the price index for personal consumption expenditures excluding food and energy (core PCE) will rise about 2 percent in 2006 and between 1¾ percent and 2 percent in 2007.

Economic and Financial Developments in 2005 and Early 2006

The economic expansion remained firmly entrenched in 2005, although the growth of real GDP late in the year was apparently restrained by the effects of the hurricanes and by sharp drops in some volatile categories of spending. In the labor market, payroll employment rose moderately for a second year in a row, and the unemployment rate declined further. As in 2004, headline inflation was boosted appreciably by soaring energy prices; however, core inflation remained subdued. In 2005, financial market conditions were once again supportive of growth, with long-term market interest rates low and credit spreads and risk premiums narrow.

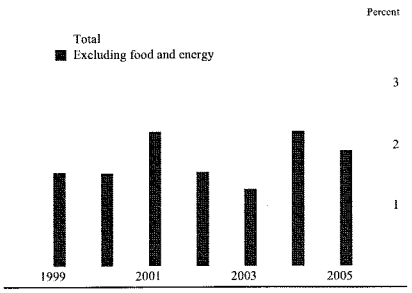
The Household Sector

Consumer Spending

Consumer spending had gathered considerable steam in 2003 and 2004 and remained vigorous in 2005. Higher energy prices last year continued to siphon off household purchasing power, and short-term interest rates moved up; nevertheless, spending was again bolstered by an improving labor market and rising household wealth.

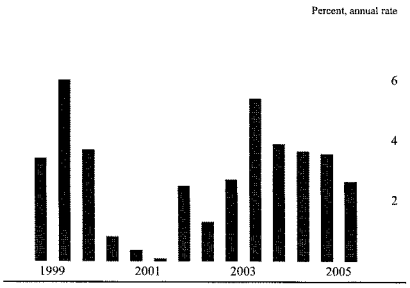
Real personal consumption expenditures (PCE) had posted back-to-back increases of 3¾ percent in 2003 and 2004 and continued to rise at about that pace over the first three quarters of 2005; in the fourth quarter, PCE growth slowed to an annual rate of just 1 percent as consumer outlays for motor vehicles slackened after a surge prompted by last summer's "employee discount" programs. For 2005 as a whole, sales of light vehicles (cars, vans, sport-utility vehicles, and pickup trucks) totaled nearly 17 million units, about the same as the annual figure for 2004. Real spending on consumer goods other than motor vehicles was robust in 2005, with substantial gains almost across the board; a notable exception was real spending on gasoline, which was up only modestly

Change in PCE chain-type price index, 1999–2005



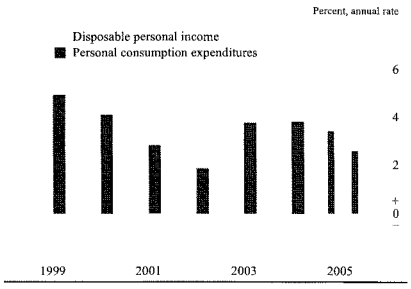
NOTE: The data are for personal consumption expenditures (PCE).
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Change in real GDP, 1999–2005



NOTE: Here and in subsequent charts, except as noted, change for a given period is measured to its final quarter from the final quarter of the preceding period.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Change in real income and consumption, 1999–2005



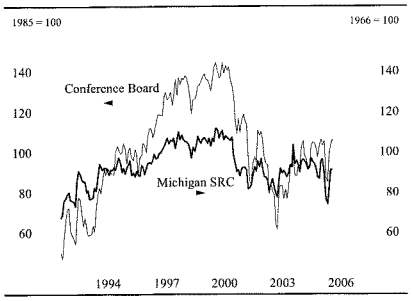
SOURCE: Department of Commerce, Bureau of Economic Analysis.

for a second year in a row as prices at the pump soared. Real expenditures on services rose moderately in 2005, as a sizable further increase in outlays for medical care was partly offset by a relatively small gain in outlays for energy services.

Excluding the estimated effects of the one-time special dividend payment that Microsoft made in December 2004, disposable personal income (DPI)—that is, personal income less personal current taxes—rose about 1½ percent in real terms in 2005, considerably less than in 2003 and 2004. Although aggregate wages and salaries advanced moderately last year and some other major types of nominal income posted notable gains, the increases in real terms were eroded by the rise in energy prices. In addition, personal tax payments rose faster last year than did personal income as measured in the national income and product accounts (NIPA). In the second half of the year, the growth of real DPI was volatile, mainly because of the hurricanes. Rental income and proprietors' income were pulled down in the third quarter as a result of uninsured losses on residential and business property. Real DPI snapped back in the fourth quarter as income in these hurricane-affected categories rebounded from the exceptionally low levels in the third quarter.

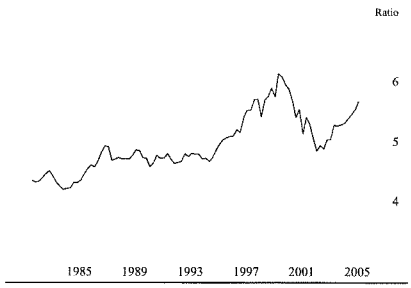
Although the run-up in energy prices restrained the growth of real DPI in 2005, its effect on overall spending appears to have been largely offset by other factors. In particular, sharp increases in household wealth since 2002 have provided many households with the resources and inclination to sustain their spending through a period of relatively weak growth of real income. Household net worth, which typically feeds through to spending over several quarters, posted sizable gains in 2003 and 2004, and it rose further in 2005 as house values continued to climb and as stock prices moved modestly higher. At the end of the third quarter (the most recent period for which complete data on wealth are available), the ratio of household net worth to disposable income stood at 5.65, well above its long-run average level of 4.75. Meanwhile, surveys by the Michigan Survey Research Center (SRC) and the Conference Board suggest that, apart from the first few months after the hurricanes, consumer confidence was about at the favorable levels that had prevailed in 2004. All in all, personal outlays exceeded disposable income in 2005. As a result, the personal saving rate, which had dropped below 2 percent in 2004, fell further in 2005, ending the year at negative ½ percent.

Consumer sentiment, 1992–2006



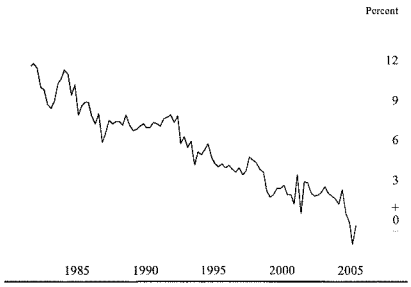
NOTE: The data are monthly and extend through January 2006.
SOURCE: The Conference Board and University of Michigan Survey Research Center.

Wealth-to-income ratio, 1982–2005



NOTE: The data are quarterly and extend through 2005:Q3. The wealth-to-income ratio is the ratio of household net worth to disposable personal income.
SOURCE: For net worth, Federal Reserve Board, flow of funds data; for income, Department of Commerce, Bureau of Economic Analysis.

Personal saving rate, 1982–2005



NOTE: The data are quarterly and extend through 2005:Q4.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

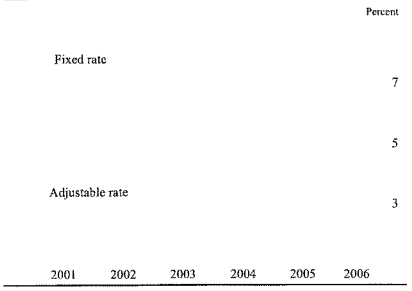
Residential Investment

Activity in the housing sector remained torrid through much of 2005. By the end of the year, however, a few tentative signs of cooling had begun to appear. In the single-family sector, starts of new units dipped in December after a string of exceptionally strong months; still, they totaled 1.7 million for the year as a whole—6½ percent above the already rapid pace in 2004. Starts in the multifamily sector totaled 350,000 in 2005, a pace similar to that of the preceding three years. Real expenditures on residential structures—which include outlays not only for new construction but also for additions and alterations as well as commissions paid to real estate agents— rose nearly 8 percent in 2005, the fourth large yearly increase in a row.

Sales of both new and existing homes set records in 2005, although they, like housing starts, seem to have lost some steam late in the year. Rates on thirty-year fixed-rate mortgages were in the neighborhood of 5¾ percent for much of the year, but they rose in the autumn. Since October, they have averaged close to 6¼ percent, at the upper end of the narrow range that has prevailed since 2003 but still fairly low by historical standards. Rates on adjustable-rate mortgages have been trending up since early 2004. The softening of home sales in recent months has contributed to an updrift in the stock of unsold new and existing homes. As of December, the stock of unsold new homes was equal to nearly five months of supply when measured at that month's sales pace. Between 1998 and 2004, the stock of unsold new homes had averaged about four months of supply.

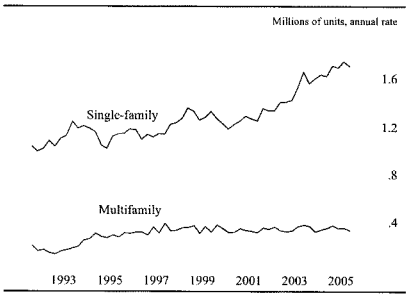
Measures of house prices that attempt to control for shifts in the quality and composition of homes sold show that prices continued to rise rapidly through the third quarter of 2005, though partial data for the fourth quarter point to some slowing. Notably, the purchase-only version of the repeat-transactions price index for existing homes, which is published by the Office of Federal Housing Enterprise Oversight and tracks sales of the same houses over time, rose 11 percent over the year ending in the third quarter (the latest available data), once again outstripping the increases in household incomes and rents. The Census Bureau's constant-quality price index for new homes, which controls for changes in the composition of sales by geography, home size, and other readily observable characteristics, had also shown sizable increases through the third quarter, but it decelerated sharply in the

Mortgage rates, 2001–06



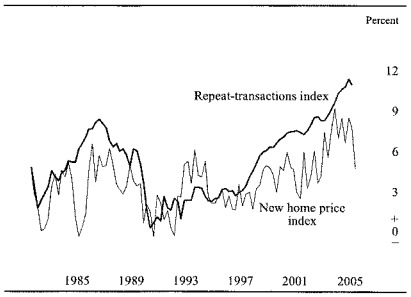
NOTE: The data, which are weekly and extend through February 8, 2006, are contract rates on thirty-year mortgages.
SOURCE: Federal Home Loan Mortgage Corporation.

Private housing starts, 1992–2005



NOTE: The data are quarterly and extend through 2005:Q4.
SOURCE: Department of Commerce, Bureau of the Census.

Change in house prices, 1982–2005



NOTE: The repeat-transactions index includes purchase transactions only and extends through 2005:Q3. The new home price index extends through 2005:Q4. Change is over four quarters.
SOURCE: For repeat transactions, Office of Federal Housing Enterprise Oversight; for new home prices, Department of Commerce, Bureau of the Census.

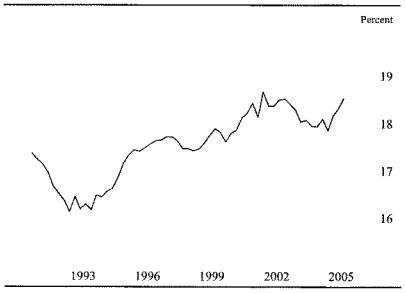
fourth quarter and was up just 4¾ percent over 2005 as a whole; in 2004, this measure had risen 8½ percent.

Household Finance

Household debt expanded about 10½ percent at an annual rate over the first three quarters of last year, roughly the same brisk pace as had been registered in 2004. Home-mortgage debt continued to grow rapidly, as homeowners took advantage of the further sizable increases in house prices last year. The use of alternative mortgage products spread further in 2005, in part because rising home values generally made house purchases less affordable. Last May federal regulators issued guidance promoting sound risk-management practices to financial institutions with home equity lending programs. Mortgage-related borrowing likely took the place of some funding with consumer credit, which expanded only modestly again last year. Overall, the expansion in household debt outpaced the growth in disposable personal income, and the financial obligations ratio moved up to a level close to the peak that it had reached earlier this decade. However, the relatively low readings on most measures of loan delinquencies last year indicate that most households were not struggling to meet their obligations.

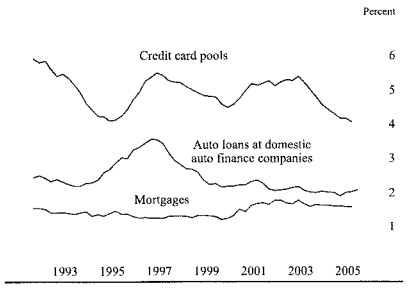
A large number of households filed for bankruptcy in the weeks leading up to October 17, the date when a new bankruptcy law took effect. The law was designed in part to diminish the ability of households to discharge their debts through chapter 7 filings. After the new law became effective, filings fell sharply to a level significantly below the average of recent years, and they have since remained low. This suggests that, to avoid the new rules, some households accelerated filings they would have undertaken eventually even under the old law. The spike in bankruptcies appears to have induced a jump in charge-offs of consumer loans in the fourth quarter.

