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FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 2007

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON

OVERSIGHT ON THE MONETARY POLICY REPORT TO CONGRESS PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

JULY 19, 2007

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FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 2007

THURSDAY, JULY 19, 2007

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 9:32 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The hearing will come to order.

The Committee is very pleased this morning to welcome the Chairman of the Federal Reserve, Ben Bernanke. We thank you for being with us to present your outlook for the Nation's economy, the Fed's conduct of monetary policy, and the status of important consumer protection regulations that are under the Federal Reserve's jurisdiction.

Mr. Chairman, we once again welcome you to the Senate Banking Committee.

Before I begin my opening statement, I wanted to recognize several special guests we have with us here this morning, Dick, the members of the European Parliament's Committee on Economic and Monetary Affairs led by Chairwoman Pervenche Beres, and we thank you very much, Madam Chairwoman, for being here, and your colleagues as well. We are honored to have you here at the Senate Banking Committee and to have you participate.

The Chairwoman mentioned to me that the last time you came here and visited us was at the last testimony of Chairman Greenspan. So this is kind of a beginning again, so we start with the first testimony here of Mr. Bernanke. So welcome and thank you for joining us here.

This hearing is being conducted pursuant to the statute and according to practice. It is an occasion to consider not just monetary policy in a narrow or limit sense but also the overall health of our economy and what the Fed, as an agency, and we, as policymakers, should do to increase prosperity and opportunity in our country. The role of the Fed is critical not just to setting monetary policy but it also serves as a regulator for the safety and soundness of the largest lending institutions, and very significantly, as a regulator and enforcer of the laws passed by the Congress to protect consumers and ensure that they have an opportunity to participate and succeed in the American economy.

Mr. Chairman, I know I do not need to tell you that the Fed stands at the center of some of the most critical economic and public policy matters of our time. In the 17 months as Fed Chairman, your steadiness at the helm of our Nation's monetary policy seems to have earned you the confidence of the markets, which is the initial step toward a successful tenure as Fed Chairman. And I congratulate you on that.

The confidence has been reflected, in part, by some of the positive economic news that we have experienced, including an official unemployment rate that is low by historical standards, by gains in the stock market, and the economy's overall stability in the face of serious problems in both the housing and automotive sectors of our economy.

Those positive factors aside, and notwithstanding the positive impact of your leadership, there are some facts that are cause for deep concern for many of us here about our Nation's economic future, in particular the future of tens of millions of hard-working Americans. Despite some increases in income, working families are facing some unprecedented economic burdens. Gas prices reached another record high of an average of almost $3.25 a gallon across the country this past Memorial Day weekend. Health care costs have increased by 25 percent over the last 5 years. And the cost of sending a young person to college has risen at more than double the rate of inflation over the past 20 years. And default and foreclosure rates, as you well know, for homeowners are an all-time high.

Mr. Chairman, there is a persistent if not growing sense among many of our fellow countrymen that their future is less secure and less hopeful today than it has been and should be. It is in that respect that the Fed's role comes into play not just as a monetary policymaker but also as a safety and soundness regulator and as an agency charged with protecting consumers. The Fed can and, in my view, should take additional steps that can make a real difference in improving our overall economic growth as well as an opportunity for all Americans to contribute and to participate in the success and prosperity of the economy.

In that regard, let me say that I am pleased that you, as chairman, have accepted the Fed's duty to act under the Home Ownership Equity Protection Act. I consider this a significant statement by you and I trust and expect that it will result in significant action by the Fed to ensure that every American who seeks to buy a home will receive a fair, reasonable, and responsible treatment by his or her lender.

Similarly, with respect to credit cards, I commend the Fed for undertaking the effort to update Regulation Z which in my view is long overdue. It is vital that consumers have the clearest and most complete information possible about credit cards so they can make the most informed decision about how to use them.

However, improved disclosure is not, in and of itself, sufficient to address abusive practices. I believe the Fed can and should play a more active role not just in improving disclosure for consumers but also in prohibiting policies and practices that are harmful to consumers. In my view, credit cards can and should be a tool for eco-

nomic achievement and advancement rather than an instrument of perpetual indebtedness.

Last, Mr. Chairman, let me raise the issue of Basel II, of the bank capital standards, with you. History has taught us that well-capitalized banks are in the best interest of our Nation when they are better positioned to weather unexpected economic shocks, thereby protecting American taxpayers from costly bank bailouts. And they enhance the competitiveness of U.S. banks by instilling confidence in the strength of these vital institutions.

As Senator Shelby and I have written to you and your fellow banking regulators, the stakes are very high for our economy in this debate. We believe that it is imperative that the four regulatory agencies together agree upon the standards that will strike the vital balance between the remarkable safety and soundness of our federally insured lending institutions and their competitiveness in the global economy.

Mr. Chairman, the challenges you face, of course, are daunting. I think I speak for all of our Committee Members here in saying that we are committed to seeing the Fed succeed at each of these three vital missions: As a center of monetary policy, a consumer protector, and a bank regulator.

What is at stake here is not just the success of your agency, obviously, and your tenure as Fed Chairman, as important as those are, but rather the success of our entire economy and in particular for the tens of millions of Americans whose hard work is the foundation of our economy's success and who deserve every opportunity to maximize the fruits of their labor.

With that, let me turn to my colleague from Alabama, the Ranking Member of the Committee, Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Chairman Dodd.

Chairman Bernanke, we are pleased again to have you before this Committee.

This hearing, as Senator Dodd has pointed out, provides the Congress a very important opportunity to have an open and detailed discussion about the Fed's monetary policy goals and their implementation. I also expect that Members of the Committee here, including myself, will take advantage of your appearance, Mr. Chairman, to raise some other issues that fall under the jurisdiction of the Federal Reserve.

I would also like to join Senator Dodd in welcoming our colleagues from the European Union Parliament that are here today. I had a nice meeting with them yesterday and we look forward to these transatlantic visits. I think they are healthy. I trust that your visit here today will be enlightening and provide you with much to discuss with the European Central Bank.

Chairman Bernanke, your testimony and report this morning note the continued healthy performance of the economy in the first half of 2000. Although real gross domestic product, GDP, increased 0.7 percent in the first quarter the consensus view among economists is that growth for the second quarter will show a rebound in the neighborhood of 2.5 percent.

Along with continued GDP growth, we have seen positive news on the job front. Gains in the payroll employment average 140,000 jobs per month in the first half of 2007. We continue to enjoy low unemployment rate in this country, both historically and relative to other industrialized nations in the world.

The global economy also continues to be strong with Canada, Europe, Japan, and the United Kingdom experiencing above trend growth rates in the first quarter. This is good news, I believe, for American businesses seeking to expand their exports around the world.

In its statement following the June 28, 2007, meeting the FOMC suggested that while core inflation readings had moderated "sustained moderation in inflation pressures has yet to be convincingly demonstrated." There is a lot in those words.

Inflation risks, not slow growth, remains the predominant concern as we continue to see a rise in energy and food prices.

I also share, Mr. Chairman, your view on the importance of low inflation in promoting growth, efficiency, and stability which in turn equal maximum sustainable employment.

Chairman Bernanke, your statement also includes an extensive discussion of the Federal Reserve's recent activities relating to subprime mortgage lending, which is a concern to all of us. The recent sharp increases in subprime mortgage loan delinquencies are troubling. The rating agency's recent moves are also very interesting too. The initiatives that you highlight in your testimony are welcome.

However, I am concerned that the weaknesses, Mr. Chairman, in the subprime market may have broader systemic consequences than we are seeing yet. We have been told that the problem is largely isolated and contained but I am concerned that that may not be the case.

I will be particularly interested in hearing your views on the scope and depth of the problem and how the Federal Reserve will monitor and manage the situation hopefully going forward. We are pleased to have you with us this morning, as I said, and we look forward to the rest of the hearing and my colleagues testimony.

Chairman DODD. Thank you very much, Senator.

Let me inform my colleagues that as soon as a quorum appears here, I am going to interrupt the hearing. I say that to you, Mr. Chairman, as well, respectfully. We have several nominees that are prepared to be confirmed by this body and I would like to be able to move on that the moment a quorum arrives here. So just to give you advance notice when that happens here, realizing people have other obligations and may be moving in and out here. So we will try to get that done.

If for whatever reason we do not, then I will be asking all of you to join me after the first vote or during the first vote sometime around noon off the floor of the Senate to try to get these matters moved along so they can be considered by the full Senate before our August adjournment.

With that, let me turn to Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman. And Chairman Bernanke, thank you very much for joining us this morning. I am particularly pleased that your testimony describes Congress as prescient in the trend toward transparency. It is not often you see the words Congress and prescient in the same sentence. Thank you for that.

Of course, you are referring to an action 30 years ago, but we will take what we can get.

As you know, we need to encourage transparency in both central banking and in financial services and particularly in the mortgage business. I appreciate your devoting much of your testimony in the work of the Federal Reserve in promoting better disclosure for mortgage borrowers and hope you and your colleagues will approach this task with great urgency.

As you know, the loans of close to 2 million subprime borrowers will reset in the next 2 years. Every day of inaction means another 2,000 to 3,000 mortgages will reset without sufficient protections. If they are lucky, many of these families will be able to take out another lousy mortgage. If they are unlucky, they may lose their life savings.

The Federal Reserve must act and must act quickly both to mitigate the damage that has already been done and to prevent a continuation of the abusive practices and products that have characterized too much of the mortgage industry over the past few years.

I understand why a lender needs to price for risk but I do not understand why the structure of mortgage products is so different in the prime and subprime markets. Most of the people in this room do not have a prepayment penalty on their mortgage. Most of us have our property taxes and our hazardous insurance escrowed.

By contrast, the loans in the subprime sector, like the 228s, seem almost designed to deceive. They are sold to borrowers with teaser rates and with dangerous features and with the smooth pitch that there is no need to worry about the reset because good things might happen in your life, a better job, a better loan, even winning the lottery. But betting on the outcome is not a sound banking practice.

It is possible that I will play like Grady Sizemore in next year's Congressional baseball game but the Indians would be well advised not to put him on waivers. Sadly, it is not very likely I will climb the fence to rob somebody of a home run next summer because Republicans just do not have that kind of power.

You obviously need to take a broad view in your position. But the very dispersion of risk that makes the subprime problem less of a worry from an economic standpoint makes it a greater problem for homeowners trying to work out an unaffordable loan. We all know it makes economic sense for a lender to mitigate losses but just try getting the right person on the phone in a timely fashion, especially if the owner of the loan sits in Shanghai.

One man's junk is another man's treasure. What may look like BBB debt to an investor on Wall Street is really the hopes and dreams of thousands of families in Slavic Village in Cleveland and

across the country. Those hopes and dreams diminish with every day that we delay.

So, I would urge you to take action quickly and comprehensively. You need to bring an end to the deceptive practices in the subprime sector, not just for banks and their affiliates but for all mortgage brokers and all types of lenders.

Thank you. I look forward to your testimony.

Chairman DODD. Thank you, Senator.

Senator Hagel.

COMMENTS OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, welcome. I will withhold my comments until the question and answer period. I just want to say that we are glad you are here with us today. Thank you.

Chairman DODD. Thank you, Senator.

Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. I will not exercise such statesmanlike restraint.

Thank you, Mr. Chairman. And thank you, Chairman Bernanke, for joining us today to discuss the state of monetary policy and its reflection on our economy.

At the past eight meetings of the FOMC, the Fed has held the Federal Fund rates steady at 5.25 percent. However, significant turmoil in the housing market particularly related to subprime mortgages, a growing trade deficit, and a negative household savings rate continue to pose tremendous challenges to setting monetary policy.

I know, Mr. Chairman, you have personally expressed concern about core inflation being higher than is desirable in the long run. But the risk of raising interest rates too high is that a weakening housing sector and rising oil prices may be taking their toll on consumers and businesses alike and slowing down the economy too much already.

I look forward to your insights about the kind of policies that are likely to be effective in addressing the challenges we face in this economy and offering real opportunities for growth that provide widespread benefits to the American people.

On a systemic level, the weakening housing sector and turmoil in the subprime mortgage market have placed pressure on both investors and borrowers. Bear Stearns has recently announced that two of its hedge funds are now worth nearly nothing after some of its investments in subprime mortgages went bad.

Last week both Moody's and Standard & Poor's significantly downgraded ratings on hundreds of subprime related bonds. The ABX Index, which tracks the performance of various classes of subprime related bonds hit new lows yesterday. In the past few months portions of the index that tracked especially risky mortgage bonds with junk grade ratings have been falling. And this is now spread into the portion of the index that track bonds with ratings of AAA or AA.

According to Merrill Lynch's latest fund manager survey which polled 186 fund managers controlling $618 billion in assets, 72 per-

cent of managers said that credit or default risk was the biggest threat to financial market stability.

I would appreciate hearing your thoughts on some of these events, particularly as they may pertain to the financial accelerator effect you spoke of in Georgia last month and the efforts of the Federal Reserve to monitor some of these risks.

Finally, the Federal Reserve has the authority and responsibility to prohibit unfair and deception lending practices. As such, Mr. Chairman, I was pleased to hear that the Fed will likely propose additional rules under the Home Ownership and Equity Protection Act, HOEPA, to provide consumers with better protections through bans on some mortgage purchases.

Additionally, I understand that the Fed will join other regulators in a pilot project to monitor the practices of nondepository subprime mortgage firms. I am interested in your perspective on what additional actions the Federal Reserve will be taking to meet the regulatory portion of its mandate.

I look forward to your testimony, Mr. Chairman. Thank you.

Chairman DODD. Thank you very much, Senator Reed.

Senator Menendez.

STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman Bernanke, it is always good to welcome a fellow New Jerseyan back to the Committee. I am glad to have the chance to have you before the Committee again this year. I think your presence here is especially important, not just because it gives Congress an opportunity to look critically at the economy to see what is working and what is not, but because it brings a discussion of the economy onto the front pages and into the homes of Americans across the country.

I think Americans from all walks of life are clearly affected when the market has a dip, by external pressure on prices, by poor investment. For many, these factors are invisible. I welcome these discussions with you because you help make them much more tangible for average people across the country.

And I assume you often ask yourself a question that I certainly do, and I believe all of us should be asking, and that is who is this economy working for? Who is this economy working for?

Most middle-class Americans face rising food and energy prices as well as health care costs while median incomes for the last 5 years have remained stagnant. I think that there is a good part of the American middle class who does not think that this economy is working for them.

Unfortunately, most are aware of changes in the economy when it affects them negatively. I would like to focus on a specific group of Americans who have been keenly aware of how the economy has not worked for them, those who dreamed of being homeowners but in the wake of the subprime tsunami have seen those dreams wash away in foreclosure and bankruptcy. More than one million Americans lost their homes last year and few have yet to recover. In fact, I would dare to argue that another storm is on its way as adjustable rate mortgages explode in coming months and force more homeowners into foreclosure.

And so in my mind this is not just simply a time for suggestions, it is a time for solutions. The Federal Reserve has, and has always had, the tools to protect Americans from this storm. But as the warning signs were posted and as the foreclosures began we saw little to no action.

Now I want to commend you for addressing this issue, especially on low document loans and underwriting to the full indexed rate. But I am still hoping for more substantive solutions that will protect the borrower. We are talking also about predatory lenders and we must take swift action. I do not believe this is one that the market is going to handle simply on its own. Congress and the Federal Reserve need to act and I look forward to discussing this more with you today.

I welcome the focus you have recently had on discussing certain inequalities in our economy and I will look forward to your thoughts on these and other issues important to the economic prosperity of our Nation.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator.

Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman.

I want to thank you for holding this hearing and I want to thank Chairman Bernanke. As Chairman of the Joint Economic Committee, I am always interested in hearing your thoughts on the current state of economy and appreciate your availability on so many issues when we reach out to you.

As I have said in the past, we live in interesting economic times. And you face a number of important challenges in setting a course for monetary policy that will achieve the multiple goals of high employment, balanced economic growth, and low inflation. Right now, there are certain reasons to be concerned about where we find ourselves.

In the short-term, even with the likely improvements in the second quarter, overall economic growth in the first half of the year has been disappointing to say the least. Most forecasters have revised downward their expectations for economic growth through the rest of the year. The Administration continues to run high budget deficit that threaten our future stability to compete with the rest of the world. And our trade gap, particularly with China, remains immense and growing at a rapid rate.

Energy prices are hovering at record highs, feeding our trade gap and fueling anxiety among middle-class families. The collapse of parts of the housing market which you call a correction has become a serious drag on our economic growth and a threat to economic security of too many American families.

And while I welcome the Fed's new pilot program to monitor independent subprime brokers, I do not think consumers will truly be safe from irresponsible and deceptive lending practices until we enact tougher Federal laws to protect the subprime mess from happening again. As indication of the weakness in the housing market continue to mount, there is an urgent need for better protections for existing and aspiring homeowners, although I do want to

thank—the Appropriations Committee did a $100 million in for the workouts. So nonprofits can do workouts that Senators Casey, Brown, and I had asked them to do.

Most importantly, a view is recognized. We have an economy whose rewards seems to be more and more going to fewer and fewer privileged Americans. We are facing the greatest concentration of income since 1928 right before the crash and the beginning of the Depression when 24 percent of all income went to the richest 1 percent. It is now close to 22 percent and will pass the 24 percent, if present trends continue, all too soon.

At a time when the wealthiest in this country have been doing extremely well, the American middle class, the engine of our economy, has not been as fortunate. Most Americans have not seen the benefits of working harder in their paychecks.

Between 2000 and 2006 the typical worker's earnings grew less than 1 percent after accounting for inflation while productivity increased a whopping 18 percent. And now that economic growth seems to be slowing, its fair to ask whether most middle-class Americans will slip even further behind. The dramatic increase in productivity and its failure to raise wage rates is a great conundrum for our economy that needs all of our attention.

I do not pretend that there are easy solutions to the troubling challenges facing our economy but we need to remember that our collective focus must be on achieving strong sustainable long-term economic growth that can be shared by all families in this country, not just those in the top 1 or 5 percent.

Unless economic fortunes in this country grew together rather than apart, we cannot be confident about our children's economic futures.

I look forward to your testimony, and thank you, Mr. Chairman, for the time.

Chairman DODD. Thank you, Senator, very much.

Mr. Chairman, we welcome you here to the Committee once again and we are prepared to receive your statement.

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

Chairman BERNANKE. Thank you. Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I am pleased to present the Federal Reserve's Monetary Policy Report to the Congress.

As you know, this occasion marks the 30th year of semiannual testimony on the economy and monetary policy by the Federal Reserve. And in establishing these hearings, the Congress proved prescient in anticipating the worldwide trend toward greater transparency and accountability of central banks in the making of monetary policy.

Over the years, these testimonies and the associated reports have proved an invaluable vehicle for the Federal Reserve's communication with the public about monetary policy even as they have served to enhance the Federal Reserve's accountability for achieving that dual objectives of maximum employment and price stability set forth by the Congress.

I take this opportunity to reiterate the Federal Reserve's strong support of the dual mandate. In pursuing maximum employment and price stability, monetary policy makes its greatest possible contribution to the general economic welfare.

Let me now review the current economic situation and the outlook beginning with developments in the real economy and the situation regarding inflation before turning to monetary policy. I will conclude with comments on issues related to lending to households and to consumer protection, topics not normally addressed in monetary policy testimony but, in light of recent developments, deserving of our attention today.

After having run at an above trend rate earlier in the current economic recovery, U.S. economic growth has proceeded during the past year at a pace more consistent with sustainable expansion. Despite the downshift in growth, the demand for labor has remained solid, with more than 850,000 jobs having been added to payrolls thus far in 2007 and the unemployment rate having remained at 4.5 percent. The combination of moderate gains in output and solid advances in employment implies that recent increases in labor productivity have been modest by the standards of the past decade. The cooling of productivity growth in recent quarters is likely the result of cyclical or other temporary factors but the underlying pace of productivity gains may also have slowed somewhat.

To a considerable degree, the slower pace of economic growth in recent quarters reflects the ongoing adjustment in the housing sector. Over the past year, home sales and construction have slowed substantially and house prices have decelerated. Although a leveling off of home sales in the second half of 2006 suggested some tentative stabilization of housing demand, sales have softened further this year, leading the number of unsold new homes in builders' inventories to rise further relative to the pace of new home sales.

Accordingly, construction of new homes has sunk further, with starts of new single-family houses thus far this year running 10 percent below the pace of the second half of last year.

The pace of home sales seems likely to remain sluggish for a time partly as a result of some tightening in lending standards and the recent increase in mortgage interest rates. Sales should ultimately be supported by growth in income and employment as well as by mortgage rates that—despite the recent increase—remain fairly low relative to historical norms. However, even if demand stabilizes as we expect, the pace of construction will probably fall somewhat further as builders work down stocks of unsold new homes. Thus, declines in residential construction will likely continue to weigh on economic growth over coming quarters, although the magnitude of the drag on growth should diminish over time.

Real consumption expenditures appear to have slowed last quarter, following two quarters of rapid expansion. Consumption outlays are likely to continue growing at a moderate pace aided by a strong labor market. Employment should continue to expand, though possibly at a somewhat slower pace than in recent years, as a result of the recent moderation in the growth of output and ongoing demographic shifts that are expected to lead to a gradual

decline in labor force participation. Real compensation appears to have risen over the past year and, barring further sharp increases in consumer energy costs, it should rise further as labor demand remains strong and productivity increases.

In the business sector, investment in equipment and software showed a modest gain in the first quarter. A similar outcome is likely for the second quarter as weakness in the volatile transportation equipment category appears to have been offset by solid gains in other categories. Investment in nonresidential structures, after slowing sharply late last year, seems to have grown fairly vigorously in the first half of 2007.

Like consumption spending, business fixed investment overall seems poised to rise at a moderate pace bolstered by gains in sales and generally favorable financial conditions. Late last year and early this year motor vehicle manufacturers and firms in several other industries found themselves with elevated inventories, which led them to reduce production to better align inventories with sales. Excess inventories now appear to have been substantially eliminated and should not prove a further restraint on growth.

The global economy continues to be strong. Supported by solid economic growth abroad U.S. exports should expand further in coming quarters. Nonetheless our trade deficit, which was about 5.25 percent of nominal gross domestic product in the first quarter is likely to remain high.

For the most part, financial markets have remained supportive of economic growth. However, conditions in the subprime mortgage sector have deteriorated significantly, reflecting mounting delinquency rates on adjustable-rate loans. In recent weeks, we have also seen increased concerns among investors about credit risk on some other types of financial instruments. Credit spreads on lower quality corporate debt have widened somewhat, and terms for some leveraged business loans have tightened. Even after their recent rise, however, credit spreads remain near the low end of their historical ranges and financing activity in the bond and business loan markets has remained fairly brisk.

Overall, the U.S. economy appears likely to expand at a moderate pace over the second half of 2007, with growth then strengthening a bit in 2008 to a rate close to the economy's underlying trend. Such an assessment was made around the time of the June meeting of the Federal Open Market Committee by the members of the Board of Governors and the Presidents of the Reserve Banks, all of whom participate in deliberations on monetary policy.

The central tendency of the growth forecasts, which are conditioned on the assumption of appropriate monetary policy, is for real GDP to expand roughly 2.25 to 2.5 percent this year and 2.5 to 2.75 percent in 2008.

The forecasted performance for this year is about one-quarter percentage point below that projected in February, the difference being largely the result of weaker than expected residential construction activity this year. The unemployment rate is anticipated to edge up to between 4.5 and 4.75 percent over the balance of this year and about 4.75 percent in 2008, a trajectory about the same as the one expected in February.

I turn now to the inflation situation. Sizable increases in food and energy prices have boosted overall inflation and eroded real incomes in recent months, both unwelcome developments. As measured by changes in the price index for personal consumption expenditures, PCE inflation, inflation ran at an annual rate of 4.4 percent over the first 5 months of this year, a rate that if maintained would clearly be inconsistent with the objective of price stability.

Because monetary policy works with a lag, however, policymakers must focus on the economic outlook. Food and energy prices tend be quite volatile so that, looking forward, core inflation, which excludes food and energy prices, may be a better gauge than overall inflation of underlying inflation trends. Core inflation has moderated slightly over the past few months with core PCE inflation coming in at an annual rate of about 2 percent so far this year.

Although the most recent readings on core inflation have been favorable, month-to-month movements in inflation are subject to considerable noise and some of the recent improvement could also be the result of transitory influences. However, with long-term inflation expectations contained, futures prices suggesting that investors expect energy and other commodity prices to flatten out, and pressures in both labor and product markets likely to ease modestly, core inflation should edge a bit lower on net over the remainder of this year and next year.

The central tendency of FOMC participants forecast for core PCE inflation—2 to 2.25 percent for all of 2007 and 1.75 to 2 percent in 2008—is unchanged from February. If energy prices level off as currently anticipated, overall inflation should slow to a pace close to that of core inflation in coming quarters.

At each of its four meeting so far this year, the FOMC maintained its target for the Federal funds rate at 5.25 percent, judging that the existing stance of policy was likely to be consistent with growth running near trend and inflation staying on a moderating path. As always, in determining the appropriate stance of policy, we will be alert to the possibility that the economy is not evolving in the way we currently judge to be the most likely.

One risk to the outlook is that the ongoing housing correction might prove larger than anticipated, with possible spillovers onto consumer spending.

Alternatively consumer spending, which has advanced relatively vigorously on balance in recent quarters, might expand more quickly than expected. In that case, economic growth could rebound to a pace above its trend. With the level of resource utilization already elevated, the resulting pressures in labor and product markets could lead to increased inflation over time.

Yet another risk is that energy and commodity prices could continue to rise sharply, leading to further increases in headline inflation and, if those costs pass through to the prices of nonenergy goods and services, to higher core inflation as well.

Moreover, if inflation were to move higher for an extended period and increase became embedded in longer-term inflation expectations, the reestablishment of price stability would become more difficult and costly to achieve. With the level of resource utilization relatively high and with a sustained moderation in inflation pres-

sures yet to be convincingly demonstrated, the FOMC has consistently stated that upside risks to inflation are its predominant policy concern.

In addition to its dual mandate to promote maximum employment and price stability, the Federal Reserve has an important responsibility to help protect consumers in financial services transactions. For nearly 40 years, the Federal Reserve has been active in implementing, interpreting, and enforcing consumer protection laws. I would like to discuss with you this morning some of our recent initiatives and actions, particularly those related to subprime mortgage lending.

Promoting access to credit and to homeownership are important objectives and responsible subprime mortgage can help to advance both goals. In designing regulations, policymakers should seek to preserve those benefits.

That said, the recent rapid expansion of the subprime market was clearly accompanied by deterioration in underwriting standards, and in some cases by abusive lending practices and outright fraud. In addition, some households took on mortgage obligations they could not meet, perhaps in some cases because they did not fully understand the terms.

Financial losses have subsequently induced lenders to tighten their underwriting standards. Nevertheless, rising delinquencies and foreclosures are creating personal, economic, and social distress for many homeowners and communities, problems that will likely get worse before they get better.

The Federal Reserve is responding to these difficulties at both the national and the local levels. In coordination with the other Federal supervisory agencies we are encouraging the financial industry to work with borrowers to arrange prudent loan modifications to avoid unnecessary foreclosures. Federal Reserve Banks around the country are cooperating with community and industry groups that work directly with borrowers having trouble meeting their mortgage obligations. We continue to work with organizations that provide counseling about mortgage product to current and potential homeowners. We are also meeting with market participants—including lenders, investors, servicers, and community groups—to discuss their concerns and to gain information about market development.

We are conducting a top to bottom review of possible actions we might take to help prevent recurrence of these problems. First, we are committed to providing more effective disclosures to help consumers defend against improper lending. Three years ago, the Board began a comprehensive review of Regulation Z, which implements the Truth in Lending Act, or TILA. The initial focus of our review was on disclosures related to credit cards and other revolving credit accounts.

After conducting extensive consumer testing, we issued a proposal in May that would require credit card issuers to provide clearer and easier to understand disclosures to consumers. In particular, the new disclosures would highlight applicable rates and fees, particularly penalties that might be imposed. The proposed rules would also require card issuers to provide 45 days advance notice of a rate increase or any other change in account terms so

that consumers will not be surprised by unexpected charges and will have time to explore alternatives.

We are now engaged in a similar review of the TILA rules for mortgage loans. We began this review last year by holding four public hearings across the country, during which we gathered information on the adequacy of disclosures for mortgages, particularly for nontraditional, traditional, and adjustable rate products.

As we did with credit card lending, we will conduct extensive consumer testing of proposed disclosures. Because the process of designing and testing disclosures involves many trial runs, especially given today's diverse and sometimes complex credit products, it may take some time to complete our review and propose new disclosures.