Household financial obligations ratio, 1991–2005



NOTE: The data are quarterly and extend through 2005:Q3. The financial obligations ratio equals the sum of required payments on mortgage and consumer debt, automobile leases, rent on tenant-occupied property, homeowner's insurance, and property taxes, all divided by disposable personal income.
SOURCE: Federal Reserve Board.

Delinquency rates on selected types of household loans, 1992–2005



NOTE: The data are quarterly. The data for credit card pools and mortgages extend through 2005:Q3; the rate for auto loans extends through 2005:Q4.
SOURCE: For credit cards, Moody's Investors Service; for auto loans, the financing subsidiaries of the three major U.S. automobile manufacturers; for mortgages, Mortgage Bankers Association.

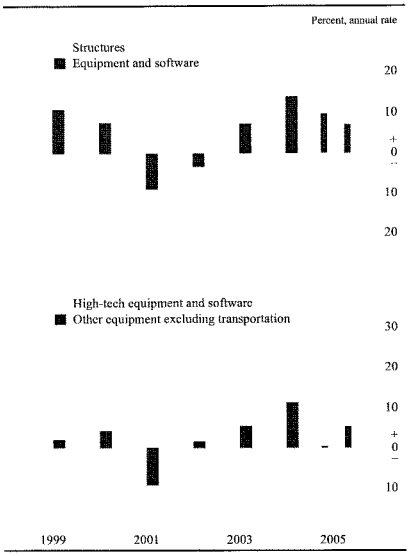
The Business Sector

Fixed Investment

Real business fixed investment rose 6½ percent in 2005. Real spending on equipment and software (E&S) posted an increase of more than 8 percent after rising nearly 14 percent in 2004. The broadly based growth in E&S spending last year was supported by favorable fundamentals: appreciable growth in final sales, ample financial resources in the corporate sector, and supportive conditions in financial markets.

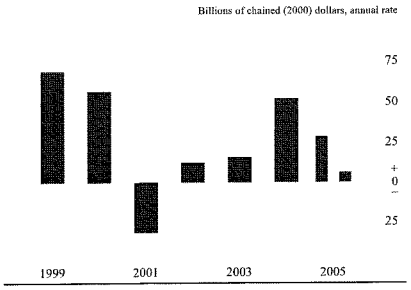
Real investment in high-technology equipment rose 17 percent in 2005, as further declines in prices provided a substantial incentive for firms to step up their outlays on such items; the increase was 5 percentage points faster than in 2003 and 2004 and about in line with the average annual gain over the past twenty-five years. Spending on communications equipment was exceptionally strong last year, as telecom service providers rolled out major new fiber-optic systems and third-generation wireless gear. Business spending for computing equipment rose roughly 30 percent in real terms, a pace close to its historical average, while spending on software posted its largest increase in several years.

Change in real business fixed investment, 1999–2005



NOTE: High-tech equipment consists of computers and peripheral equipment and communications equipment.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Change in real business inventories, 1999–2005



SOURCE: Department of Commerce, Bureau of Economic Analysis.

Although aircraft investment remained depressed as domestic airlines continued to grapple with overcapacity and soaring fuel prices, the other major categories of E&S spending outside the high-tech area did well in 2005. Business outlays on motor vehicles rose markedly, with the demand for heavy trucks especially strong. Investment in equipment other than high-tech and transportation goods—a broad category that accounts for nearly half of E&S spending when measured in nominal terms—barely rose in real terms over the first half of 2005. Investment in this category sped up after midyear, to increase moderately over the year as a whole.

Apart from the drilling and mining sector, where investment has strengthened in response to higher energy prices, outlays for nonresidential construction have yet to gain much traction. Spending on office and commercial structures has been essentially flat since 2003; construction of manufacturing facilities leveled out in 2005 after having firmed in late 2004; and investment in the power and communications sector moved down further last year. However, vacancy rates have continued to reverse some of the run-up that occurred between 2000 and 2003, and some industry reports suggest that an upturn in building activity is in train.

Inventory Investment

After having been exceptionally restrained earlier in the economic expansion, inventory investment picked up sharply in 2004, and the higher pace of accumulation extended into early 2005. The step-up in accumulation, which provided considerable impetus to industrial production for a time, brought stocks into better alignment with sales and set the stage for a subsequent downswing in inventory investment. Inventories in the motor vehicle sector were drawn down in both the second and third quarters, though accumulation resumed in the fourth quarter after last summer's surge in sales cleared out dealers' lots. Apart from motor vehicles, real stockbuilding slowed sharply over the course of the year and, according to the advance NIPA estimate, came to a halt in the fourth quarter. At year-end, inventories seemed to be in reasonable alignment with sales, even taking into account the downward trend in inventory–sales ratios that has resulted from the ongoing improvement in supply-chain management.

Corporate Profits and Business Finance

With profits posting further solid gains in 2005 and ample liquid assets on corporate balance sheets, nonfinancial businesses were able to finance much of their capital expenditures out of internal funds, pay record sums to shareholders in the form of share buybacks, and still maintain strong balance sheets. Nonetheless, elevated merger and acquisition activity and the considerable rise in share buybacks boosted the pace of business borrow-

ing. Short-term borrowing rose significantly, driven by financing from banks. The issuance of long-term debt remained moderate overall, but debt related to commercial mortgages continued to expand rapidly. Indicators of corporate credit quality generally remained favorable.

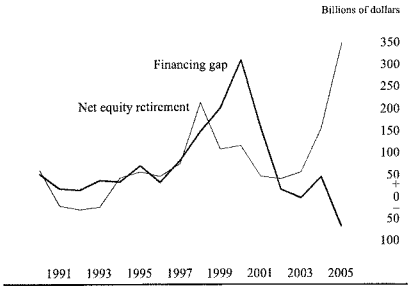
Corporate profits continued to grow strongly in 2005. The ratio of before-tax profits of domestic nonfinancial corporations to that sector's gross value added rose to more than 12 percent, near its 1997 peak. Gains in earnings were fairly widespread, with profits in the petroleum and gas industries especially strong. In the fourth quarter of 2005, operating earnings per share for S&P 500 firms appear to have been nearly 14 percent above their level four quarters earlier.

Gross equity issuance remained modest in 2005, while net equity issuance sank into deeply negative territory as corporations retired shares at a rapid pace. Both a jump in cash-financed mergers and a record-setting level of share repurchases were spurred by the strong growth of profits as well as by the substantial liquidity that firms had built up in recent years.

Net corporate bond issuance was subdued in 2005, as modest growth in nominal capital expenditures, strong cash positions, and robust profits apparently limited the demand for such financing. However, commercial-mortgage debt grew rapidly last year. Gross issuance of commercial-mortgage-backed securities likely reached a record pace in the fourth quarter.

Short-term borrowing by businesses rose smartly in 2005, as business lending by both large and small commercial banks surged. Throughout the year, respondents to the Senior Loan Officer Opinion Surveys indicated that their institutions had further eased standards and terms for lending to businesses and that the demand for such loans had continued to strengthen. Most respondents attributed the stronger demand to borrowers' increased need to finance inventories, accounts receivable, and investment in plant and equipment; a substantial fraction of respondents to some surveys also pointed to a pickup in merger and acquisition activity. By contrast, outstanding commercial paper declined last year.

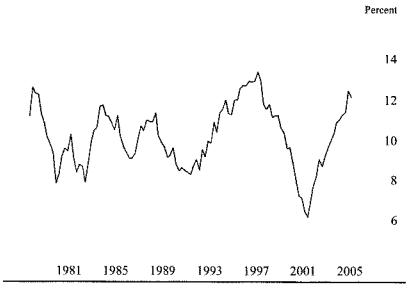
Financing gap and net equity retirement at nonfinancial corporations, 1990–2005



NOTE: The data are annual; the observations for 2005 are based on partially estimated data. The financing gap is the difference between capital expenditures and internally generated funds. Net equity retirement is the difference between equity retired through share repurchases, domestic cash-financed mergers, or foreign takeovers of U.S. firms and equity issued in public or private markets, including funds invested by venture capital partnerships.

SOURCE: Federal Reserve Board, flow of funds data.

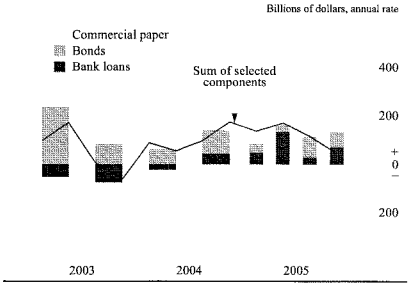
Before-tax profits of nonfinancial corporations as a percent of sector GDP, 1978–2005



NOTE: The data are quarterly and extend through 2005:Q3. Profits are from domestic operations of nonfinancial corporations, with inventory valuation and capital consumption adjustments.

SOURCE: Department of Commerce, Bureau of Economic Analysis.

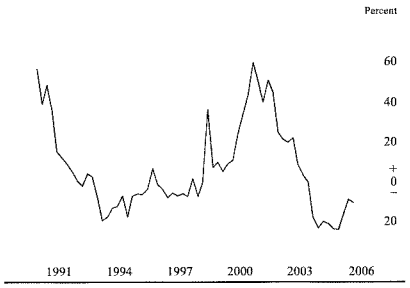
Selected components of net financing for nonfinancial corporate businesses, 2003–05



NOTE: The data for the components except for bonds are seasonally adjusted. The data for the sum of selected components are quarterly; 2005:Q4 is estimated.

SOURCE: Federal Reserve Board; Securities Data Company; and Federal Financial Institutions Examination Council, Consolidated Reports of Condition and Income (Call Report).

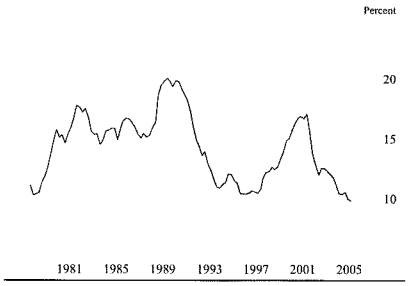
Net percentage of domestic banks tightening standards on commercial and industrial loans to large and medium-sized borrowers, 1990–2006



NOTE: The data are drawn from a survey generally conducted four times per year; the last observation is from the January 2006 survey, which covers 2005:Q4. Net percentage is the percentage of banks reporting a tightening of standards less the percentage reporting an easing. The definition for firm size suggested for, and generally used by, survey respondents is that large and medium-sized firms have sales of $50 million or more.
SOURCE: Federal Reserve, Senior Loan Officer Opinion Survey on Bank Lending Practices.

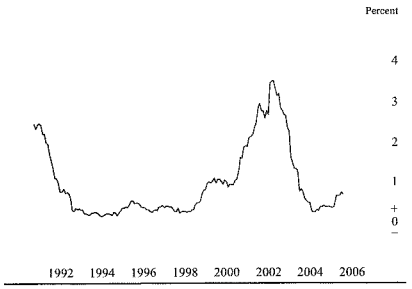
Readings on credit quality for nonfinancial companies generally remained favorable in 2005 despite some pockets of distress. The amount of corporate debt that was downgraded by Moody's Investors Service last year exceeded the amount that was upgraded, mainly as a result of the high-profile downgrades of the debt of General Motors and Ford. After trending down over the first three quarters of last year, the six-month trailing bond default rate moved up in the fall, most notably because of the bankruptcies of Delta Air Lines, Northwest Airlines, Delphi, and Calpine. However, these bankruptcies were widely anticipated and had little effect on other measures of aggregate credit quality. The credit quality of commercial mortgage debt also appeared to remain robust during 2005; delinquency rates on commercial mortgages held by banks and on those pooled into securities trended down on balance over last year, while delinquencies on mortgages held by insurance companies remained low.

Net interest payments of nonfinancial corporations as a percent of cash flow, 1978–2005



NOTE: The data are quarterly and extend through 2005:Q3.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Default rate on outstanding corporate bonds, 1991–2006



NOTE: The data are monthly and extend through January 2006. The rate for a given month is the face value of bonds that defaulted in the twelve months ending in that month divided by the face value of all bonds outstanding at the end of the calendar quarter immediately preceding the twelve-month period.
SOURCE: Moody's Investors Service.

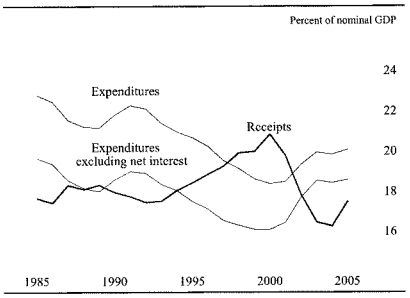
The Government Sector

Federal Government

The deficit in the federal unified budget narrowed appreciably in fiscal year 2005. Although outlays continued to rise rapidly, receipts rose even faster; as a consequence, the deficit fell to $318 billion, roughly $100 billion less than the deficit in fiscal 2004. The latest projections from the Administration and the Congressional Budget Office, however, point to a deterioration in the unified budget position in fiscal 2006, in part because of the start of the Medicare drug benefit and the need to pay for post-hurricane reconstruction and relief.