However, some other actions can be implemented more quickly. By the end of the year, we will propose changes to TILA rules to address concerns about mortgage loan advertisements and solicitations they may be incomplete or misleading and to require lenders to provide mortgage disclosures more quickly so that consumers can get the information they need when it is most useful to them. We already have improved a disclosure that creditors must provide to every applicant for an adjustable rate mortgage product to explain that better the features and risks of these products such as "payment shock" and rising loan balances.

We are certainly aware, however, that disclosure alone may not be sufficient to protect consumers. Accordingly, we plan to exercise our authority under the Home Ownership and Equity Protection Act, HOEPA, to address specific practices that are unfair or deceptive. We held a public hearing on June 14 to discuss industry practices including those pertaining to prepayment penalties, the use of escrow accounts for taxes and insurance, stated income and low documentation lending, and the evaluation of a borrower's ability to repay. The discussion and ideas we heard were extremely useful and we look forward to receiving additional public comments in coming weeks. Based on the information we are gathering, I expect the Board will propose additional rules under HOEPA later this year.

In coordination with the other Federal supervisory agencies, last year we issued principles-based guidance for nontraditional mortgages, and in June of this year we issued supervisory guidance on subprime lending. These statements emphasized the fundamental consumer protection principles of sound underwriting and effective disclosures. In addition, we reviewed our policies related to the examination of nonbank subsidiaries of bank and financial holding companies for compliance with consumer protection laws and guidance.

As a result of that review and following discussions of the Office of Thrift Supervision, the Federal Trade Commission, and State regulators as represented by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators, we are launching a cooperative pilot aimed at expanding consumer protection compliance reviews at selected nondepository lenders with significant subprime mortgage operations.

The reviews will begin in the fourth quarter of this year and will include independent state-licensed mortgage lenders, nondepository

mortgage lending subsidies of bank and thrift holding companies, and mortgage brokers doing business with or serving as agents of these entities. The agencies will collaborate in determining the lessons learned and in seeking ways to better cooperate in ensuring effective and consistent examination of and improved enforcement for nondepository mortgage lenders. Working together to address jurisdictional issues and to improve information sharing among agencies, we will seek to prevent abusive and fraudulent lending while ensuring that consumers retain access to beneficial credit.

I believe that the actions I have described today will help address the current problems. The Federal Reserve looks forward to working with Congress on these important issues.

Thank you.

Chairman DODD. Thank you very much, Mr. Chairman.

I am sure my colleagues will have some additional questions for you on dealing with HOEPA, but I want to express my appreciation for the Fed in deciding to aggressively pursue these issues beyond just the guidance and looking at regulations.

I will try to keep this about 7 minutes a round here so can get through to everybody, at least one around anyway. And then the record will stay open, as well, for those who are not here to submit some questions. And we will try to move along.

Let me, if I can, begin with the Basel II issue here.

As you know, Mr. Chairman, Senator Shelby and I earlier this week sent a letter to the four banking regulators, calling on each one of them to make sure a consensus on the final regulation on Basel II, the bank capital accords, could be reached. And while I believe that no one regulator should have a veto power certainly over these important regulations, it is critically important that the final rule be in agreement among all the regulators. Proper capital accounting is obviously critically important to competitiveness and to the safety and soundness of our financial institutions. Capital should be based on risk not who the regulator is, in my view.

One, I would ask if you would agree that there would be tremendous value to have a rule that all four regulators agree to? And conversely, obviously would it be a failure if there was a failure to reach consensus? I know you are working at this, but I want to raise that issue with you. I know how important you think it is but it is extremely important there be this consensus. I realize that you are working toward that but why don't you share with us how that is moving?

Chairman BERNANKE. Thank you, Mr. Chairman.

I think we agree that the existing Basel I capital system is no longer adequate for the largest international banks and that we need to move expeditiously forward to provide a new capital standard that will appropriately link capital to risk taking. I think that the Basel II approach, with perhaps some modifications but in essence what was agreed upon with the international banking authorities, is the right approach for providing that kind of capital base protection.

We are already rather late in this process. We have delayed the process for a year. Therefore, it is very essential that we do move expeditiously. I can assure you that the four agencies are currently

working very hard on a range of issues. Again, we all appreciate the importance of making progress.

With respect to your question, I too would strongly prefer that all four agencies would come together and agree on a single proposal. And I am relatively optimistic that we will be able to achieve that in the near future.

Chairman DODD. Thank you for that. I suspect Senator Shelby may raise a question about that as well, since we both have a strong interest in that conclusion. And we urge you to do everything you can in these coming days to reach that consensus, because of the importance of it, as you have stated here.

Let me move, if I can, to the currency manipulation issue. I know because of your previous testimony before the Committee, the issue was raised here about a speech that you gave during that trip to China along with Secretary Paulson and others in which you said that China's exchange rate practices amounted to an effective subsidy. I know there was longer remarks than that alone, but nonetheless that comment was one that certainly attracted some attention.

As you are aware, there is great concern to me and to many of our colleagues here on this issue. Senator Shelby and I have introduced some legislation that has the support of many of our colleagues here, Senator Bayh, Senator Carper, Senator Brown, Senator Casey, Senator Bunning, Senator Dole, on this Committee.

I should point out that Senator Baucus in the Finance Committee has also introduced some legislation. He and I have talked about this. The issue of currency is appropriately a matter of jurisdiction of this Committee but nonetheless there is a strong interest reflected by Senator Baucus, and Senator Schumer as well has a strong interest in this subject matter.

And so there is, without a doubt here, as you gather, among Democrats and Republicans, while there may be disagreements on a lot of other issues on this one there seems to be a growing consensus here of our concern about the currency manipulation. In fact, it is our attention here to try before the August recess to possibly markup some legislation which we have introduced and I discussed with you here.

I wonder if you could still share with us your opinion about this matter here, what it means, and some reflection on where you think this is heading. Because it is a deep, deep concern regarding our manufacturing base in this country that struggles every day to stay open and competitive in global markets. Share with us, if you will, your thoughts on this matter today.

Chairman BERNANKE. Thank you, Mr. Chairman.

I share your concern, I share your frustration about the slow pace of the appreciation of Chinese currency.

I have argued, as I did in that speech you referred to in China, that further appreciation of the currency would, in fact, be in China's interest for a number of reasons. First, it would give them an independent monetary policy. And they are, at this point, dealing with some issues of inflation and asset price increases that would be better dealt with if they had an independent monetary policy.

And second, again in reference to my comments about distortions, their economy is too oriented toward exports, not enough to-

ward the home market. And I believe that appreciation would better help orient the economy toward serving domestic needs and domestic consumers rather than relying entirely on the global market.

So, I agree with your premise that it is important that the Chinese begin to appreciate further.

Let me just raise a couple of issues which I guess I would call tactical issues without addressing any specific legislative proposal. The first is that the currency, while an important issue, is probably in itself not going to solve the trade imbalance problem. There are fundamental saving investment imbalances, both in the United States and abroad, which need to be changed in order to make real progress on the trade balance. In particular, we have emphasized with the Chinese the importance of structural changes in their economy such as increased safety net and improved financial system that would increase the share of their output going to consumers and being consumed at home. The combination of currency appreciation and this other set of measures is really what is needed to begin to move things in the right direction.

So, I would urge you to broaden focus just a bit beyond the currency to talk about the savings and investment balances that need to be adjusted in both the United States and in China.

The other point I would just make from I guess essentially a tactical point of view is that, again as I understand the frustration and concern about this particular issue and I advocate and I urge the Chinese to move their currency up more quickly, the United States and China have a wide range of issues on which we need to collaborate, coordinate, and cooperate including energy and the environment and financial services and trade and many other issues. I hope that as we look toward these sorts of measures that we try to keep in mind the importance of engaging China on a wide range of questions and not simply restricting our attention to this one important issue. But it is only one of many issues.

Thank you.

Chairman DODD. I appreciate that and I do not disagree that there are these other critical questions.

In fact, Title II of our legislation deals with some of the trade issues here that you have raised, and I think—I will let Senator Shelby speak for himself here obviously—but we understand the importance of that as well.

I cannot begin to tell you however, Mr. Chairman, of the difficulty there is for those of us who go back to our constituencies and talk about these issues here with, day after day, Chinese firms that export to the United States enjoying what you called an effective export subsidy, as a result of their undervaluation.

So it makes it very difficult for those of us to try to make the case that there are a variety of issues that we need to be working with the Chinese on. I think all of us would agree with you on that. But this issue lurks as this huge obstacle to those issues, particularly when American jobs are being so adversely affected by this.

Is it still your opinion that this is an effective subsidy on that issue?

Chairman BERNANKE. It is not a subsidy in the legal sense, that a subsidy is a payment by the government directly to producers to

support their production. Nothing like that is going on. That is not what I was referring to.

I was talking about the economic implication which is that the undervalued exchange rate creates a distortion in the economy which artificially sends resources into the export sector as opposed to in the domestic sector. So it is a distortion in the economy. From a legal perspective it is not the same thing as a subsidy.

Chairman DODD. No, I know. I notice you said effective subsidy.

Chairman BERNANKE. Or implicit.

Chairman DODD. Implicit subsidy.

Thank you very much. Let me turn to my colleague, Senator Shelby.

Senator SHELBY. Thank you, Chairman Dodd.

I want to pick up on what Senator Dodd was talking about, the Chinese. We have been dealing with this a long time. And whether it is a direct subsidy, Mr. Chairman, or a backyard subsidy they have an advantage there obviously because of the currency situation, to their advantage and to our detriment. A lot of us represent States that have substantial manufacturing industries there and we have seen ourselves the erosion of a lot of these jobs, not just in Alabama but Ohio, Connecticut, New Jersey, you name it. We have to answer to our constituents. And the American people, they know something is wrong. They know something is wrong and they look to us to do something about it and I know it is very complicated myself.

But on the other hand, do we just continue to sit back and say well, everything is fine, when we know it is not fine. We know there is an advantage there. They are manipulating it to their advantage, in my judgment.

The other thing I wanted to pick up on, what Senator Dodd has already raised, and that is Basel. I do hope, Mr. Chairman, I know you are one of the regulators, too, here. But we have talked to the FDIC Chairperson and others.

Senator Dodd and I have been on this Committee quite a while. We were here during the savings and loan debacle when the Government, the taxpayers, spent billions and billions of dollars. And that is not fun. And we want to avoid that.

I agree with Senator Dodd that I do not know of any bank, financial institution, that has gone bankrupt or has become insolvent that is well-capitalized and well-managed, you know, in combination. And if we are going through this international accord to lower our capital standards, that is probably to us. Everybody on this Committee—I cannot speak for everybody but just about, Democrats and Republicans, because we have that oversight responsibility here. And ultimately we do not want this to land in our lap. Is that right, Senator Dodd?

Chairman DODD. That is right.

Senator SHELBY. So, I will move on to some other things.

Subprime problems. The subprime problems are real, not just in New Jersey and Ohio but in Alabama and everywhere else. There has been a huge expansion, Mr. Chairman, as you know, of structured financial products. We call what, collateralized debt obligations backed by subprime debt. In concept these projects involve

converting highly risky loans, as I understand it, into a collection of securities that have a range of risk from AAA to junk.

The rating agencies provide the AAA ratings based on the idea that the structure of the products satisfactorily dissipates or spreads the risks associated with the underlying prime loan. That is the basis of that. But it appears that is not always working.

It appears that many of the assumptions here regarding these structured products, collateralized, have significantly underestimated the true risk. We have seen what the rating agencies, it has been talked about, at least Senator Menendez and also Senator Brown brought it up. We have seen S&P—and I believe Senator Reed. We have seen S&P and Moody's already downgrading the debt that they invited as AAA. How did they get to the point to rate a lot of these collateralized obligations AAA grade with so much underlying junk you might say? You cannot make gold out of lead. We know that. That has been tried.

Does all of this deeply concern you, how this came about to begin with? Because I think the subprime not only has deep repercussions when a lot of people, our constituents that have been victimized I think to some extent by this. But a lot of it has been brought about by very ingenious financial people. And then looks like the rating agencies fell right in line with them, knowing that this is not really AAA stuff. This is questionable stuff. Now it is coming home to roost. And, as someone else said earlier here, a lot of those loans are going to be reset not downward but upward.

Senator Dodd is very much out front on this, and should be as the Chairman of this Committee. And we are deeply concerned that the subprime problem is not going to just be contained so easily but could deeply spread and have some repercussions out there. What do you think?

Chairman BERNANKE. Senator, let me address the financial side. We have talked about this effect on homeowners. On the financial side, I am not sure there is anything essentially wrong with structured credit products, *per se*. But what we have learned since early this year is that a lot of the subprime mortgage paper is not as good as was thought originally. And there clearly are going to be significant financial losses associated with defaults and delinquencies on these mortgages.

As a result, the credit quality of many of the structured projects that include in them substantial amounts of subprime mortgage paper is being downgraded. The one issue is that the structured credit products are quite complex. They include many different kinds of assets. Then the risks are divided up in different so-called "tranches." So it takes quite a complex model or analysis to determine what the real value of these things is.

Senator SHELBY. But the value seems to be going down instead of up.

Chairman BERNANKE. Well, it is going down because the credit losses associated with subprime have come to light and they are fairly significant. Some estimates are on the order of between $50 billion and $100 billion of losses associated with subprime credit products.

The credit rating agencies have begun to try to make sure they account for those losses and they have downgraded some of these products.

I should say that the investors, many of them, recognize even before the downgrades occurred that there were risks associated with these products including not only credit risks but also liquidity and interest rate and other types of risks. And so the spreads they were charging on these products were not necessarily the same as would be implied by the credit rating agency.

Senator, if I could just say one word about Basel, I would be very grateful. It is simply not the case that Basel II is about lowering credit standards. It is about making the banking system safer, not less safe.

Senator SHELBY. I did not say credit standards. We are about capital.

Chairman BERNANKE. Capital standards, I am sorry. Capital standards, thank you.

The system we have now, Basel I, was designed 20 years ago for a very different kind of banking world. Banks are far more obligated. They use much more off balance sheets types of operations. The existing Basel I Accord, as the GAO study that just came agrees, and as the international banking community strongly agrees, is not safe for the largest and most sophisticated international banking organizations.

And so it is not a question of going to lower capital standards. It is a question of finding a new system that will provide capital on a risk-adjusted basis that will match the capital against the risk, and therefore make these banks safer not less safe.

So we take a backseat to nobody in the importance of making sure that these banks are safe and sound. That is our primary objective. And we believe that making this change to Basel II will increase, not decrease, the safety of these banks.

In addition, of course, in any change from one system to another there is going to be a period of uncertainty as we work through the new methods and so on. And so we have been very careful to include a wide variety of protections including, as you know, the leverage ratio, prompt corrective action, the transition floors, Pillar II, a wide variety of things that will make sure that we have the control that we need to begin to see any unsafe drops in capital, we can make the changes to ensure that the banks are operating safely and soundly.

So, I would just very strongly urge you to consider that Basel II is not about lowering capital, it is about making banks safer.

Senator SHELBY. But some banks believe it is about lowering capital. There has been a lot of stuff written about it. At the end of the day they said it would free up their capital, in other words lower the capital. That is some of our concerns.

Chairman BERNANKE. What they are referring to is situations, there are situations where banks under the old system are forced to hold a lot of capital against which is essentially very safe assets. That part of the capital is excess capital. One of the problems they face is that foreign banks that do not have as much capital against these very safe assets will be able to just come and take that business away because they do not cost as much.

So against a safe asset and one whose risk is appropriately calibrated, it seems to me appropriate to reduce capital. But against risky assets, we need to have enough capital to ensure safety.

Senator SHELBY. We want to make sure our banking system is strong. We have a great banking system. And we do not need to weaken the pillars in any way.

Mr. Chairman, thank you.

Chairman DODD. Thank you, Senator Shelby. Senator Brown.

Senator BROWN. Thank you, Mr. Chairman.

Chairman Bernanke, your response to Chairman Dodd about China, I appreciate your talking in terms of broadening the discussion beyond currency, Chinese savings, their domestic economy. You have talked in the past about intellectual property as you should. I would also implore you in the future, if you would, to also bring in labor issues in terms of slave labor, in terms of child labor, in terms of fair labor practices. We discussed that back several months ago when you were here, on international labor organization standards.

I hope that your broadening the discussion of the issues with China trade and our trade in our bilateral trade deficit which, in my first year in Congress in 1992 when I ran, was in the low double digits with China. And today is way in excess of $200 billion. As you know that, without prodding, would include labor issues in this discussion.

I would like to switch with a couple questions on the whole issue of the subprime loans. I appreciate your willingness to act under the HOEPA authority this year. I think the progress you have made is generally good. We would obviously like, if possible, for you to move a little more quickly but understanding how things go sometimes.

But a couple of questions. With the closing fees that people pay, it seems that the prepayment penalties, it seems to me do not seem that necessary from the investors standpoint. They seem more designed to lock people into bad loans. Wouldn't the better protection for lenders be to offer a fair loan in the first place rather than the prepayment penalties?

Chairman BERNANKE. Senator, we are looking at that very carefully. Our subprime mortgage guidance, which has already been issued with the other banking agencies, takes the position that prepayment penalties should not extend into the period where the interest rates reset. So they should not prevent people from refinancing when their industries are about to go up. We are looking at that specifically as part of our HOEPA rules, as well.

I agree with you, there are situations where prepayment penalties are not in the interest of the borrowers and we are looking at those.

Senator BROWN. Are those just guidelines or are those actually requirements?

Chairman BERNANKE. They are requirements. That is, they are enforced by examination and supervision of the banks. But the subprime guidance, which is a collaboration of the four banking agencies, applies only to banks and thrifts and not to lenders outside of the banking system, which is what the HOEPA was about, would apply to everything.

Senator BROWN. If this is about investors protecting their interests, as it should be in part, doesn't failure to escrow create the very risk that prepayment penalties allegedly guard against?

Chairman BERNANKE. That is another issue that we heard a lot about in our hearings in June. It also is covered in the subprime guidance and is also one of the things we are looking at very carefully for our rulemaking.

Senator BROWN. How are you approaching the determining of borrowers ability to repay a loan? You emphasize the importance. Are we setting standards on that level, also?

Chairman BERNANKE. Once again, there is some reference to that in the subprime guidance, the idea being there that the loan should be underwritten at the fully indexed rate, that is that the rate once the adjustable resets have taken place.

I should say though, particularly from the perspective of writing a rule, we are going to do our very best. But it is hard to put into a rule exactly what criteria one would use in order to decide whether a loan is affordable or not. But we are going to do our best.

In particular, we are going to look at the question of underwriting to the fully indexed rate. And also, ask ourselves whether or not there can be guidelines in terms of demonstrated payment ability or demonstrated income that we related to the payments under the mortgage.

Senator BROWN. But there are some things, understanding the difficulty of writing a rule to conclude everything, but there are certainly some things, no doc loans, better disclosures, so people understand in readable large print, if you will, on the first page what this loan is going to cost, what their adjustable rate could be in worse case scenario. All of those absolutely could be included; right?

Chairman BERNANKE. These are all on our agenda. The top page of the mortgage documents that you are alluding to is part of our Regulation Z review which will cover all home mortgage advertising solicitation and disclosures.

One concern we have about that is just that in the past these disclosures have been written by lawyers sitting in an agency. And when we put them out, the public does not understand what it really means. And so if you are going to have effective disclosures, they have to be done in a way that ordinary people can understand what the implications are.

And for that reason we have, for the Government at least, been very innovative in making sure that all of our disclosures are being consumer tested and focus group tested. And we are making sure that people really do understand what the disclosure is telling them. I think that is critical if this is really going to be effective and not just a cosmetic step.

Senator BROWN. And you can write that prescriptively in your rule?

Chairman BERNANKE. We can prescribe the form, yes.

Senator BROWN. In several of the answers, and I appreciate your answers, you spoke in terms of it is on your agenda. A skeptical look would say that implies some inertia. Are you pleased, personally, with the speed at which you are doing this? Chairman Dodd has talked about and Senator Shelby has talked about with a num-

ber of resets in the next couple of years and the number of people who are going to lose their life savings every week, every day, every week, every month. Are you satisfied you are moving as fast as you can?

Chairman BERNANKE. I believe that we are moving as fast as we responsibly can. We have to do it right. We have to make sure the disclosures, for example, are actually of value. And we have to follow, of course, the rules and regulations associated with how an agency makes rules. Congress has told us what steps we have to take and we have to follow those steps.

I would say to you, Senator, if you feel that the regulatory process is too slow the only remedy I can think of is for Congress to act directly.

Senator BROWN. We always move fast enough, too, Mr. Chairman.

Chairman BERNANKE. I understand.

Senator BROWN. Thank you.

Chairman DODD. Let me just say in that regard, Mr. Chairman, before I turn to Senator Reed here, my hope would be that you—and I am sure you will—keep us posted on the progress of this. I had a chance to speak with the Chairman a day or so ago about the very matter that Senator Brown has raised here. My hope is that you would give us a commitment to come back to the Committee once the regulation comes out to discuss it with the Committee, we would have a strong interest. I see your head nodding affirmatively.

Chairman BERNANKE. Yes.

Chairman DODD. I appreciate that response, as well. It will give us a chance to move on this.

Senator Reed.

Senator REED. Thank you, Mr. Chairman. And thank you, Chairman Bernanke. I want to return to the topic that I broached in my opening statement and Senator Shelby addressed. And that is the issue of the valuation of CDOs. What you have is an illiquid market, basically. There is a thinly traded, very complex instruments, asset valuation is difficult to determine. As a result, what we have is something described as mark to ratings. Senator Shelby alluded to that.

How comfortable are you with this approach? What are you doing specifically to engage the rating agencies to ensure that they are, and the originators of these products are, valuing their assets accurately?

As I pointed out in my opening statement, there seems to be a growing wave and realization that these assets are overvalued. Some people have suggested billions and billions of dollars. What appears to be the motivating factor in the workout of the Bear Stearns funds was the extreme reluctance to try to have the market evaluate these assets and that would cause a value of mark to market for everything else they held and probably through the whole system. This is potentially a very serious problem.

So specifically what are you doing with the rating agencies and the originators of these products to make sure they are valued effectively?

Chairman BERNANKE. The Federal Reserve does not have any specific powers or responsibilities regarding the rating agencies themselves. What we are doing is working with our banks that we supervise to ensure that they are safe and sound and that they are doing due diligence in the types of assets that they purchase or the types of assets they themselves securitize and resell. So our perspective is protecting the safety of the banking system. We do not have broader authority to dictate how these assets are created.

Senator REED. Should someone have the broader authority to do that? I mean if we assume, as I think you perhaps might, that the market will not evaluate these assets accurately because they are so thinly traded, difficult to understand, it falls upon a rating agency. And if the rating agency, if there is no supervision, is there a gap?

Chairman BERNANKE. No, I think the market will find solutions. They already are finding some. For example, even if the individual instruments are not particularly liquid, there are indices that are based on the payments from CDOs or CLOs which are traded and therefore give some sense of the market valuation of these underlying assets.

So this is a market innovation. Sometimes there are bumps associated with a market innovation. I think we just have to sit and see how it works out. There are very strong incentives in the market to change the structure of these instruments as needed to make them attractive to investors.

Senator REED. Let me change gears just slightly. You alluded to it, not the CDOs but the CLOs, the collateralized loan obligations, essentially derivatives of corporate debt. There has been a lot of discussion that it is very easy now to go out in this market and to prop up companies that do not have the ability to borrow directly. And that the underwriting standards have slipped a bit because the banks who typically do the underwriting do not hold the product. They move them out very quickly in these complex secondary markets.

First, can you comment on the underwriting standards for the corporate borrowing? Are they loosening to a degree that could—

Chairman BERNANKE. Recently, I think they perhaps tightened a bit, actually, because of some concerns that were initially prompted by the subprime mortgage lending issues.

Again from the Federal Reserve's perspectives, our principal concern is the safety and soundness of the banking system. What we have done recently is work with other regulators such as the SEC and the OCC and, in some cases also with foreign regulators, the FSA in the United Kingdom for example and German and Swiss regulators, to do what we call horizontal reviews which is that collectively we look at the practices of a large set of institutions, both commercial banks and investment banks, to see how they are managing certain types of activities. For example, the financing of leveraged buyouts, abridged equity and the like. And trying to make an evaluation of what are best practices, trying to give back information back to the companies and trying to use those reviews to inform our own supervision.

And so we are very aware of these issues from the perspective of the risk-taking by large financial institutions and we are study-

ing them, trying to provide information to the institutions themselves, and using them in our own supervisory guidance.

Senator REED. Are you confident that you can identify and monitor these risks posed by CLOs? And in a related point, do you anticipate seeing the same phenomena in the CLO market that we have seen in the CDO market, a bump?

Chairman BERNANKE. It is not our expertise to directly say that this deal is a good deal and that deal is a bad deal. What we try to do is make sure that the banks and the investment banks themselves have good controls, have good models, have good approaches, have good risk management so that they can make what we believe to be, in general, appropriate decisions about these instruments.

Senator REED. Let me shift gears again, Mr. Chairman, to try to cover a lot of ground. We have witnessed all a booming housing market until very recently. As your predecessor, Chairman Greenspan, opined in many homes their increasing equity valuation was an ATM that they could go to without leaving the house.

Current estimates are that equity withdrawals are down precipitously, 70 percent from 2005. What is your view of the macroeconomic effect as people can no longer essentially use their equity as a quick source of cash?

Chairman BERNANKE. Taking equity out of a home is one very convenient and sometimes tax favored way of getting at your assets essentially. That explains the tremendous increase in that type of cash out refinancing and home equity loans.

Our sense though, and so far this seems to be borne out by the data, is that consumers respond to changes in the value of their home essentially because there is a change in their wealth not because there is a change in their access to liquid assets. So there is probably something on the order of between four cents and nine cents on the dollar of an effect on consumer spending when home values decline. So that is one of the things we are looking at.

It should be pointed out that by, I think, the most reliable indices that house prices nationally speaking have not declined. They have only risen more slowly. So we have not yet seen anything, except in a few local areas, akin to a decline in house prices. So again, we have not seen a significant effect on consumption. We are watching it carefully. Once again, I think the so-called "wealth effect," the effect that the value of the home has on the consumer's overall wealth is probably the principal relationship between house values and consumer spending.

Senator REED. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Reed.

As colleagues are coming in here, so my colleagues are aware, Senator Bunning has arrived. We will then turn to Senator Menendez, then Senator Allard. Senator Schumer has come back and then Senator Carper and Senator Bayh have joined us, as well. I thank you for being here.

Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman.

First of all, I would like to enter my opening statement into the record.

Chairman DODD. All statements, by the way, will be included in the record and we will leave the record open for a day or so for other questions.

Senator BUNNING. I figured that.

I do not want to go over old business but I have to because everybody looked at the past Fed Chairman and the past Fed's oversight of the banking industry and what happened in the subprime area. The banks all looked very good when you looked at their bank statements. But what happened is that those mortgages, ARMs, interest-only loans were sold off. And therefore the bank statements all look clean.

But where we found we had a problem was that they were overextended, a lot of people were overextended. Instead of buying a $400,000 home it should have been a $200,000 home. Instead of an interest-only loan, it should have been a 30-year mortgage and on down on the line. That did not show up on the Fed's record but I do not think the Fed went far enough.

Do you have the capability of going far enough now to see what happens to the loan after the bank sells it off?

Chairman BERNANKE. Again, our interest in this particular case is in bank safety and soundness. And the question: Is there any recourse question? Does the bank have any responsibility for that loan?

Senator BUNNING. All of them had responsibility when they were originally taken out.

Chairman BERNANKE. There are two issues, Senator. One is the consumer protection issue and one is the safety and soundness issue. On safety and soundness, the question is does the bank have financial responsibilities in case the loan goes bad? In which case they should have capital against that. This is an example of why Basel I does not adequately capture the necessary——

Senator BUNNING. That is why we did Basel II.

Chairman BERNANKE. That is exactly right.

On the consumer side, the issue is where was the loan made? In some cases, the bank simply bought up packaged loans that were made somewhere else. And there part of the problem is that it used to be that you could only get a loan at the bank or a thrift. Now of course, there is a great diversity of lending institutions and it is not entirely a level playing field in terms of the oversight of their consumer protection.

Senator BUNNING. Please get to my question.

Chairman BERNANKE. I am sorry, what is the question?

Senator BUNNING. The question is does the Fed now have the ability to go beyond the original bank and find out what happened to that loan when it went sour? In other words, if they sold that loan off to a third party and now the people are incapable of making the payments or it was an interest-only loan or there was an ARM that popped up after 5 years.

Chairman BERNANKE. We can follow where the bank initially disposes of the loan. But if it goes through several steps, then we can only make general estimates.

Senator BUNNING. You do not figure that you have a responsibility in that respect?

Chairman BERNANKE. I do not think we have the authority.

Senator BUNNING. You do not have the authority but how about the responsibility?

Chairman BERNANKE. Without authority, I cannot be responsible, Senator.

Senator BUNNING. Let me go back to inflation and interest rates. In your statement you repeated a line from the June Fed statement that says "A sustained moderation in inflationary pressure has yet to be convincingly demonstrated." Those are quotes. What will it take for moderation to be convincingly demonstrated?

Chairman BERNANKE. Our objective is to achieve enduring price stability and in particular we want to be sure that inflation remains under good control in the medium run. There are several elements of that. One is that I think it is important to recognize that the month-to-month inflation numbers are very noisy. And so a couple of good numbers does not, by itself, mean that the problem is solved and gone away. So part of it is just simply seeing more data and getting a greater sense of assurance that the trend is really in the direction we would like to see it.

The other is that as long as there are some very important risks out there to inflation, there is the possibility of inflation—even if it has come down some—there is the possibility that it will go back up in the future. The risks that I talked about in my testimony include high resource utilization, the fact that the economy is working at a very tight use of resources.

And second, the fact that energy and food prices have raised headline inflation. Those prices might feed through into core inflation, they might raise inflation expectations.

So what we need to see is enough confidence that the risks have subsided so that we can feel confident that in the medium term inflation will be well-controlled.

Senator BUNNING. Last week, you gave a speech and spoke at length about inflation expectations. You also said that expectations are "imperfectly anchored." What in the world does "imperfectly anchored" mean?

Chairman BERNANKE. Senator, it means that expectations as measured through various means are not at a fixed number. That is, if a piece of news comes in, about, say, employment that long-term inflation expectations move. And what that means is that although the confidence in the Federal Reserve to maintain price stability——

Senator BUNNING. Isn't that in your model when you are looking at inflation, all the different things that you put in?

Chairman BERNANKE. I am thinking now about the very long-term. So if there was complete confidence—let me not overstate. I think there is a great confidence in the Federal Reserve that we will maintain low inflation in the long-term. But if that confidence were complete then people would say oh, this is a temporary movement in the economy but we know that in the long-term inflation is going to go back to whatever is the normal level. And there would not be much movement in these longer-term inflation expectations when there was a short-term development in the economy.

Senator BUNNING. But that is exactly what you are trying to do every time you meet, is to anticipate——

Chairman BERNANKE. We are trying to anticipate it. But in order to make sure that inflation in the long-term is very stable. If people are saying oil prices have gone up, that not only affects what we think inflation is going to do over the next year but it affects what we think inflation is going to be 5 years from now. Then that leads to the possibility that they do not have complete confidence that the Fed to bring inflation back down to a stable level.

Again, let me not overstate this. I think that we have made tremendous progress over the last 20 years or so in increasing the confidence the public has in the Fed's ability to keep inflation low and stable. I am only saying that there is still some imperfect degree in terms of which those expectations are completely tied down.

Senator BUNNING. Mr. Chairman, we know we are not all perfect and we know that the Fed does the best they can. We appreciate your service and thank you for being here.

Chairman BERNANKE. Thank you.

Chairman DODD. Thank you, Senator.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman Bernanke, I appreciate the testimony you have given on the subprime issue and the actions. But I am wondering if the actions reflect the crisis at hand. I find it hard to believe that months of hearings and reviews, a pilot project that will not commence until the end of the year, and guidance after guidance that seems to take only small steps, is a swift enough response for a crisis that has led to over one million foreclosures last year and ruined the American Dream of owning a home for too many people in this country.

With all due respect, when, as part of that challenge, we are talking about predatory lending, I am not convinced that the proposals the Fed has put forward will be enough to stop predatory lenders dead in their tracks.

I also hope that we have at least prospectively a better monitoring system because it is my personal opinion that, in many respects, the Fed was somewhat asleep at the switch, that we could have been more proactive in this process. It seems to me we are coming to the table with a plan after a tornado has already ripped through a community.

So, I hope that the one message I think many of our colleagues have for you and the Reserve is that you will be as swift and use the powers that were given to you under the Home Ownership and Equity Protection Act as vigorously as we would like to see you use them. I hope that that is both your intent, your mission, and in terms of timing within the context of being judicious but not be judicious to the point that we err on the side of being able to protect more people in this country.

I would like to hear your response to that in a moment. Let me get my second line of question and give you the balance of the time to answer.

In my mind, I always ask who is this economy working for? Is inflation tame or is it still a significant problem? I guess that depends upon where you sit. Consumer prices rose at a moderate rate in June with a key factor keeping things under control is collapsing clothing costs. They have dropped for the past 4 months. But after

energy, clothing is probably about the next most volatile component in the Consumer Price Index. So, I would not be surprised if sometime soon we see a major increase in prices in that regard.

In addition, we already know that the pullback in gasoline prices in June has been unwound so energy will be adding greatly to consumer woes in July. And then there is food. As you mentioned yourself, prices jumped again and since June 2006 food and beverage costs have risen by 4 percent.

With that, with the ethanol issues that are spiraling through food costs, I do not know that we can be looking for relief anytime soon, at least if you are looking at it from the context of the consumer. It seems to me that pain for the consumer is still there.

When I look at household debt in America that has risen to record levels over the past 5 years. In the first quarter of 2007, household debt relative to disposable income stood at 130.7 percent. That is the third highest ratio on record. That means the average family in America is in debt for over $130 for every $100 it has to spend. Compounding this, the average household savings rate has actually been negative for the past seven quarters, averaging a negative 1 percent for 2006.

One last measurement, one measure of this economic insecurity that I hear New Jerseyans talk to me about, that I hear other Americans talk about, is the percentage of middle-class families who have at least 3 months of their salary in savings. That percentage of middle-class families who had three or more months salary in savings rose over 72 percent from 16.7 percent in 1992 to 28 percent in 2001. But unfortunately, in the span of less than 4 years that percentage has dropped to 18.3 percent in 2004.

So, I am looking at this and I am saying to myself so you have rising food costs, you have rising energy costs, rising health costs. You have stagnant median income for the last 5 years for families in this country. You have more debt, the third-highest ratio on record, and you have less families in quite some time that have 3 months and savings or more. Who is this economy working for? And is inflation tame or is it still a significant problem?

Chairman BERNANKE. Senator, you asked a lot of questions.

Senator MENENDEZ. I have given you a lot of time. I have not even used all my time. You can take that and plus the rest of what is necessary to answer.

Chairman BERNANKE. First, on the subprime rules, as I said, I asked for a top to bottom review. We looked at every possible power that we have. We have examined each one. We have had a lot of input, a lot of hearings, and we are moving forward. We will move as expeditiously as the process allows, making sure, of course, that we do a good job. But we will move forward as expeditiously as possible to try to address these issues.

With respect to inflation, I agree in the sense that certainly over 2007 food and energy prices have risen significantly so that the overall inflation rate is higher than we would like it to be. Our concern is that high food and energy prices might somehow infect the underlying trend of inflation, for example causing people's expectations—this is Senator Bunning's question—to rise and become less persuaded that inflation will be stable in the long-run. Therefore,

that is part of the reason why we continue to treat inflation as our predominant policy concern.

With respect to the household financial situation, it is a complicated story. Part of the reason that official saving rates for households are negative as that those saving rates do not include any capital gains in assets that households may own. So in some cases, people have had their homes appreciated, as happened over the last 5 years until recently and they took money out, the money they took out would count as spending but the appreciation in their home would not count the saving.

So that has been part of the reason that saving has been so low, that people have seen increases until recently in their home equity. As that situation flattens out——

Senator MENENDEZ. But if they took their savings on their appreciation, the only way to do that would be to sell and/or accrue debt?

Chairman BERNANKE. No, they can make use of some of their capital gains by home equity loans or refinancing.

Senator MENENDEZ. But that would be accruing debt.

Chairman BERNANKE. I am sorry?

Senator MENENDEZ. If you take a loan out in order to get to your accrued appreciation, now you are going into debt to do that.

Chairman BERNANKE. But if I have $1,000 appreciation and I take out $500 in debt, I have increased my debt by $500 but I am still, on net, $500 better off than when I started.

Now having said all that, let me just say that I agree with you on the issue of consumers needing to build wealth and assets. The Federal Reserve manages the Survey of Consumer Finances, which is the best available source for family asset building, information about family asset holdings. The fact is that the bottom third of our population has almost no savings, maybe less than $500. And I think that is a very serious problem. We need to find ways to make people more cognizant of the need to save, to help them to save, so that they can build wealth and that they will have more security in case they have, for example, an illness or an unemployment spell.

So your general point that there are many families that do not have adequate wealth reserve, I think is entirely correct.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator.

Correct me if I am wrong, Mr. Chairman, but the numbers I have used, what I am told is that the average household has revolving debt in excess of $9,000, most of that being credit card debt. Just to make the point that Senator Menendez is talking about, and a negative savings rate. These are very disturbing statistics, if in fact those numbers increase like that. That is just unacceptable, I think.

Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman.

I have an opening statement I would like to have put in the record, if you would, please.

Chairman DODD. All opening statements will be put in the record.

Senator ALLARD. Thank you very much.

I want to talk about a little bit about stock market and some of the things that are going on there and how you view those. You have been getting a lot of articles written about hedge funds and private refunds and the like. Are they of much concern as far as the Fed is concerned?

Chairman BERNANKE. Hedge funds and private equity funds and other private pools of capital provide some very important beneficial services to the U.S. economy. They represent a way to share risks more broadly. Instead of all the risk sitting in the banking system, it can be spread through a whole different set of institutions. They provide a lot of liquidity in financial markets. It is easier to buy and sell when the hedge funds are taking part in market activity.

And one other particular area where private equity is valuable, it is important for our economy to have an active market for corporate control. That is we need to have some way of putting pressure on poorly managed companies or poor management that will create some discipline and improve our economic performance.

We had LBOs in the 1980s. Private equity is the current manifestation of that. Not all private equity deals are beneficial and not all of them work out well, but we do need to have a mechanism that strengthens the efficiency of our corporate sector.

Now are there concerns? There are some concerns. Hedge funds in private equity are relatively opaque in terms of seeing what their assets are. And they vary considerably in the types of investments that they make.

Recently, the President's Working Group issued a set of principles which argue that the best way to control the risk of hedge funds and other private pools of capital is through market discipline, by which we mean that the first line of defense should be the investors, the counterparties, the creditors, those people in the market who have the most to lose if a hedge fund goes bust, for example.

The role of the supervisors is to make sure that banks and other counterparties are, in fact, getting the information they need, managing the risk in the way they need to so that should there be any problems in a hedge fund that it does not spread more broadly probably in the financial system.

So, I think that is the best way to manage the risks in those pools of capital.

Senator ALLARD. Now has Sarbanes–Oxley contributed to the growth of the hedge funds, in your view?

Chairman BERNANKE. If you are referring to the private equity in particular, taking firms private, there is some disagreement about that. I think I would point out that private equity is also a very big thing in the UK, as well, where Sarbanes–Oxley is obviously not relevant. So, I do not think it is the principal explanation.

I think that what is happening is that financing is available and there are these firms that feel that they can essentially do a better job of running certain corporations than the existing management is.

Senator ALLARD. If taxes were applied to these equity funds and these hedge funds, would that have an adverse impact on our economy?

Chairman BERNANKE. I do not want to take a position on particular tax rules. I think I would just point out that hedge funds have a lot of international flexibility. They can move around. And even if they are based in another place they can still operate with U.S. corporations. And so I think there is a lot of international mobility, so to speak, in these institutions.

Senator ALLARD. This leads me to the next question. We have these sovereign wealth funds, apparently.

Chairman BERNANKE. Yes.

Senator ALLARD. They are Government Sponsored Entities and apparently they are pretty flush with cash right now. How do you view them as impacting our economy and our risk in the securities?

Chairman BERNANKE. I have talked about in the past what I called the global saving glut, which is basically the idea that outside the United States there is a huge amount of funds looking for returns. That includes reserves of China and other countries that have accumulated lots of reserves. But it also includes the profits from oil and commodity sales. And that is a lot of where the sovereign wealth funds are based on revenues from, say, oil sales. So a lot of that capital is looking for return, is looking for a home, and a lot of it is flowing into the United States.

On net, I think that is beneficial because it provides capital for our economy. It does drive real interest rates probably lower than they might otherwise be.

In terms of risk taking, the sovereign wealth funds, for the most part, are pretty passive investors. They are not active in switching between types of assets. They may sometimes have components which are more return-seeking, such as the Chinese, for example, have a component of their reserves fund that is more return-seeking. But for the most part they are pretty passive suppliers of capital.

Senator ALLARD. They are going after security more than anything; is that right?

Chairman BERNANKE. They are looking for return and, in particular, some of them—the purpose of sovereign wealth funds, in many cases, is to take the current windfall and to make sure it is available for future generations. So for example, Norway is taking its oil profits, putting them into this fund in order to help fund the retirement pensions of its citizens. For that purpose, it needs to have long-term safe assets. And that is the kind of investment that they tend to make.

Senator ALLARD. Do you feel the free trade agreement between the United States and South Korea is having a positive or negative impact on our economy?

Chairman BERNANKE. I am not conversant with any specific elements of that particular agreement, but in general, as most economists do, I think that opening the economy to trade is beneficial. It creates new opportunities for trade in both good and services as well as opportunities for investment. So as a general matter, I think that we should continue to keep our economy open both to trade and to investment, keeping in mind that trade and invest-

ment—international trade and investment sometimes do create dislocations in the economy and we should be prepared to address those, as well.

But overall, I believe that open economies are more prosperous and would therefore support, in general, free trade type agreements.

Senator ALLARD. Mr. Chairman, I see my time has expired.

Chairman DODD. Thank you. Senator Schumer.

Senator SCHUMER. Thank you. Thank you always, Mr. Chairman.

I would like to return to the issue of carried interest and partnerships, as well. I know you will not take a public position on any of these but I have two questions.

First is the breadth of what we do. In other words, some have said we should look at them for hedge funds and for private equity funds. But there is carried interest and publicly PTP's in other areas, oil and gas, venture capital, real estate. Does it make any economic sense to treat one of these industries differently than the other when the broad concept of either carried interest or taxing corporate partnerships who go corporate basically extends through all of them? Some have talked about singling out financial services and obviously I am very concerned about that.

Chairman BERNANKE. Senator, as you point out, there are two different issues.

Senator SCHUMER. Yes, they are separate issues.

Chairman BERNANKE. All else equal, I think consistent treatment under the tax code is a good approach.

The carried interest turns, as you know, on how to divide the returns to hedge fund managers between compensation for services and capital gains. And there are a lot of technical issues there. I think the Treasury or the IRS might be better at figuring out the details of that.

With respect to partnerships, the issue is whether or not the income can flow through directly to the partners. And the rule is that as long as more than 90 percent of the income is "passive" that it should. And so I think I see the argument for making the treatment uniform among partnerships. I think the question is defining what is passive and making sure we are comfortable with that definition.

Senator SCHUMER. That would apply to any industry, whether it is oil and gas, venture capital, real estate, or financial services.

Chairman BERNANKE. Yes.

Senator SCHUMER. So all things being equal, you should treat them all the same.

Chairman BERNANKE. If the underlying economic principles are the same and economic sources of income are comparable, then that is what is called horizontal equity, treating likes in the same way.

Senator SCHUMER. Exactly.

The second question I had is the proposals to treat carried interest differently in terms of tax treatment, the same with publicly traded partnerships. You know they are out there. And there are arguments on both sides. Obviously someone from New York, but someone who believes our Government has to raise revenues and the highest income people are the appropriate place to raise those

revenues—those are my beliefs, I know they are not necessarily yours. It is the very tough issue.

One of the things that greatly concerns me is if we were to raise taxes in both of these ways, would there be a danger that America would decline on a percentage basis, on a general basis, as a financial center? Obviously, that would affect New York dramatically and would be of great concern to me.

Now is that a worry on either of these two issues?

Chairman BERNANKE. On the case of carried interest, it might not affect their activities. But it might affect the location of their activities.

Senator SCHUMER. Yes. That is what I am worried about. If they all move to London or the Cayman Islands, I do care about that, for some strange reason.

Chairman BERNANKE. If they are looking for the lowest tax regime, that might be an effect. As I mentioned to Senator Allard, if the company moves to London they still could potentially be involved in U.S. investments.

Senator SCHUMER. No question. But that jobs would be in London.

Chairman BERNANKE. But the individuals might choose to move elsewhere.

Senator SCHUMER. So it is something to keep an eye on and worry about, in your opinion.

Chairman BERNANKE. It is a consideration. As you pointed out initially, I am not taking a position on this.

Senator SCHUMER. I understand. I am just asking your economic views of these things and I appreciate it.

Next, I would like to go to subprimes. Basically, you mentioned today that direct Federal legislation would help speed up the Fed's efforts to fix the problems in the subprime industry. As you know, Senators Brown, Casey, and I have introduced proposed legislation that would specifically regulate the mortgage broker industry. Our bill would establish a fiduciary duty and good faith stands for mortgage brokers and other nonbank originators and require originators to underwrite loans at the fully indexed rate, prohibit steering, among other things.

First, could you give us your thoughts—I am not asking you to endorse the specific bill—but on those concepts and whether it makes sense? And are these types of proposals some that would help the Fed's efforts to regulate the subprime mortgage broker industry?

Chairman BERNANKE. There is a whole set of diverse initiatives that you are referring to.

Senator SCHUMER. Can you comment on each of them or any of them?

Chairman BERNANKE. I will try. One issue, as you know, as we discussed earlier, is trying to make sure there is an even playing field in terms of enforcement and oversight. One suggestion that has been made is for more cooperation between Federal and State authorities, for example, through to a Federal registry or some Federal licensing.

The Federal Reserve, as I mentioned, is also trying to increase our cooperation with the State authorities. And so there are dif-

ferent ways to approach that issue. That is certainly one thing that I think is very important to increase that coordination and cooperation if possible.

Senator SCHUMER. But if the State resists you, there is not too much you can do.

Chairman BERNANKE. We have backup Federal authority in FTC, which is another possible vehicle.

Senator SCHUMER. They have not been a tiger on——

Chairman BERNANKE. As well as the U.S. Attorneys General would also have some authority in those——

Senator SCHUMER. What do you think of legislation that would require this at a Federal level?

Chairman BERNANKE. Require which?

Senator SCHUMER. Require, say, regulation of mortgage brokers in certain ways so that there is a suitability rule.

Chairman BERNANKE. In terms of the uniform authority, I think one very important question to answer is if you are not going to let the States be the primary regulators, what would be the substitute? How would you propose to do that?

Again, I think at this point my preferred approach would be to work with the States because many of the States are, in fact, very effective.

Senator SCHUMER. I am a little confused here. I thought earlier, in reference to Senator Brown's questions, you said that Federal legislation would help speed up the Fed's efforts to fix those problems?

Chairman BERNANKE. I was referring there to the HOEPA rules that we are considering and the other things that we are doing under our regulatory authority. We have certain procedures we have to follow in terms of putting out proposed rules and taking comments and the like. And I was only commenting that while we would move as expeditiously as possible, if Congress wanted to move more quickly, of course, legislation can override those procedural steps.

Senator SCHUMER. But much of your authority here is not—you cannot force it to happen basically if you have reluctant parties that you are trying to exert pressure on; is that correct?

Chairman BERNANKE. Our HOEPA authority applies to all lenders. We can set rules for all lenders but we do not have the enforcement authority outside of the banks. So finding ways to have better cooperation between the Federal and State authorities, I think, is a useful direction.

Another thing you have mentioned I know, and we have discussed this before, is counseling. I think that the Federal Reserve itself, the Reserve Banks around the country, are partnering with nonprofit agencies that do counseling. I, myself, have visited with some nonprofits that do counseling. It is not a panacea, in part because not all counselors are effective and so on. But it can be helpful and it is something to be kept in mind.

With respect to suitability, this is, I think, a very tough issue. It has to be done in a way that will not essentially drive away interest in this market. One way of thinking about suitability—let me take a step back.

If you think of suitability as requiring the lender to pick the very best of the dozens of products available for the borrower, that may be setting a standard which is not actually viable. Perhaps another way of thinking about it is equating suitability with affordability.

Senator SCHUMER. That is what we do.

Chairman BERNANKE. And essentially saying that there is some presumption that the lender will appropriately take into account ability to pay in making the loan. And that itself turns to some of the things that we are trying to think about under our HOEPA authority, which is whether or how to require underwriting to the fully indexed rate and how or whether to require more documentation than is currently required about ability to pay, for example, and what standards one might set in terms of linking ability to pay to the monthly payment. So those are some of the issues.

Senator SCHUMER. So we are somewhat on the same page on some of these things.

Thank you, Chairman Bernanke.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator Schumer.

Let me thank Senator Schumer for his comments on the issue of these matters affecting the carried interest and other issues. As Chairman of the Committee, I share some of his concerns about that, in terms of there being an equitable application of these issues here, and that we understand the full implications of what may be occurring here. You have raised them very, very well. And I think it is something the entire Committee would want to express an interest in.

So as we look at these issues here we may, at some point, Mr. Chairman, want to ask you to participate and ask you—I realize it is a bit—and you point out that the IRS and Treasury may be a more appropriate place to look but obviously your expertise and thoughts on this could be helpful as well, as we consider the implications of all of this.

But I thank Senator Schumer for his points.

Senator Bennett.

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you very much, Mr. Chairman.

Chairman Bernanke, welcome.

I have two issues I want to pursue with you and get your thoughts on, but I want to make just an observation prior.

I have been on this Committee now for over a dozen years. And we see the pressure going one way and then the other. First, the requirement on or the desire on the part of Members of this Committee to make capital available to the people that are poor. We have to do everything we can to make capital available to them and push in the direction. No, you are holding capital just for the rich. You have to make it available to the poor.

Then when we get into the subprime problem, I understand, at least on the House side, there is legislation to hold the lender responsible for the fact that they pushed money at people who could not afford to pay it. And now that the homes are being foreclosed on it is the lender's fault and we have to punish the lender for making the capital available in the first place.

It is an interesting pendulum to watch it swing back and forth in this debate. I hope we do not end up saying to the counselor, the counselor is liable if the counselor said you should make this deal rather than that deal and then the counselor has to pay the damages if, in fact, there is a problem and the people cannot pay their mortgage.

The two issues I want to talk to you about are labor and housing. In my home State of Utah, the unemployment rate is two-point-something percent and the something does not really matter. When you get down that low it is a very, very serious problem. We have a labor shortage.

Nationwide the unemployment rate is at levels approaching historic lows. I would like your reaction to that problem and what it might do with respect to inflation. Your predecessor, Chairman Greenspan, talked about tight labor markets and the impact of that on inflation.

Productivity is going up so we have to have a different historic benchmark on unemployment figures. I was taught in college that 6 percent was full employment, that you got below 6 percent and you were facing serious inflationary pressures. Interestingly enough, at the height of the last recession the unemployment was in the 6 percent range. And now we are at 4 percent or something. So, I would like your comment on that.

And then on housing, the housing bubble has the potential, in my view, of triggering an economic downturn just as the dot-com bubble that we were all excited about and thrilled about in the late 1990s triggered the recession that began in 2000 as that bubble started to burst. Everyone was delighted to see his house value go up, particularly if he did not have to buy a new one. And you referred to the number of people who took home equity loans and went out and went on a spending binge. Now the housing prices have flattened, if not fallen, in many areas. There has to be a shakeout just as there was a shakeout from the dot-com bubble there has to be a shakeout from the housing bubble.

Look into your crystal ball and see if it is, in fact, going to create an economic downturn? If so, any ideas as to how severe or when?

I know you do not make those specific prophecies and I am not asking you to. But just in a general term what you might see as the housing shakeout works its way through the economy. If you could address those two, I would appreciate it.

Chairman BERNANKE. Certainly Senator.

Just one word on your initial comment. I agree with you that legitimate subprime lending is beneficial. It gives people access to homeownership and access to credit.

So the real trick for us is to write rules, to write regulations that will screen out the abusive practices and the improper practices while preserving this market. I think that is a very challenging task.

Senator BENNETT. If I just might, a witness in a previous hearing said not all predatory lending is subprime.

Chairman BERNANKE. That is correct.

Senator BENNETT. And not all subprime lending is predatory.

Chairman BERNANKE. I agree entirely.

On labor shortages, there is, I think, a very strong demand in this country for skilled workers. In particular, we hear from our contacts around the country how difficult it is to find people, not just Ph.D.'s, but people who are familiar with plumbing and welding and other kinds of what we used to think of and still think of as blue-collar type occupations. And so I think there is an enormous opportunity here, if we can help people acquire those skills, to help them obviously but also to lower the unemployment rate that the economy can sustain because we will change unskilled workers into people who can fill these spots. I think that is very important.

With respect to the effect on inflation, the way I think about this is that the economy at a given time has a certain amount of normal potential output. If the Fed is too easy or other factors lead to increased aggregate demand, and that demand is exceeding the supply essentially, then you can get inflation pressures. And so the challenge for the Fed is always to balance supply and demand, to think about whether or not the level of demand that we are generating with our interest rate policies and with other policies, Government policies for example, is consistent with the underlying supply.

It is not so much that a given level of employment is *per se* inflationary. But if the economy is overheating, one might see a temporary dip in unemployment reflecting the extra resource utilization associated with it.

So we do not have a magic unemployment rate that we look at, say, that is too low or too high. What we try to do is look at the whole economy, look for sources of price pressure. Are firms finding it easy to raise prices? Are there indications that markets are very tight, both at the labor level and the product level? And we try to make a judgment about the balances of supply and demand and that helps to govern our thinking about this.

The labor market, you mentioned 6 percent. The labor market changes a lot over time in terms of demographics, in terms of skills and education, in terms of job finding through the Internet and so on. And so that number is not a fixed number. We always have to think about how it might be changing over time.

With respect to housing, I talked about that quite a little bit in my testimony. There is, at this point, a pretty substantial overhang of unsold new homes. So even if demand stabilizes, as we think it will soon, there is going to be a period of weakness as builders work down those inventories and reduce their construction.

Housing has been subtracting from GDP growth over the last year about a percentage point. If demand stabilizes and builders begin to work down those inventories, we think that the drag, while still negative, will begin to diminish over time. And so that effect will begin to moderate.

In the testimony we do mention housing as a downside risk. It is, of course, possible that declining housing values will cause consumers to spend less. It is possible that it might lead to fewer construction jobs. That might also have effects on the economy.

But to this point we have not seen significant spillovers from the housing sector into other parts of the economy. Most of the rest of the economy is functioning at a pretty strong level. But that is ob-

viously something we are very alert to, the possibility that the housing slowdown might have implications for other parts of the economy.

Chairman DODD. Thank you very much.

Senator Bayh.

STATEMENT OF SENATOR EVAN BAYH

Senator BAYH. Thank you, Chairman Dodd. And thank you, Chairman Bernanke, for your presence here today and for your service.

I, too, have a keen interest in some of the issues that have been raised today, particularly the currency valuation issue in China, which tends to have an impact on our manufacturing sector, which is concentrated in the Midwest. And also in the housing issue, which is having a tremendous impact on my home State right now. But I think that territory has been pretty thoroughly covered here today, so I will perhaps focus on some other things but I did not want anyone to think that my lack of questioning in those areas evinced any disinterest.

This is, of course, the beginning or we are well into a political season and I do expect you to answer any political questions. But they are going to be a number of issues debated over the next year that are going have a pretty profound impact on the course of the American economic and financial policy. So, in general terms, I would like to raise a couple of those and get your take on them if that is OK.

Our economy has done pretty well over the last decade or two, in terms of the macro level of growth. But there is a growing belief that the benefits of that growth have been disproportionately concentrated in the hands of the top 1 percent or so of the American people. There is at least one candidate who points out that about 50 percent of the wealth generated over the last couple of decades has gone to the top 1 percent in our country.

So my question to you is are there things that can be done to try and more equitably distribute the fruits of the growth that our economy has been generating into the hands of the middle class in this country?

Chairman BERNANKE. Senator, this is a very hard problem because it touches on almost all the other problems that we address as a country. I think you could break down the lack of progress of the middle class, if you like, into several different factors. One is this very long-term movement toward inequality and wages which has arisen partly because of technological change which favors higher skilled workers, to a lesser extent because of globalization. That is a long-term trend that has been going on for 30 years. That is one factor.