Nominal federal spending rose nearly 8 percent in fiscal 2005 and stood at about 20 percent of GDP—virtually the same as in 2003 and 2004 but 1½ percentage points above the recent low in fiscal 2000. Defense spending rose 8½ percent after three years of double-digit increases; outlays for nondefense discretionary programs moved up further as well, in part because of higher spending for education and for disaster relief. (Spending on disaster relief in fiscal 2005, which ended on September 30, was primarily for needs that emerged before Hurri-

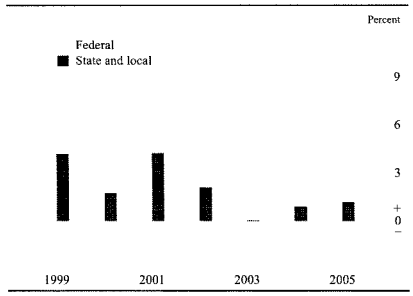
Federal receipts and expenditures, 1985–2005



NOTE: The receipts and expenditures data are on a unified-budget basis and are for fiscal years (October through September); GDP is for the four quarters ending in Q3.
SOURCE: Office of Management and Budget.

cane Katrina.) As for the major health programs, Medicare outlays continued to climb. Medicaid spending rose relatively slowly, mainly because it had been boosted during much of fiscal 2004 by the temporary increase in the federal share of the program's costs included in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). Net interest payments, which had declined steadily from 1998 to 2003 and had increased only moderately in 2004, were up significantly in fiscal 2005 as short-term interest rates rose. Thus far in fiscal 2006, outlays have continued to rise rapidly, in part because of heavy spending for flood insurance payouts and other hurricane-related disaster relief. According to the NIPA, real federal expenditures on consumption and gross investment, the part of government spending that is a component of real GDP, increased 1¼ percent over the four quarters of calendar year 2005.

Change in real government expenditures on consumption and investment, 1999–2005

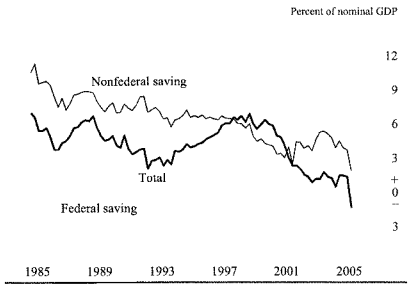


SOURCE: Department of Commerce, Bureau of Economic Analysis.

Federal receipts rose 14½ percent in fiscal 2005; as a ratio to GDP, they stood at 17½ percent—more than 1 percentage point higher than in 2004. Corporate payments rose nearly 50 percent, lifted by the robust profits of 2004 and 2005 and the termination of the partial-expensing tax incentive at the end of calendar 2004. Individual income taxes increased nearly 15 percent; nonwithheld taxes rose especially rapidly because of both substantial strength in nonwage taxable incomes (including capital gains) and certain features of JGTRRA that altered the timing of tax payments in a way that temporarily reduced the level of collections in 2004. Social insurance taxes rose in line with wages and salaries.

Mirroring the narrowing of the unified deficit, federal saving (essentially, the unified surplus or deficit adjusted to conform to the accounting practices followed in the NIPA) improved from negative 3½ percent of GDP in calendar 2004 to negative 2½ percent in the first half of 2005. However, the beneficial effect of the smaller deficit in terms of national saving was essentially offset by a sharp decline in personal saving. Measured net of estimated depreciation, national saving in the first half of 2005 was equal to just 1½ percent of GDP, about the same as in 2004 and well below the recent highs of more than 6 percent of GDP in the late 1990s. In the third quarter, net saving was dragged down by sizable hurricane-related reductions in both federal and nonfederal net saving; excluding these one-time factors, net saving in the third quarter would have been roughly the same as it was in the first half of the year. If not reversed over the longer haul, persistent low levels of saving will necessitate either slower capital formation or continued heavy borrowing from abroad, either of which would hamper the ability of the nation to cope with the retirement needs of the

Net saving, 1985–2005



NOTE: The data are quarterly and extend through 2005:Q3. Nonfederal saving is the sum of personal and net business saving and the net saving of state and local governments.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

baby-boom generation and would retard the growth of the standard of living.

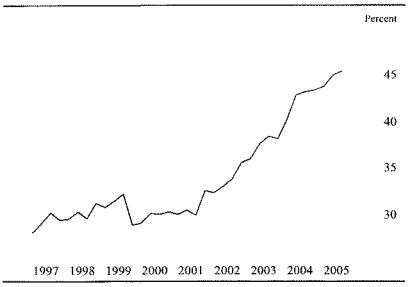
Federal Borrowing

Borrowing by the Treasury moderated somewhat in calendar year 2005—federal debt rose 7 percent last year after increasing 9 percent in 2004. Much of the improvement reflected the surge in tax receipts noted earlier. As a result, the amount of Treasury bills outstanding contracted on net in 2005, and Treasury sales of coupon securities declined. As was widely anticipated, the Treasury announced in August that it would resume regular semiannual issuance of a thirty-year nominal bond. The first such auction, held on February 9, 2006, was well received, with a high level of participation from indirect bidders. The Treasury expects issuance of the thirty-year bond to help stabilize the average maturity of outstanding marketable Treasury debt, which declined from a high of about seventy months at the end of 2000 to fifty-three months at the end of 2005.

Federal debt held by the public as a percentage of nominal GDP was steady during 2005 and stood at about 36 percent at the end of the third quarter. The federal debt ceiling did not need to be raised last year, but the Treasury has announced that it expects that the debt will reach its statutory ceiling in February 2006.

The appetite for Treasury securities among foreign investors remained strong in the aggregate in 2005. The proportion of outstanding Treasury securities held by foreign investors is estimated to have climbed to slightly more than 45 percent in the third quarter of 2005, a record. Data from the Treasury International Capital reporting system suggest that net purchases of Treasury securities by foreign private investors jumped last year, whereas such purchases by foreign official institutions slowed significantly amid upward pressure on the foreign exchange value of the dollar.

Treasury securities held by foreign investors as a share of total outstanding, 1997–2005

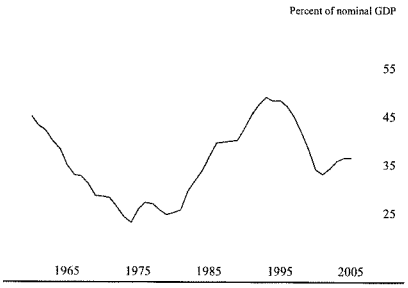


NOTE: The data are quarterly and extend through 2005:Q3.
SOURCE: Federal Reserve Board, flow of funds data.

State and Local Governments

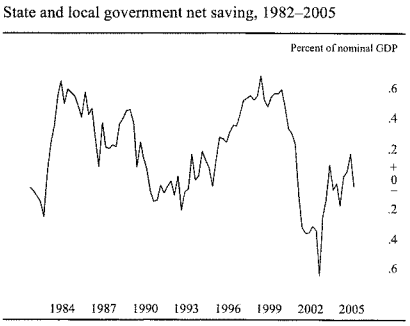
The fiscal positions of state and local governments continued to improve in 2005. Strong growth in income and retail sales boosted revenues, as did rising property values. And although the sector continued to grapple with

Federal government debt held by the public, 1960–2005



NOTE: The final observation is for 2005:Q3. For previous years, the data for debt are as of year-end, and the corresponding values for GDP are for Q4 at an annual rate. Excludes securities held as investments of federal government accounts.
SOURCE: Federal Reserve Board, flow of funds data.

State and local government net saving, 1982–2005



NOTE: The data, which are quarterly, are on a national income and product account basis and extend through 2005:Q3. Net saving excludes social insurance funds.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

higher medical costs and pressures to restore funding to programs that had been cut back earlier in the decade, states and localities generally kept a tight rein on current outlays. On a NIPA basis, net saving by state and local governments—which is broadly similar to the surplus in an operating budget—turned positive in the first half of 2005 after having been negative between 2002 and 2004, and it would have remained positive in the third quarter in the absence of the hurricanes. The sizable revenue gains reported by many states in fiscal 2005, which ended on June 30 in all but four states, appear to have extended into fiscal 2006. Even so, some governments are still struggling with strained fiscal situations, and some face significant structural imbalances in their budgets that likely will be exacerbated in coming years by the need to provide pensions and health care to a growing number of retired employees. In addition, the jurisdictions in the Gulf Coast region confront the dual challenge of substantial post-hurricane demands and diminished flows of tax revenues.

According to the NIPA, real expenditures on consumption and gross investment by state and local governments rose 1¼ percent in 2005. Real outlays for current consumption were up only about 1 percent for a second year, in part because of the relatively slow pace of hiring. Real investment expenditures also registered a small gain.

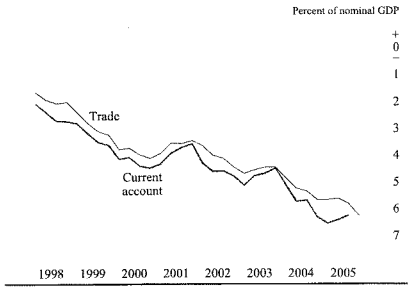
State and Local Government Borrowing

Borrowing by state and local governments picked up in 2005. Gross issuance of municipal securities was brisk, as the relatively low level of longer-term market interest rates spurred advance refundings of outstanding securities. The bulk of new capital issues last year reportedly was earmarked for education-related projects. Credit quality in the state and local sector generally remained favorable in 2005. Notable exceptions were the obligations of numerous municipal issuers in Michigan, which were downgraded last year largely as a consequence of the difficulties of GM and Ford. In addition, the obligations of a number of issuers in the regions that were hit by last year's hurricanes were downgraded in the fourth quarter, and some bonds from these areas remain on watch. Despite these isolated troubles, rating upgrades of municipal bonds slightly outpaced downgrades in 2005.

The External Sector

The U.S. current account deficit widened further in 2005. At an annual rate, it came in at just under $800 billion, or about 6¼ percent of nominal GDP, in the first three quarters (the latest available data). As in the past, a substantial portion of the widening of the current account deficit came from a larger deficit on trade of goods and services, but a decrease in net investment income also worsened the external account. Net investment income edged into negative territory in the second quarter of 2005 for the first time in the post–World War II period. Unilateral transfer payments to foreigners dropped sharply on net in the third quarter because of a surge in receipts from foreign insurance companies for damage caused by the hurricanes, leading to a slight narrowing of the deficit from the previous quarter. The trade data through December showed that the U.S. trade deficit widened further in the fourth quarter of 2005, to about $790 billion at an annual rate. This increase suggests that the fourth-quarter current account deficit, yet to be reported, will also widen substantially.

U.S. trade and current account balances, 1998-2005

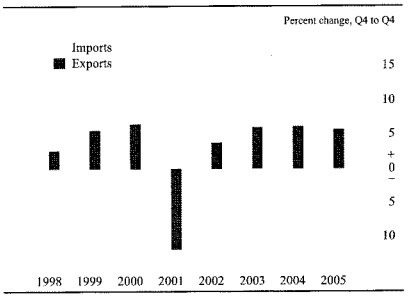


NOTE: The data are quarterly. The current account data extend through 2005:Q3, and the trade data extend through 2005:Q4.
SOURCE: Department of Commerce.

International Trade

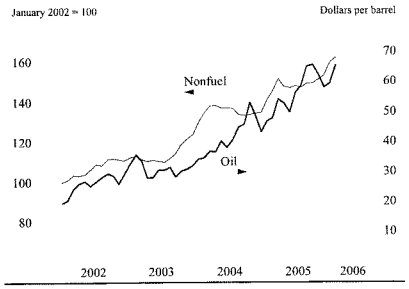
Real exports of goods and services continued the solid pace of expansion registered in both 2003 and 2004; they rose an estimated 5¾ percent in 2005, supported by robust foreign economic activity. Export growth was rapid in the first half of the year, spurred by the depreciation of the dollar in previous years; it then slowed in the second half of the year, in part owing to the dollar's appreciation since the beginning of 2005. For the year as a whole, exports of capital goods posted solid growth. Exports of aircraft performed especially well despite an interruption of their production in September because of a strike at Boeing. Exports of industrial supplies were hampered late in the year by the effects of the hurricanes on production and shipping in the Gulf Coast region. By destination, exports to Canada and Mexico grew rapidly in

Change in real imports and exports of goods and services, 1998-2005



SOURCE: Department of Commerce.

Prices of oil and of nonfuel commodities, 2002-06



NOTE: The data are monthly and extend through January 2006. The oil price is the spot price of West Texas intermediate crude oil. The price of nonfuel commodities is an index of forty-five primary-commodity prices.

SOURCE: For oil, the Commodity Research Bureau; for nonfuel commodities, International Monetary Fund.

2005, those to Western Europe also increased, but exports to Japan were relatively weak. Exports of services rose about 3 percent in 2005 in real terms.