A second factor which I think is probably temporary and I am not sure what can be done about it in any case, is that over the last few years profits have been very high and so there has been somewhat of a shift between capital and labor income. In the past, those things have corrected themselves. I am not sure that is a policy issue at this point.

A third factor is the cost of energy and the cost of health care which——

Senator BAYH. Can I interrupt you for just a minute, Mr. Chairman.

Chairman BERNANKE. Sure.

Senator BAYH. So you say in the past that the rewards to capital versus labor has tended to correct itself. If we are living in an era of more rapid rates of innovation, might that not lead it to correct perhaps not quite as quickly as in the past?

Chairman BERNANKE. We, of course, had many areas of rapid innovation in the past and it is just one of the long-standing economic irregularities that the share of capital and labor tends to stabilize over time. We saw in the 1990s, for example, that capital went ahead of labor for a while during the productivity boom and then labor began to catch up again.

So, I do think that we will see a more normal——

Senator BAYH. I do not want to use all my time on this question and I apologize for interrupting. We are not for redistributing wealth overtly. But to judge at least by the first part of your answer, if the economy is rewarding more highly skilled parts of the labor force better, then perhaps a focus on education, access to college, and those kind of things might empower the middle class to enjoy a larger share of the wealth.

Chairman BERNANKE. I agree entirely. The way I was trying to answer your question was here are some of the major things that are explaining and they all tie into these major issues, particularly this inequality. I do believe that education, in a very broad sense—not just K–12 and college—but on-the-job training, vocational schools, technical schools, junior colleges, community college, a whole variety of mechanisms can be used to give people higher skills to meet the kind of demand for workers that Senator Bennett was asking me about.

I think that is a very important part of trying to reverse this increasing inequality in wages. But there are some things like energy policy and health care policy that the cost of those things have subtracted from the gains that families otherwise would have enjoyed. Those, themselves, are very important issues.

The other thing I would mention is that there is a perception of greater economic insecurity, not just the level of income but that your tenure is not as long in a particular job, for example. There is some evidence of that. I would have to say it is not overwhelming evidence but there is some evidence that people spend a somewhat shorter period of time at a given job. Some have argued there is a little bit more volatility of income year-to-year than there was in the past.

Part of the response of the political system to the public to try and reassure them about these huge forces of globalization and technology which are taking place is steps to try to increase or reduce the feeling of insecurity. Ways to do that include, for example, trying to make health care and pension more portable between jobs so people do not feel that if they lose their job they lose everything. There might also be more creative ways to structure unemployment insurance to help people move from one job to another, to acquire necessary training, and so on.

So there are a lot of creative policies out there that could be considered. But I guess my bottom line is that this issue of income

stagnation is really a multifaceted thing. It ties into almost all of these other big issues. And so a single magic bullet is probably not there. You have to address the different components of it.

Senator BAYH. Let me ask you about another component. As you are aware, we continue to face some deficits with the aging of the population, particularly on the health care side, that is going to exacerbate it. We will have to deal with that from the spending point of view. Perhaps there are revenue issues that come into that, as well.

One of the issues that will be debated over the course of the next year and several months is going to be tax policy. So in my remaining 37 seconds, I will try to pose two questions to you and I hope you will address them both.

How would you explain to an audience of middle-class Americans that is experiencing the economic anxiety that you just mentioned, that we tax income up to a marginal rate of 35 percent but capital gains and dividends at a 15 percent rate? How would you explain to them that that is an equitable tax policy? That is number one.

Number two, there are some proposals out there to focus on the top 1 percent or so as a way to reduce the deficit, or to fund education initiatives that you just pointed out are important, or health care initiatives, that thing. Some people argue that that will have a drag effect on the economy.

I think that argument was made back in 1993, the last time rates were raised in the top brackets. In fact, the economy did very well.

So if you could address how do you explain to middle Americans the disparity between how we tax income versus capital gains and dividends on the one hand? And second, what would the likely effect on the economy be of looking at the top 1 percent, given the history in 1993 and the effect or lack thereof that that had at that point in time?

Chairman BERNANKE. Senator Bayh, I hope you can appreciate my position as the head of the nonpartisan central bank that I do not want to take——

Senator BAYH. I am asking in a purely theoretical context, Mr. Chairman.

Chairman BERNANKE. A theoretical question. I will make a couple responses.

One, the tax code overall, the general progressivity of the tax code has not changed radically. On the one hand, you mentioned 35 percent. At one point, of course, the top marginal rate was 28 percent 20 years ago. We have also seen a lot of credits for—so forth and so on.

Senator BAYH. Here is what we have going on. Forgive me for interrupting your thoughts.

That is all true. We now tax capital gains and dividends at 15. As you pointed out, given the trend in the economy, it skewed the returns toward capital a little more than labor. And yet there is the difference in the tax rates, even though on labor it was much higher in the past at the top marginal rate.

Chairman BERNANKE. To answer your question, what a defender would say is that there are both equity and efficiency arguments for differential taxation. The equity argument is much capital in-

come is also taxed, for example, at the level of the corporation. The efficiency argument is that in order to promote saving and risk-taking and investment it is better to put a lower tax on capital income.

And then your concern about the differential between labor income and capital income is an argument that would be made on the other side. So it is a very long-standing debate in economics.

Senator BAYH. And about the likely grow effect of changing the marginal rate on the top 1 percent, given the experience after 1993, the last time that was done?

Chairman BERNANKE. After 1993 there was a lot of things happening besides changes in fiscal policy.

Senator BAYH. There always are.

Chairman BERNANKE. Let me say something which I think is objective or at least as objective as can be, is that the studies that have been done of the revenue benefits of the very top rate suggest the revenues are pretty small from doing that.

So if you want to have a substantial revenue impact, you would probably have to go down somewhat further than 1 percent. So there really is a question of trading off the revenue versus whatever efficiency benefits might be involved.

I cannot give you a precise estimate of what——

Senator BAYH. On the marginal effect on growth.

Chairman BERNANKE. —the marginal impact. I do believe as a general matter that there is some trade-off. As you raise marginal tax rates, you do tend to get a less efficient economy. But the exact trade-off, economists have not really pinpointed it precisely.

Senator BAYH. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator.

I do not know if I heard you, in response to Senator Bayh's excellent questions, mention the statistics you cited that have been highly quoted now and frequently quoted in your Omaha, Nebraska, speech back earlier this year, something that I have repeated over and over again to people, and that is the declining number of union households in the country as also being a major factor in what has happened in income disparity.

I thought it was very interesting statistics, just looking at the data at what had happened. And of course, knowing that a lot of those gains that the middle-class acquired were not necessarily given out freely but negotiated rather extensively and intensively to produce the incomes, the working conditions, the hours, and so forth that raised those levels so that people moved into that income category that allowed them to purchase and to do the other things that middle-income people have historically done.

You may have mentioned that and, if you did, I may have missed it. But I thought it was a very worthwhile observation you made, among others, as to what had happened over this gap that has grown now 82 years. Great questions.

Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman.

Chairman Bernanke, welcome. It is good to see you again. Thank your coming and joining us today, and for your service.

Others have asked about the subprime mortgage market. I want to just touch briefly on that as we start out here.

Yesterday, we tried to have a hearing in this same room on FHA reauthorization. In my opening statement yesterday, I mentioned that if you look at the increase in the subprime mortgage market it really mirrors the decrease of FHA's market presence for subprime lending.

The Administration has come to us with the recommendation, a series of recommendations, on how to change things in the FHA program. I just wanted to ask if you have any thoughts on what might be an appropriate course for us?

Chairman BERNANKE. The FHA's market share is declining quite radically, as I am sure you know, down to about 3 percent.

Senator CARPER. Actually, I think they reported it about 6, down from about 14 to 6 just in the last couple of years or something like that.

Chairman BERNANKE. So there is clearly less reliance on the FHA than in the past. My sense is that part of the problem is lack of flexibility, costs of dealing with the FHA, lack of diversity of products and so on. So, I think that modernizing the FHA and trying to make it more responsive, easier for ultimate lenders to work with and so on, might reverse this trend and might give the FHA a larger share in the market which could be a positive thing.

I guess I would point out that the FHA, if I remember correctly, still has a fairly high delinquency and default rate and it has not solved the problem of delinquencies and so on.

And so as those changes get made, I would suggest moving with some caution to make sure that we do not create yet another source of problems in terms of inappropriate loans for specific borrowers.

So, I do see a case for trying to make the FHA more modern and to expand its role. But I would urge some caution and go slow on that.

Senator CARPER. Thank you.

When you were before us, I believe a year or so ago, I raised the issue of concern expressed by domestic auto manufacturers with regards to alleged manipulation of currency by not China but by the Japanese. I think you indicated in your response that as far as we can tell, at least since the earlier part of this decade, the Japanese have not been manipulating their currency.

Since that time we have had a huge debate here in the U.S. Senate about whether or not we should raise fuel efficiency requirements for cars, trucks, and vans built in this country, to do that over the next 13 years or so. The domestic auto industry has come back to us and said please do not raise CAFE standards dramatically. If you do, you will push us closer to being out of business.

They said do something about the Japanese currency manipulation. They said do something about our legacy costs, particularly health costs for employees and for pensioners. And they call on us to provide some Federal investments in plants, in their plans to enable them to move toward flexible manufacturing where they would make more than just one or two products in a plant.

I am not going to ask you to comment on all of those but I would be interested in your thoughts again on alleged manipulation by

the Japanese of their currency. A year ago you suggested that it had not been done for several years, and I just wanted to ask your views on that today.

Chairman BERNANKE. There has not been any changes to my knowledge. The last time that the Japanese intervened was in—as far as we know, was in March 2004 and there has not been a subsequent intervention since then. The yen has been quite weak reflecting in large part the fact that interest rates in Japan are quite low, which in turn reflects the policies of the Bank of Japan in the face of still very low, near deflation, inflation rates.

I view the end as being essentially a market determined exchange rate and I think that market determined rates are the way to go. And so I would not advocate any particular policy changes with respect to Japan.

Senator CARPER. Thank you.

Are you alarmed at all by our growing reliance on foreign oil?

Chairman BERNANKE. It is certainly an issue. We now import about two-thirds of our oil. We are very heavily reliant on oil. It would be very desirable for us to have a more diversified energy portfolio. I think there are ways to do that.

As a very basic approach, I could suggest three things. One is that the Government has a very substantial role and has been very effective in the past in promoting or doing basic research, developing alternative technologies either in terms of conservation or new energy sources.

A second issue is what I guess I would call regulatory certainty. We do not get new refineries, we do not get nuclear plants, not so much because the regulations *per se* are so onerous but because between the uncertainty of how they will be applied and legal suits and so on nobody wants to undertake a new investment.

So it is fine to have strong regulations to protect the environment and achieve other social goals but it would be productive to have a system whereby people who want to make investments in alternative energy forms or refineries, *et cetera*, would know in advance what they have to do in order to meet the regulatory requirements.

The third thing I would say is that although the high energy prices and high oil prices we are seeing right now, of course are very painful, and I do not want to downplay that in any way, they do have at least the benefit that they make a lot of other alternatives potentially economically viable. With regulatory certainty and basic research, among other things, that market I think can begin to deliver some alternatives.

We do have to address issues related to the environment and global warming and the like. But I think there are really a large number of possible alternatives and we should let the economy explore those.

Senator CARPER. Thank you. Those are excellent points.

The last question. In the past you have been vocal in your support for reforming our Government Sponsored Enterprises, at least the regulation of those. I think you actually gave a speech back in March that dwelled on that.

I guess my question is we seem to be hung up. The House has passed a bill, we are expecting to take up legislation later this year

that addresses GSE reform and regulation of our Fannie Mae, Freddie Mac, and Federal Home Loan Banks.

The hang up appears to be really in two areas: What kind of support should we provide for low-income housing through some kind of creation of a low-income housing fund? And the questions about the mortgage portfolio and what kind of constraints should be on the mortgage portfolio?

Any advice that you would have for us as we approach that?

Chairman BERNANKE. The Federal Reserve's concern is about financial stability. And so we have not taken a position on the housing fund type things.

But for financial stability purposes, I think there are three elements: Strong bank-like capital powers. Second, well-defined receivership positions so that if a GSE goes out of business we know under what circumstances that would happen and what the resolution of that would be. And third, anchoring the portfolio in a public purpose. Right now, it can expand almost at will and it is not tied directly to public purpose.

In my speech that you referred to, I advocated tying the portfolio to affordable housing or to housing goals in some explicit way.

So those are the recommendations that I would suggest in order to assure us, in terms of our concern which is about the implications for financial stability if these large portfolios were to come under financial stress.

Senator CARPER. Thank you very much.

Chairman DODD. Senator Carper, thank you.

Senator Akaka.

STATEMENT OF SENATOR DANIEL K. AKAKA

Senator AKAKA. Thank you very much, Mr. Chairman.

Mr. Bernanke, it is good to see you in person here. And I want to tell you my role here on the Banking Committee has come down to being very concerned about the consumers of America. Here I have looked upon this as trying to improve the quality of life for consumers, as well as to help them improve themselves. Consumer protection is important, and also equipping them with the skills and knowledge that will help them with their understandings and also to empower them with economic empowerment.

So this area has been important to me. Our modern complex economy depends on the ability of consumers to make informed financial decisions. Without a sufficient understanding of economics and personal finance, individuals will not be able to appropriately manage their finances, evaluate credit opportunities, and successfully invest for long-term financial goals in an increasingly complex marketplace.

Mr. Chairman, I really appreciate your personal involvement on the important issues of financial literacy. I also wanted to take the time to thank all of the Federal Reserve employees, and I want to include Sandy Bronstein in that, and all of those who have taken such an active role in helping improve the financial knowledge of consumers and evaluating the effectiveness of education programs.

As you know, approximately 10 million households in the United States do not have accounts at mainstream financial institutions. Unfortunately, too many of these households depend on high cost

fringe financial services. They miss out on opportunities for saving, borrowing, and lower cost remittances found at credit unions and banks. And so the unbanked has become one of my concerns.

My question to you is what must be done to bring these households into mainstream financial institutions?

Chairman BERNANKE. Senator, first let me say that I agree wholeheartedly with your views on financial literacy. As I discussed earlier, the Federal Reserve works very hard on all these disclosures for these sometimes complex financial products. But if people do not have the basic literacy to understand them and evaluate them, it is really of no use. Without financial literacy they are not going to be able to participate fully in our economy.

In terms of bringing more people into the banking system, I think it would be a positive development. The main way the Federal Reserve can help that process is what we do, which is to encourage the banks and bank holding companies that we supervise to reach out into underserved communities, partly through the Community Reinvestment Act but more generally to provide services and to try to attract unbanked people into the banking system.

I have given not only testimony before the Senate on financial literacy, but I have also given some testimony in the past on remittances which is one mechanism. Many of the remittances that immigrants send back home, they lose a significant portion of the money they are sending because of the high cost of the types of services they use and other problems. One of the ways in which credit unions and banks have made inroads into the minority communities, in particular, has been by offering better and cheaper remittance services. I think that is one particular way to get in.

But we are seeing banks more and more employing Spanish speaking, for example, tellers and understanding that there really is a good market in these low and moderate income neighborhoods. And we encourage banks to provide services in those neighborhoods.

Senator AKAKA. Mr. Chairman, FDIC has found that their Money Smart financial literacy program has resulted in positive behavioral change among consumers. I know that measuring the effectiveness of financial literacy programs is an issue that the Federal Reserve has been interested in for several years.

What has the Federal Reserve learned thus far about the effectiveness of financial education?

Chairman BERNANKE. First, a lot of what we do is partner with various groups. The Chicago Federal Reserve Bank partners with the Money Smart group that you just referred to. So a lot of what we do is try to develop best practice and to try and spread that to schools and to nonprofit organizations and so on.

In terms of what we learned, we are still, I think—and here I am referring to the entire education community—groping with how best to teach financial literacy at the school level. There is an organization called JumpStart which does testing of kids in high school. Unfortunately, the progress on financial literacy there has not been all that we would like.

One place, however, where we do see more progress, and I referred to this in my discussion with Senator Schumer, is that when potential homebuyers receive counseling nearer to the time when

they are going to be making their decisions that they do learn and they do understand and it does affect their decisions, as you might expect, because they are very highly motivated at that point to understand the terms of the contract that they are about to enter into.

So it is still a very open issue. We have a website which includes lots and lots of materials which have been tested in various contexts. But I cannot say that there is, at this point, a definitive approach. I think you have to take a little bit of this, a little bit of that, and mix it all together and recognize that financial literacy is not just a school subject. It really has to be used throughout life because it is really, as you get older and you have to worry about buying a house and sending your kids to college and retirement, that you really begin to think hard about these financial issues. Kids in the 10th grade may not be as motivated to think about them.

Senator AKAKA. I thank you so much for your responses. My time has expired, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Akaka. These are very important questions and I thank you for raising them. Your point about the 10 million households without access to mainstream financial institutions is a very legitimate concern and something I have talked a lot about myself.

The Chairman points out that the cost of this to these people, because they are using financial services, and it will cost an average person thousands of dollars more than they would otherwise pay if they were dealing with mainstream financial institutions. So the cost differentials are huge, not to mention, of course, the ability for people in those circumstances to improve their economic lot. So, I thank you for raising it.

I, too, find it remarkable, from the time a young person enters a traditional schooling system in this country through the 12th grade there is not a single requirement that I know of anywhere that there is some period of time in which just basic financial services literacy would be required. We have talked a lot about this and schools are inundated with requests and demands on them. They do not want to hear about another one. But one of the major problems is people's inability to understand basic financial obligations. So, I thank you for raising and thank you, Mr. Chairman, for your comments.

Chairman BERNANKE. A few States, Senator, have actually made these requirements but it is not universal.

Chairman DODD. Have they done that? That is good to hear.

Let me turn to Senator Shelby for one question. I have one additional one after his and then we will complete the hearing.

Senator SHELBY. Thank you.

Chairman Bernanke, GSE reform. We have talked about this before. This Committee has been interested in strengthening the regulatory system for the housing related Government Sponsored Enterprises for a number of years. The House recently, as you are probably aware, considered language giving the new proposed regulator the ability to regulate the size and the growth of the enterprise portfolios and charged the regulator to consider risk of the portfolios. However the language, which was amended on the

House floor, I understand, which passed in the House, limited the risk consideration to only risk to the enterprises.

Would you view this language, as it was passed by the House as amended on the floor, with what bank regulators have over financial institutions? That is do you consider, as a regulator, only the risk to a particular financial institution? Or do you look at the portfolio? Do you look at other things?

The portfolio your predecessor, Chairman Greenspan, says right here in this Committee and I believe you have reiterated that there is risk there in that portfolio, possibly to the taxpayer. Would you comment on this?

Chairman BERNANKE. Senator, I am aware of this legislation and the amendment. The amendment in the House does concern me greatly because I think it eliminates the ability of the regulator to take the financial system's stability overall into account. So in particular, one might imagine a situation where greatly increasing the size of the GSE portfolio is in the interest of the company but raises the risk to the overall system.

As I said a moment ago, in my role my principal concern is about the stability of the overall system. And I fear that without some consideration of the overall financial stability implications, that this new regulation would be incomplete.

Senator SHELBY. I think there are some good things in the House-passed bill but that was not one of them, in my judgment.

I appreciate your comment.

Thank you, Chairman Dodd.

Chairman DODD. Thank you, Senator Shelby. And just on that point alone, obviously we are going to looking at that and trying to get a bill done fairly soon. Again, the realization here, I just have to add two cents on this. And that is, of course, the presence of the GSEs in this area, I think many would agree, have created a possibility. One of the unique opportunities we offer in our economy is that 30-year more fixed rate mortgage which provides great stability and great wealth creation for an awful lot of people, in the absence of which it would be very difficult to achieve. So striking the balance here, the points you have raised here, and seeing to it we do not move away from the opportunity that those vehicles provide is something very important to all of us.

Let me raise a quick question if I can, as well, with you here. The hedge fund industry is obviously an important wealth creator in the country. It has done an awful lot of worthwhile things in terms of a valuable role in capital markets.

The President's Working Group, which you are a part of, back in February released a set of principles and guidelines. I would just quote, it says "To guide U.S. financial regulators as they address public policy issues associated with the rapid growth of the private pools of capital, including hedge funds. The agreement concentrates on investor protection and systemic risk concerns." The President's Working Group, at that point, determined that additional regulation was not needed.

Let me raise the issue that has been raised by others. You had a piece in the *Chicago Tribune* recently talking about the Amaranth situation, which many people pointed out, given the size of

it, it did not create that much of a bubble unless you were in San Diego and had a pension fund and then $100 million was lost.

So from your perspective, from stepping back from a macro standpoint, it had seemingly very little effect. And yet if you were dealing with the pensions in San Diego, it was a rather significant effect.

There was then a story in, I think it was *Business Week,* that I was not aware of. A lot of smaller colleges are now moving aggressively into hedge funds, according to this article. It identified colleges that had invested between 60 and 82 percent of their endowments in hedge funds. They said they may be putting their endowments in jeopardy. That was the conclusion of this *Business Week* article.

Again, they are just two newspaper stories here. I just wonder, in light of all of this, do you have any additional recommendations about this? What did the President's Working Group want market participants to do differently after the release of the principles than they were doing before? How were the Working Group agencies overseeing the impact of this new guidance that they put out? And last, do you feel that additional regulation of hedge funds is needed to avoid concerns about systemic risk?

Chairman BERNANKE. Mr. Chairman, the essence of making the market discipline approach work is that the counterparties, investors, and creditors be sophisticated and able to evaluate the investments that they are undertaking. In the case of a pension fund, the pension fund manager has a fiduciary duty to make investments which are appropriate for the risk/return needs of that fund.

So if that fiduciary manager has sufficient sophistication to use some of these things, that perhaps is OK. But in most cases I think that pension funds should probably not go heavily into these types of instruments.

In fact, on average, ERISA funds have relatively small shares of their assets in these funds. But again, in those cases and in the cases of endowments as well, it is really the responsibility of the sophisticated managers to make sure that they are making the right risk/return trade-offs. The whole system depends on those people knowing what they are doing.

Chairman DODD. Given the exposures you were talking about, and I agree with that totally. I do not disagree with what you said. Do we, you, and these other appropriate agencies bear an additional responsibility here to be more mindful of what is going on, including possibly some regulatory role here?

Chairman BERNANKE. With respect to the pension funds, for example, they already are regulated by ERISA and the Department of Labor. And they have fiduciary responsibilities and that should be enforced, obviously.

In terms of the broader issue of market discipline for private pools of capital, I would like to emphasize that this is not a laissez-faire approach. In particular the supervisors, including the Federal Reserve, have the responsibility to make sure that the institutions who are the prime brokers, the counterparties, the creditors of these private pools of capital, that they have in place adequate risk measurement techniques, risk management techniques, they have

enough information so they can make adequate assessments of the risks that they are facing.

So we, in fact, do put a lot of effort into ensuring that these institutions—and I say we, this is in collaboration with the SEC and other regulators—that they are doing sufficient due diligence to protect themselves and their own investors and depositors from excessive risk.

So that is what makes the system work, a combination of self-interested counterparty market discipline but overseen and overlaid by effective supervisory attention.

Chairman DODD. I interpret that that you do not see any additional regulation needed at this point?

Chairman BERNANKE. I do not, at this point, see any need for additional regulation, no.

Chairman DODD. Mr. Chairman, I thank you and we have a vote on here. Obviously, there will be a lot more questions for you but you have been very generous with your time. We appreciate that very much.

I am going to leave the record open for a day or two here for additional questions. We had very good participation by the Committee Members here but there may be some additional questions that they would like to raise with you. We will submit them to you in a timely fashion.

Once again we thank you immensely for your participation.

Chairman BERNANKE. Thank you.

Chairman DODD. This hearing will stand adjourned.

[Whereupon, at 12:10 p.m. the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Chairman Bernanke, we are very pleased to have you before the Committee this morning to deliver the Federal Reserve's Semi-Annual Monetary Policy Report. This hearing provides the Congress a very important opportunity to have an open and detailed discussion about the Fed's monetary policy goals and their implementation. I also expect that Members of the Committee, including myself, will take advantage of your appearance to raise some other issues that fall under the jurisdiction of the Federal Reserve.

I also would like to welcome our colleagues from the European Union Parliament. I trust that their visit today will be enlightening and provide them with much to discuss with the European Central Bank.

Chairman Bernanke, your testimony and report this morning note the continued healthy performance of the economy in the first half of 2007. Although real gross domestic product (GDP) increased 0.7 percent in the first quarter of 2007, the consensus view among economists is that growth for the second quarter will show a rebound in the neighborhood of 2.5 percent. Along with continued GDP growth, we have seen positive news on the job front. Gains in payroll employment averaged 145,000 jobs per month in the first half of 2007. We continue to enjoy a low unemployment rate, both historically and relative to other industrialized nations.

The global economy also continues to be strong, with Canada, Europe, Japan, and the United Kingdom experiencing above-trend growth rates in the first quarter. This is good news for American businesses seeking to expand their exports around the world.

In its statement following the June 28, 2007, meeting, the FOMC suggested that while core inflation readings had moderated, "sustained moderation in inflation pressures has yet to be convincingly demonstrated." Inflation risk, not slow growth, remains the predominant concern as we continue to see a rise in energy and food prices. I also share your view on the importance of low inflation in promoting growth, efficiency, and stability which in turn equal maximum sustainable employment.

Chairman Bernanke, your statement also includes an extended discussion of the Federal Reserve's recent activities relating to subprime mortgage lending. The recent sharp increases in subprime mortgage loan delinquencies are troubling. The initiatives that you highlight in your testimony are welcome.

However, I am concerned that the weaknesses in the subprime market may have broader systemic consequences. We have been told that the problem is largely isolated and contained, but I am concerned that it may not be. I will be particularly interested in hearing your views on the scope of the problem and how the Federal Reserve will monitor and manage the situation going forward.

Chairman Bernanke, we are pleased to have you with us this morning. We look forward to discussing in greater detail the Federal Reserve's performance and its views on the future direction of our Nation's economy.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR JIM BUNNING

Chairman Bernanke, I watched your testimony yesterday with interest. Apparently the markets did too, but I am not sure if they did or did not like what they heard.

You covered a lot of ground yesterday, but there is some new ground I will cover in the questions and some things that are worth repeating. First, it has been interesting to watch market reactions and expectations to Fed policy statements over the last few months. For a while, the markets did not believe your clear statements that the biggest concern was that inflation would not moderate as expected. Market indicators have moved more in line with your view in the last month or two, and I hope both the markets and you have learned about communication and the way each other think.

While this is a monetary policy hearing, I think it is worth repeating that many of us believe the Fed and other regulators share some responsibility for the current state of the housing market. Low interest rates fueled the housing boom, and loose supervision of mortgage writing allowed it to proceed. The market is certainly punishing bad behavior by lenders, but some of the damage could have been prevented by more careful scrutiny of some of the most undisciplined lending. The Fed should have been especially careful because of the credit bubble it created with cheap money.

I am glad you and your fellow regulators have taken action, and that you did not overreact and cause further damage. It is important for you to remain vigilant, but

not to give in to pressure to over regulate. I would also say to Chairman Dodd that I hope we can quickly confirm the new nominees so that the Fed board will have more industry experience when tackling these issues.

I continue to be impressed by the current economy, which seems to have passed through the worst of the slowdown caused largely by Fed tightening. My biggest concerns are rising food and energy prices, and the negative effects on the economy of the massive tax increases the new majority in Congress seems determined to allow. The current economic expansion is driven by the 2001 and 2003 tax cuts, and allowing a tax increase in 2010 will reverse years of gains in the economy and the stock markets.

I look forward to hearing your responses.

PREARED STATEMENT OF SENATOR ELIZABETH DOLE

Thank you, Chairman Dodd. Chairman Bernanke, I join my colleagues in extending you a very warm welcome. Thank you for your strong leadership as Chairman of the Federal Reserve and for joining us here today.

As you know, we have seen very strong growth in our economy over the last few years—even as our Nation has faced some extremely challenging times. Over the past year, the Dow Jones Industrial Average has risen by approximately 26 percent, and in 2006 GDP expanded by approximately 3 percent. The market continues to shatter records with both the Dow and the S&P 500 reaching all-time highs.

No question, we have hard work ahead to ensure that all levels and sectors of the economy continue to prosper. For example, the housing sector has been showing some signs of weakness . . . and high gas prices continue to be a burden, as Americans must allocate more and more of their income to fund this necessity of everyday life. According to AAA, the current average price of gas in my home State North Carolina is $2.93. The price of a barrel of oil has hovered around the $70 mark and has recently hit $75. If high gas prices and housing sector weaknesses persist, and if we face other challenges, future economic growth could be hindered.