Prices of exported goods increased at an annual rate of 2¼ percent in 2005, a bit below the rate of increase in 2004. Prices decelerated in the second and third quarters as the dollar strengthened and as pressures on prices of agricultural exports and other nonfuel commodities ebbed. Prices accelerated again in the fourth quarter, when a sharp rise in the prices of oil and metals drove up prices for many nonagricultural industrial supplies.

After expanding at a double-digit pace in 2004, real imports of goods and services decelerated to about 4½ percent in 2005, even as U.S. GDP growth remained robust. Although overall growth of non-oil imports was slower last year than in 2004, capital goods imports continued strong. The hurricanes affected several categories of imports. Despite a contraction of domestic oil consumption, real imports of oil expanded to offset reduced production in the Gulf Coast region. Chemicals imports also registered strong gains toward year-end amid hurricane-related losses in domestic production. Real imports of services moved up only 2¼ percent in 2005, a substantial cooling from their 2004 pace.

Prices of imported goods excluding oil and natural gas increased at an annual rate of 1½ percent in 2005, down from a rate of 2¾ percent in 2004. Prices decelerated in midyear as the dollar appreciated and nonfuel commodity prices steadied. However, import prices accelerated in the fourth quarter of 2005, led by higher prices for chemicals, metals, and building materials. In global commodity markets, prices of metals increased an average of 30 percent in 2005, a surge that reflected both robust global demand and limited increases in supply.

A key event in 2005 was the substantial increase in the price of crude oil. The spot price of West Texas intermediate (WTI) crude oil climbed from about $43 per barrel at the start of 2005 to a peak of about $70 per barrel in late August, at the time of Hurricane Katrina. The spot price then edged down as production revived in the Gulf of Mexico and as above-average temperatures in the United States reduced oil demand. After falling to below $60 per barrel by late November, oil prices moved up to an average of about $65 per barrel for January, in part on concerns about possible disruptions of foreign supply. However, oil prices have declined so far in February. Growing conviction among traders that oil-market conditions would remain tight in future years pushed the price of the far-dated NYMEX oil futures contract (currently for delivery in 2012) from an average of $38 per barrel for January 2005 to about $61 per barrel for January 2006.

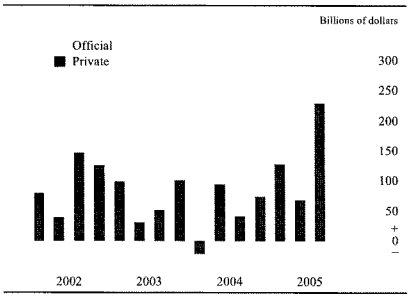
Although the rate of growth in world oil consumption slowed in 2005 from its torrid pace of 2004, spare production capacity among OPEC members remained limited, at an estimated level of only about 1 million barrels per day. With the perception that additional capacity would be slow to come on line, oil markets were highly sensitive to news about fluctuations in supply and demand. Market participants' concerns about crude oil supply were heightened by production difficulties in Iraq and by the resumption of nuclear activities in Iran, both posing risks to the stability of Middle East supply. Elsewhere, production problems in Nigeria stemming from social unrest and a marked slowdown in the growth of Russian production also kept upward pressure on oil prices throughout the year.

Domestic crude oil supply was severely hampered by last year's hurricanes, which were the most damaging in the history of the U.S. energy industry. At the peak of the disruption, all U.S. crude oil production in the Gulf of Mexico (about 28 percent of total U.S. production) and 88 percent of U.S. natural gas production there (about 17 percent of total U.S. production) were shut in. At the end of January 2006, 25 percent of Gulf oil production remained shut in, and cumulative lost production in the Gulf stood at about 22 percent of the average annual output from that region. Refinery outages, which peaked after Hurricane Rita at more than one-fourth of total U.S. refining capacity, caused sharp increases in the prices of refined products. Retail gasoline prices in the United States jumped to more than $3 per gallon in early September, briefly crimping gasoline demand and, in turn, demand for crude oil. Petroleum product prices returned to pre-hurricane levels within a few weeks as imports soared and refineries resumed operations, but they began to rise again in December and January.

The Financial Account

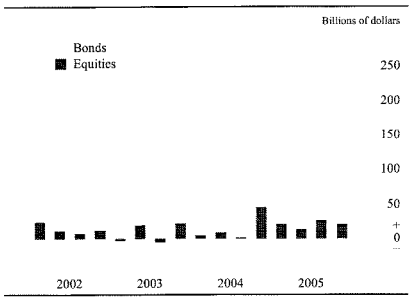
In 2005, foreign official financial inflows slowed from their extraordinary pace of 2004 but remained sizable. Most of these official inflows took the form of purchases of U.S. long-term government and private securities for reserve accumulation, primarily by Asian central banks. The slowdown in foreign official inflows last year was more than offset, however, by an increase in foreign private purchases of U.S. securities. Most of this pickup was concentrated in bonds, as in 2004, but foreign private purchases of U.S. equities also increased somewhat. Foreign direct investment flows into the United States continued to be strong in 2005, with the average pace during the first three quarters a bit higher than in 2004.

U.S. net financial inflows, 2002-05



NOTE: The data are quarterly and extend through 2005:Q3.
SOURCE: Department of Commerce.

Net private foreign purchases of long-term U.S. securities, 2002-05



NOTE: The data are quarterly and extend through 2005:Q4.
SOURCE: Department of Commerce and the Treasury International Capital reporting system.

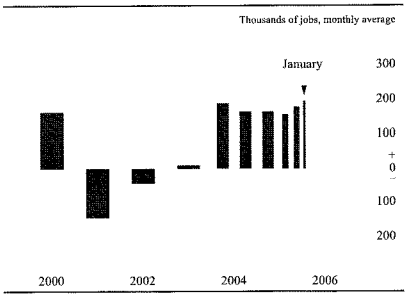
U.S. residents' net purchases of foreign securities remained brisk last year, near the levels recorded in 2003 and 2004, with smaller purchases of foreign bonds offset by larger purchases of foreign equities. By contrast, U.S. direct investment flows abroad slowed markedly during the first half of 2005 and turned negative in the third quarter. This unusual pattern reflected responses to the partial tax holiday provided in the 2004 Homeland Investment Act, which allowed firms to repatriate at a preferential tax rate previous years' earnings that had been reinvested in their foreign affiliates.

The Labor Market

Employment and Unemployment

Conditions in the labor market continued to improve, on balance, in 2005, although many individuals lost jobs in the aftermath of the hurricanes. Nonfarm payroll employment rose 175,000 per month, on average, through August, the same as the average monthly increase in 2004. Net hiring then slowed sharply in September and October, as job losses in the Gulf Coast region largely offset moderate increases in payrolls elsewhere in the nation. In November and December, monthly job growth was uneven, but it averaged 250,000, and hiring remained brisk in January. The reemployment of many of those who lost jobs because of the hurricanes appears to have provided a modest lift to overall hiring in recent months. However, others affected by the storms apparently have not found new jobs yet, and the unemployment rate among evacuees seems to have remained quite high.

Net change in nonfarm payroll employment, 2000–06



SOURCE: Department of Labor, Bureau of Labor Statistics.

Employment gains were widespread by industry in 2005. As in 2004, hiring was especially strong at firms supplying professional and business services and in health care. The construction industry also continued to exhibit a good deal of vigor, spurred by the booming housing sector. Employment in retail trade and in food services rose fairly briskly in the first half of the year, but it was held down in the second half by job losses in the Gulf Coast region. In the manufacturing sector, employment was essentially flat for a second year after three years of steep declines. In the government sector, state and local payrolls continued to rise modestly, while civilian employment in the federal government was about unchanged.

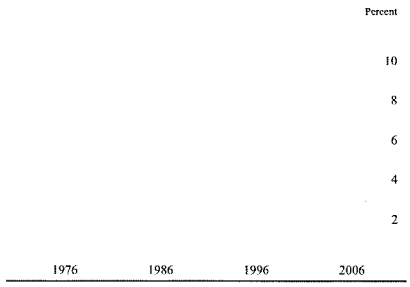
After hovering around 5½ percent during the second half of 2004, the unemployment rate fell, on net, over the first three months of 2005. During the remainder of the year, it fluctuated in a narrow range around 5 percent. In January 2006, it decreased to 4.7 percent. The labor force participation rate, which had dropped noticeably between 2000 and 2004, edged up, on net, in 2005. The participation rate in January 2006 was 66 percent, well below the high of 67¼ percent reached in early 2000 but not far from its trend, which has been declining in recent years as a consequence of demographic forces.

Other indicators also pointed to a gradual improvement in labor market conditions over the course of 2005. Initial claims for unemployment insurance drifted lower, and the job openings rate moved up. At year-end, the Conference Board reported that a larger proportion of respondents to its monthly survey thought that jobs were plentiful than thought that jobs were hard to get.

Productivity and Labor Costs

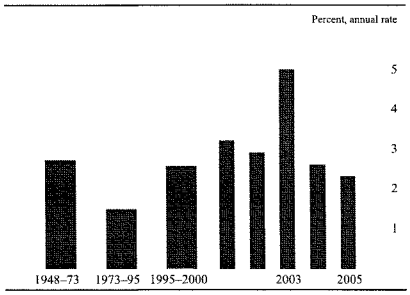
Labor productivity in the nonfarm business sector continued to advance in 2005. Last year's increase in output per hour of 2¼ percent was noticeably below the average annual gain over the preceding four years. But taking the longer view, growth in labor productivity over the past five years has averaged 3¼ percent per year, nearly ¾ percentage point faster than the already impressive gains posted between 1995 and 2000. Productivity appears to have received considerable impetus in recent years from a number of factors, including the rapid pace of technological change and the growing ability of firms to use information and other technology to improve the efficiency of their operations. Increases in the amount of capital per worker, especially high-tech capital, have also helped to spur productivity growth over the past few years, although apparently by less than was the case during the capital spending boom in the late 1990s.

Civilian unemployment rate, 1973–2006



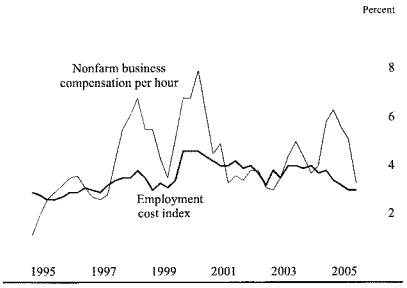
NOTE: The data are monthly and extend through January 2006.
SOURCE: Department of Labor, Bureau of Labor Statistics.

Change in output per hour, 1948–2005



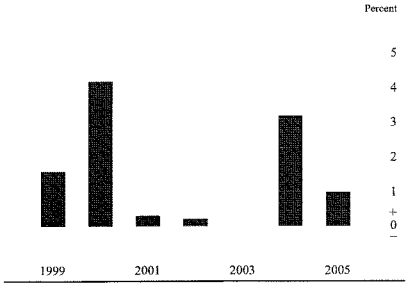
NOTE: Nonfarm business sector.
SOURCE: Department of Labor, Bureau of Labor Statistics.

Measures of change in hourly compensation, 1995–2005



NOTE: The data are quarterly and extend through 2005:Q4. For nonfarm business compensation, change is over four quarters; for the employment cost index (ECI), change is over the twelve months ending in the last month of each quarter. The ECI is for private industry excluding farm and household workers.
SOURCE: Department of Labor, Bureau of Labor Statistics.

Change in unit labor costs, 1999–2005



NOTE: Nonfarm business sector. The change in unit labor costs is defined as the change in nonfarm compensation per hour less the change in labor productivity.
SOURCE: Department of Labor, Bureau of Labor Statistics.

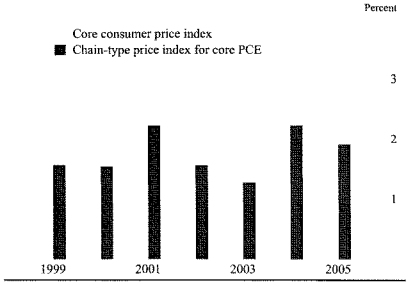
Increases in hourly labor compensation were moderate in 2005 even though overall consumer prices rose relatively rapidly for a second year and the downward pressure on wages from labor market slack diminished. As measured by the employment cost index (ECI) for private nonfarm businesses, hourly compensation increased 3 percent last year, ¾ percentage point less than in 2004. The wages and salaries component of the ECI rose just 2½ percent, the same as in 2004, while the cost of providing benefits rose 4 percent after two years of increases in the area of 6½ percent to 7 percent. Much of the deceleration in benefits costs was in employers' contributions to retirement plans, which had increased markedly in 2003 and 2004 as firms ratcheted up their contributions to defined-benefit plans to cover earlier declines in the market value of the plans' assets. Health insurance costs rose 6½ percent in 2005, the smallest increase since the late 1990s.

According to preliminary data, compensation per hour in the nonfarm business (NFB) sector—an alternative measure of compensation developments derived from the data in the NIPA—rose 3¼ percent in 2005, about the same rise as in the ECI. In 2004, NFB compensation had risen nearly 6 percent; a fourth-quarter surge in the value of stock option exercises, which are excluded from the ECI, likely contributed to that increase. The preliminary estimate for NFB compensation in 2005 reflects the apparent reversal of some of the late-2004 upswing in compensation, though it is subject to revision when more-detailed information becomes available later this year. In any event, the deceleration in hourly compensation last year held the increase in unit labor costs to 1 percent. Unit labor costs had risen more than 3 percent in 2004 after having been close to flat over the preceding three years.

Prices

Headline inflation continued to be boosted by soaring energy prices in 2005, while core inflation—which excludes the direct effects of movements in food and energy prices—remained subdued. The PCE chain-type price index rose 3 percent for the second year in a row. The increase in core PCE prices, which in 2004 had ticked up to 2¼ percent, remained high in early 2005 by recent standards. Core PCE inflation subsequently subsided and came in a shade below 2 percent for the year as a whole. The market-based component of the core PCE price

Change in core consumer prices, 1999–2005



SOURCE: For core consumer price index, Department of Labor, Bureau of Labor Statistics; for core PCE price index, Department of Commerce, Bureau of Economic Analysis.

Alternative measures of price change, 2003–05

Percent

Price measure	2003	2004	2005
Chain-type			
Gross domestic product (GDP)	2.0	2.9	3.0
Gross domestic purchases	2.0	3.4	3.4
Personal consumption expenditures (PCE)	1.7	3.1	3.0
Excluding food and energy	1.3	2.2	1.9
Market-based PCE excluding food and energy	1.0	1.7	1.7
Fixed-weight			
Consumer price index	1.9	3.4	3.7
Excluding food and energy	1.2	2.1	2.1

NOTE: Changes are based on quarterly averages of seasonally adjusted data.
SOURCE: For chain-type measures, Department of Commerce, Bureau of Economic Analysis; for fixed-weight measures, Department of Labor, Bureau of Labor Statistics.

index—which excludes prices that must be imputed because they cannot be observed in market transactions and that often move erratically—rose 1¾ percent in 2005, unchanged from its pace in 2004. A similar pattern is evident in the core consumer price index, which rose about 2 percent in both 2004 and 2005, and in broad NIPA price measures such as the price index for GDP, which was up about 3 percent in both years.

The PCE price index for energy rose roughly 20 percent in 2005 for the second year in a row. The nearly 25 percent increase in gasoline prices in 2005 largely reflected the effects of the continuing surge in crude oil prices on retail energy prices. Gasoline prices recorded some dramatic spikes—notably in the spring and after the hurricanes—when disruptions at refineries depleted inventories and pushed up the margin of the retail price over the already-elevated cost of the associated crude oil. After peaking at more than $3 per gallon in early September, gasoline prices fell sharply over the balance of 2005 as demand moderated, refinery capacity in the Gulf Coast region came back on line, and imports surged. In January 2006, gasoline prices turned up in response to higher crude oil costs, and they are now running about 50 cents per gallon higher than they were in January 2005.

Consumer prices for natural gas rose more than 35 percent in 2005, with most of the increase coming in the second half of the year. Prices started to move up around midyear and then skyrocketed in September and October after Hurricanes Katrina and Rita curtailed production in the Gulf of Mexico. Most of the shut-in production was restored by late 2005, and inventories remained ample for a normal heating season, but spot natural gas prices held at elevated levels through mid-December. They have since plummeted in response to unseasonably warm weather in much of the nation but are still far above their levels of a year ago. Reflecting higher input costs, PCE electricity prices rose 10 percent in 2005 after a much smaller rise in 2004.

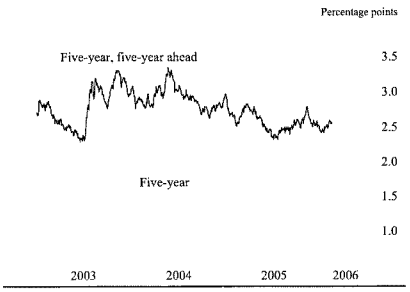
Consumer food prices rose about 2 percent in 2005 after slightly larger increases in 2003 and 2004. Food prices received some upward pressure late in the year. Crop damage from Hurricane Wilma temporarily pushed up the prices of some fruits and vegetables, and beef prices were boosted by the resumption of some exports to Pacific Rim countries after the lifting in early December of an extended ban (which was subsequently reinstated in January 2006). But, in general, the higher production of several livestock products and a bumper harvest of grains helped to limit increases in retail food prices to about the rate of core inflation.

The broad contours of core inflation in 2005 were about the same as those in 2004. Prices of core goods, which had declined in 2002 and 2003, were about flat for a second year. Prices of core services decelerated a bit—from about 3 percent in 2004 to 2¾ percent in 2005. The deceleration was concentrated in some nonmarket categories—in particular, prices of financial services provided by banks without explicit charge, foreign travel by U.S. residents, and life and motor vehicle insurance—that had posted large increases in 2004. With the notable exception of airfares, which picked up in 2005 after having fallen in 2004, prices in other market-based categories of services rose about as fast as they had in 2004.

The run-up in energy prices in 2005 boosted the cost of producing other goods and services—especially for energy-intensive items, including chemicals, plastics, and nitrogenous fertilizers. In addition, prices of other commodities such as lumber and a variety of metals, which had soared in 2004 in response to the strengthening of economic activity worldwide, moved up further in early 2005. Many of those prices slackened in the spring and summer as industrial production softened, but they turned up again in the fall. All told, however, the higher input costs left only a small mark on the prices of core goods and services. A major reason is that the robust upward trend in labor productivity helped to hold labor costs in check and gave firms scope to absorb cost increases.

Near-term inflation expectations have come under some upward pressure over the past year, but recent readings have been close to those at the beginning of 2005. Apart from an energy-related spurt to 4½ percent in early autumn, the Michigan SRC measure of households' median expectation for inflation over the next twelve months has been in the neighborhood of 3 percent to 3¼ percent since March 2005 after hovering in the area of 2¾ percent to 3 percent in late 2004 and early 2005. In January 2006, it stood at 3 percent. The Michigan SRC measure of the median expectation for inflation over the next five to ten years was also running a bit above 3 percent in late 2005, but it dipped to 2.9 percent in January of this year, a reading similar to those in 2004 and in the first eight months of 2005. Other indicators likewise suggest that

TIPS-based inflation compensation, 2003–06



NOTE: The data are daily and extend through February 8, 2006. Based on a comparison of the yield curve for Treasury inflation-protected securities (TIPS) with the nominal off-the-run Treasury yield curve.
SOURCE: Federal Reserve Board calculations based on data provided by the Federal Reserve Bank of New York and Barclays.

longer-run inflation expectations have remained well contained. According to the Survey of Professional Forecasters, conducted by the Federal Reserve Bank of Philadelphia, expectations of inflation over the next ten years remained at 2½ percent in 2005, as they have since 1998. In addition, inflation compensation, as measured by the spread of yields on nominal Treasury securities over their inflation-protected counterparts, fell a bit, on balance, in 2005.

U.S. Financial Markets

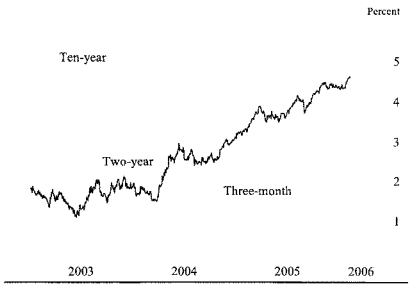
U.S. financial markets withstood some strains in 2005, most notably a large cumulative upward revision to the expected path of monetary policy, sharp increases in energy prices, troubles in the auto and airline sectors, and three major hurricanes. Longer-term market interest rates remained low, corporate risk spreads stayed relatively narrow by historical standards, and equity prices advanced modestly. Banks continued to ease standards and terms on loans to businesses, and bank lending to businesses surged. Overall, debt growth in the business sector picked up, and the expansion of household debt remained quite brisk, but federal borrowing dropped back. The M2 monetary aggregate grew moderately.

Interest Rates

The FOMC lifted the target federal funds rate a total of 2 percentage points in 2005, nearly 1 percentage point more than market participants had anticipated at the start of the year. Over the first half of 2005, short- and intermediate-term interest rates rose in line with the gradual firming in the stance of monetary policy, but longer-term interest rates moved lower on balance. For a time early in the year, rising oil prices and incoming data showing higher-than-expected inflation appeared to lift policy expectations as well as interest rates at intermediate- and longer-term horizons. The minutes of the December 2004 FOMC meeting, released on January 4, 2005, and the FOMC's conditioning of its risk assessment on "appropriate monetary policy action" after its March 2005 meeting were read as indicating more concern among Committee members about inflation pressures than investors had anticipated. The ten-year Treasury yield moved up after Chairman Greenspan's semiannual congressional testimony in February 2005, as investors reportedly focused on his remark that the low level of long-term interest rates at that time was a "conundrum." However, the subsequent release of weaker-than-expected data on consumer spending, consumer sentiment, and output led investors to mark down again their anticipated path for monetary policy and caused intermediate-term Treasury yields to retreat somewhat on balance during the second quarter, while the ten-year Treasury yield declined sharply.

On balance over the second half of the year, investors became more confident that the economic expansion had substantial momentum, and the expected path of policy and nominal Treasury yields moved considerably higher. Economic data that came in over the summer months suggested more strength in spending and output than investors had been anticipating. However, in response to the devastation caused by Hurricane Katrina in August and the subsequent landfall of two additional major storms, investors marked down sharply their expectations for the path of monetary policy, predominantly at longer horizons, and nominal Treasury yields dipped. Those declines

Interest rates on selected Treasury securities, 2003–06



NOTE: The data are daily and extend through February 8, 2006.
SOURCE: Department of the Treasury.

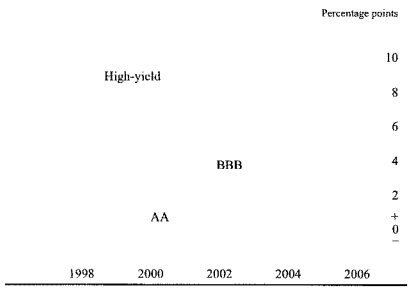
in yields proved temporary, though, as incoming data in the weeks after the hurricanes indicated that output had been expanding briskly before the storms hit and that the resulting disruptions to economic activity would probably be less severe than investors had initially feared. In addition, a drop in some energy prices might have contributed to an upgrading of the economic outlook. Over the remaining three months of the year, data on spending and production generally appeared robust, and investors raised their expectations for the path of monetary policy a bit more.

On net in 2005, the yield on the two-year nominal Treasury note rose about 135 basis points, whereas the yield on the ten-year Treasury note increased only about 15 basis points. As a result, longer-horizon forward rates extended their decline that had begun around the middle of 2004, the onset of the current tightening cycle. Although the reasons for this large cumulative drop are not entirely clear, this general pattern was also evident last year in other major industrialized economies, where longer-term interest rates mainly declined. One possibility is that higher energy prices might have led investors to trim their assessment of the cumulative amount of monetary policy restraint required over the longer run that would be consistent with sustainable economic growth. Investors also appeared to become less uncertain about the outlook and so might have become more willing to accept smaller risk premiums on long-term securities. Another possible explanation is that long-term inflation expectations have fallen and have become more firmly anchored. As measured by the spread between yields on nominal Treasury securities and their inflation-protected counterparts, inflation compensation fell a bit more than 30 basis points at the ten-year horizon over 2005. Finally, it is possible that an excess of global saving over planned investment has lowered real longer-term interest rates.

In the corporate bond market, risk spreads widened modestly in 2005, but the generally healthy state of corporate balance sheets and the robust growth of profits kept spreads low by historical standards. Spreads in the auto sector were an exception, however, as the troubles that emerged in the spring at GM and Ford and the bankruptcy of Delphi last fall boosted spreads sharply in this sector. The bankruptcies of two major airlines and the revelation of apparent accounting fraud at Refco, a large derivatives broker, did not appear to have a material effect on broad corporate risk spreads.

To date in 2006, amid uneven incoming economic data, investors' expectations for the path of the target federal funds rate have edged up, as have intermediate- and longer-term nominal Treasury rates. However, spreads on investment-grade corporate securities have changed little, whereas those on speculative-grade issues have declined somewhat.

Spreads of corporate bond yields over comparable off-the-run Treasury yields, 1997–2006

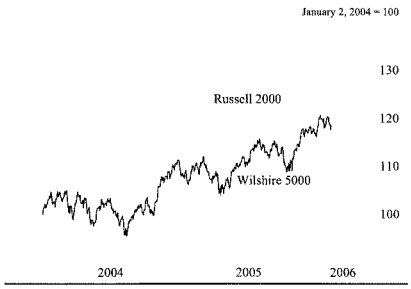


NOTE: The data are daily and extend through February 8, 2006. The high-yield index is compared with the five-year Treasury yield, and the BBB and AA indexes are compared with the ten-year Treasury yield.
SOURCE: Merrill Lynch AA and BBB indexes and Merrill Lynch Master II high-yield index.