With regard to job creation, over the past 10 months, the national unemployment rate has hovered around 4.5 percent, and the economy has continued to add jobs, bringing us to an impressive total of 8.2 million new jobs created since August 2003. While the overall national economy trends positively, too many areas of North Carolina continue to face obstacles. The forces of the global marketplace have triggered an economic transformation in our State, and many thousands of our manufacturing jobs have been lost.

New opportunities and jobs for North Carolinians, however, are being created in this transition. As our economy moves forward, in North Carolina and across America, we must educate our workforce so that all individuals can take advantage of the new jobs being created. To this end, as I have discussed with you in the past, I believe our community colleges are a tremendous resource. This certainly is the case in North Carolina—where our university system and 58-member-strong community college network have been a beacon of hope—providing retraining and remedial education to those who have lost their jobs, and developing curriculum to suit the evolving needs of employers.

Before I conclude, let me mention what I believe to be a vital resource that North Carolina workers have been able to utilize to update and improve their skill set—Trade Adjustment Assistance (TAA). The TAA program is critical to ensuring that displaced workers can train for new careers and that they do not slip through the cracks. I recently introduced legislation with my colleague Senator Cantwell to strengthen this program. Our bill would help workers whose jobs relocate to countries without preferential trade agreements with the United States to receive TAA benefits. Eligible workers can receive training, job search and relocation allowances, income support, and other reemployment services.

Mr. Chairman, we must continue backing programs such as TAA, and supporting an agenda that will create jobs and grow our economy—by reducing regulatory burdens, educating and training a highly skilled workforce, building and updating infrastructure, and ensuring affordable, accessible energy and health care.

Chairman Bernanke, thank you again for being here today. I look forward to hearing from you—and working with you—on these and other important issues.

PREPARED STATEMENT OF BEN S. BERNANKE

CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

JULY 19, 2007

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I am pleased to present the Federal Reserve's Monetary Policy Report to the Congress. As you know, this occasion marks the 30th year of semiannual testimony on the economy and monetary policy by the Federal Reserve. In establishing these hearings, the Congress proved prescient in anticipating the worldwide trend toward greater transparency and accountability of central banks in the making of monetary policy. Over the years, these testimonies and the associated reports have proved an invaluable vehicle for the Federal Reserve's communication with the public about monetary policy, even as they have served to enhance the Federal Reserve's accountability for achieving the dual objectives of maximum employment and price stability set for it by the Congress. I take this opportunity to reiterate the Federal Reserve's strong support of the dual mandate; in pursuing maximum employment and price stability, monetary policy makes its greatest possible contribution to the general economic welfare.

Let me now review the current economic situation and the outlook, beginning with developments in the real economy and the situation regarding inflation before turning to monetary policy. I will conclude with comments on issues related to lending to households and consumer protection—topics not normally addressed in monetary policy testimony but, in light of recent developments, deserving of our attention today.

After having run at an above-trend rate earlier in the current economic recovery, U.S. economic growth has proceeded during the past year at a pace more consistent with sustainable expansion. Despite the downshift in growth, the demand for labor has remained solid, with more than 850,000 jobs having been added to payrolls thus far in 2007 and the unemployment rate having remained at 4½ percent. The combination of moderate gains in output and solid advances in employment implies that recent increases in labor productivity have been modest by the standards of the past decade. The cooling of productivity growth in recent quarters is likely the result of cyclical or other temporary factors, but the underlying pace of productivity gains may also have slowed somewhat.

To a considerable degree, the slower pace of economic growth in recent quarters reflects the ongoing adjustment in the housing sector. Over the past year, home sales and construction have slowed substantially and house prices have decelerated. Although a leveling-off of home sales in the second half of 2006 suggested some tentative stabilization of housing demand, sales have softened further this year, leading the number of unsold new homes in builders' inventories to rise further relative to the pace of new home sales. Accordingly, construction of new homes has sunk further, with starts of new single-family houses thus far this year running 10 percent below the pace in the second half of last year.

The pace of home sales seems likely to remain sluggish for a time, partly as a result of some tightening in lending standards and the recent increase in mortgage interest rates. Sales should ultimately be supported by growth in income and employment as well as by mortgage rates that—despite the recent increase—remain fairly low relative to historical norms. However, even if demand stabilizes as we expect, the pace of construction will probably fall somewhat further as builders work down stocks of unsold new homes. Thus, declines in residential construction will likely continue to weigh on economic growth over coming quarters, although the magnitude of the drag on growth should diminish over time.

Real consumption expenditures appear to have slowed last quarter, following two quarters of rapid expansion. Consumption outlays are likely to continue growing at a moderate pace, aided by a strong labor market. Employment should continue to expand, though possibly at a somewhat slower pace than in recent years as a result of the recent moderation in the growth of output and ongoing demographic shifts that are expected to lead to a gradual decline in labor force participation. Real compensation appears to have risen over the past year, and barring further sharp increases in consumer energy costs, it should rise further as labor demand remains strong and productivity increases.

In the business sector, investment in equipment and software showed a modest gain in the first quarter. A similar outcome is likely for the second quarter, as weakness in the volatile transportation equipment category appears to have been offset by solid gains in other categories. Investment in nonresidential structures, after slowing sharply late last year, seems to have grown fairly vigorously in the first half of 2007. Like consumption spending, business fixed investment overall seems poised

to rise at a moderate pace, bolstered by gains in sales and generally favorable financial conditions. Late last year and early this year, motor vehicle manufacturers and firms in several other industries found themselves with elevated inventories, which led them to reduce production to better align inventories with sales. Excess inventories now appear to have been substantially eliminated and should not prove a further restraint on growth.

The global economy continues to be strong. Supported by solid economic growth abroad, U.S. exports should expand further in coming quarters. Nonetheless, our trade deficit—which was about 5¼ percent of nominal gross domestic product (GDP) in the first quarter—is likely to remain high.

For the most part, financial markets have remained supportive of economic growth. However, conditions in the subprime mortgage sector have deteriorated significantly, reflecting mounting delinquency rates on adjustable-rate loans. In recent weeks, we have also seen increased concerns among investors about credit risk on some other types of financial instruments. Credit spreads on lower-quality corporate debt have widened somewhat, and terms for some leveraged business loans have tightened. Even after their recent rise, however, credit spreads remain near the low end of their historical ranges, and financing activity in the bond and business loan markets has remained fairly brisk.

Overall, the U.S. economy appears likely to expand at a moderate pace over the second half of 2007, with growth then strengthening a bit in 2008 to a rate close to the economy's underlying trend. Such an assessment was made around the time of the June meeting of the Federal Open Market Committee (FOMC) by the members of the Board of Governors and the presidents of the Reserve Banks, all of whom participate in deliberations on monetary policy. The central tendency of the growth forecasts, which are conditioned on the assumption of appropriate monetary policy, is for real GDP to expand roughly 2¼ to 2½ percent this year and 2½ to 2¾ percent in 2008. The forecasted performance for this year is about ¼ percentage point below that projected in February, the difference being largely the result of weaker-than-expected residential construction activity this year. The unemployment rate is anticipated to edge up to between 4½ and 4¾ percent over the balance of this year and about 4¾ percent in 2008, a trajectory about the same as the one expected in February.

I turn now to the inflation situation. Sizable increases in food and energy prices have boosted overall inflation and eroded real incomes in recent months—both unwelcome developments. As measured by changes in the price index for personal consumption expenditures (PCE inflation), inflation ran at an annual rate of 4.4 percent over the first 5 months of this year, a rate that, if maintained, would clearly be inconsistent with the objective of price stability.[1] Because monetary policy works with a lag, however, policymakers must focus on the economic outlook. Food and energy prices tend to be quite volatile, so that, looking forward, core inflation (which excludes food and energy prices) may be a better gauge than overall inflation of underlying inflation trends. Core inflation has moderated slightly over the past few months, with core PCE inflation coming in at an annual rate of about 2 percent so far this year.

Although the most recent readings on core inflation have been favorable, month-to-month movements in inflation are subject to considerable noise, and some of the recent improvement could also be the result of transitory influences. However, with long-term inflation expectations contained, futures prices suggesting that investors expect energy and other commodity prices to flatten out, and pressures in both labor and product markets likely to ease modestly, core inflation should edge a bit lower, on net, over the remainder of this year and next year. The central tendency of FOMC participants' forecasts for core PCE inflation—2 to 2¼ percent for 2007 and 1¾ to 2 percent in 2008—is unchanged from February. If energy prices level off as currently anticipated, overall inflation should slow to a pace close to that of core inflation in coming quarters.

At each of its four meetings so far this year, the FOMC maintained its target for the Federal funds rate at 5¼ percent, judging that the existing stance of policy was likely to be consistent with growth running near trend and inflation staying on a moderating path. As always, in determining the appropriate stance of policy, we will be alert to the possibility that the economy is not evolving in the way we currently judge to be the most likely. One risk to the outlook is that the ongoing housing correction might prove larger than anticipated, with possible spillovers onto consumer spending. Alternatively, consumer spending, which has advanced relatively vigorously, on balance, in recent quarters, might expand more quickly than expected; in that case, economic growth could rebound to a pace above its trend. With the level

[1] Despite the recent surge, total PCE inflation is 2.3 percent over the past 12 months.

of resource utilization already elevated, the resulting pressures in labor and product markets could lead to increased inflation over time. Yet another risk is that energy and commodity prices could continue to rise sharply, leading to further increases in headline inflation and, if those costs passed through to the prices of nonenergy goods and services, to higher core inflation as well. Moreover, if inflation were to move higher for an extended period and that increase became embedded in longer-term inflation expectations, the reestablishment of price stability would become more difficult and costly to achieve. With the level of resource utilization relatively high and with a sustained moderation in inflation pressures yet to be convincingly demonstrated, the FOMC has consistently stated that upside risks to inflation are its predominant policy concern.

In addition to its dual mandate to promote maximum employment and price stability, the Federal Reserve has an important responsibility to help protect consumers in financial services transactions. For nearly 40 years, the Federal Reserve has been active in implementing, interpreting, and enforcing consumer protection laws. I would like to discuss with you this morning some of our recent initiatives and actions, particularly those related to subprime mortgage lending.

Promoting access to credit and to homeownership are important objectives, and responsible subprime mortgage lending can help advance both goals. In designing regulations, policymakers should seek to preserve those benefits. That said, the recent rapid expansion of the subprime market was clearly accompanied by deterioration in underwriting standards and, in some cases, by abusive lending practices and outright fraud. In addition, some households took on mortgage obligations they could not meet, perhaps in some cases because they did not fully understand the terms. Financial losses have subsequently induced lenders to tighten their underwriting standards. Nevertheless, rising delinquencies and foreclosures are creating personal, economic, and social distress for many homeowners and communities—problems that likely will get worse before they get better.

The Federal Reserve is responding to these difficulties at both the national and the local levels. In coordination with the other Federal supervisory agencies, we are encouraging the financial industry to work with borrowers to arrange prudent loan modifications to avoid unnecessary foreclosures. Federal Reserve Banks around the country are cooperating with community and industry groups that work directly with borrowers having trouble meeting their mortgage obligations. We continue to work with organizations that provide counseling about mortgage products to current and potential homeowners. We are also meeting with market participants—including lenders, investors, servicers, and community groups—to discuss their concerns and to gain information about market developments.

We are conducting a top-to-bottom review of possible actions we might take to help prevent recurrence of these problems. First, we are committed to providing more-effective disclosures to help consumers defend against improper lending. Three years ago, the Board began a comprehensive review of Regulation Z, which implements the Truth in Lending Act (TILA). The initial focus of our review was on disclosures related to credit cards and other revolving credit accounts. After conducting extensive consumer testing, we issued a proposal in May that would require credit card issuers to provide clearer and easier-to-understand disclosures to customers. In particular, the new disclosures would highlight applicable rates and fees, particularly penalties that might be imposed. The proposed rules would also require card issuers to provide 45 days' advance notice of a rate increase or any other change in account terms so that consumers will not be surprised by unexpected charges and will have time to explore alternatives.

We are now engaged in a similar review of the TILA rules for mortgage loans. We began this review last year by holding four public hearings across the country, during which we gathered information on the adequacy of disclosures for mortgages, particularly for nontraditional and adjustable-rate products. As we did with credit card lending, we will conduct extensive consumer testing of proposed disclosures. Because the process of designing and testing disclosures involves many trial runs, especially given today's diverse and sometimes complex credit products, it may take some time to complete our review and propose new disclosures.

However, some other actions can be implemented more quickly. By the end of the year, we will propose changes to TILA rules to address concerns about mortgage loan advertisements and solicitations that may be incomplete or misleading and to require lenders to provide mortgage disclosures more quickly so that consumers can get the information they need when it is most useful to them. We already have improved a disclosure that creditors must provide to every applicant for an adjustable-rate mortgage product to explain better the features and risks of these products, such as "payment shock" and rising loan balances.

We are certainly aware, however, that disclosure alone may not be sufficient to protect consumers. Accordingly, we plan to exercise our authority under the Home Ownership and Equity Protection Act (HOEPA) to address specific practices that are unfair or deceptive. We held a public hearing on June 14 to discuss industry practices, including those pertaining to prepayment penalties, the use of escrow accounts for taxes and insurance, stated-income and low-documentation lending, and the evaluation of a borrower's ability to repay. The discussion and ideas we heard were extremely useful, and we look forward to receiving additional public comments in coming weeks. Based on the information we are gathering, I expect that the Board will propose additional rules under HOEPA later this year.

In coordination with the other Federal supervisory agencies, last year we issued principles-based guidance on nontraditional mortgages, and in June of this year we issued supervisory guidance on subprime lending. These statements emphasize the fundamental consumer protection principles of sound underwriting and effective disclosures. In addition, we reviewed our policies related to the examination of nonbank subsidiaries of bank and financial holding companies for compliance with consumer protection laws and guidance.

As a result of that review and following discussions with the Office of Thrift Supervision, the Federal Trade Commission, and State regulators, as represented by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators, we are launching a cooperative pilot project aimed at expanding consumer protection compliance reviews at selected nondepository lenders with significant subprime mortgage operations. The reviews will begin in the fourth quarter of this year and will include independent State-licensed mortgage lenders, nondepository mortgage lending subsidiaries of bank and thrift holding companies, and mortgage brokers doing business with or serving as agents of these entities. The agencies will collaborate in determining the lessons learned and in seeking ways to better cooperate in ensuring effective and consistent examinations of and improved enforcement for nondepository mortgage lenders. Working together to address jurisdictional issues and to improve information-sharing among agencies, we will seek to prevent abusive and fraudulent lending while ensuring that consumers retain access to beneficial credit.

I believe that the actions I have described today will help address the current problems. The Federal Reserve looks forward to working with the Congress on these important issues.

For use at 10:00 a.m., EDT
Wednesday
July 18, 2007

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

July 18, 2007

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

Washington, D.C., July 18, 2007

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 July 18, 2007, pursuant to section 2B of the Federal Reserve Act

Monetary Policy and the Economic Outlook

The U.S. economy generally performed well in the first half of 2007. Activity continued to increase moderately, on average, over the period; businesses added jobs at a steady pace; and the unemployment rate remained at 4½ percent. Overall inflation, however, picked up as a result of sizable increases in energy and food prices. At the same time, core inflation (which excludes the direct effects of movements in energy and food prices) held at about the same rate as in 2006; this measure smoothes through some of the volatility in the high-frequency data and thus is generally a better gauge of underlying inflation trends.

Although real gross domestic product appears to have expanded at about the same average rate thus far this year as it did in the second half of 2006, the pace of expansion has been uneven. In the first quarter, consumer expenditures and business fixed investment, taken together, posted a solid gain. However, homebuilding continued to contract, and manufacturing firms adjusted production to address stock imbalances in that sector that had emerged over the course of 2006. In the second quarter, housing activity declined further in response to the continued softness in home sales and still-elevated inventories of unsold new homes; personal consumption expenditures (PCE) also slowed. Even so, the available data point to solid gains overall in other components of final sales, and with manufacturing inventory imbalances significantly reduced, growth in real GDP apparently sped up.

Job growth in the first half of 2007 was driven by sizable increases in service-producing industries. In the goods-producing sector, manufacturing employment contracted, especially at firms closely tied to the construction industry and at producers of motor vehicles and parts. Employment in residential construction, which had turned down in mid-2006, decreased only modestly further over the first half of 2007 despite the substantial decline in homebuilding.

Real hourly compensation increased over the year ending in the first quarter, the most recent period for which complete data are available. In the second quarter, however, gains in real compensation were probably curtailed by a steep, energy-driven rise in consumer prices. Employment continued to rise apace in the first half of 2007 in the face of moderate growth in output. As a consequence, growth in labor productivity—which had slowed in 2006 from the rapid rate observed earlier in the decade—appears to have remained modest. The cooling of productivity growth in recent quarters likely reflects cyclical or other temporary factors, but the underlying pace of productivity gains may also have slowed somewhat.

Financial market conditions have continued to be generally supportive of economic expansion thus far in 2007, though there was a notable repricing in the subprime-mortgage sector. In recent weeks, the deterioration in that sector has been particularly marked, and markets for lower-quality corporate credits have also experienced some strains. Nonetheless, spreads on such corporate credits have remained narrow on the whole, and business borrowing has continued to be fairly brisk. On balance, equity markets posted sizable gains through mid-July, in part because of continued robust corporate profits and an upward revision to investors' outlook for the economy. The improved outlook led market participants to mark up their anticipated path for the federal funds rate, and intermediate- and long-term interest rates rose significantly. The foreign exchange value of the dollar has declined moderately this year as the pace of economic activity abroad has strengthened.

Overall consumer price inflation, as measured by the PCE price index, picked up noticeably in the first half of 2007, largely because of a sharp increase in energy prices. After moving down over the second half of 2006, the prices households pay for energy subsequently turned up and by May were 14 percent (not at an annual rate) above their level at the end of last year. Food prices also contributed to the step-up in overall inflation this year. The faster rate of increase in overall prices has had only a modest effect on inflation expectations: Surveys suggest that near-term inflation expectations have risen somewhat in recent months, but measures of long-term inflation expectations have remained within the range of recent years.

The rate of increase in the core PCE price index ticked down from 2.1 percent over the twelve months of 2006 to an annual rate of 2.0 percent over the first five months of 2007, primarily accounted for by more-favorable readings between March and May. Although higher energy prices this year added to the cost of producing a wide variety

of goods and services that are included in the core index, these effects were offset by other factors—most notably, a slowdown in the rate of increase in shelter costs from the very high rates seen in 2006.

The U.S. economy seems likely to continue to expand at a moderate pace in the second half of 2007 and in 2008. The current contraction in residential construction will likely restrain overall activity for a while longer, but as stocks of unsold new homes are brought down to more comfortable levels, that restraint should begin to abate. In addition, the inventory correction that damped activity in the manufacturing sector around the turn of the year appears largely to have run its course. Thus, stock adjustment is unlikely to be a drag on production in coming quarters. Consumer spending should also keep moving up. Employment and real wages are on track to rise further, and, although the difficulties in the subprime-mortgage market have created severe financial problems for some individuals and families, the household sector is in good financial shape overall. Businesses are also continuing to enjoy favorable financial conditions, which, along with a further expansion in business output, should support moderate increases in business investment. The positive outlook for economic activity abroad bodes well for U.S. exports.

Core inflation is expected to moderate a bit further over the next year and a half. Longer-run inflation expectations are contained, pressures on resource utilization should ease slightly in an environment of economic expansion at or just below the rate of increase in the nation's potential to produce, and some of the other factors that boosted inflation in recent years have already receded or seem likely to do so. As noted, increases in shelter costs, which helped push up core inflation in 2006, have slowed appreciably this year. In addition, the paths for the prices of energy and other commodities embedded in futures markets suggest that the impetus to core inflation from these influences should diminish. And although unit labor costs in the nonfarm business sector have been rising, the average markup of prices over unit labor costs is still high by historical standards, an indication that firms could potentially absorb higher costs, at least for a time, through a narrowing of profit margins.

Nonetheless, the possibility that the expected moderation in inflation will fail to materialize remains the predominant risk to the economic outlook. The more-favorable readings on core inflation in recent months partly reflect some factors that seem likely to prove transitory. Moreover, the economy appears to be operating at a high level of resource utilization, which has the potential to sustain inflation pressures. In addition, an upward impetus to costs could emanate from other sources, including higher prices for energy and other commodities or a slower rate of increase in structural productivity. Another concern is that high rates of headline inflation, if prolonged, could cause longer-run inflation expectations to rise and could thus become another factor sustaining inflation pressures.

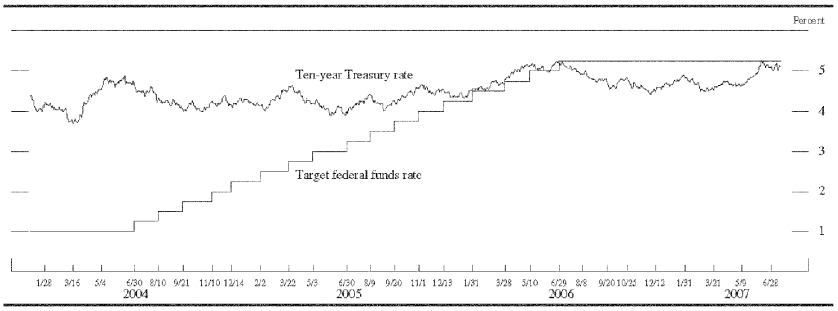
Significant risks also attend the outlook for real economic activity. On the downside, the fall in housing construction could intensify or last longer than expected. In addition, persistent weakness in the housing sector could spill over to other sectors, especially consumption. But upside risks also exist. For example, consumer spending appears to be rising less rapidly of late after a period of large increases that pushed the personal saving rate into negative territory; increases in consumption could return to their earlier pace. Exports could also boost aggregate demand more than anticipated, especially if economic conditions abroad continue to exceed expectations.

The Conduct of Monetary Policy over the First Half of 2007

The Federal Open Market Committee (FOMC) left the stance of monetary policy unchanged over the first half of 2007. At the time of the January meeting, available economic information pointed to a relatively favorable outlook for both economic growth and inflation. While manufacturing activity had softened, the housing sector had shown tentative signs of stabilizing, and consumer spending remained strong. Readings on core inflation had improved some from the elevated levels reached in 2006, and inflation expectations continued to be stable. Nevertheless, the prevailing level of inflation was uncomfortably high, and elevated resource utilization had the potential to sustain inflation pressures. Against this backdrop, the Committee decided to leave its target for the federal funds rate unchanged at 5¼ percent and reiterated in its policy statement that some inflation risks remained. The Committee also explained that the extent and timing of any additional firming would depend on the evolution of the outlook for both inflation and economic growth as implied by incoming information.

When the Committee met in March, data suggested that the ongoing weakness in the housing market had not spilled over to consumption spending, and the strains in the subprime-mortgage market did not appear to be affecting the availability of other types of household or business credit. Although investment spending had been soft, it was expected to pick up, primarily because of strong corporate balance sheets, continued high profitability, and generally favorable financial conditions. Nevertheless, sluggish business spending and the deterioration in the subprime-mortgage market suggested that downside risks to growth had increased. At the same time, readings on core inflation had stayed somewhat elevated, and increases

Selected interest rates, 2004–07



NOTE: The data are daily and extend through July 13, 2007. 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 prices of energy and non-energy commodities had boosted the risk that the expected deceleration in inflation would fail to occur. The FOMC decided to leave its target for the federal funds rate unchanged at 5¼ percent and noted in the accompanying statement that its predominant policy concern remained the risk that inflation would fail to moderate as expected. In light of the increased uncertainty about the outlook for both inflation and growth, the statement indicated that future policy adjustments would depend on the evolution of the outlook for both inflation and economic growth as implied by incoming information—a characterization that has been repeated in the two postmeeting FOMC statements since then.

In May, the data in hand indicated that the adjustment in the housing sector was continuing and appeared likely to persist for longer than previously anticipated. Moreover, growth in consumer spending seemed to have slowed in the early spring. Nonetheless, because the problems in the subprime-mortgage market apparently were contained and business spending indicators suggested improving prospects for investment, the economy seemed likely to expand at a moderate pace over coming quarters. Despite more-favorable readings for March, core inflation remained somewhat elevated from a longer perspective. Inflation pressures were expected to moderate over time, but the high level of resource utilization had the potential to sustain those pressures. As a result, the FOMC decided to leave its target for the federal funds rate unchanged at 5¼ percent and repeated in the statement that its predominant policy concern remained the risk that inflation would fail to moderate as expected.

At the June meeting, data appeared to confirm that economic growth had strengthened in the second quarter of 2007 despite the ongoing adjustment in the housing sector. Business spending on capital equipment, which had faltered around the turn of the year, firmed somewhat in the spring, and nonresidential construction advanced briskly. In addition, the inventory correction that had held down economic activity late last year and early this year seemed to have mostly run its course. Moreover, defense spending and net exports appeared poised to rebound after sagging in the first quarter. These factors more than offset a slowdown in the growth of consumer spending. Readings on core inflation remained favorable in April and May. Nonetheless, a sustained moderation of inflation pressures had yet to be convincingly demonstrated, and the high level of resource utilization had the potential to sustain those pressures. Under these circumstances, the Committee decided to leave its target for the federal funds rate unchanged at 5¼ percent. In its policy statement, the Committee repeated that its predominant policy concern remained the risk that inflation would fail to moderate as expected.

At their meetings over the first half of 2007, FOMC meeting participants continued the discussions they had formally initiated last year regarding their communications with the public. The discussions included a review of the role of the economic projections that are made twice a year by the members of the Board of Governors and the Reserve Bank presidents and which are included in the Board's *Monetary Policy Report to the Congress*. In addition, participants exchanged views on the possible advantages and disadvantages of specifying a numerical price objective for monetary policy. They also discussed the appropriate role of meeting minutes and policy statements. These discussions remain ongoing, as participants continue to evaluate the best available means for improv-

ing communication with the public in furtherance of the Committee's dual mandate for both maximum employment and stable prices.

Economic Projections for 2007 and 2008

In conjunction with the FOMC meeting at the end of June, the members of the Board of Governors and the Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, provided economic projections for 2007 and 2008 for this report. The central tendency of the FOMC participants' forecasts for the increase in real GDP is 2¼ percent to 2½ percent over the four quarters of 2007 and 2½ percent to 2¾ percent in 2008. The civilian unemployment rate is expected to lie between 4½ percent and 4¾ percent in the fourth quarter of 2007 and to be at about the top of that range in 2008. As for inflation, FOMC participants expect that the increase in the price index for personal consumption expenditures excluding food and energy (core PCE inflation) will total 2 percent to 2¼ percent over the four quarters of 2007 and will drift down to 1¾ percent to 2 percent in 2008.

Economic activity appears poised to expand at a moderate rate in the second half of 2007, and it should strengthen gradually into 2008. The ongoing correction in the housing market seems likely to continue to weigh on the rate of economic expansion over the near term. But as that process runs its course, the rate of growth of economic activity should move up somewhat. The pace of consumer spending may be restrained in the near term as households continue to adjust to the latest run-up in energy prices and to softer house prices; still, household balance sheets are generally in good shape, and increases in employment and real wages over the next year and a half should be sufficient to sustain further gains in spending. Regarding business investment, solid gains in real outlays on equipment and software seem likely in light of the anticipated expansion in business output, continuing strong profits, and generally favorable financial conditions. Opportunities to realize significant gains in efficiency by investing in high-tech equipment should provide ongoing support to equipment spending as well. Investment in nonresidential buildings also seems to be expanding briskly. In addition, prospects are favorable for continued increases in demand for exports of U.S. goods and services.

FOMC participants generally expect core inflation to edge down a bit further over the next year and a half. In assessing the apparent slowing of core inflation this spring, participants recognized that the monthly price data are volatile and that some of the recent improvement may prove to have been transitory. Nonetheless, they believe that the current environment will be conducive to some further moderation in underlying price pressures. The participants' forecasts for real activity imply a slight easing over the next several quarters of the tightness in labor and product markets. And although core inflation is expected to remain under some upward pressure in the near term from the pass-through of the increases to date in the prices of energy and other commodities, those cost pressures should subsequently wane. Accordingly, with long-run inflation expectations contained, diminished cost pressures should result in some moderation in core inflation.