Equity Markets

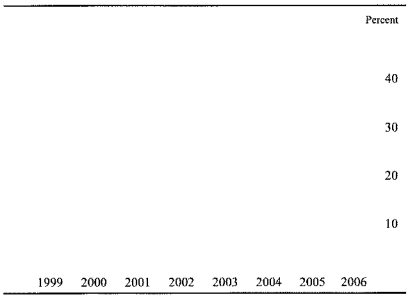
Share values, as measured by the Wilshire 5000 index, rose about 4½ percent in 2005. Higher energy prices and expectations for tighter monetary policy damped equity prices at times during the year, but these downward pressures were offset by continued strong corporate earnings growth and largely upbeat news on the economy. The response of stock prices to the hurricanes was generally muted—low longer-term interest rates and the prospect of additional fiscal stimulus apparently offset concerns that yet-higher energy prices might trim economic growth. On net last year, energy-related stocks registered substan-

Stock price indexes, 2004–06



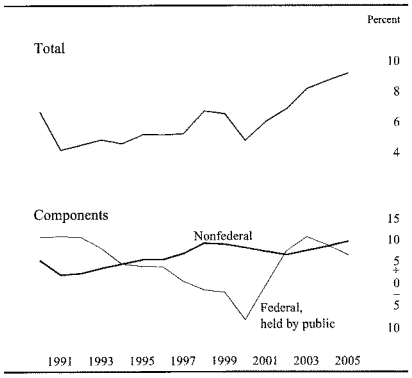
NOTE: The data are daily and extend through February 8, 2006.
SOURCE: Frank Russell Company; Dow Jones Indexes.

Implied S&P 500 volatility, 1999–2006



NOTE: The data are daily and extend through February 8, 2006. The series shown is the implied thirty-day volatility of the S&P 500 stock price index as calculated from a weighted average of options prices.
SOURCE: Chicago Board Options Exchange.

Change in domestic nonfinancial debt, 1990–2005



NOTE: For 2005, change is from 2004:Q3 to 2005:Q3 at an annual rate. For earlier years, the data are annual and are computed by dividing the annual flow for a given year by the level at the end of the preceding year. The total consists of components shown. Nonfederal debt consists of the outstanding credit market debt of state and local governments, households, nonprofit organizations, and nonfinancial businesses. Federal debt held by the public excludes securities held as investments of federal government accounts.
SOURCE: Federal Reserve Board, flow of funds data.

tial gains in response to the rise in the price of oil. To date in 2006, major equity indexes have risen modestly amid largely positive news about fourth-quarter earnings.

Volatilities of equity prices implied by prices on options contracts on both the S&P 500 and Nasdaq 100 indexes remained low over most of 2005, apparently owing to perceptions of only modest near-term macroeconomic risk. However, the spread between the twelve-month forward earnings–price ratio for S&P 500 firms and an estimate of the real long-term Treasury yield—a measure of the long-term equity risk premium—widened a bit last year and is now in the upper part of its range of the past two decades. Arithmetically, the widening in this spread can be attributed to a decline in the measure of the real long-term Treasury yield; the measure of the earnings yield on the S&P 500 changed little on balance last year.

Debt and Financial Intermediation

The total debt of the domestic nonfinancial sectors expanded an estimated 9 percent in 2005, about the same pace as in 2004. However, the composition of debt growth differed somewhat from the previous year: Borrowing by nonfinancial businesses picked up in 2005 while federal borrowing dropped back. The growth of debt of the household sector remained brisk, driven by the rapid expansion of mortgages.

Commercial bank credit expanded 10½ percent in 2005, a bit faster than the brisk pace registered in 2004. Growth of commercial and industrial loans jumped to 13½ percent, the fastest pace in more than two decades. As noted, senior loan officers reported in quarterly surveys that they had eased terms and standards on such loans last year. They attributed the easing to an improved economic outlook and more-aggressive competition from other banks and nonbank lenders. They also reported that loan demand had strengthened. Real estate lending by banks was brisk again last year, though it cooled somewhat in the fourth quarter in the wake of the backup in longer-term interest rates. Consumer loans on banks' books expanded rapidly during the first quarter of 2005 but then less so over the balance of the year, in part because some households substituted lower-cost mortgage credit for consumer loans.

Measures of bank profitability in 2005 fell back a bit from the very high levels posted in 2003 and 2004 but remained robust by historical standards. Profitability was restrained by vigorous competition and downward pressure on net interest margins from increases in market interest rates, but it was supported by excellent asset quality and reductions in noninterest expenses relative to assets. Banks' provisioning for loan losses over the first three quarters of last year was lower, on average, than in 2004, even with the increase in provisioning in the third quarter owing to the prospective surge in personal bankruptcies and to the hurricanes.

Mortgage market assets held by government-sponsored enterprises declined in 2005, as Fannie Mae reduced its mortgage portfolio about 20 percent and the rate of portfolio increase by Freddie Mac was somewhat below the rate of growth of residential mortgage debt in general.

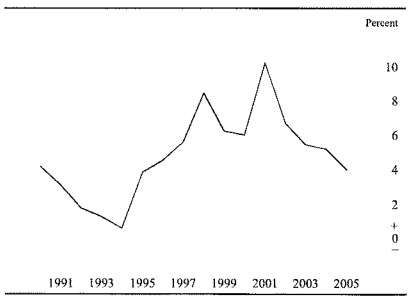
The reduction at Fannie Mae occurred partly in response to regulatory concerns about the adequacy of its capitalization. These concerns increased substantially after the company revealed in late 2004 that it had improperly accounted for certain derivative transactions. Fannie Mae's share price dropped about 30 percent last year, and Freddie Mac's declined about 10 percent. Yield spreads on both firms' debt over comparable-maturity Treasury securities were little changed on net.

The M2 Monetary Aggregate

M2 rose 4 percent in 2005, a pace significantly slower than the growth in nominal income and the lowest annual rate of expansion in about a decade.[1] As is typical in a period of rising rates, the opportunity cost of holding M2 assets increased significantly over the course of the year, as changes in rates on liquid deposits lagged those in market yields. Consequently, growth in liquid deposits almost came to a halt following double-digit expansion during the previous several years. Some offset was provided by a rapid increase in small time deposits, rates on which remained better aligned with short-term market rates. After having contracted sharply in the past couple of years, shares of retail money market mutual funds were about flat, on net, as the return on such balances improved in line with short-term interest rates. Hurricane relief efforts likely added a little to the growth of M2 last year: Funds provided by the federal government to displaced households and funds advanced by insurance companies probably buoyed M2 over the last four months of 2005, as did a rise in the use of currency in the affected areas.

1. The Board announced in November that in March 2006 it would cease compilation and publication of data on the M3 monetary aggregate; publication of M3 was judged to be no longer generating sufficient benefit in the analysis of the economy or of the financial sector to justify the costs of publication.

M2 growth rate, 1990–2005



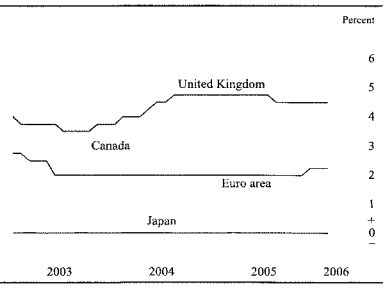
NOTE: The data are annual and extend through 2005. M2 consists of currency, traveler's checks, demand deposits, other checkable deposits, savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds.
SOURCE: Federal Reserve Statistical Release H.6, "Money Stock Measures."

International Developments

Foreign economic activity remained strong in 2005, as the global economy displayed resilience in the face of sizable increases in energy prices. Manufacturing and trade expanded in most industrial and emerging economies. As in 2004, global economic growth in 2005 was driven importantly by strong demand from the United States and China, but domestic demand picked up in a number of other countries as well. The run-up in prices of crude oil and other commodities over 2005 appeared to have had only a modest effect on measures of inflation in most countries.

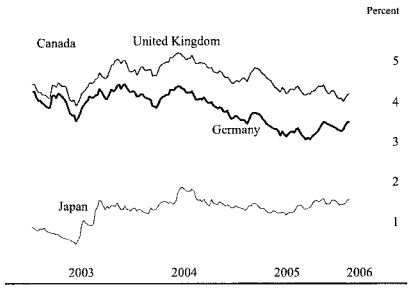
Cumulative changes in monetary policy in foreign industrial economies during 2005 varied in direction and, in contrast to the United States, were mostly small. The European Central Bank, which had maintained its main policy interest rate at 2 percent since the middle of 2003, tightened 25 basis points late in 2005, citing a need to keep inflation expectations in check. The Bank of England, after tightening 100 basis points in 2004, lowered its policy rate 25 basis points in August 2005, as the U.K. housing market had cooled and as the growth of household spending and business investment had slowed. The Bank of Canada raised its target for the overnight rate a total of 100 basis points in the latter part of 2005

Official interest rates in selected foreign industrial countries, 2003-06



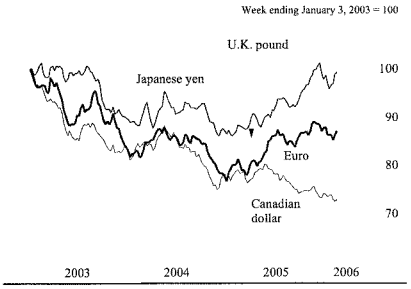
NOTE: The data are monthly. The last observation for each series is for February 8, 2006. The data shown are the call money rate for Japan, the overnight rate for Canada, the refinancing rate for the euro area, and the repurchase rate for the United Kingdom.
SOURCE: The central bank of each area or country shown.

Yields on benchmark goverment bonds in selected foreign industrial countries, 2003-06



NOTE: The data are for ten-year bonds and are weekly. The last observation for each series is the average of February 6 through February 8, 2006.
SOURCE: Bloomberg L.P.

U.S. dollar exchange rate against selected major currencies, 2003-06

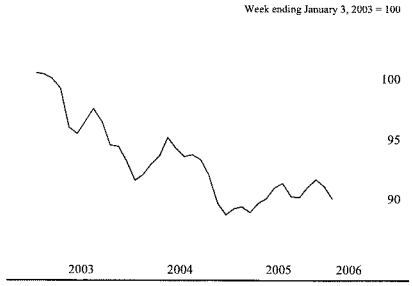


NOTE: The data are weekly and are in foreign currency units per dollar. The last observation for each series is the average of February 6 through February 8, 2006.
SOURCE: Bloomberg L.P.

and the beginning of 2006, stating that the Canadian economy was operating again at full capacity. The Bank of Japan did not depart in 2005 from its policy of quantitative easing, as it continued to provide large amounts of bank reserves to keep short-term interest rates near zero. However, in the second half of the year, amid growing evidence that an end to consumer price deflation might be near, Bank of Japan officials began to discuss publicly the possibility of ending the policy in 2006.

Ten-year sovereign yields in the euro area and Canada have declined 15 to 20 basis points on net since the beginning of 2005, and ten-year U.K. sovereign yields have dropped 35 basis points. Over the same period, Japanese ten-year sovereign yields have risen about 15 basis points, somewhat less than U.S. Treasury yields of the same maturity. Despite higher energy prices, long-term inflation expectations appear to have remained well contained abroad. In Europe, Canada, and Japan, the differences between ten-year nominal and inflation-indexed bond yields currently are little changed from their levels at the start of 2005.

U.S. dollar nominal exchange rate, broad index, 2003-06

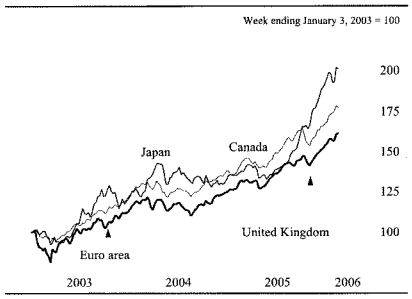


NOTE: The data are weekly and are in foreign currency units per dollar. The last observation is the average of February 6 through February 8, 2006. The broad index is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of major U.S. trading partners. The index weights, which change over time, are derived from U.S. export shares and from U.S. and foreign import shares.
SOURCE: Federal Reserve Board.

Our broadest measure of the nominal trade-weighted exchange value of the dollar has risen 2½ percent on net since the beginning of 2005. The dollar likely was supported by the FOMC's significant cumulative policy tightening, only part of which had been anticipated by market participants at the start of 2005. The dollar's overall appreciation was driven by its sharp gains against the currencies of several major industrial countries; the dollar depreciated on average against the currencies of the United States' other important trading partners. Since the start of 2005, the dollar has appreciated about 15 percent versus the euro and the Japanese yen, and 10 percent against the British pound. A notable exception to this pattern is the Canadian dollar, against which the U.S. dollar has depreciated 4 percent since early 2005. With respect to currencies of other important trading partners, the dollar has depreciated 6 percent against the Mexican peso, 17 percent versus the Brazilian *real*, and 7 percent against the Korean won.

Equity prices have risen substantially in most foreign industrial and emerging-market countries since early 2005; these prices have been supported by the continued global economic expansion and by interest rates that, in most countries, have remained well below historical averages. Rising commodity prices have buoyed share

Equity indexes in selected foreign industrial countries, 2003-06



NOTE: The data are weekly. The last observation for each series is the average of February 6 through February 8, 2006.
SOURCE: Bloomberg L.P.

prices of firms in the energy and mining sectors, and share prices in the technology sector have also increased sharply. Since the beginning of 2005, headline equity indexes, measured in local currencies, have risen about 20 percent on net in the United Kingdom, 30 percent in the euro area, and 45 percent in Japan. In the United States, by contrast, equity prices have increased only modestly over the same period.

Industrial Economies

After expanding at an annual rate of 5¼ percent in the first half of 2005, Japanese real GDP growth declined to 1 percent in the third quarter, largely because of slower inventory accumulation. Throughout the year, the most important source of support to economic growth was domestic demand, which was lifted by improvements in corporate profitability and labor market conditions. The unemployment rate declined sharply during 2005, ending the year at just under 4½ percent. The rate of deflation in core consumer prices subsided considerably in 2005; in fact, from December 2004 to December 2005, core prices posted a 0.1 percent increase. However, the GDP deflator continued to fall at a slow rate.

Economic growth in the euro area remained weak in the first half of 2005, at around a 1½ percent annual rate. Growth picked up to 2½ percent in the third quarter, spurred by stronger exports, especially by Germany. However, weakness in household spending persisted. The area-wide unemployment rate fell slightly over the year, to 8¼ percent near year-end, although employment only edged up. For the sixth straight year, euro-area inflation remained just above the ECB's medium-term goal of less than (but close to) 2 percent.

The rate of growth of real GDP in the United Kingdom slowed from 3¼ percent in 2004 to 1¾ percent in 2005. The slowdown was marked by a substantial deceleration of both private and government consumption. Labor markets remained tight, however; the unemployment rate of 2.9 percent in December was up only slightly from the twenty-year low of 2.6 percent recorded in January 2005. Consumer price inflation over the twelve months ending in December 2005 was 2 percent, in line with the central bank's official target. In contrast to the substantial run-up in real estate prices of 2004, housing price increases in 2005 were small.

Canadian economic growth was solid again in 2005. Recovering from a slow first quarter that featured a sharp but temporary pullback in exports, real GDP growth rebounded to around 3½ percent in the second and third quarters. For a second straight year, strong domestic demand underpinned growth, but net exports also made a positive contribution to growth late in the year. Employment made gains, although not as large as in the previous three years, and the unemployment rate touched a thirty-year low of 6.4 percent at year's end. After spiking in the third quarter on rising gasoline prices, consumer price inflation settled back toward 2 percent, the midpoint of the Bank of Canada's inflation target range.

Emerging-Market Economies

Growth of real GDP in China remained vigorous in 2005, supported again by robust domestic demand and exports. Both personal consumption and investment expenditures continued to grow rapidly during the year. Export growth also remained strong through most of the year, while import growth slowed. As a result, the Chinese trade surplus more than tripled and exceeded $100 billion. Consumer price inflation in 2005 was low in comparison with the previous year, when higher food prices had caused inflation to surge; the twelve-month change in consumer prices finished the year at just over 1½ percent.

On July 21, China revalued the renminbi 2.1 percent versus the dollar and announced that henceforth it would manage the value of its currency with reference to a basket of foreign currencies. Since the July revaluation, the exchange value of the renminbi versus the dollar has risen about ½ percent. Chinese authorities also have implemented some reforms of the financial system that are intended to facilitate further exchange rate flexibility, including the introduction of an over-the-counter trading system in the domestic foreign exchange market. China's foreign exchange reserves increased more than $200 billion in 2005; the pace of reserve accumulation did not

change appreciably after the revaluation of the renminbi in July.

In other emerging-market nations in Asia, economic activity also picked up substantially in 2005, driven by the growth of domestic demand and exports. Despite the global rise of energy costs, consumer price inflation generally remained contained. Equity indexes registered large increases in a number of Asian countries, led in many cases by gains in share prices of technology firms. In particular, Korean equity prices have risen about 45 percent since early 2005. Several countries in the region added to their holdings of foreign exchange reserves over the period, but in all cases far less than China did.

After a solid performance in 2004, the Mexican economy slowed in the first quarter of 2005 and contracted in the second quarter because of weaker exports to the United States and a sharp drop in agricultural production. However, the Mexican economy recovered in the second half of the year, as agricultural and manufacturing production bounced back. Aggressive tightening of monetary policy from early 2004 to March 2005 seemed to be successful in restraining inflationary pressures: Consumer price inflation declined from more than 5 percent at the end of 2004 to a bit less than 4 percent in January 2006, within the central bank's target range of 2 percent to 4 percent. The soft economy and an improved outlook for inflation led the Bank of Mexico to begin easing policy in August 2005, and the central bank has continued to ease since then. High oil revenues boosted the public-sector surplus, and yield spreads of Mexican sovereign debt over U.S. Treasuries declined to record lows.

In Brazil, growth in economic activity was moderate in the first half of 2005, and some indicators point to a slowing over the second half. Nonetheless, risk spreads of Brazilian sovereign debt declined over the course of the year to their lowest levels since 1997, the *real* appreciated strongly, and stock prices rose sharply. Concerns over inflation kept monetary policy very tight for most of the year, but the central bank began easing in September, and the policy rate was reduced a total of 250 basis points, to 17¼ percent, by January. In late December, Brazil paid in full its debt to the International Monetary Fund (IMF), using a portion of its foreign exchange reserves.

In Argentina, the economic recovery continued last year, driven in part by increases in consumption and investment. After more than three years in default, the government completed a debt swap, restructuring $80 billion in bonds and obtaining a participation rate of 76 percent. Early this year, Argentina also paid in full its IMF obligations out of its foreign exchange reserves.

Equity indexes in selected emerging-market economies, 2003-06

NOTE: The data are weekly. The last observation for each series is the average of February 6 through February 8, 2006. The Asian emerging-market economies are China, Hong Kong, India, Indonesia, Malaysia, Pakistan, the Philippines, Singapore, South Korea, Taiwan, and Thailand; each economy's index weight is its market capitalization as a share of the group's total.

SOURCE: For Asian emerging-market economies, Morgan Stanley Capital International (MSCI) index; for others, Bloomberg L.P.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

April 5, 2006

The Honorable J. Gresham Barrett
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Thank you for your letter of March 24 forwarding additional questions in connection with the February 15 hearing before the House Financial Services Committee. My responses are enclosed, and I am sending a copy to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Chairman Ben Bernanke submitted the following in response to written questions received from Congressman J. Gresham Barrett in connection with the February 15, 2006, hearing before the Committee on Financial Services:

1) As you know, President Bush recently commented in the State of the Union address that we're a country "addicted to oil." Indeed, record profits for oil producers have some of my colleagues concerned the industry is taking advantage of this addiction. As a result, implementing a windfall profits tax on the industry has been discussed.

a. What impact do you think a windfall profits tax would have on the economy?

The economic effects of a windfall profits tax on the economy would depend upon the form of the tax. For example, the Crude Oil Windfall Profits Tax enacted in 1980 was actually an excise tax on domestic oil production; it was repealed in 1988. Some current proposals for a windfall oil profits tax appear to be similar to an excise tax on oil companies; other proposals would change the methods used by oil companies to value their inventories, which would have the effect of raising their taxable profits.

In general, a tax on oil companies that reduces the after-tax return to oil company stockholders eventually would tend to shift investment away from the oil industry toward other sectors of the economy that previously had rates of return to capital less than those in the oil industry.

Also, although the tax would be imposed, in the first instance, on oil companies, the economics of the market could cause some of the tax to be passed on to consumers in higher prices for petroleum products. Higher prices for refined petroleum products, including gasoline, would tend to decrease the quantity demanded of these products, particularly in the longer run. Producers of goods and services that use petroleum products as intermediate inputs would see an increase in their costs as well, which would tend to induce them to raise their prices and thus reduce the quantity demanded of their products. Households would tend to shift consumption away from petroleum products and goods and services that use oil intensively as an input toward other goods and services.

Proposals that would revalue oil company inventories in order to increase their tax burden would have similar effects. In addition, this type of proposal could induce oil companies to maintain smaller inventories. If oil companies held lower inventories, then future market disruptions in the supply of oil could lead to more volatile swings in prices for oil and refined petroleum products.

2) As a proponent of developing alternative energy sources, I understand breaking our addiction to oil won't occur overnight. Oil's stronghold on our economy has many consumers concerned because sharp increases and extreme volatility of oil prices takes money out of their back pockets.

a. Some believe the rise in oil prices is a result of speculative market behavior.

i. What impact do you believe the futures and options markets have on oil prices?

Futures and options markets play an important role by providing a means to manage risk and by serving as a mechanism for price discovery. Participation in these markets is obviously not limited to those who have a direct commercial interest in producing or consuming the underlying commodity. In the case of the crude oil market, some observers have attempted to attribute at least part of the increase in oil prices over the past few years to the activities of hedge funds and other speculative traders. The apparent increased participation of these traders in the market, however, does not mean that their actions are actually responsible for the price run-up. In fact, increases in oil prices probably encouraged the entry of speculative investors in the market. It may also be the case that these market participants have added liquidity to the market and have facilitated the price discovery process at a time when the balance of supply and demand in the physical oil market has undergone significant change.

b. What impact do you believe high oil prices will have on our nation's well being in the short and long run?

The surge in energy prices since late 2003 has significantly reduced the purchasing power of households and decreased the profits of non-energy firms, thereby restraining both consumer spending and business investment. By rough estimate, these increases in energy prices have probably reduced real GDP growth between 1/2 percent and 1 percent per year over this period. Although some of this loss in output will be made up in the longer run as the U.S. economy adjusts to higher energy prices, the level of productivity is likely to remain lower than it otherwise would have been, as firms use less energy per worker. As for inflation, the rise in energy costs has had a significant impact on overall or "headline" inflation and has likely also affected core inflation (which excludes the direct effect of energy price increases), although thus far the impact on core inflation appears to have been relatively modest. In the longer run, these inflation effects should fade even if energy prices remain elevated, so long as monetary policy keeps inflation expectations well-anchored by responding appropriately to future price and output developments.

BOARD OF GOVERNORS
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WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

March 21, 2006

The Honorable Harold Ford, Jr.
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am pleased to enclose my responses to your additional questions following the February 15th hearing before the Committee on Financial Institutions. I have also forwarded a copy to the Committee for inclusion in the hearing record.

Sincerely,

Enclosures

Chairman Bernanke has subsequently submitted the following in response to written questions received from Congressman Harold Ford in connection with the February 15, 2006, hearing before the Committee on Financial Services:

Last month, the Federal Reserve, the FDIC, the OCC and the Office of Thrift Supervision issued for comment proposed guidance on sound risk management practices for concentrations in commercial real estate lending. Essentially, the guidelines propose limiting a bank to no more that 300% of its capital in commercial real estate loans unless they install very sophisticated "risk management" systems. Community Bankers in my state of Tennessee have told me they would be significantly impacted by these proposed guidelines and such requirements would essentially "put them out of the business they have been in for over 20 years." I understand the issue of concentration of credit and certain concentrations should be accompanied by heightened risk management techniques, but I am concerned about the singling out of a very broad and potentially diverse segment of loans (commercial real estate). Commercial real estate loans are fundamental to our nation's banking system and since many community banks are heavily involved in this kind of lending to build up their communities, the effect of this proposal may be to freeze out this lending. I would like to know whether you have any comments on this proposal and how it might affect community banks, not only in Tennessee, but nationwide?

The Federal Reserve and the other banking agencies recognize that community banks play a vital role in providing commercial real estate loans to homebuilders and businesses in their communities. The proposed guidance is not intended to limit banks in making sound commercial real estate loans in their communities. Rather, the intent of the proposed guidance is to focus bankers' attention on sound risk management practices related to commercial real estate concentrations. Over the last several years, the agencies have observed a growth in concentrations of commercial real estate lending at banks, both community and regional institutions, and, at the same time, an easing of underwriting standards. Recognizing that high concentrations in commercial real estate lending at banks in the late 1980s and early 1990s led to significant losses, the agencies thought that it was appropriate to remind banks that high concentrations in commercial real estate lending expose banks to higher credit risk and warrant increased management attention and strong risk management practices.

Some community bankers have raised concerns that the proposed guidance reflects a "one size fits all" supervisory approach and believe that examiners should consider a bank's specific characteristics when applying the guidance. The agencies recognize that a "one size fits all" approach is not appropriate and, as such, would expect our examiners to apply any final guidance on a case-by-case basis. If the proposed guidance is adopted, we would expect to tailor any supervisory response to the specific nature of the bank's

commercial real estate concentration risk, taking into account the appropriateness of its risk management practices and the adequacy of its capital.