Economic projections for 2007 and 2008

Percent

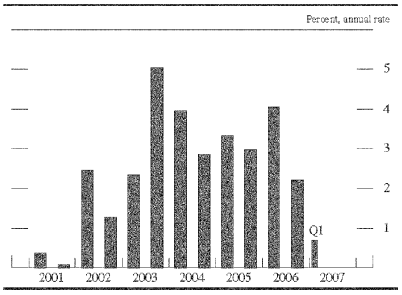
Indicator	Federal Reserve Governors and Reserve Bank presidents	
	Range	Central tendency
	2007	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	4½–5½	4½–5
Real GDP	2–2¾	2¼–2½
PCE price index excluding food and energy	2–2¼	2–2¼
Average level, fourth quarter		
Civilian unemployment rate	4½–4¾	4½–4¾
	2008	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	4½–5½	4¾–5
Real GDP	2½–3	2½–2¾
PCE price index excluding food and energy	1¾–2	1¾–2
Average level, fourth quarter		
Civilian unemployment rate	4½–5	About 4¾

1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.

Economic and Financial Developments in 2007

Real GDP increased at an annual rate of 2¼ percent in the second half of 2006, and it appears to have risen at roughly that pace, on average, over the first half of 2007. Although consumer spending and business fixed investment posted moderate gains, on balance, during the first half, the contraction in residential construction exerted significant restraint on economic activity. The rise in real GDP in the first quarter was also damped by a downswing in inventory investment, a dip in defense spending, and an unusually sharp drop in net exports. The available information suggests that GDP growth rebounded in the second quarter as the drag from inventory investment waned and as defense expenditures and net exports snapped back after their first-quarter declines. In the labor market, hiring continued at a steady pace throughout the first half,

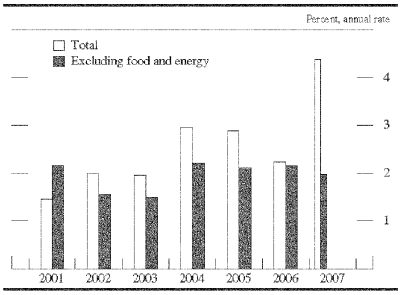
Change in real GDP, 2001–07



NOTE: Here and in subsequent figures, 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.

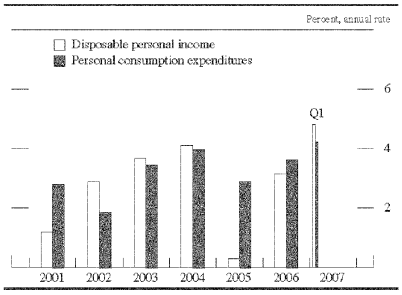
although job gains fell short of those recorded in 2006, and the unemployment rate remained at 4½ percent. Headline consumer price inflation was boosted by a reversal of the downturn in energy prices in late 2006 and a step-up in retail food prices, while core inflation was little changed. Real hourly labor compensation increased over the year ending in the first quarter, although gains in the second quarter were probably eroded by the energy-driven pickup in overall inflation. Conditions in financial markets have remained generally supportive of economic expansion thus far this year despite deteriorating conditions in the subprime-mortgage sector. Investors seemed to become more optimistic about the outlook for the economy: Interest rates rose, credit spreads on corporate bonds stayed narrow on the whole, and equity markets recorded sizable gains.

Change in PCE chain-type price index, 2001–07



NOTE: The data are for personal consumption expenditures (PCE). Through 2006, change is from December to December; for 2007, change is from December to May.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Change in real income and consumption, 2001–07



SOURCE: Department of Commerce, Bureau of Economic Analysis.

The Household Sector

Consumer Spending

After exhibiting considerable vigor in late 2006, consumer spending slowed somewhat over the first half of 2007. Spending continued to be bolstered by the strong labor market and the lagged effects of earlier increases in household wealth. However, these positive influences were partly offset by the rise in energy prices this year, which drained consumers' purchasing power, and by reduced home-price appreciation, which limited recent gains in

Consumer sentiment, 1994–2007

NOTE: The Conference Board data are monthly and extend through June 2007. The Reuters/University of Michigan data are monthly and extend through a preliminary estimate for July 2007.
SOURCE: The Conference Board and Reuters/University of Michigan Surveys of Consumers.

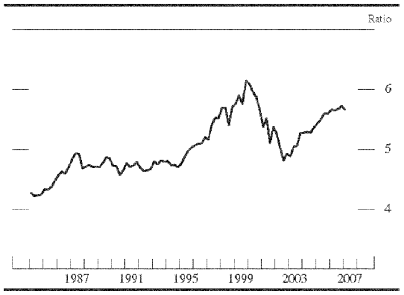
wealth for many households. Surveys of consumer sentiment have remained in a favorable range this year.

Real PCE rose at an annual rate of 4¼ percent in the first quarter. Spending on light motor vehicles (cars, sport-utility vehicles, and pickup trucks) got off to a fast start this year, expenditures on energy services were boosted by unusually cold weather in February, and outlays for other goods and services posted sizable gains after a steep run-up in the fourth quarter. The available data imply a much slower pace of spending growth in the second quarter, as sales of light motor vehicles softened and real spending on goods other than motor vehicles turned lackluster.

Real disposable personal income (DPI)—that is, after-tax income adjusted for inflation—also started the year on a strong note after a large increase in the fourth quarter.[1] Wages and salaries and some other major categories of personal income continued to rise appreciably in nominal terms throughout the first half. However, these gains were eroded in real terms by the energy-related jump in inflation in the spring, and, as a result, real DPI rose at an annual rate of just 1½ percent between the fourth quarter of 2006 and May 2007, compared with an increase of more than 3 percent over the four quarters of 2006.

Even given the sharp deceleration in residential real estate values, household wealth has remained support-

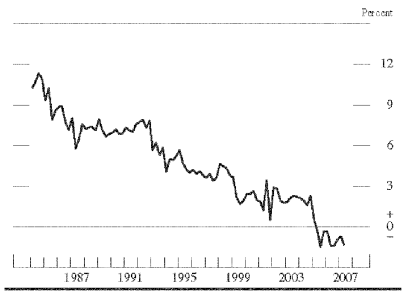
Wealth-to-income ratio, 1984–2007



NOTE: The data are quarterly and extend through 2007:Q1. 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.

1. According to the published data, real DPI rose at an annual rate of 4¾ percent in the first quarter. However, a substantial part of the increase occurred because the Bureau of Economic Analysis (BEA) added $50 billion (annual rate) to its estimate of first-quarter wages and salaries in response to information that bonus payments and stock option exercises around the turn of the year were unusually large. Because the BEA did not assume that these payments carried forward into April, real DPI fell sharply in that month.

Personal saving rate, 1984–2007



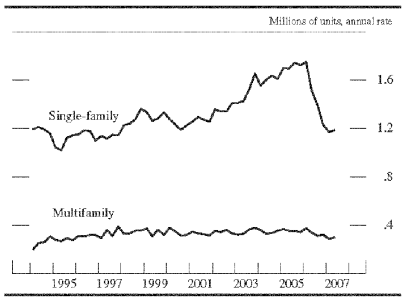
NOTE: The data are quarterly and extend through 2007:Q2; the reading for 2007:Q2 is the average for April and May.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

ive of spending growth. One reason is that the surge in equity values in recent quarters has allowed overall household wealth to keep pace with nominal income despite the softness in home prices. In addition, because changes in net worth tend to influence consumption with a lag of several quarters, the increases in wealth during 2005 and 2006 are likely still providing a good deal of impetus to spending. These increases in wealth, which have provided many households with the resources and inclination to raise their spending at a rate that exceeds income growth, have been a factor pushing down the personal saving rate over the past couple of years even as interest rates have moved up. After fluctuating in the vicinity of 2 percent from 1999 to 2004, the saving rate subsequently dropped sharply, and it stood at negative 1¼ percent, on average, in April and May of 2007.

Residential Investment

Residential construction activity remained soft in the first half of 2007, as builders continued to confront weak demand and an elevated inventory of unsold new homes. In the single-family sector, new units were started at an average annual rate of 1.18 million between January and May—more than 30 percent below the quarterly high reached in the first quarter of 2006. Starts in the multifamily sector averaged a little less than 300,000 units during the first five months of 2007, an amount at the lower end of the range of the past nine years. All told, the contraction in housing activity subtracted nearly 1 percentage point from the change in real GDP in the first quarter of 2007—almost as much as in the second half of 2006—and the drag likely remained substantial in the second quarter.

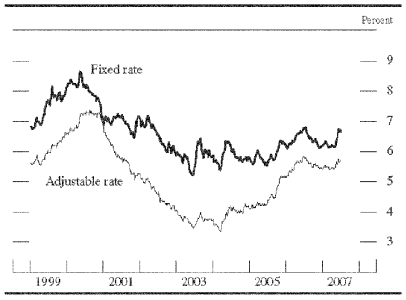
Private housing starts, 1994–2007



NOTE: The data are quarterly and extend through 2007:Q2; the readings for 2007:Q2 are the averages for April and May.
SOURCE: Department of Commerce, Bureau of the Census.

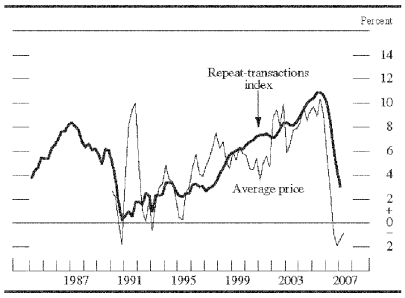
The monthly data on home sales have been erratic this year. But after smoothing through the ups and downs, the data suggest that demand has softened further after falling at a double-digit rate between mid-2005 and mid-2006 and then holding reasonably steady in the second half of last year. On average, sales of existing homes over the three months ending in May 2007 were 4½ percent below their average level in the second half of last year, while sales of new homes were down 10 percent over that period. The further weakening of housing demand this year likely reflects, in part, tighter lending standards for mortgages, and it occurred despite mortgage rates that were relatively low by longer-run standards. The ongoing slippage in sales has made it more difficult for homebuilders to make much of a dent in their inventories of new homes for sale. When evaluated relative to the three-month average pace of sales,

Mortgage rates, 1999–2007



NOTE: The data, which are weekly and extend through July 11, 2007, are contract rates on thirty-year mortgages.
SOURCE: Federal Home Loan Mortgage Corporation.

Change in prices of existing single-family houses, 1984–2007



NOTE: The data are quarterly, and changes are from one year earlier. The repeat-transactions index extends through 2007:Q1. For the years preceding 1991, that index includes appraisals associated with mortgage refinancings; beginning in 1991, it includes purchase transactions only. The data for average price extend through 2007:Q2, and the reading for Q2 is the average for April and May compared with the same period one year earlier.
SOURCE: For repeat transactions, Office of Federal Housing Enterprise Oversight; for average price, National Association of Realtors.

the months' supply of unsold new homes in May was more than 60 percent above the high end of the relatively narrow range it occupied from 1997 to 2005. Moreover, these published figures probably understate the true inventory overhang in this sector to the extent that they do not account for the surge in canceled sales in the past year; such cancellations return homes to unsold inventory but are not incorporated in the official statistics.

The rate of house-price appreciation slowed dramatically in 2006 after nearly a decade of rapid increases, and prices appear to have moved roughly sideways in the first half of 2007. The purchase-only version of the repeat-transactions price index for existing single-family homes published by the Office of Federal Housing Enterprise Oversight, which tracks sales prices of the same houses over time, rose at an annual rate of just 2 percent in the first quarter of 2007 (the latest available data) and was up just 3 percent over the year ending in the first quarter, compared with an increase of 10 percent over the preceding year. For April and May combined, the average price of existing single-family homes sold—which does not control for changes in the mix of houses sold but is available on a more timely basis—was about 1 percent below that of a year earlier.

Household Finance

Household debt expanded at an annual rate of 6 percent in the first quarter of 2007, somewhat below the pace of

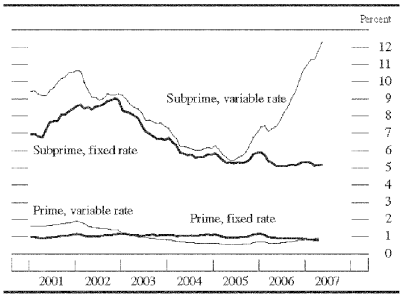
8¾ percent posted in 2006. The deceleration was primarily the result of a significant step-down in the rise of mortgage debt, which reflected the sharp slowing of house-price appreciation and the slower pace of home sales. Consumer (nonmortgage) debt has remained on a moderate uptrend this year.

Debt rose a little more slowly than personal income in the first quarter, so the financial obligations ratio for the household sector inched down, though it remained only a bit below its historical high. Most households were able to meet their debt service obligations, and measures of household credit quality were generally little changed. For example, delinquency rates on consumer loans and prime mortgages—the two main components of total household debt—stayed low through the spring of 2007, as did those on subprime fixed-rate mortgages. In addition, household bankruptcy filings continued to be subdued in the first half of the year: They ran near the average pace seen since early 2006, after the bulge that accompanied the implementation of the new bankruptcy law in October 2005.

Some households, however, have experienced growing financial strains. Delinquency rates on subprime mortgages with variable interest rates, which account for about 9 percent of all first-lien mortgages outstanding, continued to climb in the first five months of 2007 and reached a level more than double the recent low for this series, which was recorded in mid-2005. The rise in delinquencies has begun to show through to new foreclosures. In the first quarter of 2007, an estimated 325,000 foreclosure proceedings were initiated, up from an average quarterly rate of 230,000 over the preceding two years; about half of the foreclosures this year were on subprime mortgages. The decline in credit quality in the subprime sector has likely stemmed from a combination of several factors, including the moderation in overall economic growth and some regional economic weakness. In addition, a substantial number of subprime borrowers with variable-rate mortgages have faced an upward adjustment of the rates from their initial levels. When house prices were rising rapidly and rates on new loans were lower, many of these borrowers qualified to refinance into another loan with more-favorable terms. With house prices having decelerated and rates having moved higher, however, the scope for refinancing has been reduced. Moreover, investor owners may have been tempted to walk away from properties with little or no equity. Subprime mortgages originated in late 2005 and 2006 have shown unusually high rates of early delinquency, suggesting that some lenders unduly loosened underwriting standards during that period.

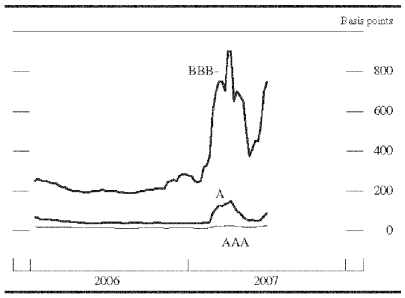
In recent months, credit has become less easily available in the subprime-mortgage market, as investors in subprime-mortgage-backed securities reportedly have scrutinized the underlying subprime loans more carefully and lenders have tightened underwriting standards. For example, more than half of the respondents to the questions on subprime residential mortgages in the Federal Reserve's April 2007 Senior Loan Officer Opinion Survey on Bank Lending Practices indicated that they had tightened credit standards on such loans over the previous three months. In June, the federal financial regulatory agencies issued a final Statement on Subprime Mortgage Lending to address issues relating to certain adjustable-rate mortgage products. Credit spreads on the lower-rated tranches of new subprime securitizations have increased sharply, on balance, this year, and issuance of subprime-mortgage-backed securities has moderated from its vigorous pace of the past couple of years. However, despite the ongoing

Mortgage delinquency rates, 2001–07



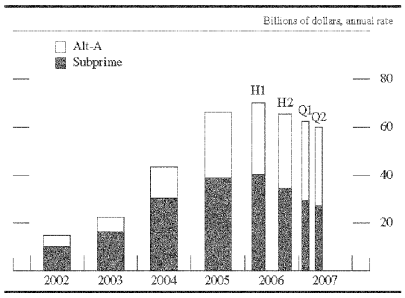
NOTE: The data are monthly. Prime-mortgage data extend through April 2007, and subprime-mortgage data extend through May 2007. Delinquency rate is the percent of loans ninety days or more past due or in foreclosure. Prime mortgages include near-prime mortgages.
SOURCE: First American LoanPerformance.

Spreads over libor of securities backed by subprime residential mortgages, 2006–07



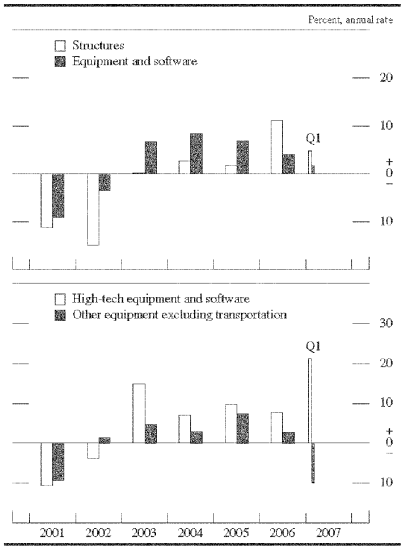
NOTE: The data are weekly and extend through July 6, 2007.
SOURCE: Merrill Lynch.

Gross issuance of alt-A and subprime-mortgage-backed securities, 2002–07



NOTE: Alt-A includes such products as mortgages with limited income verification and mortgages secured by non-owner-occupied properties.
SOURCE: *Inside MBS & ABS.*

Change in real business fixed investment, 2001–07



NOTE: High-tech equipment consists of computers and peripheral equipment and communications equipment.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

problems, the subprime market has continued to function, and new loans are being made.

The Business Sector

Fixed Investment

After having risen sharply over much of 2006, real business fixed investment (BFI) lost some steam in the fourth quarter and posted a relatively meager gain in the first quarter of 2007. The slower rise in business output in recent quarters has likely been a moderating influence on business investment expenditures. But on the whole, economic and financial conditions still appear to be favorable for capital spending: Corporate profits remain robust, businesses have ample liquid assets at their disposal, and conditions in financial markets remain supportive.

Much of the recent softness in BFI was in spending on equipment and software (E&S), which rose at an annual rate of less than 2 percent in real terms in the first quarter after having fallen nearly 5 percent in the fourth quarter of 2006. Within the major components of E&S, real spending on high-tech equipment expanded at an annual rate of more than 20 percent in the first quarter of 2007 because of both a surge in outlays on computers after the release of a major new operating system and a spurt in investment in communications gear. Aircraft purchases also posted a sizable increase. However, spending on motor vehicles tumbled, as many firms had accelerated their purchases of medium and heavy trucks into 2005 and 2006 so that they could take delivery before the Environmental Protection Agency's new emissions standards for engines went into effect this year. Elsewhere, real investment in equipment other than high-tech and transportation goods dropped at an annual rate of 10 percent in the first quarter after a fall of nearly 5 percent in the previous quarter. The weakness in this category, which accounts for roughly 40 percent of investment in E&S when measured in nominal terms, appears to have reflected, in part, appreciable declines in spending on equipment disproportionately used by the construction and motor vehicle industries and was most pronounced around the turn of the year.

Although the weakness in truck sales apparently extended through midyear, real E&S outlays apart from transportation equipment appear to have posted a solid increase in the second quarter. Incoming information suggests that high-tech spending continued to move up in real terms—albeit not as fast as it did in the first quarter. Moreover, shipments and orders for equipment other than high-tech and transportation items regained some lost ground.

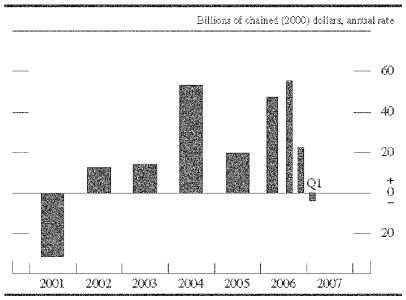
Nonresidential construction activity turned up steeply in 2006 after having been stagnant for several years, and it continued to exhibit considerable strength in early 2007. Outlays for office, retail, and industrial buildings are all running well above year-earlier levels, and—given that

vacancy rates have moved down over the past couple of years—prospects for further gains in coming quarters are good. One exception to the recent strength in this sector is the drilling and mining category, in which real outlays fell in the first quarter after three years of sizable gains. The recent softening in this category of investment may reflect, in part, reported shortages of specialty equipment and skilled labor.

Inventory Investment

Inventory investment slowed markedly in the fourth quarter of 2006 as firms acted to stem rising inventory imbalances, and it turned negative in the first quarter of 2007. The downswing in inventory investment shaved about 1 percentage point from the change in real GDP in both the fourth and first quarters, and it appears to have brought stocks into better alignment with sales. Some of the inventory correction was in the motor vehicle sector, in which high gasoline prices have been causing demand to shift to more-fuel-efficient models—a trend that, by the middle of 2006, had left dealers with bloated inventories of light trucks and sport-utility vehicles. Facing little prospect of significantly stronger sales of those vehicles in the near term, the manufacturers instituted sharp cuts in production starting in the second half of last year. The production cuts, which in the first quarter of 2007 brought assemblies of light vehicles to their lowest level in more than a decade, helped clear out dealers' lots and thus set the stage for a step-up in assemblies in the second quarter. The automakers have scheduled a further rise in assemblies in the third quarter, in part to get a good start on producing the new, more-fuel-efficient models that will be introduced to the public in coming months.

Change in real business inventories, 2001–07



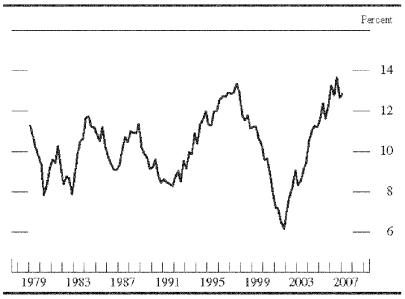
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Excluding motor vehicles, inventories appeared to be well aligned with sales through much of 2006, but they too started to look excessive as the growth of aggregate demand slowed in the latter part of the year. The emerging imbalances, some—though not all—of which appear to have been at firms that supply the construction and motor vehicle industries, prompted production adjustments that reduced non-auto inventory investment to a very modest rate in the first quarter. According to the limited available information, the pace of real stockbuilding appears to have remained low in April and May, and, for the most part, inventories seem to have moved back into rough alignment with sales. In fact, businesses surveyed in June by the Institute for Supply Management reported that their customers were mostly comfortable with their current stock levels, whereas earlier in the year an elevated number of respondents had characterized these inventory positions as too high.

Corporate Profits and Business Finance

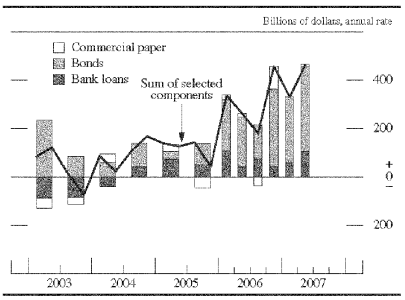
In the first quarter of 2007, growth in corporate profitability slowed from last year's pace, but the level of profitability remained high. Earnings per share for S&P 500 firms decelerated but still came in nearly 10 percent above their year-earlier level. In the national income accounts, profits of nonfinancial corporations in the first quarter were little changed from year-earlier levels after double-digit gains in 2006; nonetheless, before-tax profits measured as a share of sector GDP were nearly 13 percent, close to the high levels posted last year.

Before-tax profits of nonfinancial corporations as a percent of sector GDP, 1979–2007



NOTE: The data are quarterly and extend through 2007:Q1. 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, 2003–07

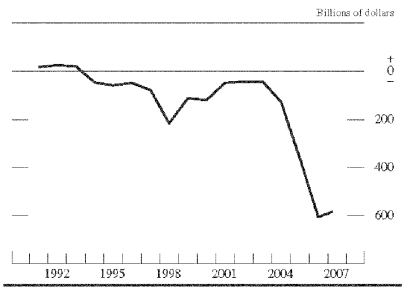


NOTE: The data for the components except bonds are seasonally adjusted. The data for the sum of selected components are quarterly. The data for 2007:Q2 are estimated.
SOURCE: Federal Reserve Board; Securities Data Company; and Federal Financial Institutions Examination Council, Consolidated Reports of Condition and Income (Call Report).

Fueled in part by continued heavy merger and acquisition activity, nonfinancial business debt expanded at an annual rate of 9 percent in the first quarter of this year, only a bit slower than in 2006, and data in hand suggest a robust pace of expansion again in the second quarter. Net bond issuance has been solid so far in 2007, and commercial and industrial lending by banks has remained strong. Although lower-quality corporate credit markets experienced some strains, generally narrow credit spreads have encouraged corporate bond issuance, and the growth of business loans has been spurred by banks' accommodative lending posture. Considerable net fractions of respondents to the April 2007 Senior Loan Officer Opinion Survey indicated that they had eased some terms—especially spreads of loan rates over their costs of funds, costs of credit lines, and loan covenants—on commercial and industrial loans over the previous three months. Banks pointed to more-aggressive competition from other banks or nonbank lenders and to increased liquidity in the secondary market for these loans as the most important reasons for having eased business lending terms. Commercial paper outstanding was flat in the first quarter but increased somewhat in the second quarter.

Gross public issuance of equity by nonfinancial corporations has continued to be moderate so far this year, but private equity issuance has apparently remained strong, as leveraged buyout activity has continued to climb. However, given the elevated levels of share repurchases and equity retirements from cash-financed mergers and acquisitions in the first quarter, net equity issuance continued to be deeply negative.

Net equity issuance at nonfinancial corporations, 1991–2007

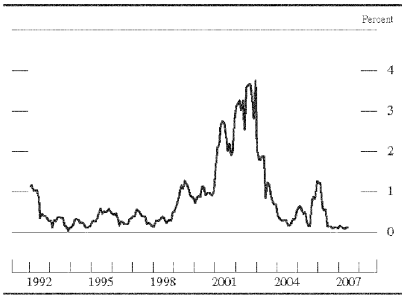


NOTE: The data are annual through 2006; for 2007, they are as of Q1. Data for 2006:Q4 and 2007:Q1 are estimated. Equity issuance includes funds invested by private equity partnerships and stock option proceeds.
SOURCE: Federal Reserve Board, flow of funds data.

Despite some deceleration in profits, the credit quality of nonfinancial firms has generally continued to be robust. The six-month trailing bond default rate has stayed near zero this year, and the delinquency rate on commercial and industrial loans at banks remained extremely low in the first quarter. For public firms, balance sheet liquidity was still high in the first quarter, whereas corporate leverage stayed near historical lows despite the large net retirement of equity. In addition, net interest payments relative to cash flow continued to be near the low end of the range seen over the past two decades.

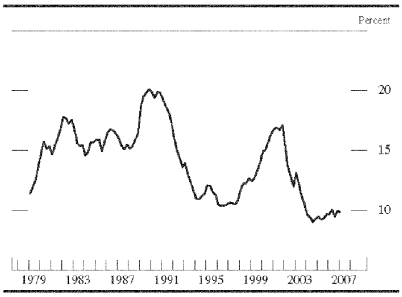
Commercial real estate debt expanded briskly in the first quarter of 2007, albeit not quite so rapidly as

Default rate on outstanding corporate bonds, 1992–2007



NOTE: The data are monthly and extend through June 2007. The rate for a given month is the face value of bonds that defaulted in the six months ending in that month, multiplied by two to annualize the defaults and then divided by the face value of all bonds outstanding at the end of the calendar quarter immediately preceding the six-month period.
SOURCE: Moody's Investors Service.

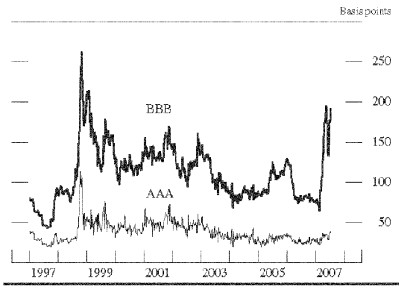
Net interest payments of nonfinancial corporations as a percent of cash flow, 1979–2007



NOTE: The data are quarterly and extend through 2007:Q1.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

in 2006, a pattern consistent with the net tightening of credit standards on commercial real estate loans reported in the Senior Loan Officer Opinion Survey. Spreads on BBB-rated commercial-mortgage-backed securities (CMBS) soared in late February and have varied within an elevated range since then. The increase reportedly came in response to a reduction in investor interest in collateralized debt obligations, sponsors of which traditionally have purchased many of these securities, and to plans by the rating agencies to increase the level of credit support required for such securities. However, because rents on commercial properties have been increasing and vacancy rates have remained moderate, credit quality has generally continued to be good. Delinquency rates on commercial mortgages held by life insurance companies and on those backing CMBS have stayed near the bottom of their recent ranges this year. The delinquency rate on commercial mortgages held by banks edged up further in the first quarter in response to a deterioration in the performance of loans for multifamily properties and for construction and land development; nevertheless, this delinquency rate remained low by historical standards.

Spreads of ten-year investment-grade commercial-mortgage-backed securities over swaps, 1997–2007



NOTE: The data are weekly and extend through July 11, 2007.
SOURCE: Bloomberg.

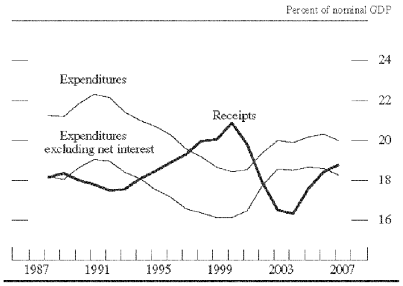
The Government Sector

Federal Government

The deficit in the federal unified budget narrowed further during the past year: Receipts continued to rise at a fairly rapid rate, while growth in outlays was relatively subdued. Over the twelve months ending in June, the unified budget recorded a deficit of $163 billion, $113 billion less than during the comparable period ending in June 2006. When measured relative to nominal GDP, the deficit has decreased steadily from a recent fiscal year high of 3.6 percent in 2004 to a little more than 1 percent during the past twelve months.

Nominal federal receipts during the twelve months ending in June were 8 percent higher than during the same period a year earlier. This increase was considerably smaller than the double-digit advances recorded in fiscal 2005 and fiscal 2006. Nonetheless, it was faster than the increase in income and pushed up the ratio of receipts to GDP to nearly 19 percent. Individual income tax receipts continued to outpace the rise in taxable personal income as measured in the national income and product accounts (NIPA), likely a result, at least in part, of larger

Federal receipts and expenditures, 1987–2007



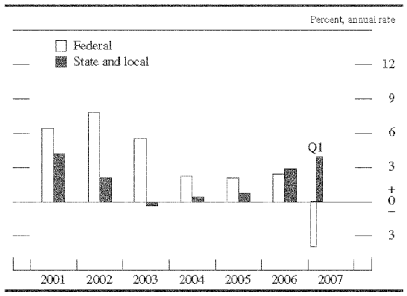
NOTE: Through 2006, receipts and expenditures are on a unified-budget basis and are for fiscal years (October through September); GDP is for the four quarters ending in Q3. For 2007, receipts and expenditures are for the twelve months ending in June, and GDP is the average of 2006:Q4 and 2007:Q1.
SOURCE: Office of Management and Budget.

capital gains realizations (which are excluded from NIPA income), the effect of some taxpayers moving into higher tax brackets as their real incomes increased, and perhaps a further shift in the distribution of income toward high-income households, which typically face higher tax rates. Corporate receipts, after rising at an annual rate of nearly 40 percent, on average, over the three years ending in fiscal 2006, rose 15 percent during the year ending in June, a rate more in line with the increase in corporate profits.

Nominal federal outlays increased less than 3 percent during the twelve months ending in June and edged down to 20 percent of nominal GDP, around the lower end of the narrow range that has prevailed since 2003. In large part, the deceleration in outlays reflected the tapering off of the temporary bulge in expenditures for flood insurance and disaster relief associated with the 2005 hurricanes. Meanwhile, spending on health programs continued to rise briskly, only in part because of the net increment to spending from the Medicare Part D prescription drug program, which started in January 2006. Defense spending was up 5 percent over the period, an increase somewhat below those recorded in fiscal years 2005 and 2006. Total federal outlays were also boosted by a sizable rise in net interest payments as interest rates moved higher, although the increase in debt service costs was significantly smaller than that of a year earlier.

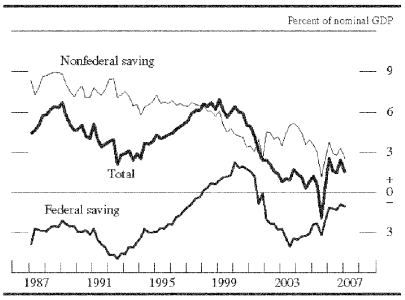
As measured in the NIPA, real federal expenditures on consumption and gross investment—the part of federal spending that is a direct component of GDP—fell at an annual rate of nearly 4 percent in the first quarter, as a drop in defense spending more than offset a moderate increase in nondefense purchases. Defense expenditures tend to be erratic from quarter to quarter, and the first-quarter dip followed a large increase in the fourth quarter. Defense

Change in real government expenditures on consumption and investment, 2001–07



SOURCE: Department of Commerce, Bureau of Economic Analysis.

Net saving, 1987–2007



NOTE: The data are quarterly and extend through 2007:Q1. 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.

spending appears to have turned back up in the second quarter, and, given currently enacted appropriations, it is likely to increase further in coming quarters.

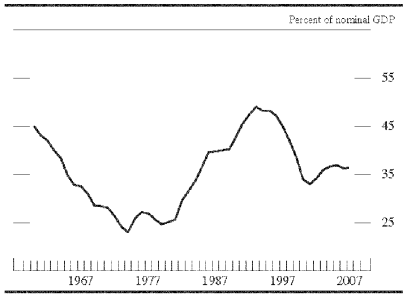
All else being equal, the significant narrowing of the unified budget deficit over the past few years raises national saving. However, the positive effect on national saving of the smaller federal deficit has been largely offset by a downward drift in nonfederal saving. Although business saving has increased substantially over this period, personal saving has dropped sharply. Accordingly, total national saving (that is, federal plus nonfederal) has recovered only a little from the exceptionally low levels reached between 2003 and 2005; measured net of estimated depreciation, it has fluctuated between 1½ percent and 2½ percent of GDP since the start of 2006. If not boosted over the longer run, persistent low levels of saving will be associated with either slower capital formation or continued heavy borrowing from abroad, either of which would retard the rise in the standard of living of U.S. residents over time and hamper the ability of the nation to meet the retirement needs of an aging population.

Federal Borrowing

Federal debt rose at an annual rate of 6¾ percent in the first quarter of 2007, a bit slower than in the corresponding quarter of last year. As of the end of the first quarter, the ratio of federal debt held by the public to nominal GDP was about 36 percent, a level little changed from that in recent quarters.

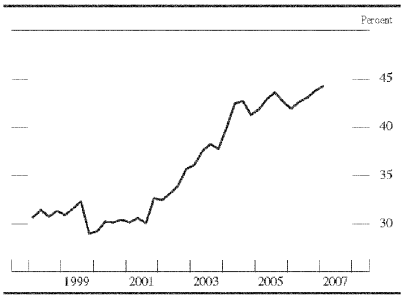
The improvement in the budget position of the federal government has led the Treasury to scale back issuance of marketable coupon securities. As part of its reduction

Federal government debt held by the public, 1960–2007



NOTE: The final observation is for 2007:Q1. 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.

Treasury securities held by foreign investors as a share of total outstanding, 1998–2007



NOTE: The data are quarterly and extend through 2007:Q1.
SOURCE: Federal Reserve Board, flow of funds data.

in issuance, the Treasury announced in May that it was discontinuing auctions of three-year nominal notes. This move had been widely anticipated and elicited little reaction in financial markets.

Overall, foreign purchases of Treasury securities appear to have increased further this year, thereby bringing the share of these securities held by foreign investors to a new high of almost 45 percent at the end of the first quarter. The proportion of nominal coupon securities purchased at auctions by foreign investors moved up in late 2006 and has stayed elevated thus far this year, albeit well off the peak reached in 2004. Balance of payments data point to sizable net purchases by foreign private investors between January and March, whereas such investors sold Treasury securities, on net, in 2006. In contrast, net purchases by foreign official investors have declined somewhat this year. Custody holdings at the Federal Reserve Bank of New York on behalf of foreign official and international accounts have only edged up since the end of 2006.

State and Local Government

On the whole, state and local governments continue to enjoy strong fiscal positions as a consequence of several years of robust revenue inflows and a period of appreciable restraint on spending after these governments' fiscal difficulties earlier in the decade. Accordingly, over the past year or so, states and localities in the aggregate have been able both to raise expenditures and to maintain healthy balances in their reserve funds. However, revenue flows in many states appear to have slowed a bit of late, a pattern similar to the one that has emerged at the federal level. For local governments, property tax receipts are still being bolstered by the earlier run-up in real estate values, but the deceleration in house prices over the past year will likely slow the rise in local revenues down the road. Moreover, many state and local governments expect to face significant structural imbalances in their budgets in coming years as a result of the ongoing pressures from Medicaid and the need to provide pensions and health care to an increasing number of retired state and local government employees.

According to the NIPA, real expenditures on consumption and gross investment by state and local governments rose at an annual rate of nearly 4 percent in the first quarter, and they apparently posted a further increase in the second quarter. Much of the strength in the first half of 2007 was in construction spending, which has been climbing since the start of 2006, in part because of very rapid increases in outlays on highways. Hiring by states and localities also exhibited considerable vigor during the first half of 2007, both in the education sector and elsewhere; on average, state and local government employment rose 30,000 per month over the six months ending in June, compared with an average monthly increase of 22,000 over the preceding ten years.

State and Local Government Borrowing

Borrowing by state and local governments has been strong thus far in 2007, largely because refundings in advance of retirements have been elevated as interest rates have remained relatively low. In contrast, issuance of short-term debt has been moderate—a development consistent with the strong budgets of state and local governments. The credit quality of municipal bonds has remained solid on the whole, as the number of bond-rating upgrades has

outpaced the number of downgrades thus far this year. The ratio of yields on municipal bonds to those on comparable-maturity Treasury securities has stayed at the low end of its range of the past decade.

The External Sector

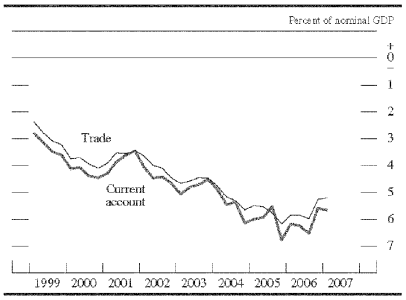
In 2006, U.S. real net exports made a positive contribution to the full year's economic growth for the first time since 1995. The contribution of net exports moved into negative territory again, however, in the first quarter of this year, as imports rebounded and exports slowed from their exceptional pace late last year. Data for April and May point to a resurgence of exports and a moderation of imports in the second quarter.

The U.S. nominal current account deficit widened a bit in the first quarter of 2007 to $770 billion at an annual rate, or about 5¾ percent of nominal GDP, from $752 billion in the fourth quarter of 2006. The larger deficit was due to an increase in net unilateral transfers abroad. Although the first-quarter trade balance deteriorated in real terms, increases in export prices outpaced those in import prices, thereby leaving the nominal trade balance unchanged. Despite the large negative U.S. net international investment position, the U.S. balance on investment income remained positive and also was about unchanged in the first quarter.

International Trade

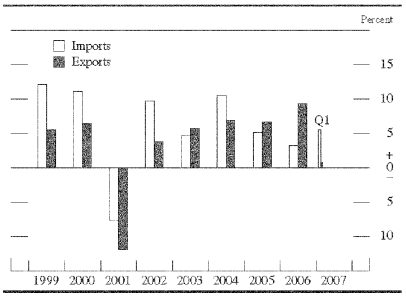
Despite continued solid foreign economic expansion and persisting stimulus from earlier declines in the dollar, the growth of real exports of goods and services slowed to an annual rate of less than 1 percent in the first quarter

U.S. trade and current account balances, 1999–2007



NOTE: The data are quarterly and extend through 2007:Q1.
SOURCE: Department of Commerce.

Change in real imports and exports of goods and services, 1999–2007



SOURCE: Department of Commerce.

from its exceptionally strong pace of more than 10 percent in the fourth quarter. The slowdown was particularly evident in sales of capital goods—especially aircraft and computers—and industrial supplies, which fell in the first quarter after rising robustly in late 2006. Also contributing to the slowdown, real exports of services rose only 2 percent in the first quarter after increasing more than 16 percent in the fourth quarter. Available data for nominal exports in April and May suggest that real export growth moved up in the second quarter, as increases in exports of services, automobiles, industrial supplies, and consumer goods more than offset a further contraction in exports of capital goods.

Prices of exported goods rose at an annual rate of 4 percent in the first quarter of 2007, up from the pace of about 2½ percent seen in the second half of 2006. Prices of non-agricultural industrial supplies, which had been reduced in the fourth quarter by lower oil prices, were pushed up in the first quarter by higher prices for metals and renewed increases in oil prices. In addition, agricultural prices—especially those of corn, soybeans, and wheat—have risen briskly over the past several quarters, in part because of the direct and indirect effects of the increased demand for ethanol. Monthly data on trade prices in the second quarter point to further increases in export prices on the strength of additional run-ups in the prices of non-agricultural industrial supplies, most notably metals.

After falling at an annual rate of 2½ percent in the fourth quarter, real imports of goods and services rose at a 5½ percent rate in the first quarter. A sharp increase in oil imports, after a fourth-quarter decline, was the most important contributor to the swing, but imports of computers, semiconductors, and natural gas also accelerated. Imports of other goods continued to be weak, likely

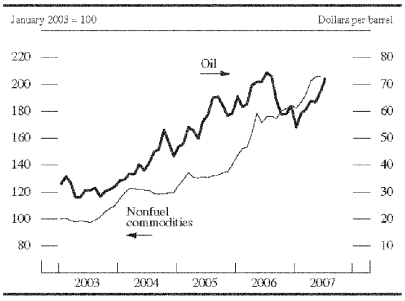
a result, in part, of slower U.S. growth; imports of autos and industrial supplies, in particular, contracted sharply. The growth of real imports of services dropped from 6¼ percent in the fourth quarter to 2¾ percent in the first quarter. Data for April and May imply some slowing of overall real imports in the second quarter. In particular, imports of oil and computers displayed noteworthy decelerations.

Prices of imported goods excluding oil and natural gas rose at an annual rate of about 1½ percent in the first quarter of 2007, as prices of both finished and material-intensive goods recorded higher rates of increase. Monthly trade price data suggest that import prices accelerated in the second quarter, partly because of higher metals prices, which have fluctuated widely in recent months but are up substantially, on balance, so far in 2007. More generally, prices of industrial supplies have been rising briskly, a movement that may reflect, in part, a response to the depreciation of the dollar in recent months. No such effect of the dollar's decline is readily apparent in the prices of finished goods.

Oil prices fell at the beginning of 2007, as unusually mild temperatures reduced oil demand and OPEC members appeared less likely to implement fully production cuts agreed to at the end of 2006. The spot price of West Texas intermediate (WTI) crude oil, the U.S. benchmark, fell from an average of $62 per barrel in December to $54 per barrel in January. Oil prices then rose gradually as it became apparent that OPEC, led by Saudi Arabia, indeed would restrain oil production further. Oil prices also have been supported by solid growth in demand, particularly in developing countries, and by long-running concerns about supply disruptions. Ongoing violence has depressed oil production in Iraq and Nigeria; the Nigerian outage recently worsened to about one-fourth of the country's estimated capacity. Since the start of the year, concerns have also intensified about a possible future disruption of oil exports from Iran. The spot price of WTI averaged $72 per barrel in the first half of July.

Despite its elevated level by historical standards, the spot price of WTI has not increased as much in recent months as have the prices of other grades of crude oil because of high inventories of WTI in the central United States arising from interruptions for maintenance and unplanned outages at refineries. Since early March, the spot price of Brent crude oil, the European benchmark, has risen about $5 per barrel more than has the spot price of WTI; the price of Brent averaged $76 per barrel in the first half of July.

Prices of oil and of nonfuel commodities, 2003–07



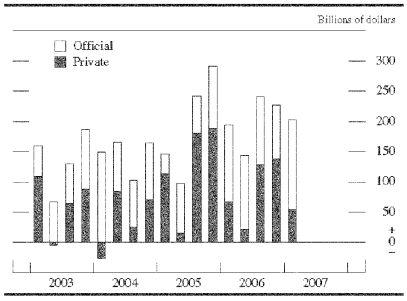
NOTE: The data are monthly. The price of nonfuel commodities extends through June 2007. The last observation for the oil price is the average for July 1 through July 13, 2007. The oil price is the spot price of West Texas intermediate crude oil. The price of nonfuel commodities is an index of forty-five primary-commodity prices.
SOURCE: For oil, the Commodity Research Bureau; for nonfuel commodities, International Monetary Fund.

The Financial Account

The U.S. nominal current account deficit continued to be financed primarily by foreign purchases of U.S. debt securities. Driven by purchases of U.S. government securities by Asian central banks, foreign official inflows moved up noticeably in the first quarter. Although demand for U.S. Treasury securities by foreign official investors eased, it was more than offset by increased official purchases of bonds and mortgage-backed securities issued by government-sponsored enterprises (GSEs). Preliminary data indicate that official inflows remained strong through April.

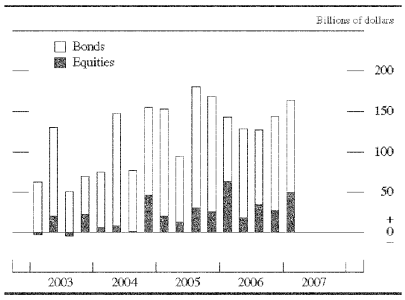
Foreign private purchases of U.S. securities maintained the extraordinary pace set in 2006. Demand for U.S. Treasury bonds extended its fourth-quarter strength, while demand for equities picked up from an already robust level; purchases of corporate bonds moderated slightly,

U.S. net financial inflows, 2003–07



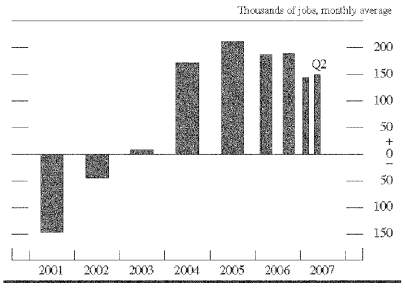
NOTE: The data are quarterly and extend through 2007:Q1.
SOURCE: Department of Commerce.

Net private foreign purchases of long-term U.S. securities, 2003–07



NOTE: The data are quarterly and extend through 2007:Q1.
SOURCE: Department of Commerce.

Net change in payroll employment, 2001–07



NOTE: Nonfarm business sector.
SOURCE: Department of Labor, Bureau of Labor Statistics.

and, on net, private foreigners sold debt issued by GSEs. Foreign direct investment flows into the United States weakened significantly; the rate of inflows in the first quarter was roughly half that in 2006.

Net purchases of foreign securities by U.S. residents, which represent a financial outflow, remained strong in the first quarter of this year. Net acquisitions of bonds continued at the brisk pace recorded in the second half of 2006, while purchases of foreign stocks, although slowing slightly, remained elevated. Outflows associated with U.S. direct investment abroad strengthened to a near-record rate.

The Labor Market

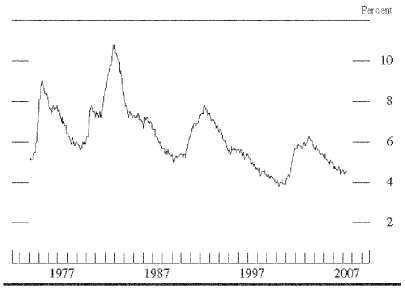
Employment and Unemployment

The demand for labor has been increasing at a moderate rate this year, somewhat less quickly than in 2006. After having averaged 190,000 per month in 2006, gains in payroll employment averaged 145,000 per month in the first half of 2007. The civilian unemployment rate has changed little since last fall and stood at 4.5 percent in June.

As was the case in 2006, job growth in the first half of 2007 was driven by solid gains in service-producing industries. In particular, hiring at health, education, and eating and drinking establishments remained on strong uptrends, and job gains at businesses providing professional and technical services were sizable. However, employment in the financial activities and administrative support sectors softened after two years of strong advances. In the goods-producing sector, manufacturing employment, which has been on a secular downtrend for more than a quarter-century, declined again over the first half of 2007. The decline this year reflected cutbacks at firms closely tied to the construction industry and at producers of motor vehicles and parts, as well as the ongoing downtrend in payrolls at manufacturers of apparel and textiles. Employment in residential construction, which had fallen in 2006 after two years of substantial increases, declined just modestly, on net, over the first half of 2007 despite the substantial contraction in housing activity.

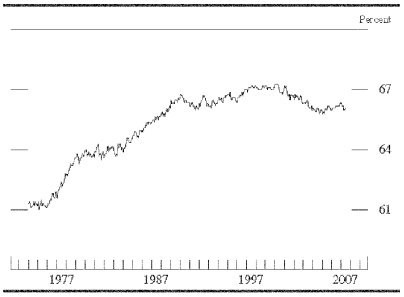
Other labor market indicators have mostly remained positive. Initial claims for unemployment insurance have stayed relatively low in recent months. In addition, readings from private surveys of hiring plans have remained in a favorable range despite recent declines, and the job openings rate has held at a high level. According to the Conference Board, households' assessments of job availability cooled a bit in the spring after having improved somewhat earlier in the year; even so, the June value for this indicator was still relatively positive.

Civilian unemployment rate, 1974–2007



NOTE: The data are monthly and extend through June 2007.
SOURCE: Department of Labor, Bureau of Labor Statistics.

Labor force participation rate, 1974–2007



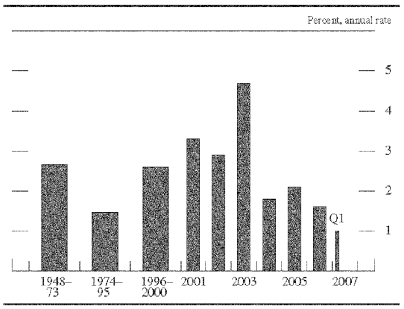
NOTE: The data are monthly and extend through June 2007.
SOURCE: Department of Labor, Bureau of Labor Statistics.

After hovering around 4¾ percent during the first three quarters of 2006, the unemployment rate fell to 4½ percent in the fourth quarter, and it remained in that neighborhood through June. The labor force participation rate has continued to be buoyed by the favorable job market, and it stood at 66.1 percent in June, within the narrow range that has prevailed since 2005. Despite the recent flatness, the participation rate has fallen appreciably since the start of the decade; the downtrend has largely reflected longer-run demographic forces that include a leveling off in the participation rate of women and an increase in the proportion of the workforce in older age groups, which have lower average participation rates than do younger age groups.

Productivity and Labor Compensation

Gains in labor productivity have slowed lately. According to currently published data, output per hour in the nonfarm business sector rose just 1 percent over the year ending in the first quarter of 2007, down from the pace of 2 percent per year recorded over the preceding two years (and down from much larger increases in the first half of the decade). The slowing in productivity was associated with the deceleration in output and thus was probably, at least in part, a temporary cyclical phenomenon. Indeed, the fundamental forces that in recent years have supported a solid uptrend in underlying productivity—the driver of real wage gains over time—remain in place. They include the rapid pace of technological change and firms' ongoing efforts to use information technology to improve the efficiency of their operations. Increases in the amount of capital, especially high-tech capital, available to each worker also appear to be providing considerable impetus to productivity growth.

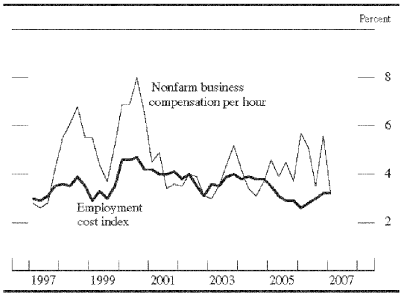
Change in output per hour, 1948–2007



NOTE: Nonfarm business sector. Change for each multiyear period is measured from the fourth quarter of the year immediately preceding the period to the fourth quarter of the final year of the period.
SOURCE: Department of Labor, Bureau of Labor Statistics.

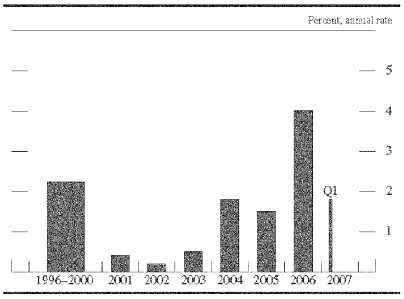
Broad measures of hourly compensation have been bounced around in recent years by the lumpiness of bonus payments, stock option exercises, and sharp swings in employer benefit costs. However, on balance, the evidence points to some pickup recently in the underlying pace of compensation gains, a development consistent with the tight labor market. The employment cost index (ECI) for private industry workers, which measures both wages and the cost of benefits, increased 3¼ percent in nominal terms between March 2006 and March 2007, compared with an

Measures of change in hourly compensation, 1997–2007



NOTE: The data are quarterly and extend through 2007:Q1. 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 nonfarm business sector excludes farms, government, nonprofit institutions, and households. The sector covered by the ECI used here is the same as the nonfarm business sector plus nonprofit institutions. A new ECI series was introduced for data as of 2001, but the new series is continuous with the old.
SOURCE: Department of Labor, Bureau of Labor Statistics.

Change in unit labor costs, 1996–2007



NOTE: Nonfarm business sector. The change for 1996 to 2000 is measured from 1995:Q4 to 2000:Q4.
SOURCE: Department of Labor, Bureau of Labor Statistics.

increase of 2½ percent over the preceding twelve months. Adjusted for inflation, as measured by the increase in the overall PCE price index, the ECI rose nearly 1 percent over the year ending in March after having fallen nearly ½ percent over the preceding year. Data on hourly compensation in the second quarter are not yet available, but a sharp rise in overall consumer prices during that period probably offset much—if not all—of the nominal gains that were realized.

The step-up in the rate of increase in the ECI over the past year was concentrated in its wage and salary component, which rose 3½ percent over the year ending in March, 1¼ percentage points more than the increase over the year-earlier period. Meanwhile, increases in the cost of providing benefits have slowed dramatically of late, in part because premiums for health insurance have stopped rising at double-digit rates. The increase in benefit costs over the year ending in March, which amounted to just 2¼ percent, was also held down by a sharp drop in employer contributions to retirement plans. The lower contributions appear to have reflected several factors, including the strong performance of the stock market in 2006 and a high level of employer contributions over the past several years; taken together, these factors significantly boosted the funding levels of defined-benefit plans.

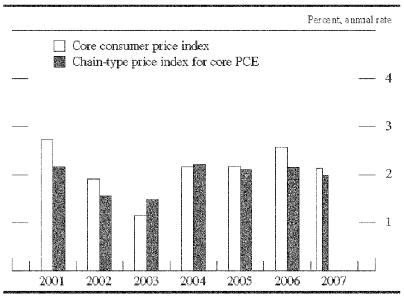
According to preliminary data, compensation per hour in the nonfarm business (NFB) sector—an alternative measure of hourly compensation derived from the data in the NIPA—rose 3¼ percent over the year ending in the first quarter of 2007, the same rise as in the ECI. Over the year ending in the first quarter of 2006, NFB hourly compensation had risen 5¾ percent, in part because of an apparent surge in the value of stock option exercises (which are excluded from the ECI) early last year. Largely reflecting the slower growth in NFB hourly compensation, unit labor costs rose 2¼ percent over the year ending in the first quarter of 2007 after increasing 3½ percent over the preceding four quarters.

Prices

Headline inflation picked up again in the first half of 2007, as energy prices surged after having eased late last year and increases in food prices quickened. The PCE chain-type price index increased at an annual rate of 4.4 percent between December 2006 and May 2007 after rising 2.2 percent over the twelve months of 2006. Core PCE prices—which exclude the direct effects of movements in food and energy prices—rose at an annual rate of 2.0 percent over the first five months of the year, 0.1 percentage point less than the increase over the twelve months of 2006.

Energy prices, which had fallen substantially in the fourth quarter of 2006, decreased further in January in response to declines in the price of crude oil, unseasonably mild temperatures in North America and Europe, and historically high inventories of petroleum products and natural gas. However, energy prices shot up from February to May, and the rise brought the net increase in the PCE price index for energy over the first five months of the year to 14 percent (not at an annual rate). The increase was especially large for gasoline, the price of which was boosted not only by higher prices for crude oil beginning in late winter but also by numerous refinery shutdowns, reflecting both planned maintenance and unplanned disruptions. Retail gasoline prices have fallen some since May as refiners have made some progress in bringing

Change in core consumer prices, 2001–07



NOTE: Through 2006, change is from December to December; for 2007, change is from December to May.
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.

output closer to seasonal norms, but they are still about $0.70 per gallon above the levels of late December.

Food prices have also picked up this year, in part because of the jump in the price of corn, which is now in demand not only as a feedstuff and food but also as an input to the production of ethanol. Between December 2006 and May 2007, the PCE price index for food and beverages increased at an annual rate of nearly 6 percent. The higher cost of corn was partly responsible for a 10½ percent rise over the period in prices for meats, poultry, fish, and eggs. The index for fruits and vegetables also posted a double-digit increase, mainly because a severe freeze in California in January destroyed a substantial portion of the citrus crop and set back the harvest of many other fruits and vegetables. Prices for food consumed away from home, which typically are influenced more by labor and other business costs than by farm prices, rose at an annual rate of 4 percent over the first five months of the year.