Without having to curtail their commercial real estate lending activities, there are ways that banks, even community banks, can manage their concentration risk while still meeting the credit needs of their communities. For example, a bank can consider loan participations, loan sales, and securitizations as a management strategy to reduce its concentration in commercial real estate loans while continuing to make loans. Alternatively, if a bank decides to retain commercial real estate loans in its loan portfolio, the bank needs to recognize the risk arising from this business strategy and ensure that its risk management practices and capital levels are appropriate for the level of risk.

The January 19th issue of The Economist had an article titled "Emerging Economies--Climbing Back." Using IMF data based on Purchasing Power Parities (PPPs) the article indicates that in 2005 emerging economies share of exports climbed to 42%, they consumed 47% of oil, but accounted only for 14% of global stock market capitalization. The article indicates that prior to the industrial revolution (until 1820) these economies controlled 80% of world output, which now stands at around 40%. Current relative economic growth rates indicate that if these emerging economies maintain their faster growth rate, in 20 years they could account for 2/3rds (67%) of output. This would suggest longer term portfolio capital flows into these emerging markets and away from the dollar, with negative long-term implications for the value of our currency. What are the long-term implications of this for both inflation and interest rates? What actions should the Federal Reserve be taking to ensure a stable economic environment at home (and hence employment) in the face of what appears to be increasing global challenges and increasing domestic spending on defense and homeland security and reduced spending on education?

Many emerging-market economies are, indeed, growing more rapidly than the industrial economies, so that their share in global output will likely rise over time. However, it is not clear that this trend, by itself, would lead to a re-direction of capital flows toward emerging-market economies and a decline in the foreign exchange value of the dollar. A wide range of factors influences the pattern of capital flows, including saving rates, productivity, the depth and breadth of financial markets, corporate transparency, government regulations, reliability of property rights, and the fairness and efficacy of the legal system more generally.

A shift in emerging markets toward net capital inflows (and corresponding current account deficits) would require shifts in the attractiveness of the investment environment in these economies relative to that in the United States and other industrial countries. Should such a development occur, it might be associated with a decline in the value of the dollar and a narrowing of the U.S. trade deficit. Neither of these events would be likely to

threaten U.S. growth or boost inflation and interest rates to a worrisome extent; in fact, the dollar fell sharply in the mid-1980s without causing significant economic disruptions. More generally, economic growth among our trading partners benefits the U.S. economy by enlarging the market for our exports and allowing us to import a wider variety of goods at lower cost. Regardless of the future evolution of the dollar, the trade deficit, and the global economy, the Federal Reserve will continue to focus its policies on maintaining stable prices and maximum sustainable employment in the United States.

You have suggested that the Federal Reserve must take into account broad financial conditions in setting the federal funds rate, including long term interest rates and the stock market. But something that comes to mind is the non-interest rate forms of tightening occurring in other sectors. For example, restrictions on mortgage lending and increasing credit card minimum payments. How much does the Federal Reserve take into account other agencies' tightening in assessing the need for further tightening in setting the federal funds rate?

In assessing the appropriate stance of monetary policy, the FOMC takes into account banks' overall lending posture--as reflected in their loan interest rates, credit standards, and non-price lending terms such as collateral, covenants, and loan limits. In making that assessment, the Federal Reserve utilizes information from a variety of sources. Among these are two Federal Reserve surveys of bank lending standards and terms. The first, the Senior Loan Officer Opinion Survey on Bank Lending Practices, is a quarterly survey of major banks around the country. It queries banks about qualitative changes in lending standards and terms on loans to both businesses and households. The second, the Survey of Terms of Business Lending, provides detailed quarterly information on price and non-price characteristics of commercial and industrial (C&I) loans.

Both of our surveys indicate that, despite the removal of policy accommodation last year, commercial banks have continued to ease credit standards and a variety of non-price lending terms on loans to both businesses and households. With regard to C&I loans, banks have also trimmed spreads of loan rates over their cost of funds in 2005. Banks attributed their easing of commercial lending policies to an improved economic outlook, strong corporate credit quality, and increased competition from bank and non-bank lenders. On the household side, domestic commercial banks have reported an increased willingness to make consumer installment loans. Although banks reportedly boosted required minimum payments on credit cards late last year, a few institutions eased standards and other terms on such loans during 2005. Banks also indicated that since late 2003 they had eased certain non-price terms on residential mortgage loans and had narrowed spreads of mortgage rates over relevant base rates. In short, the available evidence suggests that credit standards and a number of non-price lending terms for both households and businesses have eased as the FOMC has raised its target for the federal funds rate.

In the 16 months that Check 21 has been in effect, is the industry making strides in taking advantage of the law to improve the efficiency of our nation's check clearing system? How has the industry received the Federal Reserve's Check 21 product offerings? Is there any evidence that Check 21 has disadvantaged consumers in any way? Would you care to share your predictions regarding when the majority of the nation's checks will be clearing electronically?

The industry is making progress towards using the new Check 21 authority to improve the efficiency of our nation's check clearing system. As expected, the pace of Check 21 adoption has been measured as depository institutions have addressed the complexities of implementing image technology throughout their check processing operations. Although a growing number of depository institutions, currently over 600, are sending their check deposits to the Reserve Banks electronically, the number of depository institutions accepting check presentments electronically is growing much more slowly. It will only be when checks are collected fully electronically, eliminating the need to create substitute checks, that the full benefits envisioned by Check 21 will be achieved.

While it is difficult to predict, it may be reasonable to expect that by the end of this decade or the beginning of the next, the majority of the nation's checks will be cleared electronically. This prediction could be affected by a number of factors, including the potential chilling effect that may result from the current patent infringement litigation in this arena.

To facilitate this transition, the Reserve Banks have offered a suite of Check 21-related services since the act took effect. Currently, 6 percent of all checks, constituting 20 percent of the value of all checks, collected through the Reserve Banks are collected using Check 21 authority. To encourage depository institutions to accept checks electronically, the Reserve Banks recently modified their product pricing to provide incentives to paying banks to accept electronic check presentments.

We have no indication that the check processing changes related to Check 21 have disadvantaged consumers.

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WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

March 17, 2006

The Honorable Mark Kennedy
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am pleased to enclose my response to the question you submitted following the February 15 hearing before the Committee on Financial Services regarding the semiannual monetary policy report to the Congress. A copy will be forwarded to the Committee for inclusion in the hearing record.

Sincerely,

Enclosure

Chairman Bernanke subsequently submitted the following in response to a written question received from Congressman Mark Kennedy in connection with the February 15, 2006, hearing before the Committee on Financial Services:

As you know, our nation's trade deficit continues to be an issue that is a focal point of many in Congress. While various views have been put forth about how to interpret the numbers by the Commerce Department in recent years, last year you proposed an alternative view as to the likely cause of the U.S. trade deficit.

Specifically, you have indicated that the trade deficit is largely dependent on the saving surplus in developing countries.

In essence, a big part of the trade deficit and [current] account deficit is because the rest of the world wants to invest in the U.S., because of our dynamic and rapidly growing economy and the returns on investment our economy is capable of generating.

With our trade deficit for 2005 having just been reported, do you still see your analysis as an accurate portrayal of our country's trade imbalance?

As indicated by the question, in my March 2005 speech, "The Global Saving Glut and the U.S. Current Account Deficit," I identified the excess of notional saving over investment rates in the developing countries as a major factor underlying the large U.S. current account deficit. The speech proposed several reasons for why the current account balance of developing countries had swung into surplus, including the reaction of developing Asian economies to the financial crisis of 1997-98 and the effect of rising oil prices on the revenues and trade balances of the oil-exporting countries. Nothing has occurred since March 2005 to diminish support for the "global saving glut" hypothesis, and the factors contributing to this "glut" generally remain in place. The U.S. trade deficit has widened $106 billion between 2004 and 2005, but the surplus of the developing economies is generally estimated to have widened as well. Much of the widening of the U.S. deficit and of the developing country surplus is attributable to higher oil prices--a factor identified in my March speech. Additionally, U.S. economic growth again exceeded that of a trade-weighted average of industrial economies in 2005, thus continuing to support the relative attractiveness of investments in the United States.

BOARD OF GOVERNORS
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WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

March 15, 2006

The Honorable Ron Paul
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Thank you for your letter of March 3. I was pleased to be able to testify before the Committee on Financial Services last month on the Federal Reserve's semiannual monetary policy report to the Congress.

With regard to your question about the role of the dollar in the pricing of international oil transactions, I do not see any grounds for concern. The dollar is likely to remain the invoice currency for the bulk of oil transactions. Moreover, the choice of a transactions currency for a commodity, even one as important as oil, has little implication for the U.S. economy or for the role of the dollar in the global economy.

The level and volatility of oil prices will not be much affected regardless of whether oil is invoiced in dollars or euro. The dollar's preeminent role in international finance derives from the large size and dynamism of the U.S. economy; the liquidity, safety, and sophistication of our financial markets; and the credibility and soundness of our economic policies. It is these features that make dollar-denominated assets attractive to investors around the world.

Sincerely,

BOARD OF GOVERNORS
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WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

March 21, 2006

The Honorable Brad Sherman
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am pleased to enclose my responses to the questions you asked during the February 15 hearing before the Committee on Financial Services regarding the semiannual monetary policy report to Congress. A copy will be forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosures

Chairman Bernanke subsequently provided the following for the record:

As I have stated before, I believe that reducing the federal deficit is very important, especially in light of the need to prepare for the retirement of the baby-boom generation. I urge the Congress to proceed on that effort in a timely manner and to pay particular attention to how its decisions on spending and tax programs will affect the U.S. economy over the long run. However, I also believe that in my role as Chairman of the Federal Reserve, I should not be involved in making specific recommendations to the Congress regarding fiscal policy.

Chairman Bernanke subsequently provided the following for the record:

It should be noted at the outset that the Secretary of the Treasury is the chief spokesperson for the U.S. government on matters relating to the foreign exchange value of the dollar. Current U.S. policy is to let markets determine the exchange value of the dollar. This is consistent with the general view that the economy performs best when markets are allowed to freely set prices of goods, services, and assets. Stated U.S. policy has been generally not to intervene in currency markets except to counter disorderly market conditions. As regards working with other countries, on occasions in the past, the United States has coordinated intervention with foreign governments.

Although U.S. trade deficits cannot continue to widen forever, these deficits need not engender a precipitous decline in the dollar, nor should such a decline, were it to occur, necessarily disrupt financial markets, production, or employment. The dollar fell sharply in the mid-1980s without triggering substantial economic dislocations. However, the possibility of a future disruptive correction of the U.S. trade deficit cannot be ruled out. The best way to protect the U.S. economy from such an event is to continue policies designed to maintain the stability of the financial system and the flexibility and resilience of the economy. Regardless of the future evolution of the trade balance, the Federal Reserve will work to ensure that prices remain stable and employment remains close to its maximum sustainable level.

Chairman Bernanke subsequently provided the following for the record:

For a variety of reasons, Congress has sought to maintain the separation of banking and commerce in the United States. Congress reaffirmed its desire to keep banking and commerce separate in 1999 when it passed the Gramm-Leach-Bliley Act (GLB Act). That act closed the unitary thrift loophole, which previously allowed commercial firms to acquire a savings association, and authorized financial holding companies as a general matter to affiliate only with companies that are engaged in activities that have been determined to be financial in nature or incidental to financial activities. The GLB Act also placed limits on "financial subsidiaries" of member banks. These limits, among other things, allow financial subsidiaries of member banks to engage only in activities that its parent bank may conduct directly or that have been determined to be financial in nature or incidental to financial activities by the Treasury Department in consultation with the Board.

The question of whether, or to what extent, the mixing of banking and commerce should be permitted is an important issue and one that, we believe, should be made by Congress. The decision has important ramifications for the structure of the American financial system and the economy, particularly because any widespread combinations of banking and commerce likely would be irreversible. It is for these reasons that the Board has encouraged Congress to review the exemption in current law that allows a commercial firm to acquire an FDIC-insured industrial bank (ILC) chartered in certain states without regard to the limits Congress has established to maintain the separation of banking and commerce. Continued exploitation of the ILC exception threatens to remove this important policy decision from the hands of Congress.

Policies designed to maintain the separation of banking and commerce inevitably lead to questions as to what activities are financial and what activities are commercial. Under current law, Congress has determined that a number of activities, including securities underwriting and dealing, insurance underwriting and agency activities, various mutual fund activities and merchant banking, are all financial activities. Congress also has authorized the Board (in consultation with the Treasury Department) to determine whether other activities are financial in nature or incidental to financial activities and, thus, permissible for financial holding companies. Congress has vested the Office of the Comptroller of the Currency with the authority to determine what activities are part of, or incidental to, the business of banking and permissible for national banks under the National Bank Act.

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