The edging down of core PCE inflation this year largely reflected some waning of the sizable increases in shelter costs that were recorded in 2006. Core PCE inflation in the most recent few months was also held down significantly by transitory factors—most notably, a sharp drop in the price of apparel. In addition, the retail price of tobacco, which, like apparel, tends to be volatile from month to month, flattened out after a steep increase earlier in the year. Meanwhile, the rate of increase in the core consumer price index (CPI) has dropped from 2.6 percent in 2006 to an annual rate of 2.1 percent so far this year; the main reason for the sharper deceleration in the core CPI than in core PCE prices is that housing costs receive a much greater weight in this index than they do in the core PCE measure.

TIPS-based inflation compensation, 2003–07

NOTE: The data are daily and extend through July 13, 2007. 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.

Alternative measures of price change, 2006–07

Percent

Price measure	2006	2007
Chain-type (Q1 to Q1)		
Gross domestic product (GDP)	3.1	2.8
Excluding food and energy	2.9	2.7
Gross domestic purchases	3.5	2.5
Personal consumption expenditures (PCE)	3.0	2.2
Excluding food and energy	2.0	2.3
Market-based PCE excluding food and energy	1.6	2.1
Fixed-weight (Q2 to Q2)		
Consumer price index	4.0	2.6
Excluding food and energy	2.4	2.3

NOTE: Changes are based on quarterly averages of seasonally adjusted data. For the consumer price index, the 2007:Q2 value is calculated as the average for April and May compared with the average for the second quarter of 2006 and is expressed at an annual rate.

SOURCE: For chain-type measures, Department of Commerce, Bureau of Economic Analysis; for fixed-weight measures, Department of Labor, Bureau of Labor Statistics.

More fundamentally, the behavior of core inflation so far this year has been shaped by many of the same forces that were at work in 2006. Resource utilization in labor and product markets remains fairly high. And although last autumn's drop in energy prices may have offered some temporary relief, the resurgence in prices for energy and other commodities is likely putting some upward pressure on core inflation. Regarding inflation expectations, the Reuters/University of Michigan Surveys of Consumers (Reuters/Michigan) suggest that the median expectation for year-ahead inflation has moved up in response to the energy-driven pickup in headline inflation: It rose from 3.0 percent in the first three months of the year to 3.3 percent in April and remained at about this level through early July. However, longer-run inflation expectations appear to have remained contained. In fact, according to the Reuters/Michigan surveys, the median five- to ten-year expectation, at 3.1 percent in early July, has stayed within the narrow range that has prevailed for the past two years. According to the Survey of Professional Forecasters, conducted by the Federal Reserve Bank of Philadelphia, expectations of inflation over the next ten years remained around 2½ percent in the first half of 2007, a level that has been essentially unchanged since 1998. Inflation compensation as measured by the spreads of yields on nominal Treasury securities over those on their inflation-protected counterparts has also stayed within its range of recent years.

Broader, NIPA-based measures of inflation, which are available only through the first quarter of this year, slowed relative to the pace of the past couple of years. The latest data show a rise in the price index for GDP less food and energy of 2¾ percent over the year ending in the first quarter, down ¼ percentage point from the year-earlier figure. Although core PCE inflation picked up slightly during the

past four quarters, prices for some other components of final demand, especially construction, decelerated.

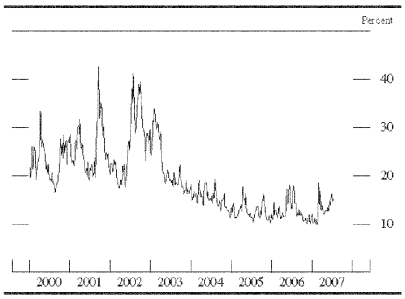
U.S. Financial Markets

U.S. financial markets have functioned well thus far in 2007 despite episodes of heightened volatility. As the year opened, financial market quotes put considerable weight on the expectation of an easing of monetary policy sometime soon. By the spring, however, investors apparently had become more optimistic about the economic outlook and, as a result, had concluded that less Federal Reserve easing would be forthcoming than they had anticipated earlier. In line with the upward shift in policy expectations, two-year Treasury yields rose about 10 basis points, on balance, through mid-July; ten-year yields increased 40 basis points. Supported by solid corporate profits and the more upbeat economic outlook, equity prices advanced roughly 10 percent on net. Despite some widening in recent weeks, risk spreads on corporate credits generally remained narrow, reflecting strong and liquid corporate balance sheets. Measures of investors' uncertainty about prospects for a number of financial asset prices widened somewhat, on balance, from low levels.

Market Functioning and Financial Stability

In late February and early March, financial market volatility increased sharply amid a pullback from riskier assets that was reportedly spurred by a variety of factors, including a sharp dip in the Chinese equity market, mounting concerns about conditions in the subprime-mortgage sector, and some softer-than-expected U.S. economic data. During the period, spreads on indexes of subprime-mortgage credit default swaps (CDS) spiked; equity markets in the United States and abroad declined; Treasury yields dropped across maturities; spreads of riskier fixed-income instruments over comparable Treasuries widened somewhat; and measures of market uncertainty, including implied volatilities derived from options prices, moved up sharply. Despite some capacity-related technical difficulties in equity markets on February 27, financial markets generally handled the volatility well. Liquidity in the Treasury market continued to be good, as record-high trading volumes were accompanied by bid–ask spreads within ranges of the past few years. Market sentiment subsequently improved—apparently a result, in part, of reduced anxiety about spillovers to broader markets of the problems in the subprime-mortgage sector—and financial markets gradually stabilized. Many asset prices reversed their earlier declines, and measures of uncertainty moved lower.

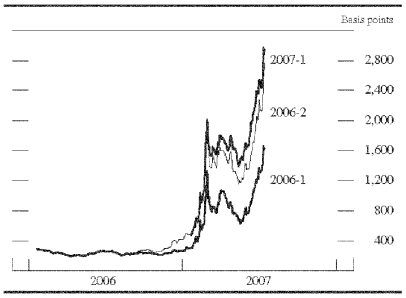
Implied S&P 500 volatility, 2000–07



NOTE: The data are weekly and extend through July 13, 2007. The series shown–the VIX–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.

Strains in financial markets increased again late in the spring, prompted largely by renewed concerns about the subprime-mortgage sector. A considerable widening in spreads on indexes of subprime-mortgage CDS contributed to, and was likely reinforced by, troubles at a few small and medium-sized hedge funds that had taken positions designed to profit from an improvement in subprime credit quality. These pressures intensified as a result of actual and anticipated downgrades of some securities backed by subprime mortgages. Investors' uncertainty

Spreads on BBB- indexes of credit default swaps on subprime mortgages, 2006–07

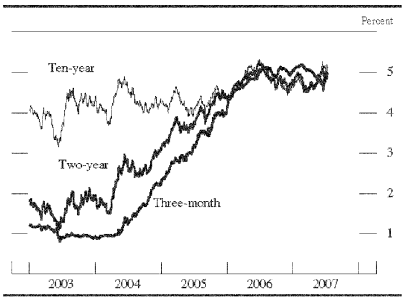


NOTE: The data are daily and extend through July 13, 2007; the spreads are relative to libor. The series shown refer to pools of mortgages originated in specific half-years, as follows: Series 2007-1 corresponds to mortgages originated in 2006:H2, series 2006-2 to those originated in 2006:H1, and series 2006-1 to those originated in 2005:H2.
SOURCE: Markit.

about a range of asset prices increased, and lower-quality corporate credit spreads widened, reportedly reflecting, in part, heightened uncertainty about the valuation of structured credit products, which are an important source of funding in the subprime-mortgage market and in other financing markets. These pressures have been contained, though: In spite of the recent rise, spreads on lower-quality corporate credits remain near the low end of their historical ranges, and, although investors recently have balked at some aggressively structured deals, financing activity in bond and other credit markets continues at a fairly brisk pace. Market participants do not appear to have pulled back from risk-taking more generally, in that equity prices have moved higher in recent weeks, and Treasury bid–ask spreads have stayed within normal ranges despite elevated trading volumes.

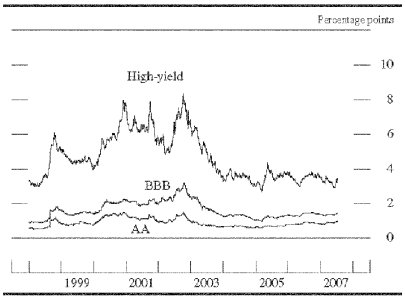
The effects on financial institutions of this year's difficulties in the subprime-mortgage sector have depended on the institutions' exposure to the sector. Several mortgage lenders—particularly monoline subprime lenders—experienced substantial losses, as they had to repurchase larger-than-expected volumes of previously securitized loans because of so-called early payment defaults. Consequently, a number of these lenders have gone out of business since the beginning of the year. Large investment banks active in the securitization of subprime mortgages suffered modest hits to their earnings, and their CDS spreads are considerably higher than at the beginning of the year. To date, most large depository institutions appear to have been less affected by the subprime difficulties, in part because of their greater diversification and generally limited subprime lending activity. CDS spreads for these institutions have moved up only a little, on the whole, thus far in 2007.

Interest rates on selected Treasury securities, 2003–07



NOTE: The data are daily and extend through July 13, 2007.
SOURCE: Department of the Treasury.

Spreads of corporate bond yields over comparable off-the-run Treasury yields, by credit rating, 1998–2007



NOTE: The data are daily and extend through July 13, 2007. The spreads shown are the yields on ten-year bonds less the ten-year Treasury yield.
SOURCE: Derived from smoothed corporate yield curves using Merrill Lynch bond data.

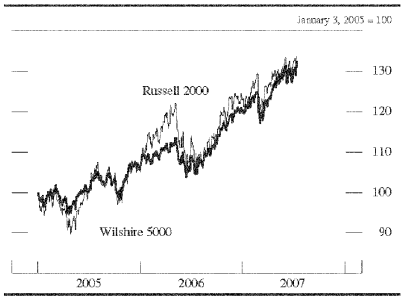
Interest Rates

Since the beginning of the year, investors appear to have become more optimistic, on balance, about the outlook for economic activity and consequently have raised their expected path for the federal funds rate. Judging from futures markets, market participants currently anticipate that the rate will decline about 25 basis points through the end of 2008; at the end of last year, market participants had expected about 75 basis points of easing over the same period. Investors also have apparently become more certain about the path for the federal funds rate: Implied volatilities derived from options on Eurodollar futures over the next year have moved down, on net, this year and remain near historical lows. Estimated probability distributions for the target federal funds rate between six and twelve months ahead were somewhat skewed toward lower rates through mid-July.

Reflecting the reduced odds placed on policy easing, yields on two-year nominal Treasury securities increased about 10 basis points over the year through mid-July. Ten-year Treasury yields rose 40 basis points over the same period. A portion of the increase in longer-term yields appears to be attributable to a widening of term premiums, although estimated term premiums remain relatively low by historical standards. Yields on inflation-indexed Treasury securities moved nearly in line with those on their nominal counterparts, thereby leaving inflation compensation only a little higher.

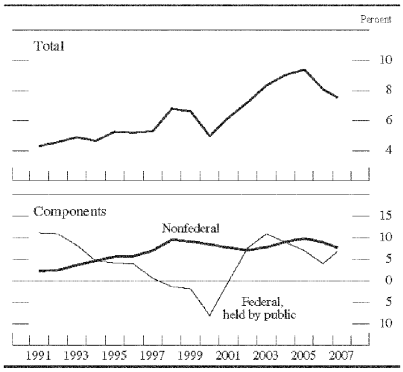
In the corporate bond market, yields on investment- and speculative-grade securities rose about as much, on balance, as those on comparable-maturity Treasury securi-

Stock price indexes, 2005–07



NOTE: The data are daily and extend through July 13, 2007.
SOURCE: Frank Russell Company; Dow Jones Indexes.

Change in domestic nonfinancial debt, 1991–2007



NOTE: For 2007, change is from 2006:Q4 to 2007:Q1 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.

ties through mid-July, and so risk spreads on such instruments are little changed on the year. The narrow spreads on corporate bonds appear to reflect investors' positive outlook for business credit quality over the medium term. The term structure of forward risk spreads for corporate bonds supports this view, as forward spreads for the next few years are low while spreads further out the curve are more in line with historical norms.

Equity Markets

Broad equity indexes increased between 8½ percent and 12 percent, on net, through mid-July. Stock prices were boosted by solid first-quarter earnings that generally met or exceeded investors' expectations and by the more upbeat economic outlook. Share prices rose for a wide range of industries, although basic materials and energy firms outperformed the broader market because of strong global demand for commodities. The spread between the twelve-month forward earnings–price ratio for the S&P 500 and a real long-run Treasury yield—a rough gauge of the equity risk premium—narrowed a bit and now stands close to the middle of its range of the past few years. After a spike in connection with the period of unsettled conditions in financial markets in late February and early March, the implied volatility of the S&P 500 calculated from options prices fell back, but it picked up again recently in response to renewed concerns about the subprime-mortgage market.

Debt and Financial Intermediation by Banks

The total debt of the domestic nonfinancial sectors expanded at an annual rate of 7¼ percent in the first quarter of 2007, a somewhat slower pace than in 2006. The deceleration in borrowing was mainly accounted for by a slowdown in household debt, particularly mortgage debt. In contrast, borrowing by nonfinancial businesses remained robust in the first quarter. Preliminary data for the second quarter suggest slightly slower growth in total domestic nonfinancial sector debt. The step-down in growth is particularly noticeable in the federal government sector, in which strong receipts this tax season held down borrowing. However, the recent data suggest somewhat faster growth in nonfinancial business debt in the second quarter, a pickup fueled by heavy merger and acquisition activity.

Commercial bank credit increased at an annual rate of about 6½ percent in the first half of 2007. However, adjusted to remove the effects of a conversion of a bank to a thrift institution, bank credit expanded at an annual rate of about 8¼ percent over the same period, somewhat slower than in 2006.

Excluding this bank-to-thrift conversion, total loans grew briskly in the first half of the year, with most bank loan types expanding vigorously. Rapid growth in commercial and industrial loans was supported by the continued robust merger and acquisition activity. Growth in commercial real estate loans was also strong even though construction and land development loans, a portion of which is used to fund residential development, decelerated sharply. Despite the ongoing adjustment in the housing

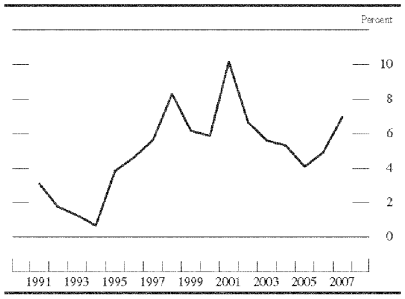
market, residential real estate loans on banks' books (adjusted for the bank-to-thrift conversion noted earlier) expanded at a strong pace. But home equity loans grew only modestly. Because rates on these loans are generally tied to short-term market interest rates, the flattening of the yield curve last year made them a relatively more expensive source of credit. Consumer loans held by banks picked up in the first quarter, but they slowed in the second quarter.

Commercial bank profitability declined somewhat in the first quarter of 2007 but remained solid. The net interest margin of the industry continued to narrow, a likely result of ongoing competitive pressures and the flat yield curve. Bank profitability was also restrained by growth in non-interest expenses and a modest increase in provisions for loan losses. Credit quality stayed strong overall: Delinquency and charge-off rates remained generally low, although delinquency rates on residential and commercial real estate loans moved up further from last year's levels.

The M2 Monetary Aggregate

M2 expanded at an annual rate of about 7½ percent over the first half of 2007. The increase evidently outstripped growth in nominal GDP by a substantial margin and exceeded the rate that would have been expected on the basis of the aggregate's previous relationship with income and interest rates. M2 rose at an annual rate of 8 percent in the first quarter before slowing to a pace of 6¾ percent in the second quarter. Liquid deposits, by far the largest component of M2, have followed a similar pattern this year. Small time deposits and retail money market funds both grew rapidly last year, as the rates paid on them moved up with short-term market interest rates. However, these components have decelerated this year because market rates have changed relatively little. Currency growth has remained modest in 2007, apparently a result of weak demand for U.S. dollars overseas.

M2 growth rate, 1991–2007



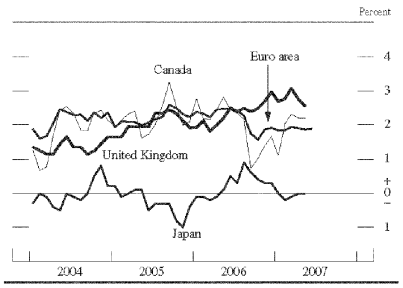
NOTE: Through 2006, the data are annual on a fourth-quarter over fourth-quarter basis; for 2007, change is calculated from 2006:Q4 to 2007:Q2 and annualized. M2 consists of currency, traveler's checks, demand deposits, other checkable deposits, savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds.
SOURCE: Federal Reserve Board, Statistical Release H.6, "Money Stock Measures."

International Developments

Foreign economic growth remained strong in the first quarter of 2007, supported by increased domestic demand in many key countries. Most recent indicators point to continued strength in foreign economies in the second quarter as well. Canada, the euro area, Japan, and the United Kingdom all posted above-trend growth rates in the first quarter. Although the expansion of the Japanese economy moderated somewhat in the first quarter, growth remained brisk relative to the average pace seen in recent years. Output accelerated in emerging Asia, led by China, and growth in Mexico appears to be picking up again after a lull in the first quarter.

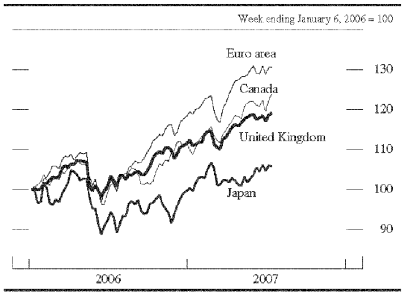
Rising energy prices boosted consumer prices in many regions of the world last year, and, in some cases, substantial increases in food prices also contributed to inflation pressures. Broad measures of price inflation have continued to rise in many foreign economies this year, as economic growth has remained strong, and core inflation has moved up noticeably in a number of these economies. In response, monetary policy has been tightened in many

Consumer prices for major foreign economies, 2004–07



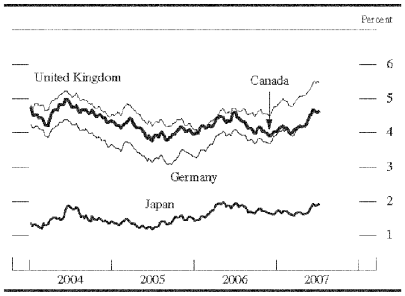
NOTE: The data are monthly; they extend through May for Canada, Japan, and the United Kingdom and through June for the euro area. Change is from one year earlier.
SOURCE: Haver.

Equity indexes in selected foreign industrial economies, 2006–07



NOTE: The data are weekly. The last observation for each series is the week ending July 13, 2007.
SOURCE: Bloomberg.

Yields on benchmark government bonds in selected foreign industrial economies, 2004–07

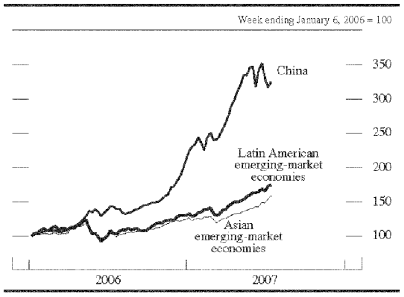


NOTE: The data are for ten-year bonds and are weekly. The last observation for each series is the week ending July 13, 2007.
SOURCE: Bloomberg.

major industrial countries as well as in some emerging-market economies. Longer-term foreign interest rates have also risen.

Global financial markets were calm at the beginning of 2007, and volatilities for many asset prices were at, or close to, record lows. Toward the end of February, conditions changed, as international investors scaled back their exposure to risky positions—particularly those funded in yen—in response to a sharp drop in Chinese stock prices and concerns about the U.S. economy. As a result, equity prices in most industrial and emerging economies fell over the course of several days, while the yen appreciated sharply against most other currencies.

Equity indexes in selected emerging-market economies, 2006–07



NOTE: The data are weekly. The last observation for each series is the week ending July 13, 2007. For the Latin American and Asian groups, each economy's index weight is its market capitalization as a share of the group's total. The Latin American economies are Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. The Asian economies are China, India, Indonesia, Malaysia, Pakistan, the Philippines, South Korea, Taiwan, and Thailand. The series for China is the Shanghai Composite Index.
SOURCE: For Latin America and Asia, Morgan Stanley Capital International (MSCI) index; for China, Bloomberg.

More-placid conditions returned in early March, and by early June share prices around the world had posted solid gains, reaching multiyear highs or even record highs in many countries. In particular, Chinese stock prices resumed their steep climb, although the rise was interrupted by occasional additional periods of heightened volatility. These episodes had no apparent disruptive effects on other global financial markets.

Most major global equity indexes experienced another increase in volatility during June and July amid concerns about the U.S. subprime-mortgage market, but they were little changed, on net, over this period. On balance, equity indexes in the major foreign industrial countries have increased between 5 percent and 12 percent in local-currency terms since the beginning of 2007. The Shanghai composite index is up more than 45 percent this year after a remarkable increase of about 130 percent last year. Leading equity indexes in other emerging Asian economies and in Latin America have also posted sizable gains in the range of 10 percent to 35 percent so far this year.

As in the United States, long-term bond yields in Canada, the euro area, and Japan rose significantly, on balance, in the first half of 2007; increases on ten-year nominal sovereign debt ranged from 25 to 70 basis points. Starting in early February, yields declined in global markets for several weeks amid growing concerns about the outlook for the U.S. economy. Since then, market participants seem to have become more optimistic about prospects for both U.S. and foreign economic growth, and yields have more than reversed the declines. Yields on

U.S. dollar nominal exchange rate, broad index, 2004–07

NOTE: The data are weekly and are in foreign currency units per dollar. The last observation is the week ending July 13, 2007. 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 the most important 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.

inflation-protected long-term securities also rose during the first half of 2007 in the major industrial countries, but, with the exception of those in the euro area, they did not rise quite as much as nominal yields did, implying some modest increases in inflation compensation.

Our broadest measure of the nominal trade-weighted foreign exchange value of the dollar has declined about 3½ percent, on net, since the beginning of 2007. Over the same period, the major currencies index of the dollar has moved down more, about 4½ percent. On a bilateral basis, the dollar has depreciated 10 percent against the Canadian dollar and roughly 3½ percent against the euro and sterling; in contrast, it has appreciated about 2½ percent against the yen. The bulk of the change against the Canadian dollar occurred in the second quarter after better-than-expected news about economic activity and expectations of monetary policy tightening in Canada. The U.S. dollar has depreciated 3 percent, on net, against the Chinese renminbi since the beginning of 2007; the pace of change in the renminbi–dollar rate has accelerated somewhat over the past two and a half months.

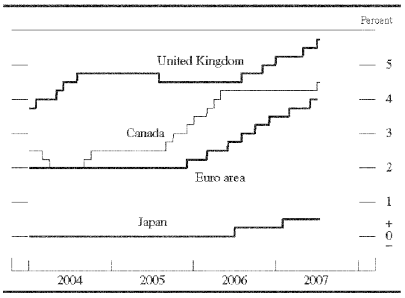
U.S. dollar exchange rate against selected major currencies, 2004–07

NOTE: The data are weekly and are in foreign currency units per dollar. The last observation for each series is the week ending July 13, 2007.
SOURCE: Bloomberg.

Industrial Economies

The major foreign industrial economies experienced above-trend growth in the first quarter of this year. In Canada, real GDP grew at an annual rate of 3¾ percent after rising nearly 2 percent during 2006; inventory accumulation figured prominently in the faster growth. In the United Kingdom, real GDP increased at an annual rate of 2¾ percent in the first quarter. Robust expansions in both countries have been accompanied by increases in inflation rates, which in recent months have hovered at or above those countries' inflation targets of 2 percent. Although the pickup in headline inflation partly reflected higher energy prices, core inflation has also trended up in recent months in both Canada and the United Kingdom. In the midst of elevated inflation and increasing rates of resource utilization, monetary policy was tightened three times this year in the United Kingdom (by 25 basis points each time) after two increases in the policy rate last year. The Bank of Canada also recently raised its policy rate 25 basis points. Market participants expect that both countries' central banks will raise their policy rates further.

Official or targeted interest rates in selected foreign industrial economies, 2004–07



NOTE: The data are daily. The last observation for each series is through July 13, 2007. The data shown are the overnight rate for Canada, the refinancing rate for the euro area, the call money rate for Japan, and the repurchase rate for the United Kingdom.
SOURCE: The central bank of each area or country shown.

Growth of real GDP in the euro area moved down to 2¾ percent in the first quarter after posting growth of 3¼ percent over the four quarters of 2006. Although export growth moderated from its strong performance of 2006, recovery of domestic demand appears to have taken firmer hold, as investment accelerated in the first quarter. Private consumption in Germany had been muted earlier this year, partly because of a hike in the value-added tax at the start of the year, but lately retail sales in Germany and the euro area more broadly have picked up, on balance, from their January lows. Survey indicators of consumer and business sentiment also point to relatively strong growth in the euro area during the second quarter. Overall consumer price inflation has remained just below the European Central Bank's 2 percent ceiling since the fall of last year, while core inflation has risen to about 2 percent from around 1½ percent last year. To combat potential inflation pressures, the Bank continued to tighten monetary policy during the first half of this year, implementing two more increases of 25 basis points in its policy rates.

Japanese economic growth moderated in the first quarter of this year to a still-brisk annual rate of 3¼ percent. Household consumption rose at a robust rate of about 3 percent, and real exports increased almost 14 percent. Investment growth slowed, although recent surveys report that businesses are optimistic about the outlook. The labor market in Japan improved further in the first five months of the year: The unemployment rate fell below 4 percent, and the ratio of job offers to applicants remained elevated. Despite the strong growth of output and improved labor markets, consumer prices were about unchanged on a twelve-month basis in May; the GDP deflator has continued to fall, though, during the period. Core consumer prices have shown small twelve-month declines over the past several months, and wages have declined relative to their year-earlier levels.

Emerging-Market Economies

Economic activity in China accelerated in the first quarter of 2007 and appears to have remained robust in the second quarter. Growth was supported by a surge in exports and a pickup in fixed investment, which had slowed somewhat in the second half of 2006. The strength of exports has resulted in a ballooning of the Chinese trade surplus. Since late 2006, inflation in China has increased—reaching a rate of 3½ percent over the twelve months ending in May—largely because of higher food prices. Continuing rapid growth of aggregate demand and liquidity pressures from the accumulation of foreign exchange reserves have raised concerns about broader, more-sustained upward pressures on inflation. Chinese authorities have tightened monetary policy through several increases in banks' reserve requirements and two increases in interest rates so far this year; they have also continued to use sterilization operations to partially offset the effect of the reserve accumulation on the money supply.

Elsewhere in emerging Asia, real GDP surged in India and the Philippines in the first quarter and remained strong in Malaysia and Singapore. Growth was generally supported by domestic demand in all four economies. Growth held steady in South Korea, as stronger domestic demand was partially offset by a drag from net exports. Incoming data point to strength in the region in the second quarter. Outside of China, inflationary pressures in several emerging Asian economies have eased somewhat this year because of the unwinding of previous increases in food prices and, in some cases, the effect of currency appreciations. During the past year, political tensions in Thailand and uncertainty about the government's policy on capital controls have periodically disrupted markets and economic activity.

In a continuation of the deceleration that started about the middle of last year, Mexican output rose a scant ½ percent in the first quarter; manufacturing (particularly in the automobile sector) was restrained by the moderation in the U.S. economic expansion, and construction slowed sharply. Recent data on industrial production, however, suggest that growth may have rebounded in the second quarter. Mexican headline consumer price inflation continues to hover at the upper limit of the Bank of Mexico's target range of 2 percent to 4 percent. Monetary policy was tightened in Mexico in April for the first time since March 2005.

In Brazil, the growth of real GDP moderated to about 3 percent in the first quarter, as the appreciation of the Brazilian *real* weighed on the external sector. The strong *real* has also helped keep inflation in check despite fairly strong economic growth and a lowering of the policy interest rate. Economic growth in Argentina moved down in the first quarter, in part because of a contraction in exports, and reported data suggest that inflation has continued to decline. Growth in Venezuela appears to have slowed sharply so far in 2007 after three years of double-digit performances, driven by expansionary fiscal policy funded by high petroleum revenues. Venezuelan twelve-month inflation picked up to nearly 20 percent in June